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Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws

Much progress has been made in recent years toward more scientifically drafted corporation laws which aim to give efficiency and scope to the management and at the same time to impose reasonable safeguards against corporate abuses. New corporation acts have recently been adopted in California, Illinois, Indiana, Idaho, Louisiana, Michigan, Minnesota, Ohio, Pennsylvania and Washington. These laws have been stimulated by suggestions contained in the Uniform Business Corporation Act.¹

Increasing interest is being shown in the possible need and advantage of a federal incorporation law.² The Companies Act of Canada, 1934, became effective October 1, 1934. It is said to be intended as a model for uniform legislation throughout the Provinces. It contains stringent provisions for protection of creditors and requirements as to financial statements to shareholders.

No part of the entire corporate mechanism, a vital instrumentality in modern business, investment and speculation, is more complicated or more poorly designed and comprehended than the legal capital requirements and the attempted safeguards against unsafe distributions of assets to the shareholders such as improper dividends, share purchases and distributions following reductions of legal capital. Many economists now favor liberal dividend distributions as against undue expansion of plants and the piling up of needless surpluses, investment

¹ Drafted by the National Conference of Commissioners on Uniform State Laws and approved by the American Bar Association at its 1928 meeting. See Ballantine, Questions of Policy in Drafting a Modern Corporation Law (1931) 19 CALIF. L. REV. 465; A Critical Survey of the Illinois Business Corporation Act (1934) 1 CHICAGO L. REV. 357.

accounts and reserves under the control of the management. At the same time the fundamental policy, sometimes expressed in the misty metaphors of the so-called "trust fund doctrine," still survives, namely, that a corporation must establish a legal capital in connection with the issue of its shares and must retain that amount as a margin of assets over liabilities before making distributions to its shareholders. The improvident declaration of dividends not only imperils creditors and senior shareholders, but also injures the corporation, misleads existing shareholders and defrauds investors. The same is equally true of the undue depletion of current assets by purchases by a corporation of its own shares and the carrying of treasury shares as if they were an asset of value or a reduction of legal capital.

The older statutory provisions as to capital, dividends and share purchases have proved entirely inadequate. In the drafting of modern corporation laws more careful limitations are being devised. But the effort to formulate more satisfactory safeguards in these matters, having closer relation to financial realities, is still going on. The policy limiting both dividends and share repurchases is fundamentally the same, namely, to preserve some minimum of financial responsibility. This is sought to be attained by establishing an accounting yardstick or financial test for the protection of creditors before the management is given authority to order withdrawals of assets. As already pointed out, the protection of the investment of preferred shareholders, of common shareholders and of incoming shareholders is also to be considered.

The legal machinery to establish and maintain some minimum amount of net assets or investment in the business is exceedingly complicated. It involves a system of rules, difficult to formulate and enforce, governing the following matters: The proper definition of "stated" or legal capital; the fixing of the issue price of shares with and without par value; the requirements as to payment in good faith of the issue price; the liability for over-valuation of the consideration received, if other than money; the portion of the consideration which may be set aside as distributable surplus on the issue of no par shares; the minimum amount of capital which must be paid in before business

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5 Pasotti v. United States Guardian Corp. (1931) 18 Del. Ch. 1, 156 Atl. 255; Warren, Safeguarding the Creditors of Corporations (1923) 36 Harv. L. Rev. 509, 542. Hills, Stated Capital and Treasury Shares (1934) 57 J. of ACCOUNTANCY 202, criticises the prevalent practices of the carrying of treasury shares as if they were an asset of value or a reduction of legal capital.
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may be begun; the regulation of the valuation of assets to be counted toward surplus; the definition of the kinds of surplus available for cash or property dividends on shares of different classes; the authorization of an alternative source or basis of dividend payments in the absence of available surplus, such as current or annual net profits; the protection of the liquidation preferences of preferred shares; the limits upon the purchase or the redemption by the corporation of its own shares; the limits upon the voluntary reduction of the amount of legal capital and the distribution of the reduction surplus; and finally the remedies for the violation of the restrictions upon distributions and withdrawals by way of personal liability of the shareholders and of the directors.

It is the purpose of this article to make a brief survey of the prevailing types of statutory restrictions upon dividends with a view to evaluating the efficiency and ascertaining the shortcomings of the standards prescribed. The concept of the legal or “stated” capital will first be considered, and then the different varieties of limitations on cash and share dividends, with comment upon the abuses and defects of the existing systems and the need of some further statutory revision. The related topics of limitations upon the purchase and redemption by a corporation of its own shares and upon the reduction of the legal capital can be referred to only incidentally. These questions of corporation finance are important because the present statutes are unduly lax and erroneous views and practices are extremely prevalent among lawyers and accountants. A mistaken declaration of dividends, a purchase of shares “out of capital” or a misleading financial statement as to legal capital and surplus may involve directors and officers in serious liabilities.

I. CONCEPT OF LEGAL CAPITAL AND CAPITAL STOCK

What is the legal or “stated” capital? This involves some discussion of the concept referred to by the vague term “capital stock” and the trust fund doctrine. In 1824 Mr. Justice Story in the famous case of

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6 Ballantine, California Corporation Laws (1932) 125-131, 301, 362; ibid., 1933 Supplement, 55-58, 145, 161.
7 As to English rules, see Samuel, Shareholders’ Money (1933) 145-149, 345, 347.
8 Notably as to the effect upon legal capital and upon surplus of the purchase by a corporation of its own shares, see Hills, Stated Capital and Treasury Shares (1934) 57 J. of Accountancy 202; Lewis, Some Legal and Accounting Questions, Michigan General Corporation Act (1933) 8 Accounting Rev. 144; Ballantine, California Corporation Laws (1932) 313-321; ibid., 1933 Supplement, 127-133, 172-181.
9 Writers on corporation law and also upon accounting and corporation finance do not seem to have apprehended or discussed this important concept at all clearly.
Wood v. Dummer10 asserted that the "capital stock" of banks is to be deemed a pledge or trust fund for the payment of their debts, a fund appropriated for such purposes by legal requirements, and said:

"The charter relieves them from personal responsibility, and substitutes the capital stock in its stead. . . . Why, otherwise, is any capital stock required by our charters? If the stock may, the next day after it is paid in, be withdrawn by the stockholders without payment of the debts of the corporation, why is its amount so studiously provided for, and its payment by the stockholders so diligently required?"11

Is the legal capital of a corporation a fund set apart in trust and pledged for the payment of corporate debts? It has been recognized in many modern cases that this loose and figurative language about capital stock being a trust fund has been a great source of confusion.12 You cannot point to any particular res or fixed assets or fund as being "capital" or "capital assets" earmarked or segregated from other assets which are surplus. All the net assets together equal capital and surplus.13 Legal capital is not a res, but a quantum or mathematical limit below which amount assets may not lawfully be withdrawn by the shareholders. Courts wobble in their language between these two concepts.14 It has been frequently pointed out that there is in truth no fund or value mingled with the corporate assets which is held by the corporation in trust for its creditors, that unsecured corporate creditors have no equitable lien on the assets of a solvent corporation.15 The assets of an insolvent corporation must be used in satisfaction of its debts before distribution to shareholders and cannot be depleted to the creditors' prejudice by dividends or the purchase of its own shares.16 What we have in reality is a system of rules as to the issue and payment for shares and the establishment of a legal capital as a limitation upon the withdrawal of assets, so that the directors may not distribute the assets to the shareholders below the point of equivalence between the amount of the assets and the amount of the liabilities including

11 Ibid. at 436; see Sanger v. Upton (1875) 91 U. S. 50, 60; Warren, Safeguarding the Creditors of Corporations (1923) 36 Harv. L. Rev. 509, 544; Zettler, The Trust Fund Theory (1925) 1 Wash. L. Rev. 81; 15 Fletcher, Cyclopedia of Corporations (1932) § 7369.
13 Hatfield, Accounting (1931) 286.
14 See Isaacs, Principal—Quantum or Res? (1933) 46 Harv. L. Rev. 776.
capital, all of which may be better expressed without the figurative terminology of the trust fund doctrine.\textsuperscript{17}

The purpose and policy of the capital requirements may be stated somewhat as follows: As a condition of granting to the shareholders the privilege of trading in a corporate capacity with limited liability, it is required that subscribers for the shares invest certain funds in the business as consideration for their shares. There is in modern laws no fixed minimum of capital which must be subscribed or paid in except for a very nominal amount. In general, that part of the consideration for the shares contributed to capital by the shareholders measures the legal capital.\textsuperscript{18} The law does not require that a business corporation maintain a net worth equal to the full amount of its legal capital as it does in the case of banks, but it prohibits certain withdrawals unless a surplus above such net worth is on hand. So far as creditors are concerned, there would be no objection to distributing all of the assets over and above a certain ratio of current assets to current liabilities or other suitable margin of value for their protection, but the interests of the shareholders require that the business should continue and that it should not be liquidated in whole or in part without their consent. Consequently, the function of legal or stated capital is threefold: (1) the protection of the creditors against the shareholders; (2) the protection of senior shareholders against junior shareholders; and (3) the protection of all shareholders against mismanagement and the impairment of their investment and its earning power.\textsuperscript{19}

In \textit{Williams v. Western Union Telegraph Company},\textsuperscript{20} the New York court had occasion to discuss the purpose of the limitations contained in early New York statutes, copied also in the statutes of California and some other states, against dividing, withdrawing or in any way paying to stockholders or any of them any part of the “capital stock” of the corporation, or reducing the capital stock without the consent of the legislature, or receiving any note in payment of any part of the subscription price of any stock.

The court explained the policy of these limitations as follows:

“These provisions were intended to prevent the division, distribution, withdrawal and reduction of the property of a corporation below the sum limited in its charter or articles of association for its capital, but not to prevent its increase above that sum. The purpose was to prevent the

\textsuperscript{17} Williams v. Western Union Tel. Co. (1883) 93 N. Y. 162; \textit{Baillyntine, California Corporation Laws} (1932) 126-131, 376; \textit{Ibid., 1933 Supplement}, 55-60.

\textsuperscript{18} Morawetz, \textit{Private Corporations} (2d ed. 1886) §§112-114, 434-440.

\textsuperscript{19} Martin v. Zellerbach (1869) 38 Cal. 300, 308, 318, 99 Am. Dec. 365, 373, 381.

\textsuperscript{20} (1883) 93 N. Y. 162; see also Small v. Sullivan (1927) 245 N. Y. 343, 157 N. E. 261.
depletion of the property of the corporation thereby endangering its sol-
vency. All the other provisions of the section show very clearly that such
was the intention. Careful provision was made that the whole amount of
capital stock should be paid in, and hence there was a prohibition against
receiving a note or other evidence of debt in payment of any installment
actually called in and required to be paid; and in case the directors
violated any of the provisions of the section they were made individually
liable to the corporation and to its creditors, in the event of its dissolu-
tion, to the full amount of the capital stock of the company so divided,
withdrawn or reduced. All these provisions show that it was the purpose
of the legislature, by means of them, to create a property capital for the
corporation, and then to keep that intact so as to secure the solvency of
the corporation and its responsibility to its creditors. The 'capital stock'
in this section does not mean share stock, but it means the property of
the corporation contributed by its shareholders or otherwise obtained
by it, to the extent required by its charter. While the term 'capital stock'
is frequently used in a loose and indefinite sense, in this section and in
legal phrase generally it means that and no more.21

Owing in part to a defective terminology, the concept of "capital
stock" as referring to the legal capital has never been clearly stated or
grasped by courts or writers. The courts loosely or figuratively speak
of the "capital stock" as a "fund" or property for the ultimate security
of the corporation's creditors, both present and future, rather than as a
quantum, a legal limit upon the withdrawal of its funds or assets ex-
cept so far as the net value of the property exceeds that limit.22 Capital
stock in the sense of legal or stated capital measures the amount of
the margin of assets over debts and liabilities required to be retained.
A law which merely forbade the withdrawal of assets below an exact
equivalence to the actual debts and liabilities at the time of withdrawal
would force the creditors to bear all the risk of insolvency arising from
any slight business loss or shrinkage of assets.

The older corporation acts were not specific in giving any statutory
definition for the determination of the legal capital since it was as-
sumed to be measured by the aggregate par value of the issued shares.
Treasury shares, being issued but not outstanding shares, have occupied
a very uncertain position with respect to legal capital and surplus.
With the advent of non-par shares a statutory definition of capital
became imperative and these formulae for the determination of the
legal capital, which differ somewhat in the several states, must be
applied in the computation of legal capital and so of surplus available for
dividends and other purposes. The legal capital may be compared with
a certain level marked by a gauge upon the corporate reservoir of
assets. If the assets stand above that level, they may be drawn off for
the shareholders. If the assets fall below that level, the remaining

21 Williams v. Western Union Tel. Co. (1883) 93 N. Y. 162, 187.
22 Smith v. Dana (1905) 77 Conn. 543, 60 Atl. 117, 121; Small v. Sullivan
supply must be reserved for business purposes and for the creditors. Capital is "impaired" and there is a capital deficit if the value of the assets falls below the amount of the liabilities plus the amount of the legal capital. No dividends may lawfully be paid unless after such payment the value of the property of the corporation (taken at proper book values according to bases recognized by accounting practice) is equal to the aggregate of its liabilities and the legal capital.

II. STATUTORY DEFINITIONS OF LEGAL CAPITAL

Modern legislation attempts to define the legal capital, whether called "stated capital," "capital," "capital stock," "paid-up capital" or some other term, in order to clarify the requirements of the law. The Uniform Business Corporation Act (section 1, subdivision X), unfortunately, continues to employ the much abused term "capital stock" to indicate the legal capital, although this term has long been involved in the most extraordinary ambiguity, confusion and vagueness of thought in the statutes, the decisions, and in accounting. "Capital stock" is sometimes used to refer to shares of stock, sometimes to the aggregate of the amount of the par value shares authorized to be issued in the certificate or articles of incorporation, sometimes to the assets or consideration received from the shareholders upon the issue of shares, and sometimes to the legal capital or amount to be deducted (as if it were a liability) from the net assets in ascertaining surplus. The term "stated capital" came first into use in laws as to non-par shares in connection with the permission to credit part of the consideration received to paid-in surplus and the balance to legal capital.

Capital stock is defined in the Uniform Business Corporation Act (section 1, subdivision X) as follows:

"The 'Capital Stock' of a corporation at any time is (a) the aggregate amount of the par value of all allotted shares having a par value, including such shares allotted as stock dividends, and

"(b) the aggregate of the cash, and the value of any consideration other than cash, determined as provided in this Act, agreed to be given or rendered as payment for all allotted shares having no par value, plus such amounts as may have been transferred from surplus upon the allotment of stock dividends in shares having no par value."

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24 CAL. CIV. CODE § 363; DEL. GEN. CORP. LAW (1933) § 34; ILL. BUS. CORP. ACT (1933) § 42 (b); MINN. BUS. CORP. ACT (1933) § 22; OHEO GEN. CORP. ACT (1931) §§38, 123, 123(b).
27 See State v. Becker (1928) 320 Mo. 908, 8 S. W. (2d) 970, an unsatisfactory discussion.
This definition of "capital stock" is very similar to the definitions of "stated capital" under the more recent acts, which will be referred to later. Under it the legal capital is measured in general by the amount of consideration received or to be received for the issued shares. The Uniform Business Corporation Act also undertakes to define the term "capital" as follows:

"The 'Capital' of a corporation is the portion of its assets acquired as consideration for shares allotted and that portion of its assets which has been treated as payment for shares allotted as stock dividends."

This definition of "capital" cannot mean that any particular assets are earmarked as capital. It must mean that "capital" includes any or all assets up to an amount equal to the value of the assets acquired as consideration for shares issued, and the amount of surplus capitalized as payment for stock dividends. "Capital" then refers to any and all the assets up to a value or net worth measured by the "capital stock," the legal capital.

Some of the states which have followed the Uniform Business Corporation Act in whole or in part as the basis of their corporation acts adopt the term "capital stock" to indicate the legal capital, an amount to be carried as a liability and to be deducted from the net assets in ascertaining surplus available for dividends. The Uniform Act, however, has not been followed in adopting the term "capital stock" by certain laws using it as a basis, for example, by the Minnesota Business Corporation Act. The Indiana General Corporation Act (section 1 (g)) uses the term "capital stock" to refer to the aggregate par value or total number of all shares authorized to be issued, and in section 1 (h) defines "capital" to mean the aggregate amount paid in on the shares issued and outstanding. The term "capital" is thus used to indicate the legal capital.

A number of states, including Delaware, use the term "capital" to refer to the legal capital. Under the New York Stock Corporation Law the words "capital stock" are used in referring to the legal capital of corporations having only shares with par value and the word "capi-
“Capital” is used in referring to the legal capital of corporations authorized
to issue only shares without par value and of all corporations author-
ized to issue both shares with and without par value. These terms are
made interchangeable as designations of legal capital. In Maryland
the awkward terms “amount of stock issued” and “amount of issued
capital stock” are used to indicate the legal capital.

Several of the more carefully drafted recent corporation acts adopt
the term “stated capital” to indicate the legal capital, thereby avoid-
ing such ambiguous terms as “capital stock” and also “capital,” which
have involved even the draftsmen of the Uniform Business Corporation
Act in confusion.

In composite, the legal or stated capital under modern acts is measured
by the aggregate par value or amount of consideration received
or to be received by the corporation for its issued shares including
treasury shares, subject to the following qualifications: (a) As to par
value shares, any consideration received in excess of par value is
credited to paid-in surplus and does not increase the legal or stated
capital. In California, if par value shares are issued for less than par
as fully paid up, only the amount of the agreed consideration is credited
to stated capital. (b) As to shares without par value, the entire agreed
consideration constitutes stated capital, provided that the directors may
designate a portion of such consideration to be paid-in surplus. In
some states, however, the amount which may be designated as paid-in
surplus is limited. (c) Stated capital also includes such amounts as
may have been transferred from surplus to stated capital upon declara-
tion of a share dividend or by action of the directors or shareholders
independently of a share dividend.

Although a few states require the capitalization of all consideration
received upon the issue of non-par shares, many acts permit the creation
of an unlimited paid-in surplus. Some modern laws, however, place limitations on the allocation of the consideration for non-par

33 N. Y. STOCK CORP. LAW (1934) §§ 12, 13, 36 (A) and (I), 37-4, 38-5.
34 Md. GEN. CORP. LAW (1933) §§ 39 (2), (3), 50, 87.
35 CAL. CIV. CODE § 300b; ILL. BUS. CORP. ACT (1933) §§ 2 (k), 19; MINN.
BUS. CORP. ACT (1933) §§ 1-X, 20; OHIO GEN. CORP. ACT (1931) § 37; PA. BUS.
CORP. LAW (1933) §§ 2, 614.
36 See UNI. BUS. CORP. ACT (1928) § 41, on reduction of capital stock. A
reduction of the legal capital, of course, does not reduce the actual value of the
corporate assets unless followed by a distribution.
37 CAL. CIV. CODE § 300b; ILL. BUS. CORP. ACT (1933) §§ 2 (a), 19; MINN.
BUS. CORP. ACT (1933) §§ 2-X, 20; OHIO GEN. CORP. ACT (1931) § 37; PA. BUS.
CORP. LAW (1933) §§ 2, 614.
38 FLA. GEN. CORP. LAW (1925) § 21; IND. GEN. CORP. ACT (1929) § 1 (h);
N. Y. STOCK CORP. LAW (1934) § 12-4B.
39 DEL. GEN. CORP. LAW (1933) § 14; Md. GEN. CORP. LAW (1933) § 39; N. J.
GEN. CORP. ACT § 121.
shares to paid-in surplus and attempt to safeguard the adequacy of the stated capital, particularly for the protection of preferred shares. The Pennsylvania Business Corporation Law (1933) and also the California General Corporation Law (1933) require the capitalization of all consideration received for shares having a preferential right to assets in the event of involuntary dissolution.40

The Michigan Act requires that at least fifty per cent of the amount of the consideration received for any shares without par value shall be determined to be capital.41 Under the 1933 Minnesota Law only that part of the value of the consideration which is in excess of the amount to which non-par shares having a preference on involuntary liquidation are entitled over other classes of shares may constitute paid-in surplus, unless otherwise provided in the contract of subscription (section 20, III). The Uniform Business Corporation Act does not contain any such limitations. The power to treat substantially all of the consideration received for preferred shares without par value as paid-in surplus rather than as stated capital seems unfair as it may allow dividends on common shares out of the proceeds of the preferred shares, under such laws as permit dividends out of paid-in surplus. Either the entire consideration for such preferred shares should be attributed to stated capital, or only the consideration in excess of the liquidation preferences should be attributed to paid-in surplus.

The danger of allocating consideration to paid-in surplus depends on the availability of that surplus. If paid-in surplus can not be withdrawn for dividends or share purchases, it assumes a semi-stated capital position, available for the absorption of losses but otherwise reserved.42 It is necessary, therefore, either to assure an adequate amount of stated capital by placing restrictions on the creation of paid-in surplus, or to prevent the withdrawal of paid-in surplus except within limits of safety.

III. Restrictions on Dividends

The statutory attempts to limit the discretion of corporate directors in the declaration of dividends are difficult to interpret and their application involves great uncertainties as to accounting terms, methods and judgments as to values.43 The principal types of restrictions on

42 See Hatfield, Operating Deficit and Paid-in Surplus (1934) 9 ACCOUNTING REV. 237, 240.
43 See Midland Savings & Loan Co. v. Dunmire (C.C.A. 10th, 1933) 68 F. (2d) 249; Ballantine, California Corporation Laws, 1933 Supplement, 140-148, 172-181; Graham and Katz, Accounting in Law Practice (1932) 146;
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dividends to be found in the statutes may be classified in general as follows:44

(1) The most frequent limitation is that dividends are payable only out of *surplus*, that is, to the extent that the net worth of the assets exceeds the amount of the legal capital. This is frequently made subject to a judicial or statutory exception as to the distribution of the proceeds of wasting assets. In general, however, dividends are forbidden if there is an impairment of deficit of net assets below the legal capital.

(2) In a few states the surplus requirement is somewhat more carefully restricted and dividends are payable only out of “earned surplus,” that is, out of accumulated profits, except that upon preferred shares or under particular circumstances they may also be paid out of paid-in surplus or some other unearned surplus.

(3) In a few jurisdictions, dividends are payable either from accumulated surplus, or in the absence of the requisite surplus, from net profits for some particular accounting period, either all or some part of the current year or for the current and the preceding fiscal years, subject to provision for the protection of shares having a preference upon liquidation. Under this rule, dividends may be paid out of annual earnings in spite of a capital deficit resulting from operations of prior years.

(4) In many states a general insolvency limitation is combined with the surplus or net profits limitation. “Insolvency” in such statutes should be interpreted to refer to inability to meet debts and obligations as they mature rather than to an excess of liabilities over the value of the assets. A surplus does not necessarily indicate financial strength. A corporation may have a *bona fide* surplus of assets over liabilities at book values but at the same time it may be “insolvent” in the sense that it cannot meet its current liabilities as they mature. It is frequently not clear in dividend statutes which of the two meanings of insolvency, (1) the inability to meet debts as they fall due, or (2) the excess of liabilities over the total value of the assets at balance sheet figures, is intended.45


A. The Surplus Limitation.—The most prevalent statutory dividend restriction is the existence of a sufficient surplus, that is, of a net worth as shown by the books in excess of the legal capital. The laws of Delaware and of many other states permit dividends out of surplus of any and all varieties, whether earned or unearned, surplus being defined simply as the excess of net assets over the legal capital. Under some laws which limit the classes of shares on which dividends from “paid-in surplus” may be paid, there is a requirement as to giving notice to the shareholders when a dividend is paid from other than earned surplus.

The surplus limitation is described in a variety of terms, all of which, however, come down to the same thing. The terms “profits,” and even “surplus profits,” and “net earnings” are usually interpreted as not being confined to earned surplus resulting from the profits of the business, but as including surplus arising from almost any kind of realized excess of value of assets over the amount of legal capital. Limitations to “profits” and “earnings” are thus usually interchangeable with those based on surplus or on prohibitions against “impairment of capital” or withdrawal of capital stock. It is said in a New York case, “The ordinary way of determining whether a corporation has surplus profits or not is to compute the value of all of its assets and deduct therefrom all of its liabilities, and thus ascertain whether the balance exceeds the amount of its shares of capital stock.” The phrases “impairment of capital” or payment “out of capital” or “out of capital stock” are shorthand expressions to indicate that the value of the net assets remaining after the dividend is paid would not equal the amount


48 As is said in Cotting v. New York & N. E. R. R. (1886) 54 Conn. 156, 5 Atl. 851, the term “net earnings” may be and often is the equivalent of surplus or net profits and is used as referring to surplus, the gains over the whole period of time for which the corporation has existed. See also Guaranty Trust Co. v. Grand Rapids, etc., Ry. (W. D. Mich. 1934) 7 F. Supp. 511, 517; Splittgerber Bros. v. Skinner P. Co. (1930) 119 Neb. 259, 266, 228 N. W. 531, 534; Park v. Grant Locomotive Works (1885) 40 N. J. Eq. 114, 121, 3 Atl. 162, 167; Branch v. Kaiser (1928) 291 Pa. 543, 140 Atl. 498.

of its liabilities plus the legal capital, that is, that the distribution
would impair the margin of net assets measured by the legal capital.
The phrase “out of surplus” means that there is net worth above the
margin of legal capital to cover the distribution.\textsuperscript{50}

B. Apparent Alternatives to Surplus; Net Profits or Earnings.—
Under the acts of Arkansas, Connecticut, Florida, Indiana, New
Jersey, Michigan, Nevada, North Carolina and some other states\textsuperscript{51} appa-
rent alternatives are provided that dividends may be declared
from “surplus” or from “net profits” or “earnings.” It must be con-
sidered whether alternative funds are actually intended by these terms,
particularly where they are used in combination with a prohibition
against the impairment or withdrawal of capital. It appears that these
terms are simply part of a description of surplus. If the term “sur-
plus” alone were used, then because of accounting usage relating to
the term “undivided profits” it might be held that a dividend could
not be declared unless there were a surplus at the beginning of the
year. Conversely, if the terms “out of net profits” or “undivided pro-
fits” alone were used, then there might be a question as to whether the
dividend could be declared from a surplus existing at the beginning of
the year or whether it would be limited to accrued earnings for the cur-
rent fiscal year.

“Surplus,” as commonly employed in accounting, describes such
part of the excess of value of the corporate assets over the sum of its
liabilities, including legal capital, as is carried by the corporation on
the books in a separate surplus account, while the term “undivided pro-
duits” designates such part of the excess as consists of profits which
have neither been distributed as dividends nor carried to surplus ac-
count.\textsuperscript{52} The term “undivided profits” or “net earnings” in connection
with the declaration of dividends thus may mean current earnings
during an existing fiscal period as opposed to the surplus of undis-
tributed earnings or profits at the beginning of the year. Many cor-

\textsuperscript{51} Ark. Gen. Corp. Law (1931) § 25, “net earnings or from surplus;” Conn.
(1925) § 23, “net earnings or from surplus;” Ind. Gen. Corp. Law (1929) § 12,
“surplus earnings or net profits or surplus paid-in cash;” Mich. Acts 1931, c. 327,
§ 22, “earned surplus or from net earnings;” Nev. Gen. Corp. Law (1931) § 26,
“net earnings or from surplus;” N. J. Gen. Corp. Act. (1920) § 30, “from its surplus
or from net profits arising from the business;” N. C. Cons. Stats. (1927) c. 22,
§ 1179, “from surplus or net profits arising from its business;” Ore. Code Ann.
(1930) c. 25, § 219, “net profits or surplus;” R. I. Gen. Law (1923) c. 248, § 41,
“surplus or net profits;” Tenn. Code (1932) § 3737, “net earnings or from the sur-
out of its net assets in excess of its capital.”

\textsuperscript{52} Edwards v. Douglas (1925) 269 U. S. 204, 214; Willcuts v. Milton Dairy
Co. (1927) 275 U. S. 215; Hatfield, Accounting (1931) 297.
porations keep two accounts, one "undivided profits," which reflects the results of current operations, and another "surplus," to which the undivided profits are transferred at the end of a fiscal period and which represents the accumulation of gains and profits for previous years.53

In most, if not all, of the statutes in which the terms "net profits" or "earnings" are employed without specifying some particular period for their determination, it thus appears that no alternatives to surplus are intended. Any surplus value over capital is "profits."54 There is properly no necessity for using both these terms, either of which may be construed as including all excess of net assets over the amount of legal capital, whether carried in a surplus account or otherwise.55 What is primarily intended is a prohibition against "impairment of capital," that is, a reduction of the value of the net assets below the amount of the legal capital.

In Goodnow v. American Writing Paper Co.,56 however, the New Jersey court construed the language of section 30 of the New Jersey Corporation Law as permitting a limited alternative. It was said that the section distinguishes between surplus and net profits in that surplus is computed by the excess of the value of the net assets over legal capital, while profits are computed according to the excess of value of net assets over the value of the consideration for shares actually paid in and not over the legal capital as measured by the par value of the shares. The case does not hold, as some writers suppose, that if par value shares are issued at a discount, "surplus" is the excess of net assets over the amount originally paid rather than over the par value of the issued shares.57 It was held that the prohibition of section 30 against paying any part of the "capital stock" over to the stockholders was intended to mean the "capital actually invested." This interpretation, however, recognizing paid-in capital as the base in measuring "capital stock" and "net profits" and aggregate par value of the

53 ACCOUNTING TERMINOLOGY, p. 117, published by the American Institute of Accountants in 1931 and 1934 has the following to say about the "surplus" account: "In some corporations 'profit and loss,' 'undivided profits,' or 'loss and gain' is used in place of 'surplus,' and in other cases two accounts are kept, one, designated as 'profit and loss' or 'loss and gain' to reflect the results of current operations, while the other, called 'surplus' is the account to which the former is transferred at the end of a fiscal period."

56 (1908) 73 N. J. Eq. 692, 69 Atl. 1014.
57 BALLANTINE, PRIVATE CORPORATIONS (1927) 509; HATFIELD, ACCOUNTING (1931) 297.
shares as legal capital in measuring surplus, seems a very doubtful one which should probably not be followed in other jurisdictions.  

**C. Paid-in Surplus as a Basis for Dividends.**—An important legislative problem is how far to limit the availability of paid-in surplus as a basis for dividends. The creation of a large initial paid-in surplus has become a prevalent practice with the advent of non-par shares and this device offers opportunities of abuse and evasion of capital limitations, especially where there are several classes of shares. Under such a lax provision as that of the acts of Delaware, New York and some other states much of the consideration contributed by one class of shares (although such shares may be preferred as to dividends and liquidation) may be distributed to the holders of junior classes of shares in the form of dividends or purchase price of shares. The more carefully drawn modern acts have, accordingly, distinguished between earned surplus and paid-in surplus, and earned surplus is made the basis or source of dividends upon common shares. Earned surplus represents the undistributed earnings either from the date of organization or from some date of reorganization or recapitalization. Thus the creation of paid-in surplus is not only curbed as to preferred shares, but the use of paid-in surplus for dividends and for share purchases is restricted even when such a surplus is established.

Such restrictions on the use of paid-in surplus in effect treat it as a reserve or margin of value for the protection of preferred shareholders and those having claims against the corporation, although it is not formally capitalized. Shareholders and share purchasers ordinarily assume that dividends represent profits of the business and not a partial return of the funds invested. Allowance of dividends from unearned surplus creates a serious danger of deception and misrepresentation, and for that reason many acts require that notice of the source be given.

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68 See, however, 14 C. J. (1919) 802; Guaranty Trust Co. of N. Y. v. Grand Rapids, etc., Ry. (W. D. Mich. 1934) 7 F. Supp. 511, 517; Peters v. United States Mortgage Co. (1921) 13 Del. Ch. 11, 114 Atl. 598. This case was decided before the Delaware amendment of 1927 defining capital and surplus.

69 See BERLE and MEANS, The Modern Corporation and Private Property (1932) 146, 162-172, 174; BERLE, Corporate Devices for Diluting Stock Participations (1931) 31 Col. L. Rev. 1239, 1248; Note (1931) 31 Col. L. Rev. 844.


63 Hatfield, Accounting (1931) 306; see Hatfield, Operating Deficit and Paid-In Surplus (1934) 9 Accounting Rev. 237.

64 See Hatfield, Accounting (1931) 290, 291.

The Illinois Business Corporation Act, 1933, (section 41) provides that dividends may be paid out of paid-in surplus only upon shares having a preferential right to receive dividends and that the source of such dividends must be disclosed to the shareholders concurrently with payment. The 1933 Minnesota Business Corporation Act (section 21) provides for notice of the source but permits the payment of dividends out of paid-in surplus to shares of any class, provided that if there are outstanding shares entitled to preferential dividends, then dividends may be declared out of paid-in surplus only on such shares. If the corporation has outstanding shares entitled to preferential dividends or to a preference upon liquidation, then only such shares may be purchased or redeemed out of paid-in surplus.

The Illinois Business Corporation Act (section 60) permits the distribution of “liquidating dividends” out of paid-in surplus and also out of “reduction surplus,” arising from reduction of legal capital, by a vote of two-thirds of the outstanding shares of each class, subject to the prior payment of all preferential dividends and the retention of net assets for the protection of the liquidation preferences of preferred shares. It would seem that no corporation should be permitted to pay dividends to the holders of its common shares out of surplus created by reduction of the legal capital, unless and until all preferred shares have been retired in full. The California General Corporation Law imposes the most careful restrictions upon the distribution of reduction surplus. The Illinois and Minnesota laws assimilate surplus arising out of reduction of the stated capital to paid-in surplus.

D. Unrealized Appreciation and Revaluation of Assets.—The Uniform Business Corporation Act and the laws of California, Illinois, Indiana, Louisiana, Minnesota, Ohio and Pennsylvania prohibit the declaration of cash dividends from a value or surplus arising from unrealized appreciation in value, unrealized profits, or the writing up or revaluing of fixed assets. These provisions are intended to prevent the payment of cash dividends out of profits not yet realized or out of

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68 Cal. Civ. Code § 348b. The purchase or redemption of the preferred shares from the reduction surplus should be made according to the order of the priorities of the different classes of preferred shares, since the distribution of such a surplus is in the nature of a partial liquidation.
69 Ill. Bus. Corp. Act (1933) § 60; Minn. Bus. Corp. Act (1933) § 20-IV.
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surplus resulting from padding the accounts by estimates and conjectures based on an unrealized increase in the value of assets. The creation of a surplus by mere writing up of the value of patents, good will, or fixed assets may too easily be employed as a purely fictitious basis for dividends. It is a difficult question in accounting and in law as to how assets are to be valued and as to when profits are to be regarded as having been realized, and in general the courts are satisfied by recognized accounting practices.

The statutes of Alabama, Idaho, Louisiana, Michigan, Ohio and Wisconsin, however, permit share dividends on the basis of surplus arising from unrealized appreciation, since such dividends involve no withdrawal of assets by the shareholders and creditors are not injured. But the declaration of dividends in shares upon the basis of such unsound values may be very misleading as will be pointed out later.

E. Current Annual Net Profits as an Alternative to Surplus.—Under the English law and also under the laws of Delaware, California and Minnesota, an alternative is allowed of paying dividends where there is no surplus and notwithstanding a capital deficit, on the basis of net profits of some next preceding accounting period, as for the current year or for the preceding fiscal year. The wisdom of this relaxation of the surplus requirement is much debated and a majority of American corporation laws do not permit it. The Delaware law since 1929 has permitted dividends “out of its net profits for the fiscal year then current and/or the preceding fiscal year,” notwithstanding there is no surplus. This is properly qualified, however, by a safeguard that the corporation must have a margin of net assets sufficient to cover the amount of capital represented by shares having a preference on liquidation. The Delaware provision as to the “fiscal year then current” must mean the fiscal year then in progress. The profits for a fiscal year cannot be computed until its expiration, but it may be possible to deter-


mine the amount of profits which has been made from the beginning of a fiscal year up to a certain date, and the Delaware provision evidently authorizes the distribution of profits as they are earned without waiting for the end of the year.

The Minnesota Business Corporation Law\textsuperscript{74} authorizes dividends “out of its net earnings for its current year or the preceding year” even in the absence of surplus. This seems to permit the distribution of profits at any time in the course of the current year. The corresponding California provision, on the other hand, reads: “Despite the fact that the net assets of the corporation amount to less than the stated capital, out of net profits earned during the preceding accounting period, which shall not be less than six months nor more than one year in duration.”\textsuperscript{75} This is safer because it requires that, if there be no surplus, a reasonable accounting period shall have elapsed before a dividend may be declared and does not permit juggling of profits and losses by the selection of too short an accounting period.\textsuperscript{76}

If the net profits of the next preceding accounting period are not seasonably used as a source of dividends under the permission of these statutes, then the balance of profit and loss would be thrown into surplus. If the corporation has a deficit, the profits of that period would go to reduce or make good that deficit and the chance to pay dividends out of the current or annual profits, in spite of capital deficit, would be lost.\textsuperscript{77}

It might at first sight be supposed that the laws of a number of states, such as Arkansas, Florida, Nevada, North Carolina, Indiana and Tennessee, give an alternative authorization of dividends either (a) from surplus or (b) from net profits or earnings, but as shown above, no alternative is given by these laws.\textsuperscript{78} The reference to net profits or earnings which they make is not to annual profits or to profits computed with respect to some fixed accounting period, but is simply a part of the description of total accumulated surplus, the excess of assets over the legal capital from the beginning. The terms “surplus” and “profits” are used as synonyms. There are no “net profits” in this sense when the capital is impaired. This is especially clear when there is a prohibition of impairment of capital or “capital stock,” thus prohibiting the distribution of annual profits in case of a capital deficit.

\textsuperscript{74} (1933) § 21.
\textsuperscript{75} CAL. CIV. CODE § 346 (2)
\textsuperscript{76} BALLANTINE, CALIFORNIA CORPORATION LAWS (1932) 343, 344; Ballantine, Questions of Policy in Drafting a Modern Corporation Law (1931) 19 CALIF. L. REV. 465, 478; Note (1933) 8 WIS. L. REV. 338, 341.
\textsuperscript{77} BALLANTINE, CALIFORNIA CORPORATION LAWS (1932) 345.
\textsuperscript{78} See supra notes 53 and 54; cf. Sparger, Profits, Surplus and the Payment of Dividends (1939) 8 N. C. L. REV. 14, 16, 21.
In such cases, current profits must be used to repair the existing deficit before any earnings can be distributed, or else the legal capital must be reduced to wipe out the deficit.

Objections of financial policy have been raised by some authorities to the relaxation of the surplus requirement by the permission to pay dividends from current annual profits of prosperous years when the total results of operations of previous years at the time of making the dividend show a deficit. Provision is commonly made for a reserve of capital to protect the liquidation priorities of preferred shares from what may amount to partial liquidation. The purpose of a dividend restriction is not to furnish a guide as to the advisability of a dividend distribution, but to establish some minimum test of whether the financial condition of a corporation forbids a dividend, having in view the safety of creditors and the interests of the different classes of shareholders as to the integrity of their investment. The surplus limitation by itself is often an unreasonably wooden one and it would be needlessly cruel to forbid dividends to shareholders when the distribution would be an exercise of sound business discretion. Professor Hatfield, an eminent accounting authority who has devoted much attention to dividend questions, admits that circumstances may justify the payment of a dividend despite the impairment of capital even when the corporation is not a wasting asset or liquidating concern. Suppose a corporation owns ten houses or ten motor busses, each worth $10,000 and each earning $1,000 per year. If one is destroyed without insurance, the current earnings would still be $9,000 per year. If there is a capital deficit of $10,000, more than a year of profitable operation will be needed to obtain a surplus. Must the income of the shareholders be entirely cut off and all the earnings be applied to wipe out the deficit unless the legal capital be reduced? May not the restoration of the deficit be spread over several years, continuing dividends in the meantime at a reduced rate or upon the preferred shares only?

It is a great hardship on the holders of preferred shares if the management of a corporation with a small deficit of the capital represented by the common shares is required to pass all dividends upon the preferred shares and retain all earnings until the legal capital is made good. Although dividends could easily be kept up from annual profits, the holders of the common shares may refuse to authorize a reduction of the legal capital to wipe out the deficit. From the shareholders'
point of view it may be far more advantageous for the management to
distribute to them the corporate income when they need it although
the capital has become somewhat impaired rather than to devote all
earnings to remove the capital deficit. To the suggestion of reducing
legal capital it may be replied that, as a practical matter, "The red
tape and legal expense of doing this, perhaps, too, the bad effect on the
company's credit of giving public notice that there has been an en-
croachment on capital, make [shareholders and] directors loath to do
so."81

IV. LIQUIDATING OR WASTING ASSET CORPORATIONS

A somewhat questionable provision is included in a number of the
recent corporation acts expressly permitting corporations which con-
sume part of their investment in its use to distribute the net proceeds
derived from the exploitation of their "wasting assets," like mines and
oil wells, without allowance or deduction for depletion, subject to pro-
vision for the liquidation rights of preferred shareholders.82 This per-
mission is usually accompanied by a requirement of notice that such
dividends are being paid without allowance for depletion. Corpora-
tions exploiting such assets may pay liquidating dividends out of the pro-
cceeds of the exploitation even if there be no surplus and even if the net
proceeds of the year are less than that portion of the purchase price
represented by the assets consumed. A sufficient margin of net assets
must, however, be retained to protect creditors and also the liquidation
preferences of any preferred shares.

In the absence of a provision covering wasting assets, the Delaware
General Corporation Law, section 34, was construed in 1927 as not to
permit a mining corporation to pay dividends when there was a capital
deficit. This section was accordingly amended in March, 1927, to au-
thorize directors in determining annual "net profits" for dividend pur-
poses to omit any deduction for depletion resulting from the necessary

81 Ibid., at 271.
82 TEL. BUS. CORP. ACT (1928) § 24 (IV); CAL. CIV. CODE § 346; DEL. GEN.
CORP. LAW (1933) § 34; IND. GEN. CORP. ACT (1929) § 12; LA. GEN. CORP. LAW
(1928) § 26; MICH. BUS. CORP. ACT (1931) § 22; MINN. BUS. CORP. ACT (1933)
§ 2; OHIO GEN. CORP. ACT (1931) § 38; PA. BUS. CORP. LAW (1933) § 701c. The
Dominion Companies Act, 1934, of Canada, provides that "no dividend shall be
declared . . . which will impair the capital of the company" but that "nothing in
this Act shall prevent a company, at least seventy-five per cent in value of the
assets of which are of a wasting character, or any mining company as hereafter
defined, from declaring or paying dividends out of its funds derived from oper-
ations of the company notwithstanding that the paid-up capital of the company
may be thereby reduced or impaired, if such payment does not reduce the value
of its remaining assets so that they will be insufficient to meet all the liabilities
of the company then existing exclusive of its paid-up capital." 24 & 25 GEO. V, c.
83, § 83.
consumption of wasting assets incidental to their exploitation by a corporation engaged in the exploitation of wasting assets. Such net proceeds, however, without any deduction for depletion are not properly designated as "net profits." One cannot properly speak of profits unless cost, depreciation, depletion and all other charges have been allowed. Even a wasting asset corporation in computing its actual net profits for tax purposes must make deduction like other corporations for depreciation and depletion.

The basic principle or policy of the wasting assets doctrine, which permits dividends regardless of the existence of surplus or even annual net profits, has never been clearly formulated because of its origin in the fallacious concept of "capital" by the English courts as a res rather than as an amount or quantum. The doctrine seems to have taken its rise in the leading English case of Lee v. Neuchatel Asphalte Co. The Lee case may be supported on the ground that under the English Companies Act the articles of association may validly provide that the directors "shall not be bound to form a fund, or otherwise reserve moneys, for the renewal or replacing of any lease, or of the company's interest in any property or concession." One of the objects of the company in that case was to acquire a concession for the extraction of asphalt and bituminous rock. All that the case necessarily involved was a decision that the shareholders could agree in the articles of association to work and liquidate this specific property without making any provision for depletion, and the statute would not forbid this. Any excess of receipts over the cost of working this property could be divided "although in some sense the capital is thereby diminished."

The doctrine of the Lee case has, however, been understood to be based upon a distinction between payment of dividends "out of capital" and a mere failure "to replace capital" which has been exhausted or lost. Payments made from current income or profits without replacement of capital which has been exhausted or lost are said not to be made "out of capital." As already pointed out, this is a fallacious

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84 Hatfield, Accounting (1931) 264, 279.
86 (1889) 41 Ch. D. 1; see also Excelsior Min. Co. v. Pierce (1891) 90 Cal. 131, 27 Pac. 44; Weiner, Theory of Anglo-American Dividend Law (1929) 29 Col. L. Rev. 461, 477, 482, (1930) 30 ibid. 355; Note (1928) 55 A. L. R. 8, 41.
87 See Hatfield, Accounting (1931) 264.
concept of capital as being a res or object in which the capital contributions were invested rather than as being a quantum or amount measured by the amount of the investment. In England this has been extended to the broader rule that losses of “fixed capital” as distinguished from “circulating capital” need not be deducted in order to ascertain the annual profits of any corporation.

By a few decisions a judicial exception has been read into some of the dividend statutes, the terms of which do not seem to permit any special treatment, as to wasting asset corporations. The California court in an early decision88 held that the then California statute (Civil Code section 309), which forbade withdrawal of capital or “capital stock” and confined dividends to “surplus profits arising from the business,” did not forbid a mining corporation from distributing the net proceeds of its mining operations without provision for depletion, although the necessary result was that something was subtracted from the value of its mine and from the net worth of its investment. But the court admitted that a mining corporation could not sell its mine or any part thereof and distribute the proceeds. There is, however, no substantial difference between the sale of a mine or an oil well accompanied by a distribution of the entire proceeds to the shareholders and the gradual extraction and sale of the ore or the oil and the distribution of the proceeds without deduction for the cost of the mineral extracted.89

Mr. Morawetz, the first writer to recognize the wasting assets doctrine, stated its basis as an exception in favor of a corporation whose sole purpose is to invest its capital in a specific piece of property, like a mine, and afterward to consume the property and distribute the proceeds. He explains, “It is implied from the character of the speculation of a mining company, that the income derived from the working of the mine shall be distributed among the shareholders as dividends, after deducting the expenses, and making reasonable provision for contingencies,”90 such as present and future liabilities.

If a corporation is specifically organized to exploit and distribute the proceeds of a particular mine or other property, the corporation may be described as a “liquidating corporation” which may properly by statute be excused from making any reserve for depletion or replacement.91 But if the purpose of a corporation which is engaged in the

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88 Excelsior Min. Co. v. Pierce (1891) 90 Cal. 131, 27 Pac. 44; see also De Brabant v. Commercial Trust Co. of N. J. (1933) 113 N. J. Eq. 215, 223, 166 Atl. 533, 537; People v. Roberts (1898) 166 N. Y. 585, 51 N. E. 293.
90 MORAWETZ, PRIVATE CORPORATIONS (1886) § 442, p. 416.
91 See HAYFIELD, ACCOUNTING (1931) 265-268.
oil or mining or similar business is a continuing one and not the exhaustion and liquidation of a particular property, then there is no reason for treating such corporation differently as to keeping its capital intact from any other continuing concern, such as a manufacturing corporation. In the case of a gold mine the shareholders do not ordinarily intend or expect that the particular mine shall be replaced out of its proceeds. Its life is limited, and everyone realizes or ought to realize that “dividends” include a gradual return of the invested capital to the shareholder. Replacement may be undesirable or impossible. Such corporations should be designated then as “liquidating” rather than as “wasting asset” corporations. The Ohio General Corporation Act (section 38) and some other acts require a corporation which proposes to pay dividends without deduction for depletion to provide for such liquidation by express statement in the articles of incorporation.

The exception excusing deduction for depletion should be limited to those corporations then which are formed for the express purpose of liquidating a particular property or estate and should not be applied to any corporations formed to carry on a continuing business which acquire wasting property in the course of their business. Thus, a manufacturing corporation which, for the purpose of obtaining power, buys an oil or gas well or coal mine should not be allowed to disregard the depletion of such property in determining whether it has income applicable to the payment of dividends. If a manufacturing corporation should pay $100,000 down for a ten-year lease of a factory or office building, it should be required, in determining whether it has income applicable to the payment of dividends, to amortize the cost of the lease. It is plain that if the corporation acquired the leasehold subject to an obligation to pay $10,000 rental each year, sound accounting and business practice would require it to deduct the rental in determining whether it had profits applicable to the declaration of dividends. Why should not the same rule be applied if the corporation paid a lump sum at the beginning in lieu of an annual rental? Even mining or oil companies often contemplate a continuing enterprise with replacement of the mines or wells exhausted and the reinvestment of funds set aside to keep the original investment intact.

In California the wasting assets doctrine has been extended to corporations organized to liquidate or dispose of specific assets, such

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as corporations organized to subdivide and sell off a particular tract of land or to liquidate the assets of a decedent's or bankrupt's estate. Such an exception had already been recognized by judicial decision under the former dividend section.95

V. ENGLISH DIVIDEND LAW

The English cases have discussed in a very confusing way the question of payment of dividends from annual profits in spite of capital deficit and their accounting peculiarities need to be pointed out. It should be observed that English cases are not applicable to American dividend law based on statutes with mandatory restrictions and adopting different definitions and conceptions of capital requirements.96 The English Companies Act97 provides by Table A that "no dividend shall be paid otherwise than out of profits," but this provision is optional and subject to variation by the articles of association.98 The mandatory sections of the English Act contain no reference to dividends.99 The English Act is construed not to require that a capital deficit be made up before dividends may be paid from annual profits. Aside from the optional limitation to "profits" in Table A as to the articles of association, the English restriction on dividends seems to be based upon an implied limitation of power, that "capital" can only be used for the purposes of the business, and that it is a violation of the provisions as to reduction of capital to return capital to the shareholders either as a dividend or in the purchase of its own shares.100 But it is said in the Lee case that the company may divide yearly "profits," so long as it pays its creditors, "although every shilling of the capital may be lost."101

The questions arise how "profits" are to be arrived at and whether there can be any "profits" unless the capital investment be kept intact, and whether if an impairment of capital occurs in one year, and in the next year the company earns money and declares dividends, this is merely a failure to remove an impairment of capital that already exists or actually a payment "out of capital." A company may sustain losses

95 Baldwin v. Miller & Lux (1907) 152 Cal. 454, 92 Pac. 1030.
97 19 & 20 Geo. V (1929) c. 23, Table A, art. 91.
100 Trevor v. Whitworth (1887) 12 App. Cas. 409; Lee v. Neuchatel Asphalte Co. (1889) 41 Ch. D. 1, 22.
101 Ibid. at 23
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of any amount for a period of years, carried forward year after year to the debit of the profit and loss account. But if the company makes in any one year a profit of say $100,000, it is permissible to distribute this amount in dividends, if it is not rendered insolvent, without any provision for recouping past losses. These "profits" may be computed from the trading operations for the year, although the concern sustained a loss of $100,000 or more of fixed assets in the same year.\textsuperscript{102} The English cases differ from the American view that earnings automatically reduce a capital deficit and that the declaration of dividends when there is a deficit impairs the capital.\textsuperscript{103}

What do the English courts mean by "Capital"? What is meant by profits? The judicial legislation of the English courts by which dividends are permitted to be paid out of the credit balance in each year's profit and loss account,\textsuperscript{104} in spite of prior losses impairing net assets below the legal capital, would seem to be based on a fallacious concept of capital as a res rather than as a quantum or measure. What is this "capital" which may not be withdrawn or returned to the shareholders? Lord Lindley, in a leading case, puts the English concept as follows:

"Moreover, when it is said, and said truly, that dividends are not to be paid out of capital, the word 'capital' means the money subscribed pursuant to the memorandum of association, or what is represented by that money. Accretions to that capital may be realized and turned into money, which may be divided amongst the shareholders."\textsuperscript{105}

With all deference, the English courts seem hopelessly "thing-minded" in their ideas about "capital." Capital is not any particular res or "money subscribed" but consists of an amount of net assets equal to the amount of the legal capital. If legal capital is covered the surplus value remaining on hand is "profit."\textsuperscript{106} If the balance sheet shows a capital deficit, any assets acquired are at once "capital" and any distribution of assets in the absence of a surplus is made out of capital. All dividends are paid out of capital unless the net assets remaining are equal to or in excess of the legal capital. Under certain circumstances the surplus requirement may need to be relaxed and it may be expedient by statute to permit dividends to be paid out of annual profits in spite of a capital deficit.\textsuperscript{107} To speak of dividing "accretions to capital" is a very poor way of saying that an increase

\textsuperscript{102} Samuel, Shareholders' Money (1933) 146, 147.
\textsuperscript{103} Branch v. Kaiser (1928) 291 Pa. 543, 140 Atl. 498; Schlatter, Payment of Dividends Before Restoring Impaired Capital (1923) 35 J. of Accountancy 172.
\textsuperscript{104} Evling v. Israel & Oppenheimer, Ltd. (1918) 1 Ch. 101, 109.
\textsuperscript{105} Verner v. General, etc., Trust (1894) 2 Ch. 239, 265.
\textsuperscript{106} Lubbock v. British Bank of S. A. (1892) 2 Ch. 198, 202; Isaacs, Principal -Quantum or Res? (1933) 46 Harv. L. Rev. 776.
in the value of any of the assets, if duly established by sale, may be counted toward the computation of surplus and of profits upon the entire transactions of a year.\textsuperscript{108}

The English courts have thus in reality legislated to permit dividends to be paid “out of capital” if the company has operated on a profitable basis for the preceding year although they have invented certain verbal sophistries or fictions to rationalize their judicial legislation. It is held that loss or depletion of fixed assets (“fixed capital”) does not affect either the surplus or the annual profits available for dividends, although loss or depletion of working capital (“circulating” or “floating capital”) must be deducted, at least such loss as is sustained during the particular year or period in question. The deficit or operating losses of previous years even of working capital apparently need not be deducted.\textsuperscript{109}

The English law does not prohibit a limited company, even a banking company, from paying dividends from annual “profits,” although it has a capital deficit and makes no deduction for depreciation or depletion of fixed assets. Dividends may be paid out of annual profits even though the net assets are of less value than the amount of legal or invested capital. One reason given is that much capital may be lost and yet the company may be a very thriving concern.\textsuperscript{110}

Australia follows the English rule as to payment of dividends from annual profit despite capital deficit. In Phillips v. Melbourne & Castlemaine Soap, etc., Co. Ltd.,\textsuperscript{111} the court says: “So long as a company pays its creditors there is no reason why, in an apparently flourishing concern, it should not go on and divide profits though every shilling of the capital may be lost.”\textsuperscript{112}

American courts refuse to follow the English rule in the absence of statute but require that depreciation and depletion be deducted from income and that a capital deficit be made up before dividends may be paid.\textsuperscript{113} The English rule is to be justified, if at all, only on the basis


\textsuperscript{109} See Lee v. Neuchatel Asphalte Co. (1889) 41 Ch. D. 1; Verner v. General, etc., Trust [1894] 2 Ch. 239, 266; In re National Bank of Wales, Ltd. [1899] 2 Ch. 629, 669; Ammonia Soda Co., Ltd. v. Chamberlain [1918] 1 Ch. 266, 299, 9 B. R. C. 819, 853n; Hill v. Permanent Trustee Co. of N. S. W., Ltd. [1930] A. C. 720, 731; Hatfield, ACCOUNTING (1931) 268-277; 2 MACHEN, MODERN LAW OF CORPORATIONS (1908) §§ 1326, 1328.


\textsuperscript{111} (1890) 16 Vic. L. R. 111.

\textsuperscript{112} ibid. at 113.

\textsuperscript{113} Briggs, Asset Valuation in Dividend Decisions (1934) 9 ACCOUNTING REV. 220, 229, 231.
that present earning capacity may demonstrate such a financial condition as to make dividends permissible in the discretion of the directors in spite of capital deficit and even in the absence of actual annual profits.

VI. SHARE OR STOCK DIVIDENDS

Careful limitations should be placed by statute upon the declaration of dividends in shares of the corporation, in view of the false impressions which may be created by such dividends. Every cash dividend diminishes by just so much the net worth of the corporation and so reduces the intrinsic value of the shares. But at the same time, if it is lawfully and prudently declared, it demonstrates the ability of the enterprise to pay dividends, holds out a promise of further dividends in the future, facilitates new stock issues, and usually increases the market value of the shares.\textsuperscript{114}

Share dividends do not distribute assets or affect the safety of creditors, but they often promise increased dividends, influence the market price of shares and so affect the interests of investors and purchasers of shares.\textsuperscript{115} Statutory provisions against paying, withdrawing or impairing “capital” or “capital stock” do not apply to stock dividends. “A stock dividend does not distribute property, but simply dilutes the shares as they existed before.”\textsuperscript{116} Limitations upon share dividends are in reality regulations of the issue of new shares without adequate consideration or basis, or under circumstances where the declaration of the share dividend would create a false impression or work a deceit upon investors.

In many jurisdictions the only limitation upon the declaration of share dividends is the existence of an adequate surplus without distinction as to the kind of surplus.\textsuperscript{117} Under the statutes of a number of states, unrealized appreciation in the value of assets may be counted toward surplus available for share dividends, although excluded as a basis of cash dividends. By the Ohio General Corporation Act (section 38) share dividends may be declared out of surplus “created” by unrealized appreciation or revaluation of the assets, including patents

\textsuperscript{114}Lynch v. Hornby (1917) 247 U. S. 339, 346.


\textsuperscript{116}Williams v. Western Union Tel. Co. (1883) 93 N. Y. 162, 189; Equitable Trust Co. v. Prentice (1928) 230 N. Y. 1, 164 N. E. 723; City Bank Farmer’s Trust Co. v. Ernst (1934) 263 N. Y. 342, 189 N. E. 241.

\textsuperscript{117}Lantz v. Moeller (1913) 76 Wash. 421, 136 Pac. 687, 50 L. R. A. (N. S.) 68 n.; Joyce v. Congdon (1921) 114 Wash. 239, 195 Pac. 29; Del. Gen. Corp. Law (1933) § 35; Briggs, Dividends and General Corporation Statutes (1933) 8 Accounting Rev. 130, 134.
and good will. All a board of directors has to do is to adopt a resolution that such assets have a fair value to the corporation in excess of the amount at which they are carried on the books and reciting what such estimated value is and causing it to be entered upon the books. By this magic they will “create an excess of assets” which the corporation may apply to a dividend in shares. At the same time the Ohio Act condemns as unsafe the practice of writing up or revaluing assets to create a surplus for cash dividends.

Suppose a corporation has a large amount of its funds invested in fixed assets, factories, warehouses, and office buildings, all needed in its business. The value of these assets may rise and fall in accordance with the real estate market and general conditions. But this will have very little to do with the question of the propriety or safety of increased dividend distributions unless the company sells its plant and realizes a profit. No greater profits will be realized from operations merely because a factory increases in value. It would seem that the padding of the accounts by estimates and conjectures by reappraisal of fixed assets and writing up of inventories, to make a surplus or basis for share dividends, may be very deceptive to the shareholders and to the investing public.\(^{118}\)

It has been held that the declaration of a stock dividend of 150 percent after the fictitious write-up of the value of a leasehold estate to more than six times its previous value in order to create a book surplus was fraudulent and might be cancelled.\(^{119}\) The declaration of share dividends from surplus derived from unrealized appreciation in the valuation of the assets estimated by the board of directors, although it takes nothing from the corporate assets, may easily result in a misleading inflation of the market value of the shares so diluted. Investors may infer that the corporation has built up a surplus from business operations and that the declaration of the share dividends represents earnings transferred from surplus to capital account. If share dividends are paid out of paid-in surplus or other unearned surplus, notice should be given the shareholders of the source or basis of the declaration. Shareholders receiving additional shares should know whether the dividend represents current earnings, a distribution of profits previously earned, a capitalization of paid-in surplus or a capitalization of estimated appreciation surplus.\(^{120}\) Share dividends are apt to be interpreted as an announcement that the corporation is in a position to pay

\(^{118}\) For other statutes which permit the recognition of unrealized appreciation as a basis for share dividends, see ILL. BUS. CORP. ACT (1933) § 41 (c); LA. GEN. CORP. LAW (1928) § 26; MICH. GEN. CORP. LAW (1931) § 22; PA. BUS. CORP. LAW (1933) §§ 701 (2), 703; UNIV. BUS. CORP. LAW (1928) § 24 (IV).


\(^{120}\) See Hoxey, Accounting for Investors (1930) 50 J. of Accountancy 251.
increased cash dividends.\textsuperscript{121} In the California General Corporation Law (Civil Code section 346a) the declaration of share dividends out of unrealized appreciation of assets is forbidden.

The "consideration" for shares issued as a share dividend is found in the amount transferred from surplus to stated capital.\textsuperscript{122} Increasing the legal capital by capitalizing surplus increases the limitation upon cash dividends.\textsuperscript{123} There is a great variation in the different corporation acts in specifying the value or consideration to be assigned to no par value shares issued as a share dividend. In Ohio, Delaware, and some other states, no specified increase of stated capital is required in case of a dividend in non-par shares, and the directors are given full discretion to determine the amount of surplus to be capitalized, if any.\textsuperscript{124} This seems to permit abuses such as dividends of shares having a liquidation preference in the absence of surplus. In general, share dividends should be permitted only when they represent an adequate transfer from surplus to legal capital.\textsuperscript{125} A distinction should be made between share dividends and share subdivisions or split-ups of non-par shares, requiring in the former the capitalization of a reasonable amount of surplus.

The amount of capitalized surplus should not be less than the aggregate par value of shares issued having a par value and not less than the aggregate of the highest amounts payable on shares without par value in the event of the liquidation, dissolution or winding up of the corporation. The issuance of shares having a par value or a liquidation preference increases the aggregate amount by which legal capital is measured and the amount of stated capital should be accordingly increased by the capitalization of surplus.

A dividend declared in shares to holders of a different class of shares affects the relative rights and preferences as between the several classes of shares in the surplus and the distribution of the assets. Several laws require the vote of all classes of shares for such reclassification. The Uniform Business Corporation Law\textsuperscript{126} provides that "no dividends payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote of the holders of a majority of the shares of the


\textsuperscript{122} Cal. Civ. Code § 298.

\textsuperscript{123} Hill v. Permanent Trustee Co. of N. S. W., Ltd. [1930] A. C. 720, 731.


\textsuperscript{125} Pa. Bus. Corp. Law (1933) § 703, provides: "Such shares shall be issued at such value as shall be fixed by the board of directors by resolution." Cf. Cal. Civ. Code § 346a.

\textsuperscript{126} § 24 (VI (c)).
class in which payment is to be made. Other classes of shares than the one in which the dividend is paid may have their rights in earnings, surplus or distribution affected. The declaration of share dividends should be subject to the approval of shareholders of every class adversely affected, in the same manner as an amendment of the articles changing the share preferences.

VII. SUMMARY OF DIVIDEND LIMITATIONS AND THEIR DEFECTS

It has been the aim of this article to consider the policy of capital requirements and dividend restrictions under modern corporation acts and to inquire into the laxity of some of these requirements in making questionable dividends permissible. The concept of a legal or stated capital has been explained as that of a margin of value established for the protection of creditors. The secondary purpose of the prescribed capital is to protect shareholders, particularly shareholders having priority as to income or liquidation, from undue withdrawal of assets from the business.

Criticisms may be directed against the formulae by which the legal or stated capital is computed or fixed in the first instance, as for example, in permitting the creation of a distributable paid-in surplus upon the issue of non-par shares. Even more serious criticisms may be urged against the lack of adequate safeguards in the methods by which the legal capital may be reduced by the shareholders from time to time and any surplus thereby created may be distributed.

During the depression much use has been made by corporations of statutory provisions for reduction of legal capital, heretofore infrequently used, to eliminate or reduce deficits and even to create on their books a "reduction surplus" available for dividends. In general the power to reduce the legal capital is placed by the statutes within the control of the shareholders. The creditors, the persons for whose protection the capital margin is primarily established, have no voice in its abrogation. Under the English Companies Act, court supervision is regarded as an important safeguard. Under the Companies Act of Canada, 1934, objection may be made by the creditors to the return of paid-up capital and the expediency and good faith of an alteration of capital must be passed upon by the Secretary of State. In the United States, on the other hand, there is much confusion in the statutes and in most states there is statutory authority for the almost

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128 In re William Brown, Sons & Co., Ltd. (Court of Sess. 1931) Sess. Cas. 701; English Companies Act (1929) §§ 48, 49; Palmer, Company Law (15th ed. 1933) 86.
129 Canada Stats. 1934, §§ 49-58, p. 335.
arbitrary reduction of the legal capital by the shareholders and for the
distribution or liquidation of any values set free by such reduction
by the directors, without regard to the priorities properly belonging
to preferred shares.\footnote{Ballantine, California Corporation Laws (1932) 362-372, 375-378; ibid., 1933 Supplement, 155-157, 161-163; 11 Fletcher, Cyclopedia of Corporations (1932) §§ 5147, 5150; 19 ibid., § 9057; Notes, Reduction of Capital Stock and Distribution of Capital Assets upon Reduction (1926) 44 A. L. R. 11; Capital Stock Reductions as Affecting the Rights of Creditors (1934) 47 Harv. L. Rev. 693.}

It should be observed that the "reduction surplus," which is a
capital surplus created by reduction of stated or legal capital, may be
derived from the capital contributions of different classes of shares
and as such should be returned first to those shareholders who have the
prior claim upon liquidation.\footnote{Ballantine, California Corporation Laws (1932) 377; see valuable note on capital reduction in (1934) 19 Corp. L. Q. 470, 473, 474. See Minn. Bus. Corp. Act (1933) §§ 21-VI, 38; Ohio Gen. Corp. Act (1931) § 8623-40.} Under the California Act (Civil Code section 348b) the distribution of the reduction surplus is limited so that preferred shares must be redeemed or retired before there may be a distribution to common shareholders, and there must be due regard
to the priorities of the different classes of shares. Such a limitation is
apparently lacking in the statutes of other states.\footnote{Hatfield, Accounting (1931) 25, 77, 79, 99, 113; Briggs, Asset Valuation in Dividend Decisions (1934) 9 Accounting Rev. 220; Weiner and Bonbright, Theory of Anglo-American Dividend Law (1930) 30 Col. L. Rev. 330, 337, 954, 966, 968.}

The prevailing type of dividend restriction is the existence of a
general surplus of value or net worth over the legal capital, which is
ordinarily stated in a balance sheet and which includes the results of
prior operations and the accumulation of past profits. In a few juris-
dictions surplus available for dividends on common shares is limited
to the earned surplus or accumulated profits. In most jurisdictions
"capital surplus," such as paid-in surplus and reduction surplus, is
available, although values arising from unrealized appreciation are not
to be counted toward surplus available for cash dividends. Notice is
sometimes required as to the source of dividends not paid out of earned
surplus.

The statutory limitations on dividends rest on vague and indefinite
accounting or financial standards, such as surplus or profits, which leave
a wide scope for accounting discretion and valuations. The existence
or amount of profits or of surplus is a matter depending to a great exten-
t upon a combination of business and accounting judgment. Regardless
of how carefully accounts are kept and how accurately the
surplus and profits are shown, every accountant knows that they do not necessarily represent the true business position and the amount properly available for dividends. Whether or not the amount of surplus or profits shown is financially available necessitates not only an analysis of the accounts but also a consideration of many uncertain factors and the exercise of judgment upon them. Book values need not correspond with market values as to fixed assets, and there is no duty to make an appraisal of the fixed assets in determining the existence of a surplus. A book surplus may represent plant and fixed assets and not current assets such as cash or realizable securities.

Creditors and investors may be jeopardized more seriously at times by the improvident declaration of dividends, permissible as far as the express limitations of the statute are concerned, than by the declaration of dividends which would involve a technical impairment of capital. There seem, however, to be no decisions that directors are legally liable for wrecking a corporation by negligence in declaring improvident dividends which satisfy the statutory accounting limitations, even though the business position of the concern were such that no reasonable and prudent man of business in the exercise of ordinary care would have made such a distribution under the circumstances. "In any case a director is not responsible for declaring a dividend unwisely. He would only be liable for paying a dividend out of capital."

In the Delaware Act and also in several recent corporation acts there are provisions designed to protect the directors from liability for improper dividends if they rely "in good faith upon the books of account of the corporation or statements prepared by any of its officials as to the value and amount of the assets, liabilities and/or net profits of the corporation, or any other facts pertinent to the existence and amount of surplus or other funds from which dividends might properly be declared and paid." There is, however, no affirmative require-

325 Dewing, Financial Policy Of Corporations (1934) 604; Hatfield, Accounting (1931) 259.
ment that the directors shall consider such financial statements and the duty of the directors in this regard might well be made more specific.139

The surplus limitation may be too strict in that it may forbid dividends that could safely and wisely be paid out of current earnings in spite of some capital impairment. There is much difference of opinion as to the policy of permitting dividends from current profits in spite of a capital deficit. In a few jurisdictions, however, the surplus restriction is relaxed and an exception is allowed permitting dividends out of profits or earnings for some specified accounting period such as the current or preceding year, in spite of a capital deficit. Provision is usually made in such acts for a capital reserve to protect the liquidation preferences of preferred shares against undue distribution of current earnings. The apparent alternatives between “profits” or “earnings” and surplus in many jurisdictions, it should again be noted, do not allow dividends in the absence of surplus, as the terms “earnings” or “profits” are frequently used only as part of a description of surplus.140

The relaxation of the surplus limitation as to so-called wasting asset corporations goes beyond the policy of the exception in some jurisdictions in excusing deduction for cost or depletion of wasting assets by corporations which are not in reality liquidating corporations but are continuing concerns to which the exception should not be extended. No one can speak of “profits” in any sense unless depreciation and depletion are deducted.141 In any case adequate provision for meeting the liquidation preferences of preferred shares should be required.

The English dividend rules have arrived by judicial legislation not only at a relaxation of any surplus requirement but also at a relaxation of the annual net profits rule. Theoretically a limited company not in liquidation can make no payment by way of return of capital to its shareholders except as a step in an authorized reduction of capital. Any other payment must be by way of dividing profits.142 But under the decisions an English company may distribute as dividends the balance to the credit of the annual profit and loss account, that is, the excess of its revenue receipts over expenses properly chargeable to revenue account, even if the company’s capital account is in debit and there is no surplus.143 The English decisions do not require that the loss, depreciation or depletion of fixed assets be deducted in ascertaining surplus or profits available for a dividend. Loss or depreciation only of “circulating capital,” that is, of working capital, need be taken

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139 See legislative suggestion in Samuel, Shareholders’ Money (1933) 141, 142, 148, 345, Draft Act, § 25.
140 See Hatfield, Accounting (1931) 297. See supra notes 53 and 54.
141 Hatfield, Accounting (1931) 265, 279, 374.
142 Hill v. Permanent Trustee Co. of N. S. W., Ltd. [1930] A. C. 720, 731.
143 Ibid.
into account in ascertaining profits for a particular year, but losses of
previous years do not have to be made up.

These English rules in reality permit the return of capital, but are
perhaps justifiable or defensible on the ground that the values of
plant and fixed assets have little bearing on the question of the safety
or propriety of dividends, which may be better determined by current
profits, present earning capacity and the working capital position.

As pointed out by writers on accounting and corporate finance, the
expediency of dividend distributions is a financial problem requiring
careful attention to all the circumstances, such as the source of the sur-
plus, the ratio of current assets to current liabilities, the needs of the
concern for working capital, the trend of earnings and the contingencies
of political and business conditions, including a forecast of the general
business outlook. The fund properly available for cash dividends is
in general to be obtained by subtracting from current assets the cur-
rent liabilities and the needed working capital and also a prudent al-
lowance for all contingencies which need to be apprehended in the
operation of the business.

No satisfactory substitutes for surplus and profits as tests of
statutory limits on permissible dividend distributions have as yet been
devised. It might be possible to discard the present stated capital
and surplus system entirely and replace it with a provision that with-
drawals must not be made unless after each such withdrawal the fair
present value of the assets would be at least equal to, say, one and
one-fourth times the debts and liabilities of the corporation.144 This
would prescribe a minimum margin of safety of twenty-five percent
over the debts and liabilities. Another possibility would be to require
a certain current ratio, that is, a fixed minimum ratio of current assets
to current liabilities as indicating a liquid position.145 It is not un-
usual to provide in bond indentures a dividend restriction based upon
the current asset ratio. Such provisions are at least an indication
that persons familiar with financial matters are not satisfied with the
protection afforded by the statutory surplus limitations and consider
the current ratio standard a workable one.146

Whatever restrictions are adopted as to dividends they should be
supplemented by a general requirement of the exercise of reasonable
care and prudence not merely to ascertain the existence of book surplus
or profits, but also needful liquidity and the financial status generally.

144 See CAL. CIV. CODE § 348b; N. C. CONS. STATS. ANN. (1919) § 1179.
145 GRAHAM and KATZ, ACCOUNTING IN LAW PRACTICE (1932) 263, 268, 277,
293.
146 Raisty, Working Capital Safeguards of Preferred Stocks (1934) 58 J. of
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Regardless of the status of the surplus or profit and loss account, dividends should not be declared when such action might endanger the ability of the corporation to meet its obligations as they fall due or curtail its operations by shortage of working capital. Statutory limitations should be regarded as restrictions, not as permissions to declare dividends improvidently up to the statutory limit. The general principle of reasonable care in management might be made more specific by requiring each director before declaration of any dividend to consider a balance sheet and a profit and loss statement signed by the company's auditors or by a public accountant showing with reasonable particularity the assets and liabilities of the company, with comments on the basis of valuations and the relation between book values and actual values, the ratio of current assets to current liabilities, the earnings and losses for the year under review, the sources of any surplus and the changes therein during the past year, the amounts of depreciation and depletion, the sufficiency of the reserves, the amount and method of carrying treasury shares, relations with subsidiaries and other matters that might be specified.

Some English lawyers and accountants condemn what their law allows in dividend distributions as contrary to sound accounting and business principles, a laxness which may lead to abuses and practices commercially vicious. But an unduly lax law is defended by some on the argument that everything may safely be left to the good faith and business prudence of the directors. It has already been pointed out that directors apparently are not held liable for mere negligence in declaring a dividend unless it violates the statutory restrictions. This makes it all the more necessary for securing the observance of some minimum of financial conservatism and prudence for the benefit of creditors and shareholders and to prevent undesirable window-dressing, to lay down some objective financial rules for purposes of a legally enforceable standard.

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148 Ibid. at 145, 148.
149 See 2 MacKen, Modern Law of Corporations (1908) § 1329. The principal sanction to enforce dividend limitations is the statutory liability of the directors. It is said in a recent report of the Federal Trade Commission, with reference to the dividend provisions of the Delaware Act: "There is such a thing as an illegal dividend in that state, rendering the directors liable in that amount, but directors are so hedged in with safeguards as to render problematical the value of such a cause of action against them." Sen. Doc. No. 92, pt. 69-A, 70th Cong. 1st Sess. (1934) 284.