

# The Stockholders' Equity Section: Form Without Substance?

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The takeover fever of the 1980s produced hundreds of leveraged buyouts, debt financed dividend distributions, and treasury stock repurchases involving massive distributions of corporate assets to stockholders. In many of these restructurings, distributions to stockholders exceeded the net book value of the corporation's assets and were possible only because corporate managers and creditors relied on the fair values (i.e., the current appraised values) of the assets to maintain a positive net worth. These distributions would not have been possible under traditional state legal capital requirements which restricted distributions to earned and contributed capital in excess of the par value of the corporation's outstanding stock. Indeed, the resulting effect of many of the debt-financed restructurings on corporate stockholders' equity sections has been to produce deficit balances not only in retained earnings, but also in total stockholders' equity. This phenomenon leads us to question the relevance of current stockholders' equity disclosures, which focus attention on the source of capital but ignore the capacity of the corporation for making distributions to stockholders.

This article describes the recent changes in state laws regulating corporate distributions which have made these distributions possible and offers alternative accounting presentations that will better inform users of financial statements about (1) corporations' compliance with state laws and (2) their capacity for making distributions. Because of

recent changes in state legal restrictions on corporate distributions new disclosures are necessary for financial statement users to be informed about the fair values of net corporate assets—the basis upon which corporate distributions now may be made in many states.

Existing balance sheet presentations of stockholders' equity segregate the various components according to whether they are contributed or earned. Thus, the typical equity section reports the par value of outstanding stock, additional paid-in capital, and retained earnings.<sup>1</sup> This segregation has its roots in state legal capital requirements designed primarily for the protection of creditors. The traditional view of minimum legal capital is that some amount of assets (usually an amount equal to the par or stated value of outstanding stock) must be maintained to buffer the claims of creditors against bankruptcy.<sup>2</sup> To protect this buffer, the dollar amount of distributions that a corporation is able to make to stockholders typically has been limited to assets earned by the corporation (i.e., current or retained earnings) or to assets contributed in excess of the minimum legal capital (e.g., additional paid-

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<sup>1</sup> AICPA, *Accounting Trends and Techniques*, 43rd ed., J. Shohet and R. Rikert (eds.) (NY: AICPA, 1989).

<sup>2</sup> M. A. Miller, *Miller Comprehensive GAAP Guide 1990* (New York: Harcourt Brace Jovanovich, 1989), p. 38.01.

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The authors gratefully acknowledge the contributions of two anonymous reviewers and suggestions provided by Barney Cargile, Frank Rayburn, Keith Shriver, and Mary Stone.

in capital). However, as this paper reveals, the traditional view is outdated given the recent changes in state corporation codes that govern distributions to stockholders.

While the legal capital concept evolved from the desire to protect creditors against prejudicial distributions to corporate stockholders, disclosures about legal restrictions on corporate distributions are important to all the parties who have a financial interest in a corporation, including government, suppliers, employees, management, and stockholders. Each of these parties has an interest in the continued viability of the business entity as well as an interest in protecting their own rights relative to the other groups in the event of reorganization or liquidation. Both the continuity of the business enterprise and liquidation rights may be affected by illegal distributions of corporate assets. However, current financial statement disclosures do not include such basic information as what legal restrictions exist regarding distributions to stockholders (e.g., dividends, redemptions, and treasury stock purchases), whether or not a corporation is in compliance with state legal requirements, or the corporation's capacity for making distributions.

As an example of the inadequacies of exist-

ing accounting disclosures, consider the 1987 and 1988 stockholders' equity balance sheet sections of Holiday Corporation, the parent corporation of Holiday Inns of America (see Exhibit 1). The January 2, 1987 stockholders' equity section reports the traditional segregation of stockholders' equity items: par value of common stock, additional paid-in capital, and retained earnings, less treasury stock at cost, and foreign currency adjustments. Total stockholders' equity is \$639 million. However, the January 1, 1988 stockholders' equity section reveals a \$770 million deficit in Holiday's total stockholders' equity. How did this deficit occur? The explanation lies in the \$65 per share dividend that Holiday distributed in 1987 to prevent a hostile takeover. This aggregate \$1.55 billion dividend, financed with borrowed funds, not only exceeded the corporation's retained earnings but total stockholders' equity as well by more than three quarters of a billion dollars.

Holiday was able to borrow a large portion of the amount required for the dividend by using the fair value (i.e., appraised value) of its real estate assets as collateral. Holiday was able to distribute the dividend (legally, according to Delaware law) because the fair value of its assets exceeded its liabilities after the

**Exhibit 1**  
**HOLIDAY CORPORATION AND CONSOLIDATED SUBSIDIARIES BALANCE SHEETS**

(In thousands, except share amounts)	January 1, 1988	January 2, 1987
Stockholders' equity		
Preferred stock, \$100.00 par value, authorized - 150,000 shares, non issued	—	—
Special stock, authorized - 5,000,000 shares		
Series A-\$1.125 par value, redeemable at \$105.00, convertible into 1.5 shares of common stock, outstanding-none and 170,171 shares (excluding none and 98,072 shares held in treasury)	—	191
Series B-\$1.25 par value, none issued	—	—
Common stock, \$1.50 par value, authorized-120,000,000 shares, outstanding-26,225,980 and 23,592,569 shares (excluding 14,613,417 and 17,246,828 shares held in treasury)	39,339	35,389
Capital surplus	12,625	205,717
Retained earnings (deficit)	(791,021)	404,655
Cumulative foreign currency translation adjustment	7,972	(63)
Restricted stock	(38,861)	(7,156)
Total stockholders' equity	<u>(769,946)</u>	<u>638,733</u>
Total liabilities and stockholders' equity	<u>\$2,399,272</u>	<u>\$2,278,189</u>

distribution, and therefore it had positive equity on a fair value basis. However, the traditional accounting disclosures of par value, additional paid-in capital, and retained earnings do not contain any information (either before or after the dividend distribution) enabling financial statement users to assess the corporation's capacity for making such distributions. While stockholders and other interested parties may have had notice of Holiday's intent to leverage its assets to make the massive dividend, only Holiday's management had information about the fair values of the assets involved.

The point of the Holiday example is that state laws governing a corporation's ability to make distributions to stockholders have continued to evolve from the time when minimum legal capital was considered to be equivalent to the par value of the corporation's stock. That traditional equivalency of minimum legal capital and par value no longer holds in many states. Thus, the traditional stockholders' equity presentation of par value, additional paid-in capital, and retained earnings is obsolete because it implies that some amount, represented by a portion of stockholders' equity, exists to protect creditors. Furthermore, Holiday's situation is by no means unique.<sup>3</sup> In recent years, hundreds of other large corporations have engaged in leveraged buyouts, debt financed dividends, treasury stock purchases and other corporate restructurings also financed largely by debt.<sup>4</sup> Thus, the issues of stockholders' equity presentation and disclosure are both timely and relevant.

The remainder of this paper is organized as follows. In the next section, we discuss the evolution of minimum legal capital requirements for corporations that influenced existing accounting presentation and disclosure practices. In the following section, we describe recent trends in legal restrictions on corporate distributions to stockholders. Finally, we provide recommendations for changes in reporting stockholders' equity that include disclosures regarding the corporation's compliance with applicable laws and the corporation's capacity to make distributions to stockholders.

## **DEVELOPMENT OF LEGAL CAPITAL REQUIREMENTS AND ACCOUNTING DISCLOSURES**

### **Development of Legal Capital Requirements**

The concept of legal capital evolved during the 18th Century as businesses began to require large amounts of capital for long-term ventures.<sup>5</sup> Early charters for long-term ventures such as banking and insurance businesses included restrictions that limited distributions to owners to the amount of profits, thus preserving the owners' original investment as permanent, nondistributable capital to provide a buffer to protect creditors. These prudent business practices were copied from charter to charter and became the basis for judicial decisions involving corporations. With the advent of the corporation as a separate legal entity and the limited liability of stockholders, the legal capital concept became important for protecting corporate creditors. Stockholders were to be both the shock absorbers for bumps in the business cycle and the recipients of any residual assets in the event of business failure. On the other hand, creditors were given a preferred legal status because they were external investors, whose control over the success or failure of the business was more limited.

According to Manning,<sup>6</sup> five judicial theories evolved concerning stockholders' liability for stock issued at less than par value: (1) the trust fund theory (stockholders hold the contributed capital in trust for creditors, retaining a residual interest upon liquidation), (2) the fraud theory (capital contributions were

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<sup>3</sup> See, for example, the annual reports for Shoney's and Interco for 1987 and 1988.

<sup>4</sup> During 1988, these corporations engaged in stock repurchases of more than \$1 billion each: UAL, IBM, CSX, Sears Roebuck, Digital Equipment, Gillette, Schlumberger, Dow Chemical, and GTE. In addition, there were over 300 LBOs in 1988; 17 LBOs were in excess of \$1 billion. The RJR-Nabisco acquisition was the largest LBO, at \$25.3 billion.

<sup>5</sup> B. Manning, *A Concise Textbook on Legal Capital*, 2nd ed. (Mineola, NY: Foundation Press, 1981) provides a complete treatment of the development of legal capital.

<sup>6</sup> *Ibid.*

required to avoid a fraud upon other investors, i.e., creditors), (3) the statutory obligation theory (stockholders held liable on the basis of state statutory requirements for maintaining minimum capital), (4) the contract by subscription theory (stockholders' liability was based on their subscription contract), and (5) the balance sheet misrepresentation theory (classic tort misrepresentation that shares were fully paid when, in fact, they were not). As Hendriksen<sup>7</sup> notes, the trust fund theory found its way into corporate accounting by the separate classification of capital stock and additional paid-in capital. Originally, the par value of capital stock was equivalent to legal capital and thus was unavailable for distribution to stockholders. The par value served as a buffer for the protection of creditors, ensuring that the stockholders rather than creditors, would in fact bear the residual risk of bankruptcy.

The earliest state statutes governing corporations gave substance to the accounting disclosure idea, restricting distributions based on two requirements: insolvency and capital impairment. Capital was assumed to be equal to the total par value of stock. For example, the 1825 Corporation Act adopted in New York made it unlawful for directors or managers "to divide, withdraw, or in any way pay to the stockholders, or any of them, any part of the said capital stock...without consent of the legislature."<sup>8</sup> However, restrictions on corporate distributions varied widely among the states even after the American Bar Association's Committee on Corporate Laws released the first Model Business Corporation Act (MBCA) in 1950. According to the 1950 Model Act, a corporation was permitted to make distributions to stockholders so long as the corporation was not insolvent.<sup>9</sup> Significantly, distribution in the form of dividends still had to come from retained earnings or, according to a 1965 amendment, from current earnings. Other distributions, such as treasury stock purchases, could be made directly from paid-in capital in excess of par value if the source of the distribution was disclosed, the corporation was not insolvent, and the articles of incorporation permitted such distribution. Thus, a

solvent corporation could make a distribution to its stockholders even though the corporation had a deficit in retained earnings.

Insolvency was not defined in most early state corporate statutes. Confusion often arose about whether insolvency meant a deficiency of assets over liabilities and legal capital (the traditional bankruptcy definition developed by courts of law) or an inability to pay debts (the definition developed by courts of equity). In the 1950 Model Business Corporation Act, insolvency was defined as the inability to pay debts as they come due in the normal course of business. As discussed below, insolvency is now defined by the 1984 Revised Model Business Corporation Act as either (1) the inability to pay debts as they come due or (2) as an excess of liabilities over asset *fair values* (i.e., appraised values). This latter interpretation allows corporations, such as Holiday, to make distributions even when the book value of total stockholders' equity is a deficit.

In this century, restrictions on corporate distributions based on legal capital have had little impact because the practice of using nominal amounts for par or stated values of capital stock has evolved, thereby giving corporate directors much latitude in declaring distributions to stockholders. In addition, although corporate boards of directors were statutorily bound to preserve paid-in capital in excess of par, they often were given the ability under state law to make transfers from paid-in capital in excess of par value to retained earnings by resolution. The recent wave of corporate restructurings has resulted in distributions in which the impairment of capital, as least as measured by GAAP, is clear-cut. Given the large number of restructuring transactions that have occurred, and the fact that many of these have been possible only because of the new flexibility of corporate

<sup>7</sup> E. S. Hendriksen, *Accounting Theory*, Fourth Edition (Homewood, IL: Irwin, 1982): pp. 464-465.

<sup>8</sup> D. Kehl, "The Origin and Early Development of American Dividend Laws," *53 Harvard Law Review* 36(1939), p. 56.

<sup>9</sup> American Bar Association Committee on Corporate Laws, *Model Business Corporation Act* (rev.) (Philadelphia: ABA, 1979), p. v.

laws, the relevance of the traditional accounting disclosures about a corporation's compliance with state law and the corporation's capacity for making distributions to stockholders merits reconsideration. These issues have become even more critical, as some recently restructured, highly leveraged corporations have begun defaulting on their obligations.

### Development of Current Accounting Disclosures for Stockholders' Equity

Accounting Research Bulletin No. 43 and Accounting Principles Board Opinions Nos. 9, 12 and 14 describe required disclosures for stockholders' equity. The treatment of capital transactions and disclosures in these pronouncements is brief and may be summarized as follows: (1) capital transactions shall be excluded from the determination of net income, and (2) disclosure of changes in the separate accounts comprising stockholder's equity is required. No mention is made in Accounting Research Bulletins, Accounting Principles Board Opinions, or Financial Accounting Standards Board Statements of the need to disclose the minimum legal capital amount or the state statutes that restrict distributions. However, legal capital is discussed in other nonauthoritative literature.<sup>10</sup>

In Technical Practice Aid Section 2210.18,<sup>11</sup> a corporation purchased such a large amount of treasury stock that its entire retained earnings and additional paid-in capital balances were exhausted. In that case, the relevant state law prohibited such purchases where capital was impaired, so the corporation inquired whether or not it was proper to write up asset values to fair value. The reply cites APB Opinion No. 6 to the effect that write-ups of asset values are not appropriate apart from reorganizations or quasi-reorganizations.<sup>12</sup>

In addition, Issues Paper 88-1, "Quasi-Reorganizations," contains some interesting comments on existing stockholders' equity disclosures.<sup>13</sup>

Because subdividing equity according to its sources appears to be *based on legal concepts and not accounting concepts*, there is no reason to prohibit a change in that subdivision if the law permits it.... *Apart from providing some inconclusive information about legal*

*restrictions on payments of dividends, statistics about the sources of a reporting entity's equity provide little useful information.* For many reporting entities these statistics have already been affected by capitalizations of earnings in connection with stock distributions, business combinations accounted for by the pooling of interests method, and the like. Further, though a deficit in reported retained earnings could result from cumulative losses from operations, a deficit is also a function of the reporting entity's dividend policy and the extent of, and the accounting for, its treasury stock transactions. The fact that there is a deficit, or its amount, may provide little useful information by itself (emphasis added).

The observation that segregating stockholders' equity according to its sources—par or stated value, additional paid-in capital in excess of par or stated value, and retained earnings—"appears to be based on legal concepts and not accounting concepts" is true historically, but it ignores the trend in state corporation codes away from using par or stated value to limit distributions to stockholders. This statement might better have said that the accounting practice is based on an outmoded understanding of legal concepts. Furthermore, the statement that "statistics about the sources of a reporting entity's equity provide little useful information" also is a telling indictment of current stockholders' equity disclosures.

Exhibit 2 shows a representative stockholders' equity presentation and accompanying note for Potlatch Corporation taken from *Accounting Trends and Techniques*.<sup>14</sup> This ex-

<sup>10</sup>AICPA Committee on Terminology, *Accounting Terminology Bulletin No. 1* (NY: AICPA, 1953); FASB, *Statement of Financial Accounting Concepts No. 6* (Stamford, CT: FASB, 1985), fn. 29.

<sup>11</sup>L. Lindenberg, ed., *AICPA Technical Practice Aids* (Chicago: Commerce Clearinghouse, 1986), p. 1171.

<sup>12</sup>Since the inquiry by the corporation's accountants was *post hoc*, the distribution apparently was illegal and would have subjected the individual members of the corporation's board of directors to personal liability. Such a result could have been avoided had the corporation simply reorganized by reincorporating in a state that has adopted the 1980 or later provisions of the MBCA.

<sup>13</sup>AICPA, Accounting Standards Division, Issues Paper 88-1, *Quasi-Reorganizations* (NY: AICPA, 1988).

<sup>14</sup>AICPA, *Accounting Trends and Techniques*, 43rd ed., J. Shohet and R. Rikert (eds.) (NY: AICPA, 1989).

ample was included in *Techniques* to illustrate the accompanying note describing the convertibility features of the preferred stock and voting rights. We include it here because the stockholders' equity section shows the traditional source of equity divisions among preferred and common stock, additional paid-in capital, and retained earnings, less treasury stock. However, what the example from *Techniques* fails to reveal, and what is disclosed nowhere in the annual report, is the amount legally available for distribution to stockholders. Although not disclosed in the annual report, Potlatch Corporation is incorporated in Delaware (though it has no operations there). According to Delaware law, as noted in the next section, capital surplus (i.e., the amount available for distribution to

stockholders) consists of the excess of net assets (*at fair value*) over par value. Therefore, the amount that Potlatch may legally distribute is at least equal to Potlatch's \$722 million book value of stockholders' equity less \$81 million par value. The *book value* is irrelevant, however, since the actual amount distributable is the *fair value* of Potlatch's assets in excess of \$81 million (and Potlatch owns approximately \$250 million in land, which could well have a higher fair value). This actual amount cannot be determined from the traditional stockholders' equity presentation and disclosures. Neither creditors nor stockholders are provided with information about the corporation's compliance with Delaware law (or even in which state Potlatch is incorporated) or its capacity for making distributions.

**Exhibit 2**  
**EXAMPLE OF CURRENT DISCLOSURE FOR STOCKHOLDERS' EQUITY**

Potlatch Corporation  
December 31

	<u>1988</u>	<u>1987</u>
	(\$000)	(\$000)
Stockholders' Equity (Note 8):		
Preferred Stock, \$3.75 Series B convertible exchangeable, without par value		
Authorized 4,000,000 shares, issued and outstanding 999,996 shares	\$ 50,000	\$ 50,000
Common Stock, \$1 par value		
Authorized 40,000,000 shares, issued 30,812,380 shares	30,812	30,812
Additional paid-in capital	73,623	73,847
Retained Earnings	650,974	567,900
Common shares in treasury 3,904,399 (3,958,769 in 1987)	(83,368)	(84,525)
Total stockholders' equity	722,041	638,034

**NOTES TO FINANCIAL STATEMENTS**

*Stockholders' Equity*

The preferred stock, which has a liquidation value of \$50 per share, is convertible at the option of the holder at any time, unless previously redeemed, into common stock of the company at the rate of 1.8868 shares of common stock for each share of preferred stock, or a conversion price of \$26.50 per share of common stock. On any dividend date beginning April 15, 1989, the preferred stock is also exchangeable at the option of the company, in whole but not in part, for 7.5 percent convertible subordinated debentures. The debentures, if issued, will be convertible into common stock of the company at the conversion price in effect for the preferred stock. The preferred stock may not be redeemed prior to April 15, 1989. On or after such date, it will be redeemed at the option of the company, in whole or in part, at redemption prices declining to \$50 per share on April 15, 1996, plus accrued and unpaid dividends. Dividends on the preferred stock are paid quarterly.

In general, all holders of Potlatch common stock as of December 12, 1985, and stockholders after that date who own shares 48 consecutive months or longer ("long-term holders") are entitled to exercise four votes per share of stock so held, while stockholders who are not long-term holders are entitled to one vote per share. All stockholders are entitled to only one vote per share on matters arising under certain provisions of the company's charter.

Source: *Accounting Trends and Techniques*, 43rd ed., J. Shohet and R. Rikert (eds.) (NY: AICPA, 1989).

## CURRENT TRENDS IN LEGAL RESTRICTIONS ON DISTRIBUTIONS

Since 1950, the American Bar Association's Committee on Corporate Laws' Model Business Corporation Act has been very influential in shaping state laws governing corporations. This model act was eventually adopted, at least in part, by 35 states. The MBCA has been revised many times over the years. However, the 1980 revisions were particularly noteworthy with regard to the concept of legal capital. The Committee's report on the 1980 revisions to the Model Business Corporation Act reflects the dramatic nature of the changes in the financial provisions that were adopted at that time:<sup>15</sup>

The amendments...reflect a complete modernization of all provisions of the Model Act concerning financial matters, including (a) *the elimination of the outmoded concepts of stated capital and par value*, (b) the definition of "distribution" as a broad term governing dividends, share repurchases and similar actions that should be governed by the same standard, (c) the reformulation of the statutory standards governing the making of distributions, (d) the elimination of the concept of treasury stock, and (e) the making of a number of technical and conforming changes....

It has long been recognized by practitioners and legal scholars that the pervasive statutory structure in which "par value" and "stated capital" are basic to the state corporation statutes does not today serve the original purpose of protecting creditors and senior security holders from payments to junior security holders, and may, to the extent security holders are led to believe that it provides some protection, *tend to be misleading*. In light of this recognized fact, the Committee...deleted the mandatory concepts of stated capital and par value... (emphasis added).

The 1980 Model Act retained the same equity definition of insolvency as the 1950 Act, i.e., the requirement that in order to make distributions the corporation must be able to pay its debts as they come due. However, a major change was introduced in Section 45(b) that includes a second substantive test prohibiting distributions if the corporation's total

assets would be less than the sum of total liabilities plus any liquidation preferences of preferred stock. This requirement, by itself, does not seem troubling. The next paragraph, though, "contains the big bomb."<sup>16</sup>

Determination [of net assets] may be based upon (i) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances, or (ii) *fair valuation* or other method that is reasonable in the circumstances (emphasis added).

The Committee report discusses at length the decision to allow fair valuation in addition to GAAP. "This does not mean that the statute is intended to reject the use and reliance upon generally accepted accounting principles; on the contrary, it is expected that their use would be the basic rule in most cases."<sup>17</sup> However, the report also states that "the statute...specifically authorizes departures from historical cost accounting and sanctions the utilization of appraisal methods for the purpose of determining the funds available for distributions."<sup>18</sup> Accordingly, it seems that attorneys have resolved, for their purposes, the debate that has raged for years among accountants as to which measurement basis is appropriate: the legal profession has resolved that when push comes to shove, fair values are more appropriate, at least for purposes of determining the measurement of asset values for distributions to stockholders.<sup>19</sup> The legal standard now appears to favor historical cost (i.e., GAAP) as a routine matter, but also permits fair values to be used. The important questions for accounting disclosure are: when and how are these fair values to be disclosed? We address these questions in the section below.

<sup>15</sup>"The Report of the Committee on Corporate Laws," *The Business Lawyer* (July 1979), pp. 1867-1889.

<sup>16</sup>Manning, *op. cit.*, p. 171.

<sup>17</sup>"The Report of the Committee on Corporate Laws," *op. cit.*

<sup>18</sup>*Ibid.*

<sup>19</sup>There is some judicial support for allowing corporations to make distributions based on excess net fair values of assets even aside from the revised MBCA (see *Randall v. Bailey*, 288 N.Y. 280 (1942)), although the decision has not been followed by any other court.

Currently, the 50 states may be classified into one of three groups for purposes of comparing restrictions on distributions.<sup>20</sup> The least restrictive group consists of 18 states, including 17 that either follow the 1984 Revised Model Business Corporation Act or have similar uniform tests for distributions, i.e., (1) the corporation must be solvent and (2) distributions must not exceed the fair value of net assets plus liquidation preferences.<sup>21</sup> Because solvency is defined in these state statutes as the ability to pay debts as they come due, the concept of par or stated value as minimum legal capital has been deleted from these state corporation codes. Accordingly, existing ac-

counting presentation of stockholders' equity by source for corporations incorporated in these states can be explained only by tradition.

The largest group, consisting of 22 states, also has a solvency requirement but, in addition, has separate requirements for distributions that take the form of dividends, treasury

<sup>20</sup>McGough, "The Legal Significance of the Par Value of Common Stock: What Accounting Educators Should Know," *Issues in Accounting Education* (Fall 1988), pp. 330-350, at p. 341.

<sup>21</sup>American Bar Association Committee on Corporate Laws, *Model Business Corporation Act Annotated* (3d Ed.) (Englewood Cliffs, NJ: Prentice-Hall, 1989), p. xxxiv.iv.

### Exhibit 3 SELECTED STATUTES LIMITING CORPORATE DISTRIBUTIONS

#### California:

##### **Sec. 500. Distributions; retained earnings or assets remaining after completion.**

Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders except as follows:

- (a) The distribution may be made if the amount of the retained earnings of the corporation immediately prior thereto equals or exceeds the amount of the proposed distribution; or
- (b) The distribution may be made if immediately after giving effect thereto:
  - (1) The sum of the assets of the corporation...would be at least equal to 1 1/4 times its liabilities...; and
  - (2) The current assets of the corporation would be at least equal to its current liabilities....

West's Ann. Cal. Code (1988 Supplement)

#### Delaware:

##### **Sec. 170. Dividends.**

(a) The directors of every corporation...may declare and pay dividends...either (1) out of its surplus...or (2) in case there shall be no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year.

##### **Sec. 154. Determination of amount of capital; capital, surplus and net assets defined.**

Any corporation may, by resolution of its board of directors, determine that only a part of the consideration which shall be received by the corporation for any of its capital stock...shall be capital; but [capital shall not be less than par value for any stock having a par value].... The excess, if any, at any given time, of the net assets of the corporation over the amount so determined to be capital shall be surplus.

Del. Code Ann. (1983)

#### Hawaii:

##### **Sec. 415-45. Distributions to shareholders.**

Subject to any restrictions in the articles of incorporation, the board of directors may authorize and the corporation may make distributions, except that no distribution may be made if, after giving effect thereto, either:

- (1) The corporation would be unable to pay its debts as they become due in the usual course of its business; or
- (2) The corporation's total assets would be less than the sum of its total liabilities and...the maximum amount that then would be payable, in any liquidation, in respect of all outstanding shares having preferential rights in liquidation.

Determinations under paragraph (2) may be based upon (a) financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances, or (b) a fair valuation or other method that is reasonable in the circumstances

Haw. Rev. Stat. (1985)

stock purchases, redemptions, and partial liquidations in accordance with the 1950 Model Business Corporation Act and subsequent modifications. Generally, these states require that dividends must come from earned surplus (i.e., retained earnings). In some cases, however, this second group of states permits distributions from capital surplus (i.e., additional paid-in capital). Par value or stated capital is never directly available for distribution. However, in many states the board of directors is statutorily granted the authority to reallocate stated capital to additional paid-in capital by resolution. Thus, distributions may come from any one of the following sources: retained earnings, additional paid-in capital, or stated capital. The remaining states use various hybrid restrictions, usually consisting of solvency and balance sheet tests.

Exhibit 3 contains excerpts from three state corporation statutes to illustrate the different legal restrictions that currently exist. As shown in the exhibit, California is one of the hybrid states, and it relies on two tests. Distributions may come either from retained earnings or may be paid exclusive of retained earnings if a balance sheet solvency test is met. California does not permit valuing assets other than marketable securities at fair value. Delaware, on the other hand, grants the corporation's directors the authority to rely on appraised values of assets in determining the amount of available surplus.<sup>22</sup> Delaware law thereby permits distributions from capital surplus (defined as the excess of net assets [*at fair value*] over stated capital) or from current net profits. Hawaii's provisions governing distributions are similar to the 1980 MBCA that was discussed in the previous section and, thus, specifically authorizes distributions up to the excess net fair value of assets.

Thus far, we have summarized the development of existing accounting presentation and disclosures and the new legal restrictions on corporate distributions to stockholders. In the next section, we suggest some alternatives for reporting a corporation's compliance with statutory restrictions on distributions to stockholders as well as the corporation's capacity for making distributions.

## RECOMMENDED PRESENTATION AND DISCLOSURES

To make stockholders' equity presentation and disclosures more relevant, attention must be given to the purpose of the disclosures. Should the purpose simply be to report the sources of capital, or should the purpose be to inform readers (1) *what* state legal restrictions exist and whether or not the corporation has made any distributions to stockholders in *violation* of the laws of the state of incorporation, and (2) the amount of capital, if any, that the directors *may distribute* legally without violating state law? If the purpose is to disclose compliance and capacity to make distributions, then identification of the source of capital, whether from earnings or paid-in sources, is irrelevant.

We agree with the statement in AICPA Issues Paper 88-1 that "Apart from providing...information about legal restrictions on payments of dividends, statistics about the sources of a reporting entity's equity provide little useful information."<sup>23</sup> Reporting capital stock, additional paid-in capital, and retained earnings in the traditional manner provides little useful information except for corporations incorporated in states that continue to follow the 1950 Model Business Corporation Act. For corporations incorporated in states that have adopted the 1980 or 1984 MBCA (allowing assets to be valued at fair value for determining the capacity for distributions), the traditional reporting based on source of capital is no longer relevant.

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<sup>22</sup>Del. Code Ann. Cum. Supp. (1988) Sec. 172 states that board members are fully protected when they rely in good faith on information provided by professionals or experts "as to the value and amount of the assets, liabilities and/or net profits of the corporation or any other facts pertinent to the existence and amount of surplus...." Delaware has been called "the Liechtenstein of the United States" because its liberal business laws have attracted 56 percent of Fortune 500 corporations and 45 percent of corporations listed on the New York Stock Exchange to incorporate in the state. P. M. Barrett, "Delaware Moves Closer to Adopting Law to Deter Hostile Takeovers," *The Wall Street Journal* (December 9, 1987).

<sup>23</sup>AICPA, Accounting Standards Division, Issues Paper 88-1, *Quasi-Reorganizations* (NY: AICPA, 1988).

What information should be reported? At a minimum, disclosure of the corporation's compliance with restrictions on distributions according to the applicable state law should be provided in a footnote to the financial statements. Presentation of the stockholders' equity section in the balance sheet could be reduced to a single line item. Of course, other balance sheet presentations are possible and should be explored. Accompanying notes should specify the number of shares authorized, issued, and outstanding for each class of stock and the rights associated with each class. For determination of compliance, the notes should clearly describe the state requirements, including whether the applicable test is solely an insolvency standard or more restrictive, and should specify how the law applies to the corporation. For example, if the state law contains an insolvency test and, in addition, requires the distribution to come from retained earnings or current earnings, then the note should so indicate and also should reveal the dollar amount necessary to meet current obligations as they come due.

In addition to disclosing the corporation's current compliance with state legal restrictions, the note also should indicate the corporation's capacity for current distributions. As with the compliance disclosure, the corporation's capacity to make distributions will depend on the particular legal requirements of the state of incorporation. For solvency states, the disclosure should indicate the corporation's current ability to meet obligations as they come due, e.g., its quick asset ratio. Other information, such as the existence of any nonrecurring obligations that are expected to come due in the foreseeable future or short-term borrowing capacity, also would be useful. For states that restrict distributions based on an excess of net assets at either book or fair value, the corporation's capacity to make current distributions within these limits should be disclosed. This would necessitate a disclosure of the excess of either book value or fair value of assets over liabilities, depending on the applicable state law.

While disclosure of the excess fair value of assets may seem heretical to some accountants,

the legal and financial communities already have adopted this approach to measure a corporation's ability to make current distributions to stockholders. Shouldn't this information be provided to stockholders, creditors, and other parties who have an interest in the continuity of the corporation? Consider the position in which the stockholders and creditors of Holiday Corporation found themselves at the end of 1987. Did they have any inkling that the Company had the capability of paying out a \$65 per share dividend? And, consider those who bought and sold the stock when rumors of a takeover were rife. Had those stockholders been informed of the possibility of a large payout, would these investors have sold their stock? Unfortunately, the investors were not given the choice because the accounting disclosures for stockholders' equity did not describe Holiday's capacity for making distributions permitted by state law.

Finally, it seems critical to update the disclosures of distribution compliance and capacity after such a restructuring has occurred so that investors can monitor the progress of the restructured entity. For example, in the case of Holiday Corporation, subsequent disclosures were made regarding the gains on sales of hotel properties, but not about discrepancies between amounts realized and appraised values. The appraisals were the basis for the extra-large dividend—and to its related refinancing. Given the events subsequent to the recapitalization (i.e., a class action suit, debt refinancing, and, ultimately, sale of the company to a foreign corporation), such disclosures undoubtedly would have been useful to stockholders, suppliers, regulators, and other interested parties.

In Exhibits 4 and 5, we provide two examples of how disclosures of compliance with state restrictions on distributions and distribution capacity might look. Exhibit 4 presents the disclosure for a corporation that is incorporated in a state that follows the approach of the 1980 and 1984 Model Business Corporation Acts. Exhibit 5 presents a sample stockholders' equity presentation and footnote disclosure for a corporation incorporated in a state that follows the earlier 1950 MBCA. In both situa-

**Exhibit 4**  
**RECOMMENDED PRESENTATION OF STOCKHOLDERS' EQUITY AND**  
**DISCLOSURES OF DISTRIBUTION LIMITATIONS**

(For Corporations Incorporated in States Following the 1980 or 1984 Model Business Corporation Acts)

**XYZ Corporation**  
**Balance Sheet**  
**December 31**  
**Stockholders' Equity Section**

	1990	1989
Stockholders' Equity	\$xxx,xxx	\$xxx,xxx

**Note xx: Stockholders' Equity**

As of December 31, 1990, there were 1,000,000 shares of common stock authorized; 500,000 issued; and 400,000 outstanding. Total contributed capital at December 31, 1990 was \$xxx,xxx. Total retained earnings at December 31, 1990 was \$xxx,xxx. There were no changes in contributed capital during 1990. For changes in retained earnings, see the accompanying statement.

**Note xx: Distributions to Stockholders**

XYZ Corporation is incorporated in the State of X. State law requires all corporations to meet two requirements before distributions can be made. The corporation must be solvent, and the corporation's assets (measured on a fair value basis) must exceed its liabilities and any liquidation preferences both before and after the distribution. As of December 31, 1990, the corporation's financial position meets both of these requirements. The fair value of the corporation's net assets is \$xxx,xxx at December 31, 1990.

(If the corporation's charter prohibits the use of the fair value basis or if the corporation's board of directors has adopted an equivalent resolution, the footnote should acknowledge that fact and then state that distributions are limited to the value of the corporation's net assets on an historical cost basis, which is \$xxx,xxx at December 31, 1990.)

tions, the current balance sheet stockholders' equity sections have been replaced with a single line reporting total stockholders' equity. The accompanying footnotes would disclose the usual information about the number of shares authorized, issued and outstanding, and also would indicate the corporation's compliance with restrictions on distributions to stockholders imposed by state law and the corporation's capacity for making such distributions. Regardless of the form of presentation, the disclosures should provide relevant information to potential investors, creditors, stockholders, management, employees, etc., about the ability of the corporation to make distributions to stockholders within the applicable legal boundaries.

One further point should be noted regarding disclosures about limitations on corporate distributions. Corporations with substantial debt often enter into agreements with their creditors to limit distributions to shareholders. These limitations usually are described in a note to the financial statements and may be even more restrictive than the limitations imposed by state law. However, these re-

strictions are not always very specific, and furthermore may be changed at any time by agreement between the corporation and the creditors. Thus, even when such debt related restrictions are present, the recommended disclosures in Exhibits 4 and 5 should be made.

## CONCLUSION

The legal capital concept has recently undergone significant change, and it will continue to change as more states adopt the provisions of the 1984 Revised Model Business Corporation Act. The new concept is to restrict the ability of corporations to make distributions to stockholders based on an equity definition of insolvency and on the excess fair value of assets over liabilities. This change in legal standards has eliminated the concept of par or stated value.

Accounting for stockholders' equity, long associated with the reporting of par or stated values as equivalent to legal capital, needs to keep pace with the changing legal requirements. Reporting capital by source is now irrelevant given the changes in many state

**Exhibit 5**  
**RECOMMENDED PRESENTATION OF STOCKHOLDERS' EQUITY AND**  
**DISCLOSURES OF DISTRIBUTION LIMITATIONS**

(For Corporations Incorporated in States Following the 1950 Model Business Corporation Act)

**XYZ Corporation**  
**Balance Sheet**  
**December 31**  
**Stockholders' Equity Section**

	1990	1989
Stockholders' Equity	\$xxx,xxx	\$xxx,xxx

**Note xx: Stockholders' Equity**

As of December 31, 1990, there were 1,000,000 shares of \$1 stated value common stock authorized; 500,000 issued; and 400,000 outstanding. Total contributed capital at December 31, 1990 was \$xxx,xxx. Total retained earnings at December 31, 1990 was \$xxx,xxx. There were no changes in contributed capital during 1990. For changes in retained earnings, see the accompanying statement.

**Note xx: Distributions to Stockholders**

XYZ Corporation is incorporated in the State of X. State law requires all corporations to meet several requirements before distributions can be made. The corporation must be solvent, dividends may be distributed only from retained earnings or from current earnings, and redemptions and treasury stock purchases may be made from retained earnings, current earnings, and/or additional paid-in capital. In addition, the Board of Directors is authorized to make changes in the stated value of common stock to transfer capital to additional paid-in capital for the purpose of making distributions. As of December 31, 1990, the corporation has complied with these requirements. Based on the above legal restrictions, distributions in the form of dividends are limited to no more than \$xxx,xxx; distributions in the form of redemptions or treasury stock purchases are limited to no more than \$xxx,xxx.

corporation codes. Thus, a single line amount for stockholders' equity could be presented along with a footnote providing additional disclosures that are targeted to the new restrictions on distributions to stockholders. At a minimum, the notes to the financial statements should indicate whether or not the corporation is complying with legal restrictions and the amount that is currently distributable

under state law. Especially in situations in which restructuring transactions (e.g., excessive debt-financed dividends, stock repurchases, or leveraged buyouts) have occurred or may occur, and are financed based on the fair values of assets, preparers should disclose the fair value of assets as supplemental information to financial statements prepared on an historical cost basis.