

THE FUTURE IS NOW: DIVIDENDS IN THE PROPERTY & CASUALTY BUSINESS

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For several years, the board of directors declares dividends to shareholders based on financial statements showing the company to be financially sound and profitable. The largest item on its balance sheets are estimates based on information then available and accepted estimation methods. Several years later, after the company receives more information, it becomes apparent the estimates in the balance sheets were too low and the company is insolvent based on current information for prior financial years. Can the the dividends be recovered from the shareholders for the benefit of the creditors? Absent knowledge that dividends were unlawful when received, the answer is no.

Courts have long held the lawfulness of dividends must be judged on information available at the time they were declared. Companies are not expected to, and indeed may not, restate prior financial statements when new information leads to changes in estimates. Recently, these principles were found applicable to casualty insurers:

"[S]o long as certain basic accounting principles and statutory requirements...are followed, retroactive evaluations play no role in ascertaining the legitimacy of any foregone dividend payments. Hindsight may be twenty-twenty, but the law turns a blind eye towards attempts to restate the financial condition of a corporation once that condition has already been lawfully determined." National Distillers & Chemical Corp. v. Stephens, 912 S.W.2d 30, 32 (Ky. 1996); Stephens v. National Distillers & Chemical Corp., 70 F.3d 10 (2d Cir. 1995).

A. Corporations Laws.

A rule requiring, or even permitting, a company to restate prior financial statements retroactively would effect thousands of businesses that estimate items on their balance sheets, including banks and savings and loans (uncollectible loans), insurers (loss reserves), natural resource companies (oil reserves and coal deposits), retailers (unsalable inventory and bad debts), and manufacturers (hazardous waste and litigation liabilities). Each year these and other businesses revise prior estimates as more information becomes available. The new estimates are uniformly recorded in the period when the change occurs, not earlier. Otherwise, investors in such firms, including shareholders who no longer own their stock, could

be forced to return dividends every time a change in estimate occurs. If lawfully declared dividends were placed at risk, it would be harder for corporations to raise investor capital.

Stockholders, creditors, regulators, and the investment community depend on the uniform application of generally accepted accounting principles, or GAAP, to determine the financial position of an enterprise.¹ State corporations laws require companies to follow "reasonable" accounting practices and principles and "generally accepted accounting principles are always 'reasonable'".² Financial statements prepared on a basis other than GAAP are deemed false and misleading by the Securities and Exchange Commission and companies who fail to follow GAAP are subject to enforcement action by the SEC and fraud actions by investors.³

Detailed rules prohibiting retroactive restatements based on hindsight information are found in GAAP. APB Opinion 20 provides "[a] change in an estimate should not be accounted for by restating amounts reported in financial statements of prior periods or by reporting pro forma amounts for prior periods."⁴ The rule affects a wide-range of businesses, as APB Opinion 20 explains:

"Changes in estimates used in accounting are necessary consequences of periodic presentations of financial statements. Preparing financial statements requires estimating the effects of future events. Examples of items for which estimates are necessary are uncollectible receivables, inventory obsolescence, service lives and salvage values of depreciable assets, warranty costs, periods benefited by a deferred cost, and recoverable mineral reserves. Future events and their effects cannot be perceived with certainty; estimating, therefore, requires the exercise of judgment. Thus accounting estimates change as new events occur, as more experience is acquired, or as additional information is obtained."

1 *United States v. Arthur Young & Co.*, 465 U.S. 805, 810-13 (1984).

2 Model Bus. Corp. Act Ann. 3d, § 6.40(d) and Official Comment 4(a).

3 According to the SEC, "[f]inancial statements...which are not prepared in accordance with generally accepted accounting principles will be presumed to be misleading or inaccurate, despite footnote or other disclosures...." 17 C.F.R. § 210.4-01(a)(1).

4 AICPA, Accounting Principles Board Opinion 20, *Accounting Changes* (July 1971) ¶ 31.

The rule that insolvency is determined at the time dividends are declared, not later, has been codified in the corporations laws of numerous jurisdictions.⁵ As the Official Comments to the Model Business Corporation Act make clear, in declaring dividends:

"Judgments must of necessity be made on the basis of information in the hands of the directors when a distribution is authorized. They should not, of course, be held responsible as a matter of hindsight for unforeseen developments. This is particularly true with respect to assumptions...as to...obligations...which do not mature for several years..." Official Comments to Model Bus. Corp. Act § 6.40, 6-199 (1997 Supplement).⁶ See Changes In The Model Business Corporation Act-Amendments to Financial Provisions, 34 Business Lawyer 1867 (July 1979).

Just as modern corporations codes prohibit the use of subsequent information to determine the financial position of insurers for prior periods, under a long line of common law authority it "is not sufficient to make the stockholder liable by showing that insolvency occurred later. The insolvency of the corporation must exist at the time the dividends are declared." Bates v. Brooks, 270 N.W. 867, 869 (Iowa 1937).⁷

5 See Ark.1987 Bus. Corp. Act, Ark. Stat. Ann. § 4-27-640(E) (3) (1989); Ga. Bus. Corp. Code, Ga. Code Ann. § 14-2-640 (e)(3) (1989); Haw. Bus. Corp. Act, Haw. Rev. Stat. § 415-45 (1991); Ill. Bus. Corp. Act, Ill. Stat. Ann. ¶ 9.10(e) (1) (Smith-Hurd 1990); Ind. Bus. Corp. Law, Ind. Code § 23-1-28-5(3) (1989); KRS § 271B.6-400(5); Md. Gen. Corp. Law, Md. Corps. & Ass'ns. Code Ann. § 2-311 (1990); Mich. Bus. Corp. Act, Mich. Comp. Laws § 21.200 (345)(5)(c) (1989); Minn. Bus. Corp. Act, Minn. Stat. Supp. § 302A.551(3)(b) (1991); Miss. Bus. Corp. Act, Miss. Code Ann. § 79-4-6.40(e)(3) (1988); Mont. Bus. Corp. Act, Mont. Code Ann. § 35-1-712(3) (1990); N.J. Bus. Corp. Act, N.J. Stat. Ann. § 14A:7-14.1(4) (West 1988); N.M. Bus. Corp. Act, N.M. Stat. Ann. § 53-11-44(C) (1983); N.D. Bus. Corp. Act, N.D. Cent. Code § 10-19.1-92(3) (1989); Or. Bus. Corp. Act, Or. Rev. Stat. § 60.181(5)(c) (1989); Pa. 1988 Bus. Corp. Law, 15 Pa. Cons. Stat. Ann. § 1551(d) (Purdon 1991).

6 The lawfulness of distributions "shall be measured" as of the date of authorization or the date of distribution (if later than 120 days after authorization). Model Bus. Corp. Act § 6.40(e).

7 See, e.g., *Palmer v. Justice*, 322 F.Supp. 892 (N.D.Tex.), *aff'd*, 451 F.2d 371 (5th Cir. 1971); *Gallagher v. New York Dock Co.*, 19 N.Y.S.2d 789, 800 (Sup.Ct. 1940), *aff'd*, 32 N.Y.S.2d 348 (N.Y. App.Div.1942); *Myers v. C.W. Toles & Co.*, 283 N.W. 603, 615 (Mich. 1939); *Bates v. Brooks*, 270 N.W. 867, 869 (Iowa 1937); *Splittergerber Bros. v. Skinner Packing Co.*, 228 N.W. 531, 534 (Neb. 1930); *Vogtman v. Merchants' Mortg. & Cred. Co.*, 178 A. 99, 102 (Del.Ch. 1935); *Bourne v. Bourne*, 148 N.E. 180, 183-84 (N.Y. 1925); *Hofkin v. United States Smelting Co.*, 266 F. 679, 681 (3d Cir. 1920); *Overland Souix City Co. v. Clemens*, 179 N.W. 954 (Iowa 1920); *Crawford v. Roney*, 61 S.E. 117, 119-20 (Ga. 1908); *Siegmán v. Electric Vehicle Co.*, 140 F. 117, 122 (Cir.Ct. N.J. 1905); *Purdy v. Lynch*, 40 N.E. 232, 236 (N.Y. 1895); *McCann v. First Nat'l Bank*, 14 N.E. 251, 254-55 (Ind. 1887).

"Whether or not there were surplus profits, so as to render it lawful to declare a dividend, is to be determined as of the time the dividend was made. If the condition of the company at the time was apparently such as to show surplus profits out of which a dividend could lawfully be paid, the payment of the dividend is not rendered wrongful by the fact that...the conditions existing at the time the dividend was paid were such, unknown to the directors, that losses were such to be sustained, or because the company subsequently becomes insolvent by reason of a business depression...or otherwise." 11 W. Fletcher Cyc. of the Law of Private Corps. § 5338 at 804 (perm. ed. rev. vol. 1986).

Under the common law, hindsight has no place in evaluating the payment of dividends:

"When reviewing the judgment and discretion of the board of directors in computing the value of the capital and surplus of a corporation as a basis for declaring dividends, the court must do so in light of facts and events as they existed at the time such judgment was exercised not 'aided or enlightened by those which subsequently take place'....'wisdom born after the event is the cheapest of all wisdom. Anybody could have discovered America after 1492.'" Gallagher v. New York Dock Co., 19 N.Y.S.2d 789, 800 (Sup. Ct. 1940), aff'd, 32 N.Y.S.2d 348 (N.Y.App.Div. 1942)

An earlier attempt to establish insolvency and recover dividends by showing, with the glow of hindsight, that balance sheet estimates turned out to be in error was rejected in Myers v. C.W. Toles & Co., 287 Mich. 340, 371-72, 283 N.W. 603, 615 (1939):

"In 1931, the popular opinion still was that prosperity would shortly return, and that conditions would improve instead of becoming worse, but it now appears that this opinion was radically wrong. The actions of the officers of the corporation should be viewed from the then appearances and not at a much later time when we are aware of subsequent events."

Any other rule would place the financial position of any business that estimates assets or liabilities in a continuous state of flux since changes in estimates are inevitable from year to year. Permitting corporations to determine their financial position retroactively would violate basic accounting principles relied upon by the business world to provide meaningful economic information about a company. Such a rule, requiring insurers to revise prior financials, would have an unsettling effect on

financial markets and, to the extent lawfully declared dividends were put at risk, raise the cost of investment capital.⁸

That shareholders fall behind creditors when assets of a bankrupt are distributed has nothing to do with the liability of shareholders for dividends legally paid when the company was solvent. Shareholders are under no obligation to the corporation or its creditors other than to pay the full consideration for their shares.⁹ Nor are shareholders personally liable for any debt or liability of the corporation.¹⁰

B. *Casualty Insurance Context.*

In a case of first impression in 1995, the Second Circuit and the Kentucky Supreme Court held the law is no different for casualty insurers.¹¹ As long as accounting principles and statutory requirements are followed, shareholders are not liable for dividends lawful when declared based on subsequent information.

In *Stephens v. National Distillers and Chemical Corporation*, two lower courts ruled that insurance company shareholders could be sued for dividends based on good faith estimates if they later proved in error. To those courts, the critical issue was whether "dividends were declared when the com-

⁸ "Even the suggestion that a dividend might be lowered will send ripples of fear through the hearts of investors who understand the influence of dividends on stock prices." G. Weiss & J. Lowe, *Dividends Don't Lie* at 6 (1988). See J. Wansley, C.F. Sirmans, J.D. Shilling & Y. Lee, *Dividend Change Announcement Effects and Earnings Volatility and Timing*, 14 *J. Fin. Res.* (Spring 1991); H. Manakyan & C. Carrol, *An Empirical Examination Of The Existence Of A Signaling Value Function For Dividends*, 13 *J. Fin. Res.* (Fall 1990); J. Lyon & D. Schroeder, *Firm Growth And The Valuation Relevance Of Earnings Levels, Earnings Innovations, and Dividends*, *J. Acct., Auditing & Fin.* (Fall 1992).

⁹ See e.g., Model Business Corporation Act § 6.22(a); Cal. Corp. Code §§ 409-415, 418, Conn. Bus. Corp. Act § 33-673 (West); Del Code Ann. tit. 8, § 162; Ill. Ann. Stat. ch. 805, § 5/6.40 (Smith-Hurd); KRS § 271B.6-220; N.J. Stat. Ann. § 14A:5-30 (West); N.Y. Bus. Corp. Law §§ 628, 629, 630; N.Y. Const. art. X, § 2 (McKinney); Ohio Rev. Code Ann. § 1701.18; Ohio Const. art. XIII, § 3 (Page); 15 Pa. Const. Stat. Ann. § 1526 (Purdon).

¹⁰ See e.g., Model Business Corporation Act § 6.22(b); Ark. Stat. Ann. § 4-27-622; Ariz. Rev. Stat. Ann. § 10-622; Colo. Rev. Stat. § 7-106-203; Conn. Bus. Corp. Act § 33-673 (West); Ga. Code Ann. § 14-2-622; Idaho Code § 30-1-622; Ind. Code Ann. § 23-1-26-3 (Burns); Iowa Code Ann. § 490.622 (West); KRS 271B.6-220; Miss. Code Ann. § 79-4-6.22; Mont. Code Ann. § 35-1-534; Neb. Rev. Stat. § 21-2041; N.H. Rev. Stat. Ann. § 293-A:6.22; N.C. Gen. Stat. § 55-6-22; Tenn. Code Ann. § 48-16-203; S.C. Code § 33-6-220; Utah Code § 16-10a-622; Vt. Stat. Ann. tit. IIA, § 6.22.

¹¹ *National Distillers & Chemical Corp. v. Stephens*, 912 S.W.2d 30, 32 (Ky. 1996); *Stephens v. National Distillers & Chemical Corp.*, 70 F.3d 10 (2d Cir. 1995).

pany's actual assets were less than its actual liabilities". However, as the Kentucky Supreme Court and the Second Circuit recognized in reversing, under state insurance laws and statutory accounting practices, or SAP, the assets of an insurer are greater than its "actual" liabilities under these circumstances. Estimated liabilities are actual liabilities for purposes of calculating surplus and paying dividends. "[I]nformation received subsequent to the distribution of dividends cannot be applied retroactively to determine the company's financial condition at the time of payment."¹²

The financial position of insurers and their ability to pay dividends is governed by state insurance law. Insurers must file an Annual Statement of financial condition pursuant to rules approved by the National Association of Insurance Commissioners ("NAIC").¹³ NAIC rules require Annual Statements be prepared in accordance with SAP. SAP measures "a company's financial condition on a specific date"--the financial statement date--to determine surplus and "the company's ability to satisfy its obligations to its policyholders and creditors."¹⁴

State insurance laws, provide that, like other corporations,¹⁵ insurers may pay dividends out of surplus funds.¹⁶ "Surplus funds" are defined in terms such as the "excess of the insurer's assets over its liabilities, including its capital stock as a liability."¹⁷

The "liabilities" of an insurer are defined to include the amount, *estimated* consistent with applicable provisions of the insurance law, necessary to pay all unpaid losses and claims incurred on or prior to the date of statement, whether reported or unreported, together with the expenses of adjustment

¹² *National Distillers and Chemical Corp. v. Stephens*, 912 S.W.2d 30-33 (Ky. 1996).

¹³ See e.g., Ky. Rev. Stat. Ann. ("KRS") § 304.3-240(2) (Banks-Baldwin 1989); Cal. Ins. Code § 923; Conn. Gen. Stat. § 38a-53(a).

¹⁴ NAIC, *Accounting Practices and Procedures Manual for Fire and Casualty Insurance Companies* at ix (1985).

¹⁵ See e.g., KRS § 271A.225(1)(a).

¹⁶ See e.g., KRS § 304.24-320; Cal. Ins. Code § 1152.

¹⁷ See, e.g., KRS § 304.24-320(2); Cal. Ins. Code §§ 700.02, 1152; Conn. Gen. Stat. § 38a-71(a)(3).

or settlement.¹⁸ "This provision tends to tame the nature of the beast in the insurance industry, namely that the full extent of an insurer's liability is difficult to grasp in light of the fact that certain claims may go unreproted for several years, and some years may have an unusually high volume of claims."¹⁹ The basis for estimating the unpaid claim liabilities of casualty insurers is set forth in the insurance law and generally requires insurers to compute reserves in accordance with regulations by the state Insurance Commissioner and to base reserves upon reasonable consideration of the ascertained experience and character of the business underwritten.²⁰

Insurance laws recognize the possibility that properly prepared reserve estimates may prove to be too low.²¹ Any changes are to be "forward-looking and not backward-correcting". Reserve estimates are to be adjusted prospectively based on experience, not retroactively.²²

Insurance laws relating to the calculation of surplus funds, the determination of estimated liabilities, and the declaration of dividends incorporate standard accounting concepts promulgated by the NAIC.²³ Included in these is the principle that changes in reserve estimates based on new information are charged to the year the change in estimate occurs, not the year the estimate was originally made. The principle insures that the primary purpose of SAP, determining the financial condition of an insurer on a specific date, is satisfied. Neither the insurance laws nor SAP require or permit²⁴ properly prepared reserve estimates on prior balance sheets to be adjusted after the fact.

¹⁸ See e.g., KRS § 304.6-040(2); Cal. Ins. Code § 923.5.

¹⁹ *National Distillers and Chemical Corp. v. Stephens*, 912 S.W.2d 30, 32 (Ky. 1996).

²⁰ See e.g., KRS § 304.6-100; Cal. Ins. Code § 923.5; Conn. Gen. Stat. § 38a-76(a).

²¹ For example, KRS § 304.6-100(2) provides, "Whenever the loss and loss expense experience of the insurer show that reserves, calculated in accordance with such regulations, are inadequate, the commissioner may require the insurer to maintain additional reserves." See also Cal. Ins. Code § 11557.

²² *National Distillers and Chemical Corp. v. Stephens*, 912 S.W.2d 30, 32 (Ky. 1996). See e.g., KRS § 304.6-100(2); Cal Ins. Code § 11557.

²³ See e.g., Conn. Gen. Stat. § 38a.

²⁴ If insurers were permitted to disregard SAP and retroactively adjust reserve estimates, they could manipulate current earnings by charging unfavorable results to prior periods.

Retroactive determination of financial condition also violates accounting principles incorporated in the Annual Statement. NAIC rules prohibit recalculation of prior-year results based on subsequent events. Under SAP, insurers must record a change in estimate in the year the change occurs, not retroactively in the period the estimate was made:

"The effects of changes in accounting estimates are included in income and expenses in the Statement of Income for the current year. For example, a change in estimate of loss reserves for losses related to prior years should be included in the Statement of Income in losses ...for the current year." NAIC, Annual Statement Instructions, Property & Casualty at 5. (Emphasis added).

GAAP rules are the same. Statement 60 of the Financial Accounting Standards Board provides that:

"Changes in estimates of claim costs resulting from the continuous review process and differences between estimates and payments for claims shall be recognized in income of the period in which the estimates are changed or payments are made." FASB, Statement of Financial Accounting Standards No. 60, Accounting and Reporting By Insurance Enterprises (June 1982) ¶ 18. (Emphasis added).

In following these rules, the Second Circuit and Kentucky Supreme Court recognized that insurance "corporations must be entitled to rely upon generally accepted accounting principles to determine their financial posture" and any "other method of evaluation would at the very least cause confusion among both participants in and observers of the financial world."²⁵ Thus, a consistent approach to changes in loss reserve estimates is critical, particularly since, as the Second Circuit has observed, changes are inevitable:

"It must be emphasized that no actuarial method is so accurate that it eliminates conjecture in the calculation of [reserves]...Overly conservative loss estimates are no answer. Overestimated reserves are harmful because...premiums are competitive and competitive return on investment is necessary to attract investors. Methods that cause substantial excess reserves to be set aside may cause losses to [an insurer] for lack of underwriting or investment."²⁶

²⁵ *National Distillers and Chemical Corp. v. Stephens*, 912 S.W.2d 30, 32 (Ky. 1996).

²⁶ *Delta Holdings, Inc. v. National Distillers and Chemical Corp.*, 945 F.2d 1226, 1231 (2d Cir. 1991), *cert. denied*, 112 S.Ct. 1671 (1992).

Finally, any suggestion that dividends should be recoverable from shareholders, because insurance laws give liquidators special powers or authority to protect "innocent creditors" is misplaced.- A liquidator "stands in the shoes of the Bankrupt"²⁷ and has no greater rights to recover dividends than the insurer. "In liquidation, the liquidator for all practical purposes takes the place of the insolvent insurer...Liquidation does not change the situation and the liquidator should not and may not be placed in a better position than the company he takes over and demand that which is not owed." Bohlinger v. Zanger, 306 N.Y. 228, 234, 117 N.E.2d 338, 341 (1954).

C. Conclusion

Under both corporations and insurance laws, financial statement estimates may not be retroactively restated to reflect subsequent information. Dividends based on estimates that were properly prepared at the time the dividends were declared are lawful. Shareholders cannot be required to return them if subsequent, hindsight information proves the estimates to have been inaccurate.

²⁷ *Mentor Lagoons Marina v. Wasserman*, 490 F.2d 1061, 1064 (6th Cir. 1974); *Stephens v. American Home Assurance Co.*, 811 F.Supp. 937, 947 (S.D.N.Y. 1993); *Bohlinger v. Zanger*, 117 N.E.2d 338 (N.Y. 1954).