

# Does Corporate Law Matter?

## Legal Capital Restrictions on Stock Distributions

by

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### I. Introduction

Does corporate law matter? One might think so given that the study of substantive corporate law doctrines remains a standard part of legal and business education and both the bar and the certified public accounting exams test would be practitioners' knowledge of these issues, but a growing number of scholars have suggested that corporate law has no impact on the investment decisions of shareholders. At the theoretical level, these scholars argue that a corporation is a "legal fiction which serves as a nexus for a set of contracting relationships among individuals."<sup>1</sup> In other words, corporations serve as a focus for a complex process that reconciles the conflicting objectives of shareholders, creditors and others parties interested in the organization within a framework of contractual relations.<sup>2</sup> From this perspective, corporate law serves only as "a set of terms available off-the-rack so that participants in corporate ventures can save the cost of contracting."<sup>3</sup> If the parties decide that the "off-the-rack" terms do not fit their particular needs, they are free to re-write or discard the unwanted provisions. Therefore, the substantive provisions of corporate law really do not matter, because the parties are always free to change them. Corporations reflect the optimal relationship between participants not because corporate law contains the optimal set of rules for corporate governance, but because the parties have chosen the set of rules for their particular corporation. If the rules chosen come from corporate law, that is mere coincidence.<sup>4</sup>

Not all legal scholars accept the nexus of contract theory,<sup>5</sup> but even scholars who accept the overall relevance of corporate law have challenged specific legal doctrines. For example, over the past generation a near consensus has been reached that statutory restrictions imposed by legal capital doctrines such as par value and surplus on the distribution of cash dividends have no genuine economic significance,<sup>6</sup> and a growing number of states no longer recognize these concepts.<sup>7</sup> Legal capital doctrines enable corporations to distribute common stock to existing shareholders as either stock splits or stock dividends,<sup>8</sup> but conventional wisdom holds that both types of stock distributions are basically cosmetic maneuvers having nothing to do with income determination, balance sheet valuation,<sup>9</sup> or shareholder wealth.<sup>10</sup> According to the prevailing view, stock distributions should be irrelevant in the sense that say, a 2 for 1 stock split is equivalent to exchanging a ten dollar bill for two five dollar bills. The transaction, by itself, does not convey information or anything else of economic significance to market participants.<sup>11</sup>

Contrary to conventional wisdom, empirical evidence suggests that shareholders associate stock distributions, i.e., stock dividends and splits, with fundamentally important information, such as increased cash dividends<sup>12</sup> or earnings.<sup>13</sup>

Our examination of the empirical evidence regarding stock distributions suggests that the conventional wisdom may also be wrong about the value of legal capital doctrines. While this type of statutory restriction may no longer protect the interests of creditors, these corporate law doctrines do matter insofar as they enhance management's ability to use different accounting treatments for stock distributions as a signaling mechanism for the communication of information about the firm. This in turn suggests that the current trend of eliminating legal capital restrictions on cash dividend may be eliminating a valuable tool for communicating information to shareholders.

This paper consists of five sections, including this introduction. The background section of this article consists of several parts. First, we provide an historical overview of the legal capital doctrines restricting dividends. Second, we briefly summarize and illustrate six basic types of state statutory restrictions on dividends and other distributions to shareholders. Third, we examine the criticisms of legal capital that has led many states to abandon the use of concepts like stated capital and surplus to restrict financial distributions to shareholders. Fourth, a discussion of the generally accepted accounting principles ("GAAP") and mechanics of legal capital and stock distributions is provided for the benefit of readers not already familiar with this topic. Fifth, we examine prior research that suggests the market value of a firm increases when it announces a stock distribution, i.e., the announcement of a stock split or dividend increases the common stock price. This research suggests that shareholder reaction to stock distribution announcements stems from the information that the stock distribution decision conveys about the firm's future earnings potential and other fundamentally important information.

In the data and method section, we test the hypothesis that if stock distribution announcements increase share prices, then the choice between stock split and stock dividend accounting treatment may also have an effect on share prices. We correct for specific flaws found in the research design of other empirical studies and present the results in the fourth section of this article. Our tests of the empirical evidence support the hypothesis that investors react more positively to the announcement of a large stock dividend than a stock split. In addition, market response is more pronounced when managers are constrained by the combination of legal capital doctrines restricting cash distributions to shareholders and the method used to account for large stock distributions.

In the final section of this article, we conclude, based on the results of our empirical tests, that statutory dividend restrictions based on legal capital enhance management's ability to use stock distributions to communicate with shareholders. This suggests that the critics of legal capital may have been too harsh and that state legislatures may be acting too hastily in replacing legal capital doctrines with other types of statutory restrictions on dividends.

## II. Background

If, as most scholars argue, legal capital has no economic consequences, then shareholders should be indifferent to how management elects to account for a stock distribution, whether as a stock dividend or a stock split. Before we can test this hypothesis, however, it is necessary to understand the interaction of legal doctrines, generally accepted accounting principles, and management discretion that determine whether a corporation will account for a stock distribution as a stock dividend or a stock split.

### *A. Historical Perspective*

Legal restrictions on dividend payments date to the earliest days of American business corporations.<sup>14</sup> In one of the earliest cases, *Wood v. Dummer*,<sup>15</sup> Justice Story stated that shareholder contributions constituted a "trust fund for the payment of all the debts of the corporation."<sup>16</sup> As originally conceived, the "trust fund" theory of legal capital simply prevented shareholders from withdrawing the assets they had contributed to the corporation until its creditors had been paid.<sup>17</sup> This was thought to protect creditors<sup>18</sup> by minimizing the risk of business failure<sup>19</sup> and by minimizing creditors' losses if the business failed.<sup>20</sup>

The use of par value greatly complicated the trust fund theory of legal capital. Par value developed into a legal minimum of what a shareholder ought to pay for the stock. This meant that issues regarding shareholder contributions to the corporation rather than corporate distributions to shareholders exerted the primary influence over the development of legal capital doctrines.<sup>21</sup> For example, if the actual purchase price exceeded the par value, the excess was credited to capital surplus. Thus, legal capital was separated into stated capital (the aggregate par value of the outstanding shares) and capital surplus. New legal doctrines were also needed to value the contributions made by shareholders and to remedy the occasions when shareholders paid less than par value.<sup>22</sup> Stock distributions presented an especially acute form of this latter problem, since shareholders paid nothing for the shares they received as stock dividends. By the early 1880's, courts resolved this issue by allowing corporations to issue stock dividends so long as they reflected an increase in the net assets of the corporation.<sup>23</sup>

As the Nineteenth century drew to a close, corporations began to issue low par stock to avoid the pitfalls of underpayment.<sup>24</sup> Perhaps as a result of a growing skepticism about the trust fund theory,<sup>25</sup> states began to authorize the use of "no par" stock, which enabled the Board of Directors to adjust the "stated value" amount each time the corporation issued stock.<sup>26</sup> Stated value served the same function as par value insofar as stated value represented the minimum issue price and the minimum amount of net assets to allow payment of dividends, but stated value provided the corporation with a great deal more flexibility in issuing stock, including stock dividends, without abandoning the trust fund theory in its entirety.<sup>27</sup>

For the next half century, the legal capital doctrines evolved within this framework that allowed corporations to choose between par and no par stock.<sup>28</sup> This framework reached its most refined point in the 1969 Model Business Corporation Act ("MBCA"),<sup>29</sup> when virtually all corporate statutes in the United States utilized the essential features of the

MBCA's framework for legal capital.<sup>30</sup> Despite the refined nature of the MBCA's framework and its near universal adoption, dissatisfaction with the entire scheme of legal capital was evident by the late 1960s. For example, the comments to the MBCA flatly denied that stock dividends added "anything to the economic interest of the shareholder."<sup>31</sup> In the early 1970s, California abandoned all traditional concepts of legal capital.<sup>32</sup> Shortly thereafter, Bayless Manning published the first edition of his legal capital treatise, arguing that legal capital had changed from an identifiable set of assets contributed by the shareholders to an account with a balance "arbitrarily" set at an amount equal to the par value multiplied by the numbers of shares outstanding.<sup>33</sup> In 1979,<sup>34</sup> the Revised Model Business Corporation Act ("RMBCA") jettisoned the "outmoded" concepts of par value and stated capital set out in the MBCA in the apparent belief that traditional legal capital doctrines were unduly complex, confusing and misleading.<sup>35</sup>

*B. Modern Statutory Approaches to Dividend Restrictions*

By the early 1980s, six identifiable statutory approaches to dividend restrictions had emerged.<sup>36</sup> Exhibit 1 identifies the approach used by each state during the period of time relevant to this study. The primary goal of these statutes is to preserve the minimum value of corporate assets necessary to secure payment of creditors' claims.<sup>37</sup>

Exhibit 1

Summary of Statutory Restrictions on Dividends

as of August 31, 1991<sup>38</sup>

State	MBCA	Balance Sheet Surplus	Nimble Dividends	RMBCA	Restrictive Ratio	Equitable Insolvency
Alabama	x					
Alaska					x	
Arizona			x			
Arkansas				x		
California					x	

Colorado		x				
Connecticut	x					
State	MBCA	Balance Sheet Surplus	Nimble Dividends	RMBCA	Restrictive Ratio	Equitable Insolvency
Delaware			x			
District of Columbia		x				
Florida				x		
Georgia				x		
Hawaii				x		
Idaho	x					
Illinois				x		
Indiana				x		
Iowa				x		
Kansas			x			

Kentucky				x		
Louisiana			x			
Maine			x			
Maryland				x		
Massachusetts						x
Michigan				x		
Minnesota						x
Mississippi				x		
Missouri		x				
Montana				x		
Nebraska	x					
Nevada			x			
New Hampshire			x			

New Jersey				x		
New Mexico				x		
New York		x				
North Carolina				x		
North Dakota						x
State	MBCA	Balance Sheet Surplus	Nimble Dividends	RMBCA	Restrictive Ratio	Equitable Insolvency
Ohio		x				
Oklahoma			x			
Oregon				x		
Pennsylvania				x		
Puerto Rico		x				
Rhode Island			x			
South Carolina				x		
	x					

South Dakota						
Tennessee				x		
Texas	x					
Utah	x					
Vermont			x			
Virginia				x		
Washington				x		
West Virginia	x					
Wisconsin				x		
Wyoming				x		

What follows is an explanation of how each of these approaches restricts a corporation's ability to make distributions to its shareholders.

### 1. The Traditional Dual Insolvency Approach

The MBCA uses the traditional dual solvency approach<sup>39</sup> based on legal capital doctrines. Section 45 of the MBCA gives the board of directors discretion to pay dividends in cash, property, or a firm's own shares. The MBCA imposes two major legal restrictions on this discretion.<sup>40</sup> The first test is a cash flow or equity insolvency test:<sup>41</sup> the corporation may

not pay a dividend when the corporation either is insolvent<sup>42</sup> or would be rendered insolvent by payment of the dividend.<sup>43</sup> In other words, the corporation may not pay dividends if it is unable to pay its debts as they become due.

The second test under the dual insolvency approach, often called the balance sheet or bankruptcy insolvency test,<sup>44</sup> focuses on whether the corporation has enough surplus<sup>45</sup> to offset the amount of the dividend. Surplus arises in essentially two ways. First, it arises from business operations measured from some particular starting point (usually the date of incorporation). It also arises from capital stock transactions, such as issuing stock at a price above par value. In the first instance, it is referred to as earned surplus.<sup>46</sup> In the latter case, it is referred to as capital surplus<sup>47</sup> to maintain the distinction between "earnings," which should normally be available for distribution to shareholders, and "capital," which should remain intact until shareholders authorize some particular action.<sup>48</sup>

The MBCA generally requires a reduction in unreserved<sup>49</sup> and unrestricted<sup>50</sup> earned surplus equal to the amount of a cash or property dividend.<sup>51</sup> A corporation may pay stock dividends out of any unreserved and unrestricted surplus provided that:<sup>52</sup> (1) if dividends are payable in shares having a par value, an amount of earned and/or capital surplus at least equal to the aggregate par value of the shares issued shall be transferred to stated capital upon distribution,<sup>53</sup> and (2) if dividends are payable in shares without par value, the board of directors shall determine the amount to be transferred from earned and/or capital surplus to stated capital.<sup>54</sup>

Several points are important here. First, the MBCA requires the corporation to satisfy both solvency tests before paying a dividend. Because no assets leave the corporation when it pays a stock dividend, a stock dividend cannot jeopardize a corporation's ability to pay its bills as they come due. Therefore, the equity insolvency test cannot prevent a stock dividend. It has been suggested that the balance sheet or bankruptcy insolvency test also cannot prevent payment of stock dividends.<sup>55</sup> While probably true in practice, it is at least theoretically possible under the MBCA for the bankruptcy test to prevent a stock dividend.<sup>56</sup> For example, if a corporation proposed to issue 100 shares of stock as a stock dividend with a par value of \$10 per share when its combined surplus was less than \$1,000, the MBCA would prohibit the dividend.<sup>57</sup> Second, stock splits, which are a division of the issued shares of any class into a greater number of shares without an accompanying increase in the corporation's stated capital, are not stock dividends<sup>58</sup> and are not subject to the solvency restrictions.<sup>59</sup> Third, section 45 of the MBCA specifies the legally permissible financial distribution, but what is legally acceptable differs from what may be construed as financially and operationally advisable.<sup>60</sup> When lenders perceive that their rights are inadequately protected by state statute, additional limitations may be imposed in the form of debt covenants to further limit financial distributions.<sup>61</sup>

## 2. The "Nimble Dividend" Provision

The MBCA provides an alternative section 45(a) that allows boards of directors to pay cash and property dividends out of either earned surplus or the sum of the "preceding and

current fiscal year's earnings."<sup>62</sup> Earnings rather than earned surplus define the operative limit on the legality of these so called "nimble dividends."<sup>63</sup> Consequently, boards of directors could conceivably declare cash dividends even when total liabilities exceed total assets.<sup>64</sup> Note that the MBCA's nimble dividend provision does not apply to stock dividends, i.e., a corporation may not pay a stock dividend if the aggregate par value of the stock to be issued exceeds surplus regardless of the corporation's earnings. This, of course, leads to the possibility that a corporation could pay a cash dividend out of current earnings, which may be a genuine threat to creditors, when it is prohibited from paying a stock dividend, which poses no threat to creditors. The alternative section 45(a), however, retains the equitable insolvency test<sup>65</sup> to protect creditors, i.e., a firm may not pay a nimble dividend if the firm is insolvent or the payment would render the firm insolvent.<sup>66</sup>

The nimble dividends test appears to have originated in Delaware as a concession to what Manning and Hanks have described as "business reality."<sup>67</sup> Unlike the MBCA, which gives directors discretion to use either current earnings or earned surplus to pay a dividend, the Delaware statute purports to make the current earnings avenue available if and only if surplus is not available.<sup>68</sup> Furthermore, the Delaware statute does not distinguish between stock dividends and cash or property dividends for purposes of nimble dividends.

### 3. The Balance Sheet Surplus Method

Some states, such as New York,<sup>69</sup> use the balance sheet surplus approach to regulate financial distributions. This approach allows dividend payments out of "capital surplus and earned surplus."<sup>70</sup> Because both earned and capital surplus can be distributed, firms incorporated in states using the balance sheet surplus method have more latitude to pay dividends than companies incorporated in states using the MBCA's dual insolvency approach.<sup>71</sup> However, this provision is more conservative than the earnings provision of nimble dividend states.<sup>72</sup> Hence, the stringency and frequency of covenants imposed on firms incorporated in surplus jurisdictions may be less severe and fewer in number than those imposed on companies incorporated under nimble dividend provisions, but stricter and greater<sup>73</sup> in number than contractual limitations imposed on firms incorporated in MBCA states.

### 4. The Revised Model Business Corporation Act

In the 1980s, the American Bar Association substantially revised the Model Business Corporation Act.<sup>74</sup> The Revised Model Business Corporation Act ("RMBCA") eliminated the concepts of stated capital, par value, and treasury shares<sup>75</sup> and broadened the definition and statutory provisions governing distributions to include all dividends, share repurchases, or similar actions.<sup>76</sup> The RMBCA retained the equitable insolvency limitation, i.e., distributions to shareholders are prohibited if the corporation is unable to pay its obligations as they become due in the ordinary course of business.<sup>77</sup> Although the elimination of legal capital could have led to the elimination of the balance sheet test altogether, the ABA chose instead to make a substantial revision to the balance sheet

test.<sup>78</sup> The revised balance sheet test allows financial distributions whenever the corporation's net assets exceed zero.<sup>79</sup>

Firms may eliminate or continue the practice of assigning par values to shares, designating stated capital, and creating other capital accounts. However, the division of equity into capital accounts is irrelevant for determining the legality of distributions.<sup>80</sup> Firms incorporated in RMBCA states may have more freedom to pay dividends than boards of directors of firms that incorporate in legal capital jurisdictions. Lenders, however, are likely to perceive that less legal protection is provided and respond by demanding more covenants with increasingly stringent provisions.<sup>81</sup>

## 5. Equitable Insolvency States

Massachusetts,<sup>82</sup> Minnesota<sup>83</sup> and North Dakota<sup>84</sup> impose only an "equitable insolvency" limitation.<sup>85</sup> This means that boards of directors may pay dividends if the corporation is able to pay its debts in the ordinary course of business after making the distribution,<sup>86</sup> even if total liabilities exceed total assets. For determining the legality of dividends, tests based on the amount of retained earnings, paid-in capital and/or earnings are irrelevant.<sup>87</sup> Payments to common shareholders merely require that sufficient value remain in the corporation to satisfy preferences of senior securities.<sup>88</sup> Lenders of firms incorporated in equitable insolvency jurisdictions receive less statutory protection and may respond by imposing stricter covenants upon firms incorporated in these jurisdictions than they impose on similar firms incorporated in a MBCA or RMBCA state.<sup>89</sup>

## 6. Restrictive Ratio Tests Statutes

California's financial distribution laws<sup>90</sup> are in many ways the most restrictive.<sup>91</sup> Like the RMBCA, the California statute focuses on distributions to shareholders rather than dividends *per se*.<sup>92</sup> The provisions for distribution are based on a corporation's current financial condition.<sup>93</sup> Corporations must satisfy an equitable insolvency limitation<sup>94</sup> and one of two alternative balance sheet tests. Section 500(a) of the California Code allows financial distributions if the amount of earned surplus immediately prior to the distribution is at least equal to the amount of the distribution.<sup>95</sup> Alternatively, the distribution may be made if immediately after giving effect thereto: (1) the sum of the corporation's net tangible assets is at least equal to one and one-quarter its liabilities not including deferred taxes, deferred income, and other deferred credits,<sup>96</sup> and (2) the current assets would be at least equal to the firm's current liabilities.<sup>97</sup> If the average earnings of the corporation before taxes and interest expense are less than the average interest expense for the preceding two years, current assets must equal one and one-quarter times current liabilities.<sup>98</sup> Lenders may perceive these statutes as providing increased legal protection, thus leading to reductions in the number and severity of covenants imposed by debtholders.<sup>99</sup> In 1988, Alaska adopted financial distribution provisions that are virtually identical to California's.<sup>100</sup>

## 7. Illustration of the Different Approaches to Statutory Restrictions

Legal capital focuses on the structure of the equity portion of the balance sheet. Exhibit 2 uses a simplified example to illustrate how different legal capital doctrines affect the amount available for cash dividends. Note that Exhibit 2 does not discuss the equitable insolvency, restrictive ratio, and nimble dividends approaches because unlike legal capital, these statutory restrictions focus on items not found in the equity portion of the balance sheet.

## Exhibit 2

An example of financial distribution statutes effect on distributable capital.

ABC Corporation

Stockholders' Equity

December 31, 19xx

Contributed capital:

Preferred stock, \$100 par

(7%, 100 shares authorized and issued) \$ 10,000 (1)

Common stock, \$5 par (20,000 shares authorized,

10,000 issued, of which 100 shares are being

held as treasury stock) 50,000 (2)

Contributed capital in excess of par value 150,000 (3)

Total contributed capital 210,000

Retained earnings (see note (a)) 300,000 (4)

Less: Treasury stock (at cost) (3,000) (5)

Total stockholders' equity \$507,000

Note (a) Retained earnings in the amount of \$77,000 is appropriated

for future plant expansion. (6)

(1) Preferential rights

- (2) Stated capital
- (3) Capital surplus
- (4) Earned surplus
- (5) Restricted capital
- (6) Reserved capital

Legally available for cash distributions:

MBCA states:  $(4) - (5) - (6) - (1) = \$210,000$

Balance sheet surplus states:  $(3) + (4) - (5) - (6) - (1) = \$360,000$

Rev. Model Bus. Corp. Act states:  $(2) + (3) + (4) - (5) - (6) - (1) = \$410,000$

The MBCA requires a reduction in unreserved and unrestricted earned surplus equal to the amount of the dividend.<sup>101</sup> There are three constraints on the payment. First, before dividends can be paid to common stockholders, the preferential rights of the preferred stockholders must first be honored.<sup>102</sup> Second, a corporation cannot own itself.<sup>103</sup> Third, neither can it recognize a gain or loss when reacquiring its own stock. The purpose of these rules is to restrict a corporation from influencing its net income by buying and selling its own shares. Hence, the amount that may be paid to acquire stock is usually limited to the balance in earned surplus and treasury stock is treated as a reduction of owner's equity without impairing legal capital.<sup>104</sup> However, the amount of earned surplus (retained earnings) available for dividends is *restricted* by the cost of the treasury stock so that future dividend payments will not reduce contributed capital.<sup>105</sup> At the board's discretion, a portion of retained earnings can also be *reserved* for special purposes such as future plant expansion. After taking into effect these other considerations, only \$210,000 is available for dividends of firms subject to the MBCA style dual insolvency test.

The difference between the balance sheet surplus and the MBCA approach is that capital surplus as well as earned surplus is available for cash distributions.<sup>106</sup> In other words, firms incorporated in balance sheet surplus states have an additional \$150,000 for a total of \$360,000 available for dividends. The preferential rights of the preferred stockholders are still paramount, GAAP restricts treasury stock, and boards may continue to reserve a portion of earned surplus for special purposes.

Exhibit 2 also illustrates that under the RMBCA,<sup>107</sup> \$410,000 of equity is legally available for cash dividends after preferential rights, the allowance for the restrictions on treasury stock, and amounts reserved at the discretion of the board. Thus, the RMBCA approach provides an additional \$50,000 over the balance sheet surplus approach and an

additional \$200,000 over the MBCA's traditional dual insolvency approach to legal capital.

### *C. Criticism of Traditional Legal Capital Doctrines*

Legal scholars have generally praised the trend away from using legal capital to restrict dividends,<sup>108</sup> and they have harshly criticized the use of legal capital notions such as stated capital and earned surplus to restrict payment of cash dividends. One of the leading commentators on legal capital concluded that the real issue is not whether to abandon legal capital as means of restricting dividends, but rather what to replace it with.<sup>109</sup> The critics contend that legal capital is, at best, a meaningless doctrine that fails to benefit any corporate stakeholders while it imposes significant transaction costs on corporate management and shareholders. In the words of one scholar, legal capital "has ceased to perform any real function."<sup>110</sup>

Modern legal scholarship has generally criticized this concept because legal capital fails to achieve what its critics contend is the concept's only goal, to protect creditors from shareholders.<sup>111</sup> If net assets less par value or stated capital does not allow payment of a cash dividend, the "shareholders could amend the corporate charter to reduce the amount of par value. Thus, the switches, levers, and throttles are in the hands of the very group whose interests conflict squarely with the creditors—the shareholders and corporate management."<sup>112</sup> As Conard noted a generation ago, creditors, "who might be the most concerned [about a change in legal capital], are neither notified nor consulted."<sup>113</sup> The ease with which stated capital can be reclassified as surplus suggests that legal capital presents no real obstacle to cash dividends.<sup>114</sup>

With the advent of de minimis or nominal par values, stated capital no longer represents the collective contributions of the initial shareholders, and par value itself has become an arbitrary number<sup>115</sup> bearing no connection to the value of the assets contributed by shareholders.<sup>116</sup> In the unlikely event that a shareholder fails to pay the de minimis par value, each of the various theories of shareholder liability for the minimum contribution raises numerous procedural pitfalls for a creditor seeking to enforce payment.<sup>117</sup> Creditors, these critics argue, have better means, ranging from credit reports to the bankruptcy code and bond covenants, to protect their interests rather than rely on legal capital.<sup>118</sup>

Legal capital also has little connection to any other assets that will actually be distributed to the shareholders or creditors. As the leading commentator on the subject noted, dividends are paid with real assets, usually cash, not "surplus."<sup>119</sup> Furthermore, legal capital is not "relatable in any way to the ongoing economic condition of the enterprise."<sup>120</sup> Creditors, it is argued, focus "not on the sufficiency of assets remaining upon liquidation of the corporation..., but rather on the corporation's prospects for remaining a viable, on-going concern."<sup>121</sup> Finally, some critics suggested that legal capital may even be misleading "to the extent that [creditors] are led to believe that it provides some protection."<sup>122</sup>

Not only does legal capital fail to protect creditors, it also imposes significant costs on corporations.<sup>123</sup> Indeed, one commentator sarcastically suggested that from the accounting and legal profession's point of view, increased professional fees was one of the "benefits" of using legal capital to restrict dividends.<sup>124</sup> The lack of restrictions on the ability to reclassify legal capital as surplus makes it possible in most situations to avoid liability for illegal dividends, but it often necessitates the invocation of burdensome formalities.<sup>125</sup> Furthermore, the corporation may choose not to make otherwise beneficial distributions to shareholders in order to avoid potential liability.<sup>126</sup>

Critics have also maintained that use of legal capital as a restriction on dividends has spawned enormous legal uncertainty<sup>127</sup> and complexity. The "complexity and ambiguity" of legal capital may also lead to increased costs in terms of litigation.<sup>128</sup> Although very few cases involving legal capital have been reported since the end of World War II,<sup>129</sup> they do continue arise.<sup>130</sup> In attempting to answer the question of how much assets a shareholder must contribute, legal capital raises questions concerning the type and valuation of assets contributed.<sup>131</sup> This, in turn, raises questions of what to do when a shareholder contributes inadequate or overvalued assets for the stock. The leading treatise on legal capital found no less than five approaches to shareholder liability for stock purchases.<sup>132</sup>

Legal capital has also contributed a great deal of complexity and uncertainty to the issue of dividends. Legal capital's restrictions on cash dividend payments, for example, are "inherently wholly dependent upon the accounting principles followed in constructing ... the balance sheet."<sup>133</sup> Generally accepted accounting principles, however, suffer from a lack of precision<sup>134</sup> and do not necessarily provide information critical to the basic legal inquiry of whether the corporation will be able to honor its liabilities after payment of the dividend in question. Even if GAAP were painstakingly precise and could accurately identify likelihood of default on a consistent basis, statutes employing legal capital doctrines do not always require use of GAAP.<sup>135</sup> For the legal capital doctrines to provide a meaningful regulation of distributions would "require the development of a full scale jurisprudence of accounting" which "[n]early everyone agrees ... would be wholly impractical and a disaster."<sup>136</sup>

All of these criticisms share a common theme, legal capital has no economic consequences because it fails to protect creditors.<sup>137</sup> However, the premise that legal capital exists to protect creditors is what may be at fault. As will be shown *infra*, the economic consequences of legal capital may be more readily found in its value to shareholders.<sup>138</sup>

#### *D. Stock Distributions*

Cash and property are not the only things that corporations distribute to their shareholders. A stock distribution occurs when a corporation issues shares of its own stock to existing shareholders. Shareholders do not contribute anything to the corporation for the stock that they receive in a stock distribution, nor is there a reduction or any other

change in the corporation's assets. The shares of stock are distributed on a pro rata basis, so the relative ownership interests of each shareholder remain unchanged.

Legal capital doctrines of par value and surplus make it possible to distinguish between two types of stock distributions, stock splits and stock dividends. In a stock split, the par value of each share of stock is reduced, but the total amount of par value reported on the balance sheet does not change.<sup>139</sup> A shareholder who owned one share of \$10 par value stock prior to a two-for-one stock split would own two shares of \$5 par value stock immediately after the split. Nothing, however, would change on the balance sheet.<sup>140</sup> Because a stock split does not affect either the total amount of stated capital or earned surplus, it has no impact on the corporation's ability to pay cash dividends.<sup>141</sup>

The same is not true for stock dividends. Stock dividends do not affect the total amount of owner's equity reported on the balance sheet, but they do reduce the amount of equity reported as earned surplus and increase the amount of equity reported as par value.<sup>142</sup> If a corporation issues one share of its own stock as a dividend on each of its outstanding shares, a shareholder with one share of \$10 par value stock immediately before the dividend will have two shares of \$10 par value stock immediately afterward. The transaction will be reflected on the corporation's balance sheet by a \$10 reduction in the amount of earned surplus and a \$10 increase in the amount of stated capital.<sup>143</sup> Note, however, that the two changes offset one another with respect to the total amount of equity. Because a stock dividend reduces the amount of earned surplus and increases the amount of stated capital, it has the potential to reduce the ability of the corporation to pay cash dividends in a state that uses legal capital doctrines.<sup>144</sup>

While legal capital doctrines provide a mechanism for distinguishing between stock splits and stock dividends, legal capital does not require one treatment over the other except that a corporation could not treat a stock distribution as a stock dividend if the aggregate par value of the shares distributed exceeded the corporation's surplus. Other forms of statutory restrictions on dividends are simply irrelevant with respect to the issuance of stock distributions. Since a stock distribution does not alter the amount or type of a corporation's assets or liabilities, it cannot affect the restrictive ratio test or the RMBCA's balance sheet tests.<sup>145</sup> For the same reason, a stock distribution cannot render a corporation insolvent.<sup>146</sup>

Legal capital doctrines are not the only things affecting the distribution of stock to shareholders. Other considerations include GAAP, stock exchange rules, and management's ability to select among different accounting treatments without violating its bond covenants.<sup>147</sup> According to the American Institute of Certified Public Accountants ("AICPA"), a corporation's representation<sup>148</sup> to its shareholders as to the nature of the stock issuance, and the size of the distribution, should be the principal considerations used to differentiate the two types of stock distribution—stock dividends and stock splits.<sup>149</sup>

In determining whether to treat a stock distribution as a stock split or a stock dividend, GAAP focuses on the quantity of shares issued<sup>150</sup> regardless of whether the corporation

has sufficient earned surplus to offset the distribution. Accounting Research Bulletin (ARB) 43 requires that all stock distributions less than 20 to 25% of the previous shares outstanding be treated as stock dividends.<sup>151</sup> Distributions within the 20 to 25% range can be treated either as stock dividends or stock splits.<sup>152</sup> When the number of shares issued as a stock dividend is so great that the nature of the transaction is comparable to a stock split, ARB 43 recommends that firms capitalize earned surplus for the stated or par value of the shares distributed only to the extent required by statute,<sup>153</sup> and such large stock dividends should be described as stock splits effected (accounted for) as stock dividends.<sup>154</sup>

Stock exchange rules generally mirror the requirements of GAAP. The American Stock Exchange requires a listed company to comply with ARB 43 when accounting for stock dividends and stock splits or provide a written opinion from its independent accountants that it is otherwise in compliance with GAAP.<sup>155</sup> The New York Stock Exchange's accounting rules, as stated in Section 703.02 of the NYSE Listed Company Manual,<sup>156</sup> require that firms reduce earned surplus by an amount equal to the fair market value of the stock distributions if the number of new shares is less than 25% of the previously outstanding shares. A distribution equal to 25% or more of the outstanding shares requires a reduction in capital surplus and an increase in stated capital for the total par value of the newly distributed shares unless the firm reduces its per share par value.

Actual accounting practices have differed substantially from GAAP. One study found that of 103 Fortune 500 companies that had stock distributions greater than 25% in 1984, only fourteen followed GAAP by treating the distribution as a stock split.<sup>157</sup> Seventy-six firms did not adjust per share par value, and the researchers could not determine the change in par value for the remaining thirteen firms. Forty-seven accounted for the distribution by charging capital surplus, twenty-three charged earned surplus, and eight charged both capital and earned surplus.<sup>158</sup>

#### *E. Information Content of Stock Distributions*

The preceding discussion of legal capital and the accounting treatments for stock splits and stock dividends raises several questions. How does the stock market react to their announcement? What purpose does their announcement serve, i.e., what privileged information can be communicated by management to investors via stock distribution announcement? Do investors react differently to announcements of stock splits vis-à-vis stock dividends? In other words, does the market interpret the combination of legal-accounting treatment differently for each type of large stock distribution.

While most legal and accounting scholars suggest that both types of stock distributions are basically cosmetic maneuvers having little to do with income determination and balance sheet valuation,<sup>159</sup> more than 60 years of studies<sup>160</sup> have shown that shareholders generally react positively to stock distribution announcement. Current studies offer an information or signaling explanation for the observed price reaction.<sup>161</sup> This premise is based on the notion that financial decisions are one method management employs to convey information about firm value.<sup>162</sup> The attribute signaled by stock distribution

announcement is either the permanence of past earnings<sup>163</sup> or an increased potential for future earnings.<sup>164</sup>

For stock distribution announcements to have meaning to investors, however, management's decision must be costly either to the firm or management itself. Otherwise, both overvalued and undervalued firms could increase share prices by splitting their firm's stock. Market efficiency suggests that this behavior would eliminate the information content associated with the stock distribution announcement. If stock distributions are cost free, then all firms could engage in stock distributions regardless of their current, past or future condition, and it would be impossible to discern any information about a particular firm's condition from a stock distribution.<sup>165</sup> In part, stock distributions may convey information to shareholders precisely because legal restrictions on cash dividends make it more difficult for some firms to engage in stock distributions than others.<sup>166</sup> Put another way, a stock distribution will not cause a shareholder to consider his holdings more or less valuable unless the distribution alters the courses of conduct available to management in the future.

One might think that if investors have preference, it would be for stock splits. After all, stock splits impinge less on a corporation's ability to pay cash dividends.<sup>167</sup> However, studies of debt covenant restrictions, an important means of legally restricting dividends,<sup>168</sup> suggest the opposite—that investors should react more positively to the more restrictive stock dividend treatment.<sup>169</sup> The reason being that stronger firms have a smaller probability of defaulting on their bond covenants or cutting cash dividends; whereas weaker firms have a larger probability. Hence, managers of strong firms will not be reluctant to account for stock distributions as stock dividends. When management of weaker firms attempt to mimic the behavior of their stronger counterparts, the reduction in earned surplus necessitated by the accounting for the distribution stock dividends increases the likelihood of reductions in cash dividends (or default on the firm's debt).<sup>170</sup> The greater the costs, including opportunity costs, associated with the reduction in earned surplus, the more positive should be the stock price response.<sup>171</sup> There is no reason why this analysis should be limited to cash dividend restrictions imposed by debt covenants. So long as some type of legal restriction on dividends exists, shareholders should react more positively to the information content inherent in the accounting treatment for stock dividends than stock splits.

Early studies demonstrated that shareholder response to stock dividends is larger than the response to stock splits,<sup>172</sup> but these studies failed to control for actual accounting treatment. A great disparity often exists between what a firm calls a stock distribution and the way in which the firm actually accounts for the distribution.<sup>173</sup> These early studies also focused on changes in earned surplus, but their results may be misleading because the statutes of most states do not restrict distributable equity to earned surplus, but also include the amounts in stated capital and/or capital surplus accounts.<sup>174</sup> More recent studies,<sup>175</sup> including this one, control for *actual* stock distribution accounting treatment and statutes governing financial distributions, as well as exchange listing and bond covenants restricting dividends. The empirical evidence reported herein supports the hypothesis that management's choice of accounting methods for which the stock

distribution accounting treatment reduces distributable equity conveys more information to investors than a treatment that does not reduce distributable equity.<sup>176</sup>

### III. Data And Method<sup>177</sup>

Two thousand seven hundred eighty-one (2,781) stock distributions of at least 25% were identified in the Center for Research in Security Prices<sup>178</sup> ("CRSP") daily master file over the period beginning January 1978 and ending December 1990. Each event<sup>179</sup> had to satisfy the following screens to be included in the empirical tests:

1. Security returns over the announcement period must be available in the CRSP file.
2. The announcement appears in the *Wall Street Journal Index*.<sup>180</sup>
3. No other confounding announcement is reported within five days of the event announcement.<sup>181</sup>
4. Firms subject to federal or other state regulatory agencies such as utilities, railroads, and financial institutions are eliminated.<sup>182</sup>
5. Foreign stocks and American depository receipts are omitted.<sup>183</sup>
6. Financial information must be available in the Q-Data file,<sup>184</sup> and either Standard & Poor's COMPUSTAT<sup>185</sup> Industrial or Industrial Research<sup>186</sup> file.

The *Wall Street Journal Index* was examined to determine the announcement date and any confounding announcements occurring within ten trading days surrounding announcement. As table 1 shows, this screening procedures reduced the sample to 492 events.

Table 1. Stock distribution sample selection procedure, 1978 - 1990.

Stock distributions identified using CRSP		2781
Confounding announcements		
	1663	

Cash dividend		
Earnings or sales	840	
Merger, acquisition, or joint venture	94	
Recapitalization	57	
Divestiture	27	
Takeover	26	
Antitakeover amendments	24	
Other ranked by declining frequency (stock repurchase (19), option listing (16), capital expenditure (18), debt redemption (18), debt rating change (10), etc.)	181	2,289 <sup>187</sup>
		492
Firms not bound by state corporate business laws		- 60
Foreign stock and American depository receipts		

		<u>- 23</u>
	-	-
-	-	409
Not included in Standard & Poor's COMPUSTAT files		<u>- 36</u>
	-	-
-	-	373
Insufficient information regarding accounting treatment		- 63
Alternative accounting treatment		<u>- 25</u>
	-	-
-		285
Final sample		

Sixty business corporations whose actions are monitored by state or federal regulatory agencies are eliminated because agency regulations may supersede the state's general business laws. Similarly, twenty-three foreign stocks are also omitted. Financial information was not available for another thirty-six companies and eighty-eight events were not included because insufficient information was available about the accounting treatment or they accounted for it using some alternative method.

Our method of screening produces an uncontaminated sample of 285 large stock distribution announcements (SDAs). 253 stock distributions satisfy all criteria necessary to be included in the regression model discussed below. The screening procedure reduces the probability that other events bias our interpretation of the parameter estimates in the statistical tests. However, the sample is not random and the results may not be generalizable to the population. Table 2 reports stock distribution announcements by year and split factor.

Table 2. Number and percentage of stock distribution announcements  
by year and split factor, 1978 - 1990.

Year	0.25	0.33	0.50	1.0	Other < 1.0	Other > 1.0	Total	Percent
1978	1	0	0	6	0	1	8	2.8
1979	2	0	4	4	1	1	12	4.2
1980	4	1	8	7	0	1	21	7.4
1981	2	2	3	19	1	2	29	10.2
1982	4	1	8	10	1	0	24	8.4
1983	1	2	17	19	0	2	41	14.4
1984	2	2	7	5	0	0	16	5.6
1985	2	3	8	5	0	0	18	6.3
1986	6	3	12	17	0	3	41	14.4
1987	2	2	5	12	0	3	24	8.4

1988	2	1	9	2	2	1	17	6
1989	2	0	9	9	0	0	20	7
1990	3	0	5	3	0	3	14	4.9
Total	33	17	95	118	5	17	285	100
Percent	12	6	33.3	41.4	1.8	6		

Almost 30% were announced in 1983 and 1986. Approximately 75% of the distributions were either two-for-one (118) or three-for-two (95). Seventeen announcements were splits greater than 100%, including eleven three-for-one stock distributions.

Prior research suggests that shareholder response to stock distribution announcement may be affected by exchange listing<sup>188</sup> and/or cash dividend policy.<sup>189</sup> Table 3 shows that NYSE-listed firms account for 159 (55.8%) events.

Table 3. Number and percentage of stock distribution announcements

by exchange-listing and cash dividend policy, 1978 - 1990.

	Cash dividend	No cash dividend	Total
Listing			

	100	59	159
New York Stock Exchange (NYSE)	35.1%	20.7%	55.8%
	52	74	126
American Stock Exchange (AMEX)	18.3%	25.9%	44.2%
Total	152	133	285
Percent	53.3%	46.7%	100.0%

The remainder (126) are announcements by AMEX-listed companies. The number of cases in which the firm did not pay cash dividends in the prior fiscal year is approximately evenly divided—152 (53.3%) cash dividend-paying stocks versus 133 (46.7%) non-cash dividend-paying securities.

Table 4 shows that 208 (73%) stock distributions can be attributed to firms incorporated<sup>190</sup> in balance sheet surplus jurisdictions.



MBCA States	Number	Balance sheet surplus states	Number	RMBCA states	Number
Arkansas	1	Delaware	129	Georgia	3
California	16	Florida	7	Illinois	1
Connecticut	5	Iowa	1	Indiana	1
Georgia	2	Louisiana	1	Massachusetts	16
Indiana	5	Maryland	5	New Jersey	1
North Carolina	2	Michigan	3		
Oklahoma	1	New Jersey	13		
Pennsylvania	3	New York	38		

Texas	12	Nevada	2		
Tennessee	2	Ohio	8		
Utah	2	Texas	1		
Washington	2				
Wisconsin	1				
Wyoming	1				
Total	55		208		22
Percent	19.3		73.0		7.7

Companies incorporated in Delaware and New York are represented most frequently. Fifty-five stock distributions (19.3%) were announced by firms incorporated in MBCA states and twenty-two (7.7%) stock distributions were declared by firms incorporated in RMBCA states where distributable equity is defined as the total of all stockholder equity accounts.<sup>192</sup>

Table 5 reports frequencies for three large stock distribution accounting treatments,<sup>193</sup> including: (1) pure stock splits for which firms decrease the par value of the common stock in proportion to the size of the distribution; (2) pure stock dividends for which firms reduce earned surplus for the aggregate par value of the shares distributed (Accounting Research Bulletin ARB 43); and (3) stock distributions for which firms

reduce capital surplus for the aggregate par value of the distributed shares (NYSE Listed Company Manual).

Table 5. Number and percent of stock distributions by legal jurisdiction and accounting treatment.<sup>194</sup>

Legal distributable equity	Stock split (change in par)	ARB 43 stock dividend (earned surplus)	NYSE stock dividend (capital surplus)	Total
MBCA state (earned surplus) <sup>195</sup>	18 6.3%	<b>11</b> <b>3.9%</b>	26 9.1%	55 19.3%
Balance sheet surplus state (earned surplus and capital surplus) <sup>196</sup>	28 9.8%	<b>36</b> <b>12.6%</b>	<b>144</b> <b>50.5%</b>	208 72.9%
Revised Model Act state (no equity restrictions) <sup>197</sup>	2 0.7	3 1.1	17 6.0	22 7.8%

		50	187	285
Total	48 16.8%	17.5%	65.6%	100.0%

In practice, forty-eight (16.8%) of the sample of large stock distributions were accounted for as pure stock splits and fifty (17.5%) of the distributions were accounted for by reducing earned surplus. However, 187 (65.6%) stock distributions were accounted for by reducing capital surplus according to NYSE accounting rules. Of this latter group, 103 were by firms actually listed on the NYSE.

In an earlier study, Grinblatt<sup>198</sup> assumed that stock distributions that result in reduced earned surplus conveys information to shareholders in that management would be reluctant to willingly account for stock distributions as stock dividends and thereby increase the probability of cutting cash dividends (or violating the firm's bond covenants) unless they were confident of increased future earnings. Grinblatt, however, failed take into account state statutes that limit corporate asset distributions to allow cash dividends equal to the sum of earned surplus and capital surplus, or the sum of earned surplus, capital surplus, and stated capital. The costly signals alluded to by Grinblatt should only apply to observations that account for large stock distributions as stock dividends if the firms are (1) incorporated in balance sheet surplus states and debit either earned surplus or capital surplus, or (2) if they are incorporated in MBCA states and debit earned surplus. When companies incorporated in MBCA states account for stock distributions according to NYSE accounting rules and transfer the aggregate value of shares distributed from capital surplus to common stock, the action is not costly because state law restricts cash dividends to the amount of earned surplus and not the amount of capital surplus. Because accounting for large stock distributions as pure stock splits does not involve transfers of capital from one equity account to another, stock splits are also not costly signals to management. In addition, the legal irrelevance of partitioning the equity portion of the balance sheet in RMBCA states means that differences among stock distribution accounting treatments is trivial. Accordingly, Table 5 cross-tabulates the sample by type of legal jurisdiction and the three observed forms of accounting treatment.<sup>199</sup>

Our distributable equity hypothesis states that if the combination of accounting treatment and legal jurisdiction is a financial signal, then we expect investor reaction to be more positive for announcements of large stock distributions for which accounting reduces distributable equity (bold L-shaped area) than for stock distributions for which the accounting does not reduce distributable equity. Our measure of investor response to announcement is the two-day mean market-adjusted returns ( $AR_i$ ) for the day the announcement appears in the *Wall Street Journal Index* and the preceding day. The abnormal return  $AR_i$  is defined as:  $AR_i = r_i - r_m$  where  $r_i$  is the difference between the return for the  $i$ 'th company and that on the market portfolio  $r_m$ .<sup>200</sup> The CRSP equally-weighted market index serves as proxy for the market portfolio. The two day abnormal returns are averaged within subsamples ( $AR$ ) to test our distributable equity hypothesis rather than Grinblatt's retained earnings (earned surplus) hypothesis.

Generalized least squares<sup>201</sup> is also used to estimate the parameters of the relations between the two-day mean abnormal return and variables representing the accounting/legal treatment combination, the amount of the reduction in distributable equity, and proxies for the various legal and contractual restrictions facing each company. The estimates are obtained from the following cross-sectional regression model.

$$AR_i = \beta_0 + \beta_1 TRT_i + \beta_2 LEV_i + \beta_3 TRTLEV_i + \beta_4 DIV_i + \beta_5 EXCH_i + \beta_6 SHRFAC_i + \varepsilon_i$$

where:

$AR$  = the two-day mean announcement period market-adjusted return;

$TRT$  = a categorical variable for the accounting/legal jurisdiction treatment;

$LEV$  = financial leverage, defined as long-term debt to net tangible assets;

$TRTLEV$  = a multiplicative dummy interaction term of accounting treatment and financial leverage;

$DIV$  = the ratio of the sum of stock dividends plus cash dividends paid to distributable equity;

$EXCH$  = a dummy variable denoting exchange listing;

$SHRFAC$  = share adjustment factor [(shares post-distribution / shares predistribution) - 1]; and

$i = 1, 2, \dots, 285$  event announcements.

Accounting treatment (" $TRT$ ") is a categorical variable that is one if distributable equity is reduced and zero if it is not reduced. A significant and positive coefficient for  $TRT$

would support our distributable equity hypothesis that the accounting choice is regarded by investors as a signal. In other words, choosing a stock distribution accounting treatment that reduces distributable equity signals more positive earnings information than choosing a method that does not reduce distributable equity.

Duke and Hunt<sup>202</sup> have shown that book value of long-term debt is significant and positively related to restrictions on earned surplus. As the level of debt increases, the probability of the firm violating its bond covenants also increases. Therefore, financial leverage ("LEV") is included in the model to control for the strength of the financial signal. It is defined as the ratio of long-term debt to net tangible assets at the fiscal year end immediately preceding the announcement.

The earnings-signaling hypothesis would predict more positive abnormal returns when distributable equity is reduced and the firm is more highly leveraged. TRTLEV is a multiplicative dummy interaction term included to capture the joint effect of accounting treatment and leverage on the earnings signal. The joint occurrence of high leverage and an accounting treatment that reduces distributable equity enters the model as one; all other joint occurrences are zero. Finding a positive relation between AR and TRTLEV would be consistent with the earnings-signaling hypothesis.

When accounting treatments for large stock distributions reduce distributable equity, the probability of maintaining the current level of non-liquidating cash dividends is reduced until the level of distributable equity is restored through earnings. Previous studies<sup>203</sup> use the ratio of cash dividends to unrestricted earned surplus to measure the cash dividend constraint. However, unrestricted earned surplus does not take into account the amount of equity capital legally distributable. In this study, the variable DIV is computed as the ratio of the sum of stock dividends that reduce distributable equity plus cash dividends paid during the year preceding the stock distribution to the unrestricted distributable equity reported at the end of that year. Stock dividends are, by definition, reductions in distributable equity and cash dividends represent future claims on distributable equity.

In addition, two other variables are included in the model. Grinblatt<sup>204</sup> found that stock price reaction to stock distribution announcements is greater for AMEX-listed firms than NYSE-listed companies. It may be that exchange listing proxies for firm size; large companies disseminating more information than small firms.<sup>205</sup> Hence, market reaction to the earnings signal content implicit in the stock distribution announcement is already partially discounted by market participants. Therefore, we include the dummy variable exchange listing (EXCH), coded 1 for AMEX firms and coded 0 for NYSE-listed companies. Grinblatt<sup>206</sup> and McNichols<sup>207</sup> find that price changes at stock distribution announcement are also positively correlated with the size of the split. To control for this relationship, we include the share adjustment factor SHRFAC as an explanatory variable.

#### IV. Results

Grinblatt<sup>208</sup> asserts that stock distributions that result in reduced earned surplus convey information to investors because the accounting treatment acts as a costly signal to

constrain management's ability to pay cash dividends. Grinblatt, however, fails to take into account that state statutes establishing limits on corporate property distributions may also allow cash dividends equal to the sum of earned surplus and capital surplus, or the sum of earned surplus, capital surplus, and stated capital. In this study 190 of the 285 total sample events satisfy these costly signal restrictions.

As shown in Table 6, investors react strongly to SDAs.<sup>209</sup> The two-day mean market-adjusted return is 1.52 percent ( $t = 10.092$ ).

Table 6. Sample and subsample market response to large stock

distribution announcements.

Furthermore, the market reacts positively for 75% of the events in this sample. These results are consistent with Grinblatt,<sup>210</sup> who document a cumulative two-day mean-adjusted return of 3.29% for their sample of 244 pure stock splits and a 71.3% frequency of positive announcement period returns.

The primary question in our analysis is whether or not shareholders react more positively to management's choice of an accounting treatment that reduces distributable equity. As shown in Panel B, the average return of 1.74% for events that reduce distributable equity is significantly greater than the 1.06% market reaction for events that do not ( $t = 2.311$ ). These results support the hypothesis that reductions in distributable equity are positive signals.

Panel C shows that shareholders react more positively to stock distribution announcements by AMEX-listed firms vis-à-vis NYSE-listed companies ( $t = 4.612$ ). However, the AR of 1.48% for cash-dividend paying firms is not significantly different from the AR from those companies that do not ( $t = 0.246$ ). Hence, the cash dividend-paying and non-cash dividend-paying groups are pooled in the regression analysis.

The model allows a test of whether shareholders differentiate and react more positively to stock distribution accounting treatments when the other factors affecting investor behavior are controlled. The parameter estimates reported in Table 7 show that the model is significant at the 0.0001 level with an F statistic of 15.473.

Table 7. Cross-sectional weighted least squares regression

results for 253 of the original 285 stock distribution

announcements.

$$AR_i = \beta_0 + \beta_1 TRT_i + \beta_2 LEV_i + \beta_3 TRTLEV_i + \beta_4 DIV_i + \beta_5 EXCH_i + \beta_6 SHRFAC_i + \varepsilon_i$$

Variable Definition

AR = the two-day mean announcement period market-adjusted return.

TRT = the accounting/legal jurisdiction treatment— 0 if distributable equity not reduced; 1 if distributable equity reduced.

LEV = financial leverage, defined as ratio of long-term debt to net tangible assets.

TRTLEV = a multiplicative dummy interaction term of accounting treatment and financial leverage.

DIV = the ratio of the sum of stock dividends plus cash dividends paid to distributable equity;

EXCH = the exchange listing -- 0 if NYSE; 1 if AMEX.

SHRFAC = share adjustment factor (shares post-distribution / shares predistribution) - 1.

Dependent variable: AR

Model F = 15.473 Prob. = 0.0001 Adjusted R<sup>2</sup> = 0.2563 n = 253

Variable	Coefficient	Standard Error	t-statistic	P-value
Constant	-0.0324	0.0098	-3.303	0.0001
TRT	0.0223	0.0078	2.859	0.0046
LEV	0.0408	0.0188	2.160	0.0317

TRTLEV	0.0171	0.0062	2.772	0.0060
DIV	-0.0394	0.4246	-0.093	0.9261
EXCH	0.0193	0.0038	5.016	0.0001
SHRFAC	0.0151	0.0059	2.542	0.0116

-

Eighteen observations are eliminated in the weighted least squares procedure due to division by zero error. Ten firms have missing data and are also eliminated. Two firms with restricted equity are eliminated, as are two statistical outliers.

A test of the hypothesis that the coefficient for the accounting/legal treatment variable TRT is positive is significant ( $t = 2.859$ ) at the 0.0046 level. This finding agrees with the univariate test statistic previously reported and lends additional support to the hypothesis that shareholders react more positively to the information conveyed by a stock distribution accounting method that reduces distributable equity.

We interpret the significant and positive parameter estimate for the financial leverage variable (LEV) as suggesting that shareholders respond positively to stock distribution announcements by leveraged companies ( $t = 2.160$ ). In addition, the combination of high financial leverage and accounting treatment that reduces distributable equity (TRTLEV) is interpreted as a more positive signal ( $t = 2.772$ ). That is, it moves management closer to its financial constraints.

The insignificant coefficient for DIV does not support our argument that the strength of the signal is positively related to signaling costs. We are unable to conclude that the stock dividend plus the distribution of cash dividends moves management closer to its financial constraints.

Market response to accounting treatment is more positive for firms listed on the American Stock Exchange EXCH ( $t = 5.016$ ). It is also more positive the greater the size of the stock distribution ( $t = 2.542$ ).

## V. Conclusion

The conventional wisdom about legal capital may be wrong. If legal capital did not matter, then the choice between stock dividend and stock split accounting treatments would not affect the market value of a firm, since the only difference between the two methods is the impact on legal capital. Our study demonstrates, however, that the price increase following the announcement of a large stock distribution effected as a stock dividend is larger than the price increase following a stock split.

The conventional wisdom, reflected in the RMBCA, the California Corporations Code, and a growing number of state statutes, presumes that distinctions among the various types of equity dictated by legal capital doctrines are irrelevant because the traditional concepts of par value and stated capital fail to protect creditors against financial distributions to shareholders. The focus on creditor protection, however, fails to consider the potential value of legal capital as one important component in conveying information from management to investors. The other two pieces being management's choice of the accounting treatment for large stock distributions and a corporation's debt restrictions.

Our analysis supports the hypothesis that the choice of stock distribution accounting method signals important information to investors. The available choices are affected by the extent to which the statute of incorporation includes legal capital doctrines, i.e., recognition of legal capital in the statute gives management more alternatives in accounting for stock distributions. With respect to statutory restrictions on dividends, the policymakers need to be especially careful that its corporate law reforms do not hinder the flow of information to common stock investors.<sup>211</sup>

In the end, corporate law does matter. Specific corporate law doctrines such as legal capital may not serve the interests for which they were created, but as the empirical evidence regarding legal capital shows, the choices about doctrines like legal capital made by legislators in drafting corporate statutes ultimately affect the wealth of shareholders for reasons not thought of by the conventional wisdom.

Appendix 1. Univariate test results for the sample and subsamples of large stock distributions.

Panel A: Test of mean two-day announcement period market-adjusted returns.

Event day	Return	Sample size	Student t	P value	% > 0
-1	1.92%	285	9.15	0.0001	71.13%
0	1.11%	285	6.07	0.0001	61.26%
Average	1.52%	285	10.09	0.0001	75.00%

Panel B: Test of market response difference based on accounting-legal treatment effects.

	Distributable equity reduced	Distributable equity not reduced	Student t	P value
AR	1.74%	1.06%	2.31	0.0218
number	190	95		

Panel C: Test of market response difference based on exchange-listing.

	NYSE	AMEX	Student t	P value
AR	0.89%	2.32%	4.61	0.0001
number	159	126		

Panel D: Test of market response difference based on prior year cash dividend policy.

	Paid cash dividend	No cash dividend	Student t	P value

AR	1.48%	1.56%	0.25	0.8060
number	152	133		

1 M.C. Jensen & W.H. Meckling, Agency Costs and the Theory of the Firm,  
3 J. FIN. ECON. 305, 310 (1976).

2 Id. at 311.

3 FRANK H. EASTERBROOK & DANIEL R. FISCHER, THE ECONOMIC STRUCTURE OF CORPORATE LAW 34 (1991). Some empirical studies have also suggested that shareholders are indifferent to both the choice of the state of incorporation and to changes in the relevant state's corporate law doctrines. See, e.g., Elliott J. Weiss & Lawrence J. White, Of Econometrics and Indeterminacy: A Study of Investors' Reactions to "Changes" in Corporate Law, 75 CAL. L. REV. 551 (1987).

4 See, e.g., Frank H. Easterbrook & Daniel R. Fischel, The Corporate Contract, 89 COLUM. L. REV. 1416 (1989). This analysis somewhat overstates the arguments of the "corporation as nexus of contract" proponents. Proponents of this theory concede that some provisions of corporate law are mandatory. Id. at 1417-18. While proponents of the nexus theory concede that certain types of market failures may justify some mandatory provisions, id. at 1436, they generally oppose mandatory terms in corporate law because such terms "halt the process of natural selection and evaluation" that corporate participants use to produce the optimal arrangement for their particular corporation. Id. at 1442.

5 Melvin Aron Eisenberg, The Structure of Corporation Law, 89 COLUM. L. REV. 1461, 1486 (1989) ("The characterization of corporation law as a standard-form contract whose terms each firm is generally free to vary is belied by the great number of mandatory rules of corporation law."); Ronald J. Gilson, Corporate Governance and Economic Efficiency: When Do Institutions Matter?, 74 WASH. U. L. Q. 327, 329 (1996) ("[O]ne need not entirely disregard corporate governance in order to question the relative magnitude of its importance").

6 Something has economic significance or consequences if it affects the decision-making behavior of business, government, unions, investors, creditors or other stakeholders in the business entity. Stephen A. Zeff, The Rise of "Economic Consequences," J. ACCT., Dec. 1978, at 56.

As previously noted, Professor Eisenberg is a harsh critic of the nexus of contract theory, yet he has also written that "the traditional [legal capital] statutory provisions concerning distributions bear virtually no relation to economic reality." Melvin Aron Eisenberg, The Modernization of Corporate Law: An Essay for Bill Cary, 37 U. MIAMI L. REV. 187, 200 (1983). Professor Bebchuk, for example, argues that regulation of corporate dividend policy is an important issue, but that "the limits on dividends established by state law are generally so weak and ineffectual as to have virtually no practical significance." Id. Lucian Arye Bebchuk, Federalism and the Corporation: The Desirable Limits on State Competition in Corporate Law, 105 HARV. L. REV. 1437, 1490 (1992). See also Philip McGough, Statutory Limits on a Corporation's Right to Make Distributions to Shareholders: The Law of Distribution in the 1984 Revised Model Business Corporation Act, 21 AKRON L. REV. 27 (1987) "Not only do [legal capital restrictions on dividends] not work, but an argument can be made that the provisions were irrelevant." There are also scholars who suggest that all

dividends lack economic consequences. See, e.g., Daniel R. Fischel, *The Law and Economics of Dividend Policy*, 67 VA. L. REV. 699, 701 (1981) "[T]he overwhelming weight of theoretical authority and recent empirical evidence does not support the proposition that dividend policy affects share prices apart from earnings." *Id.*; WILLIAM A. KLEIN & JOHN C. COFFEE, JR., *BUSINESS ORGANIZATION AND FINANCE: LEGAL AND ECONOMIC PRINCIPLES* 377 (5th ed. 1993) "[T]he total value of a firm is determined by its investment decisions and not by its dividend policy"; but see C. Wayne Shepherd & David F. Scott, Jr., *Corporate Dividend Policy: Some Legal and Financial Aspects*, 13 AM. BUS. L.J. 199 (1975) (comparing a particular firm's dividend policy with the industry standard yields important information about the company in question).

7 This is largely seen as a welcome example of the principle that policymakers should take these economic consequences into consideration when deciding such questions. Since stock distributions involve both legal and accounting issues, it should be noted that this principle applies with equal force to policymakers in the accounting profession. "There is a growing recognition that the setting of financial accounting standards which govern what business corporations must report (i.e., disclosure issues) and how they must describe their economic operations (i.e., measurement issues) needs to be viewed more broadly than simply from a technical accounting perspective? . The expanded view of standard setting comes from an increasing recognition that the legislation of accounting standards involves a potential redistribution of wealth, i.e., it imposes restrictions or costs on some while conferring benefits to others." Alfred Rappaport, *Economic Impact of Accounting Standards-Implications for the FASB*, J. ACCT., May 1977, at 89.

"It is a fair generalization that historically accounting standards have been based in a greater measure on technical accounting considerations than on the potential economic and social ramifications they might be expected to have." Arthur Wyatt, *The Economic Impact of Financial Accounting Standards*, J. ACCT., Oct. 1977, at 92.

8 Both types of stock distributions result in an increase in the number of outstanding shares of a particular corporation's common stock without changing the pro rata holdings of any shareholder. Most accountants would suggest, however, that both types of stock distributions are basically cosmetic maneuvers having little to do with income determination and balance sheet valuation. ELDEN S. HENDRIKSEN, *ACCOUNTING THEORY* 477 (4th ed. 1982).

9 *Id.*

10 Similarly, economists would argue that a stock distribution is

irrelevant by appealing to the efficient market hypothesis. "The primary role of the capital market is allocation of ownership of the economy's capital stock. In general terms, the ideal is a market in which prices provide accurate signals for resource allocation; that is, a market in which firms can make production-investment decisions, and investors can choose among the securities that represent ownership of firm's activities under the assumption that security prices at any time

'fully reflect' all available information. A market in which prices always "fully reflect" available information is called 'efficient.'" Eugene F. Fama, *Efficient Capital Markets: A Review of Theory and Empirical Work*, 25 J. FIN. 383 (1970).

11 A stock split by itself does not convey new information to market participants. *Id.* at 405. Legal scholars have criticized stock distributions and the concept of legal capital for similar reasons. See, e.g., LEWIS D. SOLOMON, ET AL., *CORPORATIONS: LAW AND POLICY* 261 (3d ed. 1994) (Stock dividends "produce no meaningful change in the financial status of the corporation or its shareholders"); Robert C. Art, *Corporate Shares and Distributions in a System Beyond Par: Financial Provisions of Oregon's New Corporation Act*, 24 WILLIAMETTE L. REV. 203, 221 (1988) (Stock distributions have "virtually no economic significance.").

12 Contrary to the conventional wisdom of accountants, economists and lawyers, empirical evidence suggests that shareholders associate stock distributions, i.e., stock dividends and stock splits, with fundamentally more important information, such as increased cash dividends. Eugene F. Fama, Lawrence Fisher, Michael C. Jensen & Richard Roll, *The Adjustment of Stock Prices to New Information*, 10 INT'L ECON. REV. 1, 16 (1969).

13 *Id.* at 9.

14 The use of legal capital to restrict dividends can be traced back to the seventeenth century. McGough, *supra* note 6, at 30. See also ALFRED F. CONARD, *CORPORATIONS IN PERSPECTIVE* 308 (1976) ("An idea almost as old as the business corporation is the notion that corporation should maintain a pool of assets which is not only equal to its debts, but contains a 'cushion' of some measure beyond its debts.").

15 *Wood v. Dummer*, 30 F.Cas. 435 (no. 17,944) (C.C.D. Me. 1824). According to Manning and Hanks, "the entire range" of legal capital doctrines can be traced to Justice Story's decision in *Wood v. Dummer*. BAYLESS MANNING & JAMES J. HANKS, JR., *LEGAL CAPITAL* 30-31 (3d ed. 1990); accord, MORTON J. HORWITZ, *THE TRANSFORMATION OF AMERICAN LAW 1870-1960: THE CRISIS OF LEGAL ORTHODOXY* 93 (1992). Justice Story, however, rested his landmark holding that the corporation held the money paid for stock as a trust fund for the benefit of the corporation's creditors not only "general principles" and "common sense," 30 F.Cas. at 436, but also on two earlier Massachusetts cases, *Vose v. Grant*, 15 Mass. 505 and *Spear v. Grant*, 16 Mass. 9.

16 30 F.Cas. 435, 436 (no. 17,944) (C.C.D. Me. 1824).

17 *Id.* at 436. (holding that creditors have the first claims upon it; and the stockholders have no rights, until all other creditors are satisfied); MANNING & HANKS, *supra* note 15, at 32; ALFRED F. CONARD, *supra* note 14, at 309 ("Nineteenth and early twentieth century decisions started from the premise that whatever values had been originally paid in for the shares should be maintained.").

18 McGough, *supra* note 6, at 29 ("Historically, the primary purpose of the law has been to protect creditors."). *Id.*

19 *Id.*

20 William H. Ralston, Note, The 1980 Amendments to the Financial Provisions of the Model Business Corporation Act: A Positive Alternative to the New York Statutory Reform. 47 ALB. L. REV. 1019 n.6 (1983).

21 "Watered stock," not purchase prices in excess of par value or illegal dividends, was the main concern of courts dealing with legal capital doctrines. "This question ? represented one of the two or three most important issues in corporate law during the late nineteenth century and generated hundreds of cases and thousands of pages of legal writing." HORWITZ, *supra* note 15, at 93 (1992). See also LAWRENCE M. FRIEDMAN, A HISTORY OF AMERICAN LAW 514-16 (2d ed. 1985).

22 MANNING & HANKS, JR., *supra* note 15, at 22-26.

23 See, e.g., *Coit v. North Carolina Gold Amalgamating Co.*, 14 F. 12, 14 (C.C.E.D. Pa. 1882) ("[I]n the case of stock dividends fairly made, in consideration of profits earned, and of accumulations of the property, ? a court of chancery would have no power to revive a claim against the stockholders because they had not advanced actual cash for the shares.").

24 MANNING & HANKS, JR., *supra* note 15, at 28-29.

25 See MORTON J. HORWITZ, SANTA CLARA REVISITED: THE DEVELOPMENT OF CORPORATE LAW, IN CORPORATIONS AND SOCIETY 13 (W.J. Samuels and A.S. Miller eds., 1987) (linking the history of the trust fund theory to changing notions of the role of shareholders in corporations). In 1891, the United States Supreme Court praised the trust fund theory as a "wholesome doctrine," but the Court also felt that the theory only applied to insolvent corporations. *Handley v. Stutz*, 139 U.S. 417, 430 (1891). A year later, the Supreme Court of Minnesota called the doctrine "misleading" in *Hospes v. Northwestern Mfg. & Car Co.*, 50 N.W. 1117, 1119 (Minn. 1892). The *Hospes* court stated that the "capital of a corporation is its property." *Id.* Corporate property, said the court in *Hospes*, "is not held in trust, in any proper sense of the term." *Id.* In direct contradiction of the *Handley* decision, the court in *Hospes* held that a creditor could not hold a shareholder liable for the unpaid par value of stock absent a showing of actual fraud.

26 MANNING & HANKS, JR., *supra* note 15, at 29-30; HORWITZ, *supra* note 15, at 97.

27 The conventional wisdom of the times was torn between a desire for flexibility and an attachment to Victorian conceptions of par value can be seen from a contemporary treatise on corporate law. WILLIAM ALLEN WOOD, MODERN BUSINESS CORPORATIONS (2d ed. 1917). At one point, Wood stresses that a corporation should "make the market value of [its] stocks ? correspond as nearly as may be with their par value." *Id.* at 35. The "general and best," Wood says, requires shareholders who

received "bonus or partly paid stock" from the corporation to "be held liable to the full amount of the par value" if the corporation becomes insolvent. *Id.* at 112. Later, however, Wood concedes that "par value may be confusing and that after a corporation is organized, it is practically meaningless." *Id.* at 297. Noting that Pennsylvania, Maryland, and Delaware had quickly copied New York's provision for no par stock, *id.* at 298-99, Wood reported that "investors, bankers and managers ? are pleased with the law and its results" and that this "tendency seems to be a simplification in the right direction." *Id.* at 309.

28 See, e.g., Comment, *The Statutory Responsibility for Payment of Dividends Out of Capital*, 35 *YALE L.J.* 870 (1926) (calling for clarification of directors' duties, rather than a fundamental overhaul of legal capital doctrines).

29 Although the last iteration of the MBCA came out in 1969, the basic legal capital framework was set out in the 1950 version of the Model Act. McGough, *supra* note 6, at 33-34.

30 MODEL BUS. CORP. ACT ANN. § 2, ¶2 (2d ed. 1971) ("These terms, or similar ones serving the same function, are used in all corporate statutes in the United States today, although they are not always defined.").

31 MODEL BUS. CORP. ACT ANN. 2d § 45(c) to (e) ¶ 2 (1971).

32 CAL. CORP. CODE §§ 166, 500; Richard O. Kummert, *State Statutory Restrictions on Financial Distributions by Corporations to Shareholders Part II*, 59 *WASH. L. REV.* 185, 187 (1984) ("[I]t is now apparent that the era began with the adoption by the California legislature in 1975 of that state's unique series of restrictions on dividends and share repurchases by corporations.").

33 MANNING & HANKS, JR., *supra* note 15, at 39 (Legal capital "is initially the product of par value-itself an arbitrary dollar amount printed on the stock certificate and recited in the certificate of incorporation-multiplied by the number of shares 'outstanding.'").

34 The amendments were proposed in 1979, *Committee on Corporate Laws, Changes in the Model Business Corporation Act-Amendments to Financial Provisions*, reprinted in 34 *BUS. LAW.* 1867 (1979), and adopted in December 1979. *Committee on Corporate Laws, Changes in the Model Business Corporation Act-Amendments to Financial Provisions*, 35 *BUS. LAW.* 1365 (1980). Because notice of the adoption was not published until the following April, *id.*, many commentators have erroneously indicated that the amendments were adopted in 1980.

35 *Committee on Corporate Law*, *supra* note 34, at 1867 ("The amendments ? reflect a complete modernization of all provisions of the Model Act concerning financial matters, including ? the elimination of the outmoded concepts of stated capital and par value"); Elliott Goldstein & Robert W. Hamilton, *The Revised Model Business Corporation Act*, 38

BUS. LAW. 1019, 1021 (1983) The amendments "eliminated the traditional concepts of par value, stated capital, and treasury shares and substituted a simpler, less confusing, and potentially less misleading treatment." Id. see also, Art, supra note 11, at 204 ("The financial provisions of [the RMBCA] proceed from a radical premise: that 'par value' of stock-the core concept of legal capital requirements throughout the country for generations-served no worthwhile purpose and should be abandoned.").

36 Kummert, supra note 32, at 196.

37 Yoav Ben-Dror, An Empirical Study of Distribution Rules Under California Corporations Code §500: Are Creditors Adequately Protected?, 16 U.C. DAVIS L. REV. 375, 378 (1983).

38 The specific state statutes referenced in this chart are: ALA. CODE § 10-2A-67 (1991) (repealed 1994); ALASKA STAT. § 10.06.358 (Michie 1991); ARIZ. REV. STAT. ANN. § 10-045 (West 1991) (repealed 1994); ARK. CODE ANN. § 4-27-6402 (Michie 1991); CAL. CORP. CODE §§ 166, 500 (West 1991) (CAL. CORP. CODE § 500 amended 1994); COLO. REV. STAT. § 7-5-110 (1991) (repealed 1993); CONN. GEN. STAT. ANN. § 33-356 (West 1991) (repealed 1994); DEL. CODE ANN. tit. 8, § 170, 173 (1991) (DEL. CODE ANN. tit. 8, § 170, amended 1993); D.C. CODE ANN. § 29-340 (1991); FLA. STAT. ANN. § 607.06401 (West 1991); GA. CODE ANN. § 14-2-640 (Michie 1991); HAW. REV. STAT. § 415-45 (1991); IDAHO CODE § 30-1-45 (1991); ILL. COMP. STAT. ANN. ch. 32, § 9.10 (West 1991); IND. CODE ANN. §§ 23-1-28-1-23-1-28-6 (Michie 1991); IOWA CODE ANN. § 490.640 (West 1991); KAN. STAT. ANN. §§ 17-6420, 17-6423 (1991) (KAN. STAT. ANN. § 17-6423 amended 1992); KY. REV. STAT. ANN. § 271B.6-400 (Michie 1991); LA. REV. STAT. ANN. § 12:634 (West 1991); ME. REV. STAT. ANN. tit. 13-A, § 514 - 515 (West 1991); MD. CODE ANN., Corps. & Assn'ns §§ 2-301, 2-309-2-3118 (1991) (MD. CODE ANN., Corps. & Assn'ns §§ 2-310 and 2-311 amended 1992); MASS. GEN. LAWS ANN. ch. 156B, §§ 9, 54, 61 (West 1991); MICH. COMP. LAWS ANN. § 450.1345 (West 1991) (amended 1993); MINN. STAT. ANN. § 302A.551 (West 1991) (amended 1991 and 1993); MISS. CODE ANN. § 79-4-6.40 (1991); MO. ANN. STAT. § 351.220 (West 1991); MONT. CODE ANN. § 35-1-711 (1991) (repealed 1991); NEB. REV. STAT. § 21-2043 (1991) (repealed 1995); NEV. REV. STAT. § 78.290 (1991) (repealed 1991); N.H. REV. STAT. ANN. § 293-A:45 (1991) (repealed 1992); N.J. STAT. ANN. §§ 14A:7-14.1, 7-15, 7-15.1 (West 1991) (N.J. STAT. ANN. § 14A:7-15.1 amended 1995); N.M. STAT. ANN. § 53-11-44 (Michie 1991); N.Y. BUS. CORP. LAW § 510 (McKinney 1991); N.C. GEN. STAT. § 55-6-40 (1991) (amended 1991); N.D. CENT. CODE § 10-19.1-92 (1991) (amended 1995); OHIO REV. CODE ANN. § 1701.33 (Anderson 1991) (amended 1993); OKLA. STAT. ANN. tit. 18, § 1049 (West 1991); OR. REV. STAT. § 60.181 (1991); PA. STAT. ANN. tit. 15, § 1551 (West 1991); P.R. LAWS ANN. tit. 14, § 1517 (1991); R.I. GEN. LAWS § 7-1.1-40 (1991) (amended 1992); S.C. CODE ANN. § 33-6-400 (Law Co-op. 1991); S.D. CODIFIED LAWS §§ 47-3-70 - 47-3-76 (Michie 1991); TENN. CODE ANN. § 48-16-401 (1991) (amended 1994); TEX. BUS. CORP. ACT ANN. art. 2.38 (West 1991); UTAH CODE ANN. § 16-10-41 (1991) (repealed 1992); VT. STAT. ANN. tit. 11, § 1889 (1991) (repealed 1993); VA. CODE ANN. § 13.1-653 (Michie 1991); WASH. REV. CODE ANN. § 23B.06.400 (West 1991); W. VA. CODE § 31-1-99 (1991); WIS. STAT. ANN. § 180.0640 (West 1991) (amended 1995); WYO. STAT. ANN. § 17-16-640 (Michie 1991).

Since August of 1991 the following states have adopted the RMBCA approach: Alabama, ALA. CODE § 10-2B-6.40 (1996); Arizona, ARIZ. REV. STAT. ANN. § 10-640 (West 1996); Connecticut, CONN. GEN. STAT. ANN. § 33-687 (West 1994); Nebraska, NEB. REV. STAT. § 21-2050 (1996); Nevada, NEV. REV. STAT. § 78.288 (1995); New Hampshire, N.H. REV. STAT. ANN. § 293-A:6.40 (1995); Utah, UTAH CODE ANN. § 16-10a-640 (1996); Vermont, VT. STAT. ANN. tit. 11A, § 6.40 (1996). Montana revised its business corporation statute effective 1992 and recodified its dividend restrictions. MONT. CODE ANN. § 35-1-712 (1995).

39 Ben-Dror, *supra* note 37, at 381 (The "dual insolvency test prohibits distributions [to shareholders] that cause either 'equitable insolvency,' an inability to pay debts as they become due, or '[balance sheet] insolvency,' wherein total liabilities exceed total assets.").

40 In addition to the two major restrictions discussed in this section, the corporation may not pay a dividend when it would violate a restriction contained in the articles of incorporation. MODEL BUS. CORP. ACT § 45 (1969) ("The corporation may pay dividends in cash, property, or its own shares, except when the declaration or payment thereof would be contrary to any restriction contained in the articles of incorporation."). The MBCA also contains provisions designed to protect the proportionate interests of shareholders. See, e.g., MODEL BUS. CORP. ACT § 45(e) (1969).

41 MODEL BUS. CORP. ACT ANN. 2d § 45 (1971) (Official Comment, at 890-91).

42 "'Insolvent' means the inability of a corporation to pay its debts as they become due." MODEL BUS. CORP. ACT § 2(n) (1969).

43 MODEL BUS. CORP. ACT § 45 (1969) ("The corporation may pay dividends in cash, property, or its own shares, except when the corporation is insolvent or when the or payment thereof would render corporation insolvent or when the declaration or payment thereof would be contrary to any restriction contained in the articles of incorporation.").

44 MANNING & HANKS, JR., *supra* note 15, at 64.

45 "Surplus means the excess of net assets over the corporation's stated capital." MODEL BUS. CORP. ACT § 2(k) (1969). Net assets means the amount by which the corporation's total assets exceed its total debts. MODEL BUS. CORP. ACT § 2(i) (1969). Total debts include all cumulative dividends accrued on all preferred or special classes of shares entitled to preferential dividends. MODEL BUS. CORP. ACT § 46(c) & (d) (1969). Stated capital means the par value of all shares issued plus all or some portion of the consideration received on shares issued without par value. Also included are such amounts having been transferred to stated capital, whether upon the issue of shares as a share dividend or otherwise, minus all reductions from such sum as having been effected in a manner permitted by law. MODEL BUS. CORP. ACT § 2(j) (1969). See also MODEL BUS. CORP. ACT § 21 (1969) (the determination of and additions to stated capital) and MODEL BUS. CORP. ACT §§ 67-69 (1969) (steps that in each case will reduce stated capital).

46 MODEL BUS. CORP. ACT § 2(1) (1969) ("'Earned surplus' means the portion of the surplus of corporation equal to the balance of its net profits, income, gains and losses from the date of incorporation."). The accounting literature refers to this same account as retained earnings. See, e.g., STANLEY SIEGEL & DAVID A. SIEGEL, ACCOUNTING AND FINANCIAL DISCLOSURE: A GUIDE TO BASIC CONCEPTS 98 (1983) ("The accumulated income of the corporation ? is separately identified in the account as Retained Earnings.").

47 MODEL BUS. CORP. ACT § 2(m) (1969) ("'Capital surplus' means the entire surplus of a corporation other than its earned surplus."). The accounting literature often refers to capital surplus as "capital in excess of par value" or "additional paid in capital." See, e.g., SIEGEL & SIEGEL, *supra* note 46, at 98.

48 MODEL BUS. CORP. ACT ANN. 2d § 2 (1971) (Official Comment, at 35).

49 Earned surplus becomes "reserved" by a board of director's resolution to that effect. Such action requires that a corporation designate a portion of earned surplus for a particular purpose thus making it unavailable for dividends. Boards of directors may appropriate earned surplus for discretionary purposes such as plant expansion or in anticipation of future losses. MODEL BUS. CORP. ACT § 70 (1969) ("A corporation may, by resolution of its board of directors, create a reserve or reserves out of its earned surplus for any proper purpose or purposes, and may abolish any such reserve in the same manner. Earned surplus of the corporation to the extent so reserved shall not be available for the payment of dividends or other distributions by the corporation except as expressly permitted by this Act.").

50 Creditors may also impose restrictions on cash dividend payments in loan agreements and indentures as a precondition to lending money. MODEL BUS. CORP. ACT ANN. 2d § 45 (1971) (Official Comment, at 890).

Treasury shares also restrict earned surplus. Treasury shares are issued shares of a corporation that have been subsequently acquired by and belong to the corporation, and have not been canceled or otherwise restored to the status of authorized but unissued shares. MODEL BUS. CORP. ACT § 2(h) (1969); see also MODEL BUS. CORP. ACT ANN. 2d § 2(g) (1971). In order to restrict a corporation from influencing its net income by trading in its own stock, a corporation cannot recognize a gain or loss when reacquiring its own shares. The amount of earned surplus is "restricted" by the cost of the treasury stock holdings so that payment of cash dividends will not reduce contributed capital (stated capital and paid-in capital). Consequently, treasury stock is a reduction of stockholders' equity even though its acquisition does not formally reduce legal capital - i.e., the amount of stockholders' equity that cannot be distributed to shareholders.

51 MODEL BUS. CORP. ACT § 45(a) (1969) ("Dividends may be declared and paid in cash or property only out of the unreserved and unrestricted earned surplus of the corporation."). An alternative section 45(a) provides that "[d]ividends may be declared and paid in cash or property only out of earned surplus or the corporation, or out of the unreserved

and unrestricted net earnings of the current fiscal year and the next preceding fiscal year taken as a single period." MODEL BUS. CORP. ACT § 45(a) (1969) (alternative). These are "nimble dividends." The MBCA also allows a corporation to reduce capital surplus instead of earned surplus for a cash or property dividend under certain circumstances. MODEL BUS. CORP. ACT § 46 (1969).

52 MODEL BUS. CORP. ACT § 45(d) (1969) ("Dividends may be declared and paid in [the corporation's] own authorized but unissued shares out of any unreserved and unrestricted surplus of the corporation.").

53 MODEL BUS. CORP. ACT § 45(d) (1) (1969).

54 Id. at § 45(d) (2) (1969).

55 HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS 921 (3d ed. 1983) ("No share dividend itself can affect a corporation's insolvency in either [the] equity or bankruptcy sense.").

56 Id. "At a minimum, there must be sufficient surplus, earned or unearned, to cover a sufficient transfer to stated capital to represent the new issued shares resulting from the share dividend." Id. Although Henn and Alexander subsequently state that a stock dividend cannot "affect a corporation's insolvency in [a] bankruptcy sense," id., they must mean bankruptcy insolvency in the strict sense of liabilities exceeding assets.

57 Of course, the corporation's board of directors could remedy this situation by amending the articles of incorporation to reduce par value and create surplus.

58 MODEL BUS. CORP. ACT § 45 (1969) ("A split-up or division of the issued shares of any class into a greater number of shares of the same class without increasing the stated capital of the corporation shall not be construed to be a share dividend.").

59 MODEL BUS. CORP. ACT ANN. 2d § 45 (1971) (Official Comment, at 925).

60 Id. at § 45 (1971) (Official Comment, at 889-90).

61 Avner Kalay, Stockholder-Bondholder Conflict and Dividend Constraints, 10 J. FIN. ECON. 211 (1982). Clifford W. Smith & Jerold B. Warner, On Financial Contracting: An Analysis of Bond Covenants, 7 J. FIN. ECON. 117 (1979). MODEL BUS. CORP. ACT ANN. 2d § 45 (1971) (Official Comment, at 891).

62 MODEL BUS. CORP. ACT. § 45(a) (1969) ("[Alternative] (a) Dividends may be declared and paid in cash or property only out of the unreserved and unrestricted earned surplus of the corporation, or out of the unreserved and unrestricted net earnings of the current fiscal year and the next preceding fiscal year taken as a single period, except as otherwise provided in this section.").

63 MANNING & HANKS, JR., supra note 15, at 82-84; HENN & ALEXANDER, supra note 55, at 892; Kummert, supra note 32, at 194.

64 MANNING & HANKS, JR., supra note 15, at 83.

65 MODEL BUS. CORP. ACT § 45 (1969).

66 Bondholders, who perceive that their rights are subject to greater jeopardy under this alternative, may, of course, respond by imposing more restrictive covenants. Kummert, supra note 32, at 196. When debt covenants restrict a larger amount of retained earnings, accounting for stock distributions as stock dividends increases the probability that a firm will default or be forced to cut future cash dividends. Mark S. Grinblatt, Ronald W. Masulis & Sheridan Titman, The Valuation Effects of Stock Splits and Stock Dividends, 13 J. FIN. ECON. 461, 463 (1984).

67 MANNING & HANKS, JR., supra note 15, at 82-84.

68 Delaware does not distinguish between earned and capital surplus. DEL. GEN. CORP. LAW § 154. The statute provides that a corporation may 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." DEL. GEN. CORP. LAW § 170(a). Manning and Hanks find the wording of this statute is ambiguous. Some accounting questions include, for example, a definition of "profits". Do profits imply earnings? What are "net" profits? A related question concerns time. Does the reference to fiscal year mean a full year so that corporations may not, at six months into the year, pay dividends out of the net profits of the first six months? In addition, what does "and/or" mean? In short, what is distributable given the ambiguous wording of the statute? MANNING & HANKS, JR., supra note 15, at 84.

69 See N.Y. BUS. CORP. LAW § 510(b) ("Dividends ? may be made out of surplus only, so that the net assets of the corporation remaining after such ? distribution shall at least equal the amount of its stated capital."). Id. New York also prohibits cash and property dividends when the corporation is insolvent or would be rendered insolvent by payment of the dividend. N.Y. BUS. CORP. LAW § 510(a). Unlike the MBCA, the New York statute does not apply this equity insolvency test to stock dividends. N.Y. BUS. CORP. LAW § 511.

70 Kummert, supra note 32, at 211-17.

71 Id. at 202.

72 Some states, such as Delaware, combine the balance sheet surplus test with the nimble dividends test. See DEL. GEN. CORP. LAW §§ 154 & 170.

73 Kummert, supra note 32, at 220.

74 Committee on Corporate Law, supra note 34, at 1867; MANNING & HANKS, JR., supra note 15, at 176-209.

75 Committee on Corporate Law, *supra* note 34, at 1867; MANNING & HANKS, *supra* note 15, at 179 (The RMBCA "eliminated almost every reference to par, and eradicated all references to stated capital, treasury shares, surpluses, and all their fearsome progeny."). *Id.*

76 REV. MODEL BUS. CORP. ACT § 1.40(6) (1987) ("'Distribution' means a direct or indirect transfer of money or other property (except its own shares) or incurrence of indebtedness by a corporation to or for the benefit of its shareholders in respect of any of its shares. A distribution may be in the form of a declaration or payment of a dividend; a purchase, redemption, or other acquisition of shares; a distribution of indebtedness; or otherwise"); see Committee on Corporate Law, *supra* note 34, 34 BUS. LAW. at 1867.

77 REV. MODEL BUS. CORP. ACT § 6.40(c)(1) (1987) ("No distribution may be made if, after giving it effect ? the corporation would not be able to pay its debts as they become due in the usual course of business); Committee on Corporate Law, *supra* note 34, 34 BUS. LAW. at 1868.

78 Committee on Corporate Law, *supra* note 34, at 1868; MANNING & HANKS, JR., *supra* note 15, at 182-86.

79 REV. MODEL BUS. CORP. ACT § 6.40(c)(2) (1987) ("No distribution may be made if, after giving it effect? the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution"); Committee on Corporate Law, *supra* note 34, at 1872; see also, Kummert, *supra* note 32, at 244.

The balance sheet test may be based upon financial statements prepared on the basis of (1) accepted accounting practices or (2) a fair valuation or other method that is reasonable in the circumstances. REV. MODEL BUS. CORP. ACT § 6.40(d) (1987) ("The board of directors may base a determination that a distribution is not prohibited under subsection (c) either on financial statements prepared on the basis of accounting practices and principles that are reasonable in the circumstances or on a fair valuation or other method that is reasonable in the circumstances"); Committee on Corporate Law, *supra* note 34, 34 BUS. LAW. at 1872.

80 Committee on Corporate Law, *supra* note 34, 34 BUS. LAW. at 1868-69; MANNING & HANKS, JR., *supra* note 15, at 183-84 (A corporation may "fix a par [value] for its shares ? [b]ut for purposes of assessing the legality of a distribution to shareholders, all those things matter not.").

81 Kummert, *supra* note 32, at 249-50.

82 MASS. GEN. LAWS ANN. ch. 156B, §§ 45, 61.

83 MINN. STAT. ANN. § 302A.551 Subdivision 1.

84 N.D. CENT. CODE § 10-19.1-92.1.

85 One commentator has suggested that while Massachusetts statutory law does not place any express limits on a corporation's ability to pay dividends, the state's common law uses a test essentially equivalent to the RMBCA. James E. Tucker, Director and Shareholder Liability for Massachusetts Corporations' Distributions to Shareholders: A Suggestion for Change in Standards of Director Liability, 28 NEW ENG. L. REV. 1025 (1994).

86 Kummert, *supra* note 32, at 257.

87 The Minnesota Act, for example, follows the basic structure of the Revised Model Business Corporation Act in that par value, stated capital, paid-in surplus, and earned surplus are no longer required. Kummert, *supra* note 32, at 256.

88 See MINN. STAT. ANN. § 302A.551; N.D. Cent. Code § 10-19.1-92(5).

89 Kummert, *supra* note 32, at 261.

90 CAL. CORP. CODE §§ 166, 500 (1996).

91 Kummert, *supra* note 32, at 242, 284-87.

92 CAL. CORP. CODE § 166 (1996) ("Distribution to its shareholders' means the transfer of cash or property by a corporation to its shareholders without consideration, whether by way of dividend or otherwise, except a dividend in shares of the corporation, or the purchase or redemption of its shares for cash or property, including the transfer, purchase, or redemption by a subsidiary of the corporation.").

93 CAL. CORP. CODE § 500 (1996) (Legislative Committee Comment) ("These provisions are based on the current financial condition of the corporation and permit a corporation to make a distribution to its shareholders out of retained earnings.").

94 CAL. CORP. CODE § 501 (1996) ("Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders (Section 166) if the corporation or the subsidiary making the distribution is, or as a result thereof would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature"); see also, CAL. CORP. CODE § 500 (1996) (Legislative Committee Comment ("any distribution is subject to a solvency test")).

95 CAL. CORP. CODE § 500 (a) (1996) ("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.").

96 CAL. CORP. CODE § 500 (b) (1) (1996) ("The distribution may be made if immediately after giving effect thereto [t]he sum of the assets of

the corporation (exclusive of goodwill, capitalized research and development expenses and deferred charges) would be at least equal to 1 1/4 times its liabilities (not including deferred taxes, deferred income and other deferred credits)").

97 CAL. CORP. CODE § 500 (b) (2) (1996) ("The distribution may be made if immediately after giving effect thereto [t]he current assets of the corporation would be at least equal to its current liabilities.").

98 CAL. CORP. CODE § 500 (b) (2) (1996) ("[I]f the average of the earnings of the corporation before taxes on income and before interest expense for the two preceding fiscal years was less than the average of the interest expense of the corporation for those fiscal years, [current assets must be] at least equal to 1 1/4 times its current liabilities.").

99 Kummert, *supra* note 32, at 234-35.

100 ALASKA STAT. § 10.06.358, *et seq.* (1996).

101 MODEL BUS. CORP. ACT § 45(a) (1969).

102 *Id.* at § 45(e).

103 See *id.* at § 2(h). Treasury shares' means shares of a corporation which have been issued, have been subsequently acquired by and belong to the corporation, and have not, either by reason of the acquisition or thereafter, been canceled or restored to the status of authorized but unissued shares. Treasury shares shall be deemed to be issued shares, but not outstanding shares.

104 See *id.* at § 6.

105 LOREN A. NIKOLAI & JOHN D. BAZLEY, *INTERMEDIATE ACCOUNTING* 792 (4th ed. 1988).

106 See, e.g., N.Y. BUS. CORP. LAW § 510(b).

107 REV. MODEL BUS. CORP. ACT § 6.40 (1984).

108 See, e.g., Ralston, *supra* note 20, at 1021 ("The need to adopt a modern approach to the regulation of dividends and other distributions is long overdue."); Art, *supra* note 11, at 225 ("The time for statutory reform of the legal capital system was long overdue, and the proper course was repeal, not repair.").

109 "The issue of whether any change is required in the state's corporate financial provisions should receive a resounding affirmative answer from the legislature in any state currently basing such provisions on legal capital. ? Legislatures deciding to alter their corporate financial provisions must then face the more difficult question of which of the alternative systems not based on legal capital should be chosen." Kummert, *supra* note 32, at 282.

110 CONARD, *supra* note 14, at 311; see also Uriel Procaccia, *Crafting a Corporate Code from Scratch*, 17 *CARDOZO L. REV.* 629, 633 (1996) ("[P]ar values have no connection to any real yardsticks of corporate worth.").

111 "It has long been recognized ? that the pervasive 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." Committee on Corporate Law, *supra* note 34, at 1867. See also Art, *supra* note 11, at 205 ("The original goals of the traditional legal capital system ? were laudable: the protection of investors and creditors."); Ben-Dror, *supra* note 37, at 378 ("the primary goal of distributions law" is the "protection of creditors"); Ralston, *supra* note 20, at 1025 ("The intention behind the traditional statutory scheme ? is to provide a cushion for the protection of creditors.").

Some scholars have suggested that legal capital serves additional purposes such as the "protection of the stockholders themselves, the stockholders as consumers." McGough, *supra* note 6, at 33. This purpose arises when the corporation is required to inform shareholders (or to receive their approval) of dividends that result in a reduction of legal capital. Apparently, this keeps the corporation from liquidating without notice to shareholders. Additionally, legal capital was supposed to protect investors by assuring "equitable contribution by each purchaser of shares of the same stock." Art, *supra* note 11, at 206. The advent of low par and no par stock eliminated the validity this latter purpose of legal capital. *Id.* at 210.

112 MANNING & HANKS, JR., *supra* note 15, at 28; CONARD, *supra* note 14, at 311 (Legal capital "can be readily reduced without the consent of, or notice to, the people likely to be most interested ?. Creditors who may be adversely affected are not consulted, nor are they even told.").

113 CONARD, *supra* note 14, at 313.

114 Richard O. Kummert, *State Statutory Restrictions on Financial Distributions by Corporations to Shareholders Part I*, 55 *WASH. L. REV.* 359, 396 (1980) ("Even in cases where the surplus limitation appears to restrict a corporation's ability to make a distribution, surplus may be created by a change in accounting principles, by the recognition of unrealized appreciation in the value of the corporation's assets, or by a reduction of stated capital."); Committee on Corporate Laws, *Changes in the Model Business Corporation Act-Amendments Pertaining to Distributions*, 42 *BUS. LAW.* 259, 261 (1986) ("While most of [pre-1980] statutes contained elaborate provisions [regarding legal capital], the net effect of most statutes was to permit the distribution to shareholders of most or all of the corporation's net assets-its capital along with its earnings-if the shareholders wished this to be done."); Art, *supra* note 11, at 211-20 (outlining the "numerous methods" used "to drain amounts out of stated capital and ? into the hands of shareholders"); SOLOMON, *supra* note 11, at 260 ("[C]oncepts of par value provided little protection to creditors because of the ease with which restrictions could be circumvented.").

115 Ben-Dror, *supra* note 37, at 379 ("[L]egal capital ? tends to be arbitrary and subject to manipulation.").

116 See Ralston, *supra* note 20, at 1021 ("Capital accounts ? have no direct relationship to any cash or other property which the corporation actually owns.").

117 MANNING & HANKS, JR., *supra* note 15, at 57 ("[I]n the unusual circumstance in which the shareholder has been left open to risk, the creditor who seeks to take advantage of that delinquency will find his way beset with one procedural pitfall after another, and almost no statutory or judicial chart to guide him.").

118 *Id.* at 98-114; accord, Art, *supra* note 11, at 210; Ralston, *supra* note 20, at 1020, 1025-28.

119 MANNING & HANKS, JR., *supra* note 15, at 37; accord, Ralston, *supra* note 20, at 1021 n.13.

120 MANNING & HANKS, JR., *supra* note 15, at 39 (emphasis in the original); Ben-Dror, *supra* note 37, at 381 ("[T]he Model Business Corporation Act's dual insolvency test serves merely to ascertain, rather than predict, bankruptcy and is therefore useful only after the fact as a tool for litigation, not planning.").

121 Ralston, *supra* note 20, at 1027.

122 Committee on Corporate Law, *supra* note 34, at 1867.

123 Kummert, *supra* note 32, at 200-09.

124 Legal capital restrictions "cause corporations ? to expend significant amounts for the advice of lawyers, accountants and possibly appraisers ?. Such groups can thus be said to benefit greatly from the existence of such provisions." Kummert, *supra* note 32, at 210.

125 MANNING & HANKS, JR., *supra* note 15, at 90.

126 Kummert, *supra* note 32, at 207-08 ("The directors, ? after considering the costs involved in determining the validity of a proposed distribution and its unavoidable risks, may decide not to make a distribution that would have been beneficial to most of the parties connected with the corporation.").

127 Ben-Dror, *supra* note 37, at 381 ("[T]he [Model Business Corporation Act's] dual insolvency test provides no consistent rule for determining the amount of allowable distributions.").

128 Kummert, *supra* note 32, at 208.

129 *Id.* at 209 n.119 ("[O]nly 126 cases have involved the corporation law restrictions since 1946.").

130 See, e.g., *Byrne v. Lord*, 1996 Del. Ch. LEXIS 65 (Del. Ch. 1996); *Hanewald v. Bryan's Inc.*, 429 N.W.2d 414 (N.D. 1988).

131 MANNING & HANKS, JR., *supra* note 15, at 45-49 (emphasis in the original).

132 *Id.* at 50-53. The five theories are: (1) the "trust fund" theory, (2) the "holding out" or fraud theory, (3) the statutory obligation theory, (4) breach of contract, and (5) misrepresentation. *Id.*

133 *Id.* at 65.

134 *Id.* at 66 ("[L]aymen who are neither trained nor experienced in accounting tend to assume that these principles have a certainty, precision and exclusivity which they do not in fact have").

135 SOLOMON, *supra* note 11, at 259.

136 MANNING & HANKS, JR., *supra* note 15, at 66.

137 Also implicit to some degree in most criticisms of legal capital is the assumption that the interests of shareholders and creditors are in conflict, i.e., that shareholders want to eliminate restrictions on dividend payments while creditors want to impose them.

138 If, as will be shown *infra*, shareholders react positively to dividend restrictions, then maybe the interests of shareholders and creditors are more in harmony than previously thought.

139 The term stock split-up "refers to an issuance by a corporation of its own common shares to its common shareholders without consideration and under conditions indicating that such action is prompted mainly by a desire to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price." FINANCIAL ACCOUNTING STANDARDS BOARD, ACCOUNTING STANDARDS, ORIGINAL PRONOUNCEMENTS ISSUED THROUGH JUNE 1973, at Chapter 7, Section B(2), (1987) [hereinafter "FASB"]. "Where this is clearly the intent, no transfer from earned surplus to capital surplus or capital stock account is called for, other than to the extent occasioned by legal requirements." *Id.* at Chapter 7, Section B(15) (1987).

Accounting Research Bulletin (ARB) 43 does not recommend a specific accounting treatment for stock splits. ARB 43, at 49-53. Accounting practice, however, dictates that firms proportionately decrease par or stated value per share while leaving the total dollar amount of the stated capital account unchanged. Bill N. Schwartz & Thomas F. Monahan, *Accounting for Stock Dividends & Stock Splits*, 31 NAT'L PUB. ACCT. 24, 24-25 (1986).

140 DONALD E. KIESO & JERRY J. WEYGANDT, *INTERMEDIATE ACCOUNTING* 782-84 (8th ed. 1995).

141 Art, supra note 11, at 223.

142 KIESO & WEYGANDT, supra note 140, at 780-81. Note that the MBCA allowed the transfer to be made from either capital or earned surplus. MODEL BUS. CORP. ACT § 45(d) (1969) ("Dividends may be declared and paid in [the corporation's] own authorized but unissued shares out of any unreserved and unrestricted surplus.").

143 Although the MBCA requires that the minimum amount transferred from surplus be equal to the par or stated value of the shares issued, MODEL BUS. CORP. ACT §§ 45(d)(1) & (2) (1969), GAAP requires that the amount transferred from earned surplus be equal to the fair market value of the stock issued. Both the American Institute of Certified Public Accountants ("AICPA") and the New York Stock Exchange ("NYSE") objected to periodic and regular payments of stock dividends. Hence, in 1941 the AICPA sought to make it more difficult for corporations to maintain such a practice by requiring that fair market value be used to record the issuance of stock dividends where such market value was substantially in excess of book value. "Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions." American Institute of Accountants, Accounting Research Bulletin No. 11, Corporate Accounting for Ordinary Stock Dividends, 102-03 (1941) [hereinafter "ARB No. 11"]. "The reasoning is ? recipients look on the stock dividends as distributions of corporate earnings equal to the market price of the shares issued. Therefore, if less than the market price were capitalized, an amount of retained earnings thought to have been distributed to the stockholders would be available for additional stock dividends or cash distributions." HENDRIKSEN, supra note 8, at 480.

144 Art, supra note 11, at 222.

145 Id. at 204-05.

146 Because a stock distribution makes no demands on the corporation's present or future assets, a stock distribution cannot by itself render a corporation unable to pay its debts as they come due.

147 Art, supra note 11, at 223.

148 ARB No. 11, at 102-03.

149 A material reduction in the market value of the common stock unit is the underlying purpose of a stock split. Id.

150 FASB, supra note 139, at Section B(10).

151 Id. at Section B(13).

152 Sherman Chottiner & Allan Young, A Test of the AICPA Differentiation Between Stock Dividends and Stock Splits, 9 J. ACCT. RES. 367 (1971).

153 FASB, *supra* note 139, at Section B(11); see also DONALD E. KIESO & JERRY J. WEYGANDT, *INTERMEDIATE ACCOUNTING* 690 (3d ed. 1980)

154 FASB, *supra* note 139, at Section B(11).

155 Instruction (iv), *Additional Listing Application -- Stock Dividends, Distributions, or Split-up*, *American Stock Exchange Company Guide*, at 3, (1988).

156 *New York Stock Exchange Revised Company Manual*, § 703.02 (1991) provides in relevant part:

Stock Dividends -A distribution of less than 25% of the outstanding shares (as calculated prior to the distribution). Capitalize retained earnings for the fair market value of the additional shares to be issued. Fair market value should closely approximate the current share market price adjusted to give effect to the distribution.

Partial Stock Split-A distribution of 25% or more but less than 100% of the outstanding shares (as calculated prior to the distribution). Requires capitalization of paid-in capital (surplus) for the par or stated value of the shares issued only where there is to be no change in the par or stated value.

Stock Split-A distribution of 100% or more of the outstanding shares (as calculated prior to the distribution). Requires transfer from paid-in capital (surplus) for the par or stated value of the shares issued unless there is to be a change in the par or stated value.

*Id.*

157 Schwartz & Monahan, *supra* note 139.

158 *Id.*; see also, Craig A. Peterson, James A. Millar, & James N. Rimbey, *The Economic Consequences of Accounting for Stock Splits and Large Stock Dividends*, 71 *ACCT. REV.* 241 (1996); Linda J. Zucca & David P. Kirch, *A Gap in GAAP: Accounting for Mid-Range Stock Distributions*, 10 *ACCT. HORIZONS* 100 (1996).

159 HENDRIKSEN, *supra* note 8, at 477.

160 See, e.g., James C. Dolley, *Characteristics and Procedures of Common-Stock Split-Ups*, 12 *HARV. BUS. REV.* 316 (1933); C. Austin Barker, *Effective Stock Splits*, *HARV. BUS. REV.*, JAN.-FEB. 1956, at 101; C. Austin Barker, *Stock Splits in a Bull Market*, *HARV. BUS. REV.*, MAY-JUNE 1957, at 72; C. Austin Barker, *Evaluation of Stock Dividends*, *HARV. BUS. REV.*, JULY. 1958, at 99; Fama et al., *supra* note 12; Sasson Bar-Yosef & Lawrence. D. Brown, *A Reexamination of Stock Splits Using Moving Betas*, 32 *J. FIN.* 1069 (1977).

161 Studies offering a signaling or information content explanation for investor reaction to stock distribution announcement include: Grinblatt et al., *supra* note 66; Paul Asquith, Paul Healy, & Krishna Palepu, *Earnings and Stock Splits*, 64 *ACCT. REV.* 387 (1989); Michael J. Brennan

& Thomas E. Copeland, *Stock Splits, Stock Prices, and Transaction Costs*, 22 J. FIN. ECON. 83 (1988); Maureen McNichols & Ajay Dravid, *Stock Dividends, Stock Splits, and Signaling*, 45 J. FIN. 857 (1990); Michael J. Brennan & Patricia J. Hughes, *Stock Prices and the Supply of Information*, 46 J. FIN. 1665 (1991).

Although Professor Fischel is skeptical about the value of dividends under any circumstances, he seems to concede that changes in dividend policy may be used by management to convey information about the firm's future prospects to shareholders. Fischel, *supra* note 6, at 708-09.

162 Hayne E. Leland & David H. Pyle, *Informational Asymmetries, Financial Structure, and Financial Intermediation*, 32 J. FIN. 371 (1977); Stephen A. Ross, *The Determination of Financial Structure: The Incentive Signaling Approach*, 8 BELL J. ECON. 23 (1977); Sudipto Bhattacharya, *Imperfect Information, Dividend Policy and 'The Bird in the Hand' Fallacy*, 10 BELL J. ECON. 259 (1979).

163 Asquith ET AL., *supra* note 161, at 196.

164 Grinblatt ET AL., *supra* note 66; McNichols & Dravid, *supra* note 161, at 871 Managers incorporate private information about future earnings in setting the split factor in a stock split. *Id.*

165 Grinblatt ET AL., *supra* note 66, at 461-62.

166 *Id.* at 463-64 ("If the firm faces legal restrictions, stock exchange rules or has bond covenants written in terms of retained earnings, the additional shares can further restrict the firm's ability to pay cash dividends. Firms that anticipate increased earnings will not find it costly to reduce retained earnings. However, firms that expect poor earnings in the future will expect the restrictions to be binding, making it costly to mimic the signals of higher-valued firms.").

167 See, e.g., Bebchuk, *supra* note 6, at 1490 (1992) (suggesting that states have gutted statutory restrictions on the payment to benefit shareholders at the expense of creditors); Joy Begley, *Debt Covenants and Accounting Choice*, 12 J. ACCT. & ECON. 125 (1990); Kummert, *supra* note 32, at 189 ("Shareholders in a publicly held corporation ? appear to value stability in [cash] dividend payments by the corporation."); McGough, *supra* note 6, at 31 ("[I]f states are competing to attract corporations, one tactic is to liberalize ? the basic restrictions on distributions.").

168 Kummert, *supra* note 32; Kalay, *supra* note 61; Smith & Warner, *supra* note 61; Ralston, *supra* note 20, at 1025-26 (Debt "covenants limit[ing] the payment of dividends [impose] standards much stricter than those found in corporate dividend statutes.").

169 The economic signaling literature posits that management might choose an accounting treatment moving the firm closer to its constraints, i.e., policies that put the firm at greater risk of defaulting on its debt covenants, because the choice will be interpreted as a signal by shareholders. Richard D. Morris, *Signaling*,

Agency Theory and Accounting Policy Choice, 18 ACCT. & BUS. RES. 47 (1987). Only high quality firms choose counter-intuitive accounting policies to communicate or signal their bright prospects to shareholders; lower quality firms would choose accounting methods dictated by conventional wisdom because they could not afford to risk their ability to pay cash dividends in the future. Id. at 53.

170 Grinblatt ET AL., supra note 66, at 463-65.

171 Michael Spence, Job Market Signaling, 87 Q. J. ECON. 355, 358 (1973); Anjan V. Thakor, Strategic Issues in Financial Contracting: An Overview, 18 FIN. MGMT. 39, 40-41 (1989).

172 Grinblatt ET AL., supra note 66, at 466-68; McNichols & Dravid, supra note 161, at 864-67.

173 Peterson ET AL., supra note 158, at 242 (fewer than 17 percent of the 285 firms in the sample actually accounted for those distributions as stock splits, despite the language employed in their announcements to the press). Schwartz and Monahan find similar evidence. They examine the annual reports for 103 Fortune 500 companies that had stock distributions greater than 25 percent for the 1984 calendar year. Their findings show that only 14 companies adjusted the par value without making a journal entry. Schwartz & Monahan, supra note 139; see also Zucca & Kirch, supra note 158.

174 Peterson ET AL., supra note 158, at 242.

175 Id. Banker, Das and Datar also present empirical evidence that previously disclosed accounting information, including the relative reduction in unrestricted surplus, is useful in explaining cross-sectional variation in investor response to stock dividend announcements. Rajiv D. Banker, Somnath Das, & Srikant M. Datar, Complementarity of Prior Accounting Information: The Case of Stock Dividend Announcements, 68 ACCT. REV. 28 (1993). However, the focus of their study is small (< 25%) stock dividends.

176 Peterson ET AL., supra note 158.

177 The data, method and results draw heavily on Peterson's research as reported in Peterson ET AL., supra note 158, and Craig A. Peterson, Financial Signaling with Stock Splits and Stock Dividends 28 (1992) (unpublished Ph.D. Dissertation, University of Arkansas) (on file with authors).

178 The CRSP data files are the property of The University of Chicago. The files provide a comprehensive security price data base for financial researchers at subscribing institutions.

179 Event studies provide a direct test of market efficiency. The magnitude of abnormal performance at the time the event actually occurs is a measure of the impact of that type of event on the wealth of the firm's stockholders. So long as the abnormal performance could not be predicted with certainty by any investor, the market response to the

new information implicit in the event announcement remains consistent with market efficiency. Stephen J. Brown & Jerold B. Warner, *Measuring Security Price Performance*, 8 J. FIN. ECON. 205, 205-06 (1980).

180 Brown and Warner's simulation analysis with monthly common stock return data shows that commonly used event-study methods will detect abnormal market performance if the empiricist can establish the time at which a specific event occurs. Brown & Warner, *supra* note 179.

181 Clarence C. Y. Kwan, *Efficient Market Tests of the Informational Content of Dividend Announcements: Critique and Extension*, 16 J. FIN. & QUANTITATIVE ANALYSIS 193, 196 (1981).

182 MODEL BUS. CORP. ACT § 1 (1969).

183 Zeff, *supra* note 6, at 58. "In all filings of foreign private issuers ? financial statements may be prepared according to a comprehensive body of accounting principles other than those generally accepted in the United States if a reconciliation to United States generally accepted accounting principles ? is also filed as part of the financial statements." Form, Order, and Terminology, 17 C.F.R. § 210.4-01 (2) (1990). "The term 'foreign private issuer' means any foreign issuer other than a foreign government ?." Definitions of Terms, 17 C.F.R. § 230.405 (1990).

184 The Q-Data file is a compilation of SEC statements available from Q-Data Corporation, St. Petersburg, Florida.

185 The Standard & Poor's COMPUSTAT data files are a compilation of company and security price information produced by Standard & Poor's Compustat Services, Inc.

186 Use of the "research" version of the current COMPUSTAT file reduces ex-post selection bias. The bias arises because the current COMPUSTAT data base contains only those companies which are currently viable entities. Companies that have merged, filed for bankruptcy, or for some other reason ceased to exist are excluded from the Industrial file. Rolf W. Banz & William J. Breen, *Sample-Dependent Results Using Accounting and Market Data: Some Evidence*, 41 J. FIN. 779 (1986).

187 Some events confounded by multiple announcements.

188 Grinblatt ET AL., *supra* note 66, at 467 & 475.

189 Fama ET AL., *supra* note 12, at 12-17; J. Randall Woolridge, *Stock Dividends as Signals*, 6 J. FIN. RES. 1, 2 (1983).

190 Moody's Industrial Manual is the source for the company's state of incorporation.

191 Georgia, Indiana, and New Jersey amended their existing state corporation business code or adopted new code based on the Revised Model Business Corporation Act in 1988, 1986, and 1988, respectively. Texas added Art. 2.38-1, which restricts payment of share dividends if

the surplus of the corporation is less than the amount required to be transferred to stated capital at the time the share dividend is paid, in 1987.

192 For firms incorporated in nimble dividend states, the legality of financial distributions may be based on current earnings. However, the amount that can be legally distributed is questionable. MANNING & HANKS, *supra* note 15. Since nimble dividend states primarily specify corporate distributions in terms of unrestricted and unreserved earned surplus (as in MBCA states) or unrestricted and unreserved surplus (as in balance sheet surplus states), and secondarily specify financial distributions according to the nimble dividend statutes, this study models these jurisdictions according to the first test.

Two groups of states have corporate distribution statutes that are not illustrated by Exhibit 2. The restrictive ratio test statutes of Alaska and California require information from a firm's balance sheet and income statement to test the legality of a cash distribution. Alaska and California corporations are modeled in this study as if they are incorporated in MBCA states because their primary test to determine the legality of a financial distribution is based on retained earnings. Current cash flows determine a corporation's ability to pay cash dividends for firms incorporated in the equitable insolvency jurisdictions. Massachusetts, Minnesota and North Dakota corporations are modeled as if they are incorporated in RMBCA states. Both Minnesota and North Dakota have based their financial distribution statutes on the RMBCA, and even though Massachusetts corporate statutes predate development of the RMBCA, its equitable insolvency limitation suggests modeling firms incorporated in this legal jurisdiction as if they adhere to the RMBCA statutes.

193 Actual accounting treatment is derived from inspection of the Changes in Shareholder's Equity section of the corporation's 10K or annual report from the Q-Data file.

194 Bold L-shaped area defines stock distributions for which the accounting treatment reduces distributable equity.

195 Includes the states of Arkansas, California, Connecticut, Georgia (pre-1988), Indiana (pre-1986), North Carolina, Oklahoma, Pennsylvania, Texas (pre-1987), Tennessee, Utah, Washington, Wisconsin and Wyoming.

196 Includes the states of Delaware, Florida, Iowa, Louisiana, Maryland, Michigan, New Jersey (pre-1988), New York, Nevada, Ohio and Texas (post-1987).

197 Includes the states of Georgia (post-1988), Illinois, Indiana (post-1986), Massachusetts and New Jersey (post-1988).

198 Grinblatt ET AL., *supra* note 66, at 463-64.

199 We also test the null hypothesis of no association between the accounting treatment for the stock distribution and the firm's legally distributable equity. Using a 3 x 3 classification table, we compare the accounting treatment with the firm's legally distributable equity.

The chi-square test (which assumes independence) rejects the null hypothesis ( $\chi^2 = 14.51$ , 4 d.f., prob. = 0.006), thus indicating a heterogeneous population. In other words, there is statistical evidence of association between the accounting treatment and legally distributable equity. It should be noted, however, that chi-square tests may not be valid when expected cell counts are less than five. Balance sheet surplus states (row 2) and RMBCA states (row 3) allow firms incorporated in their jurisdictions to distribute a greater proportion of equity capital as cash dividends. When rows 2 and 3 are combined, the chi-square test statistic ( $\chi^2 = 13.94$ ) is significant at the 0.001 level.

200 Brown & Warner, *supra* note 179, at 208.

201 Tests of model specification show that the assumption of constant error variance is not appropriate. The variance of the residuals varies positively with the DIV variable, i.e., the ratio of the sum of the stock dividends and cash dividends paid to distributable equity. Hence, weighted least squares is used to obtain the generalized parameter estimates. See, ROBERT S. PINDYCK & DANIEL L. RUBINFELD, *ECONOMETRIC MODELS & ECONOMIC FORECASTS* 129-32 (3rd ed. 1991).

202 Joanne C. Duke & Herbert G. Hunt, An Empirical Examination of Debt Covenant Restrictions and Accounting-Related Debt Proxies, 12 J. ACCT. & ECON. 45 (1990).

203 Lane A. Daley & Robert L. Vigeland, The Effects of Debt Covenants and Political Costs on the Choice of Accounting Methods: The Case of Accounting for R&D Costs, 5 J. ACCT. & ECON. 195 (1983); Robert M. Bowen, Eric W. Noreen, & John M. Lacey, Determinants of the Corporate Decision to Capitalize Interest, 3 J. ACCT. & ECON. 151 (1981).

204 Grinblatt ET AL., *supra* note 66, at 467 & 475.

205 Rowland K. Atiase, Predisclosure Information, Firm Capitalization, and Security Price Behavior Around Earnings Announcements, 23 J. ACCT. RES. 21 (1985).

206 Grinblatt ET AL., *supra* note 66, at 479-80.

207 McNichols & Dravid, *supra* note 161.

208 Grinblatt ET AL., *supra* note 66, at 463-64.

209 Appendix 1 shows the univariate test results for the sample and subsamples of large stock distributions.

210 Grinblatt ET AL., *supra* note 66, at 472 & 475.

211 Some legal scholars, anticipating the possibility that stock distributions may be used as signaling device, have criticized the practice on grounds that it is the information that shareholders react to, not the dividend or split. Art, *supra* note 11, at 221-22. But this argument misses the point. Legal capital is relevant because it allows

management to communicate important information to investors through the choice of accounting treatment for stock distributions. Elimination of legal capital could very well eliminate the communication of the information.

Other scholars are skeptical that stock distributions actually communicate information. KLEIN & COFFEE, *supra* note 6, at 276-77. Although Klein and Coffee admit that there "appears to be a small, difficult-to-explain increase in the total value of the shares of firms following stock splits," *id.*, at 276, they find it "difficult to see what additional information is conveyed by the issuance of new shares of stock" since they believe "periodic reports to shareholders" are the only means to communicate "the success or failure of the firm." *Id.* at 277. What Klein and Coffee miss, however, is that the periodic reports are simply a history of the corporation's past success or failure. As noted *supra* note 6, at 276-77, the choice of accounting treatment for stock distributions may enable management to signal its expectations of the firm's future success or failure because the choice of accounting treatment affects the company's ability to pay cash dividends in the future.