Questions of Policy in Drafting a Modern Corporation Law

Henry Winthrop Ballantine
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California General Corporation Law (1931)

It is not proposed in this article to attempt to summarize or discuss the hundreds of changes, major and minor, made by the new California General Corporation Law which will go into effect on August 14th. It may, however, be of general interest to indicate briefly some difficult questions of policy in drafting such a law for this or any other state, questions upon which opinions may well differ, and upon which a balance of convenience or risk must be estimated according to one's opinion of how the provisions will probably work out.

A serious dilemma in drafting a corporation law is to make it liberal enough to facilitate business transactions without undue formalities of checks and balances, of votes and consents of shareholders, and applications to courts, and at the same time not so lax that the management or the majority may manipulate the machinery to the prejudice of creditors or investors or the oppression of minority shareholders. The practical difficulty must always be remembered that with the freedom of admission of foreign corporations to do business in the state and the exemption of the internal organization and affairs of such corporations from local regulation, it is perfectly useless to impose drastic limitations and requirements that will simply have the effect of driving corporations from their home state to more hospitable shores.

The California State Bar Committee has received great aid from the proposed Uniform Business Corporation Act, the Ohio General Corporation Act, and other modern acts, but it has considered all questions independently. It has even ventured to make some variations from the Uniform Stock Transfer Act. It will be possible in this article to touch upon only a few of the more important questions of legislative policy and to indicate briefly the solutions adopted.

The new California Corporation Law of 1931, the result of over three years of labor by the committee of the State Bar, represents a careful balancing of aims and policies. The primary object was to draw an act which would put California on a competitive basis as to all legitimate
corporate advantages and facilities with Delaware, Nevada and other incorporating states, and thus obviate the need of resort to other states for the incorporation of California enterprises.¹

In the accomplishment of this object the first step was to eliminate the peculiar proportional stockholder's liability from the constitution and the Civil Code and clear away various antiquated constitutional and statutory restrictions. The abolition of the proportional liability has remitted creditors to the actual corporate assets as the basis of credit and for the payment of claims due, and the liability of the shareholder is to the corporation to pay up the subscription price of his shares. To facilitate the conduct of business with efficiency it has seemed necessary to give a wider scope to the powers of management than heretofore and to dispense with the requirement of votes and consents of shareholders and applications to courts and administrative officials as far as possible. The English law regards frequent applications to the courts as necessary safeguards in corporate procedure and imposes very drastic criminal penalties to give sanction to its requirements. The California law adopts the policy of allowing the directors and the majority of the shareholders to govern the corporation and relies primarily upon civil remedies to prevent abuse.

By the new California law increased powers are given to directors in various matters such as the fixing of terms of new series of shares, when so provided in the articles; the issue of bonds without the consent of the shareholders; the permission of dealings by directors who have an adverse interest; the declaration of dividends out of current earnings even though capital may be impaired, and the granting of options and conversion rights.

The powers of the majority shareholders have been increased by permitting amendments of the articles, the sale of assets, the removal of directors, the reduction of capital, and the dissolution of corporations to be authorized by majority vote rather than by a two-thirds vote. Concentration of control has been facilitated by the authorization of the creation of non-voting shares which will make possible preferred shares with contingent voting rights and the control of corporations by "management stock." By the authorization of voting trusts there may be an irrevocable delegation of control to a certain group for a period of twenty-one years. In this way shareholders may surrender their right to vote to a group of self-perpetuating trustees who will vote the trusted stock as a unit, subject to the limitations of the voting trust agreement.

¹ See Sterling, The New General Corporation Law of California (June 19, 1931) 6 Los Angeles Bar Assn. Bulletin 299. The Mt. Sinai of corporation law is now located in Delaware, although the Moses to whom the revelations are made is said to come from New York City.
Application to Existing Corporations

It was the timid policy of the enactors of the Civil Code that any corporation already existing on January 1, 1873, should not be affected by the code, unless the particular corporation elected to come under it, but the old corporation laws "under which such corporations were formed and exist," although repealed as to subsequent corporations were continued as applicable to all such corporations. (CAL. CIV. CODE §288.)

Under this cautious exception one or two important banking corporations without capital stock still cherish their exemption from the general laws governing other corporations and float like Spanish galleons on a Sargasso sea of unchanging law.

With this exception the new law is declared applicable to all existing corporations, regardless of the date of incorporation. It confers upon them and their shareholders all of the advantages of doing business under a modern code. Some constitutional questions may perhaps arise as to the impairment of certain statutory and contract rights between the corporation and its shareholders in such matters as preemptive rights, sale of assets, negotiability of existing stock certificates and amendments modifying stock preferences. As it seems doubtful what rights of shareholders may not be changed by the legislature or by a majority of shareholders under new authority given by the legislature, it has seemed the wise policy to declare that the new law is applicable to new and old corporations, and to outstanding as well as future shares, and to leave any necessary limitations or exceptions to the courts to be worked out as occasion arises.

The act does not attempt to deprive any existing corporations or any shareholders of any constitutional rights. There is a general saving clause to preserve all existing liabilities of shareholders or directors accrued at the time the new law goes into effect. (Section 280.) The act does not cover foreign corporations except where they are expressly referred to. (Section 278.)

Giving Directors Power to Fix Terms of New Series of Shares

The directors may be authorized by the articles within limitations stated therein to fix or alter the dividend rate or the redemption or liquidation price of any class or any series of any class or the number of shares constituting any series of any class in respect of shares then unissued. (Sections 290, 295.) Such a provision of the articles would give flexibility in fixing the dividend rates and certain other terms to

2 A similar method is followed in the Indiana General Corporation Act of 1929, §§ 46, 47, authorizing "reorganization" to come under the act but this would not bind dissenting shareholders as respects vested rights.

3 See Dodd, Amendment of Corporate Articles under the new Ohio General Corporation Act (1930) 4 CIN. L. REV. 129. 150.
meet the condition of the financial markets, but does not go quite so far as the Delaware, Nevada, New York and New Jersey statutes.

It has been argued that it should not be possible for a corporation without consultation with its shareholders, after it has sold preferred shares, to issue new shares of the same class at an increased dividend rate or redemption price. It is said that for the investor's protection the shareholder should have a voice in the matter. Such a power has been vigorously denounced as the authorization of "blank stock," unsettling the whole stock structure.4

In spite of some possible danger of abuse it has seemed that such power should be allowed if it is desired to enable the directors to meet changing financial conditions without the necessity of frequent amendments of the articles of incorporation. The more recent acts of other states have adopted provisions to this effect with varying degrees of latitude. It has seemed the better policy that the authority given to the board of directors in this regard should be limited to fixing and determining those terms of new issues of shares which are ordinarily affected by market conditions at the time the shares are to be issued. Certain rights and preferences for all shares of a particular class must be fixed in the articles.

Options and Conversion Rights

The new California law contains a provision somewhat similar to that of the Delaware and Ohio acts under which the board of directors is authorized by resolution to give options to purchase or subscribe or convert or exchange securities for shares in the future upon such terms as may be deemed expedient. (Section 296.) Such a resolution need not be filed in any public office and no report of it need be made. Such options may take the form of stock purchase or subscription warrants or of any form of contract, or may be in the form of a right to convert any shares or securities into shares of any class or classes. It may be doubted whether this section adds anything to the power of directors, except authority to make shares convertible without provision in the articles.5

It has been pointed out that while options on future issues of shares have come to be accepted as a customary financial device, often reserved by the organizers of investment trusts and other corporations, they are subject to grave abuse. They may be utilized as a contrivance to keep a string on all future corporate growth, prosperity and increment in value without expense or risk or adequate consideration. When exercised they may dilute the value of outstanding shares and transfer an

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interest in the surplus from the investors who took the risk to the option holders. Professor Berle expresses the opinion that if options are created, (1) they should at once be made a matter of public record, since they become a part of the capital structure of the company; (2) notice of reservation of such options should be given in all circulars and advertisements of shares; (3) they should be limited so that there are never options outstanding to purchase more than say twenty-five per cent of the authorized or future stock of the corporation; (4) all options should have a time limit and should not be made perpetual as is sometimes the case.\(^6\)

It was the opinion of the committee drafting the California law that any statutory limitations such as the above would be unwise, even as to a time limit, because the matter of granting options may be sufficiently regulated by the courts and the commissioner of corporations and any statutory regulations might unduly hamper honest business. A permit from the commissioner would have to be obtained for the issue of options and for the issue of the shares when the option is exercised. No doubt the consideration for options should be adequate and they should be held invalid if they are obtained by the management or by promoters by abuse of their powers.

*Abrogation of Preemptive Rights*

The new California law (Section 297) like the Indiana Corporation Law (Section 6 (i)) provides that the board of directors may issue shares, option rights or securities with conversion rights without first offering them to existing shareholders, unless otherwise provided in the articles. It is a question on which opinions will differ how far the law should cut down or authorize the articles to cut down the common law right of pre-emption as to new issues of shares.

The arguments in favor of preemptive rights are in general that they furnish a simple automatic means of preventing directors from issuing shares unfairly, and give to the shareholders an opportunity to preserve their relative position in the enterprise as to surplus and voting rights. There is danger that directors may favor members of their own group by offering them shares on a more favorable basis after the public has absorbed the stock first offered. The argument on the other side, however, seems conclusive for practical purposes that in a complex corporate structure the proper assignment of preemptive rights is simply insoluble. What we really have is an obligation on the part of the management to exercise the power of issuing shares in good faith in such a way that it will reasonably protect the interests of the existing shareholders.

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ers. No doctrine of preemptive rights is necessary to preclude the directors from selling stock at less than its fair value without offering it to all the shareholders, since this would be a plain breach of fiduciary duty. Frequently as a practical matter, the existence of more or less uncertain preemptive rights hampers legitimate corporate financing.\(^7\)

**Issue of Par Value Shares at Less Than Par**

A somewhat novel provision in the new law (Section 299) is to the effect that a corporation may issue par value shares at less than par, as fully paid up, if the board of directors determines that such shares cannot be sold at par. A similar provision is contained in section 6 of the Indiana Act of 1929. Under the English and Ohio acts par value shares may be issued at less than par after the corporation has been in business for a certain period. (Ohio Act, section 16; English Companies Act of 1929, section 47.) Under the present law a going corporation may issue par value shares in good faith at less than par to meet its needs.\(^8\)

It may be contended that unless a corporation is required to issue par value shares at par and to exact a consideration at least nominally equal to the par value of all shares with par value, then the purpose of having any par value at all disappears. The sole function of a par value is to fix the issue price, the amount of the original contribution to capital.\(^9\)

The policy of the law with regard to par value shares might be influenced in either one of two ways by the increasing use of shares without par value. Either the requirements as to the payment of par value might be made more rigid and effective or on the other hand par value and non-par value shares may be assimilated.\(^10\) This latter alternative seems to be the one likely to prevail. In the case of par value stock, the issue price and the amount of consideration can easily be varied by issuing the shares for property or services of uncertain value such as patents, options and good will, and then if desired having a large part of the issue donated back to the corporation to be sold as treasury shares at less than par. Under the revised law the amount of consideration for both par and non-par shares may be determined by the board of directors, subject, of course, to the usual fiduciary duties of good faith and obtaining a permit from the commissioner of corporations. No deficit of stated capital is created under section 300b by the issue of par value shares at less than par.

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\(^8\) J. F. Lucey Co. v. McMullen (1918) 178 Cal. 425, 173 Pac. 1000.


\(^10\) See Dodd, Stock Watering (1930) 301.
Valuation of Consideration for Shares

An important question of policy is whether the board of directors should be required to state by resolution its determination in monetary terms of the fair value to the corporation of consideration for which shares with or without par value are issued. This requirement is made by section 300a of the California law. Under the Delaware law, on the other hand, shares without par value may be issued for any consideration acceptable to the directors and there need be no valuation of the property or services received for them. It seems advisable, however, to require the directors to specify what the property is in their judgment reasonably worth and upon what basis it is accepted by the corporation, in justice to other shareholders. The accountants of the company will not wish to guess at values in entering the transaction upon the books, in determining how much to credit to stated capital and how much to surplus, in preparing a balance sheet and for tax and other purposes. Non-par shares may not be given away and they should not be distributed as a bonus without fixing any definite consideration for them. Such valuation seems desirable to prevent dilution and other abuses in connection with the issue of non-par shares, such as undue discrimination among the shareholders.¹¹

Authorization of Non-Voting Shares

The disfranchisement of shareholders has been violently denounced, particularly by Professor Ripley in his popular book Main Street and Wall Street (1927). Professor Ripley objects violently to the divorce of "ownership" and control. It is true that by the authorization of non-voting shares the entire control of a corporation may be vested in the common shares, or in a single class of voting shares. The entire control of the corporation may sometimes be held by the organizers who take the bulk of the voting shares, options on future issues, and the right to much of the speculative profit, while the money actually invested in the corporation may be contributed by the purchasers of non-voting fixed dividend preferred shares who may receive at best a small bonus of common shares. Such abuses are no doubt possible. On the other hand the vesting of control in active and successful managers, through non-voting shares or voting trusts, so that no other group or combination can easily dislodge them, may be greatly for the benefit of the enterprise. On the whole in view of business methods, tendencies, and the legislation of other states it has seemed best that the preservation of voting rights

should be left to the insistence of investors and underwriters and be regarded as a matter of contract.\textsuperscript{13}

An interesting constitutional question would arise if existing corporations should adopt amendments to take away the voting rights of existing shares.\textsuperscript{13}

The commissioner of corporations will probably have no discretion to require provisions for contingent voting rights in issues of preferred shares, an authority which he has exercised heretofore in regard to the issue of preferred shares by foreign corporations, or to insert conditions in permits which will have the effect of a general regulatory power over the management of corporations.\textsuperscript{13a}

\textit{Authorization of Voting Trusts}

It has been a doubtful question in the law of California whether irrevocable voting trusts could be created in view of section 321b of the Civil Code making proxies revocable.\textsuperscript{14}

The new law, section 321a, authorizes voting trusts which may be made irrevocable for a period of not more than twenty-one years. It is no doubt to be implied that such voting trusts must be created and used for lawful purposes. The usual object of a voting trust is the maintenance of a responsible management which will provide for the corporation a consistent and continuous policy in the conduct of its business, sometimes for the protection of bondholders and creditors or for preferred shareholders who have no vote.\textsuperscript{15}

No sufficient reason or policy appears for the provision contained in the statutes of a number of states regarding voting trusts that the voting trust agreement must be filed with the corporation and that any shareholder may make himself a party to any voting trust that may be formed. It is not apparent how any shareholder would gain any additional benefits or rights by becoming a party to the voting trust agreement, as he would merely surrender his right to vote to the voting trustees over


\textsuperscript{13} C. F. Maddock v. Vorclone Corp. (Del. 1929) 147 Atl. 255; Lord v. Equitable Life Assurance Soc. (1909) 194 N. Y. 212. 87 N. E. 443.

\textsuperscript{13a} Adams, Crotty, Dunn, Fussell, \textit{The New Corporate Securities Act} (July 16, 1931) 6 \textit{Los Angeles Bar Assn. Bulletin} 337, 341.


whom he would exercise no authority. A more important question is how far voting trust agreements should be made revocable by a majority of the beneficiaries, as sometimes they may continue after the object or reason for them has ceased to exist. Some provision as to the method of termination should be contained in the voting trust, otherwise it may be terminated at any time by the holders of a majority in interest under section 321a.

Abrogation of the Defense of Ultra Vires

The new California law makes an important contribution to upholding the stability and safety of legal transactions with corporations both domestic and foreign. The doctrine of ultra vires has long been the subject of criticism by courts and writers. In Davis v. Pacific Studios Corporation (1927) 84 Cal. App. 611, 616, 258 Pac. 440, 441, it is said:

"The defense of ultra vires, urged by appellant, is no longer looked upon by the courts with favor, particularly when relied upon as a shield to escape liability. It is the policy of the law and the endeavor of the courts to hold corporations as well as natural persons to their contracts. Such defense introduced against a contract which has been executed in whole or in part by the corporation is looked upon with disfavor. As to contracts of corporations that are malum in se or malum prohibitum, they will not be enforced; but as to contracts not thus objectionable, justice and public policy require that the doctrine of ultra vires should be limited in its scope and application. McQuade v. Enterprise Brewing Co., 14 Cal. App. 315, 111 Pac. 927."

The unsatisfactory jumble of case law on this subject can be remedied only by a major operation performed by the legislature. Statutes have recently been adopted in Ohio, Indiana, Louisiana and Idaho based upon a proposal included in section 11 of the Uniform Business Corporation Act, that a corporation shall have the "capacity to act" possessed by natural persons, but shall have "authority" to perform only such acts as are necessary or proper to accomplish its purposes and are not repugnant to law. The difficulty with this proposal of the Uniform Act is that the draftsman has failed to indicate clearly what legal consequences he desired to bring about, but has simply thrown out a vague direction to courts now hopelessly at sea to swim to shore through the fog by juggling the words "capacity" and "authority" as best they can.

\[21\text{Idaho adopted its Corporation Code from the Uniform Business Corporation Act, including the section on ultra vires. See (1929) 5 Idaho State Bar Proc. 78, 80. The following colloquy on this section between Jess Hawley, Esq., President of the Idaho State Bar, and President of the Corporation Code Commission, and Mr. St. Clair may be of interest:}

"MR. ST. CLAIR: There is one section that is rather confounding, as to the powers of the corporation. I think it is the second paragraph of section ten."
The California provision, section 345, points out clearly how far the limitations on the authority of the directors and representatives of the corporation imposed by the articles may be asserted. The section does not extend or enlarge the actual authority of the directors beyond the purposes specified. Shareholders may still enjoin the corporation from engaging in business outside of the purposes authorized in the articles. They may still hold directors responsible for loss from engaging in unauthorized acts. This is adequate protection for the shareholders of the corporation without invalidating legal transactions with outsiders. There is no half-way remedy. The defense of ultra vires must be abolished as between the corporation and third parties.

It will still be important under section 345 for directors and officers to ascertain whether a proposed act or transaction of the corporation is authorized by its articles or by its by-laws. But third parties, outsiders, the public, in dealing with the corporation are made secure and the

"MR. HAWLEY: We will get it, and see if Mr. Merrill can tell you what it means.

"A corporation which has been formed under this act, or a corporation which existed at the time this act took effect and of a class which might be formed under this act, shall have the capacity to act possessed by natural persons, but such corporation shall have authority to perform only such acts as are necessary or proper to accomplish its purpose and which are not repugnant to law."

"Paragraph two: 'without limiting or enlarging the grant of authority contained in subdivision I of this section, it is hereby provided that such corporation shall have authority...' et cetera.

"MR. ST. CLAIR: What does that mean?

"MR. HAWLEY: I think that that simply protects the corporation, or prevents the corporation from going back to a confusion between corporate capacity and corporate authority.

"MR. ST. CLAIR: It wouldn't have authority to do those things enumerated thereafter, because that would extend or enlarge the powers granted by the articles.

"MR. HAWLEY: Possibly I don't get your point there.

"MR. ST. CLAIR: Well, you prepare your articles, and give certain powers to the corporation. Then that reads that the corporation shall have the following powers, but not to enlarge those in the articles.

"MR. HAWLEY: You just heard what the section, or paragraph preceding that provided — that it has the capacity to act possessed by natural persons but has authority to perform only acts necessary or proper to accomplish its purposes.

"MR. ST. CLAIR: Yes, but there are a number of designated powers following what you have read. And you have to designate in your articles the powers which you propose to exercise.

"MR. HAWLEY: Well, it says 'without limiting or enlarging the grant of authority contained in subdivision I.' And subdivision I states that it shall have the capacity to act as an individual, and the authority to accomplish its purposes.

"MR. ST. CLAIR: Subdivision I provides what you shall put in your articles.

"MR. HAWLEY: No; the uniform commission intended subdivision I to do just one thing: That is to do away with ultra vires acts; and we say that your corporation has the capacity to act as an individual, but only authority to accomplish its purposes.

"I really don't see any difficulty in that.

"Maybe there are some other questions I can answer just as clearly."
corporation cannot in its relation with its promisees, creditors, pur-
chasers, grantees and encumbrancers go behind the act of the directors
and show that the particular act was outside of the authority of the cor-
poration because contrary to its articles, any more than if contrary to
the by-laws.

There may be a question whether ultra vires should not be a defense
in any individual case in favor of the corporation against a person charge-
able with actual knowledge of the charter limitations on the authority
of its representatives. This is the rule adopted in Ohio and Michigan.
But it seems far better policy to make legal transactions safe and certain
by doing away with the necessity of going into this question of knowledge
of power and authority. Persons dealing with corporations should be
enabled to rely on the authority of the directors and should not have
to consult attorneys on the frequently difficult question of whether a
transaction is intra vires or run the risk of proving their ignorance of
possible limitations on the authority of the managing board. (Compare
Stevens, Ultra Viars (1930) 4 CIN. L. REV. 419, 439.)

If an act be forbidden by law (malum per se or malum prohibitum)
or if a third party knowingly participates in the perpetration of any fraud
upon the corporation or any abuse of authority by its officers, that would
of course be a defense or ground of invalidity. The abrogation of the
defense of ultra vires does not abrogate such defenses.18

An interesting feature of the new California provision, which is some-
what revised from section 355 adopted in 1929, is extending its doctrine
to contracts and conveyances made by foreign corporations in the state,
a matter which ordinarily might be regarded as one affecting the internal
authority or affairs of the corporation and as such governed by the law
of the domicile. The new Michigan act has a similar provision.

**Effect of Adverse Interest of Directors**

Those organizing corporations evidently find the law too strict as to
the disqualification by adverse interest of directors dealing with corpora-
tions which they represent. Provisions are commonly included in articles
or certificates of incorporation of Delaware and other states to modify
the legal rules and provide that adverse interest shall not affect the
validity of any contract, but these clauses are of very doubtful validity.
The new California law, section 311, relaxes the strictness of the Cali-
ifornia decisions to the effect that the interested director's vote may
not be counted toward a majority and that his presence may not be
considered in determining whether a quorum of directors is present.19

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19 Hotaling v. Hotaling (1924) 193 Cal. 368, 224 Pac. 455. See Frank H. Buck
19 CALIF. L. REV. 304; (1929) 29 COL. L. REV. 338.
The new provision, section 311, gave rise to great doubt and difficulty in drafting. There are doubtless those who will be opposed to relaxing the strictness of the present fiduciary rules as to the effect of adverse interest. Directors should not be permitted to abuse their position. It was the view of the majority of the committee on corporations, however, that transactions with a director or between corporations with common directors should be merely voidable for unfairness and not void or voidable at the option of the corporation by reason of the fact that such director participated in a quorum or in a majority. Under section 311 even if one or more of the directors be adversely interested and be needed to make up a quorum the contract or transaction will not be either void or voidable by reason of that fact if (a) the fact of such participation is adequately disclosed and the contract or transaction is approved in good faith by an independent vote of directors sufficient for such purpose without counting the vote or votes of the adversely interested director or directors; or (b) if the fact of the participation is adequately disclosed and if the shareholders approve or ratify the contract or transaction in good faith; or (c) in any case if the contract or transaction be as to the corporation just and reasonable. It is implied that the validity of such a contract or transaction will always be subject to the general requirement that directors and officers shall exercise their powers in good faith. They cannot abdicate their duty and leave it to others to protect the corporation while they drive a harsh or unfair bargain and use their influence to the detriment of the corporation.

The exigencies of modern business demand a practical working rule to cover dealings between corporations and their directors which shall make possible such dealings even with a majority of the directors. The practice of calling directors "trustees" and subjecting them to the strict and rigorous rules which apply to dealings between a trustee and his beneficiary requires some modification. Directors must be held to reasonable limitations of fiduciary duty, but there is a distinct policy in favor of upholding contracts made by directors even though they may be interested on their own behalf or on behalf of another corporation, if such contracts are just and reasonable. Section 311 does not specify what are the presumptions or who has the burden of proof as to good faith or bad faith or as to whether the transaction is fair or unfair to the corporation under different circumstances.

There is included in the new law a provision somewhat similar to the law of Delaware, Michigan, Ohio and other states, restricting the authority of the management to loan money to directors or officers.

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without consent of two-thirds of the shareholders. There are special provisions in the Bank Act and Building and Loan Act as to loans to directors.

**Financial Questions**

Some of the most interesting and difficult legislative problems arise in connection with financial matters, particularly the provisions as to issue of shares, stated capital, the use of paid-in surplus, the sources of dividends, the purchase by a corporation of its own shares, and the reduction of stated capital. There is unspeakable confusion among lawyers and accountants over the law relating to "capital," greatly increased by that most deceptive and variable term "capital stock." In these financial matters it is with the utmost difficulty that the legal and accounting professions can get together or understand the concepts and policies of the other. It is believed that the result often is the nullification of important legal requirements by accounting methods which misrepresent the legal effect of such transactions as the purchase of shares, partly owing to the ambiguity of such terms as "capital stock" and purchase "out of surplus." The California committee has received great aid from some leading accountants in these matters.

**Limitations on Dividends**

American law is in a state of confusion as to the proper limitations to be placed upon the sources of dividends so as to preserve the stated capital or "capital stock." The "capital stock" of the corporation, as is said by the New York court, is intended as a fund for the ultimate payment of all creditors, both present and future. In the absence of statutory provision a corporation has no right to declare dividends with an impaired capital. The same limits should apply to the purchase of its own shares as to withdrawals for dividends. The Illinois committee says in a note to the recent draft of a proposed Business Corporation Law for Illinois, section 40, "Obviously no dividends should be declared at a time when the net assets of the corporation are less than the stated capital or which will reduce the net assets below the stated capital." This is probably the rule in the majority of jurisdictions. In Delaware, New Jersey, Nevada, Indiana and several other states, however, there are recognized two funds or sources for cash dividends, namely (1) surplus and (2) net profits. Under the Delaware act, section 34, dividends may be declared (a) out of net assets in excess of capital; (b) in case there shall be no excess, out of its net profits for the fiscal year then current and/or the preceding fiscal year, with a limitation for

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the protection of the preferred stock. It is not clear under the Delaware law whether dividends could be paid out of the net profits of the preceding fiscal year if losses had been suffered in the current fiscal year, and if the earned surplus of the preceding year was now impaired.\(^\text{23}\)

The California dividend section, section 346, permits cash dividends either out of earned surplus or out of net profits, despite impairment of stated capital, if earned during the next preceding accounting or dividend period which shall not be less than six months nor more than one year in duration.

This makes possible payment to the investor of returns upon his investment although the stated capital has become impaired by losses in prior years, without the formality of reducing stated capital. There is a provision as in the Delaware law which protects the equity of the preferred shares in the assets.

It was the view of the committee that corporations should be able to pay dividends out of current earnings even though stated capital has become impaired, without the formality of reducing their stated capital. Investors should not be required to forego dividends and income from their investment in order to enable the corporation to make up at once its capital losses if it is making profits from current operations. Prudent management may call for the gradual restoration of capital and a reasonable latitude should be given to the directors as to how rapidly to make up losses of prior years.

Under the former California law dividends were payable only from “the surplus profits arising from the business” and paid-in surplus or premiums on stock were not available for dividends, except as allowed on preferred shares by the amendment of 1929. “Capital stock” was interpreted to mean the entire proceeds of the issue of shares.\(^\text{24}\)

The California rule under section 346 (3) is more strict than that in Delaware and many other states as to the payment of dividends out of paid-in or contributed surplus, and out of surplus arising from reduction of stated capital. Non-par shares may not be taken advantage of for creating a paid-in surplus to be the plaything of the directors, and to avoid limitations upon the payment of dividends or reduction of capital and upon the purchase of a corporation’s own shares.\(^\text{25}\)

The California law has a separate section, section 346a, as to the declaration of share dividends, as these do not involve any withdrawal

\(^{23}\) The new Michigan General Corporation Act of 1931, §22, authorizes dividends “either from earned surplus or from net earnings” but does not specify earnings for any particular period. See also the New Jersey act, §30, (N. J. Laws, 1930, c. 120).


\(^{25}\) See Note (1931) 31 Col. L. Rev. 264.
or distribution of assets. Such dividends may be declared on the basis of paid-in surplus or surplus arising from reduction of stated capital, since they merely involve the capitalization of surplus. The Ohio act permits share dividends against unrealized appreciation in values and strange to say, does not require the transfer of any surplus to capital upon the declaration of a share dividend in non-par shares. It thus fails to draw any distinction between a stock dividend and a split-up or subdivision of non-par shares into a larger number of shares as to its effect in capitalizing surplus.

**Purchase by a Corporation of Its Own Shares**

There is a serious question of policy and conflict of opinion as to how far a corporation should be permitted to purchase its own shares and as to what is the effect of such a purchase. It was formerly, that is prior to 1929, the rule in California that a corporation was not authorized to purchase its own shares, with some minor exceptions such as collecting a debt or saving itself from loss.\(^\text{26}\)

The new law, section 342 (7), has been revised to permit the purchase by a corporation of its shares, subject to limitations of the articles, from earned surplus. The effect of this revision is to permit the purchase of shares out of earned surplus in the discretion of the board of directors without requiring the vote or written consent of the holders of two-thirds of each class of shares outstanding as under sections 354-8 (b) of the 1929 amendments. The corporation may also purchase its shares by way of redemption and in certain special situations "out of" stated capital.

It has been urged by able writers that the policy of the law as to protection of capital is not consistently carried out and that many abuses are made possible by permitting a corporation to deal in its own shares.\(^\text{27}\) There is no doubt that as Morawetz says, such power is "a fruitful source of unfairness, mismanagement and corruption."\(^\text{28}\) The purchase of its own shares is a method of secret withdrawal and distribution of current assets which may be needed in the business, or may be discriminatory, or a means of speculation with the corporate funds. It is said that many of the big investment trusts have reduced their capital to a nominal amount and have used the surplus created by the reduction to purchase their own shares, either to hold as treasury stock or for retirement or to pay dividends. The New York Stock Exchange

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has taken cognizance of this situation and has adopted a rule preventing investment trusts from dealing in their own shares or from buying their own shares for resale without permission.

A corporation should not be permitted to gamble in its own shares. Some of the greatest abuses in connection with stock market manipulation arise from the purchase of shares out of paid-in surplus or capital surplus with a view to resale. Such speculation is discouraged and limited to a considerable extent by the requirement of section 342 that the purchase must be made only from earned surplus except in certain special situations and by the requirement of section 342a that when a corporation acquires its shares under authority of section 342(7) the earned surplus shall be reduced by the amount of the purchase price, but the stated capital shall not be affected thereby. Upon the reissue or sale of such treasury shares the earned surplus may not be reinstated but the consideration received is to be added to stated capital or paid-in surplus, under section 342b, as upon an original issue of shares. The same requirements are imposed upon the device of dealing in the shares through a subsidiary or controlled corporation, a common method of evasion.29

Sale or Mortgage of Entire Assets

The sale or transfer of the entire assets of a corporation requires the authority of a majority of the directors and also of the shareholders entitled to exercise a majority of the voting power. (CAL. CIV. CODE §§ 343, 401c.) The necessity of such authorization may not be dispensed with in the articles and would be required even in cases when the corporation is in financial difficulties. An interesting provision is made for combining a sale with a plan of distribution of shares or securities received so that a consolidation may more easily be accomplished by means of a sale. (Section 343a.)30

There was some discussion as to whether a mortgage or deed of trust of all or substantially all of the assets of a corporation should require the vote or consent of the shareholders, or whether the directors should be authorized to make it. It has been argued that directors are elected to carry on the normal or usual business of the corporation and that transactions outside the usual or regular course of business should require the consent of the shareholders. This view was adopted as to mortgages of the entire assets in the proposed Illinois Business Corporation Act, section 70. The California committee was opposed to any such requirement, as a mortgage or deed of trust does not

contemplate the termination of the corporate business, and accordingly it is provided in section 344 of the Civil Code that no vote or consent of shareholders shall be necessary to authorize such a mortgage to secure bonds or other obligations. Ordinarily, unless otherwise provided by articles or statute, the consent or vote of shareholders is not necessary to the issue of bonds by a corporation. The board of directors is vested with that authority.\footnote{31} Under the New York Stock Corporation Act, section 16, however, consent to the execution of a mortgage of the property and franchise of a corporation must be given by the holders of not less than two-thirds of the voting shares outstanding.

\textit{Uniform Stock Transfer Act}

An important improvement in the law for the protection of corporations, purchasers and pledgees of stock is the adoption of the Uniform Stock Transfer Act, which aims to place certificates of stock on the basis of negotiable instruments.\footnote{32} Some changes, however, were made in the act since it seems defective in confining the term “certificates” to a certificate for shares in a domestic corporation or of a foreign corporation of a state “whose laws are consistent with the act.” It seems better to make the act apply to certificates for shares both in domestic and foreign corporations where the transfer takes place in this state. It seems also better to provide that the act applies to existing certificates as well as to certificates issued after the taking effect of the act, thus dispensing with the cautious limitation of section 23. It would be far from “uniform” to have different rules of law applicable to existing certificates and certificates in the same corporation issued after the adoption of the act, and to have uncertainty as to what rule of law applies to the transfer of foreign as contrasted with domestic certificates in this state.

It was also decided with some reluctance to omit section 13 restricting the rights of creditors by way of attachment or execution of shares to seizure of the certificate. This seriously mars the policy of facilitating transfer by making certificates reliable evidence of title. Organizations of creditors and also many attorneys were however opposed to the requirement of seizure of share certificates on the ground that this would seldom be possible. It was contended that shares of stock now enjoy many privileges and should not be placed in the class of property which cannot readily be levied upon.

There are a number of new provisions to facilitate the transfer of shares by corporations which deal with important matters not covered

\footnote{31} Citrus Growers' Association v. Salt River Association (1928) 34 Ariz. 105, 268 Pac. 773.

\footnote{32} Crotty and Sterling, \textit{California and the Uniform Stock Transfer Act} (1931) 19 \textit{Calif. L. Rev.} 150.
by the Uniform Stock Transfer Act, which act seems to be in serious need of being supplemented and made more comprehensive.

**Compensation of Dissenting Shareholders**

There was great doubt and difference of opinion as to how far provision should be made for appraisal and compensation of dissenting shareholders in event of merger, consolidation, sale of the entire assets or amendment of the articles modifying preference rights. It remains to be seen whether such provisions will accomplish any useful purpose. It is not easy to ascertain whether this remedy by way of compensation given by many modern laws is intended for the benefit and protection of the minority or for the benefit of the majority to remove any doubt about the constitutionality of fundamental changes without unanimous consent.\(^3\) The statutes which have been so far drafted upon this subject are for the most part purely experimental, differ as to the occasions upon which the remedy is given, and leave a number of questions in serious uncertainty.\(^4\)

One great point of difficulty is how far the remedy given by the statute should be made exclusive. If not made exclusive then it will not operate to facilitate corporate changes, but might tend to work an injustice upon the majority of the shareholders by enabling a minority to block necessary changes, and thus hamper business.

The corporation committee decided to proceed cautiously and to extend this remedy only in cases of merger and consolidation, and in cases where a plan of distribution of shares or securities is made a part of the authorization of a transfer of the entire assets.\(^5\) In these cases the remedy under section 369 for compensation is made exclusive and the remedies of any shareholder to litigate as to any such merger or consolidation or distribution are limited to the right to obtain compensation, except for suits to test whether the necessary number of votes or consents of shareholders has been given. This excludes any right to bring injunction proceedings on the ground of fraud or unfairness.

**Dissolution and Winding Up**

The laws of most of the states are seriously defective in relation to the winding up and dissolution of corporations. The English law on the other hand seems cumbersome and over elaborate, although it affords many valuable suggestions.

It is the policy of the new California law to leave matters of winding

\(^3\) See *In re Timmis* (1910) 200 N. Y. 177, 93 N. E. 522.


up and dissolution as far as possible to the directors acting as directors and without the necessity of application to the courts. The corporate existence is prolonged for an indefinite period for the purpose of winding up on the model of the New Jersey statutes. There seems no utility in placing a limit of three years, as in many states, upon the continuation of a quasi-corporate existence for purposes of liquidation.

Provision is made for application to the courts by the corporation or any shareholders to supervise the process of winding up the affairs of the corporation and to set a time for the presentation and proof of all claims, whether due or not yet due, or contingent or unliquidated, and the barring from participation of creditors and claimants failing to make and present claims and proofs, as under the law for the administration of the estates of deceased persons. (Section 403.)

The involuntary winding up of corporations is authorized on the petition of a certain percentage of shareholders in cases of internal dissension and of persistent fraud, mismanagement or abuse of authority. (Section 404.) This should afford an important remedy to minority shareholders in cases where the corporate property is being misapplied, wasted or lost by the management. Heretofore only the state could maintain a proceeding to wind up or dissolve a corporation involuntarily.

Organization Fees

No attempt has been made by the State Bar Committee to revise the schedule of fees, graduated according to the corporation's authorized "capital stock," imposed by section 409 of the Political Code for filing articles of incorporation or consolidation, or amended articles or agreements of merger which provide for additional shares. It may be suggested that such statutes disregard the distinction between an official fee, which is properly a charge for an official service, and an excise tax for a privilege granted. The actual cost to the state of filing and recording articles does not exceed the cost of filing and recording a deed. The authorized "capital stock" or number of shares no longer indicates the capital or size of the corporation or the value of its privileges.

Section 290d of the Civil Code which prescribed an arbitrary valuation of $10 for each share without par value as a basis for fixing the fee under section 409 of the Political Code for filing articles of incorporation, has been repealed. Cal. Stats. 1931, c.258 (Assembly Bill 1011) revising section 409, failed to provide for a valuation of non-par shares except under paragraph 7 as to amended articles and agreements of merger. The rather remarkable result seems to follow that corporations capitalized with non-par shares may file their articles for a flat fee of $5 or $15, no matter how many shares may be authorized. If it
be considered that they do not provide for any "capital stock" in the sense of a maximum capitalization in monetary terms, the fee would be $5. If it be considered that non-par shares represent a "capital stock" or capitalization of an indeterminate amount, then the fee for a capital stock of less than $25,000 would be charged, viz., $15. The provision in section 409 of the Political Code for articles not providing for a "capital stock" probably refers to non-stock corporations, which are usually not for profit.

A case is now pending in the Supreme Court (Sacramento 4412), in which it is contended that section 409 of the Political Code is unconstitutional on the ground that the graduated charges for filing a certificate of increase of capital stock reckoned according to the amount of such increase are essentially an excise tax, rather than a mere fee for the services of the officer in filing the certificate. This same objection, if valid, would invalidate the charges for filing articles under section 409 and perhaps also the fees under new section 26 of the Corporate Securities Act.

**Conclusion**

In conclusion it may be said that the new California law while very liberal in abrogating harsh liabilities and unreasonable limitations, at the same time aims to safeguard and protect the rights of creditors and shareholders so that in some respects the new law includes more effective provisions in favor of investors and of persons dealing with corporations than the law of Delaware, Ohio, Nevada and other states which have adopted liberal laws. The Ohio act encourages an undue "freedom of contract" to vary almost all statutory rules by special provisions of the articles, even for example in such matters as reduction of stated capital. Cumulative voting, which may afford representation to the minority, is not left to the choice or caprice of those who draft the corporate articles as in Delaware. The capital contributions of the shareholders are carefully guarded both for the protection of creditors and of investors against dividends from paid-in surplus and against speculation by the corporation in its own shares. The fiduciary duty of directors is expressly declared, and their authority to make loans of the corporate funds to each other is limited. Directors are required to value the consideration received for shares without par value. Provision is made for the removal of dishonest directors by the courts as well as by the shareholders, and for involuntary dissolution of corporations at the suit of the minority. Rights of inspection and of investigation of corporate records are more fully provided for than in almost any other American law. The proof of corporate existence, acts and proceedings is made as simple as possible.
The constitutional obstacles to a satisfactory corporation law in this state have been overcome. The corporation committee has completed the revision in 1931 which was commenced in the session of 1929. The problems referred to above are to some degree continuing ones. Adjustments and improvements in the corporate mechanism can be made from time to time as the need shows itself in dealing with particular situations and as further improvements are devised in the methods of organizing and regulating corporations.\textsuperscript{33}

\textit{Henry Winthrop Ballantine.}

\textsc{School of Jurisprudence,}  
\textsc{University of California.}

\textsuperscript{33} See Farrand, \textit{California Adopts "Flexible" Corporation Code} (Aug. 1931) 16 \textsc{California Citrograph}, No. 10, warning of possible abuses of too much flexibility.