TYPES OF CORPORATE DISTRIBUTIONS

One investment objective of share ownership is the receipt of profit distributions or dividends. The attractiveness of a stock investment is measured by this yield in addition to the projected value appreciation of the shares as the corporate business prospers. Shares are also entitled to receive a proportionate share of the assets of the corporation when the business is dissolved and liquidated. These distributions to shareholders are the subject matter of this chapter.

The revised Model Business Corporation Act has developed a series of financial provisions governing distributions from the corporation to its shareholders. Section 1.40 defines a distribution as a “direct or indirect transfer of money or other property (except its own shares) or the incurrence of an indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption or other acquisition of shares; a distribution of indebtedness; or otherwise.” Modern corporate practice is to refer to all of these payments to shareholders as distributions, regardless of whether they represent a distribution of corporate profits or a distribution of assets in liquidation. The term dividends, which represents the distribution of corporate profits to a corporation’s shareholders, is being phased out of corporate parlance. However, this chapter uses the term dividends to describe distributions of corporate profit to shareholders, and reserves the term distributions to describe payments made to shareholders for other reasons.

The board of directors is vested with the authority and the discretion to declare dividends from time to time. Dividends may be paid in cash, property, or shares of the corporation, but most states restrict payment to certain available funds or prohibit payment unless certain financial tests are met. Generally, if the appropriate funds are available or if the financial condition of the corporation is satisfactory, the directors may distribute all sorts of desirable things to the shareholders.

Cash is always welcome, and the cash dividend is the most common corporate distribution. Cash dividends are declared by director resolution, which usually specifies a dollar amount per share and directs payment of the dividend to all shareholders entitled to receive it.
Property dividends are less common, but are equally available for use by the board of directors. If the corporation markets a desirable product, the product itself may be a dividend distribution. For example, R.J. Reynolds Tobacco Company once distributed a specially prepared package of its tobacco products to its shareholders as a dividend, and one famous corporate case involved a scramble to purchase shares of a distillery corporation that was reported to be preparing to issue a property dividend of its liquor products during World War II when liquor was scarce. The 3M Company of Minnesota used to send its shareholders its sponge, tape, and paper products. (Now it offers to sell them at a discount to shareholders as gift packages for the holidays.) Property dividends occasionally include shares of stock of a subsidiary corporation owned by the parent corporation. There is no restriction on the type of property that may be distributed. If a corporation had a surplus of janitorial supplies, it could distribute them as dividends, subject to the approval of the shareholder public relations department.

Dividends may consist of more shares of the same corporation. Share dividends increase the number of shares owned by the receiving shareholder, but do not affect the shareholder’s proportionate ownership interest. For example, the directors may declare a dividend of 1 share of common stock for every 100 shares outstanding. Each shareholder will receive 1 extra share of stock per 100 as a corporate distribution. Fractional shares become relevant here. If Mary Smith owns 125 shares and a one-for-one-hundred stock dividend is declared, she will be entitled to receive 1 1/4 shares in the dividend. The corporation may issue a stock certificate, scrip, or an uncertificated entry in the corporate records representing the fraction. Or it may pay the fair value of the quarter share in cash, or it may arrange for the sale of the fractional interest to another shareholder similarly situated.

Dividend distributions to shareholders do not necessarily come at regularly scheduled intervals. The board of directors may declare as many or as few dividends as it deems appropriate. Directors who declare frequent dividends are usually popular with the shareholders. Large corporations with established dividend policies usually declare a regular quarterly dividend on the corporate shares, as profits permit.

A dissolution distribution is usually a one-time distribution to shareholders when the corporate assets are liquidated and business is terminated. Partial liquidations are possible, however, if the corporation ceases to operate one phase of its business and distributes assets from the discontinued operations to shareholders, but continues other active business operations thereafter.

The most important legal considerations regarding corporate distributions are the authority to declare or demand distributions; the legally available funds out of which distributions are paid; and the tax ramifications of distributions.

**Sources of Funds for Distribution**

All state statutes regulate the manner in which a corporation may distribute its assets to its shareholders, and each statute either places statutory restrictions on the effect of a dividend payment or identifies particular accounts from which a distribution may be made. Common sources of dividend funds are earned surplus or retained earnings or profits. The Model Business Corporation Act permits dividends from any source as long as the corporation remains solvent and its total assets remain greater than its total liabilities (plus any amounts payable as liquidation preferences). Many state statutes use “unreserved and unrestricted earned surplus” as the main source for dividend distributions, and also allow dividends to be paid from other more specialized accounts. Understanding of the law of corporate distributions requires a grasp of the distinctions between sources of funds for distributions and the accounting principles used in creating these accounts. Consider the following types of accounts (and their definitions in many state statutes):

1. **Net assets**—the amount by which the total assets of a corporation exceed the total debts of the corporation.
2. **Stated capital**—at any particular time, the sum of (a) the par value of all shares of the corporation having a par value that have been issued; (b) the amount of the consideration received by the corporation for all shares of the corporation without par value that have been issued, except such part of the consideration therefor as may have been allocated to capital surplus in a manner permitted by law; and (c) increases caused by issuance of new shares (e.g., a share dividend) and reductions.

3. **Surplus**—the excess of the net assets of a corporation over the corporation’s stated capital.

4. **Earned surplus**—the portion of the surplus of a corporation equal to the balance of its net profits, income, gains, and losses after deducting distributions to shareholders and transfers to stated capital and capital surplus to the extent such distributions and transfers are made out of earned surplus. Earned surplus includes also any portion of surplus allocated to earned surplus in mergers, consolidations, or acquisitions of all or substantially all of the outstanding shares or of the property and assets of another corporation, domestic or foreign.

5. **Capital surplus**—the entire surplus of a corporation other than its earned surplus.

Now review the following corporate **balance sheet** with these definitions in mind.

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**THE NOBLES COMPANY**

**BALANCE SHEET**

_December 31, 2005_

**ASSETS**

**Current Assets:**

Cash $5,000
Marketable Securities Apex Telephone Company, at cost 8,000
Accounts Receivable 2,000
Inventory 5,000 $20,000

Total Current Assets $20,000

Property Plant and Equipment 58,000

**Total Assets** $78,000

**LIABILITIES AND EQUITY**

**Current Liabilities:**

Accounts Payable $3,000
Accrued Expenses Payable 3,000 $ 6,000

Bonds, First Mortgage 13 1/2% Interest 20,000

**Total Liabilities** $26,000

**Equity**

Stated Capital
Common Shares, $1 par value; 50,000 authorized, 5,000 issued and outstanding $5,000
Preferred Shares, 5% cumulative, $100 par value; 100% or par liquidation preference; 10,000 authorized, 50 issued and outstanding 5,000

Total Stated Capital $10,000

Capital Surplus 20,000

Earned Surplus 22,000

**Total Equity** 52,000

**Total Liabilities and Equity** $78,000
Following the statutory definitions, net assets is the amount by which the total assets, $78,000, exceed the total debts, $26,000. Thus, the net assets of the corporation in this case are $52,000.

Stated capital in this example equals the par value of the 5,000 common shares plus the par value of the 50 preferred shares. The capital surplus results from the excess consideration for which the par value shares were sold. For example, the balance sheet shows capital surplus of $20,000, which could have resulted from selling the 5,000 common shares at $4 a share, allocating the $3 per share in excess of par to capital surplus, and selling the preferred shares at $200 per share, allocating the $100 per share excess to capital surplus.

Earned surplus represents accumulated corporate profits that have been earned during preceding accounting periods and retained in the corporation. The term surplus refers to the total amount of earned surplus and capital surplus. Thus, the total surplus of this corporation is $42,000. The entire equity section of the balance sheet is also called net worth.

There is one other important definition for analyzing the legality of corporate distributions. A corporation is insolvent when it is unable to pay its debts as they become due in the usual course of business. This corporation is solvent under this test, since it has cash of $5,000 and marketable securities that could be sold for at least $8,000, which could pay its current liabilities (debts that are coming due) of $6,000.

The application of these terms becomes more clear through consideration of the statutory provisions regulating corporate distributions.

**CASH AND PROPERTY DIVIDENDS**

A dividend is a distribution of cash, other property, or shares to the stockholders of the corporation in the proportion of their share ownership. Recall that various classes of stock may be treated differently with respect to dividends. Dividend preferences are common in complex corporate financial structures, and preferences must always be observed. There is also a rule that dividends must be uniform within each class or series, meaning that each share of a given class or series will receive the same distribution as the other shares of that class or series. By way of illustration, consider the Nobles Company capital structure that was described previously with 5,000 shares of common stock and 50 shares of 5% cumulative preferred with $100 par value. Suppose the directors decided to issue a dividend and to distribute $2,000 in cash to the shareholders. The preferred shareholders are entitled to be paid their preferential dividends (5% of $100 per share), so they would receive $250 in dividends first. This leaves $1,750 for distribution to the common shareholders, who should receive $0.35 per share. Each shareholder of the particular class must be treated equally. The directors could not order a distribution of $0.50 per share to some common shareholders and $0.20 per share to others.

**Shareholders’ Rights to Dividends**

The decision to distribute dividends is within the sole discretion of the board of directors, and no shareholder has a right to dividends until the board of directors authorizes it or unless the shareholders successfully challenge the business judgment of the board of directors. Cumulative preferred stock will accumulate dividends annually until they are finally paid, but even preferred shareholders have no right to dividends until they are authorized by the board of directors. In the Nobles Company example, the 5% cumulative preferred stock will accumulate a dividend entitlement of five dollars per share per year, and if the board of directors ever authorizes a dividend, the arrearage must be paid before the common shareholders may receive dividends.

Once the board of directors has authorized a dividend through an appropriate resolution, the shareholders have a right to the dividend and it becomes a debt from the corporation to the shareholders.

Section 6.40(f) of the Model Business Corporation Act makes this indebtedness to the shareholders equal to the corporation’s indebtedness to other general, unsecured creditors, unless a shareholder has specifically agreed to subordinate the right to receive dividends to the
claims of other creditors. The procedure for authorizing a dividend is discussed after the next section regarding the restrictions on sources of funds for dividends.

Restrictions on Payment of Dividends

Corporate statutes usually restrict the payment of dividends to funds contained in specified corporate accounts. There are also certain restrictions on payment even if funds appear to be available in the prescribed accounts. Section 6.40 of the Model Business Corporation Act prohibits the payment of dividends if the corporation is insolvent, or if the authorization or payment would be contrary to any restriction contained in the articles of incorporation. If the organizers intend to restrict the directors’ ability to authorize and pay dividends, the law honors their restraints.

The act further provides that dividends may be authorized only if the corporation’s total assets exceed total liabilities and (unless provided otherwise in the articles of incorporation) the amounts payable to preferred shares having a preference to assets in liquidation. In the case of the Nobles Company, this excess is $47,000: total assets ($78,000) less total liabilities ($26,000) and amounts payable in liquidation to the preferred shares (100% of par, or $5,000). The asset and liabilities values are determined from the balance sheet or based on some other reasonable and fair valuation. Thus, if the Nobles Company’s stock in Apex Telephone Company were valued in the market at $20,000, an additional $12,000 would be available for dividends.

In deciding whether the corporation would violate the rules restricting payment of dividends, the board of directors may rely upon the financial statements, fair market appraisals, or any other reasonable determination of value of the assets of the corporation. In measuring whether a dividend has the effect of causing insolvency or the reduction of net assets below the threshold amounts, the date the dividend is authorized is generally the date the determination is made. However, if the dividend is paid more than 120 days after the authorization of the dividend, the date of payment will be the relevant date for this determination.

Many states continue to permit dividends to be paid in cash or property only out of the unreserved and unrestricted earned surplus of the corporation, with a few exceptions, which are discussed in a moment. In those states, therefore, a corporation may pay dividends from available funds in its earned surplus account, and in the case of the hypothetical Nobles Company, $22,000 would be available for payment of dividends. However, there may be practical restrictions on the payment of such dividends. A glance at the balance sheet reveals that payment of a $22,000 dividend is unrealistic considering the relatively low cash position of the corporation and considering that the corporation’s total liquid assets, including cash, securities, inventory, and accounts receivable, total only $20,000. The corporation would be unable to pay a full $22,000 dividend without liquidating part of its plant and equipment, even though the funds are legally available under statute for dividends up to $22,000. Thus, in every case, the maximum legal limits on dividends will be tempered by business advisability. The directors determine the latter within the bounds of the former.

Some states, including Delaware, provide that in addition to the funds from earned surplus, dividends may be declared and paid out of the unreserved and unrestricted “net earnings for the current fiscal year and the next preceding fiscal year taken as a single period.” This means that if the corporation has no historical earned surplus, but has earnings (profits) for the past two fiscal years, dividends may legally be paid from the profit funds, without regard to the balance in the earned surplus account.

In California, the availability of funds for dividends depends on a ratio of current assets to current liabilities, and management is allowed to anticipate receipts and expenses for the next year to make the computation.

Earned surplus generally represents the accumulated profits from corporate operations as determined by accepted accounting principles. Earned surplus or earnings may be restricted in several ways. Suppose a corporation has borrowed money from a bank or other financial institution, and the terms of the loan agreement require that earned surplus be maintained at a minimum level of $10,000 for the duration of the loan. In accordance with the loan agreement, that amount of earned surplus should be restricted, and may not be used for the payment of divi-
A restriction also would be imposed when the corporation purchases its own shares from outside investors to hold as treasury shares. Most statutes require that the amount of earned surplus used to purchase treasury shares be restricted for as long as the shares remain treasury shares. Many statutes ignore the distinction between ordinary surplus and reserved or restricted surplus and permit dividends to be authorized and paid without such restrictions.

Sometimes dividends may be paid out of the depletion reserves of a corporation engaged in exploiting natural resources, such as minerals, oil, gas, and timber. The articles of incorporation must expressly authorize such dividends.

Cash and property dividend provisions vary extensively among the states. Most states couch their restrictions on legally available funds in terms of solvency: assets minus liabilities (including preferences to be paid in liquidation) or whether the corporation can pay its debts in the usual course of business. Others use earned surplus or earnings during a prescribed period. Several other states add further restrictions to prohibit dividends from unrealized appreciation and depreciation.

**Procedure for Authorization, Payment, and Accounting**

The board of directors has sole discretion to determine the amount to be paid as dividends by the corporation. Notice, however, that in the Nobles Company financial structure, the directors must pay $5 per share for 50 shares of preferred stock as a cumulative dividend before any dividends may be paid to the common shares. If the directors authorized a dividend of $3,000, they would first resolve to distribute $250, or $5 per share, to the preferred shares, and would then distribute the remaining $2,750 in a dividend of $0.55 per share for the common stock.

The decision to authorize the dividend is made at a directors’ meeting and is recorded as a resolution in the minutes.

**Example**

**Resolution to Authorize a Cash Dividend**

RESOLVED, that a dividend of $5 per share be authorized and paid on the preferred stock and a dividend of $.55 per share be authorized and paid on the common stock of this corporation out of the unreserved and unrestricted earned surplus to the holders of stock as shown by the records of the corporation on the 15th day of June, 2005, distributable on the 1st day of July, 2005, and that the treasurer is directed forthwith to mail checks for the same to the stockholders of record.

An example of a resolution for a property dividend follows.

**Example**

**Resolution to Authorize a Property Dividend**

From the report furnished the meeting on the financial condition of the Company for the fiscal year ended December 31, 2005, and for each of the subsequent months, it appeared that the Company was in a position to authorize and pay a dividend in property upon its outstanding shares of common stock.

Thereupon, after discussion it was on motion duly made, seconded, and unanimously adopted by the affirmative vote of the directors present:

RESOLVED, that a dividend on the outstanding shares of common stock of this Corporation be and it hereby is authorized and ordered to be paid in property of this Corporation, to-wit, shares of common stock of Apex Telephone Company owned by this Corporation at the rate of ten shares of common stock of said Apex Telephone Company for each share of common stock of this Corporation issued and outstanding. Said dividend to be payable on September 1, 2006, to the holders of record of said common stock of this Corporation at the close of business on August 10, 2006, from the net surplus of this Corporation as at the close of business on December 31, 2005, or from the net profits of this Corporation for its current fiscal year; and

FURTHER RESOLVED, that the proper officers of the Corporation be and they hereby are authorized and directed in the name and on behalf of the Corporation to do or cause to be done all acts or things necessary or proper to carry out the foregoing resolution.
Notice that the resolution sets a record date for a determination of stockholders who will be entitled to receive dividends. Nearly every state statute has certain rules to follow in fixing the record date, and in most states the rules are exactly the same as those regarding shareholder voting described earlier.11 These rules permit the stock transfer books to be closed before the dividend is paid. Alternatively, the directors may set a record date to determine which stockholders are entitled to receive dividends. If the books are not closed and if no date is set, the date for determining shareholders of record is the date that the board of directors adopts the resolution authorizing the dividend. The Model Business Corporation Act gives the directors authority to fix a record date for determining shareholders entitled to a dividend, but if the directors fail to do so, the record date will be on the date the board of directors authorizes the distribution of the dividend. The dividend will be paid to the shareholder of record on the record date, even if that shareholder has sold the shares before the dividend is disbursed. When a dividend has been declared by the board of directors but has not yet been paid, the shares are commonly described as ex-dividend, meaning any person who purchases the shares before the dividend is paid will not receive the dividend. It will be paid to the former owner of the shares.

When the dividend is paid in cash, both the cash account and the earned surplus account are reduced by $3,000, which maintains the balance on the balance sheet. If the dividend is paid in other property, such as the securities described in the foregoing property dividend example (which appear as current assets on the balance sheet), and if the securities distributed are valued at $3,000, both the earned surplus and the marketable securities accounts are reduced by that amount. The value of the property distributed and charged to earned surplus is determined by the book value, which is the value shown on the balance sheet.

**Tax Ramifications of Cash or Property Dividends**

In an earlier discussion of the corporate form, it was observed that one disadvantage of corporate existence is the problem of double taxation. Dividends are at the heart of that problem. The corporation is taxed on its profits, and if the after-tax profits are distributed to shareholders as dividends, the dividends are income to the shareholders and are also taxed at the individual shareholder’s rate. A corporation may avoid the problem of double taxation by paying salaries or consulting expenses to its shareholders wherever possible, since these items are deductible as expenses and the money thus expended is not taxed at the corporate level. Salaries are a viable alternative to dividends when the shareholders are employees of the corporation, as is frequently the case in small, close corporations. In large corporations, however, dividends that are subject to double taxation are necessary to provide the shareholders a return on their investment.

Cash dividends are declared on a shareholder’s income tax return as income in the actual amount distributed. Property dividends are subject to a special rule. When property is distributed as a dividend, the shareholders must report as income the fair market value of the property received, even though the book value of the property may be less.12 For example, if the distributed marketable securities of the Apex Telephone Company have a fair market value of $4,000, even though their book value is $3,000, the shareholder must report $4,000 as ordinary income.

Corporations that pay dividends aggregating more than $10 to any one person during the calendar year must file certain reports with the Internal Revenue Service, which uses those informational reports to determine whether the shareholders have reported the dividends on their individual income tax returns.

Shareholders of a Subchapter S corporation must report and pay taxes upon their proportionate share of the corporation’s entire income, regardless of whether they have received distributions of cash equivalent to their share of income. The advantage (or perhaps disadvantage) of a Subchapter S corporation is that the shareholder’s proportionate share of corporate income is attributable to each shareholder as individual income.

**SHARE DIVIDENDS**

A share dividend is a corporation’s distribution of its own shares. The number of shares owned by the shareholders is increased, but the proportionate stock ownership of each shareholder
does not change. A share dividend requires no modification in any of the characteristics of the shares, and it adds nothing to a shareholder’s ownership interest; instead, it simply dilutes the shareholder’s ownership interest by dividing the same investment into more shares. From a business and public relations perspective, a corporation issuing a share dividend has achieved the best of all possible results: it has distributed a valuable dividend to its shareholders (because the new shares distributed will have value) and it has not depleted any of its assets. The shareholders are actually receiving part of the value they already had in the stock they already owned. The new shares distributed have value only because they dilute the value of the existing shares.

**Legal Restrictions**

Most states permit share dividends from two sources: the corporation’s treasury shares, if shares have been purchased and held in the treasury; and authorized-but-unissued shares. In either case, the earned surplus account must contain available funds, and it will be adjusted to reflect the dividend.

When authorized-but-unissued shares are used for share dividends, a transfer from surplus to stated capital occurs. The Model Business Corporation Act formerly required such a transfer, and many states still follow the rule. If the shares have a par value, they must be issued at an amount equal to or greater than the par value. An amount of surplus equal to the aggregate par value of the dividend shares must then be transferred to stated capital at the time the dividend is paid. If the dividend shares have no par value, the shares are issued at a stated value fixed by a resolution of the board of directors, and stated capital receives an amount of surplus equal to the aggregate stated value. Further, the amount of surplus so transferred to stated capital must be disclosed to the shareholders when the dividend is paid.

To avoid dilution of one class in favor of another class, there is usually an additional restriction. No dividend payable in shares of any class may be paid to the holders of shares of any other class unless doing so is authorized by the articles of incorporation or by the affirmative vote or the written consent of the holders of at least a majority of the outstanding shares of the class in which the payment is to be made.

Using the Nobles Company as an example, note that the balance sheet reflects that 10,000 preferred shares with $100 par value are authorized, but only 50 of these shares are issued and outstanding. There are, therefore, 9,950 preferred shares authorized but unissued. The directors may consider issuing one share of preferred stock for each share of common stock as a share dividend, but they have two hurdles to jump: the authority to issue a share dividend to holders of one class in shares of another class, and the legally available funds for the dividend. If 5,000 shares of preferred were distributed to the common shareholders, the present holders of the 50 preferred shares would have their ownership interests severely diluted. Accordingly, either the articles of incorporation must authorize such a share dividend, or the preferred shareholders must approve the dividend. The second hurdle is insurmountable in this case, since each of the preferred shares has a par value of $100, and that amount must be transferred from surplus to stated capital for each distributed share. The surplus of the Nobles Company—the excess of net assets and stated capital—is only $42,000. To issue 5,000 shares of $100 par value stock, $50,000 in surplus must be transferred to stated capital. Consequently, this total share dividend could not be distributed; the greatest number of shares of preferred stock that could be distributed is 4,200. Note that a share dividend of one class of shares to the holders of another class is rare. Usually a share dividend will be paid to holders of each class in shares of the same class.

If the corporation has no treasury shares and all of the authorized shares have been issued, the articles of incorporation must be amended to supply additional authorized shares before a share dividend may be declared.

**Procedure for Authorization, Payment, and Accounting**

The decision to declare a share dividend is made by the board of directors, which adopts a resolution specifying the number of shares to be distributed, the proportion of distribution, record
and payment dates for the persons to receive dividends, and, if necessary under local law, the authority for the transfer of surplus to stated capital.

**Resolution to Declare a Stock Dividend**

WHEREAS, there has been accumulated from undistributed profits of the company a surplus of $22,000, which in the opinion of the board of directors can be advantageously used for the benefit of stockholders.

RESOLVED, that a stock dividend be and the same hereby is declared payable to stockholders of record as of the 10th day of July, 2005, one share of common stock of the par value of $1 per share to be distributed as such stock dividend to the holder of each outstanding share of common stock, and a like amount to the holder of each share of preferred stock of the par value of $100 each, said stock dividend to be extra and additional to any cash dividend now or hereinafter declared; and

FURTHER RESOLVED, that $5,050 of said surplus be transferred to capital to accomplish said stock dividend, and 5,050 shares of common stock of the par value of $1 per share be issued and disbursed as hereinbefore provided.

On the record date, the shareholders entitled to receive the shares are identified, and on the payment date, certificates are executed and distributed to those persons.

All accounting entries reflecting a stock dividend occur in the shareholders’ equity section of the balance sheet, because the *payment* (the value of the shares) is transferred from the surplus accounts to the stated capital account. Stated capital receives the amount of the par value of the shares if the shares have a par value, or an amount determined by the board of directors for no par shares. For example, if the Nobles Company declared a one-share-per-ten common stock dividend, 500 new shares at $1 par common stock would be issued as a dividend to the holders of the 5,000 outstanding shares. The stated capital would be increased by $500, the amount equal to the par value per share times the number of shares distributed as a dividend. The earned surplus account would be reduced by $500, since payment is theoretically made from there.

The New York Stock Exchange imposes a special accounting rule for stock dividends from companies listed on the exchange, and generally accepted accounting principles require the use of the rule for other corporations as well. Stated simply, the accounting for a stock dividend must recognize the fair market value of the shares being distributed. In the preceding Nobles Company distribution, suppose the 500 common shares, with $1 par value, have a fair market value of $10 per share. If the same shares were sold, $500 would be entered in stated capital and $4,500 would be transferred to capital surplus. When the shares are distributed as a stock dividend, the proper accounting entries are $500 to stated capital, $4,500 to capital surplus, and $5,000 from earned surplus.

Study of these accounting entries illustrates why the issuance of a stock dividend adds nothing to the true economic interests of the shareholder. The shareholder’s ownership interest in the corporation is represented by the shareholders’ equity section of the balance sheet, including stated capital, capital surplus, and earned surplus. In issuing a stock dividend, the corporation is merely transferring funds within the shareholders’ equity accounts, and not distributing any assets of the corporation. For that reason, the Model Business Corporation Act and many states have removed the statutory requirements of legally available funds as they relate to share dividends. While it is important to understand the accounting concepts to understand the source of a share dividend, the transaction has no effect on creditors or the financial well-being of the corporation. The advantage of a stock dividend lies in the future; if the business continues to prosper, the value of each share of stock will increase. The hope of shareholders is that all stock, including shares distributed as stock dividends, will appreciate in value, and the shareholders will realize huge capital gains when the stock is sold.
Tax Ramifications of Share Dividends

The tax ramifications of a stock dividend for shareholders are simple on their face but complicated in their application. The dividend itself is a nontaxable transfer, since the shareholder receives no distribution of value from the stock dividend. Rather, the ownership interest is simply divided into more shares. Thus, no tax need be paid when a stock dividend is received. The tax problem comes later.

When the shares are sold, the shareholder must compute the basis for the shares—that is, their cost to the shareholder—in order to compute the capital gains. Stated very simply, if shares were purchased for $5 per share, and subsequently sold for $8 per share, the basis is the cost of the shares and the capital gain is $3 per share. Stock dividends complicate this computation, because they require an adjustment to the basis of the original shares. For example, suppose a shareholder purchased 100 shares of Nobles Company common stock at $5 per share, and subsequently received a one-for-ten stock dividend, resulting in a total of 110 shares for the original investment of $500. The shareholder’s basis per share is now $4.545 per share, and that figure will be used to compute capital gains when the shares are sold. Further complications are apparent if the shareholder had purchased 10 shares in 2000 for $5 per share, 50 shares in 2001 for $6 per share, 25 shares in 2002 for $6.50 per share, and 15 shares in 2003 for $6.75 per share. When this shareholder later receives a ten-share stock dividend, all of these figures must be adjusted. A stock dividend may be most popular with the shareholder’s accountant because of these confusing tax computations.

STOCK SPLITS

A stock split is similar to a stock dividend inasmuch as it results in a greater division of the same ownership interest for each shareholder. However, a typical stock split usually involves some modification of the capital stock structure itself. If the corporation’s shares have a par value, a split is normally accomplished by reducing the par value of the shares so that the aggregate stated capital of the corporation is unaffected by the distribution. If the shares have no par value, the stock split effects a reduction of the stated value of each share.

The generally accepted distinction between stock splits and stock dividends stems from the mechanics of effecting the distribution. A stock dividend traditionally involves a transfer of surplus to stated capital within the shareholders’ equity section of the balance sheet. When taken from surplus and added to capital, the stock dividend may be considered to be a type of earnings distribution, although no value is actually distributed to the shareholders. A stock split, on the other hand, simply changes the total number of shares outstanding, and the stated capital remains the same. There are no shifting of funds and no distributions of earnings. This distinction between stock dividends and stock splits has little practical effect, with the singular exception that in some states a true stock split requires an amendment to the articles of incorporation.

Like a share dividend, a stock split involves the issuance of a certain number of shares for each share currently held. Splits may be two-for-one, three-for-one, or even one-hundred-for-one. Under the Model Business Corporation Act, there is no distinction in the corporate formalities required to issue a share dividend or to declare a stock split. In section 6.23, the board of directors has the authority to issue a share dividend by simply authorizing one. Under section 10.05, the board of directors also has the authority to amend the articles of incorporation to change the total number of issued shares into a greater number of shares. There are two separate procedures for accomplishing a split. If the shares have a par value, a modification of the par value of the shares is a common method. In a two-for-one split, the par value is halved, and twice as many shares are issued for the same amount of stated capital. In the case of the common shareholders of the Nobles Company, a two-for-one stock split reduces the par value of the common shares to $0.50 per share, and results in a distribution of 5,000 additional shares for the 5,000 shares presently outstanding. There are then 10,000 shares of common stock issued and outstanding represented by the same $5,000 in stated capital. The
shareholders’ equity section of the balance sheet is changed only to indicate that there are 10,000 shares issued and outstanding, and that the par value is now $0.50 per share. An amendment to the articles of incorporation is necessary to reflect the new par value in the capital structure. The amendment may also require an increase in the authorized stock of the particular class. If the Nobles Company sought to issue an eleven-for-one stock split, the presently authorized shares would be insufficient for the distribution, since 55,000 shares would be needed. The extra shares may be authorized in the same amendment that changes par value.

Shares without par value may be involved in a split, in which case an amendment to the articles may not be necessary since such shares remain without par value after the split. An amendment is required, however, if additional authorized shares are needed to accomplish the split. The initiative for the stock split begins with a resolution by the board of directors for an amendment to the articles of incorporation:

**Example**

**Resolution to Amend the Articles for a Stock Split**

RESOLVED, that Article Fourth of the Articles of Incorporation be and the same is hereby amended as follows:

“FOURTH: One hundred thousand (100,000) shares shall be common stock with a par value of $.50 per share.”

At the time this amendment becomes effective, and without any further action on the part of the corporation or its stockholders, each share of common stock of a par value of $1.00 per share then issued and outstanding shall be changed and reclassified into two fully paid and nonassessable shares of common stock of a par value of $.50. The capital account of the corporation shall not be increased or decreased by such change and reclassification. To reflect the said change and reclassification, each certificate representing shares of common stock of a par value of $1.00 theretofore issued and outstanding shall be canceled, and the holder of record of each such certificate shall be entitled to receive a new certificate representing two shares of common stock of a par value of $.50, so that upon this amendment becoming effective, each holder of record of a certificate representing theretofore issued and outstanding common stock of the corporation will be entitled to certificates representing in the aggregate two shares of common stock of a par value of $.50 authorized by this amendment for each share of common stock of a par value of $1.00 per share of which he or she was the holder prior to the effectiveness of this amendment.14

In many states, this recommendation for an amendment to the articles of incorporation must be submitted to the shareholders for an appropriate vote. Section 10.05 of the Model Business Corporation Act permits the board of directors to simply increase the total number of shares of a particular class without obtaining the approval of the shareholders.

The second method of declaring a stock split is the same procedure used to issue a share dividend. Instead of modifying the par value of the shares by an amendment to the articles of incorporation, the board of directors may authorize the issuance of new shares from the available authorized but unissued shares. In states that still impose restrictions on legally available funds, an amount must be transferred from surplus to stated capital, and the new shares may be issued for the increased stated capital. For example, the Nobles Company could accomplish a two-for-one split by transferring $5,000 from surplus to capital, thereby increasing stated capital to $10,000 and covering the issuance of 5,000 additional shares at the same par value. Although this is technically a distribution of earnings and is more appropriately described as a share dividend, it is generally referred to as a split because of the doubling of shares held by each shareholder. An amendment to the articles of incorporation may still be necessary if the remaining authorized but unissued shares are fewer than the additional shares required in the split.

In addition to the amendment procedure and transfer of surplus to capital methods of accomplishing stock splits, other rules may require **capitalization of earnings** in a stock distribution. The phrase “capitalization of earnings” refers to the second procedure of transferring
surplus to stated capital. The rules of the New York Stock Exchange and the Securities Exchange Act of 1934 should be consulted for the circumstances requiring capitalization of earnings in a stock split. In all other respects, stock splits are treated the same as share dividends. Upon appropriate resolution of the board of directors, and amendment of the articles of incorporation, if necessary, new certificates are issued to shareholders reflecting the additional shares of the split. The tax ramifications for the shareholders are identical to the tax treatment of share dividends.

CORPORATION’S PURCHASE OF ITS OWN SHARES

The corporation may purchase its own shares from its shareholders if the board of directors authorizes the purchase and the applicable state statute so permits. There are many reasons why a corporation may repurchase its shares from the shareholders. It might be required to do so under a shareholder agreement that requires the repurchase of shares when a shareholder retires or dies. It might have business reasons for reducing the number of its shareholders, such as eliminating its public corporation status by “going private” and repurchasing shares owned by public investors. Or it might simply negotiate with a shareholder to repurchase the shares with the objective of selling them at a higher price to another investor.

The Model Business Corporation Act authorizes the repurchase of shares in section 6.31, and section 6.40 treats a repurchase as a distribution to shareholders, so that the same restrictions placed upon dividends also apply here. Most states regulate the repurchase of shares as dividends are regulated, so funds used to purchase the shares are subject to solvency restrictions under the Model Act: the corporation must be able to pay its debts, and its assets must exceed its liabilities (including liquidation preferences) after payment of the purchase price. In states that use capital accounts to determine the legality of a purchase of shares the funds used to purchase the shares are limited to unrestricted and unreserved earned surplus, although usually capital surplus may be used if authorized by the articles of incorporation or by a majority vote of the shareholders.

The corporation’s purchase of its own shares is a distribution to shareholders, since the corporation exchanges cash for shares. The law refuses permission to purchase shares if the corporation is insolvent or would be rendered insolvent by the purchase. However, there are some generally recognized exceptional cases when the corporation may reacquire its own shares without making a distribution subject to statutory regulation. These include the purchase of corporate shares to eliminate fractional shares, to compromise or collect an indebtedness to the corporation, to pay dissenting shareholders entitled to payment under the law, and to retire redeemable shares.

Consider the purchasing ability of the Nobles Company. Under the Model Business Corporation Act approach, the corporation may make a distribution only if it will be able to pay its debts as they come due and if total assets exceed (and after the distribution occurs will continue to exceed) total liabilities plus the amount payable to preferred shares as a liquidation preference. The balance sheet of the Nobles Company shows total assets of $78,000, total liabilities of $26,000, and a liquidation preference for preferred shares of $5,000. Thus, the corporation has a total of $47,000 in legal purchasing power, subject to its ability to pay debts as they come due. In states that use the earned surplus and capital surplus tests, the Nobles Company would have less purchasing power. The balance sheet shows unreserved and unrestricted earned surplus of $22,000, and that amount could be used by the board of directors to purchase shares. The balance sheet also shows $20,000 in capital surplus, which could be used if the articles of incorporation or the holders of the majority of voting shares authorized the action. However, the liquidity of the company may be a practical barrier to the purchase of shares. The corporation will be limited by the relatively low cash position shown on the balance sheet under both tests.

The shares purchased by the corporation may be returned to the status of authorized-and-unissued shares, canceled, or, in some states, held by the corporation as treasury shares. Section 6.31 of the Model Business Corporation Act anticipates that the shares would be either
When treasury shares are permitted by statute, most states require that the surplus used to purchase the shares must be restricted in the amount required for the purchase, and the restriction must remain in effect as long as the shares are held as treasury shares. If the shares are subsequently sold or canceled, the restriction may be removed. To illustrate, assume that the Nobles Company repurchased 1,000 shares of its common stock to hold as treasury shares at a price of $3 per share, using $3,000 of the earned surplus for the purchase. The earned surplus account would reflect $19,000 in available earned surplus and $3,000 in restricted surplus.
earned surplus, representing the 1,000 shares of common stock held in the treasury. There-
after, the corporation may resell the treasury shares for any price (including a price below par
value). When resold, the shares are no longer treasury shares and the restriction is lifted. If
the corporation sells the shares for $2.50 per share, then only $2,500 will be added back to
earned surplus, and the loss of $500 will be permanently subtracted from that account. These
transactions show that the corporation in this situation would suffer a loss by investing in its
own shares.

Sections 6.31 and 10.05 of the Model Business Corporation Act prescribe a streamlined
procedure for canceling the purchased shares. In many states, the board of directors adopts a
resolution authorizing the cancellation of shares and a statement of cancellation is filed with
the secretary of state (see Exhibit 11–1, Statement of Cancellation of Non-Reissuable Shares).
Under the Model Act procedure, the board of directors (without shareholder approval) adopts
an amendment to the articles of incorporation to reflect the reduction in the number of au-
thorized shares, and the total number of authorized shares after the reduction. When the can-
cellation is completed, the equity section of the balance sheet is adjusted. If capital and surplus
accounts are used, the stated capital account is reduced to reflect the cancellation, and the
earned surplus is adjusted to show that only the par value of the shares has been realized by
the company. Thus, if the 1,000 shares reacquired by the Nobles Company for $3,000 were
recorded as treasury shares first and later canceled, the stated capital account would show
4,000 common shares issued and outstanding with $4,000 stated capital. The earned surplus
account would be adjusted as follows:

<table>
<thead>
<tr>
<th>After purchase, before cancellation:</th>
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<tbody>
<tr>
<td>Earned surplus</td>
</tr>
<tr>
<td>Unrestricted</td>
</tr>
<tr>
<td>Restricted</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Cancellation:

| Remove restriction—| Add par value of canceled shares | $ 1,000 |
| Subtract purchase price of shares                            | (3,000) |
| Net reduction                                                | $ (2,000) |

After cancellation:

| Earned surplus                                              |
| Unrestricted                                                | $20,000 |

Remembering that with dividend distributions, all shareholders of the same class must
be treated equally, a relevant question at this point might be, Is the corporation required
to purchase the entire class of stock if it intends to purchase any shares? The answer is no.
The corporation may purchase all or any part of a particular class, and theoretically may
select the shareholders from whom the purchase is made. However, there is a taint of un-
fairness if the selling shareholders happen to be the directors who authorized the purchase,
and the plot thickens if the corporate business suddenly takes a turn for the worse right af-
ter the sale. There are laws that protect the other shareholders in such a case. Traditional
common law principles of fraud apply here, and the shareholders are further protected
through the fiduciary duties owed them by management. If the board of directors voted to
purchase their own shares in the corporation, they may be liable to the shareholders for
self-dealing—entering into an unfair transaction in which they have a personal financial
interest. Finally, federal securities laws regulate insider trading by management, and those
laws also may resolve the harm. Nevertheless, the corporate statutes do not require that all
shareholders of a particular class be treated equally when the corporation purchases its
own shares.
PARTIAL LIQUIDATIONS

A partial liquidation is a combination of a distribution of assets, usually cash, and the purchase of the corporation’s own shares. In fact, any purchase of shares by a corporation is a partial liquidation. The concept of partial liquidation became popular when certain tax advantages were allowed for partial liquidations that qualified for special favorable tax treatment. The favorable tax consequences for partial liquidations have been eliminated in the federal tax law, but the term partial liquidation is still used whenever an identifiable segment of a business is distributed to the shareholders; for example, when a particular division of a corporation is closed and the trade conducted by that division is terminated. After creditors are paid, the assets can be distributed as a partial liquidation to the stockholders. A partial liquidation also may result from a contraction of the corporation’s business, such as the closing of certain selected manufacturing plants.

As an illustration of a partial liquidation, suppose the Nobles Company could sell a portion of its plant and equipment, and liquidate the cash received in a distribution to the shareholders in exchange for stock. The transaction could occur as follows: The company sells $13,000 in plant equipment and continues its reduced business with the remaining plant and equipment available, and the net cash from the sale is distributed to the stockholders in exchange for a proportionate amount of stock. Since the $13,000 in plant and equipment equals approximately one-fourth of the net assets, the corporation may reacquire approximately one-quarter of the total outstanding stock in exchange for the distribution. The corporation has accomplished a purchase of stock by distributing cash assets received in a partial liquidation.

The procedure for a partial liquidation begins with a resolution of the board of directors.

Resolution to Partially Liquidate

Whereas, this Corporation presently is the owner of sundry producing and undeveloped oil and gas leases, drilling equipment, oil payments, and miscellaneous properties;
Whereas, the Board of Directors deem it good business and advisable to make a partial liquidation of the Corporation and to pay out certain properties of the Corporation as a dividend in kind ratably to the stockholders of record on the 10th day of December, 2004; and
Whereas, the payment of a partial liquidating dividend will not impair the capital stock of the Corporation.
Now, therefore, be it resolved, that a partial liquidating dividend be declared and paid as of January 2, 2005, said dividend to be paid in properties in kind and consisting of the following described properties: [Here describe.]
Be it further resolved, that the Certificate of Incorporation of this Corporation be amended, reducing the capital stock of the Corporation from 5,000 shares of common stock of the par value of $1 per share to 3,750 shares of common stock of the par value of $1 per share, and from 50 shares of preferred stock of the par value of $100 per share to 37.5 shares of preferred stock of the par value of $100 per share; and that of the net book value of the assets paid out as a liquidating dividend, $1,250 of such amount be charged against the stated capital of the common shares and $1,250 of such amount be charged against the stated capital of the preferred shares, and the remainder be charged against the capital surplus account.

DISSOLUTION AND LIQUIDATION

Distributions to shareholders also are involved in a complete dissolution of the corporation, since the shareholders are entitled to receive their proportionate ownership interests in the assets after corporate creditors have been paid. Shareholders of record are identified and notice is given to creditors, permitting a reasonable period for filing claims.19
All shareholders participate ratably in the net assets of the corporation after payments to creditors, unless the articles of incorporation provide otherwise. The articles may authorize a capital stock structure with various classes or series of shares, one or more of which may be entitled to a preference to assets in liquidation. The preference will be honored before other classes of stock are entitled to their proportionate shares of assets.

**Liquidation preferences** are usually fixed as a percentage of par value or a specified dollar amount, and preferred shares, while entitled to the first priority to the assets, are limited to the liquidation amount specified. For example, observe that the preferred shares of the Nobles Company are entitled to a liquidation preference of 100% of par value per share. If dissolution occurred when the financial status of the corporation was as described earlier in the balance sheet, the net assets of the corporation would be $52,000 at dissolution. The preferred shares would be entitled to receive $5,000 of the assets (100% of $100 par value for 50 shares). The remaining $47,000 in assets would be distributed to the common shareholders, and the preferred shareholders would not share in this distribution. It is possible, however, to create participating preferred shares, so the preferred shareholders participate in the distribution of assets after receiving their preference. To illustrate, suppose that in addition to the 100% par value preference in liquidation, the articles of incorporation further provided that the preferred shares would participate equally with the common shares in liquidation. The preferred shares would still receive the first $5,000, and the remaining $47,000 would be distributed equally among 5,050 shares (5,000 common and 50 preferred). Each share of each class would receive $9.31 in liquidation in the second distribution. Thus, the total liquidation distribution to the preferred shareholders would be $109.31 per share.

Classes of preferred stock that are entitled to cumulative dividend preferences may also have a preferred claim in liquidation to the extent of the dividend arrearages. This issue has undergone some tortured construction in litigation and is not firmly settled. However, interpretation problems can be avoided by careful drafting of the articles of incorporation. Again consider the example of the Nobles Company. Its preferred shares are entitled to a 5% cumulative dividend preference, meaning that dividends of $5 per share (5% of $100 par value) accumulate annually. When a dividend is finally declared, the total arrearage must be paid to the cumulative preferred shareholders before any other shareholders may receive dividends. Suppose the Nobles Company has not declared dividends for five years and is now being dissolved and liquidated. The dividends for the preferred shares have accumulated in the amount of $25 per share. The question is whether the preferred shareholders are entitled to receive their dividend arrearages as a preference in liquidation before other classes of stock are permitted to share the assets. The articles of incorporation can provide either way, but should be specific in any case. If it is intended that the preferred shares will be entitled to a liquidation preference for unpaid cumulative dividends, the articles should so specify, and should also define a dividend arrearage or accumulation as including unpaid amounts regardless of whether the corporation has ever declared a dividend or has had funds available for a declaration of a dividend. To negate the liquidation preference for unpaid cumulative dividends, the articles should specifically state that the right to unpaid accumulated dividends is lost if the corporation is dissolved and liquidated.

**KEY TERMS**

<table>
<thead>
<tr>
<th>distribution</th>
<th>balance sheet</th>
<th>informational reports</th>
</tr>
</thead>
<tbody>
<tr>
<td>dissolution distribution</td>
<td>net worth</td>
<td>basis for shares</td>
</tr>
<tr>
<td>retained earnings</td>
<td>insolvent</td>
<td>stock split</td>
</tr>
<tr>
<td>net assets</td>
<td>dividend preference</td>
<td>capitalization of earnings</td>
</tr>
<tr>
<td>stated capital</td>
<td>depletion reserve</td>
<td>cancellation of repurchased shares</td>
</tr>
<tr>
<td>surplus</td>
<td>ex-dividend</td>
<td>partial liquidation</td>
</tr>
<tr>
<td>earned surplus</td>
<td>book value</td>
<td>liquidation preference</td>
</tr>
<tr>
<td>capital surplus</td>
<td>fair market value</td>
<td>dividend arrearages</td>
</tr>
</tbody>
</table>
CASES

DODGE v. FORD MOTOR CO.
204 Mich. 459, 170 N.W. 668 (1919)
Ostrander, C.J.

[The Dodge brothers were minority shareholders of the Ford Motor Company. Henry Ford, president of the company, owned a majority of the shares, and the company was not paying dividends to the shareholders. The Dodge brothers sued to force the company to pay dividends.]

* * *

When plaintiffs made their complaint and demand for further dividends, the Ford Motor Company had concluded its most prosperous year of business. The demand for its cars at the price of the preceding year continued. It could make and could market in the year beginning August 1, 1916, more than 500,000 cars. Sales of parts and repairs would necessarily increase. The cost of materials was likely to advance, and perhaps the price of labor; but it reasonably might have expected a profit for the year of upwards of $60,000,000. It had assets of more than $132,000,000, a surplus of almost $112,000,000, and its cash on hand and municipal bonds were nearly $54,000,000. Its total liabilities, including capital stock, was a little over $20,000,000. It had declared no special dividend during the business year except the October, 1915, dividend. It had been the practice, under similar circumstances, to declare larger dividends. Considering only these facts, a refusal to declare and pay further dividends appears to be not an exercise of discretion on the part of the directors, but an arbitrary refusal to do what the circumstances required to be done. These facts and others call upon the directors to justify their action, or failure or refusal to act. In justification, the defendants have offered testimony tending to prove, and which does prove, the following facts: It had been the policy of the corporation for a considerable time to annually reduce the selling price of cars, while keeping up, or improving, their quality. As early as in June, 1915, a general plan for the expansion of the productive capacity of the concern by a practical duplication of its plant had been talked over by the executive officers and directors and agreed upon; not all of the details having been settled, and no formal action of directors having been taken. The erection of a smelter was considered, and engineering and other data in connection therewith. In consequence, it was determined not to reduce the selling price of cars for the year beginning August 1, 1915, but to maintain the price and to accumulate a large surplus to pay for the proposed expansion of plant and equipment, and perhaps to build a plant for smelting ore. It is hoped, by Mr. Ford, that eventually, 1,000,000 cars will be annually produced. The contemplated changes will permit the increased output.

The plan, as affecting the profits of the business for the year beginning August 1, 1916, and thereafter, calls for a reduction in the selling price of the cars. It is true that this price might be at any time increased, but the plan called for the reduction in price of $80 a car. The capacity of the plant, without the additions thereto voted to be made (without a part of them at least), would produce more than 600,000 cars annually. This number, and more, could have been sold for $440 instead of $360, a difference in the return for capital, labor, and materials employed of at least $48,000,000. In short, the plan does not call for and is not intended to produce immediately a more profitable business, but a less profitable one; not only less profitable than formerly, but less profitable than it is admitted it might be made. The apparent immediate effect will be to diminish the value of shares and the returns to shareholders.

It is the contention of plaintiffs that the apparent effect of the plan is intended to be the continued and continuing effect of it, and that it is deliberately proposed, not of record and not by official corporate declaration, but nevertheless proposed, to continue the corporation henceforth as a semi-eleemosynary institution and not as a business institution. In support of this contention, they point to the attitude and to the expressions of Mr. Henry Ford.

Mr. Henry Ford is the dominant force in the business of the Ford Motor Company. No plan of operations could be adopted unless he consented, and no board of directors can be elected whom he does not favor. One of the directors of the company has no stock. One share was assigned to him to qualify him for the position, but it is not claimed that he owns it. A business, one of the largest in the world, and one of the most profitable, has been built up. It employs many men, at good pay.

“My ambition,” said Mr. Ford, “is to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their lives and their homes. To do this we are putting the greatest share of our profits back in the business.”

“With regard to dividends, the company paid sixty per cent. on its capitalization of two million dollars, or $1,200,000, leaving $58,000,000 to reinvest for the growth of the company. This is Mr. Ford’s policy at present, and it is understood that the other stockholders cheerfully accede to this plan.”
He had made up his mind in the summer of 1916 that no dividends other than the regular dividends should be paid, “for the present.”

“Q. For how long? Had you fixed in your mind anytime in the future, when you were going to pay? A. No.”

“Q. “That was indefinite in the future? A. That was indefinite; yes, sir.”

The record, and especially the testimony of Mr. Ford, convinces that he has to some extent the attitude towards shareholders of one who has dispensed and distributed to them large gains and that they should be content to take what he chooses to give. His testimony creates the impression, also, that he thinks the Ford Motor Company has made too much money, has had too large profits, and that, although large profits might be still earned, a sharing of them with the public, by reducing the price of the output of the company, ought to be undertaken.

We have no doubt that certain sentiments, philanthropic and altruistic, creditable to Mr. Ford, had large influence in determining the policy to be pursued by the Ford Motor Company—the policy which has been herein referred to.

... There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his codirectors owe to protesting, minority stockholders. A business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end, and does not extend to a change in the end itself, to the reduction of profits, or to the nondistribution of profits among stockholders in order to devote them to other purposes.

There is committed to the discretion of directors, a discretion to be exercised in good faith, the infinite details of business, including the wages which shall be paid to employees, the number of hours they shall work, the conditions under which labor shall be carried on, and the price for which products shall be offered to the public.

It is said by appellants that the motives of the board members are not material and will not be inquired into by the court so long as their acts are within their lawful powers. As we have pointed out, and the proposition does not require argument to sustain it, it is not within the lawful powers of a board of directors to shape and conduct the affairs of a corporation for the merely incidental benefit of shareholders and for the primary purpose of benefiting others, and no one will contend that if the avowed purpose of the defendant directors was to sacrifice the interests of shareholders, it would not be the duty of the courts to interfere.

We are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company. In view of the fact that the selling price of products may be increased at any time, the ultimate results of the larger business cannot be certainly estimated. The judges are not business experts. It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. The experience of the Ford Motor Company is evidence of capable management of its affairs. It may be noticed incidentally, that it took from the public the money required for the execution of its plan, and that the very considerable salaries paid to Mr. Ford and to certain executive officers and employees were not diminished. We are not satisfied that the alleged motives of the directors, in so far as they are reflected in the conduct of the business, menace the interests of shareholders. It is enough to say, perhaps, that the court of equity is at all times open to complaining shareholders having a just grievance.

Assuming the general plan and policy of expansion and the details of it to have been sufficiently, formally, approved at the October and November, 1917, meetings of directors, and assuming further that the plan and policy and the details agreed upon were for the best ultimate interest of the company and therefore of its shareholders, what does it amount to in justification of a refusal to declare and pay a special dividend or dividends? The Ford Motor Company was able to estimate with nicety its income and profit. It could sell more cars than it could make. Having ascertained what it would cost to produce a car and to sell it, the profit upon each car depended upon the selling price. That being fixed, the yearly income and profit was determinable, and, within slight variations, was certain.

* * *

Defendants say, and it is true, that a considerable cash balance must be at all times carried by such a concern. But, as has been stated, there was a large daily, weekly, monthly, receipt of cash. The output was practically continuous and was continuously, and within a few days, turned into cash. Moreover, the contemplated expenditures were not to be immediately made. The large sum appropriated for the smelter plant was payable over a considerable period of time. So that, without going further, it would appear that, accepting and approving the plan of the directors, it was their duty to distribute or near the 1st of August, 1916, a very large sum of money to stockholders.

* * *

The decree of the court below fixing and determining the specific amount to be distributed to stockholders is affirmed.

* * *
ANACOMP, INC. v. WRIGHT
449 N.E.2d 610 (Indiana 1983)
RATLIFF, JUDGE

[F. Thomas Wright negotiated with Anacomp to become an executive with that company. In the negotiations, Anacomp agreed to sell Wright 3,060 shares of common stock, and Wright bought the stock and paid for it. His employment negotiations were not successful, and during the negotiation period, Anacomp issued cash dividends and stock dividends, and declared a stock split. Wright’s original 3,060 shares had become 6,603 shares through the additional stock issued in dividends and splits. When negotiations broke off, Anacomp tried to cancel the 3,543 extra shares Wright had received during the negotiations.]

* * *

The law provides that the right to receive dividends is an incident of stock ownership which applies equally to stock and cash dividends. 19 Am.Jur.2d Corporations § 890 at 370 (1965). The general rule is stated that “whoever owns the stock in a corporation at the time a dividend is declared owns the dividend also. . . .” Bright v. Lord, (1875) 51 Ind. 272, 276; 6 I.L.E. Corporations § 102 at 506 (1958); 19 Am.Jur.2d Corporations § 890 at 371 (1965). In the words of another authority, “[s]tock dividends, like cash dividends, belong, in the absence of an agreement to the contrary, to the holders of stock at the time when the dividend is payable, and without regard to the source from which, or the time during which, the funds to be divided among the stockholders were acquired.” (Footnote omitted.) 11 W. Fletcher, Cyclopedia of Corporations § 5359 at 739 (Perm.Ed.1971).

* * *

We note that Anacomp raises no question with respect to Wright’s entitlement to the cash dividends in this appeal. Although Anacomp distinguishes at great length the completely different natures of cash and stock dividends as far as tax and trust cases are concerned, we are not convinced that there is any reason to distinguish between the two in this case. The trial court found correctly, according to the law, that Anacomp was not entitled to a return of the dividends, be they cash or stock.

Anacomp also posits the argument that even if Wright is entitled to the additional shares of stock represented by the stock dividends, he is not entitled to those shares which he accumulated as a result of stock splits. Anacomp asserts that there is a distinction between stock dividends and stock splits. We agree. Stock dividends suggest a capitalization of earnings or profits together with a distribution of the added shares which evince those assets transformed into capital. 19 Am.Jur.2d Corporations § 808 at 284 (1965). Stock splits, on the other hand, connote a mere increase in the number of shares evincing ownership without altering the amount of capital, surplus, or segregated earnings. Id. A stock split, therefore, is essentially a matter of form and not of substance in that it does not change the stockholder’s proportionate ownership or participating interest in the corporation. Id.; Rogers Walla Walla, Inc. v. Ballard, (1976) 16 Wash.App. 81, 553 P.2d 1372, 1376. Courts have recognized, however, that what is denominated by a corporation as a stock dividend may in truth be a stock split and vice versa. Rogers Walla Walla. Thus, while the corporation’s denomination of an issue of stock to shareholders as a stock dividend or a stock split may be useful and definitive for certain purposes, courts, where necessary, will look behind that denomination to the essence of the corporate transaction to determine whether the dividend was in actuality issued as a result of a transfer of accumulated earnings into capital or as a mere increase in the number of shares of stock. See, e.g., Rogers Walla Walla; Geier v. Mercantile-Safe Deposit & Trust Co., (1974) 273 Md. 102, 328 A.2d 311.

Despite Anacomp’s insistence that stock certificate numbers 33684 and 41552 were issued as a result of stock splits, the court found, and the corporate minutes in the record support the finding, that

“upon the declaration of each of the stock dividends, as stated above, Anacomp transferred additional ‘earned surplus’, or ‘capital surplus’ into its common stock account; and that although each shareholder, unless he sold some of his stock, would maintain the same proportion of stock equity in the corporate assets, the value thereof would not remain the same because the dividend stock thus issued represented part of the profits earned by Anacomp from the use of its stock investor’s cash payments including the $25,625.00 paid by Wright.”

Record at 53. Thus, we find no basis in fact or at law to support Anacomp’s position that somehow the stock split shares should be treated differently from the other dividends declared and issued to Wright.

* * *
PROBLEMS

1. XYZ Corporation has the following balance sheet at the end of 2006:

   **ASSETS**
   - Cash $ 45,000
   - Equipment 10,000
   - Building 100,000
   - Stock 10,000

   **LIABILITY AND EQUITY**
   - Accounts Payable $100,000
   - Capital Surplus 20,000
   - Earned Surplus 25,000
   - Stated Capital (Common Stock)$2 par value
     - 10,000 shares 20,000 authorized, issued and outstanding _______ 

   $165,000

   a. What is the maximum cash dividend that could be legally declared in your state?

   b. If the XYZ Corporation purchased 1,000 shares at par value to be held as treasury shares, what would be the amounts in the following accounts?
   - Assets/Stock $____
   - Stated Capital $____
   - Capital Surplus $____

2. The financial statements of Slumbertele Corporation indicate negative retained earnings for 2003 in the amount of $(10,500), and earnings of $20,150 in 2004 and $15,600 in 2005. The Company has authorized, issued and outstanding 1,000 shares of 4% cumulative nonparticipating prior preferred shares with $100 par value; 1,500 shares of 5% nonparticipating preferred shares with $10 par value; and 2,000 common shares with $100 par value. During 2001, the Company paid a $4 dividend per share to the 4% prior preferred, a $.50 dividend per share to the 5% preferred, and a $6 dividend per share to the common shares. It paid a $4 dividend per share in 2002 and a $2 dividend per share in 2003 to the 4% prior preferred. No other dividends have been paid.

   a. During 2006, which of the following is correct?
      1) The directors may not declare a dividend for the common shares.
      2) The directors may not declare a dividend because there is no surplus.
      3) The directors must pay the 4% cumulative preferred holders their total dividend arrearage before any other dividends may be paid.
      4) None of the above.

   b. If the directors pay the maximum amount legally available in dividends in 2006, which of the following will be the dividend that is distributed?
      1) $10 to the 4% prior preferred; $.50 to the 5% preferred; $7.25 to the common.
      2) $14 to the 4% prior preferred; $2.50 to the 5% preferred; $3.75 to the common.
      3) $10 to the 4% prior preferred; $2 to the 5% preferred; $6.125 to the common.
      4) $14 to the 4% prior preferred; $.50 to the 5% preferred; $5.25 to the common.

PRACTICE ASSIGNMENTS

1. Prepare a memorandum to advise the board of directors of Trouble, Inc., of the maximum dividend that can be declared for holders of common stock this year.

2. Prepare all documents necessary to accomplish a two-for-one stock split of the preferred stock.
**TROUBLE, INC.**

**BALANCE SHEET**

<table>
<thead>
<tr>
<th>ASSETS</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$ 8,500.00</td>
</tr>
<tr>
<td>Accounts Receivable</td>
<td></td>
</tr>
<tr>
<td>Current</td>
<td>$ 2,000.00</td>
</tr>
<tr>
<td>Over 30 days</td>
<td>1,200.00</td>
</tr>
<tr>
<td>Office Equipment</td>
<td>8,000.00</td>
</tr>
<tr>
<td>Less Accumulated Depreciation</td>
<td>(1,000.00)</td>
</tr>
<tr>
<td>Supplies</td>
<td>650.00</td>
</tr>
<tr>
<td>Land and Buildings</td>
<td>32,000.00</td>
</tr>
<tr>
<td>Accumulated Depreciation</td>
<td>(7,000.00)</td>
</tr>
<tr>
<td><strong>Total Assets</strong></td>
<td>44,350.00</td>
</tr>
</tbody>
</table>

| LIABILITIES                                     |         |
| Accounts Payable                                |         |
| Current                                         | 6,000.00 |
| Over 30 days                                    | 1,000.00 |
| Insurance Payable                               | 500.00 |
| Long-Term Debt                                  | 25,000.00 |
| **Total Liabilities**                           | 32,500.00 |

| SHAREHOLDERS’ EQUITY                            |         |
| Stated Capital:                                 |         |
| Common stock                                    |         |
| 50,000 shares authorized, no par value; 1,000    | 1,000.00 |
| shares outstanding                              |         |
| Preferred stock                                 |         |
| 6% cumulative dividends; 10,000 authorized;      | 5,000.00 |
| $100 par value; 50 shares outstanding           |         |
| Capital Surplus                                 | 1,000.00 |
| Earned Surplus                                  | 4,850.00 |
|                                                | 11,850.00 |
| **Total Shareholders’ Equity**                  | 11,850.00 |
|                                                | **44,350.00** |

**ENDNOTES**

5. See M.B.C.A. § 6.40(c).
7. Dividend restrictions in the articles of incorporation are suggested as important considerations at the drafting stage. See “The Articles of Incorporation” in Chapter 8.
8. See “Corporation’s Purchase of Its Own Shares” later in this chapter.
13. The Model Business Corporation Act has eliminated the concepts of treasury shares, stated capital, and surplus.
14. The procedure to amend the articles of incorporation is detailed in “Amendment of the Articles of Incorporation” in Chapter 15.
17. See “Rights of Dissenting Shareholders” in Chapter 15.
19. The dissolution procedure is more fully discussed in “Voluntary Dissolution,” “Involuntary Dissolution,” and “Liquidation” in Chapter 15.