rule is applied.[32] Furthermore, the *Restatement*, in a Comment, specifically regards the rule as inapplicable unless there is a life estate created in the ancestor.[33] Hence, the *Restatement* treats a devise to A for life, with remainder to his heirs, as not within the operation of the rule if A predeceases the testator. Certainly, this position of the *Restatement* is in accord with any view of the rule which emphasizes that the ancestor should *take* an estate of freehold. While the development of the rule in Shelley's Case in England lends some support to the decision in the *Lydick* case, in the absence of more persuasive precedent, the position taken by the *Restatement* appears to be more desirable as limiting the scope of an archaic and obsolete rule of property.

UNREALIZED APPRECIATION—COMMENTS ON MODERN DIVIDEND STATUTES

Is surplus which represents unrealized appreciation of fixed assets legally available for cash dividends?[1] In *Randall v. Bailey* such dividends were recently held authorized under the provisions of the New York Stock Corporation Law. The corporation had written up the value of its waterfront terminal property to over five times its original cost. From 1929 through 1932 a generous dividend policy was pursued even though the distributions considerably exceeded net income for the period. If the company had not listed its fixed assets at the appreciated value, the total of its liabilities and capital stock would have considerably exceeded its total assets throughout the period in question. On April 1, 1933, only eleven months after the last dividend distribution, the company went into receivership, culminating in reorganization.

Section 58 of the New York Stock Corporation Law provides: "No stock corporation shall declare or pay any dividend which shall impair its capital, nor . . . . declare or pay any dividend . . . . unless the value of its assets remaining after the payment of such dividend . . . . shall be at least equal to the aggregate amount of its debts and liabilities, including capital."[2] The trustee appointed in the reorganization proceeding sought to recover from directors of

[32] 3 Rest., Property § 312 (1940).

[33] Ibid., at Comment c. Among the earlier writers, Kent is in accord with the Restatement. 4 Kent, Commentaries on American Law 259–60 (14th ed. 1896). It seems likely that Kent was relying on the authority of Blackstone, note 15 supra. As to other writers, who in other connections seem to imply the necessity for the ancestor to take a life estate, see 1 Hayes, Conveyancing 542–46 (5th ed. 1840); Kales op. cit. supra note 24, § 440. Actually, whether or not the position of the Restatement is adopted, where the ancestor predeceases the testator, many American lapse statutes would limit the number of situations in which the problem might arise.

[1] 288 N.Y. 280, 43 N.E. (2d) 43 (1942).

[2] N.Y. Stock Corp. Laws (McKinney, 1940) § 58.

the corporation the amount of dividends claimed to violate this section. The Court of Appeals, affirming the decision of the Supreme Court,[3] held that Section 58 requires a valuation of assets before each dividend declaration and that in such valuations unrealized appreciation may be included. It therefore refused to impose liability upon the directors.

The soundness of the court's construction of the statute has been discussed elsewhere.[4] This note will be devoted to the general questions of policy which this decision raises. It may be urged in support of the rule of *Randall v. Bailey* that if the revaluation has a sound basis in increased market values or earnings prospects, creditors are not prejudiced by a dividend out of appreciation surplus, since the remaining assets exceed the liabilities by the required margin. The margin of safety principle rests, however, upon the assumption that creditors need protection against shrinkages which may jeopardize the collection of their claims. Fixed assets afford protection for creditors in two ways. In the first place, theoretically the assets may be sold to provide funds for payment of the debts—sold either by voluntary act of the corporation or under execution or other legal process. More realistically, however, fixed assets afford creditor-protection by maintaining the corporate income in order that its debts either may be paid out of earnings or may be refunded by new financing. From neither of these points of view should surplus representing unrealized appreciation be available for cash dividends. Such dividends represent an anticipation of the profit on a possible sale or of the profit from future operations, leaving creditors with the risk of future shrinkages.

This speculative aspect of dividends from unrealized appreciation is strikingly illustrated in *Hayman v. Morris*.[5] This case involved a corporation whose assets consisted of the stock of other corporations. The holding company had set up "good will" on its books at an amount representing a capitalization of anticipated earnings of the subsidiaries in excess of "normal" earnings. The court took the view that the surplus created by setting up this good will item was available for cash dividends under the rule in *Randall v. Bailey* (although the case actually involved not a dividend but a purchase by the company of its own shares). Here, the company is obviously anticipating the expected profits of the future and leaving creditors with the risk that the expectations may be disappointed.

If cash dividends out of unrealized appreciation of fixed assets so obviously violate the margin of safety principle, why is it that legislatures of many im-

[3] 223 N.Y. Supp. (2d) 173 (S. Ct. 1940).

[4] Valuation of Assets to Determine Dividend Legality—the Bush Terminal Case, 50 Yale L.J. 306, 309–10 (1940); Dohr, Randall v. Bailey—Review of Decision, 70 J. of Accountancy 564 (1940). Bonbright anticipated the court's construction. 2 Bonbright, Valuation of Property 924 (1937).

[5] 36 N.Y. Supp. (2d) 756 (S. Ct. 1942).

portant states have left the question open[6] and that the New York court has construed an ambiguous statute as authorizing the practice? The answer may be that, while the margin principle has never been directly challenged, it has never been wholeheartedly accepted by businessmen, courts, or legislatures. It is easy to understand why this has been the case. The principle has never been implemented by rules which would constitute an effective and practical system of creditor protection. There have almost never been statutes fixing substantial minimum capital before debts may be incurred. Nor, in recent years, have there been statutes restricting corporate power to incur debts in excess of a prescribed ratio to capital invested. Corporate promoters have usually been left free to fix the amount of the creditors' margin of safety, perhaps on the assumption that creditors could ascertain the amount of the capital and be guided accordingly.

One may be skeptical as to whether many creditors have extended credit in reliance on the par value of issued stock or the stated value of no par shares. Such reliance would scarcely be intelligent in view of the absence of legal limitations on the incurring of further debts and the mortgaging of corporate assets to secure such advances. Intelligent credit investigation would devote little attention to issued stock as compared with such factors as recent earnings and the character and liquidity of the assets. The problem of the short-term creditor, furthermóre, is very different from that of long-term creditors. For neither of them does the traditional capital impairment rule afford an adequate basis of reliance. Both types of creditors frequently insist upon contractual limitations on the incurring of further debts or the distribution of dividends.[7]

It would probably be impossible to prescribe by statute an adequate system of creditor protection through regulation of debt and asset ratios.The requirements of different industries are exceedingly diverse. The work of the Securities and Exchange Commission under the Public Utility Holding Company Act of 1935 shows how difficult the task is, even for an administrative body dealing with a single industry and with detailed controls over security issues and accounting.[8]

[6] Some states have enacted specific provisions covering the problem. The recently adopted corporation statutes of Illinois, Ohio, and California prohibit cash dividends from unrealized appreciation. Ill. Rev. Stat. (1941) c. 32, § 157.41(c); Ohio Code Ann. (Throckmorton, 1940) § 8623–38(b); Cal. Civ. Code (Deering, 1941) § 346. Michigan apparently allows distribution of unrealized appreciation to preferred stockholders, but the source of the dividend must be disclosed. Mich. Stat. Ann. (Henderson, 1937) § 21.22. Wisconsin, surprisingly, provides that "any corporation which has invested net earnings or income in permanent additions to its value, may declare a dividend either in money or in stock to the extent of the net earnings or income so invested or of the said increase in the value of its property; but the total amount of such dividend shall not exceed the actual cash value of the assets owned by the corporation in excess of its total liabilities, including its capital stock." Wis. Stat. (1939) § 182.19(2). California prohibits even stock dividends from unrealized appreciation. Cal. Civ. Code (Deering, 1941) § 346a.

[7] Writing Down Fixed Assets and Stated Capital, 44 Yale L.J. 1025, 1043 (1935).

[8] In the Matter of Consumers Power Co., S.E.C. Holding Co. Act Release No. 1854 (1939); In the Matter of Engineers Public Service Co., S.E.C. Holding Co. Act Release No. 2535 (1941).

In the light of such efforts the traditional dividend law appears an exceedingly crude type of control. The capital impairment rule, as applied by the courts, may in some cases appear unduly lax and in other cases unduly strict, especially after periods of far-reaching business changes. Perhaps with such situations in mind legislatures have left corporations with wide powers to reduce their capital stock. These provisions furnish a striking illustration of the failure of modern legislation to carry out the margin of safety principle. With few and relatively unimportant exceptions, reduction of capital is authorized without adequate protection for creditors.[9] In many important states, capital may be drastically reduced and dividend restrictions avoided, subject only to the requirement that assets be kept in the corporation sufficient to cover its debts and the amount of the reduced capital. Such statutes apparently reflect skepticism as to the policy underlying the capital impairment rule. Furthermore, the existence of this large loophole makes it understandable that judges should hesitate to apply the margin of safety principle strictly in other situations. Why insist on the maintenance of a given margin if the margin itself may be legally reduced by simple procedures which involve little protection for existing creditors?

If the traditional capital impairment rule is crude and inflexible in its operation and if the differences among industries and types of loans make it impracticable to establish margins of safety suggested by sound credit policy, is there any other alternative? One might suggest substituting for the traditional rules a simple requirement of due care on the part of the directors, due care in the light of the amount and due dates of the corporate debts, the extent and liquidity of the corporate assets, its requirements of working capital, and general business conditions. There are vague suggestions of such a rule by way of dicta in the cases.[10] Furthermore, Section 5 of the Uniform Fraudulent Conveyances Act might be construed to have this effect. This section makes fraudulent a transfer without consideration "when the person making it is engaged in . . . . a business . . . . for which the property remaining in his hands . . . . is an unreasonably small capital. . . ." This provision has seldom been invoked in corporate dividend cases[11] and would probably not be construed to invalidate a dividend authorized by the general corporation act. It is not inconceivable that courts might, of their own motion, work out standards of adequate stock financing to support the corporation's debts. This is suggested by decisions

9 The entire problem and possible remedies are elaborately discussed in Writing Down Fixed Assets and Stated Capital, 44 Yale L.J. 1025 (1935); Capital Stock Reduction as Affecting the Rights of Creditors, 47 Harv. L. Rev. 693 (1934).

10 Ballantine has suggested such a rule as more practical than the present, complicated statutory rules. Ballantine, A Critical Survey of the Illinois Business Corporation Act, 1 Univ. Chi. L. Rev. 357, 371 (1934).

11 In re College Chemists, Inc., 62 F. (2d) 1058 (C.C.A. 2d 1933). For the same problem under insurance statutes, see Van Schaick v. Carr et al., 10 N.Y. Supp. (2d) 567 (S. Ct. 1938). The possible application of the theory of fraudulent conveyances to improper dividends is discussed in 2 Glenn, Fraudulent Conveyances and Preferences §§ 604, 605 (1940).

which result in subordination of claims of a parent corporation based on advances to an inadequately financed subsidiary.[12] Despite these analogies, substitution of a general due care standard for dividends would probably be undesirable. It may be doubted that such a statute would often result in actual recovery from a director, especially if the alternatives were no liability or joint liability for the full amount of the illegal dividends.

There is one situation, however, where a due care rule would seem desirable: the situation of the corporation whose fixed assets have suffered a shrinkage in value. *Randall v. Bailey* apparently not only permits use of increased values for dividend purposes but also requires the use of decreased values. This aspect of the decision will probably give serious concern to corporation lawyers. Indeed, one may question the wisdom of a rule which may require frequent appraisals of fixed assets and going concern values if directors are to be safe in distributing current earnings. Prior to *Randall v. Bailey*, while the authority is meager, it has been generally thought that account need not be taken of unrealized shrinkages in fixed asset values.[13] In many cases the dividend may be entirely sound despite such shrinkages. In other cases, however, where serious and permanent impairment of earning capacity is indicated, the dividend may leave creditors with clearly inadequate protection. Here, the due care requirement might operate usefully to prevent injury to creditors in the more serious cases.

DISBARMENT PROCEEDINGS—CONTROL OF THE JUDICIARY BY UPPER COURTS

Default by the surety on a bail bond instigated an investigation by the Chicago Bar Association of the practice of municipal court judges in the approval of such bonds. As a result of this investigation the Association, acting as commissioners of the court, brought disbarment proceedings against the defendant, a municipal court judge. The commissioners charged that the respondent's failure to ascertain the financial responsibility of those posting bonds "tended to bring the bar and the judiciary into ill repute and to obstruct justice." They contended, moreover, that such carelessness violated the municipal court rule which established as "the duty of a judge [the ascertainment of] the condition of the title and the value of the real estate scheduled."[1] The complaint was *held* dismissed. *In re McGarry.*[2]

[12] Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1939); Israels, The Implications and Limitations of the "Deep Rock" Doctrine, 42 Col. L. Rev. 376 (1942).

[13] 2 Bonbright, Valuation of Property 924–25 (1937). But see Guaranty Trust Co. v. Grand Rapids, G.H. & M. Ry. Co., 7 F. Supp. 511 (Mich. 1931); Vogtman v. Merchants' Mortgage and Credit Co., 20 Del. Ch. 364, 178 Atl. 99 (1935).

[1] Rule No. 9 of the Municipal Court of Chicago. The rule is quoted in part in the instant case, In re McGarry, 380 Ill. 359, 362, 44 N.E. (2d) 7, 9 (1942).

[2] 380 Ill. 359, 44 N.E. (2d) 7 (1942).