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CORPORATE FINANCE

CHAPTER 1.5, PART II

DIVIDENDS, DISTRIBUTIONS, AND CORPORATE ACCOUNTING

CHARLES W. KNOWLTON*

Section 5.13 through 5.24 of the South Carolina Business Corporation Act of 1962¹ contain provisions concerning dividend limitations, stated capital, redeemable and convertible securities, and certain required yardsticks for corporate accounting. These provisions, as well as writings about them, do not make very good light week-end reading. However, since business corporations exist for the purpose of earning money, the application, accounting and distribution of corporate funds are topics of more than passing interest to corporate creditors, shareholders and counsel. This area of corporation law is not, and will never be, completely static. The framework of this portion of the act is derived from the A.B.A. Model Business Corporation Act.² One of the draftsmen of the latter points out that the Model Act is even now undergoing more change in this area.³ These financial provisions must safeguard certain interests but at all times adapt to the practicalities of business. "In short, it is not doctrine but function that controls in this field."⁴

Statutory rules of corporate finance are updated by the act. Some gaps are filled; some ambiguities clarified; some old issues resolved; and some new concepts are added. This article will attempt to hit the high points.⁵

STATED CAPITAL

"Stated capital" will be a new term for South Carolina practitioners. It is roughly the same as "capital stock" but

¹Hereinafter called the Act. All section references are to the Act unless otherwise stated.
²Hereinafter called the Model Act.
³See Gibson, Surplus, so What? — the Model Act Modernized, 17 BUS. LAW. 476.
⁴See footnote 3.

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in the act it is a more precisely defined and governed concept. Section 5.13 requires the maintenance of stated capital as defined in section 1.2. In the beginning, it consists of the equivalent of the par value of issued shares of stock, with the excess of any consideration over par value being allocated to capital surplus. The entire consideration received for the issuance of no-par shares is added to stated capital except such portion which the directors may allocate to capital surplus. Stated capital may be increased by the directors by transferring all or part of the surplus of the corporation and thus making it unavailable for distribution as dividends or capital surplus distributions.

Stated capital may be reduced by action of the shareholders pursuant to certain formal requirements of section 5.21 and filing of a statement thereof with the Secretary of State. Although the shareholders must be given written notice of the purpose of the meeting for acting upon the reduction, the newspaper notices currently required by section 12-279 will no longer be necessary. The surplus, if any, created thereby becomes a part of capital surplus.

DIVIDENDS IN CASH OR PROPERTY

If not prohibited by restrictions in the articles of incorporation and unless the corporation is insolvent or would become so as the result of a dividend payment, dividends in cash or property may be declared by the directors and paid. The source of such dividends is limited to "the unreserved and unrestricted earned surplus." Reams have been and will be written on the policy, definition and computation of permissible sources of dividends. Dividend restrictions are not as old as the hills of corporation law, and their earliest appearance in this country was apparently in bank charters toward the end of the eighteenth century. Such restrictions are generally regarded as a protection for creditors. But often the issue can be triangular, with directors, stockholders and creditors each having a different point of view.

In the exercise of their discretion to declare or withhold dividends, directors may err in either of two directions. They can be unduly lavish and by improvident distributions weaken

8. See footnote 3.
the corporation's financial structure. On the other hand, they can plough back more than is necessary, perhaps with the motive of supporting greater compensation for management, and deprive stockholders of a reasonable return. But the act concerns itself primarily with restraints upon dividends. The purpose of such restraints is the protection of creditors. Ballantine puts it well:

"The coveted privilege of carrying on business with limited liability has been thrown open to all applicants under general corporation acts. The law, however, seeks to safeguard creditors by requiring the making and keeping of a minimum investment in the business. Immunity from the personal liability which partners would have for the debts is granted only on condition that the profit sharers shall be risk takers. The general policy is that they must put at the risk of the business some stake which shall appear reasonably adequate for its prospective needs." 9

Capital and surplus are accounting concepts and the drafts- men of the Model Act, from which the South Carolina act is derived, obtained and relied upon advice from the American Institute of Certified Public Accountants. 10 This is highly desirable as corporate accountants and attorneys should work with a common yardstick. Careful consideration of these concepts should be given by the lawyer and not fobbed off as exclusively the accountants' milieu. Serious consequences can result from non-compliance; for example, directors are jointly and severally liable for dividends paid in violation of the provisions of the Act. 11

Before defining these concepts we might consider their functional significance. Stated capital allocates a portion of the corporate assets indefinitely to the company. Reserves are a portion of the assets set aside for a specified purpose such as equipment replacement. Capital surplus, in addition to being an inducement for credit, is not indefinitely committed but may, under certain conditions, be distributed to shareholders. Earned surplus is that portion of the assets generally available for dividends.

9. BALLANTINE, CORPORATIONS 570 (1946).
10. See articles cited in footnotes 3 and 5. The writer was so informed at a conference with some of the draftsmen of the Model Act.
The oldest dividend restriction is that there exist a surplus or net worth over and above legal or stated capital from which dividends can be paid. Modern statutes require that dividends come not merely from a "surplus" but it must be an "earned surplus."

A question arising in attempting to define "surplus" and "earned surplus" is whether to look solely at the balance sheet or to the net result of the earnings of the enterprise. The trend in modern times is to limit the dividend service to accumulated earnings. But the states have varied in their statutory definitions even when they agreed in principle. South Carolina statute law currently refers to "surplus theretofore earned" at one point and "net earnings" in another as permissible dividend sources. Georgia, in rather adamant but obscure language, prohibits dividends from profits which are not "actual legitimate net earnings."

The key financial records of a corporation are the balance sheet and the annual profit and loss statement. The former is a listing in summary form of the assets matched against the liabilities and capital and surplus accounts at a given date. The latter is a summary of the earnings record for a fiscal period. The act makes it clear that cash dividends must come only from accumulations shown in profit and loss statements over the financial history of the corporation. Thus the legal source of dividends, "earned surplus," is not the result of valuation of assets but rather accumulated profits from operations.

In the new act the term "surplus" is a balance sheet concept only: "the excess of the net assets of a corporation over its stated capital." "Capital surplus" is all surplus, other than "earned surplus." "Earned surplus," the dividend source, is defined as that portion of surplus "equal in amount to the balance of its net profits, income, gains and losses from the date of incorporation or from the latest date when a deficit was eliminated by application of its capital surplus, after deducting subsequent distributions to shareholders and transfers to stated capital and capital surplus to the extent that

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such distributions and transfers are made out of earned surplus. Unrealized appreciation of assets shall not be included in earned surplus."17 Thus the act purports to describe as a dividend source not only the end product but a required and fiscal method of computation, subject, of course, to the elasticity of such words as "profits" and "income."

Even "earned surplus" is no test of the corporation's liquidity or ability to pay dividends. While there may be a legal right to pay dividends, the directors must consider other factors, such as existing working capital, to determine whether it is wise to pay dividends. Wisdom and prudence are not easily legislated.18

In interpreting the existing statutes the Supreme Court has referred to "net profits," "net earnings" and "profits" as dividend sources.19 The new statutory definition in the act is therefore not a material departure from existing law. However, the act does have the virtue of providing a much tidier definition which should be more meaningful to more people.

In passing, it might be noted that the act does not allow so-called "nimble" dividends permitted in Delaware, where a corporation with an over-all deficit can declare dividends if there are net earnings in the current year.20 The act also lays to rest an old battle in corporation finance: whether a corporation can declare dividends from unrealized appreciation of assets or "appraisal surplus."21 One would have thought that the Model Act prohibited such a dividend but one of its draftsmen thinks not.22 To make sure, such a prohibition was specifically added to the new South Carolina Act as the final sentence in section 1.2(q).

One final reference to dividends in cash or property is in a context which the writer wistfully hopes might be more relevant in South Carolina in the future. A corporation en-

18. BALLENTINE supra note 9 at 576.
20. DEL. CODE title 8 §170(a) (2) (1953). But for a form of "nimble dividend" see discussion under SPECIAL PROVISIONS CONCERNING SURPLUS AND RESERVES.
gaged in the exploitation of natural resources (such as oil wells) or other "wasting assets" may declare dividends from depletion reserves if properly identified as such a distribution.23

SHARE DIVIDENDS

When a corporation pays a dividend in its own shares it does not part with any of its assets and the limitations on such dividends are more relaxed. Subject to its solvency and restrictions in the articles of incorporation, a corporation may declare dividends in its authorized but unissued shares.24 They are charged to unreserved and unrestricted surplus. Thus surplus is reduced on the balance sheet and stated capital increased. Note that either earned or capital surplus may be used, unlike cash dividends. If capital surplus is thus applied, it will leave any earned surplus available for cash dividends in the future. The dividend shares are issued for at least par value, or a stated value if no par stock. If issued at an amount in excess of par, such excess remains in or is added to capital surplus. Thus if the dividends come from earned surplus, the excess over par increases capital surplus.

The share dividends, according to the act,25 must be accompanied by a notice of the resultant effects upon stated capital, capital surplus, and earned surplus.

DISTRIBUTIONS FROM CAPITAL SURPLUS26

There is nothing necessarily immoral about distributions from capital surplus so long as creditors and holders of preferential securities are not harmed and it is made perfectly clear that it is not a distribution of earnings and is in effect a partial liquidation. Such distributions must be authorized by the directors and two-thirds of the outstanding shares in each class whether or not such shares otherwise have voting rights.27 Furthermore, they may not be made if any cumulative preferred dividends are in arrears or if there would be an impairment of any liquidation preferences. Capital surplus may also be used to discharge cumulative, preferred dividend

rights if there is no earned surplus. All distributions from this source must be identified as such by a notice to that effect concurrently with the payment.

ACQUISITION AND DISPOSITION OF OWN SHARES

A corporation is permitted to purchase (and later dispose of) its own shares using earned surplus, or with certain limitations (and after two-thirds vote of all classes of stock), from capital surplus. Such shares may be held as treasury shares and if desired, later distributed as share dividends, or they may be cancelled. A motive for retaining them in the treasury or as treasury shares is their resale is not subject to the limitations of an original issue. For example, original issue of par value shares must be for at least par value, but if the market value has declined, treasury shares may apparently be resold at a price set by the directors. While they are held as treasury shares they are not deemed balance sheet assets and surplus is deemed reduced pro tanto. Upon resale surplus is increased; this increase shall be in capital surplus except where the shares were acquired from earned surplus; then upon resale earned surplus may be increased. Such reacquired shares may be cancelled either at the time of acquisition or later. Upon cancellation any surplus created thereby is deemed capital surplus. The cancellation also results in a reduction in stated capital, and a notice thereof shall be filed with the Secretary of State.

Treasury shares are peculiar creatures, posing accounting problems particularly upon their resale. They are deemed issued but not outstanding, and do not carry dividend or voting rights. However, they carry pre-emptive rights in corporations whose articles grant such rights. Nevertheless, their peculiarities are more clearly spelled out by the act for accountants and attorneys than under existing law.

37. See footnote 5.
REDEEMABLE SHARES

Sections 5.18 and 5.19 of the act pertain to the issuance, redemption and retirement of redeemable shares. Redeemable preferred (but not common) stock is permitted, but the articles must authorize it and prescribe its redemption price, redemption period and conditions for redemption. Also the option to redeem must be exclusively that of the corporation. Otherwise they could pose a serious threat to the financial stability of a corporation. Prohibiting redeemable common stock is a policy determination. If financial difficulties were over the horizon and the common shareholders could be bailed out, this would leave preferred shareholders holding the bag. This would be inconsistent with the rank usually accorded preferred shareholders. In any event, shares may not be redeemed if the corporation is, or would be rendered, insolvent, or if the redemption would reduce the assets below the liquidation preferences of preferred shares.\(^{40}\)

Redemption results in automatic cancellation of such shares, and notice of the resulting reduction in stated capital must be filed with the Secretary of State.\(^{41}\)

SPECIAL PROVISIONS CONCERNING SURPLUS AND RESERVES

Definitions of surplus, earned surplus, and capital surplus, and distributions therefrom, have already been discussed. But there are uses of surplus other than for distributions to shareholders. For example, if a deficit occurs, how can it be eliminated? Section 5.22 directs that earned surplus (the cash dividend source) must first be applied. If this is insufficient to offset the deficit, then the directors may apply capital surplus to that extent.\(^{42}\) Thereafter, in computing earned surplus it is not necessary to balance profits and losses from the date of incorporation; the computation commences from the latest date that capital surplus was applied to a deficit.\(^{43}\)

An interesting, and perhaps controversial, result can occur after the retirement of a deficit with capital surplus. Future

\(^{40}\) S. C. Code §12-15.18(c) (Supp. 1962).
\(^{43}\) S. C. Code §12-15.22(a) (Supp. 1962); this is also mentioned in the definition S. C. Code §12-11.2(q) (Supp. 1962).
net profits will go into earned surplus once again and become available for dividends. The result is that to the extent capital surplus is used to retire a deficit, subsequent cash or property dividends are, in effect, paid from capital surplus. The directors can, therefore, “pave the way... for a form of ‘nimble dividends’ out of subsequent earnings to the extent of existing capital surplus notwithstanding a prior earned surplus deficit.” 44 The capital surplus used in this fashion can include so-called paid-in surplus resulting from the consideration received for the issuance of shares in excess of par value or stated value 45 and surplus resulting from reducing stated capital. 46 Some may question the wisdom of retiring deficit losses from any source other than earnings. This provision follows the Model Act but is more conservative than Delaware. 47 However, if every possibility of abuse were covered, the result would be an inflexible act whereas flexibility is imperative. After all, some questions of wisdom in financial policy can be safely left to the discretion of management.

The act gives broad authority to create reserves from earned or capital surplus. The directors may increase, decrease, or abolish such reserves. While so reserved, such funds are not available for the payment of dividends or other distributions other than the purpose of the reserve. 48

Section 5.22(d) provides that in the case of a merger or consolidation (and, we assume, that the resulting corporation is a South Carolina corporation) the earned surplus of the resulting corporation shall not exceed the aggregate net earned surplus of the constituent corporations reduced by any distributions to shareholders, or transfers of earned surplus to capital surplus or stated capital which occur in the merger. This simply prevents any distortion, up or down, of earned surplus in the merger.

Other provisions of the Section are that earned surplus may be transferred to capital surplus, 49 and that any surplus resulting from a reduction of stated capital becomes capital

47. See footnote 20.
surplus\textsuperscript{50} which can be used, as noted, to retire a deficit. The safeguard here is that reduction in capital requires shareholders' approval.\textsuperscript{51}

CONSIDERATION FOR BONDS\textsuperscript{52}

Generally, section 5.23 follows section 5.7 pertaining to consideration for shares of stock and is intended to implement Article 9, Section 10, of the South Carolina Constitution. It is also consistent with the intent of the current Code section 12-231. Subsection (e) properly permits the sale of bonds at a discount and payment of the underwriting costs from the proceeds. The purpose of the section is to prevent the taking of creditor securities by promoters or others for improper consideration. The consideration must consist of money, property, or in labor or services actually performed. Note that the quality rather than the quantity of consideration is prescribed.

CONVERTIBLE SECURITIES\textsuperscript{53}

Again flexibility and modernization have been the objectives here. Convertible securities are a popular financing device and should be permitted. They must, however, be authorized by the articles of incorporation. An important safeguard is contained; conversion must be into securities of a junior rank. For example, debentures may be converted into stock, but common stock may not be converted into preferred stock. "Upstream" conversion would be grossly unfair and is prohibited so that liquidation preferences and creditor securities may not be diluted.\textsuperscript{54} The Section also requires that sufficient authorized but unissued securities be maintained to satisfy the conversion privileges and provides that converted shares be cancelled.\textsuperscript{55}

CONCLUSION

As in all other provisions of the Act, the draftsmen drew heavily upon the Model Act, recently revised corporation acts in other states, and considered the current statutory and case

\textsuperscript{52} S. C. Code §12-15.23 (Supp. 1962).
law in South Carolina. Combining (or reconciling) the objectives of flexibility for the modern corporate business with specific rules for the corporate counsel and the courts required difficult drafting footwork at times.

Two notes of caution should be sounded. First, while the act attempts to simplify the corporate organizational paperwork, it affords a challenge to the practicing lawyer to take advantage of certain features of the act by appropriate provisions in the articles of incorporation (e.g.: sec. 5.24, Convertible Securities). Secondly, since changes constantly occur in corporate finance and accounting, the corporation law committee of the South Carolina Bar Association should review these financial provisions and suggest amendments in the light of new trends elsewhere, obsolescence of these provisions and undesirable abuses which might occur.