

# Can Premium On Capital Stock Be Declared As Dividends?

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**T**HE problem presented is: may a corporation which has sold some of its stock at a price in excess of its par value declare as dividend the excess over the par value of the stock?

The object of modern business corporations is to earn money for their stockholders or members. When such a corporation earns profits over and above the amount of its capital, the stockholders or members have the right, subject to qualifications, to have such profits set apart from the general mass of funds of the corporation, and distributed among them in proportion to their shares or interest in the corporation, and the fund set apart for this purpose is called a "dividend." (*Eaton v. English & Mersick Co.*, 7 F. (2d) 54, 57.)

It is a settled rule, even in the absence of any statutory provision, that a corporation cannot lawfully declare dividends out of its capital stock, and thereby reduce the same. "Three reasons have been given for the foregoing rule: First, to permit the payment of dividends out of capital would work a fraud on the creditors of the corporation, who have over-extend credit on the faith of its capital stock; second, each stockholder is entitled to have the capital stock preserved unimpaired for the purpose of carrying out the object for which the corporation was formed; third, the capital stock is a trust fund for the security of creditors, and cannot be withdrawn or diverted to their prejudice." (4 *Neb. Law. Bul.*

360) To this general rule that dividends can be paid only out of surplus, an exception has been made of corporations whose revenues are earned by using up their capital assets. This exception, known as the "wasting asset doctrine," permits the payment of dividends out of current yearly profits without taking into consideration the impairment of capital caused by depletion of the corporation's mineral resources. But this doctrine does not apply where there are both preferred and common stock, in which case, provision should be made to reimburse the preferred shareholders for their contribution to the corporation. (*See Wittenberg v. Federal Mining & Smelting Co.* 15 *Del. Ch.* 147, 133 *A.* 48).

The general rule, therefore, is that dividends may only be declared from surplus profits. Statutes in many states prescribe a variety of restrictions on the declaration and payment of dividends. But even in the absence of statute, dividends may be declared only from surplus profits, regardless of the origin of such profits or surplus, so long as the declaration of such dividends does not impair the capital stock of the corporation or endanger its solvency. Bearing this in mind, the question with which we are concerned, therefore, resolves itself into this: Is the premium derived from the sale of unissued stock above its par value to be considered as profits when determining the surplus profits? Or is it to be classified under another item, thus

making its distribution as dividend illegal?

In the first place, it may be stated that "an agreement by subscribers to pay more than par for their stock is not *ultra vires* as an attempt to increase the par value of the stock, but is valid and enforceable according to its terms." (*Grove v. Economic Life Ins. Co. (Del Ch.)*, 80 Atl. 809. See also *Esgen v. Smith*, 113 Iowa 25, 84 N. W. 954). The general rule is that in the absence of statutory prohibition, a corporation may sell its shares in excess of their par value. It is not unusual for a corporation to sell its stock above par at the time of incorporation, for the purpose of creating a surplus—a practice which is usually followed by insurance companies, banks, trust companies, and other financial institutions. A company with a substantial surplus is more likely to possess the confidence of the public than one that has none; and by selling stock at a premium, a more or less substantial surplus or margin is provided at the outset, which may be drawn upon to meet organization expenses, and carry the company and give it solidity until it becomes firmly established. In any case the premium is credited to Surplus. (*Corporation Procedure*, by Conyngton and Bennett, rev. ed. p. 480).

Let us first consider the nature of premium from the accountant's view-point: R. H. Montgomery, in *Financial Handbook* (pp. 1588-1589) says that "premium on capital stock is essentially a capital contribution, and appears to be so classified by most accountants." The writers classifying premium as a capital contribution naturally condemn considering it as part of the profit available for dividends, for the simple reason

that a dividend based on premium would be really a return to the stockholder of part of his original capital investment. Other writers seem to consider premium on capital stock as a profit but they nevertheless deny its availability for distribution as a dividend. Dickinson, for example, has contended as follows: "Premiums on stock issued may be a source of surplus cash received in excess of the authorized capital which must be maintained intact, but they are not profit on operations and should not, therefore, be credited as such to Income, although they may be applied to make good depreciation in fixed assets, or exceptional losses, where such depreciation or losses do not arise out of the ordinary business of the corporation." (*Accounting and Practice and Procedure*, 4th Printing, p. 128). On the other hand, W. A. Paton, states that "The essential accounting condition underlying the appropriation of any dividend is a net credit balance in the income and surplus accounts, assuming that all prior charges have been set up, and that the accounting is in general in accord with good practice. \* \* \* There may be included in the dividend base all profits from ancillary activities, including interest and dividends on securities owned, and profits on all special and unusual transactions."

From the legal standpoint, there are two lines of decisions in the United States. Several court decisions hold that premium on capital stock is available for distribution as a dividend. In the case of *Equitable Life Assurance of the U. S. v. Union Pacific Railway Co.* 212 N. Y. 360, 106 N. E. 92, L. R. A. 1915 D., 1052, the defendant corporation realized a premium of \$75 per share on

some common stock. The contract with preferred stockholders called for a non-cumulative dividend out of the profits of each year, not exceeding 4%. It was decided to pay an extraordinary dividend to the common stockholders, and the plaintiff, a preferred stockholder, objected on the ground that the premium constituted an accretion of capital and should therefore go ratably to preferred and common stockholders. The court held that the premium became part of the surplus and as such was distributable to common stockholders as dividend, saying: "It is the ordinary rule of corporate management established by decisions, statutes, and business usages that the surplus of these gains or profits, beyond what may be necessary to keep good the liability to capital stock which has been issued, may, in the discretion of the board of directors, be distributed amongst its stockholders as dividends and returns on their investment." To the same effect with respect to the nature of premium on capital stock are *Boston & M. V. Co. v. United States* (C. C. A. 1920) 265 F. 578; *Smith v. Cotting* (1918) 231 Mass. 42, 120 N. E. 177; *Hyams v. Old Dominion Copper Mining and Smelting Co.* (1913) 82 N. J. Eq. 507. Likewise in 14 *Corpus Juris* 866: "Premiums received from the sale of bonds of a corporation constitute no part of its capital and may be treated as profits out of which dividends may be made, and the same is true of premiums received from the sale of the stock of a corporation, and of profits derived by a corporation from the sale of bonds delivered to it in payment of stock subscriptions, or of profits realized by the sale of stocks of other companies."

On the contrary, the other line of decisions lay down the principle that premium is essentially capital. In the case of *Merchants' & Insurers' Reporting Co. v. Schroeder* (1918) 39 Cal. App. 226, the plaintiff corporation sought to hold the defendants, who were members of the board of directors of said corporation, liable for dividends declared by them in former years on the ground that said dividends were not made from the surplus profits arising from the business of the corporation, but were paid of the proceeds of the sale of its capital stock. In deciding for the plaintiff, the court said: "the corporation never had any surplus profits out of which any dividends could have been paid, unless the moneys received as 'premiums' above the par value of stock sold might be segregated from the assets of the corporation and treated as profits of its business. We are satisfied that the entire proceeds of sales by a corporation of its own stock, even when sold for more than par value, are part of its original assets or capital stock, and therefore cannot be profits earned through the conduct of its business." And in the case of *Brenaman v. Whitehouse*, 85 Wash. 355, 148 Pac. 24, the court held: "Property or money which represents an investment of the capital stock of a corporation, or of any part thereof, cannot be regarded as surplus profits, and distributed as dividends, irrespective of the financial condition of the corporation. When a person subscribes for or purchases shares of stock in a corporation, and pays a part only of the amount due thereon, and the shares are afterwards forfeited for nonpayment of the balance, the amount paid is not profits, but a part of the capital, and cannot be

divided among the stockholders. And the same is true of the proceeds of the sale by the corporation of shares of its own stock not previously issued." (See also *People ex rel. Queens County Water Co. v. Travis*, (1916) 171 N. Y. App. Div. 521, *aff'd* 219 N. Y. 571), stating the principle that premium is essentially capital, and if distributed, such distribution is treated as a distribution of original or surplus contributed, and not as dividend).

In the Philippines, our Corporation Law (Act 1459), Section 16, provides: "No corporation shall make or declare any dividend except from the surplus profits arising from its business, or divide or distribute its capital stock or property other than actual profits among its members or stockholders until after the payment of its debts and the termination of its existence by limitation or lawful dissolution." This, by implication, prohibits the declaration of dividends upon paid-in surplus. So that even considering premium on sale of stock as surplus profits and not as part of the capital of a corporation, it would seem that under our law, a corporation may not declare said excess proceeds in dividends for it is clear that they are not surplus profits which arise from its business. However, in the case of *Steinberg v. Velasco*, 52 *Phil.* 959, the Supreme court in deciding that the dividend declared by the defendant members of the board of directors was illegal as impairing the capital stock of the corporation, laid down a dictum: "If in truth and in fact the corporation had an actual bona fide surplus of ₱3,000 over

and above all of its debts and liabilities, the payment of ₱3,000 in dividends would not in the least impair the financial condition of the corporation or prejudice the interests of its creditors. \* \* \* In other words, that the corporation did not then have an actual bona fide surplus from which the dividends could be paid." The Supreme Court here seems to imply that if there had been a bona fide surplus, whether surplus profits arising from its business or paid-in surplus from any other source, the board of directors would have been justified in declaring the dividend.

In conclusion, it is submitted that in view of the express prohibition contained in Section 16 of our Corporation Law which authorizes the declaration of dividends only out of the surplus profits arising from its business, a Philippine corporation, with the exception of "wasting asset" corporations which do not have preferred stock, may not declare a dividend on the premium on the sale of its shares over their par value. It is also submitted that even in the absence of statutory prohibition, the rule laid down by the California and Washington courts that premium is essentially capital, is the better view. These excess proceeds should be kept by the corporation in order to meet any emergency, to make good depreciation in fixed assets, or exceptional losses, where such depreciation or losses do not arise out of the ordinary business of the corporation. This is in accord with good business practice and good accounting procedure.