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FUNDS AVAILABLE FOR CORPORATE DIVIDENDS IN WASHINGTON*

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SUBDIVISION FOUR

Subdivision four of Section 24 provides

> "No corporation shall pay dividends (*a*) in cash or property,[122] except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets and the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets, (*b*) in shares of the corporation, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock."

The assets of the corporation must be reduced by the deductions required under subdivision three and by the total of the corporation's liabilities, including the amount of its capital stock, before a surplus is available for distribution by way of either cash or stock dividend. But, though the funds available for stock dividends are subject to no other limitations in the Act, cash dividends are hedged about with the further restriction of this subdivision that they shall not be based on the unrealized appreciation of fixed assets and by the analogous provisions in regard to current assets imposed in subdivision four, *infra*.

Why are unrealized appreciation of fixed assets and unrealized profits on current assets made a proper basis of stock dividends, while similar items are barred as a source of cash dividends? We will first turn attention to the propriety of cash or stock dividends from unrealized appreciation of fixed assets.

It was well settled in America before the Act that unrealized appreciation in fixed assets could not give rise to cash divi-

*Continued from last issue.

[122] Cash and property dividends are treated alike. *Liebman v. Auto Strop Co.*, 241 N. Y. 427, 150 N. E. 505 (1926)

dends.[123] In *Kingston v. Home Life Insurance Company,*[124] the Chancellor said

> " an estimated increase in the value of the building is not a net profit arising from the business of the company its increased value when realized by a sale may perhaps be treated as a profit, but until realized it is surely unwise, inaccurate and wrong to so regard it and pay out money based on such an estimate, for it is only a guess, and if a correct one it may become incorrect later when the conditions which produced the estimated increase value change."[125]

Revaluation of a building site was held not to give rise to a surplus out of which a cash dividend could be paid in the recent case of *Wilson v. Barnett,*[126] though the force of the decision was diminished by the directors' failure to prove that they acted on the basis of expert appraisals. Support is also given by the tax case holdings that unrealized appreciation does not constitute income.[127]

On the other hand, there is little doubt but that stock dividends were allowed to be based on unrealized appreciation of fixed assets before the Act.[128] In *Northern Bank & Trust Company v. Day*[129] the valuation of a boat used by a fishing company was increased by the directors from $15,000 to $20,000 and the resulting surplus of $5,000 used as a basis of a stock dividend. The good faith of the directors was not questioned, because the boat was purchased at $22,500, although the organizers originally fixed its value arbitrarily at $15,000. The dividend was held proper in an action brought against the directors by the trustee in bankruptcy of the corporation. No distinction was drawn by the Washington court between cash and stock dividends, however, so

[123] *Dealer's Granite Corp. v. Faubion* (Texas Civ. Ap. 1929), 18 S. W (2d) 737 (1929), *Southern Calif. Home Builders v. Young,* 45 Calif. App. 679, 188 Pac. 586 (1920) *Coleman v Booth, supra,* note 62; 7 Thompson, *op. cit. supra,* note 9, sec. 5292. *Cf. Cole v. Adams,* 19 Tex. Civ. App. Rep. 507, 49 S. W 1052 (1898).

[124] 11 Del. Ch. 258, 101 Atl. 898 (1917).

[125] *Ibid.* at 101 Atl. 904.

[126] Reported in N. Y. L. J., August 2, 1928.

[127] *Eisner v. Macomber* 252 U. S. 189, 40 Sup. Ct. 189 (1920) *Gray v. Darlington,* 82 U. S. 63, 21 Law Ed. 45 (1872).

[128] Weiner and Bonbright, *op. cit. supra,* note 47 at 983. And one writer says "In determining whether or not dividends may be made from unrealized capital appreciation, dividends other than in cash or property are not concerned, as stock dividends and the like may be declared without distributing corporation assets," Hills, Dividends from Unrealized Capital Appreciation, 6 N. Y. L. R. 193, at 194 (1928).

[129] 83 Wash. 296, 145 Pac. 182 (1915).

the decision is not authority for the proposition that cash dividends can not be paid out of unrealized appreciation of fixed assets. In fact, the language indicates that creditors can not attack the validity of any sort of dividend based on revaluation of assets if the revaluation be *bona fide*. Though legality of a dividend was not the issue, the case of *State ex rel. Attorney General v. Bray*[130] is interesting. *Quo warranto* proceedings to oust a corporation of its charter were brought by the Attorney General of Missouri on the theory that the corporation had illegally issued stock. The issue in question arose from the declaration of a stock dividend based upon an unrealized appreciation in the value of the corporation's real estate and other fixed assets and the accompanying increase in corporation stock. A special commissioner found that the "net fair cash value" at reproduction cost was in excess of the new stock issue, and the Supreme Court, sitting *en banc* in the original proceedings therefore dismissed it.

The allowance of stock dividends out of unrealized appreciation of fixed assets seems never to have been satisfactorily explained. Mr. Weiner and Mr. Bonbright remark:[131]

> "The conclusion to be drawn from the cases is that the Ohio Committee and the Commissioners on Uniform Law were merely codifying pre-existing law Apparently they were not aware of this fact, nor have we been able to find any statement of this rule in the treatises. Possibly because of the general ignorance of this rule, its wisdom seems never to have been critically considered. Re-examination of it in the light of modern financial practice seems highly desirable."

The attitude of the statutes in this respect is said by the same men to be one of compromise.[132] The objection to treating unrealized appreciation of fixed assets as an earning is forcefully ad-

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[130] 323 Mo. 562, 20 S. W (2d) 56 (1929).

[131] Weiner and Bonbright, *op. cit. supra*, note 47, at 983.

[132] "The major issue of unrealized appreciation or loss is still almost wholly untouched. The tendency of the courts has unquestionably been to frown upon dividends based on unrealized appreciation. In this they have the enthusiastic support of most accountants, who refuse to consider unrealized appreciation as profits, and are reluctant even to record it on the books as a capital gain. The most recent statutes have adopted in this respect a compromise attitude. They permit such appreciation to be made a basis for stock dividends, but not for cash dividends. This position has the support of all the decided cases, although these cases may require re-examination in view of the recent practice of paying regular stock dividends." Weiner and Bonbright, *op. cit. supra*, note 47, at 985.

vanced in the case of *La Belle Iron Works v. United States.*[132] Though the case involves taxes, it is not wholly foreign to our discussion. Said the opinion

> "There is a logical incongruity in entering upon the books of a corporation as the capital value of property acquired for permanent employment in its business and still retained for that purpose, a sum corresponding not to its cost, but to what probably might be realized by sale in the market. It is not merely that the market value has not been realized or tested by sale made, but that sale cannot be made without abandoning the very purpose for which the property is held."[134]

The writer holds no brief in defense of stock dividends from unrealized fixed asset appreciation, but it is fair to notice that some argument can be made for the view taken by the Uniform Act. It is true that a stock dividend does not reduce the assets of the corporation, but simply alters the degree of interest therein among the various classes of shareholders.[135] This satisfies in some measure the requirements of the view previously taken that the reason for the law's interest in the source of dividend payments lies in its desire to protect the creditor and the shareholder. A dividend in par stock[136] requires a transfer of surplus to capital, the capital stock of the corporation being increased by the aggregate of the par value of the stock dividend. The surplus so transferred is composed of unrealized appreciation, but the assets available to the existing creditor after the dividend are no less than those available before. The subsequent creditor will be mistaken if he thinks the corporation possesses realized assets equal to the amount of its capital stock, but there seems to be as much reason for accepting the valuations of the directors in this respect as there is in connection with consideration received for shares

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[133] 256 U S. 377, 41 Sup. Ct. 528 (1921).

[134] *Ibid.* U. S. 393, Sup. Ct. 532.

[135] "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. " Sparger *op. cit. supra*, note 34, at 25. *Whitlock v. Alexander* 160 N. C. 465, 76 S. E. 538 (1912) *Town v. Eisner* 245 U. S. 418, 38 Sup. Ct. 158 (1918) *Eisner v. Macomber supra*, note 127 *Williams v. W U. Teleg. Co.*, 93 N. Y. 162 (1883) Hills, loc. *cit. supra*, note 128. And see *Hastings v. Internat'l. Paper Co.*, 187 App. Div 404, 175 N. Y. S. 815 (1919) *Sexton v. C. L. Percival Co.*, 189 Iowa 586, 177 N. W 83 (1920).

[136] As to stock without par, see subdivision six (*b*), *infra.*

issued pursuant to subscription.[137] The shareholder is uninjured because his capital contribution is still with the corporation. Practically speaking, it is doubtful if creditors extend appreciable credit in reliance upon the rule that net corporate assets must equal the capital stock. A rather pessimistic note is sounded by a recent article:

> "Cases are few in which either the creditors or the stockholders succeed in forcing the management to maintain the capital. Profits in law depend to a high degree upon the computations of accountants, and such computations rarely accord with economic fact. Stockholders and creditors in relying upon an equality in value between capital and capital stock may well heed the old rule of 'caveat emptor' "[138]

If the Uniform Act is proper in allowing stock dividends out of unrealized appreciation of fixed assets, it should certainly be a requirement that the appreciated value be genuine and of a reasonably permanent type. If conservatism be overthrown in favor of increased valuations based on transitory fluctuations of the market, there seems little to say in justification of stock dividends from such source. The ultimate responsibility for the exactment of such a prerequisite lies peculiarly within the province of the courts.

We now shift to a discussion of the availability of unrealized profits on current assets for dividend purposes. While subdivision four imposes no limitations on such a source for either cash or stock dividends, subdivision five adequately covers the field insofar as cash dividends are concerned, and our inquiry in that respect will be postponed until discussion of that subdivision. But a search of other portions of Section 24 fails to reveal language limiting payment of stock dividends to the unrealized appreciation of fixed assets, as contrasted to unrealized profit on current assets. There is no subdivision to perform for stock dividends

[137] Section 17: "For the purpose of determining whether shares have been fully paid for in order to fix the extent of the outstanding obligation of a shareholder to the corporation with respect to such shares, the following valuations shall be conclusive; (*a*) the valuation placed by the incorporators, the shareholders or the directors, as the case may be, upon the consideration other than cash with which the subscriptions for shares are made payable; (*b*) the valuation placed by the board of directors upon the corporate assets in estimating the surplus to be transferred to capital as payment for shares to be allotted as stock dividends." Rem. Rev. Stat. sec. 3803-17 Pierce's Code (1933) sec. 4592-47.

[138] Krauss, *op. cit. supra*, note 13, at 215.

the service that subdivision five performs for cash dividends. There seems good reason why stock dividends of this nature should be made unlawful. At the outset it must be remembered that allowance of stock dividends from unrealized fixed asset appreciation is itself an exception to the accepted fundamental that all dividends be based on realities and not expectations, and that even this deviation has been, as we have seen, the subject of criticism. Next, there is an inherent difference between fixed and current assets that justifies a distinction in treating with their unrealized increases in value. It is well stated by Mr. Berle and Mr. Fisher

> "The difference in quality between a fixed and a current asset suggests that more liberty ought to be allowed the practice of depicting the unrealized appreciation of a fixed asset than of a current asset, on the theory that the very nature of a current asset contemplates its convertibility into cash within a limited period. Accordingly, there would seem little ground for giving any indication whatsoever of an unrealized appreciation to current assets —let the deed of conversion tell its own story "[139]

A close reading of the material adjacent to the quotation from Mr. Weiner and Mr. Bonbright *supra,* stating that the Uniform Act adopted pre-existing law *re* stock dividends, discloses that they were discussing stock dividends from unrealized fixed asset appreciation. They say

> "There seems to be a consensus of opinion that a stock dividend is a proper device for recognizing and passing on to the shareholders the benefit of unrealized appreciation in fixed assets."[140]

Therefore their statement may not be taken as secondary authority for the proposition that the law before the Uniform Act sanctioned stock dividends from unrealized profits on current assets.

This criticism, of course, does not extend to accrued unrealized profits on current assets. They are expressly made available for even cash dividends by subdivision five, *infra,* and, *a fortiori,* are proper for stock dividends.

It is interesting to note that two recently enacted state codes are not in agreement upon the subject of stock dividends from

[139] *Op. cit. supra,* note 5, at 592.
[140] *Op. cit. supra,* note 47, at 981.

unrealized appreciation. California does not permit stock dividends on any unrealized appreciation, either of current or fixed assets, while Illinois allows them on both.[141]

SUBDIVISION FIVE

The fundamental requirement of subdivision five is that unrealized profits on current assets shall not be used as a base for cash dividends, although, as will develop later, some exceptions are allowed. There is no question of the soundness of this principle, nor of its existence in the law prior to the Uniform Act.[142] As has been said:[143]

> "One cannot avoid the impression that the real reason (and a sound one) for completely excluding unrealized appreciation from income statements, and for admitting it grudgingly, if at all, to balance sheets, is the fear of human frailty Revising values upward is unduly easy where the revision is put to no pragmatic test such as a sale. This failing seems to run through the legal decisions as well as through accounting technique. On this aspect, the experience of both professions tends to converge."[144]

Part (*a*) of subdivision five provides

> "Cash dividends shall not be paid out of surplus due to or rising from (*a*) any profit on treasury shares before resale."

This requires treasury shares to be valued as an asset[145] at the cost at which they were acquired by the corporation, subject, of course, to be devalued in accordance with provisions of subdivision three. Thus, shares acquired by gift are assets of no value for dividend purposes. Shares upon which there remains an unpaid subscription are not treasury shares, since, by Section 22,[146] the corporation

[141] *Loc. cit. supra*, note 14.

[142] *Hastings v. Internat'l. Paper Co.*, *supra*, note 135, at 175 N. Y. S. 825, *Marks v. Monroe Co. Permanent Savings & Loan Assoc.*, 52 N. Y. St. Rep. 451, 22 N. Y. S. 589 (1889). *Cf. Hutchinson v. Curtiss*, 45 Misc. 484, 92 N. Y. S. 70 (1904).

[143] Berle and Fisher, *op. cit. supra*, note 5, at 593.

[144] This statement was made in connection with both current and fixed assets and so is properly considered in the discussion under subdivision four *re* stock dividends, *supra*.

[145] Assuming that treasury stock is an asset, as was argued under subdivision three.

[146] Section 22: "If a shareholder be indebted to the corporation on account of unpaid subscriptions for shares, it shall have a lien upon such shares for such indebtedness. If such indebtedness is not paid after demand made upon reasonable notice, the corporation may sell the shares at public auction. " Rem. Rev. Stat. sec. 3803-22; Pierce's Code (1933) sec. 4592-52.

only has a lien upon such shares to the amount of the indebtedness of the shareholder. Cases allowing unrealized profits on shares seized under the forfeiture provision to be regarded as a dividend source[147] are therefore not authority for the assumption that the pre-existing law is altered by this section.

By virtue of part (*b*) of subdivision five

> "Cash dividends shall not be paid out of surplus due to or arising from (*b*) any unrealized profits due to increase in valuation of inventories before sale."

This means that items of inventory are to be carried as an asset at their cost of acquisition, subject to reduction in accordance with subdivision three, and are not to be valued at a greater figure even though a present sale would realize a larger sum. Effect is thus given to the usual accounting practice of evaluating stock in trade at "cost or market, whichever is lower," which, as previously stated, has received legal sanction. There is no question of the soundness of this provision.

Parts (*c*) and (*d*) of subdivision five lend themselves to discussion together by reason of their similarity They are

> "Cash dividends shall not be paid out of surplus due to or arising from (*c*) the unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds, or obligations are readily marketable, in which case they may be taken at their actual market value, or (*d*) the unaccrued or unearned portion of any unrealized profit in any form whatevger, whether in form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise."

The wording of these provisions imposes a modification upon the rule of subdivision four (*a*) that cash dividends may not be paid from unrealized appreciation of fixed assets. As noted previously, the accountant classifies a debt obligation as a fixed or current asset in accordance with its particular nature and the purpose for which it is held. In other words, an obligation is not inherently a fixed or a current asset, but may be either. Subdivision four laid down the rule that cash dividends can never be paid from unrealized appreciation of fixed assets, though stock dividends can. But parts (*c*) and (*d*) of subdivision five expressly

[147] For example, see *Gratz v. Redd*, *supra*, note 76, dictum at 187.

allow cash dividends from the accrued portion of unrealized profit on notes, bonds, or obligations for the payment of money There is at once apparent a conflict between the two subdivisions, since in many instances a note or a bond or some other obligation for the payment of money should be classified as a fixed asset. By the rule of statutory construction which allows the particular to control the general the result should be that the types of assets listed in parts (*c*) and (*d*) are not contemplated by Section 24 of the Act as being fixed assets insofar as cash dividends are concerned, or, alternatively, that unrealized appreciation of this particular kind of fixed assets may give rise to legal cash dividends in spite of the provisions of subdivision four. The fact that the other parts of subdivision five deal with current assets would indicate that the first of the alternatives was the proper one. On the other hand, less violence is done to accounting conceptions if the second view be adopted. At any rate, it is to be noticed that the subdivision imbues investments with some of the attributes of a current asset which are denied to other fixed assets.

The combined effect of parts (*c*) and (*d*) is first, cash dividends can be paid from the accrued portion of unrealized profits on notes, bonds, obligations for the payment of money, installment sales, credits or otherwise; second, cash dividends can not be paid from the unaccrued portion of unrealized profit on any of these items except notes, bonds or obligations for the payment of money, and cash dividends can be paid on the unaccrued portion of unrealized profit of these if they (1) were purchased or acquired at a discount, and (2) are readily marketable.

Parts (*c*) and (*d*) are, perhaps, sound insofar as they allow accrued but unrealized profits to be a source of cash dividends. In this they depart from the theme of the balance of Section 24, which refuses to recognize any type of unrealized appreciation or profit as available for cash dividend purposes. Accrued revenue is revenue which has been earned from the standpoint of time elapsed and performed.[148] Such items may be due and legally enforcible,[149] or they may be unmatured and therefore not susceptible of present collection.[150] It is easier to justify dividends from the first type of accrual than from the last. Matured and there-

[148] Paton, *op. cit. supra*, note 48, at 276.
[149] 2 Kester, *op. cit. supra*, note 12, at 183.
[150] Paton, *op. cit. supra*, note 48, at 276.

fore legally realizable claims for money are a sufficiently sound asset when it is borne in mind that those which are of doubtful collectibility from a practical standpoint have been weeded out by operation of subdivision three—in fact, proper accounting would disregard such claims even if there were no subdivision three.[151] The maturity of the claims renders them certain as to amount and thus the danger of overvaluation is avoided. Moreover, there seems to be no incentive to postpone realization in such cases—indeed, the opposite is true—and therefore it is reasonably certain that such assets will be reduced to cash in hand as soon as expedient. Accounts and bills receivable are in the nature of an accrued and matured claim, and there is no doubt of their availability for dividend purposes.[152] But all of these arguments are not applicable to the unmatured accrual and the propriety of their use as a dividend fund is therefore more questionable. In view of the fact that accountants recognize both types of accrued claims as assets,[153] however, this provision of these parts of Section 24 seems defensible.

There are instances in which courts have refused to recognize an accrued but unmatured debt claim as grounds for dividend payment. Perhaps the most striking example is that of *People v. San Francisco Savings Union.*[154] In that case directors of the bank counted as profit interest which was due on mortgages held by the bank, but which, instead of being paid, had been added to the principal and bore interest with it, as was provided by the agreement of the parties. It was conceded that the mortgaged property was ample to secure the increased principal. The directors also regarded as profit the accrued interest on United States Government bonds held by the bank. Under a statute which made dividends unlawful unless paid out of "surplus profits" the court enjoined payment of a dividend from these sources.

Marks v Monroe County Permanent Savings and Loan Association[155] deserves comment. Members of the Association bid for loans. The successful bidder gave a bond and mortgage to the Association and received cash to the amount of the face of the bond less interest for the term and the premium he had bid. A

[151] 2 Kester, *op. cit. supra*, note 12, at 183.
[152] *Supra*, note 95.
[153] Weiner and Bonbright, *op. cit. supra*, note 47, at 971, 976, but see n. p. 971. Paton, *op. cit. supra*, note 48, at 276, 2 Kester, *op. cit. supra*, note 12, at 183; Hatfield, *op. cit. supra*, note 62, at 257.
[154] 72 Cal. 199, 13 Pac. 498 (1887).
[155] *Supra*, note 142.

shareholder brought suit to compel payment of a dividend, claiming the difference between the face of the bond and the amount advanced to be profit. This the court denied, saying:

> "This mortgage has become an asset of the company, and when it it is paid the company will have made a profit by the transaction. But I do not think that the profit can be said to be earned until the transaction is closed and the money is in the treasury"

A note comments on the case

> "In a recent N. Y. case, premiums earned but not received by a building and loan society were not allowed to be considered [for dividends] The case does not seem conclusive so far as debts that have matured are concerned, since the debts there involved were due at a future date."[156]

Query whether the premiums were even earned. Another article observes in regard to the case:[157]

> "Some doubt is cast upon the propriety of including accrued but unmatured interest as profit for dividend purposes by two cases.[158] [There follows a discussion of the facts and opinion in the *Marks* case, with this conclusion] The instant case was a case where the secured debt claim had not only not been realized by a cash receipt, but had not even sustained an increase in unrealized value. In other words, the growth in value of the loan from the date of its negotiation to the date of its maturity had not even accrued, to say nothing of its not having been realized."

As pointed out by the last two sentences of the last quotation, the case was not one of accrued earnings at all, and it therefore is difficult to understand why the case may be used as authority for attack even upon unmatured accrued claims.

There can be only one quarrel with the second rule effected by (*c*) and (*d*), and that is that an exception was attached to it.

The case of *E. L. Moore and Company v. Murchison*,[159] discussed previously in another connection, is also pertinent here.

[156] Note, 3 Brooklyn L. R. 91, at 97 (1933).
[157] Weiner and Bonbright, *op. cit. supra*, note 47, at 976.
[158] The second case is that of *People v. S. F Savings Union*, previously discussed.
[159] *Supra*, note 97.

Part of the "surplus" upon which the corporation based dividends was created by purchasing the inventory of its bankrupt predecessor and writing it on the books as an asset at the book value at which it had been carried by the old corporation, which was far in excess of the price paid by the successor corporation. The dividend was held illegal, thus denying that the unrealized profit on the merchandise was a dividend source.

The Washington case of *Brenaman v. Whitehouse*[150] is most interesting. The opinion is not as full as it might be, but it and the appeal briefs show the following facts pertinent to the instant discussion The corporation of which defendants were trustees sold A, B and C each fifty shares of its stock, for which it was paid in full in cash at par. It was agreed that A, B and C could each order work to be done for them by the corporation in its line of business and that such work should be paid for one-half in cash and one-half by a return to the corporation of its stock at an agreed value somewhat in excess of par. At the time of the dividend in question some work had been done for A, B and C, but not enough to entitle the corporation to a return of its stock. The trustees considered that fifty per cent of the work so done and to be done was net profit, and, to quote the court, decided "that approximately $1,000 thereof having been earned, the board of directors were justified in treating all of it as having been earned, and declaring a dividend in that amount." The dividend was held to be illegal, although the decision was not based on the unrealized profit aspect of the case, but on the fact that the corporation had trafficked in its own stock and that "whereas the stock should have been outstanding and its value in the treasury or in the assets of the company, it was not outstanding, but was in the treasury of the company, and its proceeds were divided among the three stockholders as dividends." What the Washington court would have done if the latter ground had not been available is purely conjecture, but it is certain that the new law removes all doubt from a similar case today

In *Hutchinson v. Curtis*[161] a shareholder brought an action against a director to recover an allegedly illegal dividend. The dividend was partly based on a surplus created by anticipating profits on orders on hand for future deliveries of malt and, secondly, by an increase in the valuation of the company's supply

[160] 85 Wash. 355, 148 Pac. 24 (1915).
[161] *Supra*, note 142.

of malt. The court held that the first source was not proper, saying:

> " to calculate months in advance on the result of the future transactions and on such calculations to declare dividends, was to base such dividends on paper profits and not on the surplus or net profits required by law It does not seem to me that you can divide a hope based on an expectation of a future delivery at a favorable price of what is not yet in existence."

But the second ground was held proper because defendant showed a custom in the malting business to take into account the increase in value resulting from an increase in bulk of the malt over the bulk of the barley out of which the malt was produced. Were it not for the special circumstances involved, the second point of this case would be violative of the rule against unrealized profit.

The last branch of the *Hutchinson* case illustrates one exception recognized by accountants to their principle that unrealized appreciation is not to be recognized. It is their practice to allow such an appreciation to be shown if it results from a growth in quantity or quality of the subject matter rather than from an increase in value purely.[162] It is conceivable that the courts will give force to this exception on the ground that it is not within the prohibition of parts (*c*) and (*d*), the rationale being that the growth is not such an unrealized profit as is there contemplated but is, to the contrary, analagous to a realized growth in value. Strength is lent to this view by the fact that still another of the accountants' exceptions is expressly recognized by the Uniform Act, namely, that of accrued, though unrealized, profit.[163]

The cases just treated show the correctness of the second rule of parts (*c*) and (*d*), but its exception seems to be indefensible. The danger of allowing an increased value of current assets to be treated as a gain for purposes of cash dividends without requiring that the gain be accrued or be realized by sale is at once apparent. It violates all the reason underlying restrictions placed upon

[162] Other examples of the same exception are lumber and whiskey, which actually grow in excellence with passage of time.

[163] A third exception to the rule against recognition of unrealized appreciation is that involved in businesses engaged in long-term construction under contract, in which it is the practice to periodically book the then completed portion of the product as an asset at an amount equal to the proportion the completed part bears to the whole, e. g. ships, buildings, etc. Weiner and Bonbright, *op. cit. supra*, note 47, at 970.

problematical assets as a dividend source and apparently serves no useful purpose that may offset this fault. One may imagine the embarrassment of directors who had declared a dividend based on the market value of their corporation's bonds in the summer of 1929 when the crash came a few months later. This part of the Uniform Act is not designed to save directors such embarrassment in the future.

There seems to be no saving grace in the fact that such procedure is available only in event the obligations are "readily marketable." While this perhaps gives assurance that the obligations will be liquid, it by no means assures stability of price. In *Jennery v. Olmstead,*[164] an oft-cited case when the problem of unrealized appreciation is involved, the court remarked

> "It is claimed that profits are substantially realized by this appreciation in the value of government bonds, if the bonds are unsold, just as much as if they were sold. If unsold, it is said that the value of the bond is as well known by a simple reference to the reports of the stock market as it would be by an actual sale, and that if sold, all that is got in exchange is another article, whose value may also fluctuate from time to time, and hence there is no sense in demanding an actual sale of the bond before asserting a realization of profit. Nevertheless the bond unsold is only called worth so many dollars, according to the market price thereof, whereas the bond when sold has actually brought so many dollars, and these dollars are in money, which is a standard of value, made so by law, and that money is now on hand."

Nor is it conceived how the fact of purchase at a discount can operate to justify the exception.

SUBDIVISION SIX

Subdivision six of Section 24 states

> "Subject to the limitations contained in this section, a dividend may be declared in shares of the corporation whenever the board of directors so determine, provided that (*a*) if the dividend is to be paid in shares having a par value, the aggregate par value of such shares shall not exceed the amount of that portion of the corporation's surplus which is transferred to capital as payment for such shares, (*b*) if the dividend is paid in shares having no par value, the number of such shares may be fixed by the board of directors, (*c*) no dividend payable

[164] *Supra,* note 105.

> in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made."

Part (*a*) is obviously proper and requires no comment. Reference to section one, subdivision ten (a),[165] discloses that the aggregate value of the par-value shares distributed by stock dividend becomes a part of the capital stock.

Part (*b*) is not beyond question. As it stands it adds nothing for the directors would certainly be empowered to fix the number of no-par shares to be paid by way of stock dividend in the absence of prohibitory provision. That which is really essential in connection with dividends in no-par shares is omitted, namely, a requirement that there be transferred to capital as payment for the shares a part of the corporation's surplus equal to the aggregate of the value placed upon the no-par shares so divided.[166] That such action is contemplated by the Uniform Act may be implied from section 23 [167] and from the inclusion in the definition of capital stock [168] "such assets as may have been transferred from surplus upon the allotment of stock dividends in shares having no-par value." If no such transfer is made there is room for strong argument that the shares so issued are without consideration and are, therefore, void.[169] In *Jorguson v. Apex Gold Mines Company*,[170] the Washington Supreme Court observed.

> "This [the bond in suit] would mean the payment back to the stockholder of the money he paid for his stock, while permitting him to retain his stock as fully paid, thus leaving the issuance of the stock wholly unsupported by any consideration, a direct conflict with the constitutional provision."[171]

The new California and Illinois Corporation Laws both require such a transfer.[172] Distinction must be drawn, however, between

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[165] Set out *supra*, p. 69.

[166] See dictum in *Joyce v. Congdon*, 114 Wash. 239, 195 Pac. 29, 30 (1921).

[167] Set out *supra*, p. 69.

[168] Sec. 1, subdivision 10 (*b*), set out *supra*, p. 69.

[169] Masterson, Consideration for Corporate Shares, 2 Idaho L. J. 75, at 108 (1932).

[170] 74 Wash. 243, 247, 133 Pac. 465, 467 (1913).

[171] Wash. Constitution, art 12, sec. 6.

[172] *Loc. cit. supra*, note 14.

issuing new shares by way of dividends and splitting up old shares.

Like part (*a*), part (*c*) stands firmly upon its own feet. It squares with the Washington Constitutional provision.

> "The stock of corporations shall not be increased, except in pursuance of a general law, nor shall any law authorize the increase of stock, without the consent of the person or persons holding the larger amount in value of the stock "[173]

SUBDIVISION SEVEN

Subdivision seven of Section 24 embodies in the law the familiar "wasting assets" doctrine

> "A corporation which owns wasting assets intended for sale in the ordinary course of business, such as mines, or oil or gas wells, or timber, or a corporation which owns property having a limited life, such as a lease for a term of years, or patents, need not deduct the depletion of such assets by sale or lapse of time in the computation of the fund available for dividends, and such a corporation may pay dividends from the net profits arising from its business without deduction of such depletion, subject, however, to the rights of the shareholders of different classes."[174]

This provision does not give free hand to a corporation simply because it deals in wasting assets, however. One limitation of the doctrine is well shown by the case of *Van Vleet v. Evangeline Oil Company*,[175] which held that it did not justify payment of dividends from the proceeds of oil that had been severed from the ground before coming into the company's hands until proper allowance for depletion was made. The English courts, which created the doctrine, apply a second limitation. They distinguish "circulating" capital of a corporation from "fixed" capital, applying the wasting assets exception to the latter but not to the former. Thus, property permanently dedicated to the business need not be replaced, but assets of a liquid and circulating nature are not excepted from the general rule.[176] This idea is incorporated

[173] *Supra*, note 171.

[174] The words "or timber" are not in the Uniform Business Corporation Act, having been added by the Washington Legislature.

[175] 129 La. 406, 56 So. 343 (1911).

[176] *Verner v. Gen'l & Commercial Inv. Trust* (1894) 2 Ch. 239; *Ammonia Soda Co. v. Chamberlain* (1918) 1 Ch. 266.

in subdivision seven in that it requires depletion reserve for all assets of a corporation other than its wasting assets.

The doctrine had its birth in the case of *Lee v. Neuchatel Asphalte Company*[177] and it has not been free of criticism since.[178] It is said that some of the remarks in the *Lee* case were not necessary to its decision, and that its rule has been applied to companies whose assets are not of a wasting kind.[179] Indeed, in the later English case of *Bond v. Barrow Haematite Steel Company* the judge said.

> " the plaintiffs really relied on *Lee v. Neuchatel Asphalte Company* as an authority for a universal negative, namely, 'that no company owning wasting property need ever create a depreciation fund' In my opinion, that is not the true result of the decision. It must be remembered that in that case there had been no loss of assets. The company's assets were larger than at its formation, and the court decided nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund.[180]

Other writers say

> "It is generally stated by the text writers that the same doctrine has been accepted in this country This statement puts the situation somewhat too strongly, for most of the cases cited in support of the wasting asset doctrine are either mere dicta or else are not concerned with the problems of dividends. Quite recently the wasting asset principle has been specifically sanctioned by statutory amendment to the corporation laws of some states,[181] the form of the amendments being, in the opinion of the present writers, extremely unfortunate and dangerous."[182]

The grounds of criticism have been that the doctrine misleads shareholders who, unaware of the special practice open to their corporation, think their dividends leave assets owned by the corporation equal to the capital stock, and act upon that belief to

[177] 41 Ch. Div. 1 (1889). But Fletcher, *op. cit. supra*, note 8, sec. 5347, credits Victor Morawetz with creation of the doctrine "without citation of authority."

[178] Levy, Purchase by a Corp. of its Own Shares, 79 U. Pa. L. R. 45 (1930) Note, 3 Brooklyn L. R. 91, at 100 (1933) Note, 40 Harv. L. R. 318 (1926) Weiner and Bonbright, *op. cit. supra*, note 104, at 355.

[179] Levy, *op. cit. supra*, note 178, at 63.

[180] *Supra*, note 82, at 367.

[181] Citing Del. and Ohio Codes and Uniform Business Corporation Act.

[182] Weiner and Bonbright, *op. cit. supra*, note 104, at 356.

their detriment, and also that such a corporation should preserve its capital for the purpose of acquiring new properties to replace those wasted. There is force to these arguments, but they are not necessarily conclusive. As one judge has said, wasting assets companies "live by dying,"[183] and one must bear in mind that there is an element of uniqueness in such things as mines and patents—a directorate might be unable to find a valid replacement for their diminishing property even though their reserve for this purpose was ample. Surely there is no reason why the capital should be returned in lump sum when such an impasse arrives rather than being distributed in proportion to the use of the asset. The doctrine overcomes a second practical difficulty in that it does not require the determination of the amount of gas or ore remaining in the earth, which must be an estimation at the best.[184] Lastly, many businesses of the wasting asset type carry on extensive search for new patentable devices and physical properties and this in some degree compensates for the lack of depletion reserves.

It seems that adoption of the wasting asset exception in England might be defended and its adaptability to American corporation finance denied upon the ground of the variance in the respective conceptions of capital. As stated in a learned article by Nathan Isaacs,[185] England adopts what he styles the *res* conception of fixed capital,[186] under which the "principal may possibly be considered as increasing in terms of money value without yielding any income corresponding to this increase, or diminishing without adversely affecting income." Says he

> "This is in sharp contrast with the American accountancy which puts all that a corporation has and owes into a single balance. The words of Lord Justice Lindley in *Verner v. General & Commercial Investment Trust*[187] must seem strange to an American accountant. 'The law is much more accurately expressed by saying that dividends cannot be paid out of capital, than by saying that they can only be paid out of profits. The last expression leads to the inference that the capital must al-

[183] Pope, Dist. J., in *Stratton's Independence Ltd. v. Howbert*, 207 Fed. 419 (D. C. Colo., 1912).

[184] This observation, however, applies with less force to patents, copyrights, and timber.

[185] Isaacs, Principal, *Quantum* or *Res?* 46 Harv. L. R. 776 (1933).

[186] "Fixed" as distinguished from "circulating" capital, which distinction has been previously discussed.

[187] *Supra*, note 176.

> ways be kept up and be represented by assets which, if sold, would produce it, and this is more than is required by law. Perhaps the shortest way of expressing the distinction which I am endeavoring to explain is to say that fixed capital may be sunk and lost, and yet that the excess of current receipts over current payments may be divided.' In other words, the fixed capital is very much like the land, the fluctuating value of which does not enter into current income accounting. American accountancy, on the other hand, leaves no room, in theory, for a fluctuation in the value of capital without affecting for better or worse the funds out of which dividends may be paid. This view is related to the American legal doctrine that depleted capital must be made good before dividends may be paid.''[188]

On the whole, adoption of the wasting assets exception seems justifiable in view of the argument that may be made for it and the respectable number of cases which, if they be not conclusive, indicate that the American trend is strongly toward the principle the exception adopts.[189]

The subdivision requires that reserves be set up sufficient to cover outstanding obligations to shareholders of different classes. In this it adopts the rule of *Wittenburg v. Federal Mining and Smelting Company*.[190] In that case plaintiff shareholders of a mining company were entitled upon dissolution to payment for their stock at par value plus accumulated dividends, and the court enjoined the payment of dividends until a reserve sufficient for this purpose was created. This result is unquestionably to be preferred over the rule established by the case of *Mellon v. Mississippi Wire Glass Company*[191] which, on identical facts, reached the opposite result.[192]

Conclusion

It has appeared best to place conclusions where pertinent to the discussion throughout the body of the article, rather than to re-

[188] Isaacs, *op. cit. supra*, note 185, at 778.

[189] *Boothe v. Summit Coal Mining Co.*, 55 Wash. 167, 104 Pac. 207 (1909) *Mellon v. Miss. Wire Glass Co.*, 77 N. J. Eq. 498, 78 Atl. 710 (1910) *People ex. rel. United Verde Copper Co. v. Roberts*, 156 N. Y. 585, 51 N. E. 293 (1898) *Excelsior Water & Mining Co. v. Pierce*, 90 Calif. 131, 27 Pac. 44 (1891) *Dealer's Granite Corp. v. Faubion*, *supra*, note 123; *Stratton's Independence, Ltd. v. Howbert*, *supra*, note 183; 11 Fletcher, *op. cit. supra*, note 8, sec. 5347 2 Cook *op. cit. supra*, note 34. sec. 546. *Cf. Crocker v. Barteau*, 212 Mo. 359, 110 S. W 1062 (1908) *Van Vleet v. Evangeline Oil Co.*, *supra*, note 175.

[190] *Supra*, note 37.

[191] *Supra*, note 189.

[192] *Cf. Excelsior Water & Mining Co. v. Pierce*, *supra*, note 189.

serve them for enumeration in the concluding paragraphs. But it is not amiss to again express the conviction that Section 24 is a far step in the proper direction upon the subject of legal regulation of corporate dividends. If, in the process of interpreting this Act and of making those additions and alterations which will be shown desirable by experience, the courts and the legislature are guided by recourse to approved accounting practices and to the interpretations given similar laws in other states, a sound dividend law will have been established.