

June 2021

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Recommended Citation

Jerome J. Kesselman, Corporate Dividend Limitations, 27 Dicta 99 (1950).

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CORPORATE DIVIDEND LIMITATIONS

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In very few areas is the mutuality of accounting and law so obvious as in the field of corporate surplus and corporate dividends. Graham and Katz have very clearly recognized this when they state:¹

As in the case of partnerships, the peculiar accounting problems arising in connection with corporations are those relating to the proprietorship or net worth accounts; that is, to the handling of corporate stock, profits and dividends. And here, even more than with partnership problems, an acquaintance with accounting practice facilitates the understanding, if not the solution, of many legal problems.

In order to appreciate more fully the problems involved, one must understand the purposes served by dividend restrictions. The objectives of both the statutes and of accounting procedures are identical. Fundamentally, these objectives are of three types: (1) the creditors must be protected; (2) the investment of the stockholders must be safeguarded; (3) future creditors and future stockholders must not be misled as to the prosperity of the business.

With the development of the corporate form of organization and the resulting limitation on the personal liability of the owners, it became evident that creditors could look only to the assets of the corporation for the satisfaction of their debts. To induce creditors to lend money to such an enterprise and to protect them from losses resulting from intentional managerial policies, it became necessary to provide a safeguard. Such protection could only be provided by an assurance that the corporation would maintain a minimum degree of financial responsibility. To accomplish this objective was the intent underlying most, if not all, of the statutory restrictions on dividends. These limitations were imposed to make certain that management would retain in the business a given margin of assets over and above that required to meet the creditor claims. Put more simply, the purpose of the statutes is to assure the retention of assets beyond the bare solvency margin. It is interesting to note that this is the identical purpose behind many of the accounting procedures followed in preparing corporate financial statements.

Following the Industrial Revolution in America, with the resultant mass production of manufactured goods, the necessity arose for huge accumulations of capital in order to produce more economically. As a result, money had to be raised from a large and geographically dispersed group of investors. This caused a definite trend toward the separation of ownership and management. Too,

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¹ Graham and Katz, ACCOUNTING IN LAW PRACTICE 130 (1938).

as stocks were freely bought and sold and national security exchanges were developed to facilitate such trading in securities, this cleavage between owners and managers became even more distinct. It became apparent quite early that this separation of interests, often in conflict with each other, made it essential that stockholders be protected from unscrupulous managers. In addition, it was also obvious that in corporations where there was more than one class of stock issued, the different classes of stockholders required protection from each other. This need, too, underlies many of the statutory limitations on dividend distributions. Again, it should be noted that accountants have this objective in mind also when financial statements are being prepared.

Finally, a third principle can be found underlying most of the dividend statutes. If dividends could be indiscriminately distributed from any portion of net worth, regardless of source, a picture of false prosperity could be painted to delude prospective investors and creditors. True, a cash or a property dividend diminishes the assets of a business. However, it also indicates the profitableness of a business and its future capability to continue earning a profit. Obviously, unless these dividends being distributed are actually being distributed from accumulated past earnings, the investor and the creditor are being utterly misled as to the value of the stock, the profitableness of the operations, and the risks involved.

STATUTORY RESTRICTIONS

After this brief background of the underlying reasons for restrictions on dividend policy, it is interesting to note, in general, how the various statutes have attempted to accomplish these objectives.

Statutory restrictions are generally of four types: (1) no dividend can be paid while the corporation is insolvent or which will render it insolvent; (2) no dividend can be paid which will diminish or encroach upon the legal stated capital. In general, legal stated capital is the par or the stated value of the shares of stock issued; (3) no dividend can be paid except from accumulated past profits of the corporation less prior distributions and prior operating losses; and (4) a dividend may be paid from current earnings or profits of a specified accounting period despite the presence of an impairment of stated capital.

In Colorado, the General Corporation Act combines the first and the second of the above limitations. The relevant statutory section provides:²

If the directors . . . shall declare . . . any dividend when such corporation is insolvent, or . . . which would render it insolvent or would diminish the amount of its capital stock, all directors . . . shall be . . . liable . . .

² COLO. STAT. ANN. c. 41, § 34 (1935).

The interpretation of this wording raises many questions. First, how is the word, insolvent, used? Insolvency has two distinct meanings. The commercial meaning, that of business men generally, is the inability of a firm to meet its debts as they fall due. In bankruptcy, insolvency means that the creditor equities exceed the value of the assets. Although it has not been determined in the courts of this state, in all probability, the latter meaning is intended. One eminent author³ has referred to this conflict in the following language:

It is frequently not clear in dividend statutes which of the two possible meanings of insolvency should be taken. It has been suggested that presumably the bankruptcy test is ordinarily intended, but this is very questionable, as it seems superfluous when combined with a capital impairment test.

Assuming, however, that the bankruptcy definition was intended, a second question may be raised. In view of the provision, "which would diminish the amount of its capital stock", the first two clauses dealing with insolvency become redundant, or at best, of questionable significance. Obviously, a distribution impairing the capital stock would be illegal. Yet, the capital stock would have to be completely dissipated before an insolvency could result, whereby the assets would be less than the liabilities.

On the other hand, if the meaning of insolvency in the statute is the commercial meaning (namely, that debts cannot be paid as they fall due), questions then arise as to the amount and nature of the assets available, their liquidity, the capacity of the corporation to make profits, the due dates of the obligations, the ability to borrow money and the ability to raise additional capital by sale of stock. The answers to these problems are difficult, if not impossible.

CORPORATE SURPLUS

In view of the limitation in the Colorado statute on the impairment of capital stock, the next question is: "What then is available for distribution as a dividend?" At first blush, the answer appears to be obvious. Surplus can be distributed at the discretion of the board of directors. Does this mean all types of surplus, whether earned or not? Does it mean any surplus regardless of its source? In any effort to come to some conclusion relative to these two questions, a brief analysis of surplus becomes essential.

Surplus is defined as the excess of net assets over the total of liabilities and stated capital. Another definition might designate as surplus that part of net worth which exceeds the legal capital. Basically, there are five types of surplus, each one being determined by its original source.

Paid-in surplus arises upon the issuance or contraction of capital stock. The excess contributed by a stockholder over par value or stated value (in the case of no par stock) is paid-in surplus.

³ Ballantine, CORPORATIONS 579 (1946).

Dated surplus, often called reorganization surplus, occurs as a result of a reorganization or a quasi-reorganization. This type of surplus is nothing more than a reclassification of a portion of the original legal capital into a so-called surplus category. Even though such a reorganization must be approved by all interested parties and is legally sanctioned, it should be clearly understood that nothing of value has come into the corporation that was not there all the time. All that occurs is that certain items are reshuffled and the titles of portions of these items are then changed.

Donated surplus results from the receipt of assets by way of gift. The effect of a donation is an increase in assets without a corresponding increase in liabilities. As a result, the net worth has increased. However, it should be clear that this surplus, like the others already discussed, was not earned through successful operations of the business.

Revaluation surplus is created as a result of the appreciation of assets above their recorded book value of cost. Such surplus clearly represents an unearned increment in present values of existing assets; therefore, it might best be described as an unearned, unrealized "paper" profit.

Earned surplus is synonymous with the accumulated net profits of past operations. The balance of earned surplus represents the net profits retained in the business. This surplus is the only one of the five which results from successful and profitable operations of the business.

Since the Colorado statute simply states that dividends may be legally distributed provided such distribution does not impair capital stock, the conclusion might well be drawn that all types of surplus can therefore be distributed as a dividend to all classes of stock. Certainly this is clear in respect to paid-in surplus. The statute unequivocally provides that paid-in surplus may be distributed as earned surplus.⁴ In view of this provision in the statute, it might be wise to analyze the effects and the implications of such a situation.

Paid-In Surplus

If paid-in surplus is distributed as dividends, an immediate question is raised as to its taxable status. It should be clear that this surplus was not earned by the corporation. It was contributed to the company as a part of the consideration for which the investors received shares of stock. Therefore, it never was taxable as income to the corporation. If it, in turn, is distributed as a dividend, can it become income, and therefore taxable, to the recipient? The solution to this question depends on a number of things. If the stock which gave rise to this premium in the first place was all sold at the same price at issuance, and if this dividend from paid-in

⁴ COLO. STAT. ANN., c. 41, § 12(f) (1935).

surplus is being paid back to the class of stockholders who originally contributed it, the only answer is that the recipient does not receive income. It merely amounts to a return of capital and the distribution is, in effect, a partial liquidating distribution. If this dividend is paid to stockholders of a class other than the one which paid it in, the answer is not so clear. Even though the distribution is not from accumulated past profits, there is little doubt that the stockholders who receive it are getting a return on their investment which is not a return to them of any part of the investment itself. On the one hand, then, it would appear that such a dividend may become income to the recipient. It would seem that the above reasoning, though possible, is incorrect. A dividend from paid-in surplus is clearly a return of invested capital whether paid to the class which originally invested it or whether paid to any other class. As it is not a distribution of earnings, it cannot give rise to income, nor should it become taxable as such.

The indiscriminate distribution of this unearned type surplus contributes to two evils. First, the protection afforded creditors and the protection available to stockholders of preferential issues is thinned down and may completely disappear. Second, the recurrence of such distributions creates a deceptive picture of the prosperity of the company. Such dividends are misleading to owners and investors since they are so frequently misunderstood. Besides, management could hide completely its own inability to make profits by making such distributions as if they were coming from earnings.

If used at all, such distributions should be restricted to preferred shares, and paid-in surplus should not be distributed, even to this class of stock, unless all the earned surplus has disappeared through previous distributions or through the absorption of operating losses. In many statutes, this type of restriction has been made clear. For example, the Business Corporation Act of Illinois states, "Dividends may be paid out of paid-in surplus or surplus arising from the surrender to the corporation of any of its shares only upon shares having a preferential right to receive dividends . . .⁵".

Dated Surplus

In the case of distributions of surplus arising from a reorganization, or a quasi-reorganization, the implications are even more clear than in the situation just discussed. There is no doubt that a dividend from such dated surplus is nothing more than a return of capital. As a result, it is not income, nor should it be taxed as income. The unwise and indiscriminate dissipation of this type of surplus would clearly thin down the security of all creditors, as

⁵ ILL. REV. STAT., c. 32, § 157.41 (b) (1949).

well as of all classes of stockholders. Even though some authors feel that this surplus should be distributable to preferred stockholders when all the earned surplus has been depleted, this is erroneous. Surplus of this sort is nothing more than a part of the original legal capital which has been lopped off the capital stock account and called by another name. Such surplus should be dated and should be retained in the corporation as long as it remains in business. Only upon complete liquidation should this portion of net worth be distributed.

Donated Surplus

The availability of donated surplus is certainly much clearer than either of the two discussed previously. Very little reference can be found on this type of surplus either in the statutes, in cases or in textbooks. This is probably true because it is found less frequently on corporate records than many of the other types, but it is none the less a real type of surplus. Since it arises from the receipt of a gift, there is no possible way to infer that it has any of the distinguishing earmarks of income. As a result, when it is distributed, it is questionable as to whether it should become income to the recipient. Even though unearned, such surpluses should be freely distributable to all classes of stockholders, provided they are informed of the source from which their dividend was distributed. This is so because neither the creditors nor the stockholders should feel that this portion of net worth was created for their protection. Certainly, they had no inherent right to expect it in the first place; nor should they, then, expect it to be retained intact once received. The only limitation on such distributions of donated surplus should be that this source will be used only when earned surplus has been completely exhausted.

Revaluation Surplus

Probably the most controversial question of all arises in respect to the use of revaluation surplus as a dividend. It should be recalled that this surplus represents a "paper" profit, which has neither been earned through operations nor realized through a sale or any other type of transaction. Principally, it arises because property which the corporation has acquired and still retains has become more valuable. If such an asset is later sold and the profit is actually realized, then there is no further question that the excess received over cost is a profit and is, therefore, distributable as a dividend.

The difficulty arises in the more common case in which the asset is not sold but is kept and used in the business for the purpose for which it was originally purchased. In such a case, the fair market value of the asset is greater than its recorded value in a

going concern. Assuming, further, that this appreciation is recorded on the books, then a revaluation surplus is created.

According to the wording of the Colorado statute, it could probably be argued that such surplus becomes available for distribution to stockholders. The only question that should be asked is whether it should be distributed, even though it may be legal to do so under the statute. From a strict accountant's viewpoint, the answer is an emphatic "no", except under very limited conditions.

Since such an appreciation arises primarily from the fluctuation of the purchasing power of the dollar, the surplus represents an unrealized and unearned paper profit. If such a distribution occurs and the trend of price levels subsequently starts downward to a point where the market value of the property is no greater than its original recorded value, there has resulted a clear impairment of invested capital. Furthermore, such a distribution, if permitted, raises the question of the status of such a dividend in the hands of the recipient. Is it income to the stockholder or is it a return of capital? From the accountants' viewpoint, it is clearly a return of capital. Consequently, such a dividend is misleading to owners and diminishes the protection of both the creditors and the stockholders.

It is interesting to note that three approaches have been taken by various statutes and courts in view of the problem indicated. Many states, including Colorado, make no mention of revaluation surpluses in the statutes, and no court decisions have been handed down clarifying the situation. It would thus seem that this type of surplus might be available for distribution, even though it is unearned. A second group of states have expressly incorporated in their statutes a clear cut limitation on the distribution of such a surplus. An example is the provision in the Illinois statute that:⁶

No dividend . . . shall be declared or paid out of surplus arising from unrealized appreciation in value, or revaluation of assets.

A third approach is illustrated in a decision of the New York Court of Appeals wherein revaluation surplus is expressly permitted to be distributed as a dividend. The court stated its views in these words:⁷

In summary, I think that it cannot be said that there is a single case in this State which actually decides that unrealized appreciation cannot be taken into consideration, or, stated in different words, that cost and not value must be used in determining whether or not there exists a surplus out of which dividends can be paid.

Earned Surplus

The fifth type of surplus, earned surplus, is the last one requiring analysis. Clearly, both in law and in accounting, this surplus represents accumulated net profits of prior years and is

⁶ ILL. REV. STAT., c. 32, § 157.41 (c) (1949).

⁷ Randall v. Bailey, 43 N.E. (2d) 43 (1942).

available for distribution to all classes of stockholders without reservation. However, even in this apparently obvious situation, there have been two general approaches taken. All of the states permit the uninhibited distribution of earned surplus where there has been a retention of accumulated earnings from prior periods. Most of the statutes, however, do not permit a distribution of net profits of a given period if there is present an accumulated deficit of prior years, unless the profits of the given period are sufficient to eliminate the deficit. And even then, only the excess after the restitution of capital has occurred is distributable.

On the other hand, there are a few states⁸ which have expressly permitted the distribution of a dividend from prior years' earnings, despite the presence of a deficit with its resultant impairment of capital. For example, the General Corporation Law of California states:⁹

A stock corporation may declare dividends payable in cash or in property only as specified in one of the following subdivisions:

(b) Out of net profits earned during the preceding accounting period, which shall not be less than six months nor more than one year in duration. The corporation may declare dividends out of such net profits despite the fact that the net assets of the corporation amount to less than the stated capital . . .

SUMMARY

In an effort to summarize the accounting viewpoint, as a result of these divergent legal interpretations, it can be said that: (1) earned surplus should be distributable to all classes of stockholders without any limitation except managerial judgment as to its advisability; and (2) all other surpluses should not be distributable except under very restricted conditions and then only to a preferential class with full disclosure of its source.

That the above conclusions should also be generally accepted by lawyers is indicated by the following excerpts from the report of the Corporation Law Committee of the American Bar Association in its Model for State Business Corporation Acts (1946):

Section 41. Dividends

The board of directors of a corporation may declare and the corporation may pay dividends on its outstanding shares . . . subject to the following provisions:

(a) No dividend shall be declared or paid at a time when the corporation is insolvent or its net assets are less than its shared capital, or when payment thereof would render the corporation insolvent or reduce its net assets below its stated capital.

(b) Dividends may be paid out of capital surplus or surplus arising from the surrender to the corporation of any of its shares only upon shares having a preferential right to receive dividends, provided that the source of such dividends shall be disclosed to the shareholders receiving such dividends concurrently with payment thereof . . .

⁸ California, Delaware, Georgia, Kansas, Minnesota, Montana, Nebraska and Oklahoma.

⁹ CALIF. CORP. CODE ANN., c. 3, § 1500 (1947).