

PHILIPPINE DIVIDEND LAW REVISITED: II *

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PHILIPPINE LAW ON DIVIDENDS

Framed by a commission composed of American civil administrators, the Philippine dividend law, which has been in force since 1900, is notable for its striking resemblance to the New York dividend law of 1825. This law, found in section 16 of the Philippine corporation statute, 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 of stockholders until after the payment of its debts and the termination of its existence by limitation or lawful dissolution."

Here, again, the controversial 'surplus profits' terminology poses a difficult question of statutory construction. Does this statute authorize the declaration of dividends out of current profits, regardless of previous losses, or does it import a balance sheet surplus test?

There is the theory that the phrase 'surplus profits arising from the business' should not necessarily refer to a balance sheet surplus.⁶⁵ Thus, Kehl tells us:

"Statutes patterned on the New York Act of 1825 do not specifically provide that dividends shall not be paid when capital has been previously impaired; they merely prohibit the division, withdrawal, or reduction of capital stock. There is a difference between paying a dividend directly out of capital when there are no profits and paying a dividend out of profits even though capital may have been impaired in prior accounting periods. * * * the Act of 1825 made no attempt to provide that dividends should not be made while capital was impaired. On the contrary it provided no dividend should impair capital."⁶⁶

The substance of the theory is that the statute, if it was really intended to prohibit dividend payments directly out of stated capital when there are no profits, could have easily been drafted so as to provide that dividends cannot be paid out to stockholders "while capital stock is impaired." Not having been so phrased, the legislature may be presumed to have permitted the practice of paying dividend out of profits though the stated capital may have been impaired in prior accounting periods. In the attempt to bolster the

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⁶⁵ See Kehl, *Corporate Dividends* (1941), 49-52.

⁶⁶ Kehl, *op. cit.*, 49.

theory, it is also insisted, borrowing an argument from a leading American case,⁶⁷ that as there can be no division of stated capital which the corporation did not receive, so also there can be no division of stated capital dissipated by losses in a prior accounting period.

Before attempting to pass judgment on the central point of the theory, it may be appropriate to consider the kind of construction used in the analysis of the enactment. The construction undertaken obviously operates within the realm of pure legalistic concepts, without any endeavour to relate these concepts to the more fundamental questions of policy. One may very properly inquire whether, having determined the intention of the legislator:—assuming that such an ambitious task could be adequately discharged without such pain—it is advisable to assume further that such intention, along with the concepts that are supposed to embody it, must be changeless and timeless even in the context of a changing social process.

In any event, the theory presupposes that corporate capital is a *res* and not a *quantum*, distinct from the assets which constitute the corporate profits. It is this reification of capital that is at the basis of the fallacious argument.⁶⁸ Such terms as 'capital,' 'capital stock,' or 'stated capital' do not denote a particular *res*; rather, they imply the quantity by which the assets of a corporation exceed the total amount of its undischarged debts and liabilities to others than holders of its outstanding shares, preferred or common, and of the reserves, i.e., the value of its net assets. The argument that there is no withdrawal of what the corporation does not have suffers from a similar fallacy. There is a withdrawal, in the real sense of the word, since the stated capital is what the corporation ought to have. The legislature, in embodying a social policy in its enactment, has clearly im-

⁶⁷ *Goodnow v. American Writing Paper Co.*, 73 N. J. Eq. 692 (1908).

⁶⁸ As aptly pointed out by Ballantine: "You cannot point to any particular *res* or fixed assets or fund as being 'capital' or 'capital assets' earmarked or segregated from other assets which are surplus. All the net assets together equal capital and surplus. Legal capital is not a *res*, but a quantum or mathematical limit below which amount assets may not lawfully be withdrawn by the shareholders. Courts wobble in their language between these two concepts. . . . The legal capital may be compared with a certain level marked by a gauge upon the corporate reservoir of assets. If the assets stand above that level, they may be drawn off for the shareholders. If the assets fall below that level, the remaining supply must be reserved for business purposes and for the creditors. Capital is 'impaired' and there is a capital deficit if the value of the assets fall below the amount of the liabilities plus the amount of the legal capital. No dividends may lawfully be paid unless after such payment, the value of the property of the corporation (taken at proper values according to bases recognized by accounting practice) is equal to the aggregate of its liabilities and the legal capital. Ballantine, *Corporate Capital and Restrictions Upon Dividends*, 23 Calif. L. Rev. 229, 231, 234, 235 (1935).

posed a duty upon the corporation to hold such assets as shall make up the deficiency in the stated capital of the corporation. Again, the reasoning from the *Goodnow* case—which we shall endeavour to discuss in detail later—is inappropriate, since the facts there are quite different from the assumed facts in the problem posed. Here, the assumption is that assets dissipated formerly made up the stated capital which was paid in. In the *Goodnow* case, the corporation started out business with a deficit due to the initial issuance of watered shares, and the court took the position that under the New York statute it could, on account of its current earnings, pay out dividends, without first squeezing out the initial deficit.

There is no doubt that a great number of courts in the United States would interpret a provision, such as is found in the dividend section of the Philippine corporation statute, as importing a balance sheet surplus test. There is a deep-seated attitude on the part of American judges to treat stated capital as something upon which the creditors of the corporation may and can safely rely.⁶⁹ The point may well be conceded that the language of the dividend provision is unhappily worded. Be that as it may, it would seem fair to assume that Philippine courts will, in applying the dividend section of the corporation statute, require the showing of a balance sheet surplus. Apart from a purely syntactical interpretation, considerations of history⁷⁰ and policy will probably induce Philippine courts—as the highest court in one decision⁷¹ apparently was—to lay down two corollary propositions: (1) that only surplus profits arising from the business are available; and (2) that surplus profits may not be paid out in dividends, however, where the effect would be to divide or withdraw “capital stock” or property other than actual profits.

⁶⁹ See e.g., *Hospes v. Northwestern Mfg. Co.*, 48 Minn. 174, 50 N. W. 1117 (1892); the trust fund doctrine and its cropped version are also based on the same attitude.

⁷⁰ The New York antecedent of the Philippine dividend section was consistently held to import a balance sheet surplus test. See, e.g., *Williams v. Western Union Tel. Co.*, 93 N. Y. 162 (1885); *Roberts v. Roberts Wicks Co.*, 184 N. Y. 257, 77 N. E. 13 (1906); *Cottrell v. Albany Card and Mfg. Co.*, 142 App. Div. 148, 126 N. Y. S. 1070 (1911).

Likewise the earliest charters seem to underscore the common belief that there could be no profits available for dividend unless the capital stock remained unimpaired. See, e.g., by-law 10 of the First Bank of the United States.

⁷¹ *Steinberg v. Velasco*, 52 Phil. 953 (1929). While the language of the Supreme Court in this case is not as clear as one might wish it to be, there is little doubt that its insistence upon the presence of a “bona fide surplus above all of its debts and liabilities” so as not to “impair the financial condition of the corporation or prejudice the interests of the creditors” supports the balance sheet surplus test. *Id.*, at 959, 961.

The second operates as a clear limitation upon the first. This interpretation is likewise consistent with other portions of the statute.⁷²

It is not here suggested at all that the balance sheet surplus test is utterly adequate. Like the other tests it has its own shortcomings, and this is the reason for the recommendations put forward in the concluding chapter of this study. The point may be granted that in some instances, the requirement of balance sheet surplus might work compressively. Take, for instance, a corporation that has had losses on account of the recent war. Assuming that it now has some current earnings, it may be harsh to deprive a large group of stockholders—who have been quietly forbearing for a number of years—of any portion of dividends they would have been entitled to if there had been no past losses.⁷³ It is no answer in all cases that the law does not prevent capital reduction. Capital reduction may be resorted to in order to create a reduction surplus out of which dividends may be paid. While this is undoubtedly theoretically correct, it is equally true that a corporation may not find it easy to shoulder the heavy expenses of capital reduction, and even if it could, the possibility of reducing stated capital may not run a good chance where there are several classes of shares. Philippine corporation law very clearly indicates that any amendment to the articles of incorporation, consisting of any change in the rights of holders of shares of any class, or which would restrict the rights of any stockholders must not only have the vote or written assent of stockholders representing two-thirds of the subscribed capital stock of the corporation but also entitle the non-voting stockholder to demand payment for his shares, by filing a written objection to the amendment within 40 days after the date upon which the corporate action was taken.⁷⁴

To appreciate the difficulties inherent in the problem, an example may be necessary. Take a corporation that has two classes of shares: 5 million pesos of non-cumulative preferred (the preference

⁷² For example, Sec. 18, par. 3 provides: "A stockholder shall not be entitled to payment for his shares (referring to a situation where an amendment to the articles of incorporation affects the stockholder's rights in the manner indicated by the statute) unless the value of the corporate assets which would remain after such payment would be at least equal to the aggregate amount of its debts and liabilities exclusive of capital stock."

⁷³ Consider Paton's statement in his work, *Advanced Accounting* (1941) 570-571: "Where the accumulated deficit is large the rigid application of this rule (i.e., all losses suffered in the past must be recouped before dividends may be appropriated) may seem to work a hardship on shareholders in need of funds but there is no alternative unless the prevailing conception of corporate capital is to be radically modified."

⁷⁴ Sec. 18, Act No. 1459.

being in dividends and in assets on dissolution) and 10 million pesos of common, with a par value of 100 pesos per share. Let it be supposed that due to capital losses, the true value of the corporate assets has dropped to a million pesos. A capital reduction of 10 million pesos is desired to create a reduction surplus of 1 million pesos. The question is whose capital must be reduced to raise the 10 million pesos—the common, the preferred, or both? Must the reduction be equalized between preferred and common? It may be argued that the common shares should bear the entire reduction to the point of extinction,⁷⁵ since that is the obvious import of the contract with the preferred shareholders. The point may be made much of that common shareholders should bear the squeezing since there is an agreement with the preferred shareholders whereby the latter should enjoy preference not only in the distribution of the dividends but in the distribution of corporate capital, and since reduction surplus is actually capital, the burden created by resorting to capital reduction should be borne by the common stock. Of course, common shareholders will contend that both classes should bear the reduction proportionately. The argument may be put forward that the par value of all the shares may be reduced without decreasing the dividends to which the preferred shares would be entitled nor would their liquidation preference be hurt at all. It would seem though that this contention will not bear closer scrutiny. Capital reduction may, as is obvious in the example, produce a large surplus which the directors may pay out in dividends. Where the preferred shares are non-cumulative, as in this particular case, the owners of these shares will naturally prefer to forego their dividend which would constitute but a small portion of the surplus thus created, rather than find the common shares reaping a huge dividend, necessarily resulting in the impairment of the investment of the preferred. If, then, the point is conceded that the common stock should bear the brunt of reduction to the point of extinction, the difficult problem is at once posed whether, as in some conceivable cases, the common shareholders would vote for a capital reduction where such action would mean the certain extinction of the common stock altogether.

The stock contention in favor of the balance sheet surplus test is that it protects the creditors and stockholders more adequately than does any other test. The implication is that the creditors of

⁷⁵ Cf. *Page v. Whittendon Mfg. Co.*, 211 Mass. 424, 97 N. E. 1006 (1912) where the court held if the preferred is entitled to a preference upon dissolution, the common stock should bear the entire brunt of reduction. See also *Shanak v. White Sewing Machine*, 15A (2d) 169 (Del. Ch. 1940); *Rochester Gas & Electric Co. v. Matbie*, 18 N. Y. S. (2d) 630 (3rd Dept. 1940).

the corporation rely upon the stated capital to answer for the debts. It would be worth finding out whether creditors, short-term or long-term, do in fact rely on the stated capital. Bondholders usually find more protection in the bond indenture. The introduction of no par shares, and the permission to reduce capital to create a surplus out of which dividends may be paid, may have considerably weakened the argument that creditors have reason to close their reliance on the stated corporate capital. Short-term creditors may be more interested in the real credit standing of the corporation, considering not just the amount of its assets but their degree of liquidity. It may be conceded that preferred stockholders are better protected by the balance sheet surplus test than by a current earnings test. In so far as common stockholders are concerned, however, it may be said they are not really prejudiced if they know they are getting a return of the capital. The implication of the argument is that it may be wrong to return capital as income to a stockholder, but there is nothing wrong if he is told exactly what it is he is getting.

An even more persuasive argument against the balance sheet surplus test is the multitude of perplexing problems that it raises in connection with valuation, both as to law and the facts. One of the problems which may be initially posed is where a plant of the corporation, carried at cost on the books, drops in price—is the fund available for dividends reduced under the statute?

Another interesting question is presented regarding the referential use of the phrase, 'surplus profits arising from the business.' Is this confined to profits realized in the normal business operations, or should it also include any kind of surplus not falling under the category of 'capital'? In fine, is the phrase narrowed down to earned surplus, or should it include any kind of capital surplus? It may be worth pointing out that in 1825, when the New York parent of the present dividend statute of the Philippines was drafted, the problem of *capital surplus* was not contemplated. The New York legislature did not seem to recognize that there might be another fund available for dividends. Today, the distinction between earned surplus and other forms of surplus is acknowledged. In the United States, for example, several state statutes⁷⁶ carefully confine the fund for dividend distribution to earned surplus, out of donated assets or funds, held-in surplus arising from issuance of no-par stock, premium on par value shares, revaluation surplus created through write-ups, and reduction surplus arising from capital reduction.

⁷⁶ See, e.g., CALIFORNIA CIVIL CODE (1937), Sec. 346 (1); also, Michigan statute, 15 Stat. Ann. Sec. 21, 22.

There is no case in the Philippines which may be cited to settle this particular point, although there is such to be said in favor of the view that, as a general proposition, any kind of surplus should be considered available for dividends. This interpretation flows from the very essence and meaning of balance sheet surplus, i.e., the excess property of a corporation, however acquired, over and above its debts and the stated capital reserved to protect the creditors. The undesirable impacts of such an interpretation upon corporate financial policy will be inquired into later. It is, of course, entirely possible for a Philippine court to disregard past construction by American courts of statutes modelled upon the New York Act of 1825, and, considering relevant policy considerations, hold that the earned surplus test should prevail. The dividend section is ambiguous enough to permit such a holding.

CAPITAL

All along, the terms 'stated capital,' 'legal capital,' 'capital stock,' and 'capital' have been used in this discussion. Although under Philippine law, the principle that a dividend distribution must be made from the excess of net assets over the 'capital stock' seems to be the necessary consequence of the statutory provision, it is not at all clear what is the frame of reference of that verbal symbol, 'capital stock.' There are several implications of the term, and it is precisely because of careless usage—particularly the employment of the term in different contexts in certain American statutes and in the Philippine corporation statute⁷⁷—that there is so much confusion in judicial and non-judicial pronouncements. One may, for example, think of capital stock as the *formal authorized capital* of the corporation, expressed in number of shares and par or stated value. This is the nominal legal capitalization, and represents the maximum number of shares that may be issued without formal amendment of the articles of incorporation. Or one may use the term to refer to

⁷⁷ See, e.g., Secs. 5, pars. 7 and 8 of Sec. 6, Sec. 8, par. 3 of Section 16, Sec. 17, Sec. 30, Sec. 35, and Sec. 38. Consider the analysis of Ballantine: "Modern legislation attempts to define the legal capital, whether called 'stated capital,' 'capital,' 'capital stock,' 'paid-up capital' or some other term in order to clarify the requirement of the law. The Uniform Business Corporation Act unfortunately continues to employ the much abused term 'capital stock' to indicate the legal capital, although this term has long been involved in the most extraordinary ambiguity, confusion, and vagueness of thought in the statutes, the decisions, and in accounting. . . . Several of the more carefully drafted corporation acts adopt the term 'stated capital' to indicate the legal capital, thereby avoiding such ambiguous terms as 'capital stock' and also 'capital' which have involved even the draftsmen of the Uniform Business Corporation Act in confusion." Ballantine, *Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws*, 23 Calif. L. Rev. (1935), 229, 235, 236.

outstanding stock, i.e., the shares that have been duly issued and remain in the hands of the shareholders. Usually, the outstanding stock is much less than the authorized capital; the disparity between the two is represented by the *unissued stock*. Unissued stock may fall under two categories: 1. shares that have never been issued; and 2. shares once issued but which have been acquired by the issuing corporation through purchase, donation, or some other manner and retained, without formal cancellation. This second category is usually referred to as 'treasury stock.' Because of this semantic confusion, caused by the use of a term in different contexts, modern corporations now employ the term 'stated capital,' instead of 'capital stock,' so as to mean the amount of consideration received or to be received for the issued shares.⁷⁸ Unless otherwise indicated, the term 'stated capital' has such referential use in this study.⁷⁹

Unfortunately, however, the dividend section of the Philippine corporation statute, like its New York antecedent, uses the term 'capital stock' in its prohibitive provision:

"No corporation... shall divide or distribute its capital stock or property..."

The question then arises: what amount is represented by the term 'capital stock'? Is it the peso value of the consideration received on the issuance of the stock or the par value of the stock or the actual capital at the opening of the current accounting period?⁸⁰ Because

⁷⁸ See Ballantine, *op. cit.*, at 235, 236. When we propose the term 'stated capital' we are aware of the old significance attached to it: namely, its connection with the issue of no-par shares when permission was given to credit part of the consideration received to paid-in surplus and the balance to legal capital. Our use, however, of the term 'stated capital' is dictated by considerations of clarification in an effort to avoid such ambiguous terms as 'capital stock' and 'capital.'

⁷⁹ Cf. the definition of 'capital stock' in a New York case, cited by Fletcher, sec. 5335: "The capital stock of a corporation, is, like that of a copartnership or joint stock company, the amount which the partners or associates put in as their stake in the concern. To this means and resources of others, to such extent as their own prudence or the confidence of such other persons will permit. Such additions create a debt; they do not form capital. And if successful in their career, the surplus over and above their capital and debts becomes profits, and is either divided among the partners and associates, or used still further to extend their operations." Sanders, Hatfield and Moore, give the following definition of 'capital': "In its most general sense, 'capital' means a store of wealth from the use of which the owner hopes to obtain additional wealth; in this sense, the capital of a business consists of all its property or assets, both fixed and current. But in a narrow and technical sense, capital refers to the owner's equity in the property, thus excluding borrowed capital, which is represented by the liabilities." A STATEMENT OF ACCOUNTING PRINCIPLES (1938) II.

⁸⁰ Kehl illustrates the impact of any of these three theories upon the availability of funds for dividend purposes. If we assume that on January 1, 1939, the corporation issues 1,000 shares of P100 par value stock for property reasonably worth to the knowl-

there is no comparable Philippine case on the point, the important American case of *Goodnow v. American Writing Paper Company*⁸¹ may be worth exploring. In that case, a bill was brought against the company by a shareholder to enjoin the payment of a proposed dividend on preferred stock on the ground that the assets received in exchange for the issued shares were grossly overvalued. It was conceded that the corporation earned 2 million dollars, during its entire history, but it was claimed by the plaintiff that even considering these earnings, the value of the assets would still fall short of the total of the debts and the par value of the issued shares. The current

edge of the directors not over ₱75,000; that during the year 1939, the corporation suffers a net operating loss of ₱10,000; that during the year 1940 its net profits from operations are ₱15,000, and that there are no outstanding debts, the following balance sheets will show the respective possibilities:

1. Under the first theory of treating the capital as the peso value of consideration received, a balance sheet at December 31, 1940 would show:

<i>Assets</i>		<i>Liabilities</i>	
Plant, inventory, etc.	75,000	Capital	75,000
Cash	5,000	Surplus	5,000
	80,000		80,000

2. Under the second theory of treating capital as the par value of the stock, the balance sheet under the same circumstances would show:

<i>Assets</i>		<i>Liabilities</i>	
Plant, inventory, etc.	75,000	Capital	100,000
Cash	5,000		
Deficit	(20,000)		
	100,000		100,000

3. Under the third theory of treating capital as the actual capital at the opening of the current accounting period (January 1, 1940) the balance sheet would show:

<i>Assets</i>		<i>Liabilities</i>	
Plant, inventory, etc. as of Jan. 1, 1940	65,000	Capital	65,000
Replacement of depleted in- ventory	10,000	Surplus	15,000
Cash	5,000		
	80,000		80,000

With balance sheet surplus as the fund available for dividends, the corporation could distribute under the first theory ₱5,000, under the second nothing, and under the third ₱15,000. The third theory reduces the liability item for capital wherein prior accounting periods capital has been impaired; under it, capital would either be the consideration received or, if prior losses had impaired this amount, then the capital as impaired at the opening of the current accounting period (Kehl, *op. cit.* 28, 29). Any of these theories may be valid depending on the kind of statute in question, althought Kehl seems to be predisposed in favor of the third where the statute is ambiguous. This becomes evident when he interprets the N. Y. Act of 1825 as importing a current profits test (*idem.*, at 51).

⁸¹ 73 N. J. Eq. 692 Atl. 1014 (1908).

earning was in excess of \$300,000, the amount of the proposed dividend, which was sought to be enjoined. The American Writing Paper Company had this capitalization structure: \$17,000,000 bonds; \$12,000,000 preferred stock; \$11,500,000 common. The common shares were watered by about \$11,000,000; they were given to the promoters in exchange for certain properties. The question posed to the court was whether under the then New Jersey dividend statute, the corporation should first squeeze out the water before it could pay a dividend. The statute provided:

"The directors of a corporation shall not make dividends except from its surplus or from the net profits arising from the business of such corporation, nor shall it divide, withdraw, or in any way pay to the stockholders, or any of them, any part of the capital stock..."⁸²

The plaintiff contended that since the stock was issued for property at a gross overvaluation, there could be no dividend until the difference between the actual value of the property and the value at which it had been taken over was made up. Evidently, the plaintiff wanted the corporation to freeze the profits so as to obviate the disparity, his argument being that as long as it existed there could be no 'net profits' within the meaning of the statute. The proposed dividend, so he maintained, would operate as a division or withdrawal of the capital stock.

In sweeping language, the court said:

"When the legislature forbids the dividing, withdrawing, or paying to the stockholders any part of the capital stock, it means the capital actually invested..."

"We are led to the conclusion that the words 'capital' stock . . . mean capital actually invested, by the fact that it is only actual assets that can be divided, withdrawn, or paid over . . . (and) that the policy to be served by the prohibition of Section 30 is to prevent the frittering away of the actual assets with which the company is to do business, not the nominal assets which it has never received and for which it still has a claim "against the subscribers for unpaid stock . . ."

The court did not define the meaning of 'net profits', although it indicated that the statute clearly referred to two funds out of which dividends may be paid, namely, 'surplus', and 'net profits arising from the business'. The court clearly planted its holding on the 'net profits' alternative, and said whether 'net profits' meant annual profits, or net profits upon the whole of the company's business since its organization, the proposed dividend was justifiable.

⁸² Sec. 30 of the 1896 N. J. Statute as amended in 1904. See N. J. Laws 1904, c. 143.

From the broader question of policy, one may possibly justify the Goodnow result by asserting that a contrary result might work undue hardship on the stockholders. It may be conceded that a good number of corporations actually start out with much water. If they should earn huge sums, the requirement that the corporation first squeeze out all water by adding earnings to the capital would unduly prejudice the stockholders, particularly if a relatively small dividend was to be paid. However true that may be, there is one point that should not be ignored. When a corporation makes an open public representation that its capital is equal to the par of the stock subscribed, as it has to under Philippine corporation law,⁸³ all who deal with it have the right to rely upon that representation. Creditors should not be required to look behind the representation, in order to find out just how much is the actual contribution of the shareholders. If the misrepresentation was made by the directors, they should be held liable, jointly and severally to the corporation and the creditors for the difference between the par and the true cash value of the assets received at the time shares were issued,⁸⁴ and for damages to any person who may have been materially prejudiced thereby.⁸⁵ If the misrepresentation was participated in by all the directors and stockholders, the creditors should have the right to require that the earnings of the corporation be added to the capital in order to squeeze out the water, without prejudice, of course, to the other remedies available to creditors, such as the right of assessment against the individual stockholders. Where only a few directors or stockholders are involved, the result should be the same.

The seemingly logical argument pressed in the Goodnow case, namely, that there can be no withdrawal or division of assets that have not been paid in, may not stand closer scrutiny. When a corporation starts business with a deficit, because of watered shares, and subsequently makes profits, those earnings should be considered a part of the capital *as soon as they are made*. And they should be so considered until the deficit is wiped out. A dividend paid out while the deficiency has not been made up surely constitutes a refund of capital. This conclusion logically derives from the initial observation made that capital is not a res, but a quantum.

In an attempt to bolster its argument, the court in the Goodnow case said:

⁸³ See Secs. 7 and 9 of the Philippine Corporation Law.

⁸⁴ Sec. 16, *idem*; cf. *Shaw v. Ansaldi*, 178 App. Div. 589, 165 N. Y. S. 872 (1917), which was decided under a statute similar to the dividend section of our law.

⁸⁵ See Chap. II, Title XVIII, CIVIL CODE OF THE PHILIPPINES.

"It may not infrequently happen that stock is issued on which avowedly only a partial payment is made of the amount subscribed, which is therefore subject to further calls. We cannot think that in such a case, where the company prospers, there are no net profits available for dividends until the earnings accumulate to an amount equal to the par value of the shares . . ."

The observation seems far-fetched. Where a corporation has partly-paid shares, there is no deficiency in the capital, since it is quite obvious that there is a definite asset in the form of subscriptions receivable. Even if the shareholders should later become insolvent, the corporation may recover the difference by putting up the unpaid stock for sale and disposing of it for the account of the delinquent subscriber.⁸⁶

If the facts such as were presented in the Goodnow case had occurred in the Philippines, the court should not consider the decision in that case persuasive. In the first place, the case was decided under a dividend statute remarkably different from the dividend section of the Philippine corporation law. In the second place, where a corporation finds it important as a matter of policy to pay out dividends, although there is present a deficit, it may still do so through any of these means: (1) capital reduction, though as stated earlier, there are many difficulties inherent in such a recourse; (2) merger and consolidation in those special cases, authorized by law,⁸⁷ a remedy confined to a limited class of corporations; (3) sale of the assets of the old corporation to a new one at a price sufficient to squeeze out the water. This remedy is allowed in clear language by the Philippine corporation statute,⁸⁸ although it must be stated that practically the same difficulties which inhere in capital reduction may be present here. If the required number of shareholders, however, really desire a particular dividend distribution, in spite of an initial deficit, they should be able to resort to any of the means indicated. Otherwise, the ordinary process of freezing profits to eliminate the water should be insisted upon. Any other rule would nullify the policy objectives of capital requirement and render useless the threefold function of legal or stated capital: (1) the protection of the creditors against the shareholders; (2) the protection of senior shareholders against junior shareholders; and (3) the protection of all sharehold-

⁸⁶ The requirements are stated in Sections 38 to 48 of Act No. 1459. Cf. *Velasco v. Poizat*, 37 Phil. 802.

⁸⁷ See Act No. 2772, as amended by Act No. 2789. The privilege is limited to railway corporations.

⁸⁸ Sec. 281½ of the Philippine corporation law, which requires the affirmative vote of shareholders exercising at least 2/3 of the voting power, at a shareholders' meeting called for the purpose. Appraisal rights are likewise given to dissenting shareholders.

ers against mismanagement and the impairment of their investment and its earning power.⁸⁹

There is another point which has not been discussed at length in any Philippine or American case that has come to our attention. To allow payment of dividends when capital is impaired on account of the watering of shares or the incurring of losses in previous years would amount to an informal reduction of the corporate capital. If the provisions on capital reduction prescribing the formalities that should be complied with are to have any meaning, any such corporate distribution should be declared contrary to public policy.

Having settled the problem of what amount to preserve in the case of corporations starting out with deficit on account of watered shares, it may be well to discuss the various possibilities presented by the issuance of different shares of stock in connection with the problem of what amount to maintain as capital and why. Philippine law⁹⁰ authorizes the division of shares into classes with such rights, voting powers, preferences and restrictions as may be provided for in the articles of incorporation. As a general proposition, these shares may have a par value or have no par value. Save in cases of banks, trust companies, insurance companies, building and loan associations, shares of capital stock without par value may be issued from time to time for such consideration as may be prescribed in the articles of incorporation, or in the absence of fraud in the transaction, for such consideration as may be fixed by the board of directors from time to time, pursuant to authority conferred in the articles, or for such consideration as shall be consented to or approved by the holders of a majority of the shares entitled to vote at a meeting called for the purpose, and in the manner prescribed by the by-laws.⁹¹

Where the shares issued by a corporation are fully paid, par value shares, no difficulty is presented as long as no water exists. Where these par value shares are partly paid, the balance being payable upon call, the subscriptions receivable are properly considered as forming part of the corporate assets. Hence, the statutory rule against withdrawal or division of capital stock is not violated if dividends are paid out of earnings as long as the net assets, including the claim on the subscriptions, equal in amount the total par value of the shares subscribed.

⁸⁹ Ballantine and Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws*, 23 Calif. L. Rev. 229 (1935), 231, 232, 233. See also *Williams v. Western Union Telegraph Co.*, 93 N. Y. 162 (1883) for a discussion of the policy behind the limitations contained in the early N. Y. statutes.

⁹⁰ Section 5, Philippine Corporation Law.

⁹¹ Par. 1, Section 5, Philippine Corporation Law.

In the United States—and the same is true in the Philippines—par value shares may be sold at a price above par. The question is at once posed whether the premium so paid is part of the capital to be kept intact, or whether it is a form of surplus available for dividend distribution. If the rule in the Goodnow case were pressed to the limit, namely, that the actual contribution received should be preserved, the answer clearly is that premium is a part of capital. But such a mechanistic, inflexible rule will be hard to square with the function of the premium on par value shares as a corporate device. It may be a contribution over and above the capital item, made by a new shareholder to equalize a surplus fund already accumulated in the operation of the business, thus accomplishing two major objectives: (1) preventing dilution of the total shareholders' interests; (2) putting the new shareholders on a par with the older shareholders. For example, if a corporation started by issuing shares with 100 pesos par value fully paid, and subsequently accumulated a surplus fund of 25 pesos per share, the sale of additional shares at 100 pesos to the public will operate as a dilution of the shareholders' interests in the fund. If, however, the incoming stockholder is made to pay 125 pesos per share, the 25 pesos representing the premium, which may conveniently be tagged as 'paid-in-surplus,' equalizes the interest of all shareholders in the profits, surplus, and other earnings of the corporation which have accumulated and remain undistributed.

The American case of *Equitable Life v. Union Pacific Railroad*⁹² presented this point very neatly. The preferred stockholder in that case sought to restrain payment of dividend in the amount of \$80,000,000 to the common stockholders of the corporation. This amount had accrued by retirement of convertible bonds with common stock on the basis of one share at \$100 for \$175 of par value bonds, and part of it came from the profitable sale of stocks of other corporations. One of the problems squarely presented to the court was whether the premium on common stock of \$75 per share was capital or earnings. The court decided that the corporation need only capitalize an amount equal to par, treating the premium as an equalizing credit to surplus, in order that the interest of old and new stockholders in the surplus might be kept on a parity. The assumption was that the payment of the premium was not for permanent capital but for the purpose of putting the new shareholders on a par with the older shareholders. The court said that when this premium was paid, it became part of the accumulated profits and surplus and therefore distributable as such. The rule, qualified by the environmental circumstances of the case, is sensible and fair. The court, however, left

⁹² 212 N. Y. 360 (1914).

open the problem of classifying a premium paid by stockholders on organization for the express purpose of creating a permanent surplus or capital. American courts do not seem, in some instances, to inquire into the purpose for which the premium was paid. There is a wide split of authority on the broad question of whether premium paid on issuance of par value shares is part of the capital account or of the surplus item. For example, in *Merchants and Insurers' Reporting Co. v. Schroeder*,⁹³ a corporation, apparently just starting, sold its shares at prices above par. The corporation sued the directors to recover the dividends paid apparently out of the surplus thus created. The statute, which is similar to that of the Philippines, provided that no dividends may be paid by the directors except from the surplus profits arising from the business, "nor must they divide, withdraw, or pay to the stockholders or any of them, any part of the capital stock." In holding that the payment of dividends from surplus arising from issue of shares at prices above par was unlawful, the court said any premium paid for the shares became part of the capital. The court's holding might have been more acceptable if it had inquired in greater detail into these aspects of the problem: (1) whether there was really any surplus out of which dividends may be paid;⁹⁴ (2) the source of the surplus; (3) if the real source of the surplus was the premium paid on par value shares, the objective of the corporation in requiring the premium; (4) if the objective is economically advisable, whether the use of the premium device would promote its attainment. The decisions of some courts do not tell us whether any inquiry was made into these factors, but merely state in sweeping language that premiums paid on shares of par value should or should not be considered capital.⁹⁵

Philippine courts will do well in examining all the relevant facts and circumstances surrounding the payment of premiums. Where the purpose is to prevent dilution of the interest of the old shareholders, as in the case previously considered, thus maintaining the interests of all shareholders in the surplus on a parity, there seems to be no legitimate objection to allowing the premiums to be classified as surplus, available for dividend distribution. But where the premiums are paid in by persons buying shares of original issue,

⁹³ 39 Cal. App. 226, 178 Pac. 540 (1918).

⁹⁴ As stated by Dodd and Baker, it would seem that in this case, the premiums paid by the subscribers were offset by commissions paid by the corporation to stock salesmen, but the decision was not rested on that ground. See DODD AND BAKER, *CASES ON BUSINESS ASSOCIATIONS* (1940) 1142.

⁹⁵ For valuable investigations on the subject, see BERLE AND MEANS, *MODERN CORPORATION AND PRIVATE PROPERTY* (1932) 162-172; Report of S. E. C. on Protective and Reorganization Committees (Part VII) 28-32.

without any connection to existing surplus, the consequences may be far-reaching. There is the probability that through piecemeal declaration of such surplus, mainly or solely derived from premiums, as dividends, a misleading impression of prosperity might induce the unsophisticated investing public to attach a market value to the stock to which it is not legally and economically entitled. Likewise, the device could be used in order to divert the income stream to favored stocks, such as the common, to the prejudice of the senior securities. In these and similar circumstances, courts should feel free to strike down any attempt to classify the premium as surplus, and require the corporation to preserve it as part of the capital item.

Probably due to the fact that paid-in surplus was not very much in vogue at the time the provision governing no-par shares was drafted, and also on account of some kind of apprehension lest such a form of surplus may give rise to dangerous manipulations, the Philippine corporation statute provides in categorical language that:

"The entire consideration received by the corporation for its no-par value shares shall be treated as capital, and shall not be available for distribution as dividends."⁹⁶

The answer to the recurring problem of how much should be preserved as capital seems settled enough, at least under Philippine law, in the case of shares without par value. Whether this is desirable as a matter of policy, is, of course, another question. In considering whether this particular provision should be retained or not, it will prove valuable and helpful to study the experience of American business with respect to the practice of apportioning the consideration received for no-par shares to capital and to surplus, and relate this experience, if there be any substantial degree of relevance, to Philippine conditions. Unfortunately, no exhaustive factual study has as yet been made of the subject.⁹⁷ However that may be, it could perhaps be stated that while it is true the system of splitting up the consideration received for no-par shares has its inherent dangers, in that it makes it relatively easy for a corporation to distribute the contribution of one class of shareholders to other classes of shareholders in a manner not contemplated by the former, nevertheless there might be some advantages to be derived from such a system. For example, where it is imperative

⁹⁶ Last par. of Sec. 5, Act No. 1459.

⁹⁷ For some valuable American commentaries, see Katz, *Accounting Problems in Corporate Distributions*, 1941, 89 U. of Pa. L. Rev. 767-774; LYON, *CORPORATIONS AND THEIR FINANCING* (1938), 153-176; BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932), 162-172; cf. Haber, D., *Shares Without Par Value: Their Function in a Democracy* (unpublished essay, 1944).

to invite investment in order to carry on the normal operations of the business, it may be desirable to issue preferred stock enjoying priority in the payment of dividends. Since preferred shareholders usually insist on having dividends paid regularly, the corporation may find it necessary to give some reasonable assurance that regular distribution will be maintained, if such shares are to be sold at all. Otherwise, it may have to rely on a bond or note issue, the interest on which would have to be paid, regardless of whether the corporation was earning or not. So, in reality, the preferred stockholders in this particular merely take the place, though not completely, of bondholders. The system of apportionment by which part of the consideration is assigned to surplus gives the corporation that area of latitude and flexibility which will enable it to maintain dividend distributions even during a period of negligible earnings. Likewise, where a corporation finds it advisable to release itself from the prior charge on income to which previously issued preferred shares are entitled, it may find it necessary to resort to the redemption of the preferred shares. But usually such shares are redeemable only at a premium. Let it be supposed, for instance, that the contract with the preferred shareholders provide for redemption. The par value of the share is 100 pesos, but the redemption value is fixed at 115 pesos. The extra 15 pesos may not be paid out of the capital account, particularly in a case where the corporation has an earned surplus. But charging off this item to earned surplus might deplete that fund as to make it impracticable to pay dividends on the junior shares. Permitting the corporation to create a paid-in surplus through apportionment of the consideration received for no-par shares would protect the earned surplus from drains occasioned by the retirement of the preferred shares. Such an economically advisable measure, however, would be impossible under the rigid provision of the statute.