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The Financial Provisions of the New Washingon Business Corporation Act, Part III

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THE FINANCIAL PROVISIONS OF THE NEW WASHINGTON BUSINESS CORPORATION ACT

Part II

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Continuing the analysis of the new Washington Business Corporation Act begun in the April 1966 issue of the Review, Professor Kummert explores and compares the asset distribution regulations under the new and old acts.

B. Regulation of Asset Distributions

1. Payment of Dividends From Sources Other Than Stated Capital. Under the old act,[316] cash or property dividends could be paid only from[317] the "surplus of the aggregate of . . . [the corporation's] assets over the aggregate of its liabilities, including in the latter the amount

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†As numerous footnote references therein attest, it was contemplated in the first part of this article, 41 WASH. L. REV. 207 (1966) (hereinafter cited as part I, 41 WASH. L. REV. 207, ——) that the remainder would appear in a single concluding part. However, because of the breadth of the subject here considered and publication deadlines, the remainder has been split into parts II and III. Part I references to Nimble Dividends, Dividends by Wasting Asset Corporations, Reductions of Capital, Share Redemptions and Purchases, Share Dividends, and Director and Shareholder Liability as appearing in part II should therefore be read as referring to part III. Part III, hopefully containing the conclusion, will appear in a subsequent issue of the *Review*.

[316] The "old act," following the terms of reference adopted in the first part of this article, refers to the UNIFORM BUSINESS CORPORATION ACT, now codified as WASH. REV. CODE §§ 23.010.010-.970 (1958). THE UNIFORM BUSINESS CORPORATION ACT adopts substantially the provisions of the MODEL BUSINESS CORPORATION ACT (hereinafter referred to as "Uniform Act") prepared by the National Conference of Commissioners on Uniform State Laws and the American Bar Association in 1928. See 9 U.L.A. 115 (1957).

[317] The words "from" in the old act and "out of" in the New Act are misleading to the extent that they suggest that the cash or property paid out is to be withdrawn from surplus (old act), or earned or capital surplus (New Act). *Cf.* HATFIELD, SURPLUS AND DIVIDENDS 24 (1943). Under double entry bookkeeping, the payment of a dividend in cash or property reduces two accounts: the debit balance account representing the cash or property actually paid out, and one of the credit balance accounts relating to the owners' interest in the corporation. The object of the terms "from" and "out of" is the permissible credit balance account to be charged in connection with the distribution. Such terminology will be used in this article because it is codified in the statutes.

of its capital stock . . . ."[318] The New Act[319] permits, subject to various limitations, distribution of assets to shareholders out of earned surplus, as a primary source, and out of capital surplus, as a secondary source.[320] Cash or property dividends may be declared and paid freely out of unreserved and unrestricted earned surplus of the corporation,[321] except (1) when the corporation is insolvent before such payment or would be rendered insolvent by such payment;[322] (2) when such dividends would be contrary to restrictions in the articles;[323] or (3) when the net assets of the corporation after such payment would not equal the aggregate preferential amount payable to shareholders of preference shares in the event of voluntary liquidation.[324]

Cash may be distributed out of capital surplus by action of the directors solely to discharge cumulative dividend rights of preferred shares, and then, only if the corporation has no earned surplus, the distribution is identified as a payment of cumulative dividends out of capital surplus, and the corporation is not insolvent before such payment and will not be rendered insolvent by the payment.[325] Apart from this limited exception, cash or property may be distributed[326] out of

[318] WASH. REV. CODE § 23.01.250(4)(a) (1958).

In accord to the citation conventions established in Part I, 41 WASH. L. REV. 207, 213 n.32, unnumbered paragraphs in the new provisions will be referred to as "¶" with numbers in order of their appearance. The New Act's paragraph numbers (in parentheses) will be used whenever they appear.

[319] The New Act refers to the new Washington Business Corporation Act, adopted March 20, 1965, Wash. Sess. Laws 1965, ch. 53. See part I, 41 WASH. L. REV. 207 n.1. The New Act is based substantially upon the provisions of the MODEL BUSINESS CORPORATION ACT, hereinafter referred to as the "Model Act," prepared and revised by the Committee on Corporation Law of the American Bar Association. Differences between the New Act and the Model Act not discussed in any part of this article are listed in part I, 41 WASH. L. REV. 207 n.2.

[320] For general background on the basic dividend limitations in the New Act, see part I, 41 WASH. L. REV. 207, 234-38. See also Garrett, *Capital and Surplus Under The New Corporation Statutes*, 23 LAW & CONTEMP. PROB. 239, 242 (1958):

> The theory of the Model Act is that net assets will provide for the claims of creditors ahead of shareholders; that stated capital will provide for the permanent investments of shareholders; that capital (or paid-in) surplus will represent, in the first instance, a portion of the investments of shareholders that is less permanent but subject to special protective rules; that earned surplus will represent the accumulated and undistributed profits; that upstream transfers from earned surplus to capital surplus or stated capital should be largely discretionary with the board of directors, but downstream transfers should generally require the approval of shareholders; and that the whole purpose of the formula and restrictions accompanying it is to state when and under what circumstances corporate assets can be distributed to the shareholders.

[321] WASH. REV. CODE § 23A.08.420 ¶ 1, (1) (1965).

[322] WASH. REV. CODE § 23A.08.420 ¶ 1 (1965).

[323] WASH. REV. CODE § 23A.08.420 ¶ 1 (1965).

[324] WASH. REV. CODE § 23A.08.420(1) (1965). For arguments that the preference limitation should not apply to dividends from earned surplus, see text accompanying note 390 *infra*.

[325] WASH. REV. CODE § 23A.08.430(2) (1965).

[326] WASH. REV. CODE §§ 23A.08.420, .430 (1965), following the approach of Model

capital surplus only if authorized by the articles of incorporation or the majority of all shares outstanding, and if all cumulative dividends accrued have been paid, the corporation is not insolvent before such payment and will not be rendered insolvent by the payment, shareholders are notified of the source of the distribution, and the remaining net assets will exceed the aggregate preferential amount payable in the event of voluntary liquidation to shareholders of preference shares.[327]

a. Statutory Definitions. While the old act does not define the term "aggregate of assets," it does define the word "assets" to mean all of the corporation's property and rights of every kind.[328] Aggregating assets suggests reaching a total value or amount; but as to the process by which that action is to be undertaken, the old act offers only limited assistance. In the process, proper allowance for depreciation and depletion sustained and for losses of every character must have been made.[329] Deferred assets and prepaid expenses must have been written off at least annually in proportion to their use.[330] In addition, unrealized appreciation in value or revaluation of fixed assets must be excluded if the surplus is to be used for a cash or property dividend.[331] Finally, profits on treasury shares before resale,[332] unrealized profits due to increase in valuation of inventories before sale,[333] unaccrued portions of unrealized profits on notes, bonds or obligations for the payment of money purchased or acquired at a discount, except where such instruments are readily marketable,[334] and unaccrued or unearned

Act §§ 40, 41, refer only to distributions out of earned surplus as "dividends;" distributions out of capital surplus are simply distributions. The difference in terminology is part of an attempt by the draftsmen to place capital surplus distributions in a category distinct from dividends from earned surplus. See Hackney, The *Financial Provisions of The Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1384 (1957). In addition, the terminology is in accord with modern accounting usage. See, *e.g.*, MILROY & WALDEN, ACCOUNTING THEORY AND PRACTICE—INTERMEDIATE 538 (1960); PYLE & WHITE, FUNDAMENTAL ACCOUNTING PRINCIPLES 486 (4th ed. 1966). For purposes of comparison with the old act, capital surplus distributions will be considered under the general heading "Payment of *Dividends* From Sources Other Than Stated Capital" despite the technical inaccuracy so committed.

[327] WASH. REV. CODE § 23A.08.430 (1)-(5) (1965).

[328] WASH. REV. CODE § 23.01.010(11) (1958).

[329] WASH. REV. CODE § 23.01.250(3) (1958).

[330] WASH. REV. CODE § 23.01.250(3) (1958) adds the phrase "as may be determined by the board of directors" to the sentence in text.

[331] WASH. REV. CODE § 23.01.250(4) (a) (1958). However, unrealized appreciation in value of fixed assets could be used under the old act as a source for share dividends. WASH. REV. CODE § 23.01.250(4) (b) (1958).

[332] WASH. REV. CODE § 23.01.250(5) (a) (1958).

[333] WASH. REV. CODE § 23.01.250(5) (b) (1958).

[334] WASH. REV. CODE § 23.01.250(5) (c) (1958). This section goes on to state that if the instruments are readily marketable, they may be taken at their actual market value for purposes of aggregating assets. In connection with this exception, see note 455 *infra*.

portions of unrealized profits in any form whatever must be excluded if the surplus is to be used for a cash dividend.[335]

The old act does not define the term "aggregate of liabilities." "Capital stock" is defined in the old act as the aggregate amount of the par value of all allotted[336] shares having a par value plus that portion of any consideration agreed to be given or rendered for no par shares which has been determined by the directors to be payment for such shares.[337]

The New Act defines "earned surplus" as:[338]

> the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus. Earned surplus shall include also any portion of surplus allocated to earned surplus in mergers, consolidations or acquisitions of all of substantially all of the outstanding shares or of the property and assets of another corporation, domestic or foreign.

Earned surplus may be reserved under the New Act, and hence be unavailable for dividends, through a simple resolution of the directors to that effect;[339] but the directors can also abolish the reservation in the

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[335] WASH. REV. CODE § 23.01.250(5)(d) (1958). For a possible explanation as to why property dividends can be declared from the various types of unrealized appreciation noted in this subsection while cash dividends can not be, see note 455 *infra*.

[336] For a discussion of the term "allotted," see part I, 41 WASH. L. REV. 207, 239 n.189.

[337] WASH. REV. CODE §§ 23.01.010(10), .240(1) (1958). Surplus, defined to include unrealized appreciation in value of fixed assets, is also used in the old act to limit a corporation's right to declare share dividends. See WASH. REV. CODE § 23.01.250(4)(b) (1958). On this subject, see text *infra* part III under the heading "Share Dividends."

[338] WASH. REV. CODE § 23A.04.010(12) (1965). With respect to the last sentence of the definition, see WASH. REV. CODE § 23A.08.170 ¶ 3 (1965) which empowers directors to allocate any amount that would otherwise be capital surplus in connection with share issuances in a merger or consolidation or in acquisition of all or substantially all of the outstanding shares or of the property or assets of another corporation, to earned surplus provided that the issuing corporation's resulting earned surplus will not exceed the sum of the earned surpluses of the issuing corporation and of all corporations merged or consolidated or of which the shares or assets were acquired. See also text discussion accompanying note 424 *infra*.

With respect to transfers of earned surplus to stated capital, see WASH. REV. CODE § 23A.08.170 ¶ 4 (1965) authorizing the directors to do so by resolution. See also WASH. REV. CODE § 23A.08.150 ¶ 5 (1965) involving such a transfer in connection with a conversion of shares.

On transfers of earned surplus to capital surplus, see WASH. REV. CODE § 23A.16.130 ¶ 2 (1965), allowing such transfers on resolution of the board of directors.

[339] WASH. REV. CODE § 23A.16.130 ¶ 4 (1965), allowing such reserves for "any purpose or purposes." This power is presumably subject to the broad limitations upon directors' power *not* to declare dividends. See generally City Bank Farmers Trust

same manner.[340] A restriction of earned surplus under the New Act results from the purchase of treasury shares.[341] The restriction lasts only so long as the shares are held as treasury shares, for it is removed *pro tanto* upon the disposition or cancellation of any such shares.[342]

The New Act defines surplus as all of the corporation's surplus other than earned surplus.[343] "Surplus" is defined as the excess of the net assets of a corporation over its stated capital.[344] "Net assets" is defined as the amount by which the corporation's total assets, excluding treasury shares, exceed its total debts.[345] And, finally, "stated capital" is defined as the sum of (a) the par value of all issued shares of the corporation having par value, (b) the amount of consideration received for no par shares allocated to stated capital, and (c) any other transfers to stated capital, less all reductions permitted by law.[346]

In addition to its general definition of capital surplus, the New Act on a number of occasions specifies that certain transactions will or may have an effect on that account. Thus, the act states that capital

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Co. v. Hewitt Realty Co., 257 N.Y. 62, 177 N.E. 309 (1931) (dicta); LATTIN, CORPORATIONS 459-61 (1959).

WASH. REV. CODE § 23A.16.130 ¶ 4 (1965) also states that reserved earned surplus shall not be available for the payment of dividends or other distributions by the corporation except as expressly permitted by this act. It appears that no use has been made of the exception in the New Act, unless it was thought that depletion reserves were reserves of earned surplus. *Cf.* 1 MODEL ACT ANN. § 40 (a) ¶ 4.03; 2 MODEL ACT ANN. § 64 ¶ 4. It should be noted that if dividends were declared by the directors from reserved earned surplus, their action would probably be sufficient under WASH. REV. CODE § 23A.16.130 ¶ 4 (1965) to remove the surplus from its reserved status.

[340] WASH. REV. CODE § 23A.16.130 ¶ 4 (1965).

[341] WASH. REV. CODE § 23A.08.030 ¶ 2 (1965).

[342] *Ibid.* For a discussion of the operation of the restriction, see text *infra* part III under the heading "Share Redemptions and Purchases."

A corporation's unreserved and unrestricted earned surplus not only determines the propriety of its cash or property dividend declarations, WASH. REV. CODE § 23A.08.420(1) (1965), but also determines its right to purchase its own shares, WASH. REV. CODE § 23A.08.030 ¶ 1 (1965), and, in part, to declare dividends of its own shares. WASH. REV. CODE § 23A.08.420(4) (1965). See text discussions *infra* part III under the headings "Share Redemptions and Purchases" and "Share Dividends," respectively.

[343] WASH. REV. CODE § 23A.04.010(13) (1965).

[344] WASH. REV. CODE § 23A.04.010(11) (1965). Unreserved and unrestricted surplus determines a corporation's right to declare share dividends. See WASH. REV. CODE § 23A.08.420(4) (1965), and text discussion *infra* part III under the heading "Share Dividends." Surplus may also be transferred to stated capital in connection with a conversion of shares. WASH. REV. CODE § 23A.08.150 ¶ 5 (1965).

[345] WASH. REV. CODE § 23A.04.010(9) (1965). The term "net assets" is used in connection with preference protection provisions appearing in WASH. REV. CODE §§ 23A.08.420(1) (1965) (cash or property dividends from earned surplus or current earnings), 23A.08.430(4) (cash or property distributions from capital surplus) and 23A.16.090 (redemption or purchase of redeemable shares). See text discussion *infra* at note 386 (earned and capital surplus distributions) and part III under the heading "Share Redemptions and Purchases."

For the definition of treasury shares, see part I, 41 WASH. L. REV. 207, 224 n.94.

[346] WASH. REV. CODE § 23A.04.010(10) (1965).

surplus arises on the sale of par value shares for more than par[347] and may arise from the sale of no par shares.[348] It also arises if surplus is created by or arises out of a reduction of stated capital[349] or if earned surplus is transferred to capital surplus by directors' resolution.[350] Capital surplus is decreased, of course, by a distribution from it to the shareholders.[351] It may also be decreased by transfers to stated capital (1) for share dividends,[352] (2) in connection with a conversion of shares,[353] (3) by directors' resolution,[354] or by its application to a deficit "arising from losses."[355] Finally, capital surplus will be restricted in the event of purchases or acquisitions of treasury shares where such use has been authorized by article provision or shareholder approval.[356]

The New Act defines insolvency as the inability of a corporation to pay its debts as they become due in the usual course of its business.[357]

b. Operation of Basic Dividend Limitations. A careful examination of the statutory limitations and definitions should reveal that both acts fail to articulate the crucial premise from which the fund available for dividends under each act may be computed.[358] The old act requires

[347] WASH. REV. CODE § 23A.08.170 ¶ 1 (1965). See also, for a special example, WASH. REV. CODE § 23A.08.150 ¶ 5 (1965), dealing with conversion of shares.

It is not clear why the directors under WASH. REV. CODE § 23A.08.150 ¶ 1 (1965), should not have the authority to allocate the excess of consideration received over par value directly to stated capital if they so choose. The New Act does permit directors to transfer capital surplus to stated capital by resolution and hence the final result can be obtained in two steps if desired. See WASH. REV. CODE § 23A.08.170 ¶ 4 (1965).

[348] WASH. REV. CODE § 23A.08.170 ¶ 2 (1965). See also, for a special example WASH. REV. CODE § 23.08.150 ¶ 5 (1965), dealing with conversion of shares.

[349] WASH. REV. CODE § 23A.16.130 ¶ 1 (1965).

[350] WASH. REV. CODE § 23A.16.130 ¶ 2 (1965).

[351] WASH. REV. CODE § 23A.08.430 ¶ 1 (1965).

[352] WASH. REV. CODE § 23A.08.420(4) (1965).

[353] WASH. REV. CODE § 23A.08.150 ¶ 5 (1965).

[354] WASH. REV. CODE § 23A.08.170 ¶ 4 (1965).

[355] WASH. REV. CODE § 23A.16.130 ¶ 3 (1965). Capital surplus may be applied to losses only after all of the corporation's earned surplus has been exhausted.

[356] WASH. REV. CODE § 23A.08.030 ¶¶ 1, 2 (1965). Use of capital surplus for such purpose generally is authorized by article provision or by the affirmative vote of the holders of at least two-thirds of all shares entitled to vote on the question. See WASH. REV. CODE § 23A.08.030 ¶ 1 (1965). However, WASH. REV. CODE § 23A.08.030 ¶ 3 (1965) apparently authorizes use of capital surplus for certain types of purchases even if such authorization is not received. See text discussion *infra* part III under the heading "Share Redemptions and Purchases."

[357] WASH. REV. CODE § 23A.04.010(14) (1965). Insolvency is a limitation upon purchase of or payment for a corporation's own shares, WASH. REV. CODE § 23A 08.030 ¶ 4 (1965), cash or property dividends, WASH. REV. CODE § 23A.08.420 ¶ 1 (1965), distributions of cash or property from capital surplus, WASH. REV. CODE § 23A.08.430 (1) ¶ 2 (1965), and redemption or purchase of redeemable shares, WASH. REV. CODE § 23A.16.090 (1965). The term is also used in WASH. REV. CODE § 23A.28.170 (2) (a), (b) (1965) relating to jurisdiction of superior courts to liquidate corporations in actions by creditors.

[358] This statement of the issue appears in Hackney, *Accounting Principles in*

computation of an aggregate of assets, and provides a few rules as to how this process is to be accomplished. But how should assets be *valued* for purposes of this computation? Consider, for example, the amounts owed by customers to the corporation. Need these items be included at all? If so, should they be included at face value, the amount the corporation could reasonably expect to collect, or the amount the corporation could receive on a sale of the accounts in liquidation?[359] Similar valuation problems exist under the New Act's definitions of capital and earned surplus. To calculate capital surplus, total assets must first be computed; yet no valuation principle is stated.[360] Moreover, even though earned surplus is defined with reference to the corporation's income statements,[361] it is necessary, because of the reciprocal relationship between a corporation's balance sheet and its income statement,[362] to decide how the corporation's assets will be valued so that its income can be determined.

No case under either the old provisions or the Model Act's predecessors to the New Act has faced the issue.[363] However, each of the acts

Corporation Law, 30 LAW & CONTEMP. PROB. 791, 801-02 (1965), and 2 BONBRIGHT, VALUATION OF PROPERTY 918-20 (1937).

[359] For a discussion of the appropriate value standard under the old act, see note 364 *infra*. On the valuation of receivables issue raised in text, see 2 BONBRIGHT, VALUATION OF PROPERTY 961, 964-65 (1937); Greenough and Ayer, *Funds Available For Corporate Dividends in Washington*, 9 WASH. L. REV. 63, 82-83 (1934).

[360] As Gibson, *Surplus, So What?*, 17 BUS. LAW. 476, 487 (1962), states:

> If "surplus" has this vital role in corporate policy, the average prudent director may well inquire what surplus is. The Model Act reassuringly informs him that it is the "excess" of net assets over stated capital.
>
> But how do net assets exceed stated capital? In length, breadth, or thickness? [Footnote omitted.]

[361] Earned surplus could have been defined in the New Act in either of two ways: (1) from balance sheet data, *viz.*, as net assets less stated capital and capital surplus, with comprehensive statutory definitions for the latter two terms; or (2) from income statement data, *viz.*, as a corporation's cumulative net income less permissible deductions from such accumulation. See Hackney, *The Financial Provisions of The Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1365-66 (1957). The New Act's definition of earned surplus seems to adopt the income statement approach. WASH. REV. CODE § 23A.04.010(12) (1965). Further verification of this conclusion may be found in the facts that the definition was derived from a definition of earned surplus formulated by the American Institute of Certified Public Accountants, see Hackney, *supra* at 1366, that the New Act provides that capital surplus is the remaining surplus after deducting earned surplus from the amount equal to net assets less stated capital, WASH. REV. CODE § 23A.04.010(11), (12), (13) (1965), and that the draftsmen's comments make clear reference to income accounts in connection with the computation of earned surplus. See Comment appearing in 1 MODEL ACT ANN. § 40(a) ¶ 4.02(3); see also comment appearing in 1 MODEL ACT ANN. § 2 ¶ 4.06.

[362] See, *e.g.*, MONTGOMERY, AUDITING 426 (7th ed. 1949); de Capriles, *Modern Financial Accounting (Part II)*, 38 N.Y.U.L. REV. 1, 49 (1963); York, *Relation of the Income Statement to the Balance Sheet and Earned Surplus Analysis*, 71 J. ACCOUNTANCY 43 (1941). See also Nelson, *The Relation Between The Balance Sheet and The Profit-and-Loss Statement*, 17 ACCOUNTING REV. 132, 141 (1942); Storey, *Cash Movements and Periodic Income Determination*, 35 ACCOUNTING REV. 449, 452 (1960).

[363] Indeed, no case under either act has involved the legality of a dividend payment.

contains several provisions implying that the valuations suggested by generally accepted accounting principles are particularly relevant in determining the fund available under each for dividends.[364] These implications are buttressed by the commentators' observation that

[364] The old act's specific prohibition of unrealized appreciation in value or revaluation of fixed assets and unaccrued portions of unrealized profits generally as sources for cash dividends, WASH. REV. CODE § 23.01.250(4)(a), (5) (1958), probably were in accord with accounting principles at the time the old act was drafted. See AMERICAN INSTITUTE OF ACCOUNTANTS, ACCOUNTING RESEARCH BULL. No. 5 (1940); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, ACCOUNTING RESEARCH BULL. No. 43, p. 11 (1961) referring to the 1934 Institute rule forbidding recognition of unrealized profits in the income account. [The American Institute of Certified Public Accountants was formerly known as the American Institute of Accountants. Bulletins issued by both will hereinafter be cited as AICPA RESEARCH BULL. No.——, p.—— (date).] PATON & LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS 62-63 (1940). See generally *A Symposium on Appreciation*, 5 ACCOUNTING REV. 1 (1930). And, of course, the rules that allowance must be made for depreciation and depletion sustained and that write-offs of deferred assets and prepaid expenses must be made annually in proportion to use, WASH. REV. CODE § 23.01.250 (3) (1958), substantially restates accounting rules then in effect. See, *e.g.*, PATON & LITTLETON, AN INTRODUCTION TO CORPORATE ACCOUNTING STANDARDS 67-68, 73-74 (1940); SANDERS, HATFIELD & MOORE, A STATEMENT OF ACCOUNTING PRINCIPLES 75-76, 114 (1938). Finally, the requirement that losses of every character be recognized is also reminiscent of the conservative accounting rules developed after the great depression. See, *e.g.*, CANNING, THE ECONOMICS OF ACCOUNTANCY 134 (1929); FINNEY & MILLER, PRINCIPLES OF ACCOUNTING INTERMEDIATE 154 (6th ed. 1965).

Greenough & Ayer, *Funds Available for Corporate Dividends in Washington*, 9 WASH. L. REV. 63, 64 (1934), in connection with a thorough study of the old provisions, state the following:

> Section 24 presupposes a working knowledge of accounting and any discussion of the legal implications of the section must, perforce, utilize principles and terms borrowed from that field. However, it is not the purpose of this paper to emphasize a study of accounting concepts. It is intended, rather, to confine discussion of accounting practice to such as is necessary to allow an intelligent treatment of this section of the Uniform Act.
>
> Perhaps the reader will question the stress laid upon the views of accountants in relation to some of the topics in this discussion. Accounting precepts are not legal precepts, but there is today in the law a decided tendency on the part both of courts and of legislators to embody accounting principles in the law. It is, therefore, fair to assume, particularly where there is a paucity of case law, that courts will be influenced by the view of the accountant.
>
> [Footnote omitted.]

The first sentence of the New Act's definition of earned surplus was derived from a definition formulated by the Committee on Terminology of the American Institute of Certified Public Accountants, see Seward, *Earned Surplus—Its Meaning and Uses in the Model Business Corporation Act*, 38 VA. L. REV. 435, 436 (1952); AICPA RESEARCH BULL. No. 9, p. 75 (1941), after discussion of the problem by the American Bar Association draftsmen with members of the Institute. See Garrett, *Capital and Surplus Under The New Corporation Statutes*, 23 LAW & CONTEMP. PROB. 239, 258 (1958). As Hackney, *The Financial Provisions of The Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1366 (1957), points out, the New Act's adoption of the accountant's definition of earned surplus "argues strongly that just as accounting today is mainly concerned with the fairest possible presentation of periodic net income, regarding the balance sheet merely as a connecting link between successive income statements, so earned surplus as used in the act is intended to signify a composite income statement from the year of inception and not simply a balance-sheet increase in net assets." In 1949, the Committee on Accounting Procedure of the American Institute of Accountants approved as an "objective" the discontinuance of the word "surplus" in corporate accounting and suggested that "retained income,"

courts interpreting less directive language in other dividend statutes have relied heavily upon accounting principles.[365] It therefore would

"retained earnings," "accumulated earnings," or "earnings retained for use in the business" be used in place of earned surplus. AICPA, COMMITTEE ON TERMINOLOGY, ACCOUNTING TERMINOLOGY BULL. No. 1, ¶¶ 65-69 (1953). Garrett, *Capital and Surplus Under the New Corporation Statutes,* 23 LAW & CONTEMP. PROB. 239, 258 (1958), states that the ABA Committee on Business Corporations considered the new terminology in connection with drafting the Model Act but that it decided the term "earned surplus" had come into disrepute among accountants because it had not been legally defined, that it could be defined in an *accounting sense,* and that there was no substantial difference between surplus as defined in the Model Act and the terms proposed by the accountants for their own use. He further states that the accountants' committee conceded that the term "earned surplus" was more appropriate in a statute. To the same effect is Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act,* 38 VA. L. REV. 435 436-37 (1952).

Also, the new provisions relating to carryover of earned surplus in corporate acquisitions, WASH. REV. CODE §§ 23A.04.010 (12), 23A.08.170 (1965), see discussion in text accompanying notes 427-35 *infra,* which were adopted in view of recent changes in accounting thought and with the intent of accommodating modern accounting procedure. See Gibson, *Surplus, So What?* 17 BUS. LAW. 476-83 (1962). Finally, under WASH. REV. CODE § 23A.08.450 ¶ 3 (1965) directors are exonerated from liability for unlawful dividends if they can show good faith reliance upon financial statements stated in a written report by independent accountants to reflect fairly the financial conditions of such corporation.

WASH. REV. CODE § 23A.08.450 ¶ 3 (1965) further provides that directors relying in good faith upon financial statements of the corporation represented to be correct by the president or the officer of the corporation having charge of the books of account will be exonerated. It also exonerates them if they in good faith consider assets "to be of their book value" for purposes of determining the amount available for dividend. For a discussion of the operation of these provisions, see part III *infra* under the heading "Director and Shareholder Liability." Gibson, *Surplus, So What?,* 17 BUS. LAW. 476, 487 (1962), argues that the book value clause in WASH. REV. CODE § 23A.08.450 ¶ 3 (1965) should be interpreted to mean that a director will not be personally liable for illegal dividends if he believes in good faith that the assets have a "value" at least equal to the amount stated on the books. From this he concludes that "value is obviously the governing standard" under the Model Act. (To the same effect see Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act,* 38 VA. L. REV. 435, 438 (1952).) Gibson implies in his later discussion that value for this purpose means worth-value. The book value clause can also be interpreted as consistent with the notion that the valuations intended were those produced by generally accepted accounting principles. Because of the emphasis in modern accounting upon cost allocation and income determination rather than balance sheet worth-values, many accounts appear on corporate balance sheets as valuations having no relationship to their worth-value. See the extended discussion in Hackney, *Accounting Principles in Corporation Statutes,* 30 LAW & CONTEMP. PROB. 791, 803-13 (1965). Directors should be protected not only when relying on financial statements prepared by independent accountants in accord with generally accepted accounting principles, but also against the charge that assets valued by generally accepted accounting principles were not actually worth that value. Gibson's argument will be discussed further in text accompanying note 454 *infra.*

One of the comments to § 40(2) of the Model Act (substantially equivalent to WASH. REV. CODE § 23A.08.420 (1965), may also indicate that accounting principles were not intended to be the valuation standard: "even without an express insolvency restriction, the limitation of dividends to surplus covers a bankruptcy insolvency." As is pointed out in note 368 *infra,* this statement either misconstrues bankruptcy insolvency as being computed from accounting values or indicates that surplus is to be computed from present fair values, the bankruptcy test standard.

[365] See BALLANTINE, CORPORATIONS 529 (1946); 2 BONBRIGHT, VALUATION OF PROPERTY 919-20 (1937) (discussing cases under the capital impairment doctrine); HILLS, THE LAW OF ACCOUNTING AND FINANCIAL STATEMENTS 163 (1957); MAY, FINANCIAL ACCOUNTING 38-39, 86-102 (1946); REPORT OF STUDY GROUP ON BUSINESS

seem that a court faced with an interpretation problem relating to legality of dividends under either act should look first to the result suggested by generally accepted accounting principles. But its task is then ended only if the general purpose for collecting and assembling the accounting data, *meaningful disclosure of the financial condition of an enterprise,* has not rendered the accounting result inappropriate in view of the basic policy underlying dividend regulation, *fair accomodation of the interests of creditors and shareholders as a group and inter se.*[366] If the accounting result is inappropriate, the statutory implications of its relevance must yield to the overall purpose, and a solution consistent with that purpose must be sought.

It may well be asked whether any reliance should be placed upon accounting valuations in making legal determinations as to the available dividend fund as against, for example, using current values for such purposes. Moreover, assuming that reliance on accounting data is necessary, it may still be asked whether its extent should be made clear in the statute. These questions can be better answered after a comparison of the operation of the basic dividend limitations imposed by both acts in a number of classic dividend situations.[367]

(1) Declaration of Payment of Cash Dividends by Insolvent Corporations. Apart from the possibility that its surplus test for dividends can be said to subsume the bankruptcy test for solvency[368] (that the fair

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INCOME 25-28 (1952); Baker, *Hildebrand on Texas Corporations—A Review,* 21 TEXAS L. REV. 169, 190 (1942); Hackney, *Accounting Principles in Corporation Law,* 30 LAW & CONTEMP. PROB. 791, 818 (1965); Hills, *Model Corporation Act,* 48 HARV. L. REV. 1334, 1349 n.12 (1935); Weiner & Bonbright, *Theory of Anglo-American Dividend Law: Surplus and Profits,* 30 COLUM. L. REV. 330, 338 (1930).

[366] See in this regard HERWITZ, BUSINESS PLANNING (1966); BALLANTINE, CORPORATIONS 529 (1946): "It should be noted, however, that the courts have the last say and tend to follow on legal questions, as between conflicting accounting opinions, what will further the legal objective in view."

[367] The approach here followed is suggested by BAKER & CARY, CASES ON CORPORATIONS 1172-73 (3d unabr. ed. 1958); Hackney, *The Financial Provisions of the Model Business Corporation Act,* 70 HARV. L. REV. 13-57, 1371-84 (1957); Latty, *Uncertainties In Permissive Sources of Dividends Under Present G.S. 55-116,* 34 N.C.L. REV. 261 (1956); and by general matters of statutory interpretation raised by both acts.

[368] BAKER & CARY, CASES ON CORPORATIONS 1247 (3d unabr. ed. 1958) state: "In states having a true balance sheet surplus or capital impairment test, it would seem that an insolvency test in the bankruptcy sense is superfluous, as assets by definition exceed not only all debts but also capital." This statement assumes that a *true* balance sheet test would use worth-values (as the bankruptcy test does, see, *e.g.,* 1 COLLIER, BANKRUPTCY ¶ 1.19, at 110 (14th ed. 1966) for if it used accounting values there would be no necessary correlation between the tests. See Hackney, *Accounting Principles in Corporation Law,* 30 LAW & CONTEMP. PROB. 791, 803-13 (1965) as to why accounting values do not approximate worth-values. Since courts interpreting the old act's surplus test are likely to use accounting values, see text discussion *supra* at 358, the chances that it will encompass the bankruptcy insolvency test are at best remote.

value of a corporation's assets must exceed its debts),[369] the old act makes no reference to dividends endangering solvency.[370] However, Washington's fraudulent conveyances act[371] would apparently render voidable dividends paid by a corporation whose assets had a present fair salable value less than the amount that would be required to pay its probable liability on existing debts as they became matured and absolute.[372] The New Act, in contrast to the old, expressly prohibits declaration or payment of cash dividends resulting in a corporation's being unable to pay its debts as they become due (the equity test of insolvency), regardless of the existence of sufficient earned[373] or capital surplus[374] to support the dividend.

Three questions can be raised with respect to the adoption of the

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[369] See 11 U.S.C. § 1(19) (1964); 1 COLLIER, BANKRUPTCY ¶ 1.19 (14th ed. 1966).

[370] The Commissioner's Note to § 24 of the Model [Uniform] Business Corporation Act (see note 316 *supra*) is clear in its reference of the problem of dividends by insolvent corporations to fraudulent conveyances law. See 9 U.L.A. 170 (1957) and text following this note. As to the possibility of the surplus test encompassing the bankruptcy solvency test, the Commissioner's Note is not particularly clear:

> In a few statutes, the only provision is one with respect to dividends paid while the corporation is insolvent or causing insolvency. The rule that dividends must be paid out of capital is not the same as the rule that dividends must not be paid by an insolvent corporation, for even an insolvent corporation may earn profits, but these profits should be used in paying debts. Conversely, a corporation may be quite solvent and yet have no profits, and may, therefore, be unable to pay dividends. (Mechem, § 1343.)

It is interesting to note that the Ohio statute upon which the old act dividend provision was modelled contained a prohibition against dividends causing equitable insolvency. See Ohio Sess. Laws 1931, vol. 114, § 8623-38(c), at 62.

[371] See generally WASH. REV. CODE §§ 19.40.010-.130 (1958). The Uniform Act has been adopted by twenty-three states. See listing in 9B U.L.A. 45 (1957, Supp. 1965).

[372] Section 4 of the Uniform Fraudulent Conveyances Act ("every conveyance made . . . by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made . . . without a fair consideration"; see WASH. REV. CODE § 19.40.040 (1958)) has been interpreted to apply to dividends by insolvent corporations as that term is defined in text. See Powers v. Heggie, 268 Mass. 233, 167 N.E. 314 (1929). Section 5 of the act, relating to conveyances without fair consideration leaving the transferor with unreasonably small capital, may also apply to such dividends. See WASH. REV. CODE § 19.40.050 (1958). Where a conveyance without fair consideration is fraudulent as to a creditor, he may, when his claim matures, have the conveyance set aside to the extent necessary to satisfy his claim or disregard the conveyance and attack or levy execution on the property conveyed. See WASH. REV. CODE § 19.40.090 (1958).

In the event of bankruptcy, several provisions in the Bankruptcy Act may apply to dividends paid by insolvent corporations: (1) section 67(d), 11 U.S.C. § 107(d) (1964), which incorporates the essential portions of the Uniform Fraudulent Conveyances Act and other provisions designed to supplement and mesh with other parts of the Bankruptcy Act; (2) section 70(a), 11 U.S.C. § 110(a) (1964), which vests in the trustee the bankrupt corporation's title to its property, including the corporation's rights against shareholders for improper dividends; and (3) section 70(e) 11 U.S.C. § 110(e) (1964), which voids as against the trustee any transfer which under any federal or state law is fraudulent or voidable for any reason by any creditor. See generally BAKER & CARY, CASES ON CORPORATIONS 1175-76 (3d unabr. ed. 1958).

[373] WASH. REV. CODE § 23A.08.420 ¶ 1 (1965).

[374] WASH. REV. CODE § 23A.08.430(1) (1965).

new provisions: (a) was it necessary, in view of the existing fraudulent conveyances statute, to add a prohibition in the corporation statute against insolvency dividends? If so, (b) what is now to be the relationship between the statutory remedies? and (c) was the proper definition of insolvency chosen? Adding the equitable insolvency test to the dividend statute appears to have been worthwhile since it will impose liability for dividends declared or paid during equitable insolvency upon the directors,[375] who may be easier for creditors to sue and more at fault than the shareholder-defendants in a fraudulent conveyance suit.[376] Moreover, the definition of insolvency adopted tends to give more protection to creditors than the definition used in the fraudulent conveyance statute.[377]

In view of the corporation statute's specific, more recent treatment of the problem,[378] and its possible implication that shareholders are not to be directly liable to creditors or the corporation on illegal dividends,[379] the question may be raised whether the corporation statute ought to be the exclusive remedy relating to dividends by insolvent corporations. However, there is no evidence that either the draftsmen[380] or the members of the legislature were aware of the possible overlap between the provisions of the two statutes, and hence any inferences of intent drawn from the new provision itself are scarcely compelling. Moreover, the New Act's remedy may leave creditors with unsatisfied judgments in a number of situations where fairness would dictate that shareholder-recipients should be liable, and where the fraudulent conveyances act would so hold.[381] It would seem that the

[375] Under WASH. REV. CODE § 23A.08.450(1) (1965), directors of a corporation who vote for or assent to the declaration of any dividend or distribution of its assets to its shareholders contrary to the provisions of the act shall be jointly and severally liable to the corporation for the amount of the improper distribution. Directors found liable under WASH. REV. CODE § 23A.08.450 (1) (1965) are entitled to contribution from the shareholders receiving the distribution who know the distribution was in violation of the act. For further discussion of director and shareholder liability and defenses thereto, see text discussion *infra* part III under the heading "Director and Shareholder Liability."

[376] The Uniform Fraudulent Conveyances Act allows recovery only from the transferee, not the corporation's directors. See WASH. REV. CODE § 19.40.090 (1958); BAKER & CARY, CASES ON CORPORATIONS 1175 (3d unabr. ed. 1958).

[377] Inability to pay current obligations as they mature has been held insufficient to establish insolvency under the Uniform Fraudulent Conveyances Act. See McCarty v. Nostrand Lumber Co., 232 App. Div. 63, 248 N.Y. Supp. 606 (1931).

[378] See, *e.g.*, on this general theme, CRAWFORD, CONSTRUCTION OF STATUTES § 230, at 430 (1940).

[379] See statutory remedies discussed *supra* note 375; WASH. REV. CODE § 23A.08.450(4) (1965).

[380] The annotations and comments to the Model Act predecessor to WASH. REV. CODE § 23A.08.450 (1965) make no mention of the fraudulent conveyance act recovery possibilities. See 1 MODEL ACT ANN. § 43 ¶¶ 2, 4.

[381] Consider, for example, a dividend payment by a corporation insolvent under

best resolution of the conflicting interpretations would harmonize the operation of the statutes while giving due weight to the fact that the corporate remedy is later and more specific—*i.e.*, would treat the corporation statute as the primary mode of recovery, but would preserve to creditors a secondary line of possible recovery under the fraudulent conveyance act in the event of unsatisfied primary judgments.

The final question is whether the definition of insolvency should have been broadened to include the bankruptcy, as well as the equity, test of insolvency.[382] This proposal would in effect force directors to go beyond the current assets-liabilities matching process, required under the equitable test, into more difficult determinations as to whether the fair value of all the corporation's assets exceeds the amount of its debts.[383] Despite obvious computation problems, such a requirement seems warranted as a necessary means of protecting long-term creditors of the corporation,[384] particularly since the insolvency limitation

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both the equity and fraudulent conveyance tests where the directors are judgment proof. Creditors may be able to reach some of the shareholders in these circumstances by a creditors' bill upon the directors' statutory right of contribution from knowing shareholders. See WASH. REV. CODE § 23A.08.450(4) (1965); Sussex Trust Co. v. Bacon, 11 Del. Ch. 380, 102 Atl. 785 (1917). However, fairness would seem to demand that the creditors be preferred here even to shareholders without knowledge.

[382] At least four states use the dual definition of insolvency. See CAL. CORP. CODE § 1500; N.C. GEN. STAT. § 55-50(c) (1), (2) (1965); MD. ANN. CODE art. 23, § 37(a) (2) (1959); OKLA. STAT. ANN. tit. 18, § 1.133 (1953).

For general background of insolvency tests in connection with dividend regulation statutes, see KEHL, CORPORATE DIVIDENDS 33-41 (1941).

It should be noted that Bonbright, after a careful study of the definition of insolvency under the Bankruptcy Act, concluded that neither the equity test (because it would declare a debtor insolvent even though his inability to pay his debts was temporary) nor the bankruptcy test (because its value standard was almost meaningless) was acceptable. He offered as a definition that a person is insolvent if he cannot fairly be expected, if left to his own devices, to pay off his debts within a reasonable period of time. 2 BONBRIGHT, VALUATION OF PROPERTY 788 (1937). This test seems to obscure the valuation factor and seems as hard (if not harder) to apply as the bankruptcy test. The bankruptcy test is urged in text because it is a relatively common supplement to the equity test and because it seems useful to key the dividend test of insolvency to legal standards with which the directors may be presumed to be familiar.

[383] See 2 BONBRIGHT, VALUATION OF PROPERTY 758-63 (1937), for a discussion of the standard of valuation imposed by the Bankruptcy Act. See also Hackney, *Accounting Principles in Corporation Law*, 30 LAW & CONTEMP. PROB. 791, 820-21 (1965), for a statement of the difficulties in computing the actual value of a corporation's assets. Compare, however, the court's statement on the problem in Randall v. Bailey, 23 N.Y.S. 2d 173, 184-85 (Sup. Ct. 1940), *aff'd*, 288 N.Y. 280, 43 N.E.2d 43 (1942), quoted in note 560 *infra*.

As to whether the equity test is harder to apply than the bankruptcy test, see 1 COLLIER, BANKRUPTCY ¶ 1.19, at 92 (14th ed. 1965). For specific problems that might arise under the equitable test in a corporation statute, see Note, 13 SYRACUSE L. REV. 93, 98 (1961). *But cf.*, de Capriles, *New York Business Corporation Law: Article 5—Corporation Finance*, 11 BUFFALO L. REV. 461, 467-68 (1961).

[384] By and large, the equitable test for insolvency in this context is more effective in protecting the interests of short-term, rather than long-term, creditors since long-

is not only used in connection with dividend payments, but is also used in connection with distributions from stated capital.[385]

(2) Declaration or Payment of Cash Dividends Endangering Liquidation Preferences. The entire thrust of the old act's surplus test was toward protection of stated capital;[386] hence, to the extent that a share's liquidation preference was not represented in stated capital,[387] a preferred shareholder, absent specific contract provisions, could have no assurance that net assets equivalent to his liquidation preference would be maintained in the corporation.[388] In contrast, the New Act

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term creditors are more interested in the integrity of stated capital. See de Capriles & McAniff, *The Financial Provisions of the New (1961) New York Business Corporation Law,* 36 N.Y.U. L. REV. 1239, 1263 (1961). The question thus obviously becomes how would a bankruptcy insolvency test afford long-term creditors protection they do not already have in the dividend regulations preserving stated capital. (*Cf.* the comment in 1 MODEL ACT ANN. § 40(a) ¶ 4: "Insolvency as used in the section applies to either equity insolvency or bankruptcy insolvency. Even without an express insolvency restriction, the limitation of dividends to surplus covers a bankruptcy insolvency.") The answer once again lies in the fact that if accounting valuations are used to determine asset values for purposes of determining funds available for dividends under the surplus tests, a corporation may have both earned and capital surplus but still be insolvent under the fair value bankruptcy test. See note 368 *supra;* BAKER & CARY, CASES ON CORPORATIONS 1247 (3d unabr. ed. 1958), listing the special case of watered stock. (See, on the latter situation, discussion at text accompanying note 543 *infra.*) Even though it is thus clear that protection of long-term creditors requires addition of the bankruptcy insolvency test, it may be argued that such creditors should be left to protect themselves by contract against such exigencies. The protection here afforded, however, seems so fundamental that it should be available to all creditors and not only those with alert counsel.

It may be argued that the bankruptcy test imposes too great a burden on directors. But it seems hard to believe that avoiding what amounts to an act of bankruptcy in connection with a corporate dividend is an unreasonable requirement. Moreover, directors for this purpose will have the extra margin of the capital stock accounts as protection since the test here looks only to debts of the corporation. See Rett, *When Is A Corporation Insolvent,* 30 MICH. L. REV. 1040, 1042 (1932). Finally, the statute elsewhere seems to have imposed the same burden in connection with the protection of liquidation preferences. See text accompanying note 386 *infra.*

As to possible alterations in directors' defenses in connection with a bankruptcy test, see text discussion *infra* part III under the heading "Director and Shareholder Liability."

[385] WASH. REV. CODE § 23A.08.420(1) (1965), permitting nimble dividends, WASH. REV. CODE § 23A.08.420(2) (1965), permitting dividends from depletion reserves, WASH. REV. CODE § 23A.08.030 (1965), permitting certain purchases of shares from stated capital, and WASH. REV. CODE § 23A.16.090 (1965), regulating redemptions and purchases of redeemable shares, and discussion of each subject in text *infra* part III.

[386] See WASH. REV. CODE § 23.01.250(4)(a) (1958), defining surplus as net assets less capital stock and WASH. REV. CODE § 23.01.010(10)(a) (1958), defining capital stock in terms of par or allocated consideration.

[387] See, in this connection, the discussion of whether the minimum consideration for preference shares should be the amount of the preference, part I, 41 WASH. L. REV. 207, 243-45. If it were decided that such minimum consideration was appropriate, a secondary issue under the Old Act would be whether consideration for preference shares to the extent of the amount of the preference should be placed in stated capital. This issue is answered under WASH. REV. CODE § 23A.08.170 (1965).

[388] In some situations, of course, the stated capital of the common stock, combined with that of the preferred shares, would be sufficient to protect the preferred's liquidation preference. But without further restrictions on the reduction of capital,

requires that the net assets of the corporation remaining after a cash dividend from either earned[389] or capital surplus[390] must equal the aggregate amount payable in the event of voluntary liquidation to preferred shares with a liquidation preference. The full force of the new provisions can be appreciated only in conjunction with the draftsmen's comment to the Model-New Act's definition of net assets:[391]

> "Net assets" are not necessarily equivalent to net book value in all cases. For example, if the actual value of assets has fallen so far below book value that the directors cannot be shown to have relied in good faith on their book value *current fair values* may be the governing standard.

Thus, apart from the uncertain leeway provided by the good-faith defense, the new provisions apparently impose a super-bankruptcy insolvency test for dividends wherein the preferred liquidation preference is treated as a debt of the corporation.[392]

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see WASH. REV. CODE § 23.01.430(2) (1959), a preferred shareholder would have no assurance that the common stated capital could not be reduced.

It is not clear from the authorities whether or when an equity court would step in to protect the preferred shareholders in such a situation. In Crimmins & Pierce Co. v. Kidder Peabody Acceptance Corp., 282 Mass. 367, 185 N.E. 383 (1933), the court allowed redemption of certain class B preferred shares despite the fact that the corporation's net assets after the redemption would be less than the par value and liquidation preference of the Class A preferred. The court said that absent some statutory indication of such a limitation, it would not imply a preference protection for fear of creating a new and different contract than that written by the parties.

Query, however, whether a court faced with a common dividend undercutting the liquidation preference shortly before liquidation would not come to the rescue of the preferred. *Cf.* Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Berle, *Corporate Powers as Powers in Trust*, 44 HARV. L. REV. 1049, 1060-63 (1931).

[389] See WASH. REV. CODE § 23A.08.420(1) (1965). This provision does not appear in the basic Model Act dividend provision (limiting dividends to earned surplus) or in its recently adopted alternative provision permitting nimble dividends in addition to dividends from earned surplus. See 1 MODEL ACT ANN. § 40(a) ¶ 1. Liquidation preference protection clauses are common as limitations on "nimble dividends." See 1 MODEL ACT ANN. § 40(a) ¶ 2.02(1) indicating that all but one of the states with nimble dividend provisions have at least a liquidation upon earned surplus dividends. See as the only example N.C. GEN. STAT. 55-50(c)(3) (1965). Thus, it can be argued that all the Washington draftsmen intended was to add the usual preference limitation on the nimble dividend clause being added. However, the language of WASH. REV. CODE § 23A.08.420(1) (1965) ("No such dividend") would appear to foreclose this argument since it is not sufficiently restrictive so as to apply to only the second clause of the first sentence.

[390] WASH. REV. CODE § 23A.08.430(4) (1965). The text statement is not entirely accurate as apparently a cash distribution to shares having a cumulative preferential right to receive dividends can be made from capital surplus even though the liquidation preference limitation is not met. See WASH. REV. CODE § 23A.08.430 ¶ 2 (1965). But before this type of dividend can be declared from capital surplus, the earned surplus must be exhausted. *Ibid.* Hence, if one dollar of earned surplus exists, and the fair value of the net assets does not exceed the amount of the liquidation preference, no distribution of capital surplus can be made.

[391] 1 MODEL ACT ANN. § 2, ¶ 0.04(i) (1960, Supp. 1964). See WASH. REV. CODE § 23A.04.010(8) (1965).

[392] Net assets is defined in WASH. REV. CODE § 23A.04.010(9) (1965) as the amount by which the total assets of a corporation, excluding treasury shares, exceed the total debts of the corporation. The term "debt" is not defined in the Act but

The new provision regulating dividends from earned surplus, which was added by Washington draftsmen to the Model Act's alternative dividend section,[393] is unique in the United States for its rigor. Its closest competitor, the North Carolina provision, would permit dividends from earned surplus as long as the corporation's net assets (determined by generally accepted principles of sound accounting practice)[394] exceeded the highest aggregate liquidation preferences of shares entitled to priority of preference over the shares receiving the dividend.[395] The North Carolina provision appears to accomodate the interests of preferred and common shareholders better than either the old or the new Washington provisions. Both the new and the North Carolina provisions are superior to those in the old act in their recognition that the fundamental attribute of preferred shares, their senior liquidation rights, must be protected from possible abuse by excessive dividends on common shares.[396] However, the North Carolina provi-

Garrett, *Capital and Surplus Under The New Corporation Statutes,* 23 LAW & CONTEMP. PROB. 239, 243 (1958), indicates that the term was chosen over "liabilities" because "debts ... [was] the more certain term, because they are ordinarily fixed as to liability and liquidated as to amount, whereas liabilities connote something more in the way of contingencies and speculations." This definition of debts may exclude several items that would be recorded as liabilities under generally accepted accounting principles. See GRADY, *Inventory of Generally Accepted Accounting Principles,* ACCOUNTING RESEARCH STUDY No. 7, at 276 (1965): "all known liabilities [obligations to pay sums of money, to convey assets other than money, or to render service] should be recorded regardless of whether a definite amount is determinable"; Moonitz, *The Changing Concept of Liabilities,* 109 J. Accountancy, May 1960, p. 41, 44: "the amount of the liability must be the subject of calculation or of close estimation". See generally AMORY & HARDEE, MATERIALS ON ACCOUNTING, 101-28 (3d ed. 1959). Several recent statutes have used the word liabilities so as to include provision for unascertained obligations and other credit balances not ordinarily thought of as "debts" but which must be deducted in computing funds available for dividends. See, *e.g.,* Hackney, *The Pennsylvania Business Corporation Law Amendments,* 19 U. PITT. L. REV. 51, 66 (1951), discussing PA. STAT. ANN. tit. 15, § 2852-2 (Supp. 1956); N.C. GEN STAT. § 55-2(7) (1965), defining "liabilities" generally as "all those debts and claims which either are known to impose a fixed obligation of payment or, if contingent, have sufficient possibility of becoming fixed as to require in accordance with generally accepted principles of sound accounting practice an estimate of their probable amount." If one of these broader definitions is used, it will be necessary to exclude from liabilities capital stock, which might under certain accounting definitions be included. See Garrett, *supra* at 243; Moonitz, *supra* at 42.

[393] See note 389 *supra.*

[394] N.C. GEN. STAT. § 55-2(2) (1965).

[395] N.C. GEN. STAT. § 55-50(c)(3) (1965). This provision also regulates capital surplus dividends.

The North Carolina provision thus is designed to cover the problems that may arise where the preferred's stated capital is not equal to its liquidation preference. See part I, 41 WASH. L. REV. 207, 243-45.

[396] As the Note, *Dividends From Contributed Capital and Protection of Preferred Shareholders,* 65 HARV. L. REV. 1203, 1204 (1952), states:

> In general, the interests of the preferred which should be protected relate to its position either as a claimant to dividends or as a claimant to assets. The preferred is commonly defined as a class having a claim prior to junior shares to a specified amount of the corporate earnings, and therefore has an interest in having the corporation maintain an earning power sufficient to assure the satis-

sion does not seek, as does the new provision, to convert the preferred's liquidation claim into a debt, and thereby to insulate the preferred from the risk that the accounting valuations used in determining the dividend fund would seriously overstate actual worth.[397] Such a gross overstatement, assuming a reasonable amount of stated capital for both the preferred and common shares, would most likely occur in a precipitous decline in the value of the corporation's fixed assets.[398] The New Act then might prevent dividends *even to the preferred* despite the presence of a substantial earned surplus and sufficient current profits to support the dividend and despite the lack of any threat to creditors. It is not clear why the preferred, at least, should not be entitled to a dividend in the circumstances.[399] Thus, it would seem that the new provisions relating to earned surplus should be modified to conform to the North Carolina provision.[400]

As the following section will demonstrate, the liquidation preference protection clause appearing in the New Act's regulation of distributions

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faction of this claim. As a claimant to assets, the preferred shareholder is entitled to at least parity with the common in the final distribution of capital; an asset preference entitles him to satisfaction of his claim prior to any distribution to the common shareholders. He is consequently interested in the prospective ability of the corporation to meet this claim in case of complete liquidation.

[397] The North Carolina provision does contain, as was suggested for the New Act at text accompanying note 398 *supra*, a provision prohibiting dividends when the corporation was insolvent in the bankruptcy sense. See N.C. GEN. STAT. § 55-50(c)(2) (1965).

[398] This statement obviously begs the question of how generally accepted accounting principles deal with substantial unrealized depreciation in values, which is discussed at text accompanying note 481 *infra*.

A second possible example would be a situation involving grossly watered stock. For a discussion of this specific problem, see text accompanying note 543 *infra*.

[399] The new test might be explicable if only dividends to junior classes of shares were prohibited while the actual value of the assets was not equal to the liquidation preferences of the shares entitled to such preferences. (Compare the operation of WASH. REV. CODE § 23A.08.430 ¶ 2 (1965), regarding dividends on cumulative preferred shares from capital surplus where no earned surplus exists.) But even if the new provision had been so limited, it is still not clear why dividends to common shareholders should depend on meeting the more stringent test of actual value.

[400] It is arguable that net assets (valued under generally accepted accounting principles) equal to the preferred shares' liquidation preference should be maintained in the corporation and that until the preference aggregate is met, no dividends should be paid to any class. The North Carolina rule, in contrast, would permit dividends to be paid to preference shares down to a point where net assets were zero (assuming the bankruptcy insolvency test was then met). The choice between these two rules turns in part on the need to maintain in the corporation assets equal to the liquidation preference in order that the corporation's earning power will be at least equal to the preferred's dividend claim. However, there is the countervailing consideration of continuing the preferred dividend as long as possible so that arrearages do not arise. Since under the North Carolina rule no dividends can be paid in the junior class until the preference deficit is made up, and in view of the rather shaky position of preferred arrearages generally, see, *e.g.*, Gibson, *How Fixed Are Class Shareholder Rights?*, 23 LAW & CONTEMP. PROB. 283, 286-92 (1950), the North Carolina provision appears the better of the two.

from capital surplus should also be amended to conform to the North Carolina provision.

(3) Distribution of Cash From Surplus Arising From Capital Contributions in Excess of Legal Mimima.[401] The old act apparently permitted free use of excess capital contributions—paid-in surplus—for cash dividends,[402] irrespective of the class of shares making the contribution, the class of shares receiving the distribution,[403] the existence of sufficient earned surplus to cover the distribution,[404] and the possibility that shareholders might be misled as to the corporation's profitability by a seemingly regular distribution.[405] The New Act deals with

[401] On the possibility of cash dividends from capital surplus arising from the reduction of capital, see text discussion *infra* part III under the heading "Reductions of Capital."

It may be helpful in evaluating the following analysis to note that according to Accounting Trends & Techniques, published by the AICPA, none of the 600 corporations surveyed paid a dividend out of capital surplus in 1963 or 1964. See AICPA, ACCOUNTING TRENDS & TECHNIQUES 223 (18th ed. 1964); *id* at 249 (19th ed. 1965).

[402] See Greenough & Ayer, *Funds Available For Corporate Dividends in Washington,* 9 WASH. L. REV. 63, 70 (1934); Weiner, *The Amount Available For Dividends Where No-Par Shares Have Been Issued,* 29 COLUM. L. REV. 905, 916 (1929).

[403] Some of the most complex questions relating to permissible uses of excess capital contributions arise in corporations with two classes of stock. See text *infra* beginning at note 415; Note, *Dividends From Contributed Capital and Protection of Preferred Shareholders,* 65 HARV. L. REV. 1203, 1204 (1952); Note, *Declaration of Dividends From Paid-In Surplus,* 31 COLUM. L. REV. 844, 848-49 (1931). Although no cases appear to have considered the question, preferred shareholders, in the absence of protective statutory or contractual provisions, may be able to urge either a requirement of general fairness, see Note, 65 HARV. L. REV. 1203, 1211 & n.65 (1952), or a duty on the part of common, majority shareholders to the preferred minority. See Zahn v. Transamerica, 162 F.2d 36 (3d Cir. 1947); Berle, *Corporate Powers as Powers in Trust,* 44 HARV. L. REV. 1049, 1060-63 (1931). *Cf.* Associated Gas & Elec. Corp., 6 S.E.C. 605, 619 (1940).

The old provision was modelled in Ohio Sess. Laws 1931, vol. 114, § 8623-38. See Commissioner's Note in 9 U.L.A. 170 (1957). That provision, interestingly enough, provided that "no dividend shall be paid to the holders of any class ... in violation of the rights of ... any other class...." Ohio Sess. Laws 1931, vol. 114, at § 8623-38(f). Compare the language in WASH. REV. CODE § 23.01.250(7) (1958), relating to dividends by wasting asset corporations, discussed in text *infra* part III under the heading "Dividends by Wasting Asset Corporations."

[404] Although the old act contains no express limitation upon charging dividends to paid in surplus when earned surplus exists, such limitation is generally recognized by the accounting authorities. See *e.g.,* BLOUGH, PRACTICAL APPLICATIONS OF ACCOUNTING STANDARDS 338 (1957); KOHLER, AUDITING 496 (2d ed. 1954); RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 16.30—16.32 (2d ed. 1963); Katz, *Accounting Problems in Corporate Distributions,* 89 U. PA. L. REV. 764, 766-67 (1941). Hence, because of the incorporation of generally accepted accounting principles as interpretive devices, see text accompanying note 364 *supra,* it may have been arguable that earned surplus had to be exhausted before paid-in surplus could be used.

[405] See, *e.g.,* BAKER & CARY, CASES ON CORPORATIONS 1297 (3d unabr. ed. 1958).

It is again interesting to note that Ohio Sess. Laws 1931, vol. 114, § 8623-38 (d), required that notice be given to shareholders if dividends were paid from other than earned surplus. The Louisiana statute, also modelled on the Uniform Act, added such a notice provision to the Act. See LA. REV. STAT. § 12:26 (1950).

In connection with the recent amendment of the New York Business Corporation Law, the report of the bar associations of the City and State of New York urged

some of these problems in its extensive provisions regulating capital surplus distributions. Directors may now make distributions from excess contributions only to shares having a cumulative preferential right to receive dividends, and then only if the corporation's earned surplus is exhausted.[406] Apart from this limited situation, distributions can be made from excess contributions only if authorized by the articles or by an affirmative vote of the holders of a majority of the outstanding shares of each class, whether or not such shares can otherwise vote.[407] In addition, such distributions can be made only when all cumulative dividends accrued on preferred shares have been fully paid, and the net assets remaining at least equal the aggregate preferential amount payable to the holders of preferred shares in the event of voluntary liquidation.[408] All distributions from excess contributions must be identified as distributions from capital surplus.[409]

The policy questions inherent in the changes wrought by the New Act's provisions can perhaps be best analyzed by comparing them with the statutory system suggested by Hills in his *Model Corporation Act*.[410] Under Hills' statute, if the corporation had only one class of stock, cash dividends could be paid out of paid-in surplus only if the corporation had no earned surplus. If the corporation had a class of shares entitled to preferential dividends outstanding, dividends from paid-in surplus could be paid only on those shares. Shareholders were

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that the disclosure requirement was not of sufficient importance to justify adding the notice requirement. It argued that large corporations are protected by the S.E.C. rules and that the advantages for small corporations were illusory. See N.Y. STATE BAR ASS'N, COMMITTEE ON CORP. LAW & ASS'N OF THE BAR OF THE CITY OF NEW YORK, COMMITTEE ON CORP. LAW, JOINT REPORT ON PROPOSED NEW YORK BUS. CORP. LAW 13-14 (1961). The statute finally enacted not only contained the notice requirement, N.Y. BUS. CORP. LAW § 510(a)(2), but also provides that failure of a corporation to comply in good faith with the requirement will make the corporation liable to any shareholder under ordinary tort liability for any damage sustained. See N.Y. BUS. CORP. LAW § 520.

As the preceding section makes clear, the old act also did not limit paid-in surplus distributions where the liquidation preference of the preferred would be endangered.

[406] WASH. REV. CODE § 23A.08.430 ¶ 2 (1965).

[407] This language seems to impose a requirement that a majority of the preferred *as a class* must approve the distributions from capital surplus. Compare, however, the language establishing the class voting requirement in WASH. REV. CODE § 23A.16.030 (1965) (dealing with prejudicial article amendments), and WASH. REV. CODE § 23A.20.030 (1965) (dealing with certain mergers or consolidations). It seems clear that in order for the provision to have any significance in view of relative preferred-common voting power, a class vote must be required; hence, the New Act should be amended to provide such a vote clearly.

[408] WASH. REV. CODE § 23A.08.430(2), (3), (4) (1965).

[409] WASH. REV. CODE § 23A.08.430(5), ¶ 2 (1965). All distributions from capital surplus, as previously noted, see text accompanying note 374 *supra*, are subject to the insolvency test.

[410] See Hills, *Model Corporation Act*, 48 HARV. L. REV. 1334 (1935).

to receive notice whenever a dividend came from a source other than earned surplus.[411]

Where a corporation has only one class of stock outstanding, the alternatives thus range from completely free distribution under the old act, to Hills' intermediate position of free distribution after exhaustion of earned surplus but with notice to the shareholders, and finally to the new provisions permitting distribution with notice if authorized by article provision or majority vote of the shareholders. Creditors presumably would prefer that assets equivalent to the paid-in surplus remain in the corporation to supplement their "cushion" of stated capital. Shareholders probably desire to be informed in a meaningful way that a distribution is a return of their contribution to the corporation rather than a portion of the corporation's profits. In addition, there may well be occasions when the paid-in surplus has been contributed by one group of shareholders who may prefer to have that contribution remain in the corporation rather than distributed in part to shareholders who did not contribute it.[412] It would appear that the best accommodation of the conflicting interests involved can be made by altering two provisions in the New Act: (1) deleting as a potential source of abuse the authorization of capital surplus distributions by article provision,[413] and (2) adding the Hills' earned surplus exhaustion provision.[414] The act as so altered would protect the creditors'

[411] *Id.* at 1364. Compare CAL. CORP. CODE § 1500(c) (same but with no earned surplus exhaustion clause); N.C. GEN. STAT. § 55-50(a)(3) (1965) (no distributions in one-class case except by partial liquidation; no distributions of capital surplus to any preference class junior to the contributor); ILL. ANN. STAT. ch. 32, § 157.41(b) (1954) (same but with no earned surplus exhaustion clause). *But see* ILL. ANN. STAT. ch. 32, § 157.41a (1954) (relating to dividends in partial liquidation); MICH. STAT. ANN. § 21.22 (1963) (same but with no exhaustion clause); MINN. STAT. ANN. § 301.22 subd. 2(2) (1959) (same but with no earned surplus exhaustion clause); OKLA. STAT. ANN. tit. 18, § 1.132(a)(2) (1953) (no distributions in one-class case except by reduction of capital; no earned surplus exhaustion clause).

[412] See Note, 31 COLUM. L. REV. 844, 846-49 (1931); Greenough & Ayer, *Funds Available For Corporate Dividends in Washington*, 9 WASH. L. REV. 63, 73 (1934).

[413] The New Act article provision would permit promoters to insert a general distribution clause in the articles at a time when no outside shareholders existed, which clause could later be used to the outside shareholders' disadvantage.

Zeff, *Legal Dividend Sources—A National Survey and Critique, (II)*, 31 N.Y. C.P.A. 802, 805 (1961), suggests that only "relatively large proposed distributions" of paid-in surplus should require a shareholder vote. While there may be something to the point that small distributions of paid-in surplus may, because of the shareholder vote, not be worth the trouble they can cause, a legal standard for *de minimis* distributions would be virtually impossible to define. Moreover, the need for such small distributions is not clear.

[414] It can be argued that the New Act has an implied earned surplus exhaustion clause because of the incorporation of accounting principles as an interpretive guide and the accountants' general position toward earned surplus exhaustion as a prerequisite to dividends from paid-in surplus. See note 404 *supra*. However, WASH. REV. CODE § 23A.08.430 (1965) makes specific reference to exhaustion of earned

interest both by the exhaustion provision and by the need for shareholder approval in every distribution. And the act would then offer shareholders maximum notice of the distribution, along with a chance to approve it.[415]

For two-class situations, the alternatives range from completely free distribution under the old act, to the New Act's intermediate position of free distribution limited to shares with cumulative preferential dividend rights, when earned surplus has been exhausted, and distribution otherwise with notice, if authorized by article provision or majority class vote, provided that there are no preferred dividend arrearages, and finally to the Hills' position that no dividends be paid unless earned surplus is exhausted and then only to preferred shares. The creditors' interest would appear to be the same as in the one-class case. Preferred shareholders have an interest in seeing that distributions from paid-in surplus are not made to common shareholders, regardless of whether the surplus was contributed by the preferred or common shareholders. If the paid-in surplus arose from preferred shares, a distribution to the common shareholders obviously defeats preferred's expectation that its investment would be used permanently in the enterprise. Even if the common shareholders contributed the paid-in surplus, however, the distribution would reduce the cushion of common-share capital otherwise available to the preferred, which the preferred may have relied upon to protect its asset preference or to assure its earnings claim.[416] The interests of the common shareholders appear to be about the same as in the one-class case. The best accommodation among the conflicting interests again appears to require making three alterations in the New Act's provisions: (1) adding Hills'

surplus as a prerequisite to one type of dividend from capital surplus, those payable by director action only on cumulative preferred stock. See WASH. REV. CODE § 23A.08.430 ¶ 2 (1965). It thus seems reasonably clear that exhaustion was not desired as a general requirement to the other distribution possibilities under that section.

[415] Shareholders under the New Act as revised would then receive notification of their need to vote on the issue and the source of the distribution when made. It seems clear that notices should do more than simply state that the distribution is proposed or is from paid-in surplus. It should be clear that the funds being returned represent shareholder contributions, not earnings. It should also contain reasons for the distribution. See Zeff, *Legal Dividend Sources—A National Survey and Critique (II)*, 31 N.Y. C.P.A. 802, 805 (1961).

[416] See BAKER & CARY, CASES ON CORPORATIONS 1297 (3d unabr. ed. 1958); Note, *Dividends From Contributed Capital and Protection of Preferred Shareholders*, 65 HARV. L. REV. 1203, 1204-05 (1952); Note, *Declaration of Dividends From Paid-In Surplus*, 31 COLUM. L. REV. 844, 848-49 (1931). As the Note, 65 HARV. L. REV. 1203, 1205 (1952), points out, the advantages of the common vis-à-vis the preferred accentuate the unfairness of a distribution of paid-in surplus from common shares to the common shareholders. The common, despite its reduced investment, would still be in control of the enterprise and would still be entitled to all appreciation on the assets over the asset preference of the preferred.

earned surplus exhaustion provision;[417] (2) providing that in no event shall surplus paid in by any class of shares be used for the payment of dividends on any class junior thereto;[418] and (3) providing that dividends and other charges to paid-in surplus shall be applied to surplus paid in by junior classes of shares first, and only after exhaustion of such surplus, to surplus paid in by preference shares.[419] The act so altered would protect the creditors' interest with the earned surplus exhaustion provision, the requirement that paid-in surplus be used basically for preferred dividends, and the requirement that shareholders approve other distributions from paid-in surplus. The act would then seem to offer preferred shares reasonable protection of their strongest interest in paid-in surplus—their own contribution—while allowing distribution of paid-in surplus contributed by common shares, if preferred dividends are current and a majority of the preferred shares agree to the distribution. This limited flexibility with respect to common dividends from paid-in surplus seems a better accommodation of preferred and common interests than the absolute prohibition proposed by Hills.[420]

Although the policy considerations discussed above relate to excess

[417] The principal purpose for the earned surplus exhaustion clause in the two-class case is to prevent payment of the preferred dividend from paid-in surplus with a later payment of the common dividend from earned surplus, or in other words, common dividends from paid-in surplus. See BAKER & CARY, CASES ON CORPORATIONS 1301 (3d unabr. ed. 1958); Note, 65 HARV. L. REV. 1203, 1209 (1952).

[418] *Cf.* N.C. GEN. STAT. § 55-50(a)(3) (1965).

It may be argued that the present New Act provisions provide sufficient protection to the preferred by means of the class vote requirement. See note 407 *supra*. Unfortunately, however, in many circumstances the class vote does not adequately protect the preferred, see, *e.g.*, Note, 65 HARV. L. REV. 1203, 1213 (1952); hence the provision in text is proposed.

[419] It may be argued that this proposal imposes a severe bookkeeping burden on corporations. But, as Hackney, *The Financial Provisions of The Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1367 (1957), points out, adoption of the New (Model) Act provisions generally may cause corporations to go back to the date of incorporation and analyze subsequent transactions with a view to segregating capital from earned surplus. Since this process is required in any event, the additional requirements of segregating paid-in surplus by source and charging reductions to appropriate source accounts does not seem overly severe in view of the gains produced thereby.

[420] The New Act as revised would seem to produce results in one-class situations that are in accord with the accountants' views toward dividends from paid-in surplus. See, *e.g.*, MILROY & WALDEN, ACCOUNTING THEORY & PRACTICE—INTERMEDIATE 538 (1960) (equating paid-in surplus with stated capital and requiring distributions therefrom to be labelled liquidating dividends); LENHART & DEFLIESE, MONTGOMERY'S AUDITING 407 (8th ed. 1957) ("the incongruity of contributing to the capital of a corporation and then receiving part of it back in the guise of ordinary dividends should be sufficiently evident to encourage making the practice legally impossible"); MAURIELLO, INTERMEDIATE ACCOUNTING 483 (1950) ("the board of directors have [sic] a moral obligation to conserve paid-in surplus by not declaring dividends therefrom.").

The accounting authorities apparently have not considered the problems in two-class corporations.

capital contributions[421] rather than to other types of capital surplus,[422] most of the statutes dealing with the problem have applied the protective provisions to the entire capital surplus.[423] This extension seems warranted, particularly in view of the fact that capital surplus, as we shall see shortly, includes unrealized appreciation.

(4) Declaration of Dividends Out of Surplus Resulting From Declarant's Acquisition for Shares of All or Substantially All of Another Corporation's Assets.[424] In combination transactions under the old act, the assets acquired apparently would be recorded at their "fair valuation,"[425] with a credit to the capital stock account for the par or stated

[421] Most commentators limit the analysis stated above to capital surplus arising on the original issue of shares and offer different analysis where the capital surplus arises from share sales after the corporation has an accumulated earned surplus, from share issuances in connection with a merger or consolidation, or from a reduction of capital. See, *e.g.*, Greenough & Ayer, *Funds Available for Corporate Dividends in Washington*, 9 WASH. L. REV. 63, 70-73 (1934); Note, *Declaration of Dividends From Paid-In Surplus*, 31 COLUM. L. REV. 844, 846 (1931). For discussion of the latter two types of capital surplus, see text accompanying note 424 *infra*, and part III under the heading "Reductions of Capital."

The argument for different treatment of the second type of excess share contribution—equalization surplus—is that a shareholder buying shares from a corporation with accumulated earned surplus intends to equalize his share of the surplus accumulated prior to his entry for the benefit of others. See Equitable Life Assur. Soc. v. Union Pac. Ry. Co., 212 N.Y. 360, 106 N.E. 91 (1914); Berle, *Corporate Devices for Diluting Stock Participations*, 31 COLUM. L. REV. 1239, 1247 (1931); Greenough & Ayer, *supra* at 70; Mason, *Profits and Surplus Available for Dividends*, 9 ACCOUNTING REV. 61, 65-66 (1932); Note, 31 COLUM. L. REV. 844, 850 (1931). It is not clear that any shareholder purchasing from an existing corporation has any specific intention to have part of his investment be returnable, see LATTIN & JENNINGS, CASES ON CORPORATIONS 1147 (3d ed. 1959), nor is it clear how the equalizing amount is to be determined. See BAKER & CARY, CASES ON CORPORATIONS 1238 (3d unabr. ed. 1958). Moreover, no American statute presently provides exceptional treatment for such surplus. See 1 MODEL ACT ANN. § 41 ¶ 2; BAKER & CARY, *op. cit. supra* at 1257. Hence, it seems appropriate that the New Act provisions not attempt to deal with the subject.

[422] Examples of the types of transactions that may give rise to non-excess-share-contribution-capital surplus are donations to the corporation, transactions in treasury shares, and revaluation of the corporation's assets. On the problem of distributions from revaluation surplus, see text accompanying note 454 *infra*. On gains from treasury shares, see text *infra* part III under the heading "Share Redemptions and Purchases."

[423] See, *e.g.*, Model Act § 41; N.C. GEN. STAT. § 55-50(a)(3) (1965); Hills, *Model Corporation Act*, 48 HARV. L. REV. 1334, 1364 (1935).

[424] This category of transactions is intended to include acquisitions for shares of substantially all of the shares of another corporation, followed by immediate liquidation of the newly-acquired subsidiary. For a discussion of the problems relating to share acquisitions where the subsidiary is not liquidated, see text accompanying note 514 *infra*.

[425] See WASH. REV. CODE § 23.01.150(3) & (4) (1958); and the draftsmen's comments to WASH. REV. CODE § 23.01.170 (1958), appearing in 9 U.L.A. 161 (1957). Consistent with accounting practices of recording purchases at cost, and the general desire to avoid difficult valuation questions, if the shares issued have a fair market value, that value in all likelihood will be treated as the value of the assets received. See HERWITZ, BUSINESS PLANNING 782 (1966) One situation where the share value might not be used is where the proposed issue is so large in relation to the amount of stock already outstanding that the latter's quoted price would no longer be significant, in which event the fair market value of the assets would be used. *Id.* at 784-85.

value of the shares issued and a balancing credit to paid-in surplus.[426] The New Act[427] gives the board of directors of the acquiring corporation the choice of recording the combination transaction as under the old act[428] or by carrying forward the acquired corporation's asset values[429] and its earned surplus, to the extent that such surplus is not allocated to the stated capital of the acquiring corporation in connection with the shares issued in the combination transaction.[430] The significance of the New Act's changes can best be understood against a background of current accounting principles relating to combination transactions.

The accountants' current official position, *Accounting Research Bulletin No. 48,* distinguishes between a purchase, in which an important part of the ownership interests in the acquired corporation is eliminated, or in which other factors requisite to a pooling of interests are not present, and a pooling of interests, in which the holders of substantially all of the ownership interests in the constituent corporations

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[426] See WASH. REV. CODE §§ 23.01.010(10)(a) & (b), 240(1) & (2) (1958); part I, 41 WASH. L. REV. 207, 253-54.

The Ohio statute upon which the old dividend provision was modelled gave merging or consolidation corporations the option of carrying over the acquired corporation's earned surplus. See Ohio Sess. Laws 1931, vol. 114, §§ 8623-38(e).

[427] See WASH. REV. CODE §§ 23A.04.010(12), 23A.08.170 ¶ 2 (1965).

[428] This result would obtain under WASH. REV. CODE §§ 23A.08.150, .160, .170 ¶¶ 1 & 2 (1965), apart from the overriding effect of § 23A. See Gibson, *Surplus, So What?* 17 BUS. LAW. 476, 477-80 (1962).

[429] The New Act contains no provision to this effect. However, the Model Act predecessor provision to WASH. REV. CODE § 23A.08.170 ¶ 3 (1965) was amended in 1962 specifically for the purpose of authorizing poolings-of-interests, see Gibson, *supra* note 428, at 480-83, in which carryover of asset values is a key element. See text accompanying note 435 *infra.* Hence, it seems reasonably clear that carryovers of asset values are now permitted.

It should not be concluded that the value of the acquired corporation's assets can be ignored entirely in a pooling-of-interests case. The fair value would still be relevant in determining the adequacy of the consideration for the shares being issued. See HERWITZ, BUSINESS PLANNING 782-836 (1966); Hackney, *Accounting Principles in Corporation Law,* 30 LAW & CONTEMP. PROB. 791, 816-17 & n.73 (1965).

[430] Although this result, a part of the pooling-of-interest concept, was presumably intended under the New Act, see Gibson, *supra* note 428, at 480-83, it is doubtful that the language in WASH. REV. CODE § 23A.08.170 ¶ 3 (1965) accomplishes this intention. WASH. REV. CODE § 23A.08.070 ¶ 3 (1965) refers to amounts of surplus "that would otherwise constitute capital surplus under the foregoing provisions of this section." As Hackney, *Accounting Principles in Corporation Law,* 30 LAW & CONTEMP. PROB. 791, 817 n.74 (1965), points out, this language seems to assume that the total credit to surplus will be the same regardless of whether purchase or pooling accounting is used and that the only issue is which surplus account should be credited. In fact, of course, the total surplus credit can vary greatly between the two types of accounting because of the difference in asset values recorded, see Hackney, *Financial Accounting For Parents and Subsidiaries—A New Approach to Consolidated Statements,* 25 U. PITT. L. REV. 9, 14 (1963), and there could well be occasions when the surplus credit under purchase accounting, because of asset value decline, might be insufficient to permit the carryover of earned surplus. Hence, it would seem that a more direct approach to the earned surplus carryover is necessary. See in this connection PA. STAT. ANN. tit. 15, § 2852-704F (1959).

become owners of the continuing corporation.[431] When a combination is designated a purchase, it is recorded in the same manner as a combination transaction under the old act.[432] If, however, the combination is designated a pooling of interests, it is recorded in the same manner as a combination transaction may now be recorded under the New Act's second option.[433] The decision whether a combination is to be treated as a purchase depends, not upon the designation of the transaction according to its legal form, but rather upon the existence of continuity of ownership interests, business and management, and upon the relative dominance of any of the constituent corporations. No one of these factors is to be determinative, and the decision is to be made in view of all attendant circumstances.[434]

The New Act's provisions were added to the Model Act source provision in 1962 in an attempt to accommodate the Model Act to accountants' procedures under *Accounting Research Bulletin No. 48*.[435] The draftsmen could find "no compelling reason of public policy or business necessity for not providing that in all transactions of merger or consolidation or acquisition of assets, or even in a mere acquisition of control, the earned surplus of both participating corporations may properly be considered as earned surplus, rather than capital surplus, of the resulting enterprise."[436] They recognized that their statute went

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[431] AICPA RESEARCH BULL. No. 48, ¶¶ 1-4 (1957).

[432] *Id.* at ¶ 8.

[433] *Id.* at ¶ 9. The bulletin does permit adjustments where the acquired corporation's assets are not recorded in accord with generally accepted accounting principles or where necessary to convert its assets to a uniform accounting basis. *Ibid.*

[434] *Id.* at ¶¶ 2, 5-7.

[435] See Gibson, *Surplus, So What?*, 17 BUS. LAW. 476, 480-83 (1962).

The Model Act prior to the 1962 amendment had provided that in the event of a merger or consolidation, the net surplus of the merging or consolidating corporations which was available for payment of dividends immediately prior to the merger or consolidation, to the extent not transferred to stated capital or capital surplus, would continue to be available for dividends. See Model Act § 69(g) appearing in 2 MODEL ACT ANN. This provision was criticized for its general lack of adherence to the accounting pooling concept, see Baker, *Dividends of Combined Corporations: Some Problems With Accounting Research Bulletin No. 48*, 72 HARV. L. REV. 494, 500-01 (1959); Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1377 (1957), and imprecision in its terms. See letter addressed to the Committee on Corporate Laws of the American Bar Association, quoted in HERWITZ, BUSINESS PLANNING 797-99 (1966). The act was amended in reaction to these criticisms. See Gibson, *supra* at 481.

Of the Model Act jurisdiction, see part I, 41 WASH. L. REV. 207, 208 n.4, only Arkansas, ARK. STAT. ANN. § 64-102(k) (1966), South Dakota, S.D. Sess. Laws 1965, ch. 22, § 19, Virginia, VA. CODE ANN. § 13.1-2(i) (1964), and Wisconsin, WIS. STAT. ANN. § 180.02(11) (1957), have adopted substantially the Model Act amendment. South Carolina, S.C. CODE ANN. § 12-15.22 (1962), has adopted a provision achieving the effect of the Pennsylvania statute. See note 430 *supra*.

[436] See Gibson, *supra* note 428, at 482, stating that this was the judgment of the Committee on Corporate Laws.

beyond the accountants' practices, but felt that "room for further learning by accountants should be left."[437] The obvious question raised by the new provisions relates to their wisdom.

Initially, it should be recognized that the treatment to be afforded a combination transaction affects not only the amount of current surplus and its characterization, but also the amount of future earned surplus via the effect of the asset values upon future expense charges.[438] It may then be asked why corporations acquiring going businesses for cash or debentures are denied the carryover treatment. The answer suggested by *Accounting Research Bulletin No. 48* is that the shareholders of the *acquired* corporation have not maintained a sufficient interest in the acquiring corporation to warrant a carryover of attributes. However, the New Act's only requirement for a carryover of asset values and earned surplus is that *shares* be used in connection with a corporate combination. It apparently is immaterial that the shares do not vote, or are redeemable at an early date, that they represent a minuscule portion of the continuing corporation, or that the acquired corporation's business may be sold the day after the acquisition and the proceeds invested in a new enterprise. Yet in some of these cases, as in most of the excluded transactions involving debt, allowance of the carryover privilege would result in a windfall increase of earned surplus to the acquiring corporation's shareholders. Hence, it would seem that the New Act's provisions should be narrowed to focus upon combination transactions with sufficient continuity of interest for the shareholders of the acquired corporation.[439]

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[437] *Ibid.*

[438] For example, assume that corporation *A* acquires all the assets of corporation *B*, subject to *B's* liabilities, for 100,000 shares of $1 par value common stock whose market value is $10 per share. Assume that *B's* net book value is $500,000 and that *B* has $200,000 in its earned surplus account. If the combination is recorded as a pooling-of-interests, *A* records the net assets acquired at $500,000, and credits capital stock $100,000, capital surplus $200,000 and earned surplus $200,000. Maximum charges against *A's* revenues from *B's* assets would amount to only $500,000 over the life of the assets. If the combination is recorded as a purchase, *A* would record the net assets acquired at $1,000,000, would credit capital stock $100,000, and would credit capital surplus $900,000. Maximum charges against *A's* revenues from *B's* assets would now amount to $1,000,000, which serve to reduce future earnings below the amounts possible under a pooling-of-interests approach. Of course, to the extent that capital surplus is available for distribution, it may be said that purchase accounting may provide greater immediate dividend paying capacity than does pooling-of-interests accounting.

[439] There is some evidence that the accountants may tighten their continuity of interest requirements. See, *e.g.*, the report of Robert C. Holsen appearing in WYATT, *A Critical Study of Accounting for Business Combinations*, ACCOUNTING RESEARCH STUDY No. 5, at 111-14 (1963), wherein the author discusses the continuity requirement in connection with combinations involving cash and common shares, common and preferred shares, preferred shares alone, and treasury shares of the acquiring corporation. A fair similarity exists between Holsen's view of the continuity re-

It may be useful in deciding what degree of continuity should be required to consider the draftsmen's comment that the changes in the Model Act source provision were supported by the significance of earned surplus to the investment community.[440] But how significant is a carryover of *past* earnings to the investment community? The prime consideration of most advisers concerned with financial statements has been the estimated trend of future earnings,[441] and here the second aspect of pooling-of-interests, the carryover of asset values, is crucial. One of the reasons that managements have so readily accepted the pooling-of-interests approach is that in most cases the carryover of the acquired corporation's asset values will produce higher future earnings than if the assets are restated in terms of current values.[442] It would seem, however, that far more accurate projections of the rate of future earnings returns could be made if the acquired corporation's assets were restated in terms of current value.[443] This argument suggests that purchase accounting should be followed in every case where the combination transaction involves independent parties and that pooling-of-interest accounting should be used only where the combination involves corporations previously under common control.[444]

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quirement and that required for qualification of the transaction as a reorganization under the Internal Revenue Code of 1954. Compare the continuity discussion in Sapienza, *Tax Considerations In Corporate Reorganizations and Mergers,* 60 NW. U.L. REV. 765, 780-82 (1966). While this similarity may seem to offer support for Holsen's view regarding poolings, it should be remembered that the purpose of the tax rules, determining whether the transactions should be the subject of tax, is quite different from the accounting purpose, presenting the transaction in the most meaningful way.

It may be argued that if all that is required is a narrowing of the continuity rules, the New Act provisions are appropriate since management or the accountants need not utilize the full statutory grant. The difficulty with this position, however, is that a broad statute encourages a broad view of poolings. More importantly, if there are reasonable grounds for a narrower legal view of poolings, there seems to be no reason why the statute should not attempt to state guidelines rather than leaving it to the accountants' discretion.

[440] See Gibson, *Surplus, So What?,* 17 BUS. LAW. 476, 482 (1962).

[441] See, *e.g.,* GRAHAM, DODD, & COTTLE, SECURITY ANALYSIS 551-62 (4th ed. 1962).

[442] Kripke, *A Good Look at Goodwill in Corporate Acquisitions,* 78 BANKING L.J. 1028, 1037 (1961); WYATT, *op. cit. supra* note 439, at 58.

[443] See May, *Business Combinations: An Alternate View,* J. Accountancy, April 1957, p. 33, 35. It may be argued that the same logic requires the acquiring corporation's assets be restated in terms of current values. See HERWITZ, BUSINESS PLANNING 786 (1966). This portion of the argument involves us generally in the controversy over price level adjustments in connection with dividend capacity determinations. See text discussion beginning *infra* at 493.

[444] This is basically the position of WYATT, *op. cit. supra* note 439, at 105-06. It should be noted that the project advisory committee of the Accounting Principles Board reviewing Professor Wyatt's study felt that it was "not realistic" and that a distinction between purchases and poolings should be made on the existence of an exchange of equity shares. See *id.* at xii-xiii. Precisely what is wrong with the Wyatt suggestion from an accounting standpoint is not made clear apart from the fact that "the study seems to favor a discontinuance of almost all poolings of interests." *Id.* at xiii.

Basically similar results will obtain from an analysis of the degree of continuity to be required. The central notion of a pooling of interests is that no change of any substance has occurred by combining the assets, businesses, management, and ownership interests of the constituent corporations.[445] It would seem that relatively few combinations occur in which the changes in each of these criteria are not substantial.[446] For example, even where two corporations of approximately equal size and value combine in such a way that each shareholder's interst is preserved, the combined enterprise is twice as large and may have entirely different profit potential, product line, and management problems than either of the constituent corporations. Applying the pooling-of-interests notion, admittedly with some rigor, will produce similar results to those suggested in the analysis above of the investment community interest.[447]

This analysis suggests that the approach of the old act was more appropriate than that proposed in the New Act. However, two problems with purchase accounting should be dealt with if the old statute is to be truly effective. The first concerns the ticklish problem of dealing with a possible excess of the value of the acquiring corporation's stock over the value of the acquired corporation's tangible and intangible assets—in short, the item of purchased goodwill. Under generally accepted accounting principles, goodwill should be amortized if it appears to have a limited life;[448] but accounting practice appears to go even further, expunging goodwill by periodic charges to income even though there is no reason to assume limited life.[449] Although

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[445] See AICPA RESEARCH BULL. No. 48, ¶¶ 5-7 (1957); WYATT, *op. cit. supra* note 439, at 72.

[446] HERWITZ, BUSINESS PLANNING 782 (1966), presents as a pooling situation a combination of two real estate corporations each owning one building, where the buildings have equal value and each corporation's shareholders get one-half of the stock. Although this is a strong case for pooling, suppose one corporation's assets have a very low book value and that the corporations' earned surpluses vary significantly. It would then seem that what should be undertaken is what Wyatt refers to as a "fair value pooling," *i.e.*, both buildings should be recorded at current fair market values and the corporation, as a new entity, should have no earned surplus. See WYATT, *op. cit. supra* note 439, at 81-86.

[447] WYATT, *op. cit. supra* note 439, at 61 notes an increasing liberality in the interpretation placed by accountants upon the pooling-of-interests criteria. See also *id.* at 27; Sapienza, *Distinguishing Between Purchase and Pooling*, 111 J. Accountancy, June 1961, p. 35, 40, where the author states that relative size and continuity of management are not helpful in distinguishing between purchase and pooling but that avoidance of goodwill may be a major factor in the decision.

[448] See AICPA RESEARCH BULL. No. 43, ch. 5, ¶¶ 6-7 (1953). Where the corporation is uncertain whether the goodwill will have a life as long as the enterprise, it may amortize it by systematic charges to income despite the absence of present indications of limited existence or loss of value. *Id.* at ¶ 7.

[449] See Kripke, *supra* note 442, at 1033 and n.12.

there is no reason to quarrel with the amortization procedure, it may well be asked whether the initial existence of the goodwill has been demonstrated simply because of the excess of share value over the acquired corporation's current asset values. Kripke has argued convincingly[450] that the appropriate "cost" of the acquired corporation is the greater of the current value of its assets or the acquiring corporation's book value per share rather than the market value of the acquiring corporation's shares. Since acceptance of this suggestion would eliminate at least part of the management's objections to purchase accounting[451] and result in more useful cost data,[452] it should be considered as a possible change in the old procedure.

A second problem with the purchase-accounting technique is that it may influence the manner in which a combination is effected by making it expedient that the corporation with the smallest asset appreciation be the acquired corporation. It seems clear that accountants and the courts should ignore the formal manner of acquisition in favor of realistically determining which is the acquiring corporation.[453]

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[450] Kripke, *supra* note 442, at 1036-37 contends:

> When goodwill is created by a purchase of a company in the present climate of business acquisitions, there will seldom, if ever, be proof of the state of affairs contemplated by the advocates of amortization through income charges; namely, that the goodwill has a foreseeable limited life, or that it represents excess earning power for a definable temporary period. On the contrary, the price level out of which goodwill is created in current acquisitions seems to depend on reciprocal factors: (1) (a) optimistic expectations of rising, not falling, levels of earnings, and (b) recent use of higher multiples for capitalization of known and foreseeable earnings; and (2) a readiness to pay high prices based on the knowledge that the acquiring corporation's stock being issued in payment is a medium of exchange inflated by the same factors which inflate the value of the acquired company. If this analysis is correct, the arguments for amortizing the goodwill through the income account are without substance. The point is a fundamental one. The objection is not merely that it becomes necessary to pick a partially arbitrary method of amortization, for this is equally true of depreciation and other important charges. Rather, the point is that the amortization does not have any place in the income account, for there is no solid ground for treating the supposed exhaustion of goodwill as a cost of producing the revenues for the years in question.

Some accounting support for Kripke's position has already appeared. See report of Robert C. Holsen appearing in WYATT, *A Critical Study of Accounting For Business Combinations*, ACCOUNTING RESEARCH STUDY No. 5, at 113-14 (1963). See also WYATT, *op. cit. supra* note 439, at 91 where the author urges diminished emphasis upon the fair market value of shares in determining the cost of the acquired corporation's assets.

[451] See Kripke, *supra* note 442, at 1033-39; Sapienza, *supra* note 447; WYATT, *op. cit. supra* note 439, at 62-64.

[452] See quotation from Kripke, *supra* note 450.

[453] Ample legal precedent for such action should be provided by Farris v. Glen Alden Corp., 393 Pa. 427, 143 A.2d 25 (1958).

Two other problems with the purchase accounting solution should be mentioned. First, purchase accounting will in many situations produce results different from those dictated by the Internal Revenue Code, where the acquired corporation's basis is generally carried over to the acquiring corporation. See INT. REV. CODE OF

(5) Declaration of Dividends Out Of Surplus Arising From unrealized Appreciation. The old act expressly prohibited payment of cash or property dividends from unrealized appreciation relating to fixed assets[454] and cash dividends generally from the unaccrued portion of any unrealized profit on other assets.[455] The New Act contains no provision specifically dealing with unrealized appreciation; hence the issue must be resolved by construing the various definitions in the act in light of the purposes of dividend regulations.

George C. Seward, a member of the American Bar Association Committee on Corporate Laws responsible for drafting the source provisions of the Model Act, takes the position that earned surplus includes unrealized appreciation.[456] He argues that the term "net assets" refers

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1954, § 362(b). The extent of difficulty this problem engenders depends upon the general correlation between accounting data and tax data—probably not very high in any event—and the answer to the second problem, the effect of a legal prohibition of poolings of interest for dividend capacity determinations upon the use of the pooling of interest technique as an *accounting* device. While it is generally assumed that statutory requirements for purchase accounting make poolings impossible, see *e.g.*, Gibson, *supra* note 440, at 481, it is not clear that poolings could not be used for accounting statement purposes, barring the presence of a statutory provision keying accounting statements to the statutory requirements. Such conclusion, however, would mean that another set of books would be required to compute income and earned surplus for dividend purposes and that shareholders' reports would have to detail discrepancies between earnings per share and earnings per share eligible for dividends. Conceivably, if the potential confusion from dual reporting is great enough, the statute could be deemed controlling and poolings prohibited. However, because permitting accounting use of poolings would reduce the lack of correlation between accounting and tax data, it would seem that a court should be reluctant to find that the confusion was in fact great enough.

[454] WASH. REV. CODE § 23.01.250(4)(a) (1958).

[455] See WASH. REV. CODE § 23.01.250(5)(a)-(d) (1958). WASH. REV. CODE § 23.01.250(5)(c) (1958) qualifies the text statement by permitting notes, bonds, or obligations for the payment of money purchased or acquired at a discount to be taken at their actual market value if they are readily marketable. Greenough & Ayer, *Funds Available for Corporate Dividends in Washington*, 9 WASH. L. REV. 123, 135-36 (1934), term the exception in subsection 5(c) "indefensible" on the ground that there is little reason to separate notes or bonds from other types of assets for purposes of paying dividends from unrealized appreciation. Conceivably a court might avoid this problem by narrowly interpreting "acquired at a discount" to refer only to what is referred in the Internal Revenue Code as "original issue discount bonds." See INT. REV. CODE OF 1954, § 1232.

It is unclear why the statute permits property dividends to be paid out of surplus arising from unrealized appreciation on current assets unless the provision is intended to permit recognition of unrealized appreciation on a particular asset where that asset is to be distributed to the shareholders. See in this respect BAKER & CARY, CASES ON CORPORATIONS 1208-09 (3d unabr. ed. 1958). If this was the intent of the draftsmen, it is quite clear that the statute went much too far since under its broad language appreciation in inventory will support a dividend paid with the corporation's receivables.

[456] See Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act*, 38 VA. L. REV. 435, 440-43 (1952).

Ray Garrett, another member of the Committee, agrees with Seward's conclusion but feels that earned surplus arising from unrealized appreciation should be available only for share dividends. See Garrett, *Capital and Surplus Under the New Corporation Statutes*, 23 LAW & CONTEMP. PROB. 239, 259 (1958).

to current values and that as a result the only issue is whether appreciation in asset value gives rise to earned, rather than capital, surplus.[457] He urges that unrealized appreciation gives rise to earned surplus because: (1) accountants charge unrealized depreciation, when recognized, to earned surplus, and thus, consistency demands that unrealized appreciation accrue to the same source; (2) earned surplus is defined in the Model (and New) Act to include gains, which term ordinarily connotes appreciation in value; (3) unrealized appreciation, if credited to capital surplus, would cause peculiar accounting results upon the sale of the asset, since the gain realized on an unwritten-up asset would be earned surplus whereas a portion of the gain on a written-up asset might well be locked into capital surplus by the Model (and New) Act's rules relating to such surplus; and finally (4) the Illinois Business Corporation Act, source for most of the Model Act's provisions, specifically prohibited dividends from unrealized appreciation, but this provision was omitted in drafting the Model Act sections.[458]

It has been previously asserted that, contrary to the approach implied in Seward's arguments, the appropriate means for solving problems of interpreting accounting terms in the New (Model) Act is for the court to look first to the result suggested by generally accepted accounting principles and to accept that result if it is consonant with the basic policies underlying dividend regulation.[459] Although there may have been room for doubt as to the accountants' position at the

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[457] Seward, *supra* note 456, at 440. Gibson, the present vice-chairman of the ABA Committee on Corporate Laws, also takes the position that the current value of assets is to be used in determining the amount by which net assets exceed stated capital and hence in determining overall surplus. See Gibson, *Surplus, So What?*, 17 BUS. LAW. 476, 487 (1962).

[458] *Id.* at 440-43.

[459] See text accompanying note 364 *supra*.

Seward's strongest arguments relate to interpreting the accounting terms to permit recognition of unrealized appreciation as an element of surplus, and more particularly, earned surplus. His argument that consistency demands unrealized appreciation be recognized as earned surplus disregards the possibility that accountant's practices, as described by Seward, may be more consistent with a higher level objective (*e.g.*, creditor protection) than consistency in the account to be effected by the recording of unrealized appreciation or depreciation. The problem with treatment of sales if the asset was written-up perhaps can be solved by writing it down to cost immediately prior to its sale. If this maneuver is not appropriate under the New Act restrictions on transfers to and from capital surplus, then those rules should be changed—at least in the event that it is concluded that sound policy prohibits treatment of unrealized appreciation as earned surplus. With respect to the Illinois statute, it should be noted that that statute uses an impairment of capital test for dividend fund determination. ILL. REV. STAT. ch. 32, § 157.41(a) (1963). The New Act test involves the accountants' definition of earned surplus which may have been interpreted to exclude unrealized appreciation as a source by its very terms. The basic Illinois test is not quite as capable of this construction.

time Seward wrote,[460] the Accounting Principles Board of the American Institute of Certified Public Accountants recently opined that "property, plant and equipment should not be written up by an entity to reflect appraisal, market or current values which are above cost to the entity."[461] The Board also approved an earlier Institute rule to the effect that "unrealized profit should not be credited to income account of the corporation either directly or indirectly,"[462] which has been generally interpreted as applying to appreciation on goods held for sale in the ordinary course of business.[463] Under the test described

[460] The controversy concerned the possibility of unrealized appreciation relating to fixed assets appearing in the accounts, for the Institute's position with respect to recognition of unrealized appreciation on current items has been relatively constant since 1934. See AICPA RESEARCH BULL. No. 43, p. 11 (1961), stating the rule quoted at text accompanying note 462 *infra*. On the subject of unrealized appreciation of fixed assets, the Institute had taken the position in 1940 that "appreciation [of fixed assets] normally should not be reflected in the books of account of corporations." AICPA RESEARCH BULL. No. 5, ¶ 2 (1940). This admonition against reflecting unrealized appreciation was removed when *Research Bull. No. 5* became a part of *Research Bull. No. 43*. *Research Bull. No. 43* stated only that "historically, fixed assets have been accounted for on the basis of cost. However, fixed assets in the past have occasionally been written up to appraised values because of rapid rises in price levels." AICPA RESEARCH BULL. No. 43, ch. 9B. ¶ 1 (1961).

[461] STATUS OF ACCOUNTING RESEARCH BULLETINS, OPINIONS OF THE ACCOUNTING PRINCIPLES BOARD, OPINION No. 6 ¶ 17 (1965, effective as of December 31, 1965).

As to the current status of the Opinions of the Accounting Principles Board, see discussion in text accompanying note 569 *infra*.

The SEC, as a matter of policy, disapproves the writing-up of assets over their cost. See RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 3-9 (2d ed. 1963). Two blue-sky administrations have specific rules against recording unrealized appreciation. Bulletin No. 47, Tenn. Dep't of Ins. & Banking, BLUE SKY L. REP. ¶ 45,613; Okla. Sec. Comm'n Rule 63-12, BLUE SKY L. REP. ¶ 39,635.

[462] See generally ACCOUNTING PRINCIPLES BOARD, STATUS OF ACCOUNTING RESEARCH BULLETINS, OPINION No. 6, at ¶ 11 (1965) (effective as of December 31, 1965), which does not disapprove of the rule appearing in AICPA RESEARCH BULL. No. 43, p. 11 (1961).

[463] The rule goes on to recognize an exception for inventories in industries in which there is a trade custom, due to the impossibility of determining costs, to take inventories at net selling price, which may exceed cost. See generally AICPA RESEARCH BULL. No. 43 ch. 4, statement 9, ¶ 16 (1953). Thus, it seems reasonable that the rule was intended to be concerned with unrealized appreciation on inventory and not on fixed assets. See 2 HERWITZ, BUSINESS PLANNING 247 (temp. ed. 1964).

Three accounting research studies, prepared for the Accounting Principles Board as vehicles for discussion and analysis prior to the issuance of pronouncements by that Board, present differing views toward unrealized appreciation. MOONITZ & SPROUSE, *A Tentative Set of Broad Accounting Principles for Business Enterprises*, ACCOUNTING RESEARCH STUDY No. 3, at 55 (1962), takes the position that general changes in the price level should be recognized in the accounts, with corresponding adjustments in invested capital and that changes in the value of particular assets in excess of the general changes in the price level should be reflected in the income for the period. On April 13, 1962, the Accounting Principles Board stated that it felt that the approach taken in *Accounting Research Study No. 3* was "too radically different from present generally accepted accounting principles for acceptance at this time." STAFF OF THE ACCOUNTING RESEARCH DIVISION, *Reporting the Financial Effects of Price-Level Changes*, ACCOUNTING RESEARCH STUDY No. 6, at xi-xii (1963), on the other hand, took the view that effect of price-level changes should be disclosed as a supplement to statements prepared by conventional accounting methods and that changes in reproduction cost could be ignored as not affecting a corporation's overall income. In the price-level suppplementary data, all elements of the financial statements would be restated by

above, the remaining issue is whether this result is consonant with basic dividend policy.

Although the courts have reached mixed results on the question,[464]

means of a single index of the general price-level as of the balance sheet date so that all financial data will be expressed in terms of dollars of the same purchasing power. The study distinguishes the effects of a changing price-level upon non-monetary items from such effects upon monetary items. It concludes that the effects of a changing price-level upon monetary items give rise to a gain or loss that should be recognized in the corporation's financial statements. The final statement of relevance appears in GRADY, *Inventory of Generally Accepted Accounting Principles*, ACCOUNTING RESEARCH STUDY No. 7, at 214 (1964): "The amount of any revaluation credits should be separately classified in the stockholders' equity section, and it is not available for any type of charge except on reversal of the revaluation."

[464] The cases are collected in BAKER & CARY, CASES ON CORPORATIONS 1177-1208 (3d unabr. ed. 1958) and in HERWITZ, BUSINESS PLANNING 328-35 (1966).

The leading authority on the question is Randall v. Bailey, 288 N.Y. 280, 43 N.E.2d 43 (1942). In that case, the corporation had written up certain realty from a book value of $1,500,000 to its assessed value of $8,700,000 and declared dividends from the resulting appreciation. The corporation's trustee in bankruptcy brought an action to hold the directors liable for such dividends under the New York dividend statute which at that time provided:

> No stock corporation shall declare or pay any dividends which shall impair its capital or capital stock, nor while its capital or capital stock is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon a reduction of the number of its shares or of its capital or capital stock, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities including capital or capital stock as the case may be.

The trial court held for the defendants because it felt that the last major clause of the statute (beginning "unless the value of its assets") could not grammatically be construed to modify the first limitations on dividend payments. It then rejected plaintiff's argument that only realized gains could be taken into account for dividend purposes, stating that an earlier amendment to the New York statute removing the words "surplus profits" from the statute indicated an effort to abolish any requirement of realization. The court said the test was "whether or not the value of the assets exceeds the debts and the liabilities to the stockholders," and that for this purpose "all assets must be taken at their actual book value." The court of appeals affirmed, basing its decision primarily upon a construction of the statute that placed the "unless" clause as a qualification upon the earlier dividend limitations. As HERWITZ, BUSINESS PLANNING, 328-32 (1966), notes, a number of questions may be raised about both opinions in the case. For example, the trial court's construction of the New York dividend statute not to permit the reading of the "unless" clause back into the earlier dividend limitations scarcely seems consistent with its later conclusion that the earlier dividend limitation should be interpreted to encompass a value of assets test; the latter conclusion would in essence mean that the legislature had stated the same test in two different ways. Moreover, there are policy reasons for distinguishing between the second series of clauses in the statute relating to reductions of capital from the earlier clauses relating to ordinary dividends. See text discussion *infra* part III under the heading "Reductions of Capital." Regarding the court of appeals opinion, the court never really answered the trial court's grammatical construction problems. Moreover, merely reading the "unless" clause into the first series of dividend limitations does not afford a positive grant to pay dividends from unrealized appreciation but merely represents a second hurdle which must be cleared in connection with any dividend payment. And, of course, there is the failure of both courts, in construing a statute quite obviously involving accounting terminology, to pay attention to accounting practices as to the possibility of payment of dividends from unrealized appreciation.

The most recent cases considering the issue where the statute was not explicit have involved repurchases of shares. See Mountain State Steel Foundries Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960), and Baxter v. Lancer Indus., Inc., 213 F. Supp. 92 (E.D.N.Y. 1963), both of which permitted use of current values.

the commentators generally have taken the position that unrealized appreciation should not be available as a dividend source.[465] The various arguments on dividends from unrealized appreciation can best be evaluated if the increase in current value over cost, labelled unrealized appreciation, is divided into two components: the portion attributable to increases in the market prices for individual assets and the portion attributable to decreases in the value of money.[466] Dividends from the unrealized appreciation due to increases in market prices of individual assets have been decried for lack of objective standards by which the appreciation can be measured and, hence, lack of controls upon unscrupulous managements.[467] A more telling complaint, however, is that the use of such unrealized appreciation for dividends presupposes more immediate cash conversion possibilities for the assets concerned than the assets possess in the ordinary course of business.[468] The arguments against dividends from unrealized appreciation arising from price-level increases, to the extent such appreciation has been separately recognized, generally center on the

[465] See, *e.g.*, BALLANTINE, CORPORATIONS 574 (1946); KEHL, CORPORATE DIVIDENDS 100 (1941); LATTIN, CORPORATIONS 478 (1959); Folk, *Revisiting the North Carolina Corporation Law: The Robinson Treatise Reviewed and the Statute Reconsidered*, 43 N.C.L. REV. 768, 840 (1965).

[466] See BAKER & CARY, CASES ON CORPORATIONS 1206 n. 1 (3d unabr. ed. 1958); Comment, *Significance of Appreciation and Changing Price Levels in Corporate Dividend Policies*, 35 MICH. L. REV. 286 (1936).

[467] See, *e.g.*, BALLANTINE, CORPORATIONS 574 (1946); *cf.* Broad, *The Applicability of Generally Accepted Accounting Principles*, 104 J. Accountancy, Sept. 1957, p. 31. To some extent this problem can be surmounted through the use of "specific" (as opposed to general) price indexes that have begun to be developed for various types of equipment and construction. As more of these indexes are developed, and they become more reliable, objections to dividends from such unrealized appreciation will center on the second argument raised in text immediately following.

[468] See, *e.g.*, LaBelle Iron Works v. United States, 256 U.S. 384, 393-94 (1935); BAKER & CARY, CASES ON CORPORATIONS 1195 (3d unabr. ed. 1958); Baker, *Hildebrand on Texas Corporations—A Review*, 21 TEXAS L. REV. 169, 187 (1942); Gibson, *Surplus, So What?* 17 BUS. LAW 476, 487 *passim* (1962).

The argument has frequently been stated in terms of lack of realization. See, *e.g.*, Berks Broadcasting Co. v. Craumer, 356 Pa. 620, 52 A.2d 561, 574 (1947): "The reason why a purely conjectural increase in valuations cannot be considered for the purpose of dividends is because such re-appraisals, however apparently justified and accurate for the time being, are subject to market fluctuations, are merely anticipatory of future profit, and may never be actually *realized* as an asset of the company." The court defined realize as "convert to actual money." So defined, the argument assumes too much for it would preclude application of principles of accrual accounting. The true issue would seem to be as stated in text, although one may prefer a "realization" rule for its ease in administration.

If the issue is the relative proximity in the operating cycle of the assets converted to cash, it may be argued that appreciation relating to inventory should be allowed as a dividend source. To some extent, such appreciation may be already being recognized by corporations following the first-in-first-out method of inventory costing. See Hackney, *The Financial Provisions of The Model Business Corporation Act*, 70 HARV. L. REV. 1257, 1380 n. 110 (1957). *But cf.* AICPA RESEARCH BULL. 43, at 11 (1961). Other ramifications of this problem are explored at text accompanying notes 558-77 *infra*.

notion that a shareholders' investment, in terms of its original purchasing power ,should be maintained in the corporation.[469] Additionally, it may be argued that recognition of price-level increases as a dividend source would be inconsistent with national price-level control policies since the increased dividends possible from such sources would add to inflationary tendencies already inherent in a rising price-level.[470]

The proponents of dividends from unrealized appreciation offer relatively little in support of their position. Seward, despite his arguments in support of treating unrealized appreciation as earned surplus, concedes that "such dividends, as a general rule, are not good practice."[471] He implies,[472] as others have suggested,[473] that unrealized appreciation should be a valid dividend source only as a protective measurement against director liability. It would seem, however, that if directors' potential liability for improper dividends is too severe, a more direct solution would be to reexamine the liability rules rather than needlessly broaden the scope of the permissible dividend fund.

In view of the lack of policy arguments supporting dividend payments from unrealized appreciation, and the possible ambiguity regarding validity of dividends from that source under the New Act, the act should be amended to exclude such appreciation clearly from earned surplus.[474] Unrealized appreciation, if recognized, would then be capital surplus, and thus subject to the controls over its distribution previously discussed.[475]

[469] See Comment, *Significance of Appreciation and Changing Price Levels in Corporate Dividend Policies,* 35 MICH. L. REV. 286, 291-95 (1936); BAKER & CARY, CASES ON CORPORATIONS 1195 (3d unabr. ed. 1958).

For a more thorough discussion of price-level adjustments and the protection of the purchasing power of stated capital originally contributed, see text accompanying notes 493-513 *infra.*

[470] Comment, *Significance of Appreciation and Changing Price Levels in Corporate Dividend Policies,* 35 MICH. L. REV. 286, 296 (1936).

[471] Seward, *supra* note 456, at 441.

[472] See Seward, *supra* note 456, at 443 where he states: "even though conservative accounting and business policy, in the absence of extremely unusual circumstances, recommend against such procedure, a board of directors acting under the Model Act would have the power to augment earned surplus by recognizing appreciation in the value of assets."

[473] See HERWITZ, BUSINESS PLANNING 324 (1966), where the author suggests that the decision in *Randall v. Bailey* may have been influenced by the strictness of directors' liability standard under New York law.

[474] For an example of one state adopting the Model Act which has undertaken this step, see Carrington, *Experience in Texas With The Model Business Corporation Act,* 5 UTAH L. REV. 292, 296-97 (1957).

[475] One additional step that might be taken would be to limit by statute the situations in which unrealized appreciation could be recognized. See, *e.g.,* N.C. GEN. STAT. § 55-49(e) (1965), requiring that the surplus arise from a "revaluation of assets made in good faith upon demonstrably adequate bases of revaluation."

As to the relation between recognition of unrealized appreciation as capital surplus and quasi-reorganizations, see text discussion *infra* part III under the heading "Reductions of Capital."

(6) Declaration of Dividends When the Corporation Has Suffered Unrealized Diminution in the Value of its Assets.[476] While no court has answered the precise question under the old act,[477] the commentators state[478] that its requirement that allowance be made for "losses of every character"[479] probably means that unrealized diminution in the value of assets must be taken into account in determining the amount of surplus available for dividends. Under the New Act, earned surplus takes into account a corporation's "losses" since incorporation.[480] Seward argues that "diminution in value is a 'loss' even though not realized by a sale," partly because of his assertion that net assets are determined by current values, and partly because he feels that the statement quoted represents the accountants' position.[481] According to *Accounting Research Bulletin No. 43,* however, the treatment afforded unrealized diminution in value depends on the particular type of asset. Inventory is to be written down when the goods' disposal in the ordinary course of business will produce less than cost, regardless of

[476] This section is not concerned with the problem of the effect of watered assets upon a corporation's dividend paying capacity, which is considered at text accompanying note 543 *infra.*

[477] Only a limited number of cases have considered the effect of unrealized diminution in value upon a corporation's dividend-paying capacity, of which Randall v. Bailey, 23 N.Y.S.2d 173 (Sup. Ct. N.Y. City), *aff'd without opinion,* 29 N.Y.S.2d 512 (Sup. Ct. App. Div. 1941), *aff'd,* 288 N.Y. 280, 43 N.E.2d 43 (1942), and George E. Warren Co. v. United States, 76 F. Supp. 587 (D. Mass. 1948), are the most prominent. In *Randall,* 23 N.Y.S.2d at 184, the trial court held that "the same reasons which show that unrealized appreciation must be considered are equally cogent in showing that unrealized depreciation likewise must be considered." (For an analysis of the *Randall* trial court's opinion on unrealized appreciation, see note 464 *supra.*) In George E. Warren Co. v. United States, *supra,* a Maine statute permitting dividends from profits was construed to require a holding company to write down the carrying value of its securities to their market value. The court, 76 F. Supp. at 593, referred to the "large and permanent declines in security values" and said that "the decline in value ... was radical and part of a permanent settling down of security values." For other cases, see George E. Warren Co. v. United States, *supra* at 592; BAKER & CARY, CASES ON CORPORATIONS 1211-14 (3d unabr. ed. 1958); 2 BONBRIGHT, VALUATION OF PROPERTY 924-25 (1937).

[478] See 1 MODEL ACT ANN. § 40(a) ¶ 2.02(6)(b); Baker, *Hildebrand on Texas Corporations—A Review,* 21 TEXAS L. REV. 169, 189 (1942); Mulford, *Corporate Distributions to Shareholders and Other Amendments to the Pennsylvania Business Corporation Law,* 106 U. PA. L. REV. 536, 538-39 (1958). *But see* Greenough & Ayer, *Funds Available for Corporate Dividends in Washington,* 9 WASH. L. REV. 63, 83-85 (1934), where the authors interpret the old act as requiring recognition of unrealized diminution in value of current assets but state that "there is some doubt as to the practice it demands in the case of an unrealized fall in the value of fixed assets." They argue that the act should be interpreted to demand write-downs of permanent losses but not "market fluctuations."

[479] WASH. REV. CODE § 23.01.250(3) (1958).

[480] WASH. REV. CODE § 23A.04.010(12) (1965).

[481] Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act,* 38 VA. L. REV. 435, 440-41 (1952). He cites as authority for his statement Company Revaluation of Assets: Charging of Losses, SEC Accounting Release No. 1, April 1, 1937. That release, however, seems to have been concerned with a write-down of obsolete fixed assets, at least in the view of the chief accountant.

whether the diminution is due to physical deterioration, obsolescence, changes in price levels, or other causes.[482] Marketable securities representing the investment of cash available for current operations will be written down only where the market value is substantially less than cost and it is evident that the decline in market value is not due to a temporary condition.[483] Apart from their possible inclusion in quasi-reorganization write-downs,[484] no mention is made of fixed asset write-downs. Few accountants, however, support write-downs of fixed assets in situations not involving obsolescence.[485] Nor is there much support for write-downs of long-term investments in securities when there is no evidence of a permanent decline in value.[486] Assuming that only the write-downs permissible under these rules are encompassed

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[482] AICPA RESEARCH BULL. No. 43, ch. 4, statement 5 and ¶ 8 (1953). This is a restatement of the rule of pricing inventories at cost or market, whichever is lower. Market is defined as a current replacement cost except that market should not be less than net realizable value (estimated selling price in the ordinary course of business less costs of completion and disposal) reduced by an allowance for a normal profit margin, nor should it exceed net realizable value. *Id.* at statement 6 & ¶ 9.

[483] AICPA RESEARCH BULL. No. 43, ch. 3, ¶ 9 (1953).

Accounts receivable under the bulletin are to be carried at "net of allowances for uncollectible accounts." *Ibid.* Thus, if expected cash realizable value (as distinguished from what the receivables would bring on a sale to a third party) is within the value spectrum sought, receivables would also be written down on a fall of such realizable value.

[484] See AICPA RESEARCH BULL. No. 43, ch. 7 (1953), and text discussion *infra* part III under the heading of "Reduction of Capital."

[485] GRADY, *Inventory of Generally Accepted Accounting Principles for Business Enterprises,* ACCOUNTING RESEARCH STUDY No. 7, at 253 (1965), states only that "there are situations in which cost is no longer meaningful. By carrying plant at cost, less accumulated depreciation, there is a representation that the remaining balance of the investment is properly chargeable to future operations and has a fair chance to be recovered. If this assumption appears no longer valid with respect to material items, it may be prudent to recognize the loss by reducing the book value to the estimated remaining useful cost to the enterprise." Whether this statement goes beyond obsolescence and includes write-downs for price-level or replacement cost changes is not clear. Most accountants, however, sanction write-downs for obsolescence with fairly liberal standards as to when an asset is obsolescent. See, *e.g.,* ALEXANDER, INCOME MEASUREMENT IN A DYNAMIC ECONOMY 55 (1950); WIXON, ACCOUNTANTS' HANDBOOK 18:39 (4th ed. 1964); Mauriello, *Depreciation, Depletion, and Fixed Asset Valuation,* in 1 ACCOUNTANTS' ENCYCLOPEDIA 193 (1965). *But see* FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—INTERMEDIATE 308 (6th ed. 1965), stating that some accountants postpone recognizing an obsolescence loss until the loss is recognizable for tax purposes. Although some accountants do favor recognition of declines in the replacement costs of fixed assets, see, *e.g.,* SPROUSE & MOONITZ, *A Tentative Set of Broad Accounting Principles for Business Enterprises,* ACCOUNTING RESEARCH STUDY No. 3, at 55 (1962), the vast majority of accountants are currently against such practice. See, *e.g.,* FINNEY & MILLER, *op. cit. supra* at 341; GRANT & NORTON, DEPRECIATION 387 (rev. printing 1955); MEIGS, JOHNSON & KELLER, INTERMEDIATE ACCOUNTING 443 (1963). Few accountants countenance write-downs merely for price level declines. See, *e.g.,* KERRENBROCK & SIMONS, INTERMEDIATE ACCOUNTING, COMPREHENSIVE VOL. 480 (2nd ed. 1953).

As to the difference between obsolescence and a decline in reproduction costs, see Paton, *Measuring Profits Under Inflation Conditions: A Serious Problem for Accountants* in ZEFF & KELLER, FINANCIAL ACCOUNTING THEORY 369-70 (1964).

[486] See GRADY, *op. cit. supra* note 485, at 260.

within the accountants' definition of a "loss,"[487] the issue remains whether that definition is appropriate as a matter of dividend policy.

Again it is helpful to separate changes in value into changes resulting from a general increase in the value of money (or fall in the general level of prices) and those resulting from changes in the replacement costs of individual assets. There seems to be little reason why price-level declines should result in a contraction of a corporation's dividend paying capacity, apart from the possibility that the corporation may incur a loss in repaying debts with more valuable dollars that may not be offset by the increase in value of its own cash holdings.[488] Indeed, reduction of dividend capacity because of price-level declines would seem contrary to national policy since it might prevent payment of dividends at a time when distribution of the funds would help ameliorate the factors causing the price-level fall.[489] From the standpoint of dividend policy, the need to recognize declines in the replacement cost of individual assets would seem to depend upon the likelihood that replacement costs will increase[490] before the assets are realized in the ordinary course of business and the corporation's competitive disadvantages because of the decline in replacement costs.[491] While the accountants' rules are generally in accord with these policies, there is

[487] Under the principles espoused by MOONITZ & SPROUSE, *op. cit. supra* note 485, declines in the replacement cost of a corporation's assets, beyond those attributable to declines in the general level of prices, would result in a current loss from holding the assets. But the effects of the price level decline itself would merely be a restatement of capital. See *id.* at 170. If the views presented in *Accounting Research Study No. 6* were adopted, a general decline in the price level would result in recognition of gains or losses on monetary items but not on other assets. See ACCOUNTING RESEARCH STUDY No. 6, *op. cit. supra* note 463, at xii.

[488] See BAKER & CARY, CASES ON CORPORATIONS 1212 (3rd unabr. ed. 1958); and the proposal of ACCOUNTING RESEARCH STUDY No. 6, at xii (1963), discussed *supra* note 463. See also Latty, *Uncertainties in Permissive Sources of Dividends Under Present G.S. 55-116*, 34 N.C.L. REV. 261, 277 (1956).

[489] See BAKER & CARY *op. cit. supra* note 488.

[490] This seems to be the problem underlying statements by courts and accountants concerning the permanence of the decline. It may well be asked why such "losses" must be recognized for dividend purposes before the period in which they are actually "realized." *Cf.* ACCOUNTING RESEARCH STUDY No. 6, *op. cit. supra* note 488, at 7, suggesting that a corporation's overall profit position will be unchanged by replacement cost recognition. The answer, of course, is that current recognition of the losses and consequent prevention of dividends to that extent helps protect stated capital which otherwise might be invaded if dividends were currently declared and the loss taken into account in the later period.

[491] A new competitor to the corporation would have the advantage of purchasing its equipment at the lower prices, BAKER & CARY, CASES ON CORPORATIONS 1211 (3d unabr. ed. 1958), see MAY, FINANCIAL ACCOUNTING 100-101 (1943), and if its threat were severe enough, sound dividend policy would appear to require an earnings freeze to the extent necessary to remove the disadvantage. Baker, *Hildebrande on Texas Corporations—A Review*, 21 TEXAS L. REV. 169, 192-93 (1942), suggests as a second example a situation where the corporation for some ulterior reason had paid a price higher than replacement costs for the particular assets.

enough deviation between their rules, particularly concerning price-level changes, and the policies to demand that courts carefully consider situations involving unrealized diminution for appropriate dividend effects rather than simply following current accounting practices.[492]

(7) Effect of Rising Price Level on Computation of Fund Available for Dividends.[493] Neither act provides a clear answer to the question whether a corporation in determining its dividend capacity must take into account the effect of a rising price level upon the relevant financial information.[494] Generally accepted accounting principles, despite prolonged and frequent pleas to the contrary,[495] do not currently require price level adjustments.[496] Instead, corporations are given the option

[492] A troublesome factor in the background of any situation involving unrealized diminution is the relative freedom that corporations have in reducing their capital, and hence, in absorbing declinations in value. See Baker, *Hildebrand on Texas Corporations—A Review,* 21 TEXAS L. REV. 169, 194 (1942); Comment, *Writing Down Fixed Assets and Stated Capital,* 44 YALE L.J. 1025 (1935). See also Fitts, *The Relation of Depreciation to the Determination of Surplus and Earnings Available for Dividends,* 33 VA. L. REV. 581, 600 (1947). Thus, any decision here must be made in full view of the policy considerations presented regarding such reductions. See text discussion *infra* part III under the heading "Reductions of Capital."

[493] This section does not deal with problems of rising replacement costs. That problem, often confused with the topic of this section, is discussed at text accompanying note 563 *infra.*

[494] Under the old act, the question would turn on whether the language requiring "*proper* allowance for depreciation . . . sustained, and losses of every character" demanded such adjustments. See WASH. REV. CODE § 23.01.250(3) (1958). The question under the New Act involves construction of the language "net profits, income, gains and losses." See WASH. REV. CODE § 23A.04.010(12) (1965).

[495] See, *e.g.,* SWEENEY, STABILIZED ACCOUNTING xi (1936) ("The truthfulness of accounting depends largely upon the truthfulness of the dollar—and the dollar is a liar!"); MONTGOMERY, AUDITING iv (7th ed. 1949) (same sentiment); PATON & PATON, CORPORATION ACCOUNTS AND STATEMENTS 527 (1955) (same sentiment).

On April 28, 1961, the Accounting Principles Board agreed that the assumption in accounting that fluctuations in the value of the dollar may be ignored was "unrealistic," and instructed that a research project be set up to study the problem. See quotation from the minutes of the Accounting Principles Board in the project so set up, STAFF OF ACCOUNTING RESEARCH DIVISION, *Reporting The Financial Effects of Price-Level Changes,* ACCOUNTING RESEARCH STUDY No. 6, at 1 (1965). *Accounting Research Study No. 6* concluded that financial reporting should reflect the effects of inflation and deflation by restating all elements of the financial statements in supplementary statements by means of a single index of the general price level. See also SPROUSE & MOONITZ, *A Tentative Set of Broad Accounting Principles for Business Enterprises,* ACCOUNTING RESEARCH STUDY No. 3, at 17-18, 55 (1962), favoring correction for price level changes but not specifying whether changes are to be made in conventional accounts.

For a history of the problem, see Zeff, *Episodes in the Progression of Price-Level Accounting in the United States,* The Accountants' Magazine, April 1964, pp. 285-304.

[496] See AICPA RESEARCH BULL. No. 43, ch. 9A (1953) (the Institute "believes that accounting and financial reporting for general use will best serve their purposes by adhering to the generally accepted concept of depreciation on cost, at least until the dollar is stabilized at some level."); *id.* at ch. 4, statement 3 ("the primary basis of accounting for inventories is cost ...."). The SEC is in accord with these views. See RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 3.13—.16 (2d ed. 1963).

of using the last-in-first-out assumption as to the flow of inventory costs (and hence matching more closely current costs with revenue),[497] making annual appropriations of net income or surplus in contemplation of replacement of fixed assets at higher prices,[498] or using the declining-balance method of computing depreciation.[499] The obvious question raised is whether the purposes of dividend regulation require a result different from the current management-option approach suggested by generally accepted accounting principles.

The dividend policy issues can be best evaluated in full view of what can be done by current price-level adjustment procedures, as exemplified by those described in *Accounting Research Study No. 6*.[500] That study recommends that all elements of a corporation's conventional financial statements be restated in supplementary statements by means of the gross national product implicit price deflator index as of the balance sheet date so that all the financial data will be expressed in terms of dollars of the same purchasing power.[501] It also recommends that gains or losses resulting from the effect of a changing price level upon a corporation's monetary items—principally cash and contracts to receive and pay money—be specifically recognized as an element of

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[497] AICPA RESEARCH BULL. No. 43, ch. 4, statement 4 (1953).

[498] *Id.* at ch. 9A, ¶ 6.

Under *Accounting Research Bulletin No. 43* if unrealized appreciation has been recorded on the corporation's books, depreciation must be based on the written-up cost. See AICPA RESEARCH BULL. No. 43, ch. 9B (1953), as endorsed by ACCOUNTING PRINCIPLES BOARD, STATUS OF ACCOUNTING RESEARCH BULLETIN, OPINION NO. 6 ¶ 17 (1965). This raises questions under both acts as to whether the revaluation surplus can be transferred to earned surplus as it is realized through the depreciation process. Although AICPA RESEARCH BULL. No. 5 ¶ 14 (1940), clearly stated that such realized surplus upon transfer became appropriated earned surplus unavailable for dividends, AICPA RESEARCH BULL. No. 43, ch. 9B is silent on the matter. Seward, as previously noted, feels that no authority under the Model Act exists for such a transfer if the appreciation is capital surplus. Seward, *Earned Surplus—Its Meaning and Use in The Model Business Corporation Act*, 38 VA. L. REV. 435, 443 (1952). See also DODD & BAKER, CASES ON CORPORATIONS 1035 n.33 (2d ed. 1951), where the authors express doubt about the practice where senior securities have been issued, or traded in, in reliance upon financial statements reflecting the write-up.

In view of Seward's doubt on the matter, the New Act probably should be amended to provide for transfers of capital surplus arising from unrealized appreciation to earned surplus upon realization by sale of the asset or by depreciation charges. See in this respect PA. STAT. ANN. tit. 15, § 704B (1958).

[499] AICPA RESEARCH BULL. No. 44 (Revised 1957).

[500] STAFF OF ACCOUNTING RESEARCH DIVISION, REPORTING THE FINANCIAL EFFECTS OF PRICE-LEVEL CHANGES (1965).

[501] *Id.* at xi. For a lengthy discussion of the problem of selecting an index number for making such adjustments, see *id.* at 61-117.

For a reasonably detailed example as to how the adjustments would be made, see *id.* at 121-33. For other examples, see JONES, PRICE LEVEL CHANGES AND FINANCIAL STATEMENTS—CASE STUDIES OF FOUR COMPANIES 12 *passim* (1955); KENNEDY & MCMULLEN, FINANCIAL STATEMENTS—FORM, CONTENT AND INTERPRETATION 340-71 (1957); MASON, PRICE-LEVEL CHANGES AND FINANCIAL STATEMENTS —BASIC CONCEPTS AND METHODS 14-22 (1956).

net income.[502] Apart from this rather complex adjustment,[503] the only other major problem in adjusting the elements of the corporation's income statement into year-end dollars involves depreciation.[504] To compute depreciation, the assets must be "aged," the appropriate index applied so as to convert the costs into current year-end dollars, and depreciation computed upon the current costs. The most important balance sheet adjustments restate the corporation's inventory, plant and equipment and common shareholders' equity in year-end dollars. As the study notes, such price-level adjusted data would permit directors and courts to determine whether a particular dividend would deplete the *real* stated capital originally contributed by the shareholders.[505]

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[502] *Id.* at xii. Under the study's proposal, the purchasing-power gain or loss on monetary assets and liabilities appears only on the supplementary, rather than conventional, financial statements. *Id.* at 126.

Possibly because of the unrealized appreciation present therein, see example in note 503 *infra*, a controversy exists as to whether monetary gains and losses ought to be an item of income as against presentation as part of an analysis of changes in the shareholders' equity. See *id.* at 13, 149-65. The study recommended income statement treatment, arguing that monetary gains and losses have occurred in the same sense that interest has accrued, or that bond discount has accumulated or been amortized. See *id.* at 43. It seems clear that the price level may change before the monetary asset is collected or utilized, or before a monetary liability is discharged, particularly where the gain or loss concerns preferred shares or long term debt. Hence, dividend policy previously discussed in connection with unrealized appreciation would seem to require that unrealized net monetary gains not be recognized as enlarging a corporation's dividend capacity. Unrealized net monetary losses appear to be fundamentally a form of contingency reserve and should be treated as such for dividend purposes by directors.

[503] See generally ACCOUNTING RESEARCH STUDY No. 6, *op. cit. supra* note 495, at 126-28. To compute the gain or loss on monetary items, changes in the corporation's cash and contracts to receive and pay money during the year must be analyzed to determine the price-level at the time the changes occur. Once these data are available, the various transactions are converted into year-end dollars and the resultant effect upon the net monetary items balance is computed. The adjusted net monetary items balance is then compared with the balance without adjustment, to determine the net gain or loss. That gain or loss, if realized through repayment, must in later years be reconverted into year-end dollars as of the end of the later year.

The possibilities for unrealized gains in these computations can be demonstrated by an example. Assume that a corporation borrows, when the price level is 150, $200,000 on a long-term loan. Assume that at the end of the first year the price level is 180 and that no principal payments have been made on the loan. At the end of the first year, the corporation would have a purchasing-power gain of $40,000 [($200,000 x 180/150)—$200,000] despite the fact that the transaction is in no sense closed.

[504] For other adjustment problems, see *id.* at 38-42.

[505] Under the study's procedure, substantial portions of the increases in the asset items resulting from conversion to year-end dollars in a period of rising price-level would be reflected in the adjusted stated capital account, paid-in surplus (if any), and retained earnings. See *id.* at xii. Such increases are, of course, unrealized and hence subject to the objectives previously noted in connection with the payment of dividends from unrealized appreciation. See text accompanying note 454 *supra*. The presence of such unrealized appreciation in such accounts, particularly earned surplus, would mean that a corporation's dividend capacity could not be determined simply by examining the corporation's current price-level adjusted balance sheet and earned surplus statements. Earned surplus available for dividends could be determined only by accumu-

The fact that the courts in the past have ignored the problem perhaps[506] suggests that current dividend regulation policy requires only that the dollar amount of stated capital, rather than purchasing power equivalent to the amount originally contributed, is all that need be maintained in the corporation.[507] If this is the current policy, it is submitted that that policy should be reexamined, particularly in view of the relative ease with which stated capital may be distributed. Much has been made in the past of stated capital as a "cushion" for senior shareholders and long-term creditors.[508] Yet the cushion doctrine is made virtually illusory by the failure to take into account declines in the purchasing power of the dollars concerned.[509] Even in a corporation with a single class of stock and no long term debt, the shareholders' expectation that only *profits* will be freely distributable is scarcely being satisfied when the dividend policy makes no requirement that profits be determined after deducting an adequate provision for asset consumption.[510]

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lating the income as shown as the corporation's income statements adjusted to year-end dollars of the particular year covered by the statement (and as adjusted to year-end dollars of the current year).

One item statements adjusted for price-level changes would make clear is the transfer of real capital from preferred shareholders and long-term bondholders to common shareholders in the event of rising prices. See, *e.g.*, Jones, *The Effect of Inflation on Capital and Profits: The Record of Nine Steel Companies*, 87 J. Accountancy, Jan. 1949, p. 9, 26. These groups could protect themselves by insisting by contract that their liquidation preferences be protected with dollars possessing purchasing power equivalent to their original contributions. But at the moment it does not appear that the law has gone so far as to protect their capital absent such a contractual provision. See Dean, *supra* note 509.

[506] See, *e.g.*, DEAN, BUSINESS INCOME UNDER PRESENT PRICE LEVELS 86 (1949); JONES, EFFECTS OF PRICE LEVEL CHANGES ON BUSINESS INCOME, CAPITAL, AND TAXES 141 (1956); Spear, *Dividend Policies Under Changing Price Levels*, 27 HARV. BUS. REV. 612 (1949).

[507] *Cf.* Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1383 (1957).

[508] See, *e.g.*, part I, 41 WASH. L. REV. 207, 235-38.

[509] See Comment, *Significance of Appreciation and Changing Price Levels in Corporate Dividend Policies*, 35 MICH. L. REV. 286, 296 (1936) ("the failure of modern accounting to take account of appreciation in the monetary value of corporate assets causes part of the economic wealth which the stockholders originally invested in the business to be diverted into the income account. If this diversion of capital into corporate income is not detected, and the income is unthinkingly paid out entirely in dividends, the result is inevitably an impairment of corporate capital."). *But see* Dean, *Provision for Capital Exhaustion Under Changing Price Levels*, 65 HARV. L. REV. 1339, 1341-43 (1952), who argues that as long as the obligation to creditors (and presumably preferred shareholders) is measured in terms of nominal dollars without any adjustment for changes in the value of the dollar, depreciation may be based on cost. The fact that creditors and senior shareholders may have their investment returned in dollars with less purchasing power does not alter their expectation that the corporation by its activities will not increase their risk of loss by diminishing their margin of safety by declaring unwarranted dividends in periods of rising prices.

[510] See generally REPORT OF GROUP ON BUSINESS INCOME, CHANGING CONCEPTS OF BUSINESS INCOME 99 (1952); Kiley, *Some Legal Problems Arising From Profit Determination in Periods of Rising Prices*, 24 U. CINC. L. REV. 519, 527-33 (1955).

This is not to say that implementation of a dividend policy revolving about maintenance of capital in purchasing power equivalent to the dollars originally contributed would not be a difficult matter. Indeed, the accountants' hesitancy toward changing their principles seems more due to difficulties in finding an objective, verifiable technique by which such adjustments could be made, than to disagreement with the basic objective.[511] But there seems to be little reason why consideration of a requirement that the financial data interpreted in making dividend decisions be stated in dollars of constant purchasing power should not now begin.[512] Such an adjustment may cause some initial difficulty in interpretation by management and courts;[513] but once the initial difficulties are surmounted, dividend policy would rest on a much sounder footing.

(8) *Determination of the Dividend Fund For A Corporation Owning Stock in Subsidiary Corporations.* The legal issues involved in determining a parent corporation's dividend capacity can be best understood in the context of the various accounting procedures that may be used in reporting parent-subsidiary operations. Two radically different procedures are available to account for the parent corporation's investments in subsidiaries: the legal-basis method and the economic-basis method.[514] Under the legal-basis method, the parent and its

[511] See quotation from minutes of Accounting Principles Board, *op. cit. supra* note 495; Hackney, *supra* note 507, at 1382 (1957).

[512] A statutory requirement that the financial data be adjusted for changing price-levels would be premature as accountants and management have not yet had sufficient experience with the techniques. But perhaps the statute could encourage efforts in this direction if it recognized as a permissible term in preferred shares, see in this connection WASH. REV. CODE § 23A.08.120 ¶ 2 (1965), a clause designed to protect the shares' liquidation preference against changes in the price level.

[513] Illustrative of the type of difficulties that may arise is the problem of the effect of technological change upon the validity of the price-level index. Accounting Research Study No. 6 concludes that the problem can be only partially overcome by present statistical techniques and that as a result an index series should not be used for projections too far in the past. It recommends a cut-off date of 1945 for application of the index; thus all units acquired prior to 1945 will be valued as if acquired in that year.

Another problem that may arise is that a number of corporations may have paid out dividends illegally in the past, relying in good faith on incorrect data. See, *e.g.*, Jones, *The Effect of Inflation on Capital and Profits: The Record of Nine Steel Companies*, 87 J. Accountancy, Jan. 1949 p. 9, 13, reporting that the nine companies involved paid $409 million in dividends from capital during 1941-47, in contrast to the reported net incomes *after* dividends of $543 million. DEAN, BUSINESS INCOME UNDER PRESENT PRICE LEVELS 86 (1949), suggests that because of the novelty of the problem and the lack of crystallization of thought on proper procedures, the courts would not hold directors liable for past failures to take into account price-level increases. The problem no longer can be considered novel but absent some reasonably clear statutory authorization, it seems unlikely that a court even today would impose liability in the circumstances. See also problem discussed in note 505 *supra*.

[514] The terminology used above is suggested by FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—INTERMEDIATE 269 (6th ed. 1965). Others label the procedures the

subsidiary are treated as separate entities with the result that the subsidiary's earnings have no effect upon the parent's financial statements until the subsidiary pays dividends.[515] In contrast, under the economic-basis method, the parent records increases and decreases in the investment account to reflect changes in the subsidiary's net assets because of income, losses, and dividends.[516] The offsetting entries to the changes in the parent company's investment account are made to the parent's income accounts.[517] As between these two procedures, the

cost and accrual methods, see, *e.g.*, 2 MOONITZ & JORDAN, ACCOUNTING 235 (rev. ed. 1964), or the cost and adjusted-book-value bases, see, *e.g.*, Hackney, *Financial Accounting for Parents and Subsidiaries—A New Approach to Consolidated Statements*, 25 U. PITT. L. REV. 9, 18-19 (1963). It seems best to avoid terminology calling the legal-basis a "cost" method since the carrying value of the investment in the subsidiary in a pooling-of-interests does not coincide with the ordinary notions of cost. See Hackney, *supra* at 16-17, suggesting that the appropriate carrying value in such circumstances is net book value of the underlying assets rather than current fair value of the stock issued.

[515] See, *e.g.*, BAKER & CARY, CASES ON CORPORATIONS 1339-40 (3d unabr. ed. 1958); FINNEY & MILLER, *op. cit supra* note 514 at 269-71. Under this method, post-acquisition losses by the subsidiary would not be recorded on the parent's books unless the losses are substantial and indicative of a permanent decline in value and earning power of the subsidiary. See text discussion accompanying note 486 *supra;* Hackney, *supra* note 514, at 19.

The recognition afforded to a cash or property dividend by the subsidiary to the parent corporation depends on whether it has post-acquisition earnings and, if it does not, whether it was acquired in a purchase or a pooling. If the subsidiary has post-acquisition earnings, its dividends would be income to the parent and augment the parent's earned surplus. See, *e.g.*, FINNEY & MILLER, *op. cit. supra* note 514, at 270. If the subsidiary has no post-acquisition earnings, and it was acquired in a purchase, the parent would reduce its investment account by the amount of the dividend. See AICPA RESEARCH BULL. No. 43, ch. 1, ¶ 3 (1953). Where the subsidiary has no post-acquisition earnings but the acquisition was a pooling-of-interests, the accountants offer no answer. See AICPA RESEARCH BULL. No. 48, ¶¶ 10 & 2 (1959). It would seem, however, that since the pooling-of-interests concept envisions accounting for the enterprise as if the subsidiary had been in its role since organization, a dividend from any earned surplus of the subsidiary should be income to the parent. See Hackney, *supra* note 514, at 22. *But see* BAKER & CARY, *op. cit. supra* at 1337-38.

Accountants appear to be willing to use a LIFO system for determining whether a dividend is from post-or-pre-acquisition earnings. See FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—ADVANCED 356-57 (5th ed. 1960); sources cited in BAKER & CARY, *op. cit. supra* at 1334 n.5.

[516] See, *e.g.*, FINNEY & MILLER, *op. cit. supra* note 514, at 271-72; 2 MOONITZ & JORDAN, ACCOUNTING 235-37 (rev. ed. 1964).

Although the accounting authorities are not particularly clear on the point, it would seem that if the subsidiary is acquired in a pooling-of-interests transaction, the parent corporation can in connection with the recording of the investment on the economic-basis method add to its earned surplus the subsidiary's earned surplus to date of acquisition (adjusted for amounts capitalized by the parent). *Cf.* Salmonsen, *Reporting Earnings After an Acquisition*, 117 J. Accountancy, March 1964, p. 51.

[517] See AICPA RESEARCH BULL. No. 51, ¶ 19 (1959) (so stating with respect to economic-basis reporting of unconsolidated subsidiaries in consolidated reports); ACCOUNTING PRINCIPLES BOARD, STATUS OF ACCOUNTING RESEARCH BULLETINS OPINION No. 6, at ¶ 16 (1965), stating that paragraph 19 of *Research Bull. No. 51* describes the equity (economic-basis) method and that paragraph 6 of chapter 7B of *Research Bull. No. 43* (stating that a shareholder's increase in his equity through undistributed earnings does not give rise to income by the shareholder) should not be construed as prohibiting the equity method of accounting for substantial intercorporate investments. See also 2 MOONITZ & JORDAN, ACCOUNTING 235 (rev. ed. 1964).

legal-basis method seems to be the generally accepted method of reporting a parent's investment in its subsidiaries on a continuing basis.[518]

In addition to these techniques, accountants employ as an aid to shareholders and creditors of the parent company statements consolidating the operations and financial position of the parent and its subsidiaries as if the group were a single company.[519] These consolidated statements are generally designed to eliminate the effects of intergroup transactions, obligations and proprietorship investments.[520] One obvious, and important, effect of the procedure for dividend purposes is that consolidated earned surplus would include at least post-acquisition earnings of the subsidiaries.[521] Consolidation presupposes ownership of at least a majority voting interest[522] and that the resulting statements will "make the financial presentation which is most meaningful in the circumstances."[523]

[518] *E.g.*, FINNEY & MILLER, *op. cit. supra* note 514, at 272; WIXON, ACCOUNTANTS' HANDBOOK 23.13 (4th ed. 1956). *But see* RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 7.9 (2d ed. 1963) ("it is becoming more and more customary to carry the investments in subsidiaries at the amount of the parent's equity in the subsidiaries, with the increase in equity being reflected in the parent company's income statement.") AICPA RESEARCH BULL. No. 51, ¶ 19 (1959), may be thought to be contrary to the text statement, but the bulletin refers to treatment of investments in consolidated statements where one would expect to find equity reporting. It is unclear whether the opinion of the Accounting Principles Board endorsing the description of the economic-basis method was meant to endorse the preference for methods also stated in paragraph 19 of AICPA RESEARCH BULL. No. 51 (1959).

[519] See generally AICPA RESEARCH BULL. No. 51 (1959); FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—ADVANCED, chs. 17-26 (5th ed. 1960); 2 MOONITZ & JORDAN, ACCOUNTING, AN ANALYSIS OF ITS PROBLEMS chs. 8-10 (rev. ed. 1963); WIXON, ACCOUNTANTS' HANDBOOK § 23 (4th ed. 1964).

[520] See AICPA RESEARCH BULL. No. 51, ¶¶ 6-7 (1959); BAKER & CARY, CASES ON CORPORATIONS 1342 & n.29 (3d unabr. ed. 1958).

[521] If the subsidiary had been acquired in a purchase, consolidated earned surplus would include only post-acquisition earnings of the subsidiaries. See AICPA RESEARCH BULL. No. 51 ¶ 9 (1959); Hackney, *Financial Accounting For Parents and Subsidiaries—A New Approach to Consolidated Statements*, 25 U. PITT. L. REV. 9, 22 (1963). But if the subsidiary was acquired in a pooling-of-interests transaction, *all* of the subsidiary's earned surplus should appear in the consolidated earned surplus. See AICPA RESEARCH BULL. No. 48, ¶¶ 10, 9 (1957).

[522] AICPA RESEARCH BULL. No. 51, ¶ 2 (1959), states that the usual condition for a controlling financial interest is ownership by one company, directly or indirectly, of over fifty per cent of the outstanding voting shares of another company. Exceptions to this rule are recognized where control is likely to be temporary, where control does not rest in the majority owners or where the minority interest in the subsidiary is so large in relation to the equity of the shareholders of the parent in the consolidated net assets that consolidated statements would not be meaningful. See also the discussion in WIXON, ACCOUNTANTS' HANDBOOK 23.3 (4th ed. 1964). The SEC rules generally prohibit consolidating any subsidiary which is not majority owned by the parent. See SEC Reg. S-X, art. 4, rule 4-02(a), 17 C. F. R. § 210.3-.17 (1964). *But see* in this connection SEC Securities Act Releases Nos. 4657, 4657A (Dec. 6 and 7, 1963); Rappaport, *Consolidation of Sattelite Companies: The Atlantic Research Case*, 34 N.Y.C.P.A. 131 (1964), concerning the possibility that effective control, rather than record control, may demand consolidation.

[523] AICPA RESEARCH BULL. No. 51, ¶ 3 (1959). The Bulletin advises separate statements where the subsidiary is a bank or an insurance company or where the sub-

Both acts appear to prohibit the use of consolidated statements in connection with determining the parent's dividend capacity through limiting reference terms, *viz.*, "its" or "*the* corporation."[524] With respect to the treatment of the investment account in the parent's financial statements for dividend purposes, either act, interpreted under generally accepted accounting principles, would seem to mean that the legal-basis of reporting would be required.[525] But the inquiry remains whether this result is consistent with dividend regulation policy.

The commentators generally report that use of consolidated statements, or their effective equivalent for dividend purposes—economic-basis reporting of subsidiary investments[526]—is not favored for determining the dividend capacity of the parent corporation.[527] The reason generally advanced for such disfavor is the similarity of recognizing

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sidiary is a finance company and the parent is engaged in manufacturing operations. *Ibid.* The SEC's position is similar. See RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 15.3-15.4 (2d ed. 1963).

[524] See WASH. REV. CODE § 23.01.250(4)(a) (1958) ("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, including in the latter amount of *its* capital stock ...."); WASH. REV. CODE § 23A.04.010(12) (1965) ("'earned surplus' means the portion of the surplus of *a* corporation equal to the balance of *its* net profits ... from the date of incorporation...."); WASH. REV. CODE § 23A.08.420(1) (1965) ("dividends may be declared and paid in cash or property only out of the unreserved and unrestricted earned surplus of *the* corporation....") (Emphasis added.) "Corporation" is defined under both acts so as to be incapable of expansion to a consolidated group. See WASH. REV. CODE § 23.01.010(1) (1958); WASH. REV. CODE § 23A.04.010(1) (1965). Compare in this respect CAL. CORP. CODE §§ 118, 3009, defining a "holding corporation" and permitting such corporation to include in its required annual report to shareholders either a consolidated balance sheet or the parent's separate balance sheet. Despite the lack of limited reference terms in the relevant statutes and the existence of these provisions, however, 1 BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 261 (4th ed. 1965), indicate that consolidated statements cannot be used for dividend purposes in California.

[525] Apparently Seward's view would permit subsidiaries' earnings to augment the parent's earned surplus. See Seward, *Earned Surplus—Its Meaning and Use in the Model Business Corporation Act*, 38 VA. L. REV. 435, 440 (1952).

[526] The economic-basis method is keyed, as in essence are consolidation procedures, to the parent's interest in the subsidiary's surplus. Moreover, accountants apparently make the same set of adjustments for intercompany gains and losses under the economic-basis method that are made under the consolidation procedures. See AICPA RESEARCH BULL. No. 51, ¶ 20 (1959). Hence, the parent's surplus under the economic-basis method should approximate the consolidated surplus.

[527] See BALLANTINE, CORPORATIONS 548 (rev. ed. 1946); HILLS, THE LAW OF ACCOUNTING & FINANCIAL STATEMENTS 38 (1957); KATZ, INTRODUCTION TO ACCOUNTING 202 (1954); LATTIN, CORPORATIONS 489 (1959); de Capriles, *Modern Financial Accounting*, 38 N.Y.U.L. REV. 1, 45 (1963).

The closest case in point is Cintas v. American Car & Foundry Co., 131 N.J. Eq. 419, 25 A.2d 418 (Ch. 1942), *aff'd on opinion below*, 132 N.J. Eq. 460, 28 A.2d 531 (ch. 1942), which involved the computation of the amount of an annual dividend credit to non-cumulative preferred under the New Jersey rule. The court rejected defendant's contention that enterprise accounting should be used stating that the corporate identity would be disregarded only in order to prevent fraud, deception, evasion or injustice. For comment on the case see Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343, 355 (1947); May, *The American Car and Foundry Decision*, 74 J. ACCOUNTANCY 517 (1942); Comment, 56 HARV. L. REV. 132 (1942).

subsidiary profits as part of the parent's dividend-capacity to recognizing unrealized appreciation as a dividend source.[528] However, the principal objections to using unrealized appreciation—the lack of objective means of determination and the cash conversion probability characteristics—do not seem applicable to the parent's recognition of the subsidiary's earnings.[529] Since the subsidiary presumably has determined its earnings in accord with generally accepted accounting principles, its earnings should be as objective as the parent's own earnings. And while the parent probably does not anticipate selling the subsidiary's stock, the subsidiary has realized the profits concerned in ordinary operations and they could possibly be declared to the parent as a dividend, if necessary.[530]

The ultimate issue involved would seem to be how much significance is to be accorded the fact that the subsidiary is nominally a separate legal entity.[531] There seems to be fairly general agreement that consolidated statements afford both creditors and shareholders of the parent company a more meaningful financial picture of the enterprise's operations.[532] Yet the law balks at using the same data for dividend purposes, apparently because the parent's creditors can reach the subsidiary's assets only after the subsidiary's creditors have been satisfied.[533] But this means that subsidiary operations are disadvantaged in comparison with operation of the activity as a division of the parent, since transfer of the funds from the subsidiary to the parent—by hypothesis not needed by the parent for the dividend—may be subject to federal income taxes.[534] Even if federal income taxes are

[528] See KATZ, INTRODUCTION TO ACCOUNTING 202 (1954); KEHL, CORPORATE DIVIDENDS 145-46 (1941); LATTIN, CORPORATIONS 489 (1959).

[529] See text accompanying notes 467-75 *supra*, discussing these aspects of ordinary unrealized appreciation.

[530] See Hackney, *Financial Accounting for Parents and Subsidiaries—A New Approach to Consolidated Statements*, 25 U. PITT. L. REV. 9, 26-28 (1963); KATZ. INTRODUCTION TO ACCOUNTING 202 (1954); LATTIN, CORPORATIONS 489 (1959); de Capriles, *Modern Financial Accounting*, 38 N.Y.U.L. REV. 1, 46 (1963).

[531] See, *e.g.*, de Capriles, *Modern Financial Accounting*, 38 N.Y.U.L. REV. 1, 43-45 (1963). In this respect it is interesting to note that the accountants' preference for the legal-basis method of reporting subsidiary investments is said to be the result of "the restrictions inherent in the legal concept of separate corporate entities." See FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—INTERMEDIATE 272 (6th ed. 1965).

[532] See, *e.g.*, GUTHMANN, ANALYSIS OF FINANCIAL STATEMENTS 548-50 (4th ed. 1953); RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 15.3 (2d ed. 1963).

[533] See de Capriles, *Modern Financial Accounting*, 38 N.Y.U.L. REV. 1, 45 (1963).

[534] If the parent and the subsidiary file consolidated federal income tax returns, the dividends by the subsidiary will not be subject to tax. See Treas. Reg. § 1.1502-3(b)(2)(ii) (1966). In order to be eligible to file consolidated returns, the parent must own, directly or indirectly, at least 80% of all voting stock and all other classes of stock outstanding. See INT. REV. CODE OF 1954, § 1504(a). If, however, consolidated returns are not, or cannot be, filed, the subsidiary's dividends will be free from tax only if the parent owns sufficient stock in the subsidiary to qualify for consolidated

not an issue, however, the necessity of a dividend declaration by the subsidiary to the parent to support the parent's dividend can hardly be explained as a matter of parent-creditor protection when the parent may be called upon to reinvest the funds immediately in the subsidiary.[535] If the parent has preferred shares outstanding, their interests are generally best protected by permitting the subsidiary's earnings to be used as a dividend source by the parent.[536] And since the dividends paid from such surplus can not be said to have been paid from the common shareholders' contributed capital, they would appear to have no particular interest militating against using the subsidiary's earnings as a dividend source for the parent.[537] Hence, it would seem that dividend regulation policy, on balance, would favor use of consolidated data in determining the size of the parent's dividend fund.[538]

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reporting, the parent elects to forego certain tax advantages, and the dividends come from qualifying earnings and profits of the subsidiary. See INT. REV. CODE OF 1954, § 243(b). If the parent cannot qualify under either provision, it is entitled to an eighty-five per cent dividend credit. INT. REV. CODE OF 1954, § 243(a)(1). Hence, the distributions might be subject to a tax as high as *7.2%* under current rates.

Federal income taxes have been cited as the main reason for statutory amendments permitting parent dividend declaration without subsidiary dividend payment. See Mulford, *Report of the Corporation Law Committee*, 34 PA. B.A.Q. 418, 421 (1963) (relating to the Pennsylvania provision discussion at text accompanying note 540 *infra)*; Bullard, *Corporate Accounting and the Law*, 1953 WASH. U.L.Q. 32, 47 (iscussing a change of the sort enacted in the North Carolina statute discussed at text accompanying note 539 *infra*).

[535] It has been argued that unless the subsidiary's earnings are paid up to the parent, it may have losses which will destroy its potentiality for such distributions and the parent would then be left with a payment out of capital. But as Hackney, *supra* note 530, at 28, points out, any dividend is declared on the basis of information currently on hand. A parent could declare a dividend from its own earned surplus and the following year suffer catastrophic obsolescence losses. If these losses were not foreseeable, however, the dividends would have been proper.

[536] If the subsidiary's earnings are available for dividends by the parent only after the subsidiary declares a dividend, the parent's earnings can be controlled by the majority common shareholders to the disadvantage of the preferred shareholders. See Note, 56 HARV. L. REV. 132 (1942), dealing with Cintas v. American Car & Foundry Co., 131 N.J.Eq. 419, 25 A.2d 418 (ch. 1942), discussed in note 527 *supra*.

[537] Hackney, *supra* note 530, at 28 goes even further by arguing in support of the Pennsylvania statute discussed at text accompanying note 540 *infra*, that the modern conception is that capital and capital surplus are not so much for the protection of creditors as for the support and protection of shareholders and that the shareholders should thus be able freely to forego the cushion if they desire. It does not seem necessary to go this far to support the amendment. On the modern role of legal capital, see part III *infra* at "Reduction of Capital."

[538] *But see* OHIO REV. CODE ANN. §§ 1701.32(a), 1721.32(E), 1701.33 (1964) which prohibit the subsidiary's earnings as a source for the parent's dividends.

If the legal-basis reporting method is adhered to, a question that must be answered is whether gains and losses on intergroup transactions must be taken into account in determining the parent's earned surplus. BAKER & CARY, CASES ON CORPORATIONS 1343-44 (3d unabr. ed. 1958), indicate that gain has not thus far been vitiated by absence of arms-length dealing. It would seem that intercompany transactions must be carefully scrutinized in connection with determining the parent's earned surplus because of the ease with which profit can be shifted back and forth from parent to subsidiary.

A number of different methods are available by which this policy could be effectuated. It is possible that the courts could reach the desired results simply through interpretation of the language of either act since neither prohibits use of economic-basis reporting. However, since the issue is subject to doubt and a long adverse history, it would seem wiser to amend the statute to state the result clearly. At least three statutory approaches to the subject are available. The first, following the recent North Carolina statute, would permit a parent corporation to treat share dividends received from the subsidiary as earned income to the extent of the amount of the subsidiary's earned surplus capitalized in connection therewith.[539] A second, following the recent amendment to the Pennsylvania statute, would endorse economic-basis reporting of subsidiary investments, treat increases in such investment accounts due to subsidiary earnings as capital surplus, and permit dividends from such capital surplus when the parent has no earned surplus and when the distribution is appropriately labelled.[540] A third would permit parent corporations to determine the relevant financial data on the basis of either the parent-only statement or a consolidated statement.[541] Of these approaches, the Pennsylvania statute seems slightly better than the others because it avoids direct use of consolidated data (and hence confusion regarding the entity

[539] N. C. GEN. STAT. § 55-49(1) (1965). See also Bullard, *Corporate Accounting and The Law*, 1953 WASH. U.L.Q. 32, 50, suggesting such an approach.

[540] PA. STAT. ANN. tit. 15, § 2852-702(A)(4) (Supp. 1965) provides:

> Dividends may be declared and paid in cash or property out of unrestricted capital surplus of the corporation to the extent of the net aggregate undistributed, unrestricted and unreserved consolidated earned surplus of such corporation and its majority-owned subsidiaries organized under the laws of a state territory or possession of the United States of America if at the time of any such dividend such corporation has or as a result of such dividend will have no earned surplus. In computing such consolidated earned surplus, the financial statements of the corporation and its majority-owned subsidiaries shall be consolidated after eliminating all inter-company items, and there shall be deducted an amount equal to the aggregate of all dividends theretofore paid pursuant to this subsection (4). Each such dividend when made shall be identified as a payment out of capital surplus not in excess of such consolidated earned surplus.

The Pennsylvania act provides that unrealized appreciation generally is capital surplus when recorded. See PA. STAT. ANN. tit. 15, § 2852-702 (Supp. 1965). For a detailed discussion of section 702(A)(4), see Hackney, *supra* note 530, at 9-34.

A rather interesting question under the Pennsylvania statute is whether the parent must make provision in computing the capital surplus for federal income taxes that would have to be paid if the subsidiary does pay dividends to the parent in the future. See on this question MONTGOMERY, AUDITING 490-91 (7th ed. 1949).

[541] This suggestion is patterned upon the California provisions discussed in note 524 *supra*. From the standpoint of accounting procedure, this suggestion would operate substantially as the Pennsylvania approach does since accountants presumably would follow the economic-basis of reporting in order to support dividend declarations by the parent. If this approach were to be pursued, it would seem that the statute should also require, as does Pennsylvania's, that the parent's earned surplus be exhausted before any dividends could be paid from the subsidiary's earned surplus.

concept), and because it avoids the requirement of a declaration of a stock dividend by the subsidiary.[542]

(9) Declaration of Dividends By A Corporation With Watered Stock. The old act apparently prohibited declaration of dividends by a corporation until the capital deficit created by the issuance of watered stock had been offset by accumulated surplus.[543] Resolution of the question under the New Act involves a process of elimination. Upon proof of watered assets, and assuming no change in their inherent value, the corporation presumably must reduce net assets by the amount of the water.[544] Under the statutory definitions in the New Act, a reduction in net assets must be accompanied by a reduction in either stated capital or surplus.[545] Since the act does not contemplate a reduction of stated capital in the circumstances,[546] the issue is

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[542] The requirement of a declaration of a stock dividend by the subsidiary would mean in essence that preferred shareholders would not be quite as well protected as under the Pennsylvania rule. See note 536 *supra*. The second problem with the stock dividend approach is that it may involve a needless divergence from generally accepted accounting principles. See AICPA RESEARCH BULL. No. 43, ch. 7B ¶ 6 (1953). Moreover, the approach may not remove from the subsidiary's earned surplus gains on intergroup transactions.

[543] See Commissioners' Notes in 9 U.L.A. 170 (1957), indicating that such was the effect of Ohio Sess. Laws 1931, vol. 114, § 8623-38, at 62, upon which WASH. REV. CODE § 23.01.250 (1958) was modeled. No significant deviation between the Washington provisions and the Ohio statute exists regarding this point. Hence, it seems reasonable to conclude that the text statement is the Washington rule also.

Some difficulty arises in determining what statutory language supports this conclusion. Greenough & Ayer, *Funds Available For Corporate Dividends in Washington*, 9 WASH. L. REV. 63, 85 (1934), seem to associate it generally with the operation of WASH. REV. CODE § 23.01.250(3) (1958). But the same result could be obtained by using an interpretation of asset values consistent with generally accepted accounting principles. See text accompanying notes 550-57 *infra*.

[544] Although the New Act does not contain a provision requiring assets to be recorded at their fair value as of the time of acquisition, see in this respect N. C. GEN. STAT. §§ 55-50 (c)(2), 55-52(e) (1965), it is implicit in the New Act's watered shares provisions that such recording is intended. See WASH. REV. CODE §§ 23A.08.-150, .210 (1965); Hackney, *Accounting Principles In Corporation Law*, 30 LAW & CONTEMP. PROB. 791, 815 (1965).

Accountants generally reject the par or stated value of stock as a reasonable basis for originally recording assets acquired in favor of either the fair market value of the stock given or the fair market value of the property acquired. See, *e.g.*, BIERMAN, FINANCIAL AND MANAGERIAL ACCOUNTING 218 (1963); GRADY, *Inventory of Generally Accepted Accounting Principles For Business Enterprises*, ACCOUNTING RESEARCH STUDY No. 7, at 196 (1965); HATFIELD, SANDERS & BURTON, ACCOUNTING PRINCIPLES AND PRACTICES 339 (1940); MEIGS, JOHNSON & KELLER, INTERMEDIATE ACCOUNTING 514-15 (1963); MONTGOMERY, AUDITING 233 (7th ed. 1949). *But see* FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—INTERMEDIATE 291 (6th ed. 1965), where a distinction is drawn between the obligation of the company accountant and the public accountant; GILLMAN, ACCOUNTING CONCEPTS OF PROFIT 477 (1939).

[545] See WASH. REV. CODE § 23A.04.010(9), (10), (11) (1965); Garrett, *Capital and Surplus Under The New Corporation Statutes*, 23 LAW & CONTEMP. PROB. 239, 242 (1958).

[546] On reduction of stated capital under the New Act, see WASH. REV. CODE §§ 23A.16.010, .110, .120 (1965); part III *infra* under the heading of "Reductions of Capital"; HERWITZ, BUSINESS PLANNING 350-58 (1966).

whether the reduction is to affect capital surplus or earned surplus. As Hackney suggests, however, it is probably implicit in the New Act's provisions that the only charges permitted to capital surplus are those specified in the act.[547] Hence, the apparent result under the New Act is that dividends from earned surplus will be frozen until the water has been "squeezed" out of the assets either by collection, subsequent earnings, or a reduction of stated capital.[548]

It may well be asked whether this result represents sound dividend policy.[549] Accountants faced with watered assets charge the com-

[547] See Hackney, *The Financial Provisions of The Model Business Corporation Act*, 70 HARV. L. REV. 1357, 1390 (1957). Hackney uses as support for this view the Model Act predecessor to WASH. REV. CODE § 23A.16.130 ¶ 2 (1965), which permits directors by resolution to transfer earned surplus to capital surplus, stating that apparently it was thought that the board might not otherwise have the power to do so. It would seem that the view can also be supported simply by the general structure of the New Act since it seems implicit in the various differences between dividends from earned surplus and those from capital surplus that charges to capital surplus must be restricted if restrictions on disposition thereof are to have any significance. See Hackney, *The Pennsylvania Business Corporation Law Amendments*, 19 U. PITT. L. REV. 51, 72-73 (1957). And, of course, it is clear that if the earlier suggestions regarding exhaustion of earned surplus before distributions can be made from capital surplus are adopted, see text accompanying notes 414-15 *supra*, the conclusion in text must be adopted as a necessary incident of the scheme. *Cf.* BAKER & CARY, CASES ON CORPORATIONS 1301 (3d unabr. ed. 1958).

A difficult question arises as to whether the statute ought to be amended to provide specifically that charges to capital surplus other than those permitted by the Act are prohibited. See, *e.g.*, PA. STAT. ANN. tit. 15, § 2852-704(D) (1958). A concomitant of such a provision would be a series of fairly detailed provisions as to permissible charges, which would presumably be basically keyed to charges permitted under generally accepted accounting principles that were consistent with good dividend policy. See for a discussion of such provisions Hackney, *The Pennsylvania Business Corporation Law Amendments*, 19 U. PITT. L. REV. 51, 73-74 (1957). The main difficulties with this approach are the resulting statutory complexity and the need to seek statutory complexity and the need to seek statutory amendments as accounting theory on permissible charges to capital surplus evolves.

It would appear that the presence of some statutory ground rules on the subject would be superior to the present statutory ambiguity. But perhaps the flexibility problem can be avoided by including in the statutory scheme charges to capital surplus considered to be consistent with sound dividend policy as determined by (for example) the state commissioner of corporations. For more detail on this proposal, see text *infra* part III under the heading "Director and Shareholder Liability."

[548] Of course, if one begins analysis of the question from the standpoint of whether the capital deficit is a "loss" for purposes of New Act definition of earned surplus, one presumably would conclude following generally accepted accounting principles that it is not. See authorities cited in notes 550 & 551 *infra*. But the structure of the Act requires implicitly that charges be tried first against stated capital and then against capital surplus. If the charge cannot be made against either, as seems to be the case with a capital deficit, then earned surplus must be the recipient.

There is some question as to whether a capital deficit can be removed under the New Act by a reduction of stated capital. Under WASH. REV. CODE § 23A.16.130 ¶ 1 (1965), any surplus created by a reduction of capital is capital surplus. Capital surplus, according to WASH. REV. CODE § 23A.16.130 ¶ 3 (1965), can be used to reduce or eliminate "any deficit arising from losses, however incurred...," after earned surplus has been exhausted. But is a capital deficit a loss? The accountants' treatment of it clearly indicates that it is not, see text accompanying note 550 *infra*, and sources there cited, but if the deficit is chargeable under the statute to earned surplus it apparently must be a "loss" under WASH. REV. CODE § 23A.04.010(12) (1965).

[549] The leading case on the question is Goodnow v. American Writing Paper Co.,

pensating reduction to a separate account which is shown as an offset to the capital stock outstanding account.[550] While treatment of the discount account thereafter varies,[551] the generally accepted view seems to be that it should not be written off against earnings or paid-in surplus, but rather, should be carried as a stated capital offset until either collected or written off in connection with a reduction of stated capital.[552] Behind this treatment lies the premise that a capital deficit does not affect a corporation's income or retained earnings.[553]

In support of the New Act's conclusion, it may be argued that stock watering is such a despicable practice that decisions on dividend questions should be shaped with a view to condemning it.[554] But it is hard to see why dividend policy should be distorted in an attempt to remedy defects existing in the law relating to stock watering. The clear thrust of the New Act's provisions is that dividends can freely be declared from earnings. Freezing earnings because of stock watering would thus exceed creditors' expectations, at the expense of all the innocent shareholders in the corporation. And the financial benefits of an earnings freeze can be provided to creditors and preferred shareholders[555] more directly by revision of the stock watering provisions to

73 N.J. Eq. 692, 69 Atl. 1014 (1908), *affirming* 72 N.J. Eq. 645, 66 Atl. 607 (1907). The statute there permitted dividends from surplus, or net profits arising from its business but prohibited the dividing, withdrawing, or in any way paying to the shareholders any part of the "capital stock." The court held that profits were an alternative dividend source to surplus over legal capital and also held that profits were to be ascertained by reference to the "capital stock paid in," and not to normal share capital. The court said that the prohibition against dissipating capital was "to prevent the frittering away of the actual assets with which the company is to do business, not the nominal assets which it has never received, and for which it still has a claim against the subscribers of unpaid stock." *Id.* at 1016. For other cases both pro and con on the *Goodnow* problem, see DODD & BAKER, CASES ON CORPORATIONS 994-97 (2d ed. 1951); Northwestern Elec. Co. v. FPC, 321 U.S. 119 (1944).

[550] See, *e.g.*, WIXON, ACCOUNTANTS' HANDBOOK 21.22 (4th ed. 1964); SEC Reg. S-X, rule 3.17, 17 C.F.R. § 210.3-17 (1964).

[551] WIXON, ACCOUNTANTS' HANDBOOK 21.23 (4th ed. 1964), states that despite the accounting principle stated directly following in text above, the discount has often been removed from the books through charges to any surplus account that has been legally available. See also FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—INTERMEDIATE 131 (6th ed. 1965); HILLS, THE LAW OF ACCOUNTING AND FINANCIAL STATEMENTS 88 (1957). *Cf.* SEC Reg. S-X, rule 3.17, 17 C.F.R. § 210.3-17 (1964), indicating that discount on capital shares may at least in some circumstances be amortized. The latter may well be limited to commissions and expenses on the share issuances. See RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 14.19 (2d ed. 1963).

[552] *See, e.g.*, FINNEY & MILLER, PRINCIPLES OF ACCOUNTING—INTERMEDIATE 131 (6th ed. 1965); WIXON, ACCOUNTANTS' HANDBOOK 21.23 (4th ed. 1964).

[553] See HATFIELD, SURPLUS AND DIVIDENDS 27 (1943).

[554] See LATTIN, CORPORATIONS 474 (1959). Query if the New Act really achieves this result when a likely result of its provisions will be a write-off of the discount account which clearly sets forth the fact of contingent liability by holders of watered shares. See WIXON, ACCOUNTANTS' HANDBOOK 21.22 (4th ed. 1964).

[555] If the suggestions made previously are adopted, creditors would be protected by the bankruptcy insolvency test, see text accompanying note 382 *supra*, and by the statutory right of suit for water in the event of insolvency. See part I, 41 WASH. L. REV.

allow solvent corporations to sue holders of watered shares either for the amount of the water or cancellation, depending on the equities of the situation.[556] It thus seems that a solution closer to the accountants' view would be more consistent with dividend policy than the New Act's conclusion.[557] Possibly the accounting result could be reached simply by interpreting the New Act to permit a stated capital offset account, but better resolution of the problem would be obtained by specific statutory recognition of a discount on stated capital account, which could be eliminated only by collection or reduction of stated capital.

c. Some Basic Policy Questions. The question previously postponed, whether accounting valuations should be used in making legal determinations as to the available dividend fund, may now be considered. Seward[558] and Gibson,[559] members of the ABA committee responsible for drafting the Model Act, have both taken the position that the appropriate value standard for dividend questions under that act is "current value." Even if the previous discussion is ignored, however, substantial objections to a "current value" standard can be raised. The first, and most important, is that determinations of "current value" will involve directors and courts in the complex and sub-

207, 255-60. The preferred shareholders' liquidation preference would also be protected, see text accompanying note 389 *supra*, but their interests are not protected in the event of insolvency. See part I, 41 WASH. L. REV. 207, 256. For a discussion of the possible harms to the interest of preferred shareholders in the circumstances, see DODD & BAKER, CASES ON CORPORATIONS 997-99 (2d ed. 1951).

[556] See in this regard part I, 41 WASH. L. REV. 207, 258 n. 307. A court under such a statute could presumably permit guilty shareholders still in the corporation to offset future dividend declarations against their watered shares' liability.

[557] Sections (1) and (2) of WASH. REV. CODE § 23A.08.420 (1965), permitting "nimble" dividends and dividends by wasting asset corporations without deduction for depletion both point in the direction of the conclusion suggested in the text. For discussion thereof, see part III under the headings "Nimble Dividends" and "Dividends By Wasting Asset Corporations."

It may be argued,of course, that pursuing the earnings concept for dividends in these circumstances ignores much of the legal thinking to the effect that legal capital is a quantum rather than a res. See, *e.g.*, Ballantine & Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws*, 23 CALIF. L. REV. 229, 234 (1935); Gose, *Legal Significance of "Capital Stock,"* 32 WASH. L. REV. 1, 5 *passim* (1957). But the accountant's thesis does not go this far since it would act to preserve in the corporation not the res of the original assets but an amount equal to their original fair market value.

[558] Seward, *Earned Surplus—Its Meaning and Use in The Model Business Corporation Act*, 38 VA. L. REV. 435, 440 (1952).

[559] Gibson, *Surplus, So What?*, 17 BUS. LAW. 476, 487 (1962). For the statutory basis of Gibson's argument, see note 364 *supra*. Garrett, *Capital and Surplus Under The New Corporation Statutes*, 23 LAW & CONTEMP. PROB. 239, 259 (1958), seems to be of the same general view.

Gibson, however, goes on to argue eloquently for a dividend test based upon earnings. See Gibson, *supra* at 490-94. As should be clear by now, it is the author's position that this is precisely the test presented under the Model (New) Act's earned surplus test. *Cf.* HERWITZ, BUSINESSPLANNING 339 (1966).

jective process of valuing a corporation's assets.[560] A second related objection arises because generally accepted accounting principles are not based on current values and, as a result, dividend determinations would be made and reported on a basis incompatible with the firm's earnings as reported to shareholders and creditors.[561] A third and final objection is that the statement that a "current value" standard is to be used in connection with the Model Act ignores the focus in the act

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[560] See, *e.g.*, BAKER & CARY, CASES ON CORPORATIONS 1195-96 (3d unabr. ed. 1958); Hackney, *Accounting Principles In Corporation Law*, 30 LAW & CONTEMP. PROB. 791, 819-21 (1965), who states a number of the difficult questions that must be answered in connection with determining "current values." 2 BONBRIGHT, VALUATION OF PROPERTY 973-74 (1937), states:

> but [a current value test] presents such serious practical difficulties of valuation that we doubt the wisdom of attempting to enforce it with respect to most types of corporations. It would impose on the directors the duty, period after period, of redetermining the value of their business enterprise in order to decide whether, and to what extent, there is an equity in excess of stated capital. Only with corporations whose assets are of a highly marketable form, as with insurance companies and investment trusts holding liquid securities in their portfolios, would this procedure of revaluation be feasible. To demand of the directors of the United States Steel Corporation, or of the American Telephone & Telegraph Company, or of the Pennsylvania Railroad Company, that they shall make their dividend payments depend on an ascertainment of the current value of their whole business—for no mere summation of the so-called "values" of the separate assets would suffice—is to impose upon them a task that no responsible businessman should be asked to assume.

But see the opinion of the court in Randall v. Bailey, 23 N.Y.S.2d 173, 184 (1940), *aff'd without opinion*, 29 N.Y.S.2d 512 (1st Dept. 1941), *aff'd*, 288 N.Y. 280, 43 N.E.2d 43 (1942), stating:

> I see no cause for alarm over the fact that this view requires directors to make a determination of the value of the assets at each dividend declaration. On the contrary, I think that is exactly what the law always has contemplated that directors should do. That does not mean that the books themselves necessarily must be altered by write-ups or write-downs at each dividend period, or that formal appraisals must be obtained from professional appraisers or even made by the directors themselves. That is obviously impossible in the case of corporations of any considerable size. But it is not impossible nor unfeasible for directors to consider whether the cost of assets continues over a long period of years to reflect their fair value, and the law does require that directors should really direct in the very important matter of really determining at each dividend declaration whether or not the value of the assets is such as to justify a dividend, rather than do what one director here testified that he did, viz. "accept the company's figures." The directors are the ones who should determine the figures by carefully considering values, and it was for the very purpose of compelling them to perform that duty that the statute imposes upon them a personal responsibility for declaring and paying dividends when the value of the assets is not sufficient to justify them. What directors must do is to exercise an informed judgment of their own, and the amount of information which they should obtain, and the sources from which they should obtain it, will of course depend upon the circumstances of each particular case.

[561] Annual reports, and newspaper accounts thereof, are virtually the only means by which shareholders and creditors receive detailed financial information about a corporation. If these individuals make some effort to determine that dividends are not being paid from capital, as they should, they will be able to make such determinations only by the presence of extensive supplementary reports reconciling dividend determining data with the accountants statement of earnings. Such data could, of course, be provided (though few directors would seem desirous of having to reduce their dividend deliberations to writing) but absent a statutory requirement it seems most unlikely that it will be provided.

upon accumulated earnings rather than upon a surplus of current asset values over liabilities and stated capital.[562]

If these objections are not sufficient reason for rejecting current values as a standard, the preceding discussion should have demonstrated the difficulties in merely using current values without attempting to distinguish price-level changes from changes in replacement costs. Even if the value changes do not involve changes in the value of the dollar, general recognition of changes in replacement cost, where the changes are not realized, does not appear to be sound dividend policy. It may be argued, however, that replacement costs should be used in the process of determining a corporation's income for dividend purposes.[563] But such a move would mean a change in the concept of capital from the traditional legal notion of capital as a quantum equal to shareholders' dollar contributions for par or stated value shares to an economic concept in which the basic productive capacity of the enterprise must be maintained before there could be any net income.[564] However desirable the maintenance of economic capital may be as a long-term objective,[565] the reluctance of accountants to venture into the field suggests that objective techniques for accomplishing these results are not currently available.[566] Hence it would seem that even in this area dividend determinations should be made on the basis of traditional accounting data, historical cost, modified by price-level indices.[567]

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[562] See 2 BONBRIGHT, VALUATION OF PROPERTY 974-75 (1937); Hackney, *Accounting Principles in Corporation Law*, 30 LAW & CONTEMP. PROB. 791, 821 (1965).

[563] See, *e.g.*, materials in AMORY & HARDEE, MATERIALS ON ACCOUNTING 271-89 (3d ed. 1958); *cf.* EDWARDS & BELL, THE THEORY AND MEASUREMENT OF BUSINESS INCOME 110-15 (1964); SPROUSE & MOONITZ, *A Tentative Set of Broad Accounting Principles For Business Enterprises*, ACCOUNTING RESEARCH STUDY No. 3, at 23-36, 55 (1962); Soloman, *Current-Cost Accounting*, Ill. C.P.A., Autumn 1965, p. 22; AMERICAN ACCOUNTING ASSOCIATION COMMITTEE ON CONCEPTS AND STANDARDS, ACCOUNTING AND REPORTING STATEMENTS FOR CORPORATE FINANCIAL STATEMENTS AND PRECEDING STATEMENTS AND SUPPLEMENTS 6 (1957); Zlatkovich, *A New Accounting Theory Statement*, J. ACCOUNTANCY, Aug. 1966, p. 31, 34.

[564] See Hackney, *Accounting Principles In Corporation Law*, 30 LAW & CONTEMP. PROB. 791, 810-11 (1965).

[565] For possible arguments against use of replacement costs, see STAFF OF ACCOUNTING RESEARCH DIVISION, *Reporting The Financial Effects of Price Level Changes*, ACCOUNTING RESEARCH STUDY No. 6, at 6-7 (1963).

[566] Even the authors of *Accounting Research Study No. 3*, Sprouse and Moonitz, seem to admit that satisfactory indexes of construction costs and of machinery and equipment prices are not currently available. SPROUSE & MOONITZ, *op. cit. supra* note 563, at 34. See also Hendriksen, *Purchasing Power and Replacement Cost Concepts—Are They Related*, 38 ACCOUNTING REV. 435 (1963).

[567] This is not to suggest that from a financial standpoint management need not take into account current replacement costs in determining the size of any dividend. This should be an aspect of the directors' fiduciary duty to maintain the economic health of the company. See discussion in text *infra* part III under the heading "Director and Shareholder Liability."

This is not to say that involvement of generally accepted accounting principles in dividend fund determinations does not itself present some problems. One long-time problem with such references has been the difficulty in determining precisely which accounting procedures were generally accepted.[568] This problem to some extent has been alleviated by the creation of the Accounting Principles Board by the American Institute of Certified Public Accountants[569] whose opinions have the effect of the substantial authoritative support necessary for a principle to be generally accepted.[570] Unfortunately, accounting principles can also have substantial authoritative support (and thus be generally accepted) despite significant variation from Board opinions, though extensive deviations are deterred by disclosures required if principles contrary to Board opinions are followed.[571] Even if Board opinions were deemed to constitute generally accepted principles, however, a scanning of the previous footnotes should indicate that frequently the opinions provide no answer to a particular question and that consultation of other general accounting sources is necessary. Another problem with the use of accounting principles is that frequently a wide range of alternative accounting procedures is generally acceptable,[572] which means in essence that a corporation's income is similarly capable of a wide range. It is to be hoped that in the future the range of alternatives will be narrowed and that in the meantime

[568] GRADY, *Inventory of Generally Accepted Accounting Principles For Business Enterprises,* ACCOUNTING RESEARCH STUDY No. 7, at 52-53 (1965), equates (as does the American Institute of Certified Public Accountants, see AICPA, *Disclosure of Departures From Opinion of the Accounting Principles Board,* Special Bull. 1964) generally accepted accounting principles with accounting practices which have substantial authority back of them. The sources for determining whether an accounting practice has substantial authoritative support are: (1) practices commonly found in business; (2) requirements and views of stock exchanges and commercial and investment bankers; (3) regulatory commissions' uniform systems of accounts and rulings (though departures from generally accepted principles are to be disclosed); (4) regulations and accounting releases of the SEC; (5) opinions of practicing and academic certified public accountants; and (6) opinions by the committees of the American Accounting Association and the American Institute of CPA's.

[569] The Board was established in April 1959 for the specific purpose of preparing a statement of the basic postulates and of the broad principles of accounting. For a lengthy discussion of the Board, see Sprouse & Vagts, *The Accounting Principles Board and Differences and Inconsistencies In Accounting Practice: An Interim Appraisal,* 30 LAW & CONTEMP. PROB. 706 (1965).

[570] AICPA, *Disclosure of Departures From Opinions of The Accounting Principles Board,* Special Bull. 1964.

[571] *Ibid.*

[572] For example, AICPA RESEARCH BULL. No. 43 permits cost for inventory purposes to be determined under any one of several assumptions as to the flow of cost factors, such as FIFO, LIFO, or average costs. AICPA RESEARCH BULL. No. 43, ch. 4, statement 4 (1953). And generally accepted methods for computing depreciation on fixed assets range from the straight-line method to declining-balance depreciation. See AICPA, ACCOUNTING TERMINOLOGY BULL. No. 1, ¶ 56 (1953); AICPA RESEARCH BULL. No. 44 (Revised) (1957).

insistence on consistency in application of principles will reduce intracorporate deviations.[573] These problems and the instances previously noted in which the results under accounting principles do not coincide with sound dividend policy suggest that the answer to the second question previously reserved—whether the statute should specifically state the extent of its reliance on generally accepted accounting principles—should be no. Accounting principles, however helpful in dividend determinations, are in the process of evolution and refinement, and there is no guarantee that the eventual principles will correlate well enough with dividend policy to deserve current incorporation in the statute.[574]

[573] Fortunately, the prime purpose of dividend regulation is not to compare corporation's performance with that of another in the same line but rather to attempt to resolve conflicting legal interests in the distribution of dividends. *Cf.* Sprouse & Vagts, *supra* note 569, at 723. In the latter pursuit, many accounting variations will be less important where consistently applied.

[574] See in this connection the following statement in SPROUSE & MOONITZ, *A Tentative Set of Broad Accounting Principles For Business Enterprises,* ACCOUNTING RESEARCH STUDY No. 3, at 10 (1962):

> In order to make the transition from the postulates as set forth above to the principles developed in this study, some additional steps are necessary. The first is a clear recognition that broad principles must transcend the historical limitations of profits "available for dividends" or "subject to income tax." This is not to say that the effects of dividends and of taxes should be ignored; to do so would ignore a significant part of the environment in which accounting operates. Rather the task is to formulate those principles which will enable us to measure the resources held by specific entities and the related changes *before* consideration of taxes and dividends. The measurements should be independent of the dividend and the tax questions but, at the same time, should facilitate the solution of those questions, as well as of others related to financial position and operating results. Put another way, broad principles of accounting should not be formulated mainly for the purpose of making good, or validating, so to speak, the principles of sound dividend or tax policy.