January 2018

The Concept of Surplus as Applicable to Dividends

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Recommended Citation
F. R. Schfield, The Concept of Surplus as Applicable to Dividends, 2 Wyo. L.J. 114 (1948)
Available at: http://repository.uwyo.edu/wlj/vol2/iss3/3
NOTE

THE CONCEPT OF SURPLUS AS APPLICABLE TO DIVIDENDS

Accountants define surplus as assets minus liabilities and capital stock. Surplus may, and as a general rule does, include more than net earnings only. To distinguish the various kinds, accountants have devised names for the different surplus accounts that give some indication of their origin. The purpose in separating surplus accounts is to show the various sources other than earned surplus, which generally reflects only the accumulated profits earned from the operations of the business. When only one surplus account is kept on the books of a corporation it results in entering in the one account of such diverse items as net earnings, premium on stock, profit or loss on treasury stock, profit or loss on capital assets, appreciation of fixed assets, and many other items of a similar nature.

In *Williams v. Western Union Telegraph Company*, where the question was whether or not the company had a surplus from which to declare a stock dividend, it was held "its capital stock may be reduced below the amount limited by its charter; but whatever property it has up to that limit must be regarded as its capital stock. When its property exceeds that limit, then the excess is surplus." It should be pointed out that this definition appears to be too broad in that it makes no reference to liabilities. A more concise definition and one that appears to be

more in accord with corporate practice is the one given in Edwards v. Douglas, 4
in which the court speaking through Mr. Justice Brandeis said:

"The word 'surplus' is a term commonly employed in corporate finance
and accounting to designate an account on corporate books. . . . The
surplus account represents the net assets of a corporation in excess of all
liabilities including its capital stock. This surplus may be "paid-in" as
where the stock is issued at a price above par; it may be 'earned surplus'
as where it was derived wholly from undistributed profits; or it may,
among other things, represent the increase in valuation of land or other
assets made upon a revaluation of the company's fixed property."

It should be observed that this definition takes into account at least three different
kinds of surplus—earned, paid-in, and revaluation surplus. Each of these has at
various times been considered by the courts in determining the funds available for
distribution as dividends.

**Paid-In Surplus**

Paid-in surplus may arise in a number of different ways; from premiums re-
ceived on the sale of stock, reduction of paid-in capital, or as a profit resulting
from the exchange of preferred stocks or bonds for common stock. The above
transactions are indicative of the manner in which paid-in surplus may be used for
the payment of dividends depends to a large extent upon the statute under which
the company is incorporated.

Under California statutes, premium on sale of stock is regarded as paid-in
capital and not as paid-in surplus and so cannot be used for dividends. 6 On the
other hand, the Oregon statute has been construed to permit premiums received
on sale of stock to be paid out in dividends. 7 Other jurisdictions have recognized
the permissability of payment but have stated that the distribution is a return of
capital. 8 Premiums received on the sale of bonds has been made available as a
source from which dividends may be paid. 9

As distinguished from premiums on sale of stock, gains resulting from retire-
ment of convertible bonds in exchange for common stock on the basis of $1.00 of
common stock for $1.75 of bonds has been held to be a profit. 10 Likewise a gain

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   Action by executor to recover taxes paid on the ground that dividends received were
   paid from a depletion reserve and were not taxable as they represented a return of
capital. The Revenue Act of 1917 provided: "that any dividends paid in that year or
   subsequent years, shall be deemed payable from the most recently accumulated un-
divided profits or surplus." The Court in construing the words "undivided profits or
   surplus" said, "Congress did not use the words 'surplus account or undivided profits
account'; its language is 'undivided profits or surplus'!" Held, that the dividend was
taxable.


7. Union Pac. Life Ins. Co. v. Ferguson, 64 Ore. 395, 129 Pac. 529, 45 L. R. A. (N.S.) 958
   (1913).

8. People ex rel. North America Trust Co. v. Knight, 96 App. Div. 120, 89 N.Y. Supp. 72,
   (4th Dept.) (1904).


from the purchase and sale of stock of other companies has been held to be a profit and available for distribution as dividends.11

**Earned Surplus**

Among accountants the generally accepted definition of net profits is the one given in the case of *Eisner v. Macomber.*12 In this case the court said: "Income may be defined as the gain derived from capital, from labor, or from both combined, provided it be understood to include profit gained through a sale or conversion of capital assets." While the definition is relatively simple the courts have at various times been faced with a number of problems in determining the legality of dividends supposedly declared from net profits.13 As will be seen, many of these problems involve the valuation of assets, which will also be considered, though in a different light, under the heading of "Reappraisal Surplus".

Profits are usually determined on a calendar or fiscal year basis, at which time the books are closed for the period. In the process of closing the books, good accounting practice requires that all accrued items of income and all accrued expense items should be included in the profit and loss account.14 While it is probably not necessary to the legality of a dividend that the accrual method be followed in determining net profits, the Supreme Court of Iowa once indicated that a dividend was illegal where income items had been accrued but expense items had not.15

Other charges to profit and loss are made so as to reduce certain assets to their estimated realizable value. The amounts so charged are set up in reserve accounts in the balance sheet, and the effect of these charges is to reduce the net profit or increase the net loss which is then closed out to surplus.16 Accountants have adopted different bases for the valuation of assets and it is by these bases that the amount to be credited to the reserve account each year is determined.17 The possible bases are either present market value, which includes both appreciation and depreciation of assets, or original cost of the asset less its reserve.

It has generally been held that the net income available for dividends should not be determined until charges for depreciation of fixed assets have been deducted.18

Cases involving so called "wasting asset" corporations present the somewhat similar problem of depletion. Depletion refers to the exploitation of a natural

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resource such as timber, oil, coal and other items of a similar nature,\(^{19}\) which when once used cannot be replaced, so that the effect is that of an asset with a gradually decreasing value.\(^{20}\) Unless a corporation was formed for the express purpose of working just the one asset and then going out of business, it would seem desirable to set up a depletion reserve so as to keep its capital intact for the purchase of other wasting assets.\(^{21}\) Otherwise if dividends are paid from net profits without making charges for depletion a part of capital is being returned with each dividend.

The "wasting asset" doctrine was first announced fifty-nine years ago in an English case, Lee v. Neuchatel Asphalt Co.\(^{22}\) The essence of the doctrine is that a corporation engaged in exploiting a natural resource need not make any charges for depletion against income before ascertaining profits from which dividends may be paid.

In the Lee case the company was formed to take over the assets of six other companies and issued preference and ordinary stock in payment. Plaintiff, an ordinary shareholder, sought an injunction to restrain the corporation from paying dividends to the holders of the preference stock, who were preferred as to dividends only, on two grounds: first, that the company's capital was impaired and should be restored before dividends were paid; second, that a reserve for the estimated depletion of the ore should be set up out of profits before declaring a dividend and that if this were done, there would then exist no net profits out of which a dividend could be paid. The trial court dismissed the action and the plaintiff appealed. On appeal, the court took the view that in the absence of any clause in the articles requiring the corporation to maintain its capital intact, the directors were under no legal obligation to do so, on the theory that part of the capital invested in a wasting asset was of necessity expended in securing the profits. Hence, it was held that the corporation could legally pay a dividend without first setting up a reserve for the estimated depletion. It was further held that the evidence showed, not an impairment of capital, but in fact, an increase in the value of the assets since the formation of the company.

The opinion indicates, that had the shares been paid for in cash and not issued in exchange for assets, the case would stand on a very different footing and be open to very different consideration.

From the cases decided in this country, it is not clear whether the rule will


\(^{21}\) Inscho v. Mid-continent Development Co., 94 Kan. 370, 146 Pac. 1014, Ann. Cas. 1017B, 546 (1915). This case involved a suit by a preferred stockholder to recover dividends declared but not yet paid. At the time of the declaration, there was approximately $2200.00 in its treasury and a balance due and payable in the amount of $2500.00 on a contract for the building of a pipe line to move its natural gas to its customers. The Kansas court took the view that a corporation engaged in the production and sale of natural gas may properly charge to current earnings the cost of drilling new wells to keep production equal to demand and held that there were no net earnings out of which dividends could have been paid on the preferred stock, as the creditors of the corporation had a superior claim to the money in the treasury.
be applied generally to wasting asset corporations or whether it is to be limited to fact situations substantially the same as in the English case.

California was one of the first jurisdictions to apply the rule in *Excelsior Water & Mining Co. v. Pierce*, in which case the fact situation was essentially the same as in the English case. Whereas there were two classes of stock outstanding in the *Lee* case, neither however being preferred as to assets, in this case only one class of stock had been issued. In both cases the capital was intact. The Justice who wrote the opinion in this case cited the *Lee* case as authority in holding that profits derived from mining ore were available for dividends without first setting up a depletion reserve out of such profits and that dividends paid from such a fund was not in violation of section 309 of the California Civil Code.

However, upon different facts, a Delaware court refused to follow the rule. In this case, *Wittenburg v. Federal Mining & Smelting Company*, stockholders who were preferred as to assets on dissolution, sought an injunction to prevent the payment of dividends on the common stock before a reserve equal to the estimated depletion of the ore was set up out of profits. At the time of the declaration of dividends, the company because of depletion had a large capital deficit and plaintiffs claimed that the corporation could not legally pay a dividend unless its net assets were at all times equal to the par value of its outstanding preferred stock. The defendant corporation interposed a demurrer which was overruled, and on appeal, this was affirmed. The Delaware court distinguished the cases of *Lee v. Neuchatell* and the *Excelsior Water & Mining Co. v. Pierce*, on the ground that there are present here two factors which were not raised for consideration in those cases. One factor being the different equities existing between the two classes of stockholders and the other, the impairment of capital. In affirming the overruling of the demurrer, it was held that the "wasting asset" doctrine is not an exception to section 34 of the Delaware statute prohibiting the payment of dividends where the capital of the company is depleted and its net assets are less than its paid-in capital.

After the decision was rendered in this case, the Delaware legislature amended the statute, which amendment was construed in a second opinion, in *Federal Mining & Smelting Co. v. Wittenburg*. The statute as amended provides: "... Subject to any restrictions contained in its certificate of incorporation, the directors of any corporation engaged in the exploitation of wasting assets may determine the annual net profits derived from the exploitation of such wasting assets without taking into consideration the depletion of such assets resulting from lapse of time or from necessary consumption of such assets incidental to their exploitation. . . ."

Under the amended statute as construed in the second *Wittenburg* opinion the rule now prevailing in Delaware is that a wasting asset corporation has only

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| 24. Derring's Ann. Codes and Statutes of California, Vol. 2 (1885), Section 309 provides: "... the directors of a corporation must not make dividends, except from surplus profits arising from the business thereof."
| 27. Act approved March 2, 1927. |
to keep its capital stock intact to the extent that its outstanding stock of all classes is entitled to a preference in the distribution of assets.

The New Jersey court applied an even more liberal rule in Mellon v. Mississippi Wire Glass Co.\(^{29}\) Here, a stockholder, who was preferred as to assets on dissolution, sought to enjoin the directors of a corporation from declaring a dividend on common stock before setting up a reserve fund from which the holders of the preferred stock could be paid the par value of their stock. Plaintiff claimed that since the greater part of the capital stock of the company was invested in patents, the value of which was being reduced by the passage of time, there would be no assets left from which to redeem the preferred stock on dissolution. It was held that in the absence of a contract between the preferred stockholders and the corporation to set up such a reserve fund, the corporation was under no legal obligation to do so.

There are cases indicating that the rule might be applied to dividend situations in other jurisdictions. In Crocker v. Barteau,\(^{30}\) plaintiff sold two-thirds interest in a mining lease to be paid for from the first “net profits” of the mine. It was held that “first net profits” consisted of the excess of current receipts for the first ore taken from the ground less the current expenses for producing the ore. This language indicates that charges for depletion should not be made before estimating net profits. A Texas court\(^{31}\) applied the rule in the case of a granite quarry where it was construing the phrase “net profits” as used in a contract. It too, used language indicating that the rule might be applied to dividend cases. In a New Jersey case\(^{32}\) involving the construction of the word “income” as used in a trust indenture, it was held that dividends paid out of a depletion reserve were income to the trust and not capital.

In contrast to the depreciation and depletion questions are those questions that are raised in connection with the valuation of notes and accounts receivable. It is considered good accounting practice to charge off against income each year the estimated amount of notes and accounts that business experience indicates will prove to be uncollectible.\(^{33}\) In the Quinn case, where the question was whether or not there was a surplus from which dividends could have been declared, it was held that the worth of such accounts receivable must be calculated at the date of declaring the dividends.\(^{34}\) A Delaware court has held, that proper deductions must be made for shrinkage in notes and loss in collection when it is sought to ascertain whether there is a surplus from which a dividend may be paid.\(^{35}\) Likewise an Iowa court, in considering the legality of a dividend has held that outstanding accounts receivable should not be stated as an asset without setting up a reserve for those accounts which may prove valueless.\(^{36}\)

\(^{29}\) 77 N. J. Eq. 498, 78 Atl. 710 (1910).

\(^{30}\) 212 Mo. 359, 110 S.W. 1062 (1908).


\(^{32}\) De Brabant v. Commercial Trust Co. of New Jersey, 113 N. J. Eq. 215, 166 Atl. 533 (1933).


\(^{36}\) Hubbard v. Weare, 79 Iowa 678, 44 N.W. 915 (1890); see Spencer v. Low, 198 Fed. 961 (C. C. A. 8th 1912).
Thus it appears that a going concern should make necessary and proper deductions from earnings so as to provide for replacement of assets and estimated possible losses resulting from normal operation before determining the amount available for dividends.

**Revaluation Surplus**

The problem of revaluation or reappraisal surplus is very closely connected with that of unrealized profits. The distinction between the two terms is that unrealized profits is generally applied to increases in market value of current assets whereas revaluation surplus usually refers to increased values in fixed assets. The question raised by a consideration of both these items is the same, should they be included in determining whether or not a surplus exists from which dividends may be paid? There is a conflict in the authorities on this question; one line of authority follows the rule that dividends may only be paid from the normal operations of the business. This rule has become known as the “surplus profits” rule and does not include unrealized profits. A second line of authority applies the “present value” test which permits the inclusion of unrealized appreciation in determining surplus available for dividends.

A number of cases have dealt with the question of unrealized profits resulting from appreciation of current assets. In *Jennery v. Olmstead*, it was held that unrealized profits on bonds not yet sold should not be included in net profits for the year. The New York Supreme Court held that an increase in the value of cattle not realized by actual sale is not a proper item to be taken into consideration in determining actual surplus for a going concern, and a dividend paid from such surplus is illegal. In construing an executory contract, it was held that estimated profits to be made on orders for future delivery of goods are not “net profits” within the meaning of the statute.

In states where the “surplus profits” test is the rule, it seems that unrealized appreciation in value of fixed assets could not be considered as an element of profit in determining surplus for purposes of paying dividends. A case squarely in point is that of *Southern California Home Building v. Young*, wherein an action was brought against five former directors to recover dividends alleged to have been illegally declared and paid. A judgment for the plaintiff corporation was affirmed on appeal. The illegality of the dividends depended upon whether or not a surplus existed at the time of declaration and payment. Appreciation in the value of real property over its original cost had been recorded upon the books and included in surplus. The California court held that such appreciation was not profits within

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38. 36 Hun 536 (N.Y. 1885), aff'd, 105 N.Y. 654, 13 N.E. 926.
40. Hutchinson v. Curtis, 45 Misc. 484, 92 N.Y. Supp. 70 (1904). This was an action against director of corporation to recover and pay over to corporation amount of dividends alleged to have been paid from capital and not surplus. Judgment for plaintiff under a New Jersey statute which provided: “... no corporation shall pay dividends except from surplus or net earnings arising from the business...” N.J. Comp. Stat. 1910, sec. 30.
the meaning of section 309 of the Civil Code which provided: "the directors of a corporation must not make dividends, except from surplus profits arising from the business thereof". The rule was also applied in a Texas case\(^2\) where the court held that an increase in the value of lands owned by a corporation cannot be considered as profits until realized by actual sale.

A New York case, Randall v. Bailey,\(^3\) held to the contrary in 1942. This was an action by a trustee of an insolvent corporation to recover dividends declared and paid in the years 1928 through 1932, on the ground that such dividends were illegal because no surplus existed from which they could have been paid. Recovery was denied. It was conceded that real property was carried on the books at a value in excess of original cost. If it should have been carried at cost, there was no surplus. If on the other hand, it could be carried at the value assigned by the corporation's officers, there was a surplus. To determine which policy should have been followed involved a construction of section 58 of the Stock Corporation Law, which provides: "No stock corporation shall declare or pay any dividend which shall impair its capital or its capital stock, now while its capital or capital stock is impaired . . . , unless the value of its assets remaining after the payment of such dividends . . . , shall be at least equal to the aggregate amount of its debts and liabilities including capital or capital stock as the case may be." In construing this statute it was held that in enacting the above section, the legislature substituted the "present value" test for the "surplus profits" test; and that the unrealized appreciation was properly included in surplus.

It should be pointed out that the opinion gave strong approval to the definition of surplus as defined in Edwards v. Douglas,\(^4\) where the Court speaking through Mr. Justice Brandeis said: "... or it may among other things represent the increase in valuation of the company's fixed assets made upon a revaluation of the company's fixed property." The opinion further went on to state that in de-

\(^{43}\) 228 N. Y. 280, 23 N. Y. S. (2d) 173, 43 N.E. (2d) 43 (1942); see also Cannon v. Wiscassett Mills Co., 195 N. C. 119, 141 S.E. 344, 348 (1928), where the court took the view that "for the purposes of determining the amount to be declared and paid as a dividend, it is necessary that the true value of the assets, in cash, and not the mere book value should be ascertained, for no dividend can be lawfully declared and paid except from the surplus or net profits of the business." This decision appears to be in harmony with the Randall case but a doubt may arise as to the confusing language adopted with reference to surplus or net profits. If used in the sense that upon a present valuation, there is an excess of assets over liabilities and capital stock, it is completely harmonious. If, however, it is used in the sense of prior accumulated surplus or current earnings so as to exclude unrealized appreciation or depreciation, it would not only be in conflict with the Randall case but in harmony with Southern California Home Builders v. Young, 48 Cal. App. 679, 188 Pac. 586 (1920). Another interesting case that should be considered in this connection is that of Towles v. South Carolina Produce Ass'n, 187 S. C. 290, 197 S.E. 305, 306 (1938). In this case, Mr. Justice Baker, in a very powerful dictum said: "The trial judge sustained the Master in his findings, correctly holding: 'The terms net profits or surplus profits may be defined as what remains after deducting from the present value of all the assets of a corporation the amount of all the liabilities, including the capital stock'. a corporation can in good faith pay a dividend out of net earnings as thus defined, or out of a surplus theretofore earned and established; and a corporation cannot in good faith pay a dividend out of capital assets, or when its capital is impaired, or when to do so would reduce its capital assets." Here, while the court is speaking about "present value", it is in fact, defining and applying the "surplus profits" rule and as thus applied, it is contra to the Randall case and more in harmony with the Young case.
\(^{44}\) 269 U. S. 204, 214, 46 Sup. Ct. 85, 88, 70 L. Ed. 235 (1925).
termining whether or not a surplus exists from which dividends may be paid, the
test to be applied under the "present value" theory is whether the value of the
assets exceeds the debts and interest of stockholders. Hence, all assets must be
taken at their actual value, and unrealized depreciation in fixed assets like un-
realized appreciation must be considered even though this requires that the direct-
ors make a determination of value of assets at each dividend declaration.

The wisdom of the rule as laid down in the \textit{Randall} case appears to be doubt-
ful. It is not as conservative as the "surplus profits" rule and its application in
periods of rising real estate values may prove disastrous in later periods of falling
value to the extent that a corporation's current cash position may be seriously
injured.\textsuperscript{45}

There seems to be no cases in which the Supreme Court of Wyoming has had
occasion to consider any of these problems. Apparently, the only restriction on the
payment of dividends in this state is that imposed by section 44-127 of Wyoming
Compiled Statutes (1945) which provides:

"If the directors of any corporation shall knowingly and negligently
declare and pay any dividends when the corporation is insolvent or
any dividend, the payment of which would render it insolvent, they shall
be jointly and severally liable for all debts of the corporation then exist-
ing and for all that shall thereafter be contracted as long as they shall
respectively continue in office, provided the amount for which they shall
be so liable shall not exceed the amount of such dividend. . . ."

This does not seem to provide a satisfactory test for determining the fund
from which a dividend may be paid, since there is no indication of the meaning of
the term "insolvent". Is it meant to be construed in the bankruptcy sense or as
commercial or equitable insolvency? Inasmuch as creditors might be injured
when either condition arose, a reasonable interpretation of the statute would seem
to be that the term should be used in either the bankruptcy or equitable insolvency
sense, depending upon the facts. Further this statute would seem not to impose
any restriction on the impairment of capital.

Some light may be shed on these questions by an examination of two cases
decided under a Mississippi statute\textsuperscript{46} which is substantially the same as the Wyoming
statute now under consideration. In \textit{Kretschmar v. Stone},\textsuperscript{47} it was held that
a receiver, with court authority, may bring a suit against a stockholder to recover
dividends paid while the bank was insolvent. The opinion, however, does not

\textsuperscript{45} Titus v. Piggly Wiggly Corp., 2 Tenn. App. 184 (1925). This case is an excellent il-
illustration of the means to which a revaluation surplus may be put. Assets consisting
of licenses, patents and investment which had an earning power of $400,000.00 yearly
were written up from $815,000.00 to $5,810,000.00. Charged to this revaluation surplus
was a loss of $2,500,000.00 incurred by speculation in its own securities. The earned
surplus at the time of revaluation was $1,129,000.00 and if the loss had been charged
to earned surplus that account would have then showed a deficit which would have
to be restored before a dividend could be paid. This situation was avoided by creating
the revaluation surplus and charging to it the loss, thereby preserving the earned
surplus intact and available for dividends. This transaction was approved by the
Tennessee court on the theory that the capital had not been impaired by the declara-
tion of dividends, since the assets revalued had actually increased in value. It should
be observed that part of the assets, the patents at least, were of the character of a
"wasting asset", the value of which decreases yearly.

\textsuperscript{46} Miss. Code Ann. 1930 sec. 4149.

\textsuperscript{47} 90 Miss. 375, 43 So. 177 (1907).
discuss the meaning of the term “insolvent”. Kimbrough v. Davies,48 indicates that the impairment of capital is impliedly prohibited by the statute. In this case, the corporation on winding up its affairs set aside an amount estimated to be sufficient to pay the corporation’s debts and distributed the remaining assets to stockholders. In a suit by a creditor against a stockholder, it was held that a corporation’s capital cannot be withdrawn until all its debts have been paid.

There is, however, no indication in these cases whether or not the “surplus profits” or the “present value” test would be applied in ascertaining if a fund existed from which a dividend may be paid. In Massachusetts where a similar statute49 is in force, there are cases containing dicta to the effect that there is an implied common law restriction on the payment of dividends except from profits.50

The Wyoming legislature in 193951 put the section in its present form,52 by combining section 28-131 and 28-132 (of Revised Statutes of 1931) and in so doing deleted the phrase “the payment of a dividend which would diminish the capital stock”.

It seems that the statute as it now reads is open to at least three possible interpretations. First, that the impairment of capital is impliedly prohibited by the statute; second, that the impairment of capital is not prohibited; and third, that the phrase was deleted inadvertently.

F. R. Schofield

48. 104 Miss. 722, 61 So. 697 (1913).