PHILIPPINE DIVIDEND LAW REVISITED: I

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In an earlier article published in this Journal,[1] it was pointed out that while the public has admittedly a continuing interest in the maintenance of a sound dividend policy on the part of private corporations, our law has not gone far enough to recognize and secure this pressing interest.

As a starting point of the discussion of what our dividend law *should* be, it might be well to discuss that law as it really *is*. A study of trends and policies is salutary and helpful, but it does not tell us where we are. To improve one's lot implies the necessity of first knowing one's location.

ANGLO-AMERICAN ANTECEDENTS

Our dividend law, introduced by American administrators, has its roots in Anglo-American antecedents. It will therefore prove valuable to make a brief survey of the historical background of the dividend law in England and the United States.

Before 1800, no English or American case had been decided illustrating the nature of the corporate dividend.[2] In England, the earliest joint stock companies did not have what is called today as 'fixed capital.' The prevailing practice then was for the company to raise funds for each trading venture, and divide the entire proceeds upon the conclusion of the business transaction, without making any distinction between capital and profit.[3] Because of the confusion resulting from mutiple financial records, the concept of permanent capital gained wide acceptance in 1700, and with it came the need of preserving for stockholders the capital investment from which yearly profits were to flow. Hence, the corollary task of differentiating clearly capital from income. In 1697, when Parliament authorized an increase in the capital of the Bank of England, it expressly provided that recipients of dividends paid from capital were to be held liable to the creditors of the bank.[4] But even earlier than this were

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[1] Salonga, For a National Policy Towards Corporate Earnings, XXIV Phil. Law Journal 269 (October, 1949).

[2] Williston, History of the Law of Business Corporations. Before 1800, 2 Harv. L. Rev. 149, 160 (1888). A detailed historical analysis of American dividend law may be found in Kehl, The Origin and Early Development of American Dividend Law, 53 Harv. L. Rev. 36 (1949).

[3] 1 SCOTT, JOINT STOCK COMPANIES to 1720 (1912) 60, 153, 157; see also KEHL, CORPORATE DIVIDENDS (1941) 1, 2.

[4] 8 and 9 Will. III, c. 20, sec. 49.

the charters issued in the early part of the seventeenth century, imposing the common limitation that dividends be paid from profits.[5]

These two statutory standards, capital impairment rule and the profit rule, are the antecedents of present-day statutes in many American states. In the United States, prior to 1825 (when New York enacted the first general dividend regulation statute) [6] the special charters granted to three important banks were a little more explicit as to what fund may be considered available for dividend purposes. Section 8 of the Bank of America charter authorized the Board of Directors to

> "make from time to time such dividends, out of the profits, as they may think proper." [7]

A similar provision was made in the constitution of the Bank of New York in 1784.[8] It was in 1790, with the enactment of the charter of the Bank of the United States, that an elaboration of the dividend limitation found in the two preceding charters was accomplished. The provision, attributed to Hamilton's drafting, recited:

> "Half yearly dividends shall be made of so much of the profits of the bank, as shall appear to the directors advisable; and once in every three years, the directors shall lay before the stockholders, at a general meeting, for their information, an exact and particular statement of the debts, which shall have remained unpaid after the expiration of the original credit, for a period of treble the term of that credit; and of the surplus profit, if any, after deducting losses." [9]

Although the charter of the said bank did not contain any provision forbidding the payment of dividends out of 'stated capital,' the by-laws adopted subsequent to the grant of the charter made it plain:

> "That in case the board of directors shall at any time make a dividend, exceeding the profits of the bank, and thereby diminish the capital stock, the members assenting thereto, shall be liable in their several individual capacities for the amount of the surplus so divided." [10]

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[5] This restriction was used in 1620 in the charter of James I to the New River Company. CARR, SELECT CHARTERS OF TRADING COMPANIES (28 Selden Society) 106, 112.

[6] N. Y. Laws 1925. c. 325, sec. 2.

[7] 7 J. of Cong. 1781-82 (Claypoole Ed.) 108-09, 257-58.

[8] N. Y. Laws 1791, c. 37. Art. 17, 2 Works of HAMILTON (Hamilton ed. 1850) 330, 332.

[9] I Stat. 191, Sec. 7-XIV (1791). It must be pointed out that this section became the prototype for dividend regulations in the majority of early American special charters. See KEHL, *op. cit.* 6.

[10] By-law 10. Dunlap's American Daily Advertiser (Philadelphia), Nov. 14, 1791, p. 2. KEHL, *op cit.* 7.

Thus, at the close of the eighteenth century, the two standards obtaining in England were formally adopted in America. But there is one major contribution of American jurisprudence which has been frequently overlooked. The important charters in America vested the power to declare dividends in the directors of the corporation, while in England the distribution rested for a number of years with the general body of stockholders,[11] influencing a few special charters in the United States which laid down a similar provision.[12] This rule still prevails in civil-law countries today, notably France and Switzerland.

The precursor of dividend legislation in many states, the New York General Act of 1825 (which resembles the Philippine dividend law) has exerted a wider influence than any other enactment. It was entitled "An Act to prevent Fraudulent Bankruptcies by Incorporated Companies." It contained this important provision:

> "That it shall not be lawful for the directors or managers of any incorporated company in this state to make dividends, excepting from the surplus profits arising from the business of such corporations; and it shall not be lawful for the directors of any such company to divide, withdraw, or in any way pay to the stockholders, or any of them, any part of the capital stock, without the consent of the legislature; * * * and in case of any violation of the provisions of this section, the directors under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large on the minutes of the said directors at the time, or were not present when the same did happen, shall, in their individual and private capacities, jointly and severally, be liable to the said corporation, and to the creditors thereof, in the event of its dissolution, to the full amount of the capital stock of the company so divided, withdrawn, paid out, or reduced." [13]

While many states adopted the profits rule and the capital impairment rule, a new test appeared for the first time in the general Massachusetts Manufacturing Regulation of 1830.[14] This act became the basic provision for the dividend regulation in the Revised Statutes of 1836, which contained the following provision:

> "If the directors of any such company shall declare and pay any dividend, when the company is insolvent or any dividend, the payment of which would render it insolvent, they shall be jointly and severally liable for all the debts of the company then existing, and for all that shall be

[11] 1 SCOTT, JOINT STOCK COMPANIES to 1720 (1912) 157; DU BOIS, THE ENGLISH BUSINESS COMPANY AFTER THE BUBBLE Act (1938) 291.

[12] See, e.g. Durham Aqueduct Co. (1798) 1 Conn. Priv. Laws (1837 Ed.) 42, 43; Greenwich Turnpike, R. I. Laws, Feb. Sess. 1803, p. 20, sec. 13.

[13] N. Y. laws 1825, c. 325, sec. 2. In 1828, the Act of 1825 was incorporated as a section of the general corporation provisions of the N. Y. Revised Statutes. N. Y. Laws 1828-29, c. 20, sec. 17.

[14] Mass. Laws, Jan. Sess. 1830, c. 53, sec. 9.

thereafter contracted, so long as they shall respectively continue in office; provided, that the amount for which they shall all be so liable, shall not exceed the amount of such dividend, and that if any of the directors shall be absent, at the time of making the dividend, or shall object thereto, and shall file their objection in writing with the clerk of the company, they shall be exempted from said liability." [15]

This statutory rule, commonly known as the 'insolvency tests', has likewise influenced the dividend law of many an American state.

Historically, therefore, the principal function of the various dividend rules was to preserve a quantitative minimum of assets in the interest of protecting creditors. Early judicial approval of this solicitude was emphatic in the famous case of *Wood v. Dummer*,[16] which laid down what is now popularly labelled as the 'trust fund doctrine.' In that case, an action was brought by certain noteholders against stockholders for recovery of dividends paid by a bank. The facts revealed that the bank, upon the termination of its charter, paid out 75% of its capital to its stockholders, without leaving sufficient assets for the redemption of the outstanding circulating notes held by the plaintiffs. In deciding that the creditors may recover the improper dividends from the stockholders for the satisfaction of their claims, Mr. Justice Story said:

"It appears to me very clear upon general principle, as well as the legislative intention, that the capital stock of banks is to be deemed a pledge or trust for the payment of the debts contracted by the bank * * *

"The individual stockholders are not liable for the debts of the bank in their private capacities. The charter relieves them from personal responsibility and substitutes the capital stock in its stead."

Out of the 'trust fund doctrine' came the corollary propositions: (1) that the shareholders have no right to the capital stock until the creditors have been paid; (2) that the creditors may follow the trust fund into the hands of any person, including stockholders, having notice of the trust attachment.

The trust fund doctrine *eo nomine* has suffered devastating criticism from practically all quarters. It has been pointed out, for example, that the statement "the capital of a corporation constitutes

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[15] Mass. Rev. Stat. 1836, c. 38, sec. 23. The 1836 enactment modified the Act of 1830 in the following respects: (1) directors alone rather than president and directors were made liable; (2) the measure of liability was changed from the amount of the dividend to the extent of existing corporate debts, or debts contracted subsequently but not in excess of the amount of dividend; (3) directors were made jointly and severally liable, but exonerated those who were absent or filed protest. See KEHL, *op. cit.* note 71, at 13.

[16] 3 Mason 308; Fed. Cas. No. 17944 (C. C. Me. 1824).

a trust fund for the benefit of creditors" is captious, since corporate property is not held in trust.[17] The corporation has the whole beneficial interest in the capital, as well as the legal title. The decision in the case should however be judged on the basis of the environmental facts. The stockholders of the bank, who were fully aware that a liquidation was under way, should not expect to be paid in priority to creditors on liquidation. Payment of dividends which purports to be made from profits is governed by entirely different considerations. If the 'trust fund' doctrine means nothing more than that corporate property must first be appropriated to the payment of the debts of the corporation before there can be any distribution of it among stockholders—and this is undoubtedly the cardinal point of the decision—then it would be fair to state that the doctrine merely follows the common law restriction that dividends cannot be paid from 'stated capital,' but only from 'net profits.'

This common law restriction has been invoked in the United States even though a less stringent liability is imposed by specific statutory provisions.[18] If the trust fund doctrine were pressed to the limit, the result would admittedly be an absolute recovery from shareholders who received dividends which impaired capital, where they are needed to satisfy the creditors should the corporation become insolvent later. The logic is stated in one case, where the court held that the good faith of the recipient was immaterial, since this (liability) is not based on any statute but upon the equitable ground that the stock is regarded as a trust fund for all the debts of the corporation, and the good faith of the shareholders is no defense." [19] Hence, according to the cases that follow this line, all creditors regardless of the time they became such, may hold an innocent shareholder liable not only for insolvency dividends, but also for dividends which merely impair capital.

Fortunately, a great number of American courts have adopted what may be called a "cropped version" of the trust fund doctrine. The leading case of *MacDonald v. Williams* [20] restricted the applica-

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[17] Cf. *Hospes v. Northwestern Mfg. and Car Co.*, 48 Minn. 174, 50 N. W. 1117, 15 L. R .A. 470 (1892). See also *McDonald v. Williams*, 174 U. S. 397 (1899), which rejected the trust fund doctrine as to innocent shareholders who received from a solvent corporation dividends out of capital.

[18] See, e.g., *Spiegel v. Beacon Participations*, 8 N.E. (2d) 895, 912 (Mass. 1937; *Benas v. Title Guaranty Trust Co.*, 216 Mo. App. 267 S. W. 28, 29 (1924).

[19] *Williams v. Boice*, 38 N. J. Eq. 364, 367 (1884); see also *Detroit Trust Co. v. Goodrich*, 176 Mich. 168, 141 N. W. 882 (1913).

[20] 174 U.S. 397 (1899). Cf. *Bartlett v. Smith*, 182 Md. 478, 160 Atl. 440 (1930) where it was held that 'capital stock' is not a trust res, but dividends paid after insolvency are taken from a fund held in trust for the creditors which does not belong to the corporation and to which the corporation can give no title to share-

tion of the trust fund doctrine to dividends declared while the corporation was insolvent or which rendered it insolvent. Conversely stated, dividends paid while the corporation is not insolvent, or where the receiving stockholders are not aware of the illegal nature of the dividends, may not be recovered even though the corporation should later go into insolvency. The necessary implication is that dividends which merely impair capital but do not render the corporation insolvent may be enjoined, but once paid may not be recovered.[21]

Another general common law principle frequently invoked as a limitation on the right to declare and pay dividends is the fraudulent conveyance rule. Assimilated largely from the Statute of Elizabeth,[22] it is now embodied in several state statutes. Although there are many ways of expressing the rule, the substance is that all conveyances prejudicing creditors are subject to attack and may be avoided for the satisfaction of their claims.[23] The question inevitably arises whether the fraudulent conveyance rule and the cropped version of the trust fund doctrine amount to quite the same result. The consequences are identical in so far as insolvency dividends are concerned, for both rules permit the creditors who are such at the time of the dividend distribution to recover the insolvency dividends from the stockholders, regardless of whether the latter received them in good faith or not.[24] There are, however, some distinctions in the application of the two rules. Where it is sought to prevent by way

holders who did not receive the money distributed for value. Accord: *Powers v. Heggie*, 268 Mass. 233 (1929) *Wood v. National City Bank*, 24 F. (2d) 661 (C.C.A. 2d. 1928).

[21] In *Brown v. Byrne*, 75 S. W. 2d 484 (1934), the court said that where there are no creditors affected, the directors owning *all* of the corporate stocks may by unanimous consent make any distribution of the corporate capital that they wish. But see Hildebrand, Texas Corporations, sec. 932, where this unlimited right accorded shareholders is criticized. The argument is that shareholders should not be permitted to tamper with the corporate capital, in the interest of present and future creditors, since this should be the price exacted of shareholders for the privilege of conducting a business without personal liability.

[22] 13 Eliz. c. 5 (1570). The test of fraud was the absence of consideration for the transfer and the fact that at the time the transferror was insolvent. See Weiner, Theory of Anglo-American Dividend Law, 29 Col. L .Rev. (1929) 461, 463, 464.

[23] See Powers, *Trustee v. Heggie*, 268 Mass. 233, 167 (1929) Cf. arts. 1291. par. 3, 1292 and 1297 of the Civil Code. In the *Powers v. Heggie* case, the court held that the dividends received by the stockholders of a corporation that was insolvent at the time of declaration may be recovered by the creditors since the dividends were fraudulent as to them and the good faith of the shareholders did not alter the fact that the dividend was a mere gift.

[24] See *Wood v. National City Bank*, 24 F. 2d. 661 (2nd Cir. 1928) where Judge Hand, in dismissing the decree for insufficiency, with leave to amend, made the observation that both under the trust fund doctrine and the fraudulent conveyance rule, insolvency dividends may be recovered from the shareholders.

of injunction, instead of recover, the declaration or payment of dividends which impair capital, or while capital is impaired, but which do not render the corporation insolvent, the trust fund doctrine may well be invoked since under it *all* the capital must be kept intact. The fraudulent conveyance rule, on the other hand, covers insolvency dividends, but not impairment dividends. There is likewise a difference between the two rules with respect to who may sue. The trust fund doctrine protects present as well as future creditors, while the fraudulent conveyance rule may be invoked only by present creditors who are the ones immediately prejudiced by the divided payment. Future creditors may take advantage of the fraudulent conveyance rule when—and only when—the dividends are distributed with an actual intention of defrauding them. Again, under the trust fund theory, anyone who participates in the breach of trust is liable. The implication is that the directors of the corporation may be held personally liable, without regard as to whether they received the dividends alleged to violate the rule. It is not clear at all whether under the fraudulent conveyance rule, the directors under similar circumstances would be held liable.

Because of the semantic confusion that is caused by the varied usage of the term 'insolvency', it is important in applying common law and, for that matter, statutory limitations to determine just when a dividend may be said to render the corporation 'insolvent.' Presumably, it could relate to a situation where assets remaining to the corporation after the payment of the dividends are insufficient in amount and in promptly realizable character to enable it to meet its debts and liabilities to others than shareholders, as such debts and liabilities mature in the ordinary course of business.[25] This situation has been commonly described as insolvency in the equity sense. On the other hand, the reference may be to a situation where the fair value of the corporate assets falls short of the aggregate amount of debts and liabilities to others than shareholders. This situation is known as insolvency in the bankruptcy sense. A modified test is found in the fraudulent conveyance sense of the term 'insolvency', where the only distinction from insolvency in the bankruptcy sense is that the value of the assets must be their present fair saleable value.[26]

The importance of knowing the referential use of the term 'insolvency' may be illustrated by a simple example. Assume that a

[25] There are two competing theories as to the basis for evaluting assets in order to determine whether the corporation is insolvent in the equity sense. One view maintains that the assets must be measured at their fair realizable value; another view maintains that the assets must be measured at their quickly realizable value, taking into account the depressing effect of forced sales.

[26] See, e.g., sec. 67 (d) of the Uniform Bankruptcy Act.

statute has an impairment of capital section and an insolvency dividend section. Ordinarily, the latter adds nothing to the former. But if the equity sense of insolvency is used, it is at once conceivable to have a dividend which, while not impairing capital, may render the corporation insolvent. This is particularly true in those cases where the corporation uses up all of its available cash and liquid assets. The point may be made more explicit in the following (though overdrawn) example:

Assets		*Liabilities*	
Cash	10,000	Current	60,000
Plant and Equipment	90,000	Capital Stock	25,000
		Surplus	15,000
Total	100,000	Total	100,000

Under the capital impairment section of the statute, the surplus indicated on the balance sheet may be considered available for dividends, since what remains is theoretically sufficient to cover the current liabilities and the capital stock. The insolvency section of the same statute, if understood in the equity sense, may however preclude the distribution of that surplus since there are no sufficient liquid assets to answer for the amount of current liabilities, assuming that in this particular instance, the corporation is unable to raise promptly such an amount with its fixed assets.

As previously indicated, each state today has its own dividend statute, apart from the common-law rules already considered. The restrictions embodied in these statutes may roughly be classified into four:

1. No dividend may be paid while the corporation is insolvent or which will render it insolvent.
2. No dividend may be paid except from a surplus as normally computed on a corporate balance sheet.
3. No dividend may be paid except from current profits.
4. No dividend may be paid except from the balance of earned and hitherto undistributed surplus.

The so-called 'insolvency' statutes prohibit dividends if the corporation is, or thereby is rendered, insolvent. Massachusetts is the leading exponent of the rule. Its statute [27] provides that directors shall be jointly and severally liable for the debts of the corporation when they declare or assent to a dividend if the corporation is, or thereby is rendered, bankrupt or insolvent. This poses once again

[27] Mass. Laws Ann. c. 156, sec. 37.

the question insolvency here should mean inability of the corporation to meet its obligations as they mature, or whether it should refer merely to a situation where the liabilities, exclusive of capital, exceed the corporate assets. Unless the statute in question expressly adopts the bankruptcy test, the equity sense is held to be the controlling test.[28]

The underlying function of the insolvency test is the protection of creditors. In the equity sense, greater emphasis is given to liquidity, rather than the quantity, of corporate assets, and to that extent maximizes creditor protection. It is quite possible, of course, for a corporation to be insolvent in the bankruptcy sense and yet remain solvent in the equity sense. The converse, as we have previously stated, may be true. To repeat, it is possible for a corporation to be insolvent in the equity sense, although its capital may remain unimpaired by a dividend declaration. This is particularly true in cases where there is a small amount of current, liquid assets and a disproportionately large amount of fixed assets, on one hand, and a substantial amount of current liabilities, on the other.

Several states, possibly to avoid these incongruities, have combined the Massachusetts insolvency rule and the capital impairment test in one statute. The forerunner of this mixed type is the New York Manufacturing Act of 1848,[29] which provided:

> If the trustees of any such company shall declare and pay any dividend when the company is insolvent, or any dividend the payment of which would render it insolvent, or which would diminish the amount of its capital stock, they shall be jointly and severally liable for all debts of the company . . .

Clearly, this insolvency-capital impairment statutory restriction allows dividends only from a surplus representing the excess of assets over liabilities, including capital, as computed on a balance sheet. However, if the financial condition of the corporation is such as to make it difficult for it to pay debts as they mature, dividends may not be declared, despite the existence of the balance sheet surplus. This mixed type has been adopted in a good number of states.[30]

Growing out of the common law rule of permitting dividends from profits, but not out of capital, the balance sheet surplus test is now adopted in the majority of the states. The manifest objective is to preserve the 'capital' of the enterprise, in the interest of both

[28] *Calnan v. Guaranty Security Corp.* 271 Mass. 533, 542, 171 N.E. 830 (1930).
[29] N. Y. Laws 1848, c. 40, sec. 13.
[30] Illinois, Sh. Ill. Ann. Stat. Chap. 32, sec. 41; Colorado, 1935 Col. St. Ann. Chap. 41, sec. 34; Iowa Code 1946 Chap. 491, sec. 491, 41; Oregon Compiled Annotated Laws 1940, Tit. 77 C. 1, sec. 77. 22.

creditors and shareholders. The original version is found in the New York Act of 1825,[31] and was embodied in two clauses. The first clause prohibited dividends "except from the surplus profits arising from the business." The second clause forbade payment, division, or withdrawal of capital stock without the consent of the legislature. The term 'surplus profits' is at best ambiguous. In determining what is comprised within that descriptive term, two possible interpretations may be given: (1) that the term refers to the balance sheet surplus account, which indicates the net result of all operations since the beginning of corporate existence to date; or (2) that the term merely refers to the profit and loss statement which shows the result of the operations during the current period. If the former interpretation is accepted as correct, the necessary result is that no funds for dividends are or can be made available unless the operations as a whole show an excess of assets over capital and liabilities. If the latter, then losses incurred during previous accounting periods may be ignored, and dividends may be paid out without the necessity of making good the previous losses by using correct profits.

The courts have resolved the confusion by holding that the term imported a balance sheet or capital impairment test [32] and even in the absence of the second clause, the term 'surplus profits' has been construed to mean balance sheet surplus.[33] The present New York statute is a decided improvement upon the 1825 version, and in that respect signifies an abandonment of the ambiguous 'surplus profits' wording in favor of explicit balance sheet surplus phraseology. The statute now provides:

> "No stock corporation shall declare or pay any dividend which shall impair its capital, nor while its capital is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders . . . unless the value of its assets remaining after the payment of such dividend . . . shall be at least equal to the aggregate amount of its debts and liabilities, including capital." [34]

Said to be the earliest dividend rule in both England and America,[35] the current net profits is accepted in Delaware and New Jersey. Statutes of this type permit as an alternative fund for paying dividends net profits generally, or net profits of certain current years.

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[31] N. Y. Laws 1825, c. 325, sec. 2.

[32] See *Roberts v. Roberts Winks Co.*, 184 N. Y. 257, 77 N. E. 13 (1906); *Williams v. Western Union Tel. Co.*, 93 N. Y. 162 (1885); *Equitable Life Ass'n v. Union Pac. Railroad Co.*, 162 App. Div. 81, 148 N.Y.S. 382, aff'd 212 N.Y. 360, 16 N.E. 92.

[33] *Bank of Morgan v. Reid*, 27 Ga. App. 123, 167 S.E. 555 (1921).

[34] N.Y. Stock Corp. Law, sec. 58, as amended. N.Y. Laws 1939, c. 364.

[35] KEHL, *op. cit.* 32.

For instance, the Delaware statute provides that in case there shall be no excess of net assets over capital, dividends may be paid by a corporation out of its net profits for the fiscal year then current and/or the preceding fiscal year . . ." [36]

Here, again, there is a necessity of clarifying the reference of the term 'net profits.' Conceivably, it may mean any one of these three: (1) the earnings of the corporation in its entire history, in which case past operating profits and losses should be considered before current earnings may be made available; or (2) the profit for the current accounting period, without considering prior operating losses; or (3) current profits from regular operations as shown on a profit and loss statement, disregarding non-recurring profits or losses, such as losses caused by war.

While any of these possible referential uses may depend on the particular statute in question, the distinguished characteristic of the general 'net profits' type of statute seems to be that of disregarding losses from previous periods, making current profits available for dividends instead of freezing them in order to cover losses of previous periods. Some statutes, such as those of California and Delaware, contain a qualifying provision that before current profits may be distributed, the net assets remaining should at least equal the capital *represented* by outstanding shares having an asset preference upon liquidation.[37] The implication seems to be that the actual amount of such asset preferences is not the determining factor, but the capital represented by the shares enjoying preference. So, where the stated capital of the preferred shares is less than their liquidation preferences, the corporation is only bound to preserve sufficient assets to cover up the former.

Because of the vagueness and the obvious laxity of the balance sheet surplus test, leading itself to various manipulative accounting practices, there is now an increasing tendency to adopt what may be called the 'earned surplus' test. The balance sheet surplus test makes no distinction between 'earned surplus' and the different types of surplus, such as paid-in surplus, reduction surplus, or revaluation surplus. The harmful consequences of the absence of such distinction will be inquired into later. Stated generally, the normal basis of dividends on common shares under the earned surplus rule consists of the realized and accumulated profits over the capital margin. The earned surplus account would refer to the value arising from

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[36] Del. Rev. Code (1935) c. 65, sec. 34; see also N.J. Stat. (1937) sec. 14: 8-19.

[37] Cal. Civil Code, 1937, sec. 346; Del. Rev. Code 1935, c. 65, sec. 34; Minn. Bus. Corp. Act 1933, sec. 301. 22.

the accumulated net profits earned in the operations of the business and also the gains from the sale of fixed assets, less dividends declared and losses charged against the account.[38] In some modern enactments, notably that of California, the earned surplus rule stands alongside net profits test, insolvency test, and capital impairment rule,[39] thus combining the best features of each scheme of dividend regulation. The merits of the earned surplus test will be touched upon in greater detail in the latter part of this study.

Before taking up the present dividend rules in the Philippines, it may be meet at this juncture to turn to the dividend regulations in civil-law countries, particularly France and Germany, for purposes of comparative study.

DIVIDEND RULES IN CIVIL-LAW COUNTRIES

French jurists and courts are emphatic in their insistence upon the integrity of capital (fixite du capital social), although there is no formal prohibition against capital impairment.[40] This attitude necessarily and logically flows from the restriction of dividends to the 'net profits' as tested by the balance sheet. There can be no surplus, and consequently no profits, while capital is impaired or rendered impaired by a dividend distribution. A striking distinction between French and Anglo-American conception of capital is that under French law capital represents the par value of the authorized shares, which must be entirely subscribed to, regardless of the consideration for them.[41] The only exceptions to the rule that a corporation cannot pay dividends while capital is impaired, or which will result in capital impairment are: (1) where there is a stipulation of fixed interest to be paid regardless of the financial condition of the corporation; (2) where the corporation is a *societe a actif defectible,* or in English terminology, a wasting asset corporation. The first exception has been the subject of seemingly endless debate.[42]

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[38] See Ballantine and Hills, Corporate Capital and Restrictions Upon Dividends, 23 Calif. L. Rev. 229 (1935); Hills, Model Corporation Act, 48 Harv. L. Rev. 1334 (1935).

[39] See Sec. 346 of the California Civil Code, 1937.

[40] See LYON-CAEN, RENAULT, AND AMIAUD, TRAITE DE DROIT COMMERCIAL, no. 8895; PIC, TRAITE GENERAL DE DROIT COMMERCIAL (1925) nos. 508 and 8; HOUPIN AND BOSVIEUZ, TRAITE GENERAL DES SOCIETES (1935) V. 2, 557.

[41] A valuable comparative study made of French, Anglo-American, and Egyptian law on dividends is BADR, A., CORPORATE DIVIDENDS; A COMPARATIVE STUDY (Published by Imp. Universite Fouad, 1947).

[42] Pro: PIC, *op. cit.*, n 1183; LYON-CAEN, RENAULT, AND AMIAUD, *op. cit.*, 895; Cass., Nov. 15, 1910, Sirey, 1911, 1, 6 with note Lyon-Caen, Dalloz Periodique, 1912, 1, 97 with note Percerou; *Saint-Martin, Legasse v. Goutiere*, Cass., May 5, 1915, Sirey, 1915, 1, 65 with note Lyon-Caen. Con: Beudant, note in Dalloz Periodique, 1867, 1, 193; Demangeat, note in Sirey, 1881, 1, 257.

Those who favor the validity of the stipulation regard it as a corporate charge, which, in the absence of profits, may be deducted from the capital. The argument is that the rule against impairment of capital forbids secret diminution but not open impairment. Creditors cannot complain since they are charged with knowledge that all corporate charges will be deducted from capital, in the absence of profits. These corporate charges are justifiable since this type of fixed interest stipulation is necessary for the financing of the enterprise during its critical period.[43] Those who are against the scheme contend that a corporation giving fixed interest to some members of a corporation (societe) runs counter to the basic concept of a business association which must of necessity involve a certain degree of risk on their part. The crux of the argument is that a stipulation of this kind would in effect convert the member of a corporation into a creditor. It would exempt him from participating in any loss, and allow him to get back his original contribution under the guise of fixed interest, to the prejudice of the creditors and in disregard of the prohibition against payment of dividends out of capital.

The second exception applies to corporations whose principal assets have a limited tenure, such as mines, patents, copyrights, leaseholds, or a government concession to exploit some public utility. These corporations may, under French law, pay dividends to shareholders without making allowance for the depletion of its assets. Because of the peculiar nature of these corporations, shares may be retired during the corporate life, provided expressly authorized by the certificate of incorporation. This practice has been roundly criticised, in that it violates the basic principle of capital integrity (fixite du capital social). The implication is that these corporations should not be allowed to protect stockholders without sufficient protection being extended at the same time to the creditors.[44] Dividends should be paid only when the depleted capital is reconstructed, through a reserve created for that purpose.

As intimated before, 'net profits' constitutes the fund available for dividends under French law. The term has been held to refer to the excess of assets of the corporation over its liabilities including capital, as shown on a balance sheet properly prepared and re-

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[43] See Thenard, La validite de la clause d'interest fixes payable en cas d'absence de benefices, 60 Journal des Societes (France, 1939) 193.

[44] LYON-CAEN, RENAULT AND AMIAUD, op. cit. 896, who maintain that a corporation which disregards the depletion of its capital should be required to provide for extra protection of its creditors by imposing an additional assessment on its shareholders in the event the corporation fails to meet its debts. Translated and cited by BADR, *op. cit.* 19.

flecting a true inventory.[45] Distinctively characteristic of French law is the judicial restriction, consistently followed in a series of cases,[46] that only the portion of 'net profits' which is liquid or promptly convertible into cash may be paid out in dividends. This restriction has been vehemently attacked by those who consider any excess of assets over liabilities, including capital, as profits available for dividends, regardless of liquidity.[47]

One remarkable aspect of French law concerns the declaration and payment of dividends. The authority of declaring dividends is vested in the body of shareholders, meeting in an ordinary session, the so-called *assemblee generale ordinaire des actionnaires.* This assembly meets usually after the close of the accounting period, to approve the financial statement and pass on the question of dividend distribution. The exercise of the authority finds basis in the existence of a balance sheet surplus, as shown by a balance sheet properly prepared, as otherwise those who did not vote for the dividend may act *ut singuli* to attack the dividend declaration.

No legal obligation exists on the part of the corporation to distribute all the available surplus as dividends. There is ample discretion vested in the body to apply part of the surplus to the acquisition of new assets, to the expansion of the business, the amortization of shares authorized by the articles, or even to the purchase of its own shares where circumstances render that step desirable. So long as the assembly set in good faith, their decision is normally not subject to review or revision by the courts. However, the articles of association must be respected, particularly in reference to

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[45] See *Ringuit v. Founier*, Cass. Ch. Civile, Feb. 2, 1914, Gazette du Palais, 1914, issue of March 2, 1914, 1161, Bulletin des Arrets de la Cour de Cassation 47 (1914): "Profits mean the excess of the assets over the aggregate of liabilities resulting from a proper inventory."

[46] Thus, in *Ministere Public v. Desliniers*, Cass. Crim., July 21, 1898, Sirey, 1901, 537, the court said: "Profits available for distribution are only the excess of assets over liabilities resulting from operations completed on the day of the close of the accounting period and composed of cash or value immediately convertible into cash."; Leonard, Cass. Crim. Jan. 22, 1937, Sirey, 1938, 1297. See also PIC, TRAITE GEN. DE DROIT COMMERCIAL (1929) V. 2., and part, 473, 658.

[47] In his criticism of the Supreme Court decision in *Ministere Public v. Desliniers, supra*, Wahl argues: (1) the law speaks of 'profits' in general terms; if there is to be any restriction imposed, it is because creditors must be protected. Therefore the restriction should be confined only to the purpose intended to be served. If the corporation has not assets over capital and liabilities, it has profits which it can dispose of without any sound objection from creditors who have no right to complain as long as the capital representing their guaranty is kept intact; (2) if the dividends are restricted to liquid surplus, this may induce the corporation either to retain a large amount of unproductive cash, or if it has insufficient cash, to dispose of some of its assets at sacrifice to provide fund for dividends. Wahl, Sirey (1901) 1537, 539.

the rights of the different classes of shareholders. If the decision of the body violates the rights of these classes, as stipulated in the articles, the injured stockholders may sue the corporation for relief.

One of the most important problems of dividend regulation in France is that of restricting the building up of secret reserves. The practice of not showing all the net profits on the financial report has been resorted to for several reasons: (1) to withhold completely or in part the distribution of profits to those who are entitled to them; (2) to diminish the taxable income; (3) to build up additional reserves for contingencies. There are many ways of achieving the end—by overstating the annual deductions for depreciation or bad debts, by prematurely writing off some of their assets out of current profits, or, more crudely, by reducing the aggregate of their assets or exaggerating their liabilities.[48] The disastrous consequences of such a practice are too obvious, and too often the general body of stockholders do not seem to be able to do any effective checking. The result is that the general public are often in the dark; inspired rumors could lead to speculation on the securities of the corporation.[49] Naturally, the courts are quite hostile to the practice of building up 'hidden' or 'secret' reserves, as they are called, though it has been said that where the corporation is induced by loyal motives, the courts tolerate the practice of exaggerating somewhat the depreciation rates.[50] Exactly when motives are 'loyal' and when 'disloyal' is of course a very tenuous question, to say the least.

The German Corporation Law of 1937, particularly its provisions on dividend distribution, cannot be understood adequately without considering the fundamental principles that inspired its promulgation. First of all, there was the 'principle of leadership.' The new law, according to the official report, was intended to do away with the idea that "the Board in the course of its administration depends to the extent hitherto known on the mass of irresponsible shareholders who mostly lack the necessary insight into the position of the business."[51] Secondly, there was the theory, inspired by Walter Rathenau, that the interest of the enterprise as such should prevail in case of any conflict.[52] The essence of the theory is that

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[48] BADR, *op. cit.* 37, 38.

[49] This problem is not uncommon to France alone; it is a serious problem in Switzerland and presumably, in Germany. See note 24, *supra*.

[50] See Hamel, La reglementation du bilan dans des societes par actions, 40 Annales de droit commercial (France) (1931) 283, 289.

[51] See the Official Reasons, accompanying the Act, cited by Mann, F. A., The New German Company Law and Its Background, 3s v. 19, Journal of Comparative Legislation (1937) 229.

[52] RATHENAU, Vom Aktienwesen, eine geschaftliche Betrachtung (1918); see also

"the enterprise as such is an independent legal object, the interest of which is the principle to which precedence over all other interests is due and which pervades the life of the company."[53] Flowing directly from this theory are the two propositions: (1) individualistic control by the shareholders is to be restricted; (2) the Board of Administrators (or Directors) should have a dominant role in the conduct of the enterprise. Somewhat akin to the second principle was the prevailing political philosophy at the time of the enactment of the law. No better summation can be made than that which the Minister of Justice wrote:

> "In the first place there is the replacement of merely individualistic views by the legal idea that the enterprise is not only the outer frame for pursuing the interests of individual citizens but also, as such, a legal good of a special character and an institution for special purposes, an institution which the State must protect and promote even in so far as the necessity for protection and promotion is inconsistent with the individual interests of the shareholders. Apart therefrom the transformation of the power of control within the company assumes distinct shape. It is partly a consequence of modern tendencies of concentration, partly due to the desire for giving greater mobility to the active forces within the Board. The object of making the development of enterprises independent of varying majorities of shareholders could only be reached by a restriction of the rights of the general meeting and the individual shareholders . . . On the strength of these ideas the Draft Act recognizes the principle, approved of by the Courts, that the interests of the enterprise as such are as worthy of protection as the individual interests of the individual shareholder."[54]

Implicit in the provisions of the new law is the dissatisfaction with the practice of having anonymous supervisors whose role and influence in the old law was over and above that of the board of administrators. Many of the supervisors were unknown to the public, but their power, because they sat on the boards of various corporations, was far-reaching and weighty.

In consonance with these fundamental principles, the German Corporation Law of 1937 effectively limits the participation of the general assembly of shareholders in the preparation and disposition of the annual balance sheet.

The Board of administrators is required to prepare, during the first three months of the fiscal year, a balance sheet and a profit and

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Netter, O., Zur aktienrechtlichen Theorie des Unternehmens an sich, Festschrift fur Albert Pinner (1932) 507.

[53] Mann, *op. cit.* 224.

[54] See the Explanations Accompanying the Draft Act of 1930, cited by Mann, *op. cit.* 226. Professor Reichel said the law would degrade the shareholders to a mere *misera contribuens plebs*, and glorify a "Fascist tyranny of the Board." See REICHEL, Juristiche Wochenschrift (1930), 1459.

loss statement, both of which are to be submitted to the council of supervision,[55] and the latter, generally within the period of one month after submission, is required to render its opinion with respect to these yearly reports to the board of administrators.[56] The remarkable aspect of the new law is contained in Sec. 125, par. 3:

> "If the council of supervision agrees to the proposed balance sheet, then it is binding upon the corporation; however, the Board of administrators and the council of supervision may decide, at their discretion, to submit the same to the general assembly of shareholders."

This is the most important modification instituted by the enactment, and in the language of the writer, "gives the Board the predominant position" [57] in the enterprise. The powers of the board are vast and are only limited by the requirement that their decision should not violate the interests of the "creditors or the public." [58] The possibility of disagreement between the board of administrators and the council of supervision is rare, indeed, and it may well be doubted whether they exercise at all the discretionary right to submit the proposed balance sheet to the general assembly. The only safeguard against the exercise of arbitrary powers by the Board lies in their incurring of certain criminal and civil liabilities,[59] and in the possibility of the assembly's refusal to give them a discharge.[60]

The general assembly is given the right to participate in the distribution of the "net profits." The board of administrators is required by law to submit a proposal for distribution of "net profits" to the council of supervision, and thereafter to the general assembly, together with the recommendation of the council.[61] What "net profits" actually refers to is, of course, determined by the balance sheet. But since in passing on the distribution of "net profits," the general assembly is bound by the balance sheet prepared by the board of administrators and approved by the council of supervision,[62] it is fair to infer that the competence of the general assembly is largely theoretical. It must be noted, however, that in the distribution of net profits, the corporation is bound to put aside annually as legal

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[55] Section 125 (1).

[56] Section 125 (2).

[57] Mann, *op. cit.*, 230.

[58] It should also be noted that the yearly financial reports may be void, if they have not been audited, and if they fall under the special cases enumerated in Sec. 202. See Mann, *op. cit.*, note 7, 230.

[59] Secs. 84, 296.

[60] Sec. 104. A simple majority will be sufficient to give a discharge.

[61] Par. 2, Sec. 126.

[62] See Sec. 130. Hence in German law there are two kinds of reserve: the legal reserve and the voluntary reserve.

reserve five percentum of the net profits until the total reserve amounts to ten per centum of the total capital of the corporation.[62] The proposal for distribution of the net profits, subject to the legal reserve requirement, may be to distribute or not to distribute at all any dividend. If the resolution of the assembly approves a proposal of non-distribution the net profits form part of the total reserve.[63] The corporation is at liberty to undervalue its assets, and conversely, it exposes itself and the officers to serious liabilities if writing-up of assets is undertaken.[64]

Having surveyed briefly the peculiar aspects of civil-law regulation of dividends in at least two countries, we shall now proceed to a reexamination of Philippine law on dividend distribution.

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[63] See TEICHMANN and KOEHLER, *Aktiengesetz* (Berlin, 1939) 276 *et seq.*
[64] See generally TEICHMANN and KOEHLER, *op. cit.*