For A National Policy Towards Earnings of Corporations

By Jovito R. Salonga*

One of the more reassuring aspects of contemporary insight, shared by an ever increasing number of people, is the awareness that the public has a continuing interest in the maintenance of a sound dividend policy on the part of the private business enterprises. As corporations continue to assume a progressively important role in the economic life of the nation, more and more people will find themselves dependent on the stability and the judicious management of these business units. The stockholders demand, in consideration of the risk they take to the extent of their respective contribution, not only the right, though this has become largely theoretical, to control the management but the right to share in the earnings. Creditors who invest their money to keep the enterprise going have an interest in the preservation of such assets as will make payment of their claims relatively certain. Courts have yielded to their insistence that, on account of the limited liability which attaches to corporate shareholders, as distinguished from the unlimited liability of an individual entrepreneur, corporate assets should not be dissipated or withdrawn unless their interests are sufficiently protected. Workers, whose very security and well-being are at stake, ask for decent working conditions, higher wages, and stability of tenure. Corporate management, quite convinced of their importance in the amassing of earnings and relying upon the the power they wield within the institutional structure, vote themselves the compensation they say—whether sincerely or not—they deserve. The consuming public is interested in the maintenance of relatively stable prices, and society as a whole has a vital interest in the healthy expansion of productive activity.

To be sure, the financial soundness of corporate structures has a significant bearing on all these claims and interest. A bad dividend policy may well spell the collapse of a corporation. If undertaken by many in strategic fields of industry, improper dividend policies may lead to complete cessation of productive operations, the consequent loss of livelihood to many, loss of investment to those who have a financial stake in the enterprises, a disturbance in the distribution of vital neces-

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sities, and even weaken the faith of many in the soundness of the whole economic structure.

Dividend regulations as a whole assume, however, that those who are directly and immediately involved are the stockholders and the creditors. Heretofore, the emphasis had been laid primarily on creditor protection. The fact that the stockholder incurs a limited liability has been regarded to be sufficient justification for the attitude. Under Philippine law, as is true in the case of American corporation statutes, the creditors of a corporation cannot look beyond the stockholder's subscription to capital for the satisfaction of their claims. Hence the insistence that original capital should be permanently devoted to the risks of the corporate enterprise in substitution, however incomplete, to the unlimited personal liability of an individual entrepreneur.

Of late, increasing stress is being given to shareholder protection. It is true that an ordinary investor expects profits from the business. But it is also true that he expects that dividends will be paid out of profits, not out of the capital he paid in as his stake in the concern. Since an improper dividend may create a beguiling display of prosperity, there is the great probability that the mass of scattered, unorganized, and ill-informed stockholders will, as long as they receive periodical distribution of dividends, be effectively prevented from taking timely steps to call the management into account. They may find out subsequently that what they had considered to be dividends were in fact their own contributions being returned in the form of profit distributions. To the extent that such distribution of 'profits' draws out more and more investment from a gullible public, there is a corresponding increase in terms of mishandled funds. There is one legal aspect here that should not be overlooked. Directors have the obligation to keep the stated, or as is sometimes said, 'legal' capital, intact in order to carry out the purposes for which the corporations was established. These purposes, laid down in formalistic language in the articles of incorporation, constitute in the traditional view the basic 'agreement' of the stockholders *inter sese*. Again, although a particular distribution may be proper in so far as creditors are concerned—in that their claims are not adversely affected yet it may be regarded as a breach of duty on the part of the management toward stockholders belonging to one or more classes. This is particularly true in corporations where the management is identified with the common stockholders. Instances are not few when improper dividend declarations have been made by directors related to junior stocks for the purpose of destroying the contractual preferences of senior stocks.

There is the other side of the picture which cannot be ignored. Traditional rules of corporation law consider the directors, by the very nature and importance of their position, as the men who can properly sit in judgment on the financial condition of the corporation. Being such judges, they are to determine from time to time (1) what portion of the available fund should be distributed as dividends, when and to what class of shareholders, (2) what portion should be set aside and reinvested in the business (3) or whether total distribution or total reinvestment should be done. This is the most important and, obviously, the most critical aspect of any dividend policy. Courts have given assent to the proposition that the fund available for dividends may exist, but this should not mean that it should be completely exhausted for such purpose. Undoubtedly influenced in many instances by the philosophy of non-interference in private enterprise, judges have quite consistently held that only in extreme cases where there is a clear showing of abuse of discretion or bad faith will courts attempt to override the decision of corporate management.[1]

Here, indeed is a veritable source of conflict. Judicial hesitation is predicated on the assumption that a fair dividend policy is a difficult matter of business judgment, experience, and foresight. Courts will not attempt to substitute their judgment on complicated questions of business policy for that of corporate directors. Hence, the investing of a wide discretion in the directors to use the corporate resources, either to adopt a policy of accumulation by reïnvestment of the earnings or a policy of distribution. The latter, as pointed out, could easily be carried to the extreme. On the other hand, an undue accumulation beyond the justified needs of the business may well work a diversion of the income stream to fixed salaries and 'incentive compensation' through profit sharing contracts and bonuses, thus favoring the directors who may own only a few shares. There is also some merit in the criticism

[1] Thus in Chanon v. Chanon Company, 218 Ill. App. 397, (1920) the court said: "As a general proposition, the action of the board of directors in refusing to declare a dividend is final, and such discretion will not be interfered with by a court of equity in the absence of bad faith or arbitrary or unjustifiable conduct." See Dodd, The Modern Corporation, Private Property and Recent Federal Legislation, 54 Harv. L. Rev. (1914) 917. 'Management' is here used in the broad sense of the term. The traditional view is stated in Fletcher, Cyclopedia of Corporation. (Pers. Ed. 1932) sec. 5325.

[2] See Amos, J. E., The Economics of Corporate Savings (1937) 22 Un. Ill. Studies in Soc. Sci. No. 2; Epstein, R.C. and Clark, F. M. Industrial Profits in the United States (1934); Nerlove, S. H. A Decade of Corporate Incomes, 1920-1929 (1932); Curry, Utilization of Corporate Profits in Prosperity and Depression (1941) 9 Mich, Bus. Stud. No. 9; S. Fabricant, Recent Corporate Profits in the United States (National Bureau of Economic Research, Bulletin No. 50 (1934); G. H. Sage, Dividend Policy and Business Contingencies, Harv. B. Rev. (Winter, 1937) 251; D. Friday, Profits, Wages Prices (1921); R. P. Marple, Capital Surplus and Corporate Net Worth (1936); Graham and Dodd, Security Analysis (1940) Bliss, J. B. Financial and Operating Ration in Management (1935) Nat. Bur. Econ. Res. Bull. No. 28; Tirrel, A. D. The Distribution of Profits (Harv. Grad, School of Business Adm. 1931).

that the practice has been manipulated by men owning a large block of shares in order to reduce surtaxes on their income, a measure whose unfairness to the smaller stockholders who would prefer cash dividends is at once obvious. To what extent corporate directors in the Philippines have been enabled, particularly during the "gold boom", to manipulate the corporation's security prices or speculate in inventories or in securities of other companies through such a procedure may never be known. The long-term effects of large surplus accumulations upon the whole economic structure of the nation have been the subject of profitable investigations in the United States in recent years. There is the view held that the withholding of earnings from stockholders tends to dissipate rather than preserve savings, a disastrous result deriving from long-continued investment in fixed capital.[3] Some writers in the United States, in analyzing the overexpansion which preceded the depression of 1929, have emphatically asserted that such overexpansion was due "in no small measure to the disinclination of directors to relinquish earnings to stockholders".[4] Directors, of course, will endeavor to justify their act of plowing back the profits by arguing that they are actuated by the desire of eventually maximizing the net returns to the shareholders. Very rarely, indeed, do we find any articulation of such altruistic sentiment as prompted one of the dominant forces in American business to say:

> "My ambition is to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back in the business." [5]

The court in this particular case did not find his plan to share profits with the public by reducing the prices of cars very convincing. Said the court:

> "The difference between an incidental humanitarian expenditure of corporate funds for the benefit of the employees, like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others, is obvious. There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his co-directors owe to protesting, minority stockholders. A business corporation is organized and carried

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[3] See e. g. Kimball, Depreciation and Savings (1935) 10 Acc. Rev. 365
[4] Dewing, Financial Policy of Corporations (4th ed. 1941) Vol. II at 789
[5] Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919)

> on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits among stockholders in order to devote them to other purposes .... it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that if the avowed purpose of the defendant directors was to sacrifice the interest of shareholders it would not be the duty of the courts to interfere."[6]

In spite of the rather vigorous language employed, the court was careful in limiting its decree as not to interfere seriously with the program of expansion contemplated. Presumably, the position of the courts on this point has not yet changed, since it is considered difficult for them to say at what point the interest of the community should be placed ahead of that of the stockholders. The problem has become largely academic, however, because of the so-called "business judgment" rule or what one may describe as the policy of judicial non-interference. As long as corporate managers refrain from asserting that the retention of earning was motivated by broader considerations of public welfare and instead stress that what they are merely doing is to plow back earnings today to pay higher dividends tomorrow, courts may not interfere with what is supposed to be a decision of business experts. Thus, we hear the argument so frequently put forward that the eventual maximization of net returns will be the result of present surplus accumulations.

To be more specific, the reasons for surplus accumulation have been multiplied in recent years.[7] There is the time-honored argument that reserves must be accumulated against the hazards of depression and thereby stabilize dividend distributions. Expressed in more sophisticated language, it is asserted that during periods of prosperity, corporations should pay out as a matter of policy an amount consider-

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[6] ibid., at

[7] The following reasons have been invoked to justify surplus accumulations: (1) strengthen the financial position of the corporation; (2) increase its productive activity; (3) eliminate an original overcapitalization (squeeze out the water); (4) make it possible to pay dividends regularly; (5) strengthen the long run credit position; (6) protect the corporation against such hazards as a general depression, a changing demand for products, the possibility of tax liabilities and other contingencies; (7) set aside reserves in order to comply with legal requirements for dividends; (8) provide funds for the retirements of corporate securities. See Curry, O.J. Utilization of Corporate Profits in Prosperity and Depression, Mich. Business Studies', No. 4 (1941). See also Sloan, L. F., Corporation Profits (1929); Kreps, T. J. Dividends, Interest, Profits, Wages, 1922-1935, Quarterly Journal of Economics, August 1935; Seligman, E. R. A., Taxes on Surplus Called a Danger, New York Times, March 22, 1936. sec. 3. pp. 1, 6.

ably less than their full earnings as dividends; and in support of such policy it is said: (1) that corporations should accumulate a reserve against which undetermined losses of subsequent periods may be debited without impairing the original paid-in capital; (2) that corporations should reinvest a relatively large fraction of their net incomes during good years in order to stabilize their dividend rates through prosperity and depression.[8] This argument, actually translated into practice in many enterprises, has led Keynes to suggest that accumulation becomes an obsession and an end in itself.[9]

Keynes' suggestion has been verified by recent comprehensive statistical analysis in the United States. A very valuable study made by Curry [10] of the earnings of specific enterprises covering the important period between 1921 and 1936, with the view to showing how much of the earnings during prosperous years were reinvested as compared with the amounts paid in cash dividends, how the witheld earnings were invested, and what eventually happened to the investment, disclosed: (1) that there was no apparent relation between the earnings reinvested during the twenties and dividends paid during the early thirties; (2) that corporations which paid most of the dividends during the depression operated at a profit even during the lean years and that only a limited amounts were paid in excess earnings; (3) that the corporations that found it necessary to charge dividends to surplus made drastic reductions in the rates, and that although the aggregate amount of dividends paid from surplus charges is large in many cases, when compared with earnings withheld during the twenties, these payments seem quite inadequate to recompense the stockholder for his forbearance during the prosperous years.[11]

It would of course be speculative to say whether Keynes' suggestion is true when applied to conditions in the Philippine business world. The dearth of desirable factual investigations on this and other points having to do with dividend regulation should make it imperative for those charged with framing of a national policy toward private corporations to have available a comprehensive, thorough-going study which should reveal, *inter alia,* (1) the earnings over a period, preferrably representing a complete business cycle, of private enterprises in every important field of industry and trade; (2) how these earnings were apportioned between dividends and surplus accumulations; (3) how such surplus accumulations in the corporate treasury were used. This study, if pursued analytically, should likewise show whether the

[8] See Sloan, op. cit. at 265; Dreps, op. cit. at 573
[9] Keynes, Essays in Persuasion (1932) 370
[10] Curry, op. cit.
[11] Curry, op. cit. 92-94

alleged prosperity-stabilizing function and the risk-buffer function of accumulated surplus have been effectively discharged so as to warrant the sacrifice which such a procedure imposes upon the stockholders.

It is not here suggested that retention of earnings as such is vicious and should be condemned outright. Much stress has been laid on the thesis that retention of corporate earnings will have the effect of strengthening the financial position of the enterprise, thus benefitting the stockholders in the long run.[12] This argument may concedely have a certain degree of validity. The figures that appears on the income statement and the balance sheet are not absolutely accurate, although efforts are being made by accounting authorities, however, dividend they may be on a great number of questions, to achieve the nearest approximation to the truth. Even if that should be achieved, there is still the problems of contingencies and fluctuations which any business enterprise must face, but whether directors exert any conscious, intelligent effort to approach that problem or whether they prefer to accumulate large surpluses without making any specific allowances from gross earnings, so that if—as they might say—something should come up, they would have an unappropriated reserve to depend on is of course, another question. It may be assumed that corporation executives are well aware of the limits of accounting methods, and it may not be doubted that there is some justification in their attitude towards retaining earnings as a remedial measure, particularly in respect to strengthening the working capital position of the corporation. But where the risk-buffer argument is invoked to justify witholdings of dividends for almost any purpose, one may question the wisdom of a procedure that puts the stockholders at the mercy of a group of men wielding control over their investment. To be sure, the financial stability of any enterprise will depend on many external variables beyond managerial control. The conversion of surplus accumulations into industrial equipment without any broad, panoramic study of all relevant trends and conditions may well result, as it did during the depression period in the United States,[13] in overequipment and unwise expansion.

But the risk-buffer function is not the only justification invoked. Courts have also apparently yielded to the insistence of management that surplus could be accumulated to insure stability of dividends through fat and lean years, despite the existence of net profits or a

[12] See Sloan, Corporation Profits (1929) 265, et. seq.; Fabricant S., Recent Corporate Profits in the United States (National Bureau of Economic Research, 1934, Bulletin No. 50).

[13] See note 3, *supra*; see also R. G. Tugwell, The Industrial Discipline (1933) 203-27; cf. Ayres, The Divine Right of Capital (1946); Raymond, The Limitist (1947).

substantial surplus.[17] To realize this avowed objective, it would be necessary for management to keep accumulated earnings in cash or promptly realizable cash, since cash is the usual form of dividend distribution. This would necessarily preclude investment in additional plant expansion, since it will probably be hard to convert this readily into liquid funds, without incurring loss, when the corporation goes into a period of depression. Yet, more often than not, retention of earnings is largely dictated by considerations of plant expansion, and has been justified on that score.[18] In lean years, the presence of a balance-sheet surplus (which is the requirement under Philippine law) alone and by itself has little connection with the ability of a corporation to pay cash dividends if the accumulated surplus has been invesfed in fixed assets. It may be possible, in order to pay dividends in such period, to liquidate the surplus thus invested in such assets, along with the inventories and receivables of the company, but as aptly put by one writer, "the process of drawing upon reserves is wholly dependent upon continued sales and collections at prices below costs and is exactly what managers and stockholders seek to avoid. This process of disinvesting throws labor out of employment, is devastating to the market value of the stockholder's investment, and cannot be regarded as a satisfactory dividend reservoir."[19]

The whole question then reduces itself to whether it should be economically wise, under the particular circumstances of a case, to retain this increase in the total shareholders' investment in the enterprise as against paying it out to them in dividends. If the directors are quite convinced that the financial position of the corporation will be strengthened by the policy of retention, eventually resulting in an increase in net returns to the shareholders, one might say that no portion of the earnings ought to be plowed back unless the return upon the increment of capital employed will in all probability be as large as could be earned upon the same capital employed outside the corporate enterprise. Stated in another way, as long as the prospective return from further capital investment in the corporate venture is not less than the rate of interest on alternative investments of equivalent risk, the directors may properly reinvest earnings.[20]

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[17] For a collection of American cases on this point, see Dodd and Baker, Cases and Materials on Business Associations (1940) 1199, 1200, 1201. Cf. the Philippine Cases of Yangco v. El Hogar Filipino, 38 O. G. 575 (1939) and Steinberg v. Velasco, 52 Phil. 953 (1930)

[18] See e. g. Van Arsdell, Acctg. Rev. vol. 15, cited by Patron, Accountants's Handbook (1945) 1030; cf. Ashley, Corporation Surplus and Dividend Policy, also cited by Paton, id.

[19] Curry, op. cit. 20.

[20] This is the burden of Buchanan's thesis in his work, The Economics of Corporate Enterprise (1940) Chapter 7, 8, and 9

The defect in this analysis is the presupposition that corporate accounting methods are infallible. As long as man know and realize that many factors having significance upon both the immediate and the long-run standing of the enterprise cannot be represented in the financial sheet, however carefully prepared, and that such factors cannot readily be tagged in terms of pesos and centavos, directors will reasonably insist that they be given some area of discretion in the matter of accumulating surplus. To say that the surplus can be used only if it can be guaranteed that it will earn as much in another investment of the same risk is to assume that the 'surplus' can be mathematically determined with precision. Accountants will be the first to admit the limitations of their reports, and while we may reasonably demand and exact a high quality of financial journalism in the light of our preferred goal of intelligibly acquainting the whole public with necessary facts concerning the business ventures of the community, we should never commit the error of ignoring the obvious fact that financial reports are at times based on assumptions that may not be validated.

There is the fundamental point which has frequently been overlooked in the discussion of a particular dividend policy: whether the direction of investment is a prerogative that belongs to the owner of the capital, i.e., the stockholder himself, or to the directors. Dewing, in contending that such prerogative belongs to the stockholder, says:

> "A director likes to participate in the growth of his corporation. He easily encourages in himself the belief that the surplus earnings of his business can wisely be invested in the business in order to carry out a policy of expansion . . The directors assume that they can invest the shareholders' money better than the shareholders themselves can."[21]

and by way of footnote, he tells us:

> . . . "I am contending that the average stockholder is a better judge than is a single board of directors as to whether his funds, designed for further investment, should go in one channel in preference to another. I am contending that the direction of investment is a prerogative which belongs to the owners of the capital; the stockholders endowed their directors with the authority of managing a single corporation, not the authority of managing their investments."[22]

Even if we go the whole way with Dewing in his questionable assumption that all contingencies impinging upon a business can be intelligently recognized and adequately provided for by specific allowances from gross earnings, it would be highly dubious to say that stockholders can wisely carry out a policy of expansion which he assumes

[21] Dewing, Financial Policy of Corporations (4th ed.), 1941 II, 788.
[22] See notes, id.

when he stated that his plan would place the "responsibility for the decision to carry out a policy of expansion—a decision necessarily depending on general economic conditions with which the stockholders are probably as able to cope as the directors squarely upon the stockholders who, in the end, bear the burden of mistaken policy."[23] What Dewing is advocating is practically the same procedure that is being followed in continental civil-law countries which reposes the authority of declaring dividends in the body of shareholders. But the widespread dissatisfaction in those countries with such a procedure, because of the obvious fact that shareholders merely act in accordance with the preconceived plans of the "board of administrators",[24] should furnish an object lesson. In the United States and in the Philippines the suggestion of Dewing would be sound, if (1) management control devices, such as proxy arrangements and voting trusts, are not resorted to in such a degree as to conceal the real source of authority; (2) the great body of stockholders in publicly-held corporations can be adequately and fully informed as to the financial standing of the corporation. Otherwise, the net result would be to pass on the responsibility from the board of directors to those who wield power only in the formal sense of the word; and thereby enable the former to escape liability.

Whether it is the board of directors or the general body of stockholders that decide in favor of surplus accumulations, there still remains the important question whether by doing so, a particular corporation may not lay itself open to the charge of over investment, hoarding, or at least, misdirected investment. Undue accumulation of earnings in a particular industry may hurt the long-term interest of the community in just as great a degree as improvident distribution of earnings. A survey of judicial pronouncements shows, however, that judges have been more concerned in striking down the latter, but have not shown as great an inclination to condemn the former.[25]

[23] Id. at 789

[24] Speaking of the German Company Law of 1937, Mann, F. says: "Supremacy of the Board had already become a fact in the life of German companies, and it has now received its theoretical blessings." See Mann, The New German Company Law and Its Background, 19 Journal of Comparative Law and Legislation, 220, 225 (1937); Cf. the following statement on Swiss law: "The general body of stockholders approve the balance sheet, without knowing it. "Burgi & Komentar Zunc Scweizerischen Zivilgesetbuck, v/5 b. Die Aksengesell chaft; cf. Kaufmann, Das Recht auf Dividende (St. Gallen, 1947) 20.

[25] The situation in the Philippines may be considered unfortunate since, in spite of the many speculative activities that characterized the early thirties, there was no noticeable inclination on the part of stockholders to challenge the actuations of corporate directors. On the subject of dividend regulation, the cases are very few and while here and there we find the highest court very properly censuring the juggling of accounts to conceal from stockholders the financial condition of the corporation to save a favored few (Steinberg v. Velsaco, 52 Phil. 953, 1930), and condemning the setting up of a reserve for decline in value of plant assets amounting to the net profits of two years in order to avoid paying dividends to the preferred shareholders (Yangco v. El Hogar Filipino, 38 O.G. 575, (1939), it may be asserted that these sporadic, isolated decisions have not had much influence on the conception that whatever the certified public accountant, in the employ of the corporation, says must be taken as true: ipso dixit.

The lack of statutory regulation and administrative rules, with appropriate sanction, in the Philippines covering this particular point provides a fresh opportunity to those who have been empowered to frame and shape our institutions of social control to reevaluate and reexamine certain cherished legal concepts in the light of our quest for a wider distribution of basic social values. It is very probable that any such reexamination with a view to putting forward positive measures to combat the evils of undue accumulation of profits, will meet with strong opposition from some persons who assume, whatever be their motivation that the existing situation is the best and that they have some sort of vested interest in the preservation of the **status quo.** Such opposition may be weakened, if not entirely disposed of, by making those who wield great influence within and as happens usually, beyond the corporate mechanism conscious that the survival value of the system of private enterprise will depend on whether it can meet the reasonable demands and expectations of a society that is becoming ever more complex and confused.

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The power of government is a trust committed by the people to the government, no part of which can be granted away.

—STONE v. MISSISSIPPI