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Appreciation and Dividends

By L. L. Briggs

Although American and English court decisions on the subject date back for more than a quarter of a century, the legal status of appreciation of a corporation's assets as a source of dividends was not brought to the attention of the general public until 1928 and 1929 when many investment trusts were considering the declaration of dividends on the basis of increases in value of their securities, which had resulted from the long upward trend in the stock market. Since the treatment of appreciation is an important unsettled point in the determination of surplus available for dividends I have thought it worth while to bring together the leading court decisions and the few statutes that have a bearing on the subject.

The courts of England and the United States have been uniform in holding that realized appreciation resulting from the sale of fixed assets is surplus which is available for dividends. First let us review a few of the English decisions. In an early case, *Robinson* v. *Ashton* (1875) 20 Eq. 28, the issue before the court was whether or not a partner was entitled to half of the profit arising from the sale of a mill. Sir George Jessel, master of the rolls, held that as there was no special agreement, the mill was an asset of the partnership, and, since the selling price was in excess of the book value, the difference was profit and was divisible between the partners in their profit-and-loss sharing ratio. In *Lubbock* v. *British Bank of South America* (1892) 2 Ch. 198, the court decided that profit realized on the sale of a bank building was a proper source of dividends. According to the court in *Foster* v. *New Trinidad Lake Asphalte Company* (1901) 1 Ch. 208:

> ". . . an appreciation in total value of capital assets, if duly realized by sale or getting in of some portion of such assets, may, in a proper case, be treated as available for purposes of dividend."

One of the late decisions is that of *Cross* v. *Imperial Continental Gas Association* (1923) L. R. 2 Ch. Div. 553. In this case the defendant sold corporation property at an increase of about $7,500,000 over book value, out of which it was proposed to pay a dividend amounting to approximately $1,000,000. The debenture stockholders objected on the ground that the statute pro-

hibited dividends from capital gains. The court held that the dividends were legal.

Now, let us consider the American cases in point. In *People* v. *Sohmer* (1913) 143 N. Y. S. 313, a corporation leased a building for $200,000. Later, when the property became more valuable, the company sold the lease for $1,050,000 and paid $850,000 to its stockholders in dividends. In his opinion, Justice Lyon said:

"The sum $850,000 was no part of the capital but was the product of capital. It was derived from an increase in the value of the assets of the company. It represented the profits of the realtor upon its lease, and its division among the stockholders constituted a dividend from surplus profits."

People ex rel Queen's County Water Company v. *Travis* (1916) 171 App. Div. (N. Y.) 521 is a case in which a water company purchased land that it subsequently sold at a profit and distributed this gain as a dividend. The court held that the realized capital appreciation was available for such a purpose and said:

" . . . It is immaterial, therefore, whether the water company made these profits by selling water or selling land."

In *Equitable Life Assurance Society* v. *Union Pacific Railroad Company* (1914) 212 N. Y. 360, the defendant company had made a profit of more than $58,000,000 by the purchase and sale of stock of another corporation and had declared a dividend partly upon the basis of this profit. A holder of preferred stock attempted to restrain payment of the dividend. Justice Hiscock said:

"Ordinarily the profits made by a corporation on the purchase and sale of property would so clearly belong to a fund applicable to the payment of dividends that there would be no debate about it. . . . I think it is abundantly established by decisions which are in conformity with and fortified by commercial understanding and experience that the gains or profits realized by a corporation at least from its active transactions such as those under consideration here constitute profits and surplus which are available for dividends."

According to 7 *Ruling Case Law*, section 261:

"An appreciation in value of assets may be taken into account in determining whether or not a profit has been made, and may be distributed as dividends in the same manner as profits arising from earnings, where such appreciation has been actually realized."

Although there is considerable confusion among the decisions on the subject, most of the courts of the United States have held that unrealized appreciation of asset values is not available for dividends. In *Jennery* v. *Olmstead* (1885) 36 Hun. 536, the issue was whether a savings bank had made a profit from which the salary of the president could be paid. The president contended that the difference between the purchase price and market value of

certain government bonds then owned by the bank should be called profits. Justice Peckham answered the contention in this way:

"It is not a proper way to ascertain the fact of profits to estimate the value of bonds yet unsold and upon finding the estimated value to exceed the price paid, to call the difference profits. It is not profits in any true sense of that term. If the bonds were actually sold at such price, the transaction would then be completed and the profits actually realized instead of merely estimated. . . . It is claimed that the 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 a profit. Nevertheless the bond unsold is only worth so many dollars, according to the market price thereof, whereas the bond when sold has actually brought so many dollars, and the dollars are in money, made so by law, and that money is now on hand."

In *Kingston* v. *Home Life Insurance Company* (1917) 11 Del. Ch. 258, it was held that surplus resulting from the estimated appreciation in the value of land purchased with corporate capital was not available for dividend purposes. The directors revalued part of the company's property and added $15,000 to a building account with a corresponding credit to surplus. In his opinion, the chancellor said:

"Some things seem clear even to me, and one is that an estimated increase in the value of the building owned by the insurance company and occupied by its officers and employees, however accurately the increase be estimated, is not a net profit arising from the business of the company. If it is an investment of capital 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 of value change."

Hill v. *International Products Company* (1925) 220 N. Y. S. 711 is a case in which the company paid a dividend based upon surplus resulting from an estimated increase in the size and weight of cattle owned by a department of the corporation. Justice Mahoney said:

"It would seem to me that this alleged in value of cattle not realized by an actual sale of cattle is not a proper item to be taken into consideration in determining the actual surplus of a going concern."

In *Wilson* v. *Barnett*, a case reported in New York "Law Journal" of August 2, 1928, corporate directors declared a preferred stock dividend from surplus which came from a reappraisal of an old hotel site. The receiver of the company sued the directors and the court held them personally liable for the amount of the

dividend. Justice Baugh, in *Dealers' Granite Corporation* v. *Faubion* (1929) 18 S. W. (2d) 737, stated the principle in these words:

" . . . And the general rule seems to be that increase in the value of lands held by a corporation cannot be considered profits, at least until such lands are sold and the profits actually realized."

In *Southern California Home Builders* v. *Young* (1920) 188 P. 585, the directors paid three dividends on the basis of statements prepared by bookkeepers of the company, appraisals of corporation property, and the certificate of a certified public accountant. The plaintiff brought an action against the directors of the corporation on the ground that the appraisal value was inflated and that, as a result, the dividends were not legitimate since they were from capital. Justice Brittain, in giving judgment for the plaintiff, made the following statement:

"Mere advance in value of property prior to its sale or estimated profits on partially executed contracts, do not constitute profits, because the fluctuations of the market . . . may bring about a condition such as was found in the present case where the estimated profits were in fact liabilities or direct losses."

Marks v. *Monroe County Permanent Savings and Loan Association* (1889) 22 N. Y. S. 589 is a case in which the defendant association lent money to its members on bond and mortgage. The member would give a mortgage for a certain amount and would receive that amount less discount at a given per cent. for the time specified in the contract. An example given in the case was that of the association paying a borrower $495 cash for a mortgage of $525. The issue before the court was whether the discount was available for dividends. In his opinion, Justice Ramsey said:

". . . But I do not think the profit can be said to be earned until the transaction is closed and the money is in the treasury. Until that is done there may be no profits. The failure to pay may make the asset worthless. This distinction between the gain by the appreciation in value of an asset, and the final gain of money in hand by its sale at an enhanced value, is taken and made the rule of the decision in *Jennery* v. *Olmstead*. . . . I think the holding of the court in that case, that profits are not realized because the value of the assets is enhanced, is controlling here against the plaintiff."

In *Moore* v. *Murchison* (1915) 226 Fed. 679, Mrs. Moore paid $7,800 for assets that were inventoried at more than $15,000. A corporation was organized and Mrs. Moore turned these assets over to it for 78 shares of common stock with a par value of $100 a share. The directors entered the assets on the books at their face value, thereby creating a surplus from which they declared a dividend. The company later became bankrupt and the trustees

sued the directors. The court held them personally liable for the full amount of the dividends. According to the facts of *Hastings* v. *International Paper Company*, 187 App. Div. (N. Y.) 404, the inventoried goods of the defendant corporation had increased in value during the previous two years and these assets had been placed on the balance-sheet at the appreciated value. In regard to this appreciation, the court said:

"This sum of $18,869,666.88 does not represent actual profits, as the materials have not been turned into money. Moreover, the apparent large profits may pass into the air on a falling market."

In *Coleman* v. *Booth* (1916) 268 Mo. 64, the company wrote up the value of its goodwill in order to show a surplus against which a dividend might be declared and justified the reappraisal on the ground of the corporation's high earning power. The court condemned this procedure and held the directors liable for the dividends declared. The court apparently thought that the increase in goodwill as indicated by the write-up did not exist.

Next, let us review cases in which unrealized appreciation of assets apparently has been sanctioned as a source of dividend. *Hutchinson* v. *Curtis* (1904) 92 N. Y. S. 70 is a case involving the American Malting Company, which bought barley by a bushel of 48 pounds for the purpose of making malt that was sold by bushel of 34 pounds. The process of manufacture produced about 15 per cent. more of malt by the bushel than the barley measure of the raw product. This increase was added to the inventory and credited to surplus to be used as a basis for quarterly dividends to the preferred stockholders. In his opinion, Justice Clarke said:

". . . Of course, this increase has a value as it is sold as malt at malt prices. For the purpose of inventory, the company has ascribed to it the value of the barley. This, plaintiffs claim, is error, because that amount has already once been charged to the malt account, and they say that this increase should have no value ascribed to it until sold and delivered, when its proceeds go into the books as cash. But it certainly is an asset of the company, and as an asset at inventory periods, or when it is necessary to ascertain the actual condition of the company, it must be valued in some way. As it has always been the custom in the malting business to treat it as treated by this company, I am unwilling to disregard that custom . . ."

In *Splittgerber Brothers* v. *Skinner Packing Company* (1930) 228 S. W. 531, the defendant corporation having learned that real estate which cost $98,661.67 was valued at $372,779.55 by an appraisal company, added the increase to the asset account, credited it to surplus and declared dividends from such surplus. The increase in value was approved by the lower court. Although

the upper court reversed the decision on other grounds it apparently considered the surplus based upon the revaluation to be a legitimate source of dividends if the appraisal was bona fide. District Judge Raper approvingly quoted 14 *Corpus Juris* 804 in the following words:

"If the assets of a corporation are valued honestly and fairly in view of all the facts known at the time of the declaration, a dividend is not rendered unlawful by the fact that such assets subsequently prove to be worth less than the valuation placed upon them."

In *Privat* v. *Grand Bay Land Company* (1919) 41 S. D. 494, the defendant corporation was organized in South Dakota for the purpose of buying and selling land in Alabama. It purchased large tracts, cut them up into small tracts and sold them to people in the north. The company claimed the right to declare dividends when its assets exceeded its liabilities, and in estimating its assets it included unsold lands at market value on the dividend date, regardless of the cost price. In an action against the corporation to recover dividends paid from such unrealized appreciation, the lower court gave judgment for the defendant and this was affirmed by the supreme court of South Dakota.

Since a stock dividend takes nothing from the business, the legal objection to cash dividends from unrealized appreciation does not apply to it. *Berwind-White Mining Company* v. *Ewart* (1895) 32 N. Y. S. 716, involved a suit by a stockholder to enjoin a stock dividend which apparently was based upon unrealized appreciation. The court refused to grant the requested injunction. In *McGinnis* v. *O'Connor* (1909) 72 A. 614, the stockholders of a corporation having a capital stock of $15,000 agreed that the plant and goodwill were worth at least $25,000. In a dictum, Justice Worthington stated that the increase of $10,000 could be treated as profits for the basis of a stock dividend in the reorganization of the company.

In *Northern Bank and Trust Company* v. *Day* (1915) 83 Wash. 296, the Standard Fish Company paid $22,500 for a boat and entered it on the books at $15,000. Later it was decided to raise the book value of the asset to $20,000 to create a $5,000 surplus which was added to an earned surplus of $10,000 and this amount was made the basis of a $15,000 stock dividend. In an action by the trustee in bankruptcy against a stockholder to recover the dividends paid, the court decided in favor of the defendant. *State* v. *Bray* (1929) 20 S. W. (2d) 56, is a case in which the defendant corporation increased its capitalization and paid a large

stock dividend based upon appreciation of real estate and other fixed assets. In an action against the corporation by the state of Missouri to declare the charter forfeited on the ground of an illegal issue of stock, the defendant was able to prove that the appreciated value of the assets in question was not greater than the replacement value and thereby won the case.

Stock dividends from unrealized appreciation of assets are expressly authorized by the uniform business corporation act which has been adopted by Ohio and Idaho. The reasoning of the Ohio State Bar Association committee on corporation law on this point follows:

> "A corporation should never write up its assets on account of some fancied or estimated unrealized appreciation in value of assets in order to clear a deficit from its balance-sheet or to create a surplus to enable it to pay dividends for the reason that shareholders and the public may thereby be misled, but if such action is taken in the open and an honest redetermination of the value to the corporation of its assets is made in the manner in which a determination of such value would be made if shares were being issued for considerations other than cash, no one can possibly be injured for the reason that an equivalent result could be accomplished by the organization of a new corporation and the sale of entire assets to such new corporation."

Alabama also has a statute which makes this class of appreciation available for stock dividends. According to section 6991 of the 1923 code:

> "Before the board of directors of any corporation shall be authorized to declare any such stock dividends, other than on a surplus of money, it shall order the appraisal of all tangible assets of the corporation by a competent appraiser or appraisers."

New York, Vermont, and Wisconsin, the other states that have statutes explicit enough to include or exclude appreciation, make unrealized appreciation a legitimate basis for stock dividend purposes.

So far as I have been able to ascertain, there is no American decision which sanctions the offsetting of depreciation by appreciation. However, there is an English case which has been cited as authority for such action. In *Ammonia Soda Company* v. *Chamberlain* (1918) 1 Ch. 266, the corporation owned soda beds which were becoming exhausted as a result of the company's operations. A depletion reserve account was kept and the books showed a deficit. The soda beds were found to be richer than originally had been suspected. The directors reduced the depletion reserve in order to eliminate the deficit and then declared dividends from subsequent earnings. In an action against the directors, the court held that they were not liable for the distribution of such divi-

dends because the English law did not require the setting aside of a depletion reserve. The court also said that there was no rule of law which prohibited a corporation from setting off appreciation in the value of its capital assets, as determined by an honest valuation, against losses in revenue. This case involves an increase in value due to the discovery of new assets rather than an appreciation in the market value of the same assets. It is doubtful whether this decision is authority for offsetting depreciation in the value of certain assets by appreciation in the value of other property because depletion rather than depreciation is concerned.

Statutes directly or indirectly involving appreciation may be divided into two groups: the general dividend statutes and the statutes explicitly mentioning appreciation. The general dividend statutes may be classified as the balance-sheet group and the surplus-profits group. In the jurisdictions having the first-mentioned type of legislation, dividends may be declared only when the assets exceed the liabilities and the capital stock. In these states, by implication, dividends may be based upon appreciation of assets. The only legitimate source of dividends in the second group of states is surplus profits. Consequently, these states do not permit the declaration of dividends from appreciation unless that appreciation comes within the classification of surplus profits.

Two states have statutes which take a definite stand on the availability of unrealized appreciation for the purpose of cash dividends. The Wisconsin statutes (1925) 182:19 read as follows:

"Any corporation which has invested or may invest its net earnings or income or any part thereof in permanent additions to its property or whose property shall have increased in value, may lawfully declare a dividend payable to stockholders upon its capital either in money or in stock to the extent of the net earnings or income so invested or of the said increase in the value of its property; but the total amount of such dividend shall not exceed the actual cash value of the assets owned by the corporation in excess of its total liabilities, including its capital stock."

According to *112 Laws of Ohio* (1927) Sec. 8623:

"No corporation shall pay dividends in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, plus stated capital, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets; . . ."

Thus, we see that Wisconsin expressly permits cash dividends from unrealized appreciation of assets for dividend purposes while Ohio clearly prohibits such dividends.

To summarize—the courts are agreed that realized appreciation of corporate assets is available for dividend purposes, but most jurists have held that unrealized appreciation may not be distributed to stockholders in the form of cash dividends. There are a few decisions which apparently are contrary to the general rule but these were decided so as to conform to recognized trade practices or to take cognizance of some circumstance peculiar to the particular case. Stock dividends from unrealized appreciation are expressly legalized by statute in six states and the general dividend statutes of the other jurisdictions probably legalize such dividends by implication. No American decision permits a corporation to offset depreciation by appreciation. The general dividend statutes do not expressly permit cash dividends from appreciation, but it has been said that some of them do so by implication. Wisconsin has a statute which expressly permits cash dividends from unrealized appreciation, while Ohio has a statute which expressly prohibits such dividends.

In closing, it may be said that the general trend of the statutes and the common law in regard to appreciation is to conform to conservative accounting practice by prohibiting cash dividends from unrealized appreciation in the value of corporate assets and by allowing stock dividends to be based upon such appreciation.