
NATURAL RESOURCES JOURNAL

Volume 5
Issue 1 *Winter 1965*

Winter 1965

Corporate Dividends in New Mexico

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CORPORATE DIVIDENDS IN NEW MEXICO

The declaration and payment of dividends is a characteristic of a profit seeking corporation. Generally, stockholders of larger corporations, as compared to closely held corporations, are more concerned with the financial than the control aspect of their investment. This desire of the stockholder for a periodic return on his investment is one of two opposing forces that are the concern of this Note. The other force is the creditor and his constant struggle to see that the cushion insulating a sound financial investment from a dangerously risky venture is not deflated by the unlawful declaration and payment of dividends.

The purpose of this Note is to discuss the funds legally available[1] for the distribution of dividends, to enumerate some transactions affecting the funds, and to analyze the extent of a board of directors' discretion in the distribution or retention of the accumulated profits.

New Mexico, not unlike other states,[2] has had little opportunity to construe its corporate dividends statutes. Fortunately, New Jersey, the state from which New Mexico adopted its dividend

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1. The funds legally available for the distribution of dividends are all too often ambiguously described as surplus. For purposes of this Note, the term "surplus," without further modification, means the excess of the net assets (assets minus liabilities) of a corporation over its stated capital. Where shares have a par value, stated capital is usually defined as an amount equal to the aggregate par value of the shares issued; where the shares are no par, stated capital is the aggregate credited to the capital stock accounts.

In New Mexico, stated capital takes on a somewhat different significance in relation to no par stock:

> For the purpose of this act [51-4-1 to 51-4-13], the stated capital (as that term is hereinafter used in this act) of a corporation issuing shares without nominal or par value shall be the capital with which the corporation will begin business increased by any net additions thereto, or diminished by any net deduction therefrom; but stated capital shall not include any net profits or surplus earnings until transferred to capital, and shall not be larger in amount than the excess, as shown by the books of the corporation, of its assets over and above its liabilities, other than liabilities on account of shares of stock issued or to be issued by such corporation. In the case of a corporation having outstanding shares with a nominal or par value, as well as shares without a nominal or par value, for the purpose of this act the portion of stated capital applicable to the shares without a nominal or par value shall be the excess of stated capital over and above the total par value of outstanding shares having a nominal or par value.

N.M. Stat. Ann. § 51-4-3 (Repl. 1962).

2. See Note, *Dividend Sources In Florida*, 12 U. Fla. L. Rev. 72 (1959).

statutes, has answered a great many questions for New Mexico.[3] This factor will cause the decisions of the New Jersey courts to be relied upon for interpretation and construction of the New Mexico dividend statutes.

I

DIVIDEND SOURCES—THE SURPLUS OR NET PROFITS TEST[4]

> No corporation shall make dividends, except from the surplus or net profits arising from its business, nor divide, withdraw, or in any way pay to the stockholders, or any of them, any part of its capital stock, or reduce its capital stock, except according to this article . . . .[5]

The problem arising under the surplus or net profits test is simply pinpointed by stating the issue as follows: Does the phrase "surplus or net profits" describe merely one fund or does it describe two funds available for the distribution of dividends? The Supreme Court of New Mexico has dealt with two situations bearing upon the issue.

The first decision was *Cartwright v. Albuquerque Hotel Co.*,[6] which rather inconclusively treated the subject. The supreme court was confronted with the problem of whether preferred stockholders could by agreement arrange to have dividends distributed regardless of whether surplus or net profits existed. The supreme court announced that an attempt to authorize dividends without a reservation as to the impairment of capital was void as against declared

3. Cartwright v. Albuquerque Hotel Co., 36 N.M. 189, 11 P.2d 261 (1932). New Mexico follows the rule that when this state adopts the statutes of another state, it is presumed that the construction of the courts construing those statutes is also adopted. Gray v. Armijo, 70 N.M. 245, 372 P.2d 821 (1962).

4. New Mexico's dividend test is commonly called the surplus or net profits test. Other jurisdictions having similar dividend distribution tests include: Me. Rev. Stat. Ann. ch. 53, § 39 (Supp. 1963) ("profit . . . , but the capital shall not thereby be reduced"); N.J. Stat. Ann. § 14:8-19 (1939) ("surplus . . . , or from the net profits arising from the business"); R.I. Gen. Laws Ann. § 7-3-28 (1956) (same as New Mexico); S.D. Code § 11.0706 (Supp. 1960) ("surplus profit . . . nor . . . divide . . . capital stock").

5. N.M. Stat. Ann. § 51-3-17 (Repl. 1962). The omitted portion of this section pertains to the joint and several liability of directors for violation of the section and the manner in which a director who dissented from the illegal declaration and payment and a director who was absent from the meeting may exonerate themselves from such liability.

6. 36 N.M. 189, 11 P.2d 261 (1932).

public policy. The public policy was, of course, the desire to protect the common shareholders' equity as well as creditors' claims.

The *Cartwright* court did not render any binding decision upon the problem of whether the term "surplus" was synonymous with the term "net profits." The appellees did contend, however, that the company could have paid the contracted dividend out of its net income (profits) without impairing capital. The appellees admitted that no findings were asked for or made as to the corporation's ability to pay dividends from profits. The decision stated that neither did the appellees seek nor did the court award relief on the ground that profits existed from which a dividend could be declared. One might argue that by implication the supreme court was saying that if net profits existed there was the possibility of a dividend distribution even if the capital of the corporation was impaired at the time. However, in the light of a later decision[7] by the same supreme court, the more reasonable conclusion would be that the *Cartwright* decision was indecisive.

The second decision, *Woodson v. Lee*,[8] clearly indicates that the supreme court was using the terms surplus and net profits synonymously. The supreme court explicitly asserted that "the position of defendants that income which is 'for distribution to the stockholders' of a corporation is a dividend, and that under § 51-3-17, N.M.S.A. 1953, distribution of any of these funds was prohibited so long as there was a capital deficit"[9] was well taken.

The significance of the *Woodson* holding is that it precludes the contention that the New Mexico dividend statute designates two funds as being available for the declaration and the payment of dividends. It was by no means evident, before *Woodson*, that the New Mexico Supreme Court would rule that only one fund would be legally available for dividends. The term "one fund" should not be misunderstood. It means "surplus,"[10] and surplus contains vari-

7. Woodson v. Lee, 73 N.M. 425, 389 P.2d 196 (1963).

8. *Ibid.*

9. *Id.* at 428-29, 389 P.2d at 199. If any confusion is created by the words of the supreme court it may be in the court's use of the term "funds." It seems apparent that the court is using the term to mean money available for dividend distribution. Keeping in mind, however, that the basic issue is whether one fund or two funds are available for dividends, it can be seen that the use of the term "funds" is somewhat misleading.

Apparently, the supreme court is equating net profits and retained earnings. In accounting terminology, retained earnings equal net profits arising from operations since the beginning of the corporation's existence.

10. See note 1 *supra*.

ous subdivisions such as reduction surplus, paid-in surplus, earned surplus, and other surpluses. And, surplus is to be distinguished from annual or current net profits which may be realized regardless of the fact that capital is impaired. New Mexico, having taken its statute[11] from New Jersey, could have looked to that state's decisions for guidance in interpreting the statutory language. If the supreme court had perused the New Jersey statute or decisions, it would have discovered that the statute adopted by New Mexico had been amended. The New Jersey statute which New Mexico adopted was amended to make it clear that two funds were intended.[12] *Goodnow v. American Writing Paper Co.*,[13] decided in New Jersey four years after the amendment, contained language indicating[14] that two funds were available and that one of those funds, "net profits," could be used to pay dividends though the capital was in fact impaired.

Upon scrutinizing *Goodnow*, it appears that the New Jersey court held no more than that the legislature made a distinction between surplus and net profits which may well have been insignificant. The New Jersey court stated that the distinction between net profits and surplus did not necessarily indicate that net profits meant the difference between gross earnings and what is commonly denominated operating expenses. Net profits, meaning gross earnings less operating expenses, may be called annual net profits. On the other hand, the New Jersey Legislature may have intended that "net profits" meant net profits upon the company's business from its organization.[15] The alternative left open by the *Goodnow* decision has been answered in later cases which selected the meaning to be net profits upon the company's business from its organization. This selection

11. N.M. Stat. Ann. § 51-3-17 (Repl. 1962).

12. Goodnow v. American Writing Paper Co., 73 N.J. Eq. 692, 694, 69 Atl. 1014, 1015 (Ct. Err. & App. 1908):

> Under the act of 1896 there was room to contend that the words 'net profits' were intended to be synonymous with the word 'surplus;' the language used was 'from the surplus or net profits.' Under the act of 1904, this contention is no longer possible; the language used is 'from its surplus, or from the net profits.' The evident intent of the change is to point out two funds from which dividends may be made.

13. 73 N.J. Eq. 692, 69 Atl. 1014 (Ct. Err. & App. 1908).

14. The indication by the *Goodnow* court was at least strong enough to persuade the Second Circuit. In *Borg v. International Silver Co.*, 11 F.2d 147, 151 (2d Cir. 1925), the circuit court, citing *Goodnow*, states "it is not unlawful in New Jersey to pay dividends out of profits though the capital be in fact impaired."

15. 73 N.J. Eq. 692, 69 Atl. 1014 (Ct. Err. & App. 1908).

can be more appropriately denominated as "retained earnings" or "earned surplus."[16]

The reasoning used in the selection of the retained earnings definition of "net profits" is that net profits are inconsistent with a capital deficit; and, therefore, if annual net profits are insufficient to offset a capital deficit, it would be improper to consider such profits within the intendment of the statute.[17] Perhaps, the rationale should be articulated as a balancing of the interests of creditors versus the interests of investors in the corporation. It must be emphasized that the rationale does not clearly lead to a construction of the dividend statute that negates use of annual or current profits for the distribution of dividends. Valid reasoning can be predicated upon an entirely different ground which would seem to justify annual or current profits being paid as dividends when capital is impaired. For instance, if a corporation has issued an outstanding cumulative preferred stock and the capital is impaired, and if the retained earnings definition instead of the annual or current net profits definition was chosen, "the result would be . . . to saddle the corporation with a steadily increasing burden of accrued and unpaid dividends despite the existence of current earnings from which dividends could be paid without further capital impairment. This result is manifestly undesirable."[18]

The two lines of reasoning are thus apparent. The first branch is that the term "net profits" is not synonymous with the term "annual" or "current" net profits, because if the legislature intended to make legal the distribution of dividends when capital was impaired, they would have preceded the term "net profits" with the modifying language of "annual" or "current." This is apparently New Mexico's position. The contrary reasoning is predicated upon the premise that the use of the terms "surplus" and "net profits" obviously was meant to establish two primary funds from which a distribution could be made. "Net profits" must mean annual or current net profits if two funds were intended. Otherwise, if "net profits" meant

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> Earned surplus [retained earnings] represents the retained portion of current and prior years' net income, plus or minus the cumulative effect of unusual and nonrecurring gains or losses or other credits and charges assigned directly to earned surplus.

Finney & Miller, Principles of Accounting Intermediate 127 (5th ed. 1958).

17. Lich v. United States Rubber Co., 39 F. Supp. 675 (D.N.J.), *Aff'd mem.*, 123 F.2d 145 (3d Cir. 1941), interpreting N.J. Stat. Ann. § 14:8-19 (1939).

18. Weinberg v. Baltimore Brick Co., 35 Del. Ch. 225, 114 A.2d 812, 818 (1955).

"net profits from the beginning of the business," the term would have no legal significance, being merely a part of surplus or the equivalent of retained earnings.

Having established the interpretation followed by New Mexico, we will now consider the factors which affect the one fund selected or "surplus."

A. Paid-in Surplus[19]

Some jurisdictions permit dividends out of any kind of surplus, earned or unearned, without further limitation. New Mexico is such a state,[20] there being no limitation upon the term "surplus,"[21] at least insofar as par or nominal value stock is concerned. However, where a New Mexico corporation has shares without nominal or par value, paid-in surplus, apparently, is not available for the distribution of dividends. First, paid-in surplus is not an earned surplus; and, the statute dealing with no par dividend distribution qualifies the term "surplus" by the term "earnings."[22] Also, the New Mexico

19. The account designated paid-in surplus includes:
(A) Surplus resulting from transactions in the company's own stock:
(1) Premiums on par value stock.
(2) Excess of amounts received for no-par stock over amounts set up as stated values thereof.
(3) Forfeited part payments on stock subscriptions.
(4) Surplus resulting from miscellaneous stock transactions and changes:
(a) Sale of treasury stock at more than cost.
(b) Retirement of stock at a cost less than the amount set up as stated capital.
(c) Conversion of stock of one kind into a smaller amount of stock of another kind.
(d) Reduction of stated capital.
(B) Surplus resulting from stockholders' contributions:
(1) Donations by stockholders, including gifts and forgiveness of indebtedness.
(2) Assessments on stockholders.
(C) Surplus resulting from contributions by outsiders, including gifts of assets (such as a plant given to induce a company to locate in the donor city) and forgiveness of indebtedness.
Finney & Miller, Principles of Accounting Intermediate 125 (5th ed. 1958).

20. Henn, Corporations § 320 (1961).

21. N.M. Stat. Ann. § 51-3-17 (Repl. 1962) (pertaining to par or nominal value stock).

22.
No corporation having shares without nominal or par value, issued under the provisions of this act [51-4-1 to 51-4-13], shall declare or pay any dividend out of capital or out of anything except net profits or *surplus earnings.*
N.M. Stat. Ann. § 51-4-8 (Repl. 1962.) (Emphasis added.)

statutes define stated capital in a manner which prohibits paid-in surplus disbursement to shareholders of no par stock.[23]

The only surplus legally or definitionally available to shareholders of no par, therefore, is earned surplus or retained earnings and not unearned surplus or paid-in surplus. Moreover, in the situation of a corporation having both par and no par stock, any existing paid-in surplus as a result of the sale of the par value shares is not available for distribution to the no par shareholders. Other jurisdictions have taken a different approach and have allowed directors to set an amount to be considered capital and the excess to be considered paid-in surplus on the no par.[24]

New Mexico's preclusion of paid-in surplus distributions to holders of no par stock is well founded in that it affords creditors greater protection. For example, if New Mexico allowed payment of dividends from unearned surplus and permitted variation of the stated capital amount, the no par stockholders having control of the corporation through their voting power could set a low stated capital and pay a dividend out of the paid-in surplus created. This action would diminish the stockholders' equity to a point which would endanger the creditors' security.

The conclusion is that paid-in surplus is part of the fund available for the declaration and payment of dividends on nominal or par value stock, but since it is unearned surplus it is not part of the fund available for dividends to holders of shares without nominal or par value.

B. Capital Reduction Surplus

New Mexico allows the declaration and payment of dividends exclusively out of "surplus or net profits,"[25] or "net profits or surplus earnings."[26] The question remains in New Mexico as to whether a capital reduction can be effected to release capital; and, thereby, create a surplus from which a legal dividend can be declared on both par and no par shares.

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23. N.M. Stat. Ann. § 51-4-3 (Repl. 1962), quoted in note 1 *supra*.
24. *E.g.*, N.J. Stat. Ann. § 14:8-6 (1939):
> The board of directors shall have the power within thirty days after the issuance of any shares without nominal or par value to determine what part of the consideration for such shares shall be capital and what part, if any, shall be surplus.

25. N.M. Stat. Ann. § 51-3-17 (Repl. 1962) (par value).
26. N.M. Stat. Ann. § 51-4-8 (Repl. 1962) (no par value).

One of two reasons probably exist for the use of a capital reduction: (1) by its aid, many corporations eliminate or reduce capital deficit, thus restoring hope for the declaration and payment of dividends; and (2) the expedient may be used when it develops that assets are greater than can be used profitably by the corporation and the shareholders want to withdraw part of their investment without effecting a complete dissolution.[27] Reduction surplus is not earned surplus; and, apparently, is not available in New Mexico for dividend disbursement to no par shareholders. This results in the peculiar situation that the New Mexico statutes[28] provide for a procedure to reduce capital on both par and no par, but allow its distribution as dividends only to par shareholders. If the reason for the reduction was because the assets of the corporation were greater than necessary to conduct the business, it seems absurd to prohibit distribution to the no par shareholders. A reduction where the assets are too great should make available surplus from which both par and no par shareholders can benefit. The New Mexico statutes should be amended to distinguish the reasons for reduction and to provide for a different treatment of reduction surplus when there is a capital deficit and when there is an excess of assets.

Realizing that reduction results in a natural conflict between the stockholders and the creditors, the New Mexico statutes should make provision for this conflict. The formal procedure set forth in the statutes merely prescribes the manner by which a capital reduction may be accomplished,[29] and authorizes the amendment of the certificate of incorporation to disclose the change;[30] these provisions alone are not sufficient. Clearly, a reduction of the authorized capital stock or number of shares, without any attempt to vary the conditions existing as to stock issued or subscribed for or the conditions as to paid-in capital, creates no serious problem.[31] A reduction affecting capital stock or capital already contributed should be statutorily controlled because of its effect upon present and future creditors and the shareholders of the corporation.[32] Since creditors of a corporation have only the corporate assets to satisfy claims, it is

27. Legislation, 47 Harv. L. Rev. 693 (1934).

28. N.M. Stat. Ann. § 51-3-18 (Repl. 1962) (treating par value shares); N.M. Stat. Ann. § 51-4-10 (Repl. 1962) (treating no-par reduction same as reduction of par value).

29. N.M. Stat. Ann. § 51-3-18 (Repl. 1962).

30. N.M. Stat. Ann. § 51-2-20 (Repl. 1962).

31. Baker & Cary, Corporations 1308 (3d ed. 1959).

32. *Ibid.*

recommended that dividends should not be declared and paid out of reduction surplus except after an amount is earmarked to provide for outstanding creditors' claims. The burden to correct this situation is not the New Mexico Supreme Court's; the legislature should enact a provision controlling the earmarking of reduction surplus to protect the unsecured creditors.

C. Treasury Stock Surplus

Authorized and issued stock of a corporation which is later reacquired but not cancelled is treasury stock.[33] Treasury stock transactions are of interest because of the effect they have upon surpluses available for the distribution of dividends. Two points of time will be focused upon in this discussion of treasury stock: the effect upon surplus at (1) the time of purchase and (2) the time of resale. Of course, a surplus created upon resale would be paid-in surplus and available for dividend disbursement only to par value shareholders.

The New Mexico statutes give little aid as to the method that should be used to account for treasury stock. The statutes do no more than state that a corporation may decrease its own capital stock by retiring or reducing any class of stock and then describe the manner by which the decrease may be accomplished.[34]

New Mexico, however, has one judicial pronouncement concerning the procedure used in accounting for treasury stock.[35] The supreme court asserted that (1) whether or not the purchase or acquisition of a corporation's own stock was to be considered a reduction of capital was a matter of intention of the corporation at the time of the acquisition, (2) treasury stock could properly be reflected as an asset of the purchasing corporation, and (3) the supreme court did not intend to suggest the proper bookkeeping method for treasury stock, but that the method chosen at the time of acquisition must be continued and uniformly applied.[36]

The supreme court's pronouncements relating to treasury stock were apparently made in consideration of whether or not a different standard of accounting should apply when determining surplus availability. It does seem rather arbitrary to allow a corporation to

33. Finney & Miller, Principles of Accounting Intermediate 145 (5th ed. 1958).
34. N.M. Stat. Ann. § 51-3-18 (Repl. 1962).
35. Woodson v. Lee, 73 N.M. 425, 389 P.2d 196 (1963).
36. *Ibid.*

treat treasury stock in any manner it desires so long as the chosen method is uniformly applied. For instance, neither creditors nor stockholders would have any assurance that their respective interests would be protected. If a corporation acquired stock and carried it as an asset, it would not properly reflect the fact that there was a contraction of capital. In this instance, a new creditor might advance credit on the belief that the corporation's supply of capital was greater than actually existed. This would in effect impair the existing creditors' claims against the corporation. The same type of handling, if the acquisition price had been greater than the issuance price, would not reflect a reduction in any surplus account, and under the New Mexico statute[37] a dividend could be declared and paid as though there had been no acquisition of the corporation's own stock. On the other hand, the stockholder might purchase stock expecting that if in the future there was an acquisition of treasury stock it would be reflected by the corporation as an asset, thereby leaving unencumbered the surpluses available for the declaration and payment of dividends. This illustration is intended to show that it is somewhat arbitrary to allow the accounting procedure for treasury stock to be left to a corporation's own self-serving selection of a uniform but not necessarily appropriate procedure. This, however, is exactly the situation that exists in New Mexico.

It would seem wholly inadequate to merely point out the difficulty without suggesting a remedy to the situation—a situation which has been completely neglected by the New Mexico Legislature and which has been stated by the New Mexico Supreme Court as properly handled by accounting uniformity regardless of the method.

Treasury stock transactions and the related problems are by no means unique to New Mexico. A considerable amount of legislative effort has been directed toward revision of corporation statutes, enough perhaps to indicate the trend of modern statutory provisions with respect to treasury stock transactions.[38] "The wide variety of treasury stock provisions . . . recently enacted . . . adequately demonstrates . . . that accountants . . . [have not adopted a] method of disclosure . . . that would reflect properly the legal status of the stockholders' equity accounts."[39] The fact that there

37. N.M. Stat. Ann. § 51-3-17 (Repl. 1962).

38. Sprouse, *Accounting or Treasury Stock Transactions: Prevailing Practices and New Statutory Provisions*, 59 Colum. L. Rev. 882 (1959).

39. *Id.* at 899.

are a wide variety of provisions throughout the different states should not be any solace to the responsible parties in New Mexico who have not attempted to alleviate the complete void in the statutes.

Two suggestions and one recommendation are made for consideration of a solution to the unanswered question of treasury stock accounting in New Mexico. First, the legislature should consider adopting the "contraction of capital" method, whereby the funds expended by a corporation for its own shares are disclosed by a reduction of the contributed capital in the pro-rata portion that each reacquired share represents, and any excess over the pro-rata portion should be shown as a distribution of retained earnings. Under this method, the resale of the treasury shares should be handled in the same manner as was the original issuance of the stock, *i.e.*, the capital stock account would be increased by the par or stated value of the stock and the excess credited to paid-in surplus, and losses debited first to any paid-in surplus resulting from previous treasury transactions and next to retained earnings.[40] Stockholders and creditors should find that treasury stock transactions handled in this manner accurately reflect the economic status of the corporation.[41]

An alternative suggestion would be to limit the acquisition of a corporation's own stock to the retained earnings of the corporation. This theory, perhaps, would be in accord with the notion that the creditors' cushion of capital would not be affected and would be in accord with the expectations of creditors. However, in New Mexico, if the interpretation that "surplus"[42] means any surplus account, it would be of little significance to limit the purchase of treasury stock only from retained earnings, because dividends could still be declared and paid to par shareholders out of paid-in surplus, thereby decreasing the creditors' protection. It is urged, therefore, that the "contraction of capital" method be adopted by statute in New Mexico.

40. Finney & Miller, Principles of Accounting Intermediate 152-53 (5th ed. 1958), discussing the sale of treasury stock at cost, in excess of cost, and at less than cost.

41.

> In favor of the 'contraction of capital' procedure is the manner in which it reflects the logical economic interpretation of the transaction, *i.e.*, the withdrawal of the investment contribution originally received in consideration for the shares and the distribution of a 'dividend' out of retained earnings if the withdrawal exceeds that original contribution.

Sprouse, *supra* note 38, at 899-900.

42. See note 11 *supra* and accompanying text.

D. Earned Surplus[43] *and Restrictions*

In the preceding section, it might have been intimated that earned surplus or retained earnings are always available for distribution as dividends. It is not always technically true that earned surplus may be distributed. Some portion of a corporation's earned surplus or retained earnings may be restricted, either as a result of statutes, or as a consequence of clauses in contracts with creditors or stockholders, or by voluntary action of the board of directors.[44]

The primary purpose of these restrictions is to indicate that certain amounts are not available for dividends, or that the directors intend not to use them for that purpose.[45] The restrictions are generally earmarked funds set aside for contingencies or proposed projects. Proper accounting practice would require disclosure of the surplus restrictions or appropriations so investors and creditors will not be misled. Even if the restriction is not disclosed, the corporation's circumstances may indicate that retained earnings should be considered restricted. It is the duty of the accountant to disclose the restrictions, but the final decision of whether retained earnings are legally available is the responsibility of the court.[46]

E. Unrealized Appreciation[47]

The following hypothetical is set forth to bring the issue into focus. Suppose a corporation is in possession of realty with a book value of five thousand dollars, and that upon a recent appraisal it is learned that the market value of the land is ten thousand dollars. And, further, suppose that the corporation wrote up the realty upon

43. See note 16 *supra*.

44. Finney & Miller, Principles of Accounting Intermediate 128-30 (5th ed. 1958). In New Mexico earned surplus may be restricted or earmarked for "working capital" purposes. N.M. Stat. Ann. § 51-3-16 (Repl. 1962).

45. Finney & Miller, Principles of Accounting Intermediate 128-30 (5th ed. 1958).

46. See text at pp. 166-67 *infra* discussing compelling dividend distribution because of abuse of discretion in retaining accumulated profits.

47. "Unrealized appreciation" is, in accounting terminology, a subdivision of the term "surplus"; it is sometimes referred to as "appraisal surplus" or "appraisal increment." The general rule is that accounting for fixed assets should be based upon cost and appreciation should be recognized upon sale of the assets. Finney & Miller, Principles of Accounting Intermediate 176-77 (5th ed. 1958). See Note, 20 U. Pitt. L. Rev. 632 (1959), discussing cash dividends payable from unrealized appreciation of fixed assets.

their books creating an appraisal surplus because of the appreciation. The issue is whether the unrealized appreciation now appearing upon the corporation's books is included in the term "surplus" in section 51-3-17 of the New Mexico statutes, which would release five thousand dollars for dividend distribution.

The New Mexico Supreme Court discussed the availability of unrealized appreciation as a surplus account from which cash dividends may be declared and paid to stockholders in *Woodson v. Lee*.[48] In *Woodson*, the supreme court examined *Randall v. Bailey*,[49] the landmark decision establishing the availability of appraisal surplus for distribution of dividends. The New Mexico court rejected *Randall* and declared that the generally accepted view is that the "assets of the corporation should not be appreciated in value until sold."[50] The supreme court also noted that exceptions existed in New York[51] (where *Randall* was decided) and where a state's corporation statute authorized the use of unrealized appreciation for dividend purposes.

A reading of the New Mexico court's discussion of *Randall* strongly indicates that unrealized appreciation is not surplus within the meaning of the dividend statute in New Mexico. A complete analysis of *Woodson* adds confusion, however, because the court also declared that accounting procedures consistently applied at the time of the purchase and sale of the stock should be the standard applied in the determination of surplus availability.[52] This might be construed to mean that if a corporation had been recognizing unrealized appreciation at the time of the purchase and sale of the stock and had been consistently following that accounting procedure from year to year, then the corporation could declare and pay dividends from unrealized appreciation. The supreme court probably

48. 73 N.M. 425, 389 P.2d 196 (1963).

49. 288 N.Y. 280, 43 N.E.2d 43 (1942).

50. Woodson v. Lee, 73 N.M. 425, 431, 389 P.2d 196, 201 (1963).

51. In discussing the *Randall* decision the New Mexico Supreme Court stated:

> The New York rule, announced in Randall v. Bailey, 288 N.Y. 280, 43 N.E.2d 43, which permitted revaluation of assets of a corporation to arrive at surplus out of which dividends could be paid, was reached because of the language of the New York statute which is materially different from our own, and because of the legislative history of changes made in the law.

Id. at 431-32, 389 P.2d at 201.

52. The standard is whether the employed accounting methods are consistently applied whether or not such methods are "generally accepted accounting principles." *Id.* at 432, 389 P.2d 202.

did not intend the discussion of accounting procedures to be read in conjunction with the discussion of unrealized appreciation. In fairness to the supreme court, the following rule should be gleaned from *Woodson*: that a uniform method of accounting consistently applied to determine surplus for dividends will not be altered by the court barring the absence of good faith or the presence of fraud, except that the court will intervene to prohibit the distribution of cash or property or stock dividends[53] from unrealized appreciation.

Some states have handled appreciation accounting by statute.[54] New Mexico needs special legislation to clarify the uncertainty; or, at least, a more precise pronouncement by the supreme court to avoid confusion. Of course, New Mexico's choice should be clearly against utilization of unrealized appreciation for dividends, because of the uncertainty of market fluctuations which may cause the estimated appreciation never to be realized by the corporation.

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53. The New Mexico Supreme Court has not indicated that the type of dividend (cash, property, or stock) will cause any change in their attitude toward the availability of unrealized appreciation for distribution as a dividend. In Berks Broadcasting Co. v. Craumer, 356 Pa. 620, 52 A.2d 571 (1947), although the Pennsylvania court was discussing express statutory language, it was stated that there was reason that stock dividends and cash or property dividends should be treated differently when the question involved unrealized appreciation. The New Mexico Supreme Court or the New Mexico Legislature is going to be confronted with the issue of whether the types of dividends should be treated differently. Perhaps, the reasoning of the *Berks* court will be of aid.

Discussing cash or property dividends in relation to unrealized appreciation, the *Berks* court stated:

> The object of this prohibition [*i.e.*, denying use of unrealized appreciation for dividend] is to afford a margin of protection for creditors in view of the limited liability of the shareholders, and also to protect the interest of the shareholders themselves by preserving the capital so that the purposes for which the corporation was formed may be carried out.
>
> * * * *
>
> The reason why a purely conjectural increase in valuations cannot be considered for the purpose of dividends is because such re-appraisals, however apparently justified and accurate for the time being, are subject to market fluctuations, are merely anticipatory of future profit, and may never be actually *realized* as an asset of the company.

52 A.2d at 573-74.

In discussing stock dividends the *Berks* court stated:

> The reason for this distinction [stock dividends compared to cash or property dividends] is that a stock dividend cannot affect creditors or shareholders adversely since, unlike a cash or property dividend, it does not decrease the company's assets.

52 A.2d at 575.

54. See, *e.g.*, N.C. Gen. Stat. § 55-49(d) (Repl. 1965).

F. Depreciation

Accountants consider depreciation as an expense which must be provided for regardless of the level of earnings.[55] Depreciation must be taken into consideration before the retained earnings available for dividends can be gauged. A sufficient number of court decisions establish the fact that an accounting for a depreciation deduction is required, and that the payment of dividends which exceeds the legal sources available less a deduction for depreciation is an impairment of capital.[56]

New Mexico's position in respect to the necessity of a depreciation deduction is clouded by the same language of the supreme court[57] that causes confusion in the other surplus areas. The assertion by the supreme court that a uniform accounting procedure would not be interfered with regardless of whether or not generally accepted accounting methods had been followed indicates that the supreme court would *not* recognize that depreciation should be charged as an expense before retained earnings would become free for dividend distribution.

In *Whittaker v. Amwell Nat. Bank*,[58] a New Jersey court said that whether or not dividends declared and paid are distributed out of surplus or net profits depends upon the determination of the actual value of all the assets of the company at the time when the profits or surplus accrued. The court also stated:

> This can only truly be done by taking into the account the cost of repairs, and also a reasonable allowance for depreciation for wear and tear or constant use, giving credit for all actual permanent improvements. The statute not only warrants, but compels this course.[59]

Although the New Mexico Supreme Court has given great weight to consistency in accounting procedures, a proper regard for consistency should not preclude a desirable change in procedure. When the supreme court is confronted with the situation where a corporation is consistently following a procedure not recognizing deprecia-

55. Finney & Miller, Principles of Accounting Intermediate 355-56 (5th ed. 1958).
56. *Ibid.*
57. Woodson v. Lee, 73 N.M. 425, 389 P.2d 196 (1963).
58. 52 N.J. Eq. 400, 29 Atl. 203 (Ch. 1894).
59. *Id.* at 404, 29 Atl. at 205.

tion as an expense before distributing surplus, the supreme court should apply the correct accounting procedure. Thus, the corporation should be required to account for depreciation, either upon the theory that it is desirable to deduct depreciation before disclosing surplus, or upon the idea that there is a lack of good faith if depreciation is not deducted before surplus is released for distribution. It should be manifestly apparent that neither the supreme court nor the directors of a corporation should be placed in a situation which can be easily avoided by legislative action. The New Mexico dividend statutes in this area as well as others are deplorable, and should be revised.

G. Wasting Assets[60]

The exhaustion of the cost or value of a wasting asset, such as a lumber tract, an oil well, or a mine, is called depletion. Depletion results from the conversion of natural resources into inventories.[61] In some states, wasting asset corporations, by common law or by statute, are allowed to pay dividends out of surplus or net profits plus depletion charges. The theory of such judicial or statutory interpretation is that creditors and shareholders should realize that the sales of the natural resources, reduced to inventory, are partially earnings and partially a return of investment. The wasting asset doctrine, however, is an exception to the generally accepted rule that dividends may not be declared where it will impair capital.

The New Mexico Supreme Court has not been confronted with the wasting asset situation. When the supreme court is faced with the issue of whether or not New Mexico recognizes such an exception, it may respond as did the Supreme Court of Delaware in *Federal Mining & Smelting Co. v. Wittenberg*.[62] In *Wittenberg* the court stated, after observing that the authorities might have been impressive if the issue before the court was the wisdom of adopting by judicial decision the wasting asset doctrine, that

> [T]he crucial question . . . is whether corporations known as wasting asset corporations are excepted from the operation of our statute law with respect to the payment of dividends.[63]

60. See, generally, Annot., 55 A.L.R. 8 (1928).

61. Finney & Miller, Principles of Accounting Intermediate 372 (5th ed. 1958).

62. 15 Del. Ch. 409, 138 Atl. 347 (Sup. Ct. 1927); see also Annot., 55 A.L.R. 8 (1928).

63. 138 Atl. at 351.

The *Wittenberg* court held that the doctrine was not a recognized exception to the Delaware dividend statutes. The New Mexico Supreme Court, if the situation arises, will be faced with the same crucial question because of the similarity of the sections[64] of the New Mexico statutes now in existence and the sections[65] of the Delaware statutes existing at the time of *Wittenberg* in 1927.

When the Supreme Court of New Mexico is asked to declare that a wasting asset corporation shall be excepted from the clear language of the New Mexico statutes, there is no reason why the supreme court should be expected to usurp the legislative power and recognize such an exception. The supreme court should request the legislature to make the decision that rightly belongs to that branch. The court in *Wittenberg* left the decision to the Delaware legislature which responded by recognizing the exception through an amendment to their corporation laws.[66]

The Delaware law in effect at the time of *Wittenberg* has been subsequently amended. The New Mexico legislature should consider the Delaware statute[67] and capitalize upon Delaware's experience which has led to its adoption.

II

DECLARATION AND PAYMENT OF DIVIDENDS

Unless otherwise provided in the original or amended certificate of incorporation, or in a bylaw or resolution adopted by a vote of at least a majority of the stockholders, the directors of every corporation

64. N.M. Stat. Ann. §§ 51-3-16, -17 (Repl. 1962). See note 65 *infra* quoting the comparable Delaware statutes.

65. Del. Rev. Stat. tit. 9, ch. 65, § 34 (1915):

> The Directors of every corporation created under this Chapter shall have power, after reserving over and above its *capital stock paid in*, such sum, if any, as shall have been fixed by the stockholders, to declare a dividend among its stockholders of the whole of its accumulated profits, in excess of the amount so reserved, and pay the same to such stockholders on demand; provided, that the corporation may, in its certificate of incorporation, or in its bylaws, give the Directors power to fix the amount to be reserved. [Emphasis added.]

Del. Rev. Stat. tit. 9, ch. 65, § 35 (1915):

> No corporation created under the provisions of this Chapter, nor the directors thereof, shall make dividends except from the *surplus or net profits* arising from its business. . . . [Emphasis added.]

66. Del. Laws 1927, ch. 85, § 16, at 244. See Wittenberg v. Federal Mining & Smelting Co., 15 Del. Ch. 351, 138 Atl. 352 (Ch. 1927).

67. Del. Code Ann. tit. 8, § 170 (1953).

> created under this article shall, in January in each year, *after reserving over and above its capital stock paid in, as a working capital* for said corporation, *such sum, if any, as shall have been fixed by the stockholders*, declare a dividend among its stockholders of the *whole of its accumulated profits exceeding the amount so reserved*, and pay the same to such stockholders on demand.[68]

A. Compelling Dividends

The rule regarding compelling declaration and payment of dividends may be generally stated as follows: If there is no special provision or contract prohibiting dividends and if the surplus or net profits of a corporation are such that dividends may be declared and paid on the common or preferred[69] stock, the directors may either declare dividends or apply the funds to some other legitimate corporate purpose. The courts will not interfere unless it can be shown that fraud exists or there exists some arbitrary or unreasonable conduct on the part of the directors which would amount to a breach of trust.[70]

The New Mexico Supreme Court has stated that it is as much the duty of corporate directors to distribute earnings as to abstain from a distribution impairing capital.[71] This, however, is the extent to which the situation has been judicially discussed in New Mexico. If fraud or unreasonable conduct are present, the New Mexico Supreme Court would be expected, in the exercise of its equity power, to enforce the rights and satisfy the reasonable expectations of shareholders when profits not required for corporate business, including retention for unexpectancies, are withheld.[72]

In the absence of fraud or unreasonable conduct, when should a court act to compel dividends and what are other operative forces in this area? Since New Mexico adopted its corporate dividend statutes from New Jersey, some of the situations that have occurred in New Jersey will be considered in the hope that their exposure will

68. N.M. Stat. Ann. § 51-3-16 (Repl. 1962). (Emphasis added.)

69. See Cartwright v. Albuquerque Hotel Co., 36 N.M. 189, 11 P.2d 261 (1932). The opinion states that the word "dividend" in the New Mexico statutes seems to apply equally to a dividend upon preferred as well as common stock. *Id.* at 192-93, 11 P.2d at 263.

70. Annot., 76 A.L.R. 885, 888 (1932).

71. Cartwright v. Albuqueqrue Hotel Co., 36 N.M. 189, 195, 11 P.2d 261, 264 (1932).

72. See Stevens v. United States Steel Corp., 68 N.J. Eq. 373, 59 Atl. 905 (Ch. 1905) (holding no reason existed to force a declaration).

acquaint those concerned with corporate affairs with the latent ambiguities in the New Mexico statute.

B. Unless Otherwise Provided

The New Mexico statute[73] states that by a provision in the original or amended certificate of incorporation, or by bylaw or resolution adopted by a majority of the stockholders, a corporation can provide for its own method or rules for the distribution of earnings in the form of dividends. Of course, the provisions replacing those of the statute cannot be in contravention of public policy.[74]

The New Jersey court[75] has had the opportunity to interpret the effect of the phrase "unless otherwise provided" and has professed the view that directions of a supplemental provision can fully cover the subject of dividends,[76] thereby displacing the statutory dictates. Care must be practiced in obviating the statute. For instance, in *L. L. Constantin & Co. v. R. P. Holding Corp.*,[77] the statute and a corporate bylaw were in accord. Later, an amendment displacing the statutory provisions was made to the certificate of incorporation. The amendment was held not controlling because it had not purported to change the bylaw. This was done with due regard to the rule that where an inconsistency exists between the certificate of incorporation and a bylaw the certificate controls. Any attempt in New Mexico to avoid the effect of the statute should be clear and unambiguous.

C. Accumulated Profits

The term "accumulated profits," as used in the New Mexico statutes, is another term that has caused courts interpretative trou-

73. N.M. Stat. Ann. § 51-3-16 (Repl. 1962).

74. See, *e.g.*, Cartwright v. Albuquerque Hotel Co., 36 N.M. 189, 11 P.2d 261 (1932), where a contract, providing for distribution of dividends to the preferred stockholders regardless of the existence of surplus or net profits as specified in N.M. Stat. Ann. § 51-3-17 (Repl. 1962), was held to be void as against public policy.

75. Stevens v. United States Steel Corp., 68 N.J. Eq. 373, 59 Atl. 905 (Ch. 1905). The *Stevens* decision also held that the corporation was a necessary party defendent in an action to compel the declaration of dividends. See Annot., 15 A.L.R.2d 1124 (1951) (discussing parties necessary in action to compel dividends).

76. A supplemental provision can cover the whole subject of dividend distribution so long as such provision is not against public policy—*e.g.*, the provision cannot lead to the impairment of capital.

77. 56 N.J. Super. 411, 153 A.2d 378 (Super. Ct. 1959).

ble. The New Mexico statute provides that the directors shall reserve over and above its capital stock paid in an amount as a working capital. Furthermore, the statute states that the directors shall declare a dividend of the whole of its "accumulated profits" in excess of that reserved. Accumulated profits in excess of the amount reserved are available for dividends; therefore, it is necessary to determine whether certain items—*e.g.*, earned profits not received or earned profits invested in fixed assets—are included within the meaning of "accumulated profits."

Several issues have been raised in the New Jersey courts pertaining to the term "accumulated profits." For example, the New Jersey court[78] has recognized that earned accumulated profits may be a very different thing, for the purposes of distribution, than acmulated profits, in that accumulated profits earned by the corporation may not have been received. To illustrate, a corporation may be carrying large accounts receivable which are reflected as accumulated profits in the proprietorship accounts, when in fact five to fifteen per cent may turn out to be bad debts. Therefore, if a shareholder could compel a distribution of "accumulated profits" earned but not received, a creditor's security would be jeopardized.

The New Jersey statute adopted by New Mexico[79] has been amended by New Jersey to read "surplus or net profits"[80] instead of "accumulated profits." The New Jersey legislature, although not articulating whether "surplus" and "accumulated profits" are synonymous, recognized that the term "accumulated profits," at best, is confusing. Perhaps, a review of the New Jersey legislative history will be a guide to New Mexico, regarding the proper interpretation of "accumulated profits." New Mexico has not substantially amended its statute since adoption, and because of this fact only the early legislative history of the New Jersey statute will be discussed.

In 1891, the New Jersey law was amended, providing that accumulated profits consisting of real property or merchandise necessary for conducting the business of the corporation should not be

78. Stevens v. United States Steel Corp., 68 N.J. Eq. 373, 59 Atl. 905, 908 (Ch. 1905).

79. N.M. Stat. Ann. § 51-3-16 (Repl. 1962).

80. N.J. Stat. Ann. § 14:8-20 (1939). New Jersey's action in changing "accumulated profits" in § 14:8-20 to "surplus or net profits," construed with the change of "surplus or net profits" in § 14:8-19 to "surplus, or net profits" can be interpreted to mean that dividends cannot be compelled if capital is impaired, even though the directors can pay dividends out of annual net profits while capital is impaired.

regarded as a fund available for declaration of dividends.[81] This change amended a statute very similar to New Mexico's. The intent of the New Jersey legislature in enacting the proviso was that the providing only for the setting off of a working capital out of profits was an inadequate protection against the unjust demand of a shareholder for cash based upon the theory that accumulated profits meant more than profits so completely realized as to stand as cash or the equivalent of cash.[82] A New Mexico corporation, if the New Jersey legislative action correctly anticipated the problem, could be faced with a situation of having to borrow funds or liquidate investments to pay dividends upon the demand of a single shareholder.

The other New Jersey legislative action which is important to New Mexico came in 1896[83] when New Jersey reinstated its former law by omitting the 1891 proviso. This, in effect, left "working capital" undefined as it is in New Mexico. The omission of the proviso must have been done with the idea that the power to set off working capital was sufficient protection from the forcing of dividends when the funds were not available. The New Jersey court,[84] however, realized that by not defining "working capital" and by using the ambiguous term "accumulated profits," a corporation's existence might be endangered by forced borrowing or liquidating in order to pay dividends. To compensate for the removal of the proviso, the New Jersey court[85] established a rule giving the directors a broad discretion in determining "working capital."

The New Mexico Legislature should restrict the definition of "accumulated profits" by defining "working capital." However, the legislature may not cure the ambiguous language before the supreme

81. N.J. Laws 1891, ch. 106, § 52, at 176. This amendment to the New Jersey law pertained specifically to manufacturing corporations; however, by subsequent change it applied to all corporations chartered under the New Jersey law. There is no reason why New Mexico should limit the statutory construction to any one type of corporation, because any corporation requiring some asset to continue functioning should not be forced to sell or borrow to declare a dividend upon the mere fact of a book account disclosing accumulated profits. New Mexico's statute § 51-3-16 pertains to any corporation created under the act; this is further reason not to take a restricted view.

82. Stevens v. United States Steel Corp., 68 N.J. Eq. 373, 59 Atl. 905 (Ch. 1905), discussing the New Jersey statute New Mexico adopted and further revisions made by New Jersey.

83. N.J. Laws 1896, ch. 185, § 47, at 293. The New Jersey statute at this date varied from New Mexico's present law. In New Jersey the stockholders (in New Mexico the directors) were given the authority to determine working capital unless by certificate of incorporation or in the bylaws the directors (stockholders in New Mexico) were granted the responsibility.

84. Stevens v. United States Steel Corp., 68 N.J. Eq. 373, 59 Atl. 905 (Ch. 1905).

85. *Ibid.*

court is faced with the problem. The supreme court may adopt the general rule which allows interference only in circumstances of fraud or unreasonable conduct. Or, the supreme court can follow the New Jersey rule allowing interference only in cases of gross abuse of discretion.

The New Jersey Court of Chancery, in *Stevens v. United States Steel Corp.*,[86] has stated what it considers to be the most intelligent reading of the statute. Their conclusion seems to be well founded:

> [O]ur statutes . . . have tried to . . . regulate the discretion of directors in declaring dividends, by laying down a convenient rule defining a situation in which stockholders may justly claim that dividends have been 'improperly' withheld. . . . [N]o rule of equity . . . requires directors to sell property of the corporation at a loss, or borrow money, in order to pay dividends, because an appraisement of the corporate assets exhibits a surplus, or what bookkeepers might call 'profits.'[87]

It is recommended that the New Mexico Supreme Court be guided by the rule enunciated in *Stevens* by the New Jersey Court of Chancery: That the directors of a corporation, acting in good faith, are allowed to control the business of declaring dividends, and the directors can limit the power of a single stockholder to sue for an annual distribution of "accumulated profits," as they appear on paper, to actions of bad faith or gross abuse of discretion.[88] This rule should be satisfactory to both creditor and shareholder.

D. Capital Stock Paid In

Section 51-3-16 of the New Mexico statutes states that the directors shall declare a dividend after reserving over and above its *capital stock paid in* the whole of its accumulated profits. A reading of section 51-3-17 of the New Mexico statutes reveals that the dividends may be declared only out of surplus or net profits. It has been stated that surplus includes paid-in surplus, and that paid-in surplus is that realized above the par or nominal value on the issuance of stock.[89] If section 51-3-16 by the term "capital stock paid in" means

86. *Ibid.*

87. 59 Atl. at 911.

88. Stevens v. United States Steel Corp., 68 N.J. Eq. 373, 59 Atl. 905 (Ch. 1905). Of course, at the time of *Stevens* the power to control accumulation was vested in the majority stockholders instead of the directors.

89. See note 19 *supra* and accompanying text.

the amount in fact paid in and not merely the par value received, one could conclude that this is another of the legislative restrictions upon distribution of the whole of a corporation's accumulated profits. That is, distribution of paid-in surplus could not be compelled by showing a lack of good faith or an abuse of discretion. This lends credence to the view that the term "accumulated profits" is a much narrower term than it might appear to be upon first glance.

CONCLUSION

The varied and innumerable areas of conflict and confusion that exist in the New Mexico dividend statutes make evident the need for legislative reform. A comprehensive study should be made by the legislature. When this needed project is undertaken, it is hoped that this Note will help to expose some of the many areas requiring reform.

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