ABSTRACT

This thesis is an in-depth comparative study and critical examination of several wide-ranging problems in the law of corporation finance of Britain and the principal jurisdictions of Canada and the United States of America. The problems examined include Inadequate Capitalization, Stock-watering, Reduction of Capital, Purchase by a Corporation of its Shares, and Dividends. The thesis examines the trends and patterns in the different jurisdictions and appraises their merits and defects. The study concludes that the conceptual ambiguities and practical difficulties which abound in the laws of corporation finance are aggravated by the failure of the law to work out rational rules based on a clear and unifying policy for the raising and maintenance of capital. The necessity for such a policy is advocated in view of the inadequacy of the existing institutions and devices for the protection of the multifarious interests involved in corporate business enterprises.

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Title of Thesis: The Raising and Maintenance of Capital (A Comparative Study of Some Problems in the Law of Corporation Finance).

Department: Institute of Comparative and Foreign Law, Faculty of Law.

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ABREGE

Cette thèse se présente sous la forme d'une étude comparative en profondeur et d'un examen critique de quelques problèmes du droit des corporations financières de Grande Bretagne et des principales juridictions du Canada et des Etats-Unis d'Amérique. Y sont étudiés entre autres l'insuffisance de capital, la dilution de capital, la réduction de capital, le rachat de ses actions par une corporation et les problèmes concernant les dividendes. On y examine ensuite les tendances et positions de ces différentes juridictions, pour en évaluer les mérites et les défauts. En conclusion cette étude montre que les ambiguités conceptuelles et les difficultés pratiques qui abondent dans le droit des corporations financières sont aggravées par l'insuffisance de la loi à élaborer de règles rationnelles, basées sur une politique claire et uniforme de souscription et de maintien du capital. La necessité d'une telle politique semble évidente lorsque l'on considère l'imperfection des institutions actuelles et des moyens de protection des multiples intérêts impliqués dans les corporations commerciales.

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Doctorat en droit civil.

THE RAISING AND MAINTENANCE OF CAPITAL

(A Comparative Study of Some Problems in the Law of Corporation Finance)

by

K. Ponnuswami

A thesis submitted to the Faculty of Graduate Studies and Research in partial fulfilment of the requirements for the D. C. L. degree

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June 1969

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PREFACE

This thesis is a comprehensive, in-depth comparative doctrinal study of several wide-ranging and important problems in the law of corporation finance of Canada, Britain and the United States of America. Being the first of its kind, the presentation, examination and evaluation are original, though the writings of eminent scholars in the field of law, economics and accountancy in all the countries have greatly helped to shape and mould the views of the writer. Due acknowledgements have been made in the text and notes of the assistance derived by the author from other published work. Part I of the thesis contains background materials and the author has heavily relied upon the works of other writers in writing the chapter on Historical Introduction, but has verified them in several instances from original sources. Parts II and III constitute the core of the thesis and the final chapter sums up the broad conclusions of the study.

ACKNOWLEDGEMENTS

First and foremost I am indebted to Dr. Jacob S. Ziegel, Professor of Law and my Research Director, for the sympathy, understanding and kindness that he has shown me during my three years as a graduate student as well as the patience with which he has read through the tedious pages of my manuscript. But for his critical and searching comments and questions, I would have fallen into serious errors or omissions in my appreciation of the knotty legal problems covered by this study. His labours extended not only to the substance of my work, but even to its style and syntax. I am unable to find words adequate to express my gratitude to him. I had the opportunity to assist him in the preparation of his STUDIES IN CANADIAN COMPANY LAW and to participate in his seminars on corporation law which greatly helped me to acquaint myself with the Canadian company laws.

My grateful thanks are due to the Institute of Comparative and Foreign Law, its former Director, Dr. J.J. Gow, and present Director, Dr. H.R. Hahlo, and to Dean Maxwell Cohen, for the financial assistance and encouragement extended to me which made it possible for me not only to pursue my research, but spend three memorable years in Canada which included the Centennial year of Canadian Confederation.

I wish to acknowledge my indebtedness to Mr. William P. Hackney, of Reed, Smith, Shaw and McClay, Pittsburgh, Pa., U.S.A., who generously spared his time to clear some of my doubts on the American

Model Business Corporation Act.

I am also thankful to the staff of the Law Library for the help that they cheerfully gave me at all times.

I owe a deep debt of gratitude to Mrs. H. Blevins who typed this voluminous thesis not only with extreme patience and skill, but rare intelligence and understanding. But for her this work would have taken far longer to complete.

Last, but not least, I am indebted to the University of Delhi, India, for granting me sufficient leave of absence to undertake and complete this work.

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FOREWORD

It is necessary at the outset to define and delimit the scope and nature of the study undertaken here. This need arises particularly because of the remarkably wide sweep of the term "corporation".[1] Of all the wide variety of institutions known to the law under the omnibus title of "corporations" our study is limited to business corporations.[2] Thus we exclude from the scope of our inquiry corporations sole, all public corporations including municipal corporations, ecclesiastical corporations, and eleemosynary corporations. Further we shall devote attention primarily to the modern business corporation formed and functioning under general incorporation laws with limited liability. In the history of corporation law these belong to the modern times, being just over a hundred years old. Our concern, if any, with business corporations created by royal charters and special statutes will only be incidental and peripheral. In order to keep the work within manageable proportions we have also to refrain from any investigation of financial corporations, such as banking, mutual fund or insurance companies, and public utility companies which are regulated often by special statutes.

No justification need be offered for embarking on this study. But it may be mentioned that the corporate form as employed in business enterprise is "an instrument for the attraction, organization and utilization of capital resources"[3] and "in the main a device for

raising and putting to use large masses of capital"[4], and that, therefore, a study of corporate capital is a study of a most fundamental aspect of corporate enterprise. From the beginning to the end of any corporate enterprise it is a matter of vital interest to everyone concerned with it — the investor, the management, the creditor, anyone dealing with the company and even the community at large. The second obvious justification is the need for comparative study. Comparative law — or comparative methodology — has its most significant role to play in the field of commercial law, especially now when international investment and trade are assuming proportions to an extent hitherto unknown in the history of the world.

The work is divided into four parts. Part I will be a historical survey of the grass-root principles and a general introduction. Part II will deal with problems connected with the "Raising of Capital". Part III, which will be devoted to the "Maintenance of Capital", will be the central part of the thesis and will scrutinize many a controversial question which frequently occurs in that area. Part IV will be an attempt at appraisal.

Traditional concepts evolved at a different age and in a different economic and political environment need to be re-examined, retained if found sound and rejected if found to have outlived their usefulness. The post-War decades have witnessed a great spurt in company law reform all over the world.[5] Comparative studies are likely to be most fruitful at this time.[6]

The comparative study undertaken here will cover the United States of America and the Commonwealth with particular reference to Great Britain and Canada. Of the fifty American jurisdictions attention is chiefly devoted to the federal securities statutes,[7] the Model Business Corporation Act,[8] the Uniform Business Corporation Act,[9] the corporation statutes of Delaware,[10] New York[11] and California,[12] the blue sky law of California[13] and the Uniform Securities Act.[14] Of the Canadian jurisdictions stress is laid on the Dominion,[15] Ontario[16] and Quebec[17] company statutes and the Ontario and Quebec securities laws.[18] This choice of the jurisdictions or statutes is based on their practical importance. Thus the importance of the federal securities Acts in the United States cannot be exaggerated. They have given birth to a federal corporation law in America.[19] The Model Business Corporation Act has become the model for "modernizing" the corporation laws in many jurisdictions.[20] The importance of Delaware can be seen from the fact that as on 31 December 1966 35% of all corporations whose stock was listed on the New York Stock Exchange were incorporated in Delaware.[21] The Delaware Corporation Statute is also well-known for its pro-management bias and lack of adequate safeguards for shareholders and creditors. The importance of New York needs no proof. It has been reported that of the 197,724 corporations incorporated in the whole of the United States in 1964, 36,274 (or slightly over 18%) were incorporated in the New York jurisdiction.[22] California has been chosen as representative of jurisdictions which

adopt to a greater or lesser extent a paternalistic approach toward corporate enterprise. It is hoped that these jurisdictions or statutes represent reasonably adequately the American approaches and attitudes, though unfortunately some recent corporation law reforms of significance, such as in North Carolina, had to be excluded from careful examination.

The inclusion of Britain and Canada in the comparative study needs little explanation. British company law is still the substantial basis of the company laws of most Commonwealth jurisdictions and British statutes have been adopted almost verbatim in many of them. Canada's importance lies in that we find in its company laws a meeting and blending of British and American ideas and institutions. Canada might well prove to be the conduit through which the salient features of American corporate experiences might flow to the rest of the Commonwealth. It is, therefore, hoped that a comparative study of the corporation and security laws of America, Britain and Canada is valuable and important.[23]

PART I : GENERAL

CHAPTER 1

THE HISTORICAL BACKGROUND WITH SPECIAL REFERENCE TO CAPITAL

It will be convenient to divide our historical survey into two major sections: A. Business Corporations Before the Advent of General Incorporation Laws for Business Purposes. This embraces the period up to the end of the eighteenth century and was the era when "freedom of incorporation for business purposes" did not exist in the common-law world. We examine this period to discover the ideas, aspirations and prejudices which were then prevalent and their impact on the future. B. Business Corporations After the Advent of General Incorporation Laws for Business Purposes. This embraces the nineteenth and twentieth centuries when "freedom of incorporation" came to be accepted and corporate enterprise has had its most phenomenal growth.

A. BUSINESS CORPORATION BEFORE THE ADVENT OF GENERAL INCORPORATION LAWS FOR BUSINESS PURPOSES.

The concept of absentee ownership — that is, investment in the capital of a business enterprise without participation in its management, — and limited liability — that is, non-liability of the investor for the debts of the business enterprise beyond the amount of his invest-

ment, — are far more ancient than joint stock corporate commercial activity. The divorce of control from ownership and the concept of limited liability are not modern phenomena.

Thus in the medieval contract of commenda one lent capital to another for employment in trade on the term that the borrower (commendatarius) was entitled to his expenses and a share in the profit (usually 1/4 to 1/2) and that if the capital was lost through no fault of the borrower, the lender (commendator) should bear the loss.[1] The commendator, unlike the ordinary money-lender undertook a special risk and the law rewarded him by exempting him from the rules of usury.[2] This contract, which was common in the middle ages in Europe, "was the direct ancestor of the French société en commandite",[3] the limited partnership as it is known in the common-law countries.

Though the commenda was known in England, the limited partnership did not take root in that country for diverse reasons.[4] When at long last it was introduced into England in 1907[5], it was too late to gain popularity. The device was never introduced into India or other Afro-Asian British colonies. In contrast the American states borrowed the European device early in the nineteenth century, New York and Connecticut doing so in 1822.[6] But the continental concepts did indirectly influence the form of commercial societies which emerged in England in the seventeenth century.[7]

Again, the concept of corporate personality as an aggregation of human beings combining for a common purpose is not modern. It was familiar to the Romans. When after the end of the Dark Ages

order returned to Europe and a renaissance of Roman law began, the continental jurists rediscovered the universitas and distinguished it from the societas (partnership) and the co-proprietorship. At the same time the canonists further elaborated upon the idea to evolve the concept of the ecclesia as a universitas and a persona.[8]

Though these concepts of corporate personality, limited liability and severance of control from ownership were known from early times, it was the growth of European overseas mercantile adventures after the middle of the sixteenth century that prompted the need both for joint stock enterprise and the corporate form as the instrument of organisation. Foreign trade meant that ships had to be built at enormous expense and that the great risks attendant on navigation had to be borne. This could not be done by a single proprietor or a few partners, but only by a large number of persons. Besides these enterprises needed special powers to organize and regulate their affairs and special trading privileges such as monopolistic rights. Such powers and privileges could only be obtained from the sovereign.[9] From this evolved the notion that incorporation was a royal prerogative, the grant of a special privilege. Blackstone grouped under one head corporations brought into existence by an Act of Parliament and those created by king's charter. Both were modes of creation of corporations by the king, the royal assent being a necessary ingredient of every Act of Parliament. Quite often Acts of Parliament merely confirmed a corporation already created by royal charter.[10] Indeed the conflict between the King and the Parliament over the validity of monopolies and other special privileges granted

by a royal charter made it prudent to obtain a parliamentary confirmation of such privileges.[11] We also find special Acts of Parliament authorising the king to create corporations in future with specified powers. Parliament also at times itself created corporations by special Acts, but these appear to have been not too frequent.[12] A royal charter was a "mark of royal favour and protection", a "symbol and source of corporate life."[13] Incorporation, therefore, remained particular and a concept of general incorporation or freedom of incorporation did not exist at this time.[14]

Like the medieval guilds, the early corporate function was purely regulatory, every member conducting his own trade, but subject to the rules and regulations of the incorporated body. Thus the famous East India Company, which went to trade with India and won an Empire for Britain, was a "regulated company" when it was created in 1600 under a charter of Queen Elizabeth I. On the other hand the Dutch East India Company organized in Holland in 1602 had a permanent joint stock capital. In 1612 the English Company also "began to issue stock on a more permanent basis, steadily lengthening the period of time for which the stock was issued."[15]

1. THE ENGLISH SCENE UP TO 1720.

By the end of the seventeenth century joint stock companies came into extensive use for several reasons. The success of the English and Dutch East India companies demonstrated their usefulness. Their value for the promotion and conduct of new industries was soon recognized.

Besides, the government became interested in joint stock enterprise as it found in them a valuable means to raise public loans.[16] The Bank of England was so born. A group of persons who had lent money to the state was incorporated in 1694 by the state as a joint stock company and empowered to carry on the business of banking.[17] The technique was to utilize the "capital lent to the state as 'a fund of credit' on which loans could be raised by the incorporated body for its trading operations."[18] This became the common feature of corporate capitalization in England in the eighteenth century. Later this technique blossomed into the ingenious idea to form a company to take over the whole of the state debt, obtain valuable trading privileges, give the state creditors shares in the company in lieu of their claims against the state, and hope that the company will become a bonanza. The South Sea Company was chartered in 1711 in this way and granted a monopoly of trade with South America. Similar ideas and greater ambition inspired John Law to form the Compagnie de la Louisiane ou d'Occident in 1717 in France to take over the grant for the Mississippi trade.[19] Boom in company promotion, wild speculation, quest for quick wealth, and bribery of government officials and legislators to obtain special favours were the order of the day.[20]

Inspired by the phenomenal successes of incorporated joint stock enterprises, there came into existence many joint stock enterprises which never sought nor obtained incorporations. They were organized on the same lines as the incorporated companies and differed from them only in that they lacked a charter.[21] There was no legal impediment in

the way of organizing and operating such unincorporated joint stock enterprises.[22]

We shall pause here and take stock of the ideas that had developed and achievements made by the end of the second decade of the eighteenth century in England.

1. The necessary consequence of incorporation was the distinct and separate existence of the corporation and its members. It was clear as early as the fifteenth century that an individual incorporator was not personally liable for the debts of the corporation.[23] In the second half of the seventeenth century this principle was judicially accepted.[24] Incorporation was sought obviously to secure this advantage as well. The liability of the incorporator or shareholder was to the company to pay "leviations" as assessed upon them by the company.[25] This led the way to limitation of liability which could be achieved by a contract between a company and its members stipulating the maximum amount of leviations that may be made upon a member.[26] The position as summed up by Holdsworth was that "by the adoption of the corporate form a clear line could be drawn between corporate liability and individual liability; and that by bargains made between the company and its members, the individual liability of the members of the company could be limited in any way agreed on between the contracting parties."[27] Such contracts "were both common and efficacious."[28]

2. Commercial advantages of incorporated joint stock enterprise — such as perpetual succession, capacity to sue and be sued in corporate name and to act by common seal, the ability of the majority of members

to bind the whole body of shareholders, continuity of management, special powers and privileges such as self-government and monopoly rights, transferable shares, severance of corporate and individual liability, the possibility for limitation of individual liability — were fully understood and taken advantage of.[29] It is indeed the availability of this superior device that made unattractive to English entrepreneurs the continental kind of limited partnership. The joint stock enterprise gave the investor the best form of investment in business; the government a convenient way of raising a public debt.[30] It brought together the saving of the nonmercantile classes and the business acumen of the mercantile community. "[T]he combination of the specific and detailed knowledge of the traders, with the broad outlook of the man of affairs, tended towards greater efficiency."[31]

3. By the end of the seventeenth century dealing in shares had become numerous. And so did the abuses — frauds of promoters, market-rigging by dealers. In fact as the usefulness of joint stock enterprise was being increasingly recognized, so were its potential abuses "to perpetuate gross frauds upon the public, and to encourage wild speculation and gambling in stocks and shares."[32] These were condemned early by a report of the Commissioners of Trade published in 1696.[33] The legislature was confronted with the task of devising regulation in a field in which it had had no previous experience and it enacted a statute to regulate the brokers,[34] but did nothing to control fraudulent promoters. The law was in its infancy, new to the lawyers and novel to the legislature.

4. Nothing like a doctrine of ultra vires was known and once a charter was obtained, the incorporated body felt free to engage in any activity, however remote from the purposes for which it was incorporated.[35] This led to the trading of charters as it was far less expensive to buy one from a company ceasing business and to use it to carry on some other venture rather than to obtain a new charter.[36] That the powers of a chartered company were circumscribed by its charter and that a transgression of the limits would expose it to the risk of forfeiture of its charter became established only in 1720.[37]

5. The notion that capital should be preserved intact and its corollary that dividends could not be paid out of capital had not taken root.[38] The payment of dividends out of capital was common.[39] Accounts were kept in a very irregular manner.[40]

To put an end to the wild speculations and "the pernicious art of stock jobbing" which had become rampant, Parliament thought it wise to put an end to unincorporated joint stock enterprise. The prevailing ills were attributed to the "usurpation" of corporate form by unincorporated groups.[41] The result was the ill-conceived and ill-drafted Bubble Act of 1719-20[42] which arrested the free growth of joint stock enterprise in England for over a century. To get rid of the rat, Parliament decided to set the barn on fire. The Act was repealed only in 1825.[43]

2. THE AMERICAN SCENE UP TO 1775.

Like the history of British India, American history begins with the chartered English corporations.[44] "The colonization of America

and the appropriation of India were achieved primarily through the medium of such chartered companies."[45] In 1720 there was as yet no United States and there was none to be for another half a century and more.[46] The thirteen little Atlantic colonies owed allegiance to the British Crown, but each had its legislature and its own statutes. Till the middle of the eighteenth century the colonies had few men who could be called lawyers, there were no facilities for legal education, and the courts were presided over by civil servants little versed in the law.[47] Any great development of American corporation law at this period was obviously an impossibility.

It was assumed that the colonial governments had implied authority delegated to them by the Crown to create political agencies with legal personality for purposes of local government.[48] They extended the underlying rationale of this implied authority to the incorporation of religious societies for the support of churches.[49] But when Massachusetts[50] assumed to herself during the Cromwellian Commonwealth the authority to incorporate the Harvard College in 1650, while under English law a college could be created only by a royal charter, her colonial charter was forfeited for that reason in 1684 by a writ of scire facias before the Lord Chancellor during the reign of Charles II.[51] The British Parliament extended in 1741 to the colonies the Bubble Act of 1720 and "forbade for the future any American grants of corporate privileges"[52] as well as the formation of unincorporated joint stock companies with transferable shares and consisting of more than six persons.[53] In the result the development of corporate commercial

enterprise under an American charter had to await the Revolution.[54]

There were, however, in the colonial period a few unincorporated business companies engaged in active business.[55] The extension of the Bubble Act to the colonies inhibited the growth of such companies. Besides, the colonies were economically in their infancy, technologically undeveloped, and psychologically hostile to business corporations as they detested the only ones they knew, namely, the monopolistic and privileged English chartered companies for foreign trade.[56]

3. THE AMERICAN SCENE : 1775 - 1783.

The English Bubble Act of 1720, which was extended to the American colonies in 1741 lost its vitality in the colonies in 1775 with the Revolution, though in England its life-span continued for another half century. But the period from the Revolutionary War (1775) to the Treaty of Peace with England (1783) was a time of political uncertainty and economic turmoil unconducive to any growth of business activity.[57] But the War and the severance of foreign mercantile relationships produced the need for a bank and as a result the Bank of North America was established by a charter granted by the Congress of the Confederation in 1781. We are not here concerned with all the constitutional issues involved in its creation.[58] This was the only American corporation that was created during these turbulent years.

4. THE AMERICAN SCENE : 1783 TO THE END OF THE EIGHTEENTH CENTURY.

The conclusion of peace in 1783 marks the turning point in the history of American corporate enterprise as the task of nation building commenced in an independent United States. The development was particularly significant after the coming into effect of the federal constitution in 1789.[59] Of the three hundred and odd charters granted for business corporations between 1780 and 1800, ninety percent were granted only after 1789, that is, in the last decade of the eighteenth century.[60] We shall pause here and take stock of the ideas generated and achievements made in the United States by the end of the eighteenth century:

1. The granting of charters became a function of the legislatures of the states.[61]

2. "/T/he English tradition that corporate powers were to be granted only in rare instances . . . was opposed by a strong and growing prejudice in favor of equality."[62] The principle of freedom of incorporation soon manifested itself in general incorporation statutes for ecclesiastical, educational and literary purposes.[63] New York enacted the first general incorporation law for religious purposes in 1784, New Jersey in 1786, and Delaware in 1787. Pennsylvania enacted such a statute in 1791 "for any literary, charitable, or for any religious purpose."[64] The South Carolina Constitution of 1778 assured to Protestant Christian Churches freedom of incorporation.

3. There was, however, practically no instance of the extension of the principle of freedom of incorporation to joint stock business enter-

prises.[65] This had to await the second decade of the nineteenth century to make its first appearance.

4. There was considerable prejudice against trading corporations based upon the prejudice which existed against the monopolistic English chartered corporations[66] and as a result there were hardly any ordinary trading corporations.[67]

5. Despite the marked increase in the number of corporations during this period, corporate securities figured but slightly in the security markets.[68]

6. The paid up capital of the corporations which existed at this time was small — less than $50,000 in a majority of the cases; less than $10,000 in a good number.[69]

7. Of the charters granted prior to 1800, two-thirds were to companies formed for road and river transportation, that is, companies of a quasi-public character. Of the remaining one-third, a substantial majority were banking and insurance companies.[70] Banking and insurance corporations were mostly successful; manufacturing companies were mostly failures despite the assistance which they received from the states in one form or another such as tax-exemptions, protective tariffs, subscription to their capital, bounties, and lottery privileges.[71]

8. Though many of these companies did not prosper, Davis observes that there was "no instance prior to 1800 of losses to creditors of business corporations. The stockholders suffered, but the failure did not spell bankruptcy . . . . This freedom from losses by outside creditors certainly conduced to the wider use of the corporate form

with its limited liability, which might otherwise, as happened later, have come for this reason into bad odor."[72]

9. Limited liability "was recognized as an attribute of an incorporated company, almost invariably without specific mention". In fact it was the main object for seeking incorporation.[73]

10. Stockholders were then, as now, indifferent about attending general meetings or sending proxies.[74]

11. Most charters specified voting rights and restricted them in one way or another: e.g., by a ceiling on votes or a progressive reduction of votes as the shareholding increased.[75]

12. Little attention was paid to the preservation of the corporate estate and no system of reserves existed.[76]

B. THE ADVENT OF GENERAL INCORPORATION LAWS FOR BUSINESS PURPOSES : THE FREEDOM OF INCORPORATION OF THE NINETEENTH CENTURY AND THE DEVELOPMENTS OF THE TWENTIETH CENTURY.

The transition from the doctrine that incorporation was a special privilege granted to particular enterprises to that of freedom of incorporation available to all under a general statute could well be described as a revolution in corporate history. It was indeed slow to come in most parts of the world. In Germany it came about only in 1870. Though France "led the way in the liberalization of corporate law", it was only in 1867 that it became possible in that country to form a société anonyme without specific authorisation by the state.[77] Freedom

of incorporation came to England only in 1844; limited liability only after another eleven years. In the United States it was conceded in New York in 1811 and spread to the other states in the forties of that century. This corporate revolution was accelerated by the industrial revolution.

Ever since corporate law has been continually revised in these countries with a view to the prevention of possible abuses. The German law which was contained in the Commercial Code (HGB) of 1870 was revised in 1884 and 1897; in 1937 it was separately enacted as the Aktiengesetz and now we have the Aktiengesetz of 1965 which came into force on the 1st of January, 1966.[78]

It was the code de commerce of 1807 that laid the foundation of the modern French corporation. In 1867 the French corporation law was thoroughly revised and state authorization for their formation was eliminated. The law was revised in 1893, 1903, 1907 and 1917, besides many minor amendments.[79] On July 24, 1966 — the ninety ninth anniversary of the law of 1867 — the new French law on commercial companies was promulgated. The new law is a thorough-going revision "of long preparation and wide discussion" and by it, it is claimed, "many irritating controversies in legal theories or court practice are now solved, onerous and inoperative formalities are now abolished and new safeguards are now introduced."[80]

In England after the Act of 1844, the statutory reforms which culminated in the consolidations of 1862, 1908, 1929 and 1948 are important. We shall deal with the English statutory developments in

some detail as they generally set the pattern of development in the British Commonwealth.

1. ENGLISH DEVELOPMENTS IN THE NINETEENTH CENTURY : THE FORMATIVE PERIOD OF MODERN COMPANY LAW IN BRITAIN.

Incorporation remained particular, and not general, and a royal charter or a special statute remained the mode of incorporation till about the middle of the nineteenth century in England. The nineteenth century brought with it great economic upsurge and the unincorporated joint stock enterprise which remained inhibited till then as a result of the Bubble Act now came to the surface once again in defiance of that statute to meet the growing needs of the new industries which required large amounts of capital.[81] The years 1807 and 1808 were years of boom, adventure and enterprise just like those immediately preceding the Bubble Act. We find at this period a battle between the philosophy of the Bubble Act and the demands of commercial enterprise in which, as could be expected, the obsolescent statute became the casualty,[82] though only after a great deal of struggle, litigation and much uncertainty.[83] Unincorporated joint stock enterprises grew feverishly apace under the compelling force of economic opportunity and necessity and "a veritable avalanche of extravagant promotions and general speculation"[84] erupted in the boom of 1824-25 when money was abundantly available and seeking avenues for investment.[85] "Individuals of every description . . . princes, nobles, politicians, placemen , patriots, lawyers, physicians, divines, philosophers, poets . . . hastened to venture in schemes of which scarcely

anything was known except the name."[86] Simultaneously with it grew opposition and hostility to joint stock companies and limited liability in the minds of the public,[87] but it could do little to halt the trend of events. The Bubble Act was repealed and the repeal was justified on the ground that it was "unintelligible and impossibly severe" and that it had stood in the way of formation of companies for worthwhile purposes.[88] Fraudulent promotions were left to be dealt with by the common law.[89]

With the Bubble Act gone, the nuisance that existed for joint stock unincorporated enterprise was no doubt removed, but it soon became obvious that this was not the end of all problems, but only the beginning of many. First of all, incorporation and limited liability could still be obtained only by incorporation under a royal charter or a statute which were luxuries beyond the reach of most except the privileged few. Indeed charters of incorporation were often refused and corporate privileges were "kept under lock and key and doled out sparingly, if at all."[90] As the decision to grant charters in fact had to be made by the Board of Trade, it became a privilege dependent upon the discretion of a government department which was resented by many. Even when charters were granted, limited liability was often denied and charters usually provided for double liability which continued for six years after the transfer of his shares by a member.[91] Moreover, the limited partnership which had for long been known on the continent and advantageously employed in them for centuries and which had spread to America, did not find entry into Britain.[92]

The inevitable result was the resort to the joint stock unincorporated enterprise with all its imperfections and disadvantages. In 1824-25 an enormous amount of speculation took place and 160 schemes were started at this time proposing to raise a capital of £160,000,000. A crisis soon followed. The amount actually raised by these enterprises was £27,417,900 almost the whole of which was lost.[93] For several years thereafter there was a lull in joint stock activity. Moreover, the repeal of the Bubble Act left the legality of unincorporated joint stock enterprise to be determined according to common law and it was only after considerable litigation extending over two decades that its lawfulness was unequivocally recognised.[94]

In 1834 Parliament by a statute empowered the Crown to confer by Letters Patent on unincorporated trading associations certain corporate privileges such as that of suing and being sued in the name of a principal officer.[95] The Act was unfortunately not liberally applied and corporate privileges were more often denied than granted.

The general philosophy that prevailed at this time was that joint stock enterprise was not to be supported for purposes for which individual industry was competent.[96] Adam Smith's view expressed in his WEALTH OF NATIONS, published in 1776, that only such trades and businesses all operations of which could be reduced to a routine or uniformity, such as banking and insurance, could be successfully carried on by a joint stock company not having a monopoly, was still considered an infallible axiom.

The unincorporated joint enterprise, organised on the model of the incorporated company with transferable shares and with severance of ownership and management, was indeed a de facto corporation, but was treated in law as an ordinary partnership. The application of partnership rules to an organisation which had grown to be very different from ordinary partnerships had very disastrous consequences. First they had to sue and be sued just like ordinary partnerships which meant that every shareholder had to be impleaded as one of the plaintiffs or defendants, and whenever any one of them died, his representatives had to be brought on record before the action could continue. This made it extremely difficult, if not impossible, for third parties to enforce their claims against the enterprise. It made it equally hard for enforcing the claims of shareholders among themselves. Second, the liability of every shareholder was unlimited and he had to answer with everything he had for the debts of the business. However much this may make sense in the case of ordinary partnerships, it was most inappropriate to a shareholder owning a transferable share without actual control over the activities of the concern. Thirdly, there was the peculiarly English rule affirmed without a shadow of doubt in Waugh v. Carver[97] which rendered anyone who received a share in the profits of a business liable as a partner for all the partnership debts, even if it were a widow of a deceased partner receiving a gratuitous pension magnanimously given her by the remaining partners out of deference to the memory of her deceased husband! This made it impossible for an enterprise of this kind to borrow on the basis that the creditor should receive a rate of

interest which fluctuated with the profits of the business. It made it impossible for small investors making an investment in these enterprises without exposing themselves to the risk of losing all their hard-earned savings. It made it impossible for a person with capital to assist another with skill but no capital without exposing himself to the total risk of the joint venture.

The Bellenden Ker Report of 1937 on the Law of Partnership brought out at the instance of the Board of Trade spotlighted the difficulties in suing and obtaining a remedy against a large unincorporated partnership, but did not recommend the introduction of a system of limited liability partnership. Parliament passed an Act in 1837[98] authorising the Crown to grant corporate privileges to unincorporated enterprises and providing for the termination of the liability of a member upon the transfer by him of his shares.

In 1844 there were almost a thousand companies (corporate, quasi-corporate, or unincorporated), apart from banks, engaging in various fields of economic activity.[99] The time had come for Parliament to act for the protection of the public and the outcome was the Joint Stock Companies Registration and Regulation Act of 1844.[100] The Act sought to protect the public by ensuring publicity throughout the course of promotion of a company and hoped thereby to minimize speculation.

The Act of 1844 provided that all partnerships with transferable shares, partnerships with more than 25 partners, and all assurance companies[101] were compulsorily registrable as joint-stock companies

under the Act. Registration was to be done twice: a provisional one before the public was approached for subscriptions and a final registration after subscriptions for shares had been received. A "deed of settlement" containing the information now required to be stated in the memorandum and articles of association — other than limited liability which did not come about for another decade — had to be filed for registration. Provisional registration enabled the promoters to do all acts necessary to constitute the company, but nothing beyond.[102] Final registration conferred corporate personality "for the Purpose of carrying on the Trade or Business for which the Company was formed, but only according to the Provisions of this Act, and of /the Deed of Settlement/, and for the purpose of suing and being sued, and of taking and enjoying the Property and Effects of the . . . Company."[103] No minimum capital or minimum par value for shares was prescribed. But before final registration at least a quarter of the nominal capital of the company had to be actually subscribed and the deed of settlement had to be signed by at least a quarter of these subscribers. The Act was the first general statute in England recognizing freedom of incorporation.[104] But limited liability was not granted and the members were liable exactly as those of unincorporated joint stock companies.[105] However, a creditor of the incorporated unlimited company had to seek recourse first against the assets of the company and only if he was unable to obtain satisfaction from the company could he proceed against an individual member.[106]

The battle for freedom of incorporation having been won, the pressures for limited liability as a matter of right revived and gained momentum.[107] The depression that had followed the collapses of 1837 was giving place to the railway boom.[108] There was a rapid rise of stock exchanges in various provincial centres.[109] Almost a thousand companies were registered under the Act of 1844 — apart from banking companies — in a dozen years.[110] Limitation of liability became the subject of exhaustive study by parliamentary committees.[111]

The Report of 1850 of the Select Committee on Investments for Savings of the Middle and Working Classes partially investigated the question of the expediency of facilitating the limitation of liability, but gave no opinion upon it and recommended that the Crown should grant charters to useful undertakings at a reasonable cost, though with due caution.[112] The Report of 1851 of the Select Committee on the Law of Partnership[113] found that the unlimited liability imposed by the law of partnership deterred the middle and working classes from investing in profitable enterprises and recommended that "under the supervision of a competent authority, rules should be laid down and published for the guidance of persons applying for . . . charters, with requisite precaution to prevent fraud; and on compliance with such rules, that charters should be granted." But on the question of limitation of liability of partners the Committee recommended that a commission of "adequate legal and commercial knowledge" should be appointed to examine "the important and much controverted question of limited and unlimited liability of partners."

In 1852 yet another investigation was launched, this time by a Royal Commission.[114] Opinions of witnesses and the Commissioners sharply varied: some believed that unlimited liability was some safeguard against speculation whereas limited liability would promote wild speculation; the protagonists refuted these arguments. Opposition to limited partnerships was also based on the fear that it would be detrimental to the interests of and facilitate fraud upon creditors and that it would make it easy for partners by collusion to commence business "without the stipulated capital being bona fide paid in" and to withdraw the paid in capital "in the name of profits and other disguises." The antagonists of limited liability argued that "where unlimited power of borrowing exists, unlimited liability should attach"; the protagonists asserted that limited liability would substitute a "responsible capital" in the place of an illusory credit because "the credit of a partnership of limited liability will be limited also, and will be governed by the security afforded by the known capital, and not by a vague estimate of property supposed to exist independently of the business, which in nine cases out of ten has no existence at all, or only a delusive existence."[115] Persons dealing with a limited partnership will, without relying on an illusory credit of the partners, make sure by vigilant investigation whether the partnership was credit-worthy, they argued.[116] But the opposition prevailed and the Commission in its Report of 1854[117] thought it inexpedient that limited liability should be made freely available to partnership enterprises.

Despite the adverse report of the Royal Commission of 1854 the House of Commons passed a unanimous resolution the same year to the effect that the law of partnership needed to be reformed so as to permit persons to contribute to the capital of partnership firms on terms of sharing their profits without incurring unlimited liability as partners.[118] The Board of Trade thereupon stopped granting charters pending legislation and the government introduced into and rushed through Parliament as a temporary measure the Limited Liability Bill to meet the situation.

The Limited Liability Bill of 1855 sought to amend the Joint Stock Companies Act of 1844 to enable the companies registered under the latter Act to limit the liability of all their members upon satisfying certain conditions intended to prevent "mere gambling bubbles." The conditions were (1) that the companies should have a minimum capital of £20,000 and each share a minimum par value of £25 and (2) that at least three-fourths of the nominal capital must be subscribed and at least one-fifth of the par value of each share paid up before final registration was granted. The debates on the Bill encompassed all the usual prejudices and arguments — unsuitability or corporate organization for ordinary trading purposes, the danger to creditors, etc.[119] The minimum capital and the minimum par value for shares were opposed by the protagonists of limited liability and the government, yielding to the pressure of criticism, abandoned the requirement of minimum capital[120] and also reduced the par value requirement to £10.[121] But the provision that three-fourths of the nominal capital

had to be subscribed[122] and one-fifth of the subscribed capital had to be paid up[123] were retained.[124]

The House of Lords added some further conditions which were accepted by the House of Commons, though reluctantly.[125] (1) The deed of settlement had to be executed by at least 25 subscribers which meant that the company had to have a subscribed capital of at least £250 and a paid up capital of £50. (2) Following the law of Massachusetts,[126] the directors were made jointly and severally liable for all the debts of the company, if they declared and paid dividend knowing that the company was insolvent or would thereby be rendered insolvent. (3) At least one of the auditors of the company must have been approved by the Board of Trade. (4) Again following Massachusetts law, loans to shareholders were forbidden and any officer responsible for, or acquiescing in, a contravention of this prohibition became personally liable for its repayment to the company. (5) A limited liability company should cease business forthwith as soon as it appeared from the yearly accounts or auditor's report that three-fourths of the subscribed capital had been lost or become unavailable in the course of trade. In such a case the directors had immediately to take steps to wind up the company.[127]

These safeguards of the Limited Liability Act of 1855,[128] some of which resemble the continental company laws of even today, were only retained till February of the very next year[129] when the Joint Stock Companies Act of 1856[130] was enacted. This gave expression in full measure to the philosophy of laissez-faire, namely, "the right

of individuals to use their own property, and make such contracts as they please, to associate in whatever form they think best, and to deal with their neighbours upon such terms as may be satisfactory to both parties."[131]

The Act of 1856 was the first English statute to adopt the policy of full freedom of incorporation with limited liability without the slightest obstruction in the way of their formation — a policy of "comprehensive liberality".[132] The Act contained no restrictions to check wild speculations or to preserve the capital from dissipation in the form of dividends or interest, or provisions to create reserves for a rainy day. All protests on this score were brushed aside. The Act of 1856 abrogated the restrictions which were contained in the Act of 1855 such as minimum par value for shares, minimum subscription for shares, minimum payment for subscribed shares, Board of Trade approved auditor, etc. The prohibition of loans to shareholders was abrogated. The minimum number of subscribers was reduced from 25 to 7. The provision which required compulsory winding up when three-fourths of the subscribed capital was lost was changed into a voluntary decision. Dual registration was substituted by a single registration. Model articles for the internal management of companies were suggested by the Act, and these became the famous Table A in the consolidating Act of 1862. The change of policy from the Act of 1855 to that of 1856 was indeed radical.[133]

The Act of 1856, at the same time as it liberalized incorporation, amplified some provisions for disclosure of information to the public and restricted some others which were required till then. It embraced the

philosophy of publicity as the way to help the public to protect itself. The suffix "limited" had henceforth to be appended to the name of a limited company. Every company had to have a registered office and the name of the company had to appear outside the office, on the letter-heads, etc. Following New York corporation law provision was made to enable the shareholders to apply to the Board of Trade to have the affairs of the company inspected.[134] Publicity was mainly intended as a safeguard to creditors. The register of members was made accessible to the public upon payment of a fee. The annual return was required to give information about the company's capital and shareholders. Yet no provision was made for the filing of balance sheets and for their inspection by the public or the creditors. Even the safeguard of the appointment of auditors and the registration of prospectuses with the auditor's report which existed under the Act of 1844 was discarded in the Act of 1856. Shareholders were denied access to the account books of the company, — (a right which they had hitherto enjoyed) — unless the articles so provided. But the growth of the profession of auditing and accounting in the second half of the century made good where the law lagged to protect the shareholders.[135]

The Act of 1856 for the first time denied the creditors of the company a right of action against the shareholders. It may be recalled that they could do so under the Act of 1844 if they had exhausted their remedies against the company without obtaining satisfaction of their claims. The Act of 1855 continued this rule with the qualification that in such a case the shareholder could not be made to pay beyond the

amount remaining unpaid on his shares. The Act of 1856 made it clear that the shareholder's liability was to the company only.[136] Thus "the corporate character of a limited liability company won the upper hand over the partnership element in it."[137] The joint stock enterprise was finally emancipated from, and emerged victorious in the battle against, the prejudices and suspicions that had for long bedevilled its growth. As observed by Hunt, "/O/ut of the long controversy there had emerged an instrument for the attraction, organization and utilization of capital resources; there had been forged one of the tools without which subsequent economic expansion would certainly have been seriously handicapped, if not impossible."[138]

2. ADVENT OF FREEDOM OF INCORPORATION IN THE UNITED STATES : DEVELOPMENTS OF THE NINETEENTH AND TWENTIETH CENTURIES.

We have seen that by the end of the eighteenth century the granting of corporate charters in independent America became a function of the legislatures of the States and that general incorporation statutes were enacted for the incorporation of religious, educational and literary associations. But business corporations were incorporated by individual charters granted under special Acts. The trend soon developed to adopt standard forms of incorporation statutes for the principal types of business corporations. But still business corporations were created under special Acts which incorporated by reference the standard form general statutes. These early general Acts did not, therefore, enable the incorporation of companies without specific legislative authorisation.

Statutes on the modern lines for incorporation of business companies without specific legislative authorisation made their first appearance only in the second decade of the nineteenth century. In 1811 New York enacted a general corporation statute which enabled any five or more persons to form a corporation "to engage in definitely specified types of manufacturing, by signing, acknowledging and filing with the secretary of state a certificate of incorporation setting forth the corporate name, its location, objects, capitalization and number of shares, and the names and addresses of its first board of directors." This Act limited the capital to $100,000 and the life of the corporation to twenty years. It also imposed additional liabilities upon the shareholders for the benefit of the creditors if, in the event of the dissolution of the corporation, its assets were insufficient to pay the creditors.[138a]

Nor were the legislatures too ready to extend the privilege of limited liability to manufacturing enterprises even when they were willing to grant them corporate charters. They were more ready to grant limited liability to such enterprises as canals, toll bridges, turnpikes and banks, but in the case of manufacturing concerns the corporate charters expressly preserved unlimited shareholder liability. Besides the legal requirements were stringent and were essentially designed to protect creditors: e.g., minimum paid up capital before business could be commenced; shares were to have a par value; no dividends were to be paid out of capital, or the capital reduced otherwise, to the prejudice of creditors; the kinds of securities that could be issued were strictly delimited. We have seen that the English Acts of 1855 and 1856

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borrowed some of these safeguards from the American statutes.[139] By 1850 general incorporation statutes were common in the United States and they provided the usual mode of incorporation, but these statutes did not authorise incorporation for any lawful purpose, but restricted the purposes and powers, limited corporate life to a definite term, restricted the amount of authorised capital, gave no powers to a company to hold the shares of other companies — all indicative of a certain reservation towards these companies and a preference for individual enterprise.[140]

Thus as late as 1882, the Massachusetts corporation law still prescribed a maximum ($1,000,000) and a minimum ($5,000) limit for the capital of mechanical, mining and manufacturing companies.[141] Before a company could commence business the whole capital had to be paid in and a sworn statement to that effect had to be filed with the Secretary of the Commonwealth.[142] Shares could be allotted in exchange for property only if its valuation was approved by the Commissioner of Corporations.[143] Directors and officers were made liable to corporate creditors if they paid a dividend when the corporation was, or was thereby rendered, insolvent, or if they permitted the debts of the corporation to exceed its share capital,[144] or if they borrowed money for the corporation when the corporation had "loaned money to a stockholder", or if they allotted the corporation's shares for over-valued consideration.[145] Shareholders were made liable to creditors where capital was reduced and repaid to them by the corporation, or where special stock had been created and not redeemed, or where wages remained unpaid

to employees, or where debts were contracted before the stockholders had fully paid for their shares.[146] An annual statement of assets and liabilities had to be filed with the Commissioner of Corporations in such detail as was required by him. The Act contemplated only one kind of shares — apart from a "special" kind with "guaranteed dividend" which might be created by a three-fourths vote of the ordinary shareholders.[147] The powers of the management were made in a number of cases subject to the control of the shareholders.[148] Shareholder approval was necessary in all cases of conveyances, mortgages and long term leases of real estate,[149] or for increasing the capital (in which case the existing shareholders were given a right of pre-emption at the par value).[150] Directors had no power to alter the rights of shareholders through the creation of additional shares or to expand the enterprise. Lest management should get control through proxies, it was provided that no proxy could cast more than fifty votes unless all the shares he represented were owned by the same person. In sum, we find that the law was restrictive in nature and guided by a somewhat paternalistic philosophy of protecting the creditors in particular, and the shareholders and the enterprise in general. And all this is in marked contrast with the laissez-faire philosophy and the comprehensive liberality of the English Act of 1856. But yet "concern for the welfare of investors did not bulk large in the legislative consciousness,"[151] probably because the nineteenth century American corporations were of small size, compared with the giant corporations of today in that country, and were "financed for the most part through local subscriptions

rather than by resort, as so often at present, to nationwide systems of security distributions or to stock exchanges with a national or international clientele."[152] Moreover, "the combination of corporations through the medium of holding companies was practically unknown" at this time.

But the advent of the era of the huge railway companies by the middle of the nineteenth century marked the beginnings of the growth of the powers of the management and a gradual abdication by the state of control over corporations.[153] These companies were constantly in need of more and more capital and they therefore sought and obtained powers to raise huge additional capital. These included the power to issue new securities carrying preferential rights even over existing shares and to alter and even take away the pre-existing rights of shareholders.[154] The states began competing with each other to make their corporation laws more attractive to corporate promoters by conferring wide powers on managements.[155] This charter-mongering competition, which is peculiar in its intensity to the American states, has given a distinct character to American corporation laws of the twentieth century. With the growing size of the corporations, the growing power of their managements, and the wide diffusion of their shares, the divorce between ownership and control has proceeded apace to such lengths that the modern American shareholder has been "reduced . . . to a point where he becomes a petitioner for wages of capital."[156]

New Jersey was the pioneer in this movement in America of what is now described as "enablingism" with its corporation law of 1896.[157]

In 1898 the New Jersey Law of 1896 was amended "somewhat along the line of the English 'Companies Act, 1862'."[158] The old philosophy of paternalism was now giving place to the new theory that the state owed no duty to creditors or stockholders to ensure corporate solvency, that a corporation formed and functioning free from fraud should be allowed to do anything that an individual may do, and that the state should only ensure that the corporation makes a full disclosure of its affairs.[159] Massachusetts embraced this theory by replacing its restrictive law of 1882 and in its place enacting a new Act in 1903.[160] The new Act dispensed with the need for the approval of the Commissioner of Corporations of the company's valuation of non-monetary consideration for allotment of its shares; now all that was necessary was to give him such details of the consideration as he required. It abolished the maximum limit on capital and reduced the minimum to $1,000; it was no longer necessary to issue the whole authorised capital all at once; directors were no longer liable for borrowing in excess of capital; directors' powers were enlarged and, for example, shareholder approval was no longer needed for mortgaging the corporation's assets.[161] Different kinds of shares with varying rights could be created by a company as provided for in its charter of incorporation. The directors' liability was, however, preserved, if dividends were paid when the corporation was, or was thereby rendered, insolvent or if shares were illegally issued.

In sum, the philosophy of laissez-faire combined with managerial authority is the dominant characteristic of modern American corporation

laws.

An important development which occurred early in this century in America is the no-par shares or shares without a nominal or par value. These were first allowed in New York in 1912.[162] Delaware followed the example in 1917,[163] Illinois in 1919,[164] and Massachusetts in 1920.[165] Now they are allowed in almost every state[166].

By about the 1930's Ohio[167], Indiana,[168] California,[169] Louisiana,[170] Michigan,[171] Minnesota,[172] Washington,[173] Pennsylvania,[174] and Illinois[175] had all enacted new corporation statutes "modernizing" their corporation laws in the spirit of the New Jersey law of 1896 and in the spirit of the more recent example of Delaware.[176] The Illinois Act,[177] while it follows the general trend in the other American states, has devised new safeguards for the protection of investors and creditors. It was adopted as the basis of the Uniform Act of 1928.

Securities regulation also began appearing from the second decade of the twentieth century. Kansas was the first in this field.[178] Now almost all states have blue-sky laws to control the issue and sale of securities. The federal government also entered this field in the 1930's to regulate inter-state issues and the federal statutes have grown to be the most important and efficacious in protecting corporate investors.[179] Indeed federal regulation of corporate activity is considerable in the United States.[180]

3. ENGLISH DEVELOPMENTS AFTER THE ADVENT OF FREEDOM OF INCORPORATION

As we have seen[181] the Act of 1856 marks the victory of laissez-faire in the field of corporate commercial organization in England. Then followed the consolidation by the Companies Act, 1862,[182] which could aptly be described as the foundation of modern company law in England and the Commonwealth.

The Act of 1862 gave birth to the doctrine in Ashbury Ry. Co. v. Riche by its absolute prohibition of any alteration of the objects for which a company was incorporated. We shall deal with that doctrine in so far as it is relevant to us in a later chapter. The Act introduced the concept of company limited by guarantee. It also brought within its scope banking and insurance companies. It was an elaborate Act with 212 sections and three schedules. It was amended in 1867 to permit with safeguards reduction of capital and subdivision of shares,[183] to enable companies to have directors with unlimited liability,[184] to empower the Board of Trade to exempt a charitable company from having to use the suffix "limited" at the end of its name,[185] etc. This amending Act itself was quite extensive with almost 50 sections. An amending Act of 1877[186] clarified the fact that even paid up capital could be reduced under the provisions of the Act of 1867. An Act of 1879[187] enabled the conversion of an unlimited company into one with limited liability and made certain special provisions for banking companies. In the following year (1880) another amending Act[188] was passed which

enabled a company to return by a special resolution accumulated and undivided profits to its shareholders "in reduction of the paid up capital of the Company . . . the unpaid capital being thereby increased by a similar amount."[189] It also empowered the registrar to strike out the names of defunct companies.[190] In 1890 three important statutes were enacted at the same time. One of them enabled companies for the first time to alter their objects within prescribed limits and subject to safeguards for the benefit of creditors.[191] Another laid down detailed provisions concerning the winding up of companies.[192] The third — the Directors' Liability Act[193] — imposed civil liability on directors and others authorising the issue of prospectuses containing untrue statements. Finally the amending Act of 1900[194] made the certificate of incorporation of the registrar conclusive,[195] imposed restrictions as to commencement of business and allotment of shares,[196] prescribed the contents of prospectuses[197], required the holding of the "statutory meeting"[198], provided for the registration of mortgages and charges[199], reintroduced compulsory audit[200], etc. Thus we find the gradual growth of the English company law and the establishment of its basic tenets before the beginning of the twentieth century. We also find laissez-faire ideas yielding place to some extent to rules designed to protect the creditors and the public.

THE TWENTIETH CENTURY : The law for the first time gave specific recognition to the private limited companies by the Companies Act of 1907.[201] They could now be formed with only two members.[202] The Act also permitted the payment of interest to shareholders in an

exceptional case[203], required a statement in lieu of prospectus in the case of public companies which did not invite the public to subscribe for their shares[204], enlarged the contents of prospectuses[205], enlarged the provisions concerning the registration of mortgages and charges[206] and audit and auditor's reports[207], provided for the holding of annual general meetings[208], and made certain provisions relating to winding up. It also provided for reorganization of capital, safeguarding at the same time the preferential or special rights attached to any existing class of shareholders.[209]

In 1908 an uptodate consolidation of the statutory law enacted since 1862 was made by the Companies (Consolidation) Act, 1908[210], consisting of nearly 300 sections and half a dozen schedules.

Two decades later the statutory law with intervening amendments[211] was consolidated in the Companies Act, 1929.[212] In 1939 the Prevention of Fraud (Investments) Act[213] was passed. Capital issue control was introduced during the second World War and has outlived the War.[214]

After the War the statutory law was consolidated in the Companies Act, 1948[215], which is the current English company statute.

By the end of 1959 the Jenkins Committee on Company Law Reform was appointed and its report was published in 1962[216]. After the lapse of four years the Companies Bill, 1966, was to be introduced to implement the recommendations of the Committee partially,[217] in particular to abolish the "exempt private company" created by the Companies Act of 1948 and to enlarge the disclosure requirement relating

to company accounts. After a "long and stormy" passage through Parliament, it has been enacted as the Companies Act, 1967.[218] Besides abolishing the exempt private company and widening the requirement of corporate financial disclosure , the Act greatly enlarges the powers of the Board of Trade with regard to inspections.

4. CANADA : FORMATIVE PERIOD IN CANADIAN STATUTORY DEVELOPMENTS.

Anglo-American impact on Canadian company law can be seen from the very beginning of company legislation in this country. The first general incorporation statutes[219] of Canada were enacted in 1849, one for Upper Canada and the other for Lower Canada, for the formation of joint-stock enterprises for the construction of roads and bridges. Wegenast has observed that these were modelled upon a New York statute of 1848.[220] In 1850 the Parliament of the United Provinces enacted a general incorporation statute, closely following a New York precedent, for the incorporation by registration of joint-stock companies "for Manufacturing, Mining, Mechanical or Chemical Purposes."[221] A general Act of 1860 provided for the incorporation of companies for "manufacturing, ship building, mining, mechanical or chemical business" by the process of petitioning the court and obtaining a judicial decree.[222] An Act of 1864 provided for incorporation by the method of letters patent issued under the seal of the Governor in Council.[223]

The method of incorporation by letters patent issued under a general Act is a distinctly Canadian feature which is traceable to the

Act of 1864. Wegenast observes that "The form of the Act of 1864 and the mode of incorporation laid down in it, as well as many of its general provisions . . . have been perpetuated in the Companies Acts of the Dominion and of the provinces of Ontario, Quebec, New Brunswick and Manitoba and until recently in Nova Scotia and Prince Edward Island."[224] It was re-enacted as the Dominion Act of 1869 after the British North America Act was passed in 1867 and made applicable with some exceptions for the incorporation of companies "for any of the purposes or objects to which the legislative authority of the Parliament of Canada extends."[225] In 1861 the Joint Stock Companies General Clauses Consolidation Act had been passed to govern companies incorporated by special Acts and this was also re-enacted in 1869 as a Dominion statute of the Parliament of Canada.[226] What is noteworthy is that at this stage the English Acts of 1856 and 1862 had fully recognized incorporation as a matter of right and not a royal favour, but this precedent was not followed in Canada. The result of this can be seen even today in the Canadian statutes which confer on the Provincial Secretaries or the Secretary of State far more discretionary powers than what the Registrar possesses in Britain and other countries such as India where the British example was faithfully followed.

The Joint Stock Companies Letters Patent Act of 1869 was repealed in 1877 by the Canada Joint Stock Companies Act of that year.[227] The Act of 1877 abandoned the requirement found in its predecessor with regard to subscribed and paid-up capital.[228] In the revision of 1886 the Act was re-named the Companies Act.[229] It was replaced in 1902

by the Companies Act of that year.[230] In the revision of 1906 the Companies Act of 1902 and the Companies Clauses Act were combined into parts of the same statute along with provisions relating to loan companies, etc.[231] The requirement of disclosure of material contracts in prospectuses and provision for inspection were introduced in the Acts of 1877 and 1902 respectively following the English precedents.

The British North America Act conferred authority on the Provincial legislatures to incorporate companies with Provincial objects. After Confederation Quebec passed an Act, closely based upon the Act of 1864, for the incorporation of companies in that province. Ontario did exactly the same but only after a delay of a decade.[232] In the meantime it purported to incorporate companies under the Act of 1864 under the erroneous impression that the powers under that Act had devolved upon the Province after the passing of the British North America Act.

We witness in Canada two processes of incorporation of business enterprises, viz. (i) by letters-patent granted under a general incorporation statute the model for which was originally provided by the Dominion Acts and (ii) by registration of memorandum and articles of association under Companies Acts fashioned directly on the English model. Even in the first case the English legislation with regard to prospectuses, inspection and others have been assimilated and fitted into the statutory framework for incorporation by letters-patent.

The American influence on Canadian statutes is similarly substantial. For example, all Canadian jurisdictions authorise no-par shares to a greater or lesser extent and all of them have Blue Sky laws which were originally inspired by the Kansas Act of 1911. Manitoba was quick to follow the American example with its Sale of Shares Act of 1912; Saskatchewan followed in 1914, Alberta in 1916 and New Brunswick in 1923.[233] The paternalistic licensing method of securities regulation found in Canadian provinces is unmistakably of American parentage.

The cross currents of American and British influence give the Canadian statutes distinctive characteristics not found in other Commonwealth jurisdictions. They have, moreover, produced marked distinctions between the Canadian jurisdictions themselves both of style and substance. We shall explore the modern statutory developments in Canada in future chapters, but it may be mentioned that the proposed new Ontario Business Corporations Act which borrows heavily from the New York Business Corporation Law bears witness to the continuation of a trend which began over a hundred years ago in this country.

CHAPTER 2

GENERAL INTRODUCTION

The main purpose of this chapter is to attempt to adopt a common vocabulary and terms of reference for use in the rest of this thesis. Terminological variations among the statutes are as varied as substantive differences. It is therefore believed that a common terminology will be a useful tool in the comparative study. For instance, the English "certificate of incorporation" is very different from the Delaware "certificate of incorporation". In the Commonwealth countries we speak of shares and debentures of companies; in America they are referred to as stocks and bonds of corporations. The expression "stated capital" is peculiar to America and Canada. For these reasons it is believed that a general introduction will be helpful, even though it has necessarily to deal with elementary matters.

A. PROCESS OF INCORPORATION

We may categorize the process of incorporation prevailing in the common law countries into three broad prototypes:

1. THE ENGLISH PROTOTYPE: Under this type two constating documents, viz. the memorandum of association setting out the name, objects and authorised capital of the company to be formed, and the more elaborate articles of association containing the internal regulations for the company, signed by the requisite number of subscribers, are

ordinarily required to be filed with the registrar for registration[1] whereupon, if the documents are in order and the legal requirements have been complied with, the registrar is bound to issue a certificate of incorporation. From the date mentioned in the certificate the company comes into existence as a legal person with perpetual succession.[2] This process obtains in the United Kingdom, India and most of the Commonwealth countries, and in the Canadian Provinces of Alberta, British Columbia, Newfoundland, Nova Scotia and Saskatchewan, and in the Yukon and the Northwest Territories of Canada.

It must be mentioned that there are differences between the company statutes of the various jurisdictions falling within this group. For instance, the English and Indian statutes require seven or more subscribers to form a public company and two or more for a private company, while those of the Canadian provinces, like the American jurisdictions, require three or more in all cases.[3] In England and India, the registrar is bound to register a company, if the requirements of the statute have been complied with by the subscribers. In the Canadian provinces of Saskatchewan and Nova Scotia such registration is not mandatory, but discretionary. Under the Saskatchewan company statute, for example, the registrar may, instead of registering the memorandum and articles, refer the matter to the Lieutenant-Governor in Council "who may refuse registration at his discretion."[4]

Again all the Canadian statutes, like the American, authorise no-par shares, whereas most of the Commonwealth countries including Britain do not. Thus the memorandum of association of an English or

Indian company has to state the amount of authorised capital and its division into shares of a fixed nominal amount. But the memorandum of a Canadian provincial company may authorise a specified number of no-par shares.

2. THE AMERICAN PROTOTYPE: Under this type which obtains in the American states those who want to form a company[5] prepare a "certificate of incorporation," or, as it is also called, the "charter," "articles of incorporation," "articles of association," "certificate of organization," "charter of incorporation," "articles of agreement," "agreement of incorporation," etc., setting forth the particulars required by the statute, and file it with the secretary of state or other public official as prescribed. Upon the recording of the document by the office of the secretary of state, the corporate existence of the company begins. In a few American states the existence is for a limited period (25 years in Arizona, 100 years in Utah), but in most it is perpetual (Delaware, Illinois, New York, California). Though only one document has to be registered, its contents are more extensive than that of the English memorandum. In this prototype, the by-laws are not required to be filed for registration.

3. THE LETTERS PATENT PROTOTYPE: This type obtains under the Canadian federal corporation statute, and in the Canadian provinces of Ontario, Quebec, Manitoba, New Brunswick and Prince Edward Island. Under this type those who want to form a company — being not less than three in number — must apply to the Secretary of State or the Provincial Secretary for letters-patent setting out the pre-

scribed particulars in the application. The letters patent granted by the Secretary will embody such of the averments in the application as to him "seems expedient."[6] From the date of the letters patent the company comes into existence.

When the proposed new Ontario Business Corporation Act is enacted, the Ontario law will cease to belong to the "letters patent" prototype and move closer to the American pattern. The new Act authorises that "One or more persons, being a body corporate or a natural person who is of the age of twenty-one years or more, may incorporate a corporation by signing and delivering to the Minister in duplicate articles of incorporation."[7] The Act enjoins that "If the articles conform to law and the approval of any person or body required by Statute to approve the incorporation has been given, the Minister shall, when all the prescribed fees have been paid ... issue... a certificate of incorporation ...."[8] When the proposed new Act becomes law, Ontario will be the first letters patent jurisdiction to abandon incorporation by the exercise of ministerial or executive discretion and to adopt a policy of incorporation as a matter of right. The Lawrence Committee on whose report the proposed new Act is based observed candidly that "the Ontario system of incorporation by ministerial act is an historical anachronism which ought not to be preserved," that it serves no useful purpose, is needlessly cumbersome and involves unwanted administrative interference.[9] The Ontario reform may indeed become the beginning of the end of the century old Canadian system of incorporation by letters patent.

Thus there are basic terminological and substantial differences between these prototypes. Variations also abound between the statutes within each prototype. This three-fold categorization is merely intended to facilitate ease of reference.[10] We shall use the term "charter" to denote the memorandum of association of the English type, the "certificate of incorporation" and its numerous variations in the American type, and the "letters patent" of the Canadian type.

B. BY-LAWS

In England the articles of association have to be filed by every company except by companies limited by shares which choose to adopt Table A of the First Schedule in entirety. That Table applies to all companies limited by shares insofar as it is not excluded by, or inconsistent with, the articles filed by the company. It should be noted that the articles of association are, like the memorandum of association, therefore public documents and any person may inspect these and other documents kept by the registrar of companies upon payment of the prescribed fees.[11]

In contrast the by-laws of an American company or a Canadian letters-patent company are not publicly filed nor are they open to inspection by the public.

The articles of association can be amended or changed only by shareholder action. While it is true that, inevitably, the original articles as well as the memorandum are framed by the promoters, they cannot after the incorporation of the company be altered by the action

of the board of directors. Here again the by-laws of an American company or a Canadian letters-patent company differ from the English articles.

The American Model Act authorises the board of directors to adopt the initial by-laws at the organisation meeting of the corporation and, unless the charter reserves the power to the shareholders, to alter, amend, or repeal the by-laws or adopt new by-laws.[12] The Act does not require shareholder approval or ratification of the by-laws and so entrusts the board with a great deal of power over the management of the affairs of the corporation. The Comment to the section notes that the section changes the common law rule that the power to adopt, amend or repeal by-laws resides in the shareholders.[13] This Model Act reform has not been adopted by New York or Delaware. The Delaware Act authorises the incorporators or initial directors named in the charter to adopt the original by-laws. Then the Act adds:

"Thereafter the power to make, alter or repeal by-laws shall be in the stockholders or, in the case of a non-stock corporation, in its members; but any corporation may, in its certificate of incorporation, confer that power upon the directors or, in the case of a non-stock corporation, upon its governing body by whatever name designated."[14]

The New York Business Corporation Law authorises the initial adoption of by-laws by the incorporators and subsequent amendments, additions or repeal "by vote of the holders of the shares at the time entitled to vote in the election of any directors." The charter or a by-law adopted by the shareholders may confer power on the board to

amend, repeal or adopt by-laws, but the Act makes it clear that "any by-law adopted by the board may be amended or repealed" by the shareholders.[15] Hence the New York law recognises the ultimate authority of the shareholders in respect of by-laws.[16]

Canadian letters-patent jurisdictions also differ from the English pattern. The Canada Act authorises the board to adopt, repeal, or amend by-laws to be effective only till the next annual general meeting, unless it is, in the meantime, sanctioned at a general meeting or confirmed at that annual meeting. The board is, however, empowered to pass by-laws to regulate "the appointment, functions, duties and removal of all agents, officers and servants of the company; the security, if any, to be given by them to the company and their remuneration" and these by-laws do not need the sanction of, or confirmation by, the general meeting.[17] Ontario does not recognise any such exception, but is otherwise in accord with the Canada Act.[18] The Quebec Act specifies the corporate acts which can be effected by "by-laws" and requires the approval of such by-laws by "the vote of at least two-thirds in value of the shares represented by the shareholders present at a special general meeting of the company" and their confirmation in some cases by supplementary letters patent.[19]

In sum, the word "by-law" does not have the same significance or connotation. We shall in these pages use it to include the articles of association of the English prototype statutes, even though they differ substantially from the by-laws of American or Canadian letters-patent companies. For example the doctrine of constructive notice of public documents applies to articles of association so as to bind those who

deal with English companies, but the by-laws of American and Canadian letters-patent companies do not bind third parties unless they have actual notice of them.

C. PUBLIC AND PRIVATE COMPANY.

We have seen that the express statutory recognition of the "private" limited company took place in the first decade of this century. The privileges and immunities afforded to them — e.g. the privilege not to publish their financial position, the right to commence business forthwith upon incorporation — made the distinction between them and the public companies very important. The distinction is now a feature of the company statutes of all Commonwealth jurisdictions with the exception of those of the Provinces of Quebec and Nova Scotia.[20]

In contrast, American corporation statutes have not, until very recently, made any such distinction or special provisions for close corporations. Recently Delaware has introduced special provisions for close corporations.[21] Maryland and Pennsylvania have also enacted comprehensive legislation on close corporations. Though the New York Business Corporation Law did not enact a separate statute for close corporations, it contains provisions designed for the special needs of close corporations.[22] Several other American jurisdictions have also done so.[23] It must be mentioned that the American corporation laws have been adapted by the ingenuity of lawyers and the resourcefulness of the courts to the special needs of close corporations long before

the legislatures began paying attention to them.

The proposed new Business Corporation Act of Ontario does away with the distinction between public and private companies — a distinction which had existed in that Province since 1912.[24]

From the standpoint of creditors and prospective creditors the distinction between public and private companies and the exemption of private companies from disclosure of their financial position makes little sense. The English Act of 1908, which for the first time introduced the requirement of public filing of corporate accounts, thought it fit to exempt from this requirement the "private" companies which it defined for the first time. This English example was followed in most Commonwealth jurisdictions. But surprisingly Ontario never introduced the requirement of public filing of accounts in the case of any company, but adopted the distinction between private and public company nonetheless in 1912. The immunity from public disclosure of accounts afforded to private companies by the English Act of 1908 was narrowed considerably by the Act of 1948 which invented the concept of "exempt private company" for the purpose. The English Companies Act of 1967 has now abolished the "exempt private company" with the result that all companies, private and public, must hereafter file their annual accounts with the registrar.[26]

The rules relating to the raising and maintenance of capital, whatever they may be, and the requirement of public disclosure of corporate accounts are intended as safeguards for those who deal with limited companies. It makes little difference whether the companies

are public or private, closely-held or widely-held, as long as the shareholders enjoy the benefit of limited liability. Indeed the safeguards are even more urgent and imperative in the case of private companies which have enjoyed the advantage of secrecy and escaped the deterrence of publicity. Dean Latty has remarked that "it is probably in close corporations that the darkest deeds are being done."[27]

This thesis, therefore, assumes that the distinction between public and private companies, or widely-held and closely-held companies, does not make any substantial difference in the context of problems related to the raising and maintenance of capital and consequently treats all limited companies on the same footing. Indeed the great bulk of companies formed under the company statutes, whether in America or the Commonwealth, are close corporations and often one-man or family concerns.[28]

D. VOTING RIGHTS.

Companies in all the jurisdictions enjoy a large measure of freedom to classify their shares and attach different rights to them. One very important consequence of this freedom from the point of view of corporate control is that it is possible for companies to deny voting rights to any class of shares, to confer qualified voting rights, or to bestow disproportionate voting rights.[29] This, it is easy to visualise, opens the door for the owners of a minority of share capital — usually the promoters to whom deferred shares are issued — to gain control, exclusively or disproportionately, over the company. Restrictions have

been imposed in a number of jurisdictions on the freedom of companies to attach voting rights to different classes of shares, but in Britain the companies statute imposes none. The London Stock Exchange, however, disapproves the issue of non-voting common shares and it appears that the practice is not wide-spread in England. There is, however, no legal objection to a company issuing non-voting common.

American companies enjoy equal freedom to attach different voting rights to different classes of shares by suitable charter provisions. But in one respect American statutes are more explicit than the English. They spell out the cases in which a class of shares will be entitled to vote as a class, whether or not they are entitled to vote thereon by the provisions of the corporation's charter. The Model Act enumerates ten instances of charter amendment which would require such class approval, even if the shares are otherwise non-voting shares.[30] Similarly, each outstanding share is entitled to vote upon a proposed plan of merger or consolidation, even if it is not entitled to voting right under the corporation's charter.[31]

The Canada Act forbids the issuance of shares "with voting rights limited in such a way as to attach to any other class or classes of shares the exclusive right to control the management of the company by the election or removal of the board of directors or otherwise."[32] This enigmatic provision is the result of the half-hearted response of the Canadian Parliament to the recommendation of a Royal Commission that common and preferred shares should carry equal voting rights and that management shares should be forbidden.[33] As the Act stands, there

is nothing in it to forbid the classification of common shares, but in such cases the Federal Department requires that they should all carry full voting rights.[34]

The Ontario Act enjoins that "If a company has more than one class of shares, one class shall be common shares designated as such and the other class or classes shall be preference shares howsoever designated."[35] If so, an Ontario company cannot have different classes of common shares or nonvoting common shares. One of the Regulations framed under the Ontario Act requires that if there are preference shares with restricted voting rights, the aggregate capital with such restricted voting right ought not to exceed 90% of the total aggregate capital of the company. This means that at least 10% of the authorised capital should carry full voting rights.[36] It has been pertinently pointed out that none of these fully voting authorised shares need, however, be issued![37]

The proposed new Ontario Act is to the same effect except that shares other than common shares will be known as "special" shares and such "special" shares can be designated as preference shares only if they have attached to them "a preference or right over the common shares."[38] This is a definite improvement as under the existing Act even deferred shares fall under the designation of "preference" shares!

Subject to these limitations in the Canada and Ontario Acts, Canadian companies also enjoy freedom to classify their share capital and attach to them different rights, including the right to vote.[39]

A distinguished American writer has advocated the abolition of voting rights for all shares and vesting them in the board of directors,[40] but no jurisdiction has chosen to carry enablingism that far. The statutes have generally left allocation of control to be based on freedom of contract.

E. QUORUM AND RESOLUTIONS

American jurisdictions differ strikingly from their Anglo-Canadian counterparts in their high quorum requirement for shareholders' meetings.

The English Act affords freedom to companies to fix the quorum for general meetings in their by-laws. Table A provides that "save as herein otherwise provided, three members present in person shall be quorum."[41] If within half an hour of the appointed time for the meeting a quorum is not present, the meeting will stand adjourned to the same day and time the next week, the members present at the adjourned meeting will constitute quorum even if it be less than three.[42] An ordinary resolution needs a simple majority in its favour of the votes cast upon the resolution by those who are entitled to vote on it; a special resolution and an extraordinary resolution need three-fourths majority of such votes.[43] Votes can be cast in person or by proxy.[44] So at a meeting in which three votes are cast in person and none by proxy, an ordinary resolution can be carried by two votes in its favour. If three votes are cast in person and one by proxy, a special or extraordinary resolution can be carried by three votes in favour of that

resolution. With the traditional indifference of shareholders to general meetings and with the very low quorum requirements, it can be seen that important corporate acts such as charter or by-law amendments can be effected with a very small number of votes and without the management being under any compulsion under ordinary circumstances to solicit proxies.

Moreover, any regulation in Table A can be excluded or modified by a company filing special articles of that effect and it would therefore seem to follow that even a lesser quorum may be provided for. The Act itself contemplates of meetings where the quorum may consist of just a single member of the company present in person or by proxy.[45] If the by-laws do not make any provision for quorum, the Act prescribes that two members personally present in the case of a private company and three members personally present in the case of a public company constitute a quorum.[46]

Suffice it to say that a negligible number of votes cast may bind a vast number of apathetic shareholders to important corporate acts or transactions. What matters is not the total number of shareholders or the total number of shares or the number that attend a meeting, but the number of votes cast in person or by proxy by the holders of shares entitled to vote on the resolution.

The Canadian jurisdictions generally fall in line with this English precedent. The Canada Act authorises the board to make "by-law" (subject to the letters patent) prescribing quorum to be effective till the next ensuing annual meeting of the shareholders [47] and provides

for the confirmation or sanctioning of the "by-laws" passed by the board of directors.[48] It also provides for shareholders' resolutions at general meetings in order to appoint inspectors to investigate the affairs of the company.[49] Ontario adopts a similar style. In all such cases the Acts require that the resolution, confirmation or sanction should be effected by a simple or special majority of the votes cast at the general meeting. The Quebec Act alone adopts a different formula and requires that by-laws should be sanctioned "by a vote of not less than two thirds in value of the shares represented by the shareholders present at a general meeting called for the purpose of considering the by-law " in certain cases.[50]

The American jurisdictions not only prescribe high quorum requirement for shareholders' meetings,[51] but also require that shareholder approval should be given by the affirmative vote of holders of "at least a majority"[52] or "at least two-thirds"[53] of the outstanding shares of the corporation entitled to vote on the resolution. Thus the criterion is not the number of votes cast, or the number of shareholders present, but the number of outstanding shares entitled to vote on the matter. It should be obvious that shareholder approval in America has a greater significance and dimension than in the Commonwealth countries. It is therefore necessary for American corporations to solicit proxies in sufficient numbers. This no doubt involves delay, expense and inconvenience,[54] but it makes shareholder approval and shareholder participation in corporate decision-making more meaningful, especially combined with the proxy regulations of the Securities and Exchange Commission.

F. SHARES WITHOUT NOMINAL OR PAR VALUE

No-par shares are permitted in almost all the American states and, with only minor exceptions, all American states authorise no-par preference as well as common shares.[55]

All the Canadian company statutes authorise no-par shares, but no-par preference shares having a preference as to capital are not permitted in most jurisdictions. Under the Dominion Act "shares having priority as to capital or being subject to redemption or purchase for cancellation" have to have a par value and so cannot be issued as no-par.[56] In Ontario the position is the same when the statute of that Province permits no-par preference shares but adds that such no-par preferred shares do not have a preference in respect of the repayment of capital and are not subject to redemption or purchase for cancellation."[57] In other words, an Ontario company cannot issue redeemable preferred no-par shares, nor can it purchase no-par shares for cancellation. In New Brunswick preferred shares having a preference as to principal cannot be issued as no-par shares.[58] Quebec does not permit no-par shares in the case of "redeemable shares or shares having priority as to capital."[59] In the letters patent jurisdictions only Manitoba and Prince Edward Island seem to permit no-par preference shares having a preference as to principal or liable to redemption or purchase for cancellation. In Alberta preferred shares must have a nominal par value and so cannot be issued as no-par shares.[60] The remaining memorandum jurisdictions — Saskatchewan, Newfoundland, Nova Scotia and

British Columbia — seem to permit no-par preference shares even having a preference as to capital or liable to redemption or purchase for cancellation.

No-par shares are not permitted in Britain, though in 1954 the Gedge Committee recommended their introduction on an optional basis in the case of ordinary, but not preference, shares.[61] Like Britain most countries of the Commonwealth including India do not permit no-par shares. No-par shares are alien to almost all the continental countries which on the other hand prescribe minimum par value for shares.

It could, therefore, be said that no-par shares are, at least in the common-law world, an American innovation which has found its first entry in the Commonwealth into Canada.[62] They were first introduced in New York in 1912. Delaware followed in 1917, Massachusetts and Rhode Island in 1920, New Jersey in 1921 and the other states followed suit before long. In Canada no-par shares were first introduced by an amendment to the Dominion statute in 1917.[63] Quebec followed in 1920[64] and Ontario in 1924.[65] Now there is no jurisdiction in Canada where no-par shares are forbidden completely.

American and Canadian experience gained over half a century in this field is, therefore, of especial interest to the rest of the common-law countries. No-par shares have been a subject of great deal of controversy and debate during this period; with debate and with experience the law has grown and developed considerable refinement and sophistication in the American states and the Canadian jurisdictions.

Any innovation meets initially with suspicion, prejudice and opposition, but time allays fears and experience helps to plug loopholes. This is as true of no-par shares as it is of the concept of limited liability itself.

CHAPTER 3

SECURITIES LAWS AND ADMINISTRATION

The securities statutes and their administration constitute a very important instrument of public regulation of corporate enterprise in America and Canada. Failure to take into account their impact at every stage of our inquiry will lead us into grievous errors in our appreciation of, and conclusions about, the American and Canadian corporation laws. Unfortunately it is not possible to examine in detail the Blue Sky laws of all the American States and Canadian Provinces as, in the words of Professor Loss which are as apposite to Canadian as to American securities statutes, "the amount of variation and frequently unnecessary complexity in both substance and verbiage is staggering."[1] It is here proposed to give an outline of (i) the federal securities laws of the United States and (ii) the California securities law, as broadly depictive of the American spectrum, and (iii) the Quebec and Ontario securities statutes as broadly indicative of the Canadian scene. The purpose of this chapter is to indicate the scope, nature and range of these Acts with a view to stressing their relevance to our future discussions, though it should be emphasised that it would be far from feasible to examine the impact of every securities statute on every one of the problems which will be discussed in the following pages. Nothing is harder than to classify and categorize these statutes, each with its own scheme, structure and philosophy. It has been found,

for instance, that the forty eight American State Blue Sky laws contain in all some 2,800 exemptions.[2]

A. UNITED STATES [FEDERAL] SECURITIES REGULATION.

All American business corporations are incorporated under state statutes and there has never been, unlike in Canada, a federal incorporation law even for the formation of inter-state companies. American corporation law is therefore basically state law and intra-corporate relations are governed and regulated by the state law. But a great and important body of federal law relating to transactions in corporate securities has grown and been superimposed in the past three decades and a half upon these creatures of state laws.[3] This body of federal law, which continues to grow in scope and importance,[4] forms today the common core of the corporation laws of the entire country. The Securities and Exchange Commission (S.E.C.) has vigourously implemented the federal statutes and the rules made by that administrative agency form an important part of that federal corporation law.[5]

The federal entry into this field began with the Securities Act of 1933[6] (popularly known as the "truth in securities law"). The Act seeks (i) to ensure disclosure of material financial and other information concerning securities offered for sale to the public and (ii) to prohibit misrepresentation, deceit and other fraudulent acts and practices in the sale of securities generally — the anti-fraud provision.[7] The anti-fraud provision applies to <u>all</u> sales of securities (involving inter-state commerce or the mails), whether or not made to the public. In the case of a public

offering of securities a registration statement must be filed with the S.E.C. The disclosure provisions owe their origin to the English Act of 1929. But unlike the registrar who has no authority but to file the prospectus delivered to him, the S.E.C. subjects the registration statement to its penetrating scrutiny to ensure that adequate disclosures have been made. In the result, though the British and the United States statutes are founded on a philosophy of full disclosure, the administrative role of the S.E.C. has in practice subjected public issues of securities to public control in a significant measure.

It should, however, be mentioned that, in principle, the S.E.C. has no authority to deny registration or otherwise bar the securities from public issue, once proper disclosures have been made, even if the price or terms of the securities are unfair and even if the prospects of the company's success appear dim.[8]

The Securities Exchange Act of 1934,[9] which created the S.E.C. as an "independent, bipartisan, quasi-judicial agency" of the United States Government, has a very much wider sweep and may well be described as a hotch-potch statute. It extends the disclosure philosophy by requiring continual disclosure of material information of securities listed on national securities exchanges and to some extent of securities traded on the over-the-counter market. Of its various provisions attention to the following may be drawn here. Its well-known section 10(b) forbids any person "To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange, or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the /S.E.C.7

may prescribe as necessary and appropriate in the public interest or for the protection of investors."[10] This subsection and the rules and regulations prescribed by the S.E.C. thereunder have given rise to a growing volume of federal corporation law, to which we referred earlier, the full limits of which have not yet been reached. In addition the Act proscribes specific instances of manipulation of security prices which create a false or misleading appearance of active trading in any security, etc.[11] The Act requires the directors, officers, and beneficial owners of more than 10% of the "equity" securities[12] of a company listed on an exchange to file initial and monthly reports with the S.E.C. and the exchange showing their holdings of each of the company's equity securities and any changes therein. Besides they are rendered accountable to the corporation for "short-swing" profits reaped by them by buying and selling, or selling and buying, such equity securities within any six months' period.[13]

Besides these two Acts the S.E.C. performs a protective role under the Trust Indenture Act of 1939[14] which prescribes standards for the protection of purchasers of debt-securities offered for public sale. It performs an advisory function in Chapter X proceedings under the Federal Bankruptcy Act. It is not necessary to call attention here to the other federal Acts administered by the S.E.C.

The S.E.C. exercises control under the federal Acts in a number of ways. Thus, if it finds a registration statement incomplete or inaccurate in any material respect, it can prevent it from becoming effective by issuing an order until it is rectified as required by the Com-

mission.[15] If no such order is made the registration statement becomes effective in twenty days, but the S.E.C. can make a stop-order suspending its effectiveness if it discovers that the statement is untrue in any respect, or omits material facts required by the Act or needed to make any stated fact not misleading.[16] In contrast the British Registrar has none of these powers. The S.E.C. has investigatory powers to decide whether a stop-order should issue.[17] Under the 1934 Act the S.E.C. has wide powers to suspend and withdraw the registration of a national securities exchange, to suspend and expel any member or officer of any such exchange, to alter or supplement its rules, and even to suspend trading of a security or all trading on the exchange for a particular period.[18] The S.E.C.'s orders under the Acts are reviewable by the courts of Appeals of the United States.

The S.E.C. has powers to investigate violations of the provisions of the Acts and of its rules and regulations made under them. If the investigations reveal fraud or other violations, the S.E.C. may (i) apply to the appropriate federal District Court for an order enjoining those unlawful acts or practices and (ii) refer the facts to the Attorney General recommending criminal prosecution of the offenders.[19] Most important is the power given to the S.E.C. to make rules and regulations necessary to carry out the broad provisions of the Acts.[20]

The Acts also provide for civil private actions. Under the 1933 Act any person acquiring a security relying upon an untrue registration statement[21] or untrue prospectus[22] may bring civil actions to recover damages. Corresponding provisions exist in the 1934 Act.[23] But what

is most significant is that private remedial actions have been allowed by the courts for violations of provisions and S.E.C. rules in respect of which the Acts have not specifically provided for private action. Many such private actions have been prosecuted[24] under section 10(b) of the 1934 Act[25] and the S.E.C. rule X-10b-5.[26] In view of the importance of that section and the rule they are extracted below:

Section 10(b) reads:

> "It shall be unlawful for any person, directly or indirectly . . .—
>
> (a) *** ***
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

S.E.C. rule 10b-5 reads:

> "It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which they are made, not misleading, or
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security."

The section and the rule, enforced by private actions, have been instrumental in the development of a "wholly new and far reaching body"[27] of federal corporation law, eclipsing the importance of the provisions for private remedial actions contained in the Acts and the traditional common-law action of fraud. It will be seen in a later chap-

ter how this development has produced an effective weapon to control some of the abuses inherent in the repurchase of their shares by corporations.

It should however, be noted that the policing by the federal administrative agency of all the million and more of the business corporations, most of which are close corporations, all over the huge country is virtually impossible and a large part of it has necessarily to be done by the State Blue Sky administrators. The 1933 Act sets out a list of securities and transactions which are exempt from its registration statement and prospectus requirements. Of these the following may be noted: (i) intra-state issues in which the entire issue of securities is offered and sold exclusively to residents of the state in which the issuer is both incorporated and doing business;[28] (ii) transactions by an issuer not involving any public offering;[29] (iii) transactions by persons other than issuers, "underwriters", or broker-dealers;[30] (iv) "small" issues, not exceeding $300,000 in the aggregate, that may be exempted by the S.E.C. by its rules and regulations;[31] and (v) securities exchanged by the issuer with its existing security holders exclusively where no commission or other remuneration is paid or given directly or indirectly for soliciting such exchange — cases of voluntary reorganization.[32] The Act of 1934 ensures disclosure, initially and continually, in the case of (i) listed securities and (ii) over-the-counter securities of issuers with total assets exceeding one million dollars and equity security holders of record numbering 500 or more.[33] It will therefore be seen that a wide field is left for exclusive regulation by the states. Moreover, the federal Acts

do not pre-empt the field to which they apply, but expressly save the application concurrently of the State Blue Sky laws.

B. STATE BLUE SKY LAWS IN AMERICA[34]

The State Blue Sky laws and their administration, which antedate the advent of the federal security laws by two decades and more, range from rudimentary to paternalistic. Delaware along with Nevada has the distinction of having no blue sky law at present.[35] New York's Martin Act enacted in 1921 has only rudimentary provisions for securities registration and is essentially an anti-fraud statute.[36] It contains no provisions for administrative scrutiny and requires no licence of permit before a company may issue securities. In a substantial number of jurisdictions there are only filing requirements. No attempt will be made here to examine these statutes. It is sufficient to say that they vary widely in scope, philosophy and enforcement. An account of the California securities statutes will be given as illustrative of the paternalistic blue sky laws which obtain in some of the states. The Uniform Securities Act, drafted by Professor Louis Loss and Mr. Edward M. Cowett and promulgated in 1956, is, like the federal securities Acts, essentially a disclosure statute and has been adopted more or less in over twenty states.[37] We need not debate here whether paternalism or enablingism is the more appropriate philosophy for securities regulation in the context of the modern corporation.[38] Suffice it to say that the difference between the federal securities Acts and the "paternalistic" securities laws of States such as California is in practice not very substantial.[39]

California Securities Law: The California Securities Law of 1968[40] which became effective on the 2nd of January this year is the most thorough-going revision of the securities law of that state in half a century. We shall first state the law as it stood prior to that date and then the new law. The Kansas Act of 1911 is the fore-runner of the permit system found in California and some other states as well as the Canadian Provinces. Under that Act the Kansas Bank Commissioner was empowered to forbid a company to do any business in that State if he found that the

> "articles of incorporation or association, charter, constitution and by-laws, plan of business or proposed contract, contain any provision that is unfair, unjust, inequitable or oppressive to any class of contributors, or if he decides from his examination of its affairs that /the issuer/ is not solvent and does not intend to do a fair and honest business, and in his judgment does not promise a fair return on the stocks, bonds or other securities by it offered for sale."

Obviously this is complete government control of private business corporations. Within two years of the Kansas Act 17 American States and 2 Canadian Provinces chose to follow in its paternalistic foot-steps.[41] California's security law belongs to this family and the California Commissioner of Corporations, who heads the Division of Corporations of the State Government, exercises far greater control over corporations, domestic and foreign, than does the S.E.C. under the federal securities laws.

(a) California Securities Law Till the End of 1968.

Under the California Securities Law as it was in force till the end of 1968[42] every company,[43] whether incorporated in California or

not, had to apply for and obtain a permit[44] before it could "sell", offer for "sale", or negotiate the "sale" of, or take subscriptions for any "security" of its own issue. "Security" included treasury stock.[45] "Sale" or "sell"[46] meant every disposition, attempt to dispose, of a security or interest in a security for value and included "an exchange; any change in rights, preferences, privileges, or restrictions on outstanding securities." A permit from the Commissioner was required not only for the issue of new securities but also for an issue of share dividends, alteration of outstanding securities through charter amendments, and exchanges of securities effected through merger, consolidation, or voluntary recapitalization.[47] The Commissioner exercised control over all these transactions by his power to grant or deny a permit. He was authorised to refuse a permit unless he found that[48]

> "the proposed plan of business of the applicant [for permit] and the proposed issuance of securities are fair, just and equitable, and that the applicant intends to transact its business fairly and honestly, and that the securities that it proposes to issue and the method to be used by it in issuing or disposing of them are not such as, in his opinion, will work a fraud upon the purchaser thereof."

The permit authorising the issue and sale of the securities set out the amount of issue permitted, and the consideration, terms and condition of the issue. The Commissioner was empowered to impose conditions "requiring the deposit in escrow of securities, the impoundment of the proceeds from the sale thereof, limiting the expense in connection with the sale thereof, the waiver of assets and dividends, [etc.,] as he deems reasonable and necessary or advisable for the protection of the public and the purchasers of the securities."[49]

In order to enable the Commissioner to decide whether a permit should be granted or denied to a corporation, the Act required the application for permit to specify, inter alia, "An itemized account of its financial condition, the amount and character of its assets and liabilities" and a "detailed statement of the plan upon which it proposes to transact business."[50] With a view to protecting the rights of shareholders, and classes of shareholders, the Act empowered the Commissioner to refuse a permit for an exchange of securities, in whole or in part, if he found that the plan of exchange was not "fair, just, or equitable to all the security holders affected."[51]

The Commissioner has exercised his "fair, just, and equitable" jurisdiction to impose conditions to control promoters from taking advantage of their privileged position for self-aggrandizement, to prevent the issue of shares "for past services or intangible assets of unproven value," to regulate the terms and conditions of the issue of founders' shares, and to ensure that the corporation did not launch into business before sufficient capital was raised.[52]

The Act granted no exemption from its permit requirement even to securities listed on a national securities exchange, or in respect of which the S.E.C. was exercising supervision, or small issues based on the amount or number of securities, or non-public offerings.[53]

The Act was not, however, without its lacunae. It was not clear, for instance, whether the Act applied to non-issuer transactions; securities issued by firm-commitment underwriters escaped completely from the Commissioner's jurisdiction. It definitely needed streamlining and

the new California law fulfils this need.

(b) The New Securities Law of California.

The main achievement of the new California Corporate Securities Law of 1968[54] which became effective on the 2nd of January this year (hereinafter referred to as the new or 1968 law) is "the elimination of regulatory effort and burden where such was unnecessary or duplicative of the regulatory efforts of the [S.E.C.]" and the enhancement of "the regulatory efforts and jurisdiction of [the California Commissioner] where such was lacking or had been previously weak."[55]

Duplication of regulatory effort has been eliminated, for instance, where the S.E.C. is exercising jurisdiction. The new law provides for "qualification by coordination" in respect of securities for which a registration statement has been filed under the federal Securities Act of 1933.[56] At the moment the federal registration statement becomes effective, qualification for the sale of the securities in California automatically becomes effective. Similarly the new law provides for "qualification by notification" in respect of securities registered under section 12 of the federal Securities Exchange Act of 1934 or the Investment Company Act of 1940.[57] In these cases the need to obtain a permit can be avoided by applying to the Commissioner for qualification by coordination or notification. In all other cases the securities will, unless exempted, have to be qualified by permit.[58] It is unlawful to offer or sell in California securities issued by a corporation, whether or not by or through underwriters, unless they are so qualified.[59] The application for permit should specify (i) the maximum amount of securities proposed

to be offered in California; (ii) any adverse order made in connection with the offering by the S.E.C., or a State regulatory authority, or a court; and (iii) such other information as may be prescribed by the rules framed by the Commissioner; and it must be accompanied by such documents as may be prescribed by the Commissioner by rules.[60] The old standard for granting or denying permit is preserved and the Commissioner is empowered to refuse a permit "unless he finds that the proposed plan of business of the applicant and the proposed issuance of securities are fair, just and equitable, that the applicant intends to transact its business fairly and honestly, and that the securities which it proposes to issue and the methods to be used by it in issuing them are not such as, in his opinion, will work a fraud upon the purchaser thereof."[61]

The Commissioner is, however, empowered to issue a stop-order denying effectiveness not only to a qualification by permit, but also a qualification by coordination or notification, or suspending or revoking such qualification if he finds that (i) the order is in public interest and that (ii) "the proposed plan of business of the issuer or the proposed issuance or sale of securities is not fair, just, or equitable, or that the issuer does not intend to transact its business fairly and honestly, or that the securities proposed to be issued or the method to be used in issuing them will tend to work a fraud upon the purchaser thereof." The new law curtails the Commissioner's power to issue a stop-order, or suspend or revoke a permit, or refuse to grant a permit, on the ground that the price at which the security is to be offered is unfair, unjust or inequitable, if the securities are being publicly offered for

cash pursuant to a registration statement under the federal Securities Act of 1933 and the offering is the subject of a firm commitment underwriting by an underwriter or a syndicate of underwriters all of whom are registered under the federal Securities Exchange Act of 1934. But the Commissioner may do so on the ground of unreasonable discounts, commissions or other compensation to underwriters, sellers or others, or unreasonable amounts or kinds of options.[62]

In sum, the Commissioner's paternalistic control is in effect substantially preserved by the new law. It should also be mentioned that the qualification requirement applies not only to the issuer[63] but also to firm-commitment underwriters making the distribution. This changes the long-standing California rule under which the latter was regarded as a non-issuer transaction not requiring a permit.[64] In this respect the new law enlarges the Commissioner's jurisdiction.

The new law, like its predecessor, forbids any person to offer or sell securities in California in any non-issuer transaction[65] unless the security is qualified by coordination, notification, or permit for issuer transactions, or is qualified by notification for non-issuer transactions as provided by the Act,[66] or it is exempted security or relates to exempted transaction as specifically provided by the Act. The application for qualification for non-issuer transactions should contain such information and be accompanied by such documents as may be prescribed by the Commissioner by rules.

The Act also forbids any issuer to offer or sell in California any security issued by it (i) in connection with any change in the rights,

preferences, privileges, or restrictions of or on outstanding securities or (ii) in any exchange of securities by the issuer with its existing security holders exclusively, or (iii) in any exchange in connection with any merger or consolidation or purchase of corporate assets in consideration, wholly or in part, of the issuance of securities, unless the securities are qualified for sale by permit issued by the Commissioner or they are exempted under the Act.[67] The application for such permit should make the same disclosures as in the case of an application for permit for qualification of the securities for issuer transactions.[68] The Commissioner is empowered to refuse such permit unless he finds that the proposed plan of recapitalization or reorganization and the proposed issuance of securities are fair, just, and equitable, to all security holders.[69]

To sum up, the new law provides for qualification of securities for (i) issuer transactions, (ii) non-issuer transactions, and (iii) for recapitalizations and reorganizations, by the methods (i) coordination,[70] (ii) notification and (iii) permit, and specifies the transactions and securities which are exempted from the requirement of qualification. Like its predecessor it defines "sale" (or "sell") as "every contract of sale, or disposition of, a security or interest in a security for value" and includes within its scope "any exchange of securities and any change in the rights, preferences, privileges, or restrictions of or on outstanding securities."[71]

We have noted the elimination by the new law of duplicative regulatory effort where the S.E.C. is keeping vigil. This can be seen

also from the exempted securities. One of the most important of these exemptions is that of "Any security listed or approved for listing upon notice of issuance on the New York Stock Exchange; and any warrant or right to purchase or subscribe to any such security."[72] Of the about 2,500 listed companies in America, somewhat over half are listed on the New York Stock Exchange and it was estimated a few years ago that there were nine billion shares listed on that Exchange whose value at market quotations approximated to $500 billion.[73] The significance of the exemption can therefore be easily visualized. The exemption applies not only to the listed securities, but also to additional securities of the same class including such additional issues in the form of rights offerings or in connection with recapitalizations or reorganizations. The exemption applies not only to offerings by or on behalf of the company, but also to non-issuer transactions, even if the shareholder is a controlling person who is for that reason required to register the offering under the federal Securities Act of 1933.[74]

Exemption from qualification for issuer transactions is granted, inter alia, in the following cases: (i) Any offer or sale of common stock by a California corporation if, immediately after the proposed sale and issuance, there will be only one class of stock outstanding which is owned beneficially by no more than 5 persons. This exemption is, however, subject to a number of conditions limiting its scope to genuinely closed companies.[75] (ii) Any offer or sale of any evidence of indebtedness, whether secured or unsecured, and any guarantee thereof, in a transaction not involving any public offering.[76]

Exemption from qualification for non-issuer transactions is granted in the following cases among others:[77] (i) Any offer or sale by a bona fide owner thereof for his own account if the sale (a) is not accompanied by the publication of any advertisement and (b) is not effected by or through a broker or dealer in a public offering. (ii) Any offer or sale effected by or through a licensed broker-dealer pursuant to an unsolicited order or offer to buy.

Exemptions are granted from qualification for issuer transactions as well as for recapitalizations and reorganizations in a number of cases.[78] Some of these are cases in which the California interests affected are not significant. Furthermore, the Commissioner is empowered to exempt by rule any other transaction the qualification of which he finds is not necessary or appropriate in the public interest or for the protection of investors or which in his opinion is not comprehended within the purposes of the statute.[79]

To sum up, the new law, while it continues California's paternalistic tradition in securities regulation, has, however, shrunk its jurisdiction in areas where the S.E.C. is already exercising an effective control and where the interest of the investor, particularly Californian, is not significant. Non-issuer transactions which escaped the regulatory powers of the Commissioner under the old law, are now brought within his jurisdiction. In granting a qualification by permit the Commissioner is required to apply the State's traditional "fair, just and equitable" standard.[80]

C. SECURITIES LAWS IN CANADA.

All the Canadian Provinces have securities statutes, but there is none at the federal level though there is a federal incorporation statute — the exact reverse of the position in the United States.[81]

The prospectus provisions of the English Acts have been followed from time to time in the Companies Acts of Canada and the Provinces[82] long before they were adopted in the United States Securities Act of 1933. It is not necessary to trace the details of this adoption of the English provisions, but it is of interest to note that the Ontario Companies Act of 1907 made its prospectus provisions applicable to all companies with more than 10 security holders.[83] But the Ontario Act of 1912 adopted the English pattern of prospectus and statement in lieu of prospectus with exemption for private companies and extended the prospectus requirement to offerings by underwriters as well as issuers.

While the English influence came via the Companies Acts, the American impact resulted in the enactment of Blue Sky laws in the Provinces on the pattern of the Kansas Act of 1911.[84] Manitoba enacted the Sale of Shares Act in 1912 on the Kansas model to control the sale and issue of securities by non-Manitoba issuers. Saskatchewan followed in 1914 and Alberta in 1916.[85]

Suffice it to say that securities regulation through prospectus provisions in Companies Acts and fraud prevention Acts on the English model and securities regulation through Blue Sky laws on the American model met early and coalesced in the Canadian Provinces. But Canada has not so far succeeded in enacting securities statutes at the federal

level. There are also constitutional problems in applying the provincial securities Acts to Dominion incorporated companies issuing or selling shares in a Province.[86] Without involving ourselves in constitutional issues we shall restrict ourselves to a consideration of the Ontario and Quebec security laws as broadly indicative of the Canadian system.[87]

The most recent Canadian securities statute is the Ontario Securities Act of 1966[88] which implements the recommendations of the Kimber Committee.[89] Its predecessor, the Ontario Securities Act of 1945[90] was the first Canadian statute on the modern lines. Many provinces have followed Ontario's lead.

ONTARIO: The Ontario Act of 1966 requires all persons and companies to register with the Ontario Securities Commission (O.S.C.) for the purpose of "trading" in securities.[91] "Trading" includes "any sale or disposition of or other dealing in or any solicitation in respect of a security for valuable consideration . . . ."[92] No company or individual can trade in securities in Ontario unless it or he is registered with the O.S.C. and this requirement applies to Dominion and other Provincial companies as well as those incorporated under the Ontario Act.[93] It applies to primary distributions by the issuer as well. The Director of the O.S.C. is required to grant or renew registration if in his opinion "the applicant is suitable for registration and the proposed registration is not objectionable." He is empowered to restrict a registration by imposing terms and conditions, e.g. as to the duration of the registration or as to the kind or class of securities. It will be seen that the Act does not indicate the criteria or standard to be applied by

the Director or the O.S.C. in determining the "suitability" or "objectionability" of an applicant. The only fetter on the Director's authority to refuse to grant or renew registration is that he should not do so without giving the applicant an opportunity to be heard.[94] He is also empowered to suspend or cancel a registration where in his opinion such action is in the public interest.[95]

A large number of exceptions to the requirement of registration of the "trader" is enumerated by the Act.[96] Of these, the following may be noted: (i) An isolated trade in a specific security by or on behalf of the owner, for the owner's account, where such trade is not made in the course of continued and successive transactions of a like nature, and is not made by a person or company whose usual business is trading in securities. (ii) A trade in a security of its own issue that is distributed or issued by a company to holders of its securities as a stock dividend or other distributions out of earnings or surplus. (iii) A trade in its own security or any other security that is distributed or issued by a company to the holders of its securities as incidental to a bona fide reorganization or winding-up of such company, or distribution of its assets for the purpose of winding-up its affairs. In both cases (ii) and (iii) no commission or other remuneration should be paid to any person in respect of such distribution. (iv) Rights issues if the company has given the O.S.C. the required notice and the Commission has not objected to it within ten days thereafter. (v) A trade in a security of a company that is exchanged by or for the account of such company with another company or its stockholders in connection with a consolidation, amalgamation,

merger or reorganization of either company or in connection with a take-over bid as defined in the Act. (vi) Trading in the securities of a private company issued by the private company if the securities are not offered for sale to the public. The O.S.C. is authorised to grant further exemptions by its regulations.

The Act provides for disclosure in prospectuses for primary distribution of securities to the public. Primary distribution to the public means not only the issue to the public of previously unissued securities, but also trades in previously issued securities for the purpose of distributing them to the public held by any person or company or combinations of persons or companies in sufficient number to affect the control of the company. The distribution to the public may be made by the company or by the underwriter or otherwise.[97] The Act forbids any person or company to trade in a security either on his own account or on behalf of any other person or company where such trade would be in the course of primary distribution to the public of such security, until there have been filed with the O.S.C. both a preliminary prospectus and a prospectus in respect of the offering of such security and receipts therefor obtained from the Registrar of the Commission.[98] The Act authorises the Director to direct, at his discretion, the Registrar of the O.S.C. to issue a receipt for the prospectus, unless it appears to him that[99]

"(a) the prospectus or any document required to be filed therewith,

(i) fails to comply in any substantial respect with any of the requirements /of the Act or of the O.S.C./ regulations,

(ii) contains any statement, promise, estimate or forecast that is misleading, false or deceptive, or

(iii) conceals or omits to state any material facts necessary in order to make any statement contained therein not misleading in the light of the circumstances in which it was made;

(b) an unconscionable consideration has been paid or given or is intended to be paid or given for promotional purposes or for the acquisition of property;

(c) the proceeds from the sale of the securities to which the prospectus relates that are to be paid into the treasury of the company, together with other resources of the company, are insufficient to accomplish the purpose of the issue stated in the prospectus;

(d) such escrow or pooling agreement as the Director seems necessary or advisable with respect to securities issued for a consideration other than cash has not been entered into; or

(e) that such agreement as the Director deems necessary or advisable to accomplish the objects indicated in the prospectus for the holding in trust of the proceeds payable to the company from the sale of the securities pending the distribution of such securities has not been entered into."

Of course these provisions do not apply to the securities of private companies.[100] The Act also exempts from them securities "listed and posted for trading on any stock exchange recognized by the Commission where such securities are distributed to the public through the facilities of such stock exchange pursuant to the rules of such stock exchange and the requirements of the Commission, provided that a statement of material facts, which shall comply as to form and content with the regulations, is filed with and is acceptable to such stock exchange and the Commission."[101]

QUEBEC: The Quebec Securities Act also forbids anyone to "trade" in any security unless he is registered as a "security issuer," or a "broker," or as a salesman of a registered security issuer or broker.[102] Trading in securities is defined widely and includes (i) alienation or disposal, or attempt to alienate or dispose, of a security or an interest in or option on a security and (ii) any underwriting of all or part of an issue of securities.[103] Registration as security-issuer is dispensed with only in respect of a few kinds of securities.[104] There are a number of transactions in securities which are exempted from the registration requirements, such as isolated transactions, rights issues, etc.,[105] in the same way as the Ontario Act.

The Act declares that "The granting of registration as contemplated by this act shall be under the jurisdiction of the [Quebec Securities] Commission" and that the Commission may "grant, refuse, suspend, cancel or reinstate the same, at its discretion."[106] All registrations have to be renewed every year. No appeal or review lies against the Commission's decision to refuse, suspend, or cancel a registration.

The Act contains elaborate provisions for public issue of securities and enjoins that "no issue of securities shall, in this Province, be an object of an initial sale, offer of sale or distribution to the public before the [Quebec Securities] Commission has permitted trading."[107] This applies not only to the issuer, but also any "person or company or . . . a group of persons or companies acting together" who offer a controlling block of shares. The Act requires a prospectus, previously approved by the Commission, to accompany such issues giving full information as

prescribed by regulations.

The Quebec Act brings within the administrative control of the Q.S.C. primary and secondary distributions of securities to the public as does the Ontario Act. But unlike the Ontario Act close corporations are not granted immunity from the jurisdiction of the Quebec Commission and an annoyed member of the Montreal Bar has described it as "the most infuriating feature of the Securities Act of Quebec" and has drawn the attention of those "who . . . from time to time forget to comply with the Act in regard to non-public issues" that "upon the filing of an abject apology [under section 93 of the Act] and a modest fee the blot on your client's corporate escutcheon can be wiped away."[108] Understandably he expresses the view that "no useful purpose is achieved and the officials of the [Quebec Securities Commission] who, one must surmise, automatically approve, without investigation, the myriad applications in respect of non-public issues, might put their time to more profitable use."[109]

D. SECURITIES REGULATION IN BRITAIN.

The prospectus requirements for public issues of shares and debentures are, and have always been, part of the English Companies Acts.[110] The prospectus provisions apply to direct invitations by or on behalf of the company, or by or on behalf of any person who is or has been engaged or interested in the formation of the company, as well as offers for sale, i.e. where the company allots shares or debentures with a view to the allottee making a public offering. Some excep-

tions are recognized to the disclosure in prospectus, e.g. where the securities are identical in all respects with those of the company quoted on the stock exchange, rights issues. The stock exchange to which application is made for listing securities is also empowered to grant exemption from the disclosure requirements which would be unduly burdensome having regard to the circumstances of the issue.

The distinctive feature of the English law is that it has never provided for administrative scrutiny of whether prospectuses issued by companies conform to the legal requirements of disclosure. The English law has generally disfavoured administrative intervention. A departmental committee appointed by the Board of Trade to inquire into what amendments were necessary in the Companies Acts, 1862-1890, observed in 1895:[111]

> "Your Committee . . . have dismissed from their consideration every suggestion for a public inquiry by the registrar or other official authority, into the soundness, good faith, and prospects of the undertaking at this or any other stage of a company's formation. To make any such investigation into the position of every new company complete or effectual would demand a very numerous staff of trained officers, and lead to great delay and expense, while an incomplete or perfunctory investigation would be worse than none. It would be an attempt to throw what ought to be the responsibility of the individual on the shoulders of the State, and would give a fictitious and unreal sense of security to the investor, and might also lead to grave abuses."

This has remained the basis of the English company law and all that is required is that a copy of the prospectus should be delivered to the registrar on or before the date of its publication. The registrar is only required to satisfy himself that the prospectus is dated and duly signed and accompanied by the prescribed documents.[112] The Act, however, spells out the civil and criminal liabilities for misstatements and mis-

leading omissions in prospectuses.[113] Needless it is to say that the English law is far from paternalistic and the role of the registrar is minimal with little resemblance to that of the S.E.C. or the Blue Sky administrators in America or Canada. Most Commonwealth countries faithfully follow the British laissez faire tradition.

The Prevention of Fraud (Investments) Act of 1958,[114] and its predecessor, the 1939 Act of the same title, can be regarded as falling within the family of securities statutes as known in the United States and Canada.

The Act of 1958 forbids any person to engage in the business of dealing in securities, either as a principal or as an agent or servant, except with a licence granted by the Board of Trade to so engage. Contravention is punishable with imprisonment or fine or both. The term "securities" which is widely defined includes shares and debentures and stocks of shares and debentures. In other words all those who deal in corporate securities are to be licensed. "Dealing in securities" means (i) making or offering to make with any person, or (ii) inducing or attempting to induce any person to enter into or offer to enter into —

> "(a) any agreement for, or with a view to, acquiring, or disposing of, subscribing for or underwriting securities . . ., or
>
> (b) any agreement for the purpose or pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities."

It would have followed that a company making an issue of its own securities either by a prospectus, or offer for sale, or placement, and every officer or agent acting on its behalf would have to obtain a

licence under the Act, but the Act makes it clear that the prohibition against dealing without a licence does not apply to "issuing any prospectus to which [section 38] of the Companies Act, 1948, applies or would apply if not excluded" by section 38(5) (b) or section 39 of the Companies Act.[115]

The requirement of a principal or representative's licence does not apply to, inter alia, a member of any recognized stock exchange or recognized association of dealers in securities, nor does the prohibition against dealing in securities without a licence apply to transactions effected with or through the agency of such member or his agent.

In sum, at least one of the parties to a dealing in securities should be a holder of a licence issued under the Act of 1958, or a member of a recognized stock exchange or dealers association, or the transaction must be the issuing of a prospectus to which the Companies Act applies or would apply but for its exemptions. Thus the English Acts still predominantly emphasise, and leave much to, self-regulation by stock exchanges and dealers' associations and prefer to refrain from paternalistic intervention.[116]

More important are the anti-fraud provisions of the Act.[117] Section 13 makes it an offence punishable with imprisonment up to seven years for any person to induce or attempt to induce, or conspire so to induce or attempt, another person to make an investment in securities or other property by any statement, promise or forecast which he knows to be misleading, false or deceptive, or which he makes recklessly or by dishonest concealment of material facts. Section 14 makes it a

punishable offence to distribute or have in possession circulars or disseminate information, to bring about such fraudulent investments. This section does not, however, apply to distributions of prospectuses to which the Companies Act applies or would apply but for specific exemption. It must be noted that the Act of 1958 imposes no civil liability in such cases which should therefore be sought only under the general law or any other special statute such as the Misrepresentation Act of 1967.[118]

CHAPTER 4

MEANING OF CAPITAL

> "The corporation cannot, like the human individual, make hand labor or the labor of brains the basis of its work; it must have a fund of actual property dedicated to its avowed purpose. This is its capital — the most fundamental concept underlying the financial policy of corporations." DEWING, 1 FINANCIAL POLICY OF CORPORATIONS, 44 (5th ed. 1953).

The need for defining the meaning of the term "capital" is obvious, for the central theme of the thesis is the raising and maintenance of "capital." The need being conceded, we are at once faced with a formidable and bewildering task, for the term is notoriously enigmatic, even viewed as an economic expression, and its ambiguities are aggravated by loose or inconsistent usage.[1] Economists, accountants and lawyers are concerned with the expression but do not understand it in the same way. This chapter will attempt to indicate the meaning and significance of "capital" in its various contextual usages rather than to formulate a unified definition, even if it were possible, but it must be immediately pointed out that the deeper we delve into the mysteries of capital, the more confounding do its ambiguities become. The following expressions will be examined in this chapter:

1. Assets, Fixed Assets and Current Assets;
2. Share Capital and Stated Capital; and
3. Loan Capital and Equity Capital.

A (a). Assets.

The term "assets" or "total assets" is not defined by any corporation statute nor by the Model Act,[2] but the American Uniform Act defines it thus: "The 'Assets' of a corporation include all its property and right of every kind."[3] Indeed the term "assets" is of far greater importance than the term "capital" or even "share capital," for it is the assets that a company employs in its business to generate income or profit. It is to the assets that those who deal with a corporation look to for their security. The composition of the assets is bound to have an important bearing on the company's operation and even its future. Those who contemplate extending credit to a corporation examine (a) the working capital of the company, i.e. the excess of current assets over current liabilities, (b) the current ratio, i.e. the ratio of current assets to current liabilities, and (c) the acid test ratio, being the ratio of "quick assets" (i.e. total cash and net receivables) to current liabilities, in addition to factors pertaining to the earning record and potential.

In fact, when we speak of the "maintenance of capital" we do not mean the setting apart in a separate bank account of the moneys raised by the issue of shares as a security for creditors. Any such rule would be absurd as the moneys raised by the issue of shares are intended to be employed in the pursuit of the company's objects. What we do mean is the maintenance of assets of a certain worth, whatever be its measure. If only the legal rules spoke directly in terms of the "assets" of a corporation rather than of "capital," perhaps we would have been saved much of the confusion that surrounds the law of corporation finance.

When we say that no dividend should be paid "out of" capital, we are not helping clarity, as dividends whenever they are paid, are always paid out of the cash assets (or rarely, out of non-cash assets) of the corporation.[4] This is not a mere semantic quibbling as will be shown in the future chapters.

American statutes do not require companies to place their balance sheets and other accounts before general meetings, though most of them provide for the holding of annual meetings of shareholders.[5] On the other hand they give the shareholders the right to inspect the company's accounts and other records and books and either require the company to send the shareholder by mail upon his written request "its most recent financial statements showing in reasonable detail its assets and liabilities and the results of its operations,"[6] or provide for an annual report to be sent to the shareholders within a prescribed time after the close of the fiscal or calendar year with a copy of the balance sheet and profit and loss account, "unless the by-laws expressly dispense with such report."[7] Delaware gives the shareholder the right to inspect "for any proper purpose" the books and records of the corporation, and to make copies or extracts therefrom, by making a "written demand under oath stating the purpose thereof."[8] Gower points out that the right of inspection of corporate accounts and other books and records is seldom recognised by corporations in practice without a law suit.[9] No such right is recognised in the Commonwealth jurisdictions.[10]

The English Act and the Canadian Acts contain elaborate provisions to ensure financial disclosure not only to shareholders but also

to creditors and the public.

Unlike the American statutes the Anglo-Canadian Acts have provisions for (i) financial statements to be sent to shareholders and others before the annual general meeting, (ii) financial statements to be placed before the general meetings and (iii) public filing of financial statements.

Under the English Act a company should place before its annual general meeting a profit and loss account and a balance sheet complying with the statute, along with the auditors' and directors' reports.[11] The Canada Act requires the directors to place before the annual meeting not only the balance sheet and profit and loss account, but also a statement of surplus, and has elaborate provisions about the financial statements.[12] Other Canadian Acts have more or less similar provisions.[13]

Under the English Act a copy of all these financial statements should be sent by the company at least 21 days before the meeting to every member and debentureholder (whether or not he is entitled to receive notice of general meetings of the company) and to every other person entitled to it.[14] Under the Canada Act this should be done only in the case of shareholders of public companies and at least 10 days before the meeting and in the case of shareholders of private companies and debentureholders a company is bound to furnish them only "upon demand being made therefor."[15]

Under the English Act all these financial documents and reports should be annexed to the annual return to be made by companies to the registrar within 42 days after the general meeting.[16] Under the Canada Act copies of the financial documents should be sent by public companies

to the Department of the Secretary of State within 7 days after copies have been mailed to the shareholders.[17]

It should be mentioned that with the abolition of the "exempt private company" by the English Companies Act of 1967, the immunity which private companies had enjoyed ever since their statutory recognition in 1907 and which was restricted to "exempt" private companies in 1947, viz. the privilege of not having to file their financial statements with the registrar, has now been completely abrogated.[18] No limited company can now escape the glare of publicity involved in the public filing of its accounts. Though this salient reform is yet to be introduced into Canada, it is worthwhile recalling that the proposed new Ontario Act seeks to abolish the distinction between public and private company. Instead it distinguishes between "a corporation that is not offering its securities to the public" and "a corporation that is offering its securities to the public" and requires the latter to place before their annual general meetings a "comparative financial statement" and also send their shareholders "comparative interim financial statements" which will enable the shareholders to compare the performance of the corporation over a comparable period.[19]

All these elaborate provisions emphasise the importance of the "assets" and their "value" to a company, its shareholders, creditors, and members of the public who might deal with it. But the categorisation of assets, and even to a greater extent their "valuation", have presented, particularly to the accounting profession, problems of enormous magnitude.

An important categorization of assets which has practical significance, is that between (a) fixed assets and (b) current assets.[20]

A (b). Fixed and Current Assets.

Fixed and current assets are also sometimes referred to as "fixed capital" and "circulating capital" — an example of the use of the word "capital" in the sense of "assets" which use, as we shall notice, was common in the English rules of the law of corporation finance.

No statute gives us a definition of these expressions. They are merely convenient terms to describe the composition of a company's assets at a given time in the context of the purpose for which it is for the time being devoted.[21] The classification is not rigid and is often governed by the practices of the particular business. Fixed assets are assets such as land, buildings, furniture and fixtures, equipment and machinery, which are relatively permanent in nature and are used in the business, but are not meant for sale or other disposition in the regular course of the business.[22] Current assets are assets such as cash, or receivables and inventories which will be converted into cash in the ordinary course of business within a short period (an arbitrary period of one year being usually chosen for the purpose).[23]

These two categories are not exhaustive and a company may have assets which do not fall in either fold. It may have long-term or permanent investments in real estate or securities. These are not fixed assets as they will not be used for the company's business like plant and machinery; they are not current assets as they are not realizable

within a year. A company may have acquired intangible assets like patents, copyrights, leaseholds and goodwill and these are usually classified as a group in themselves. Deferred charges, prepaid expenses, unamortised bond discounts, organizational expenses, commissions and expenses on the issue of shares are presented as assets in balance-sheets insofar as they relate to future years and it must be obvious that they should be treated as a distinct and separate category of assets.

A (c). Valuation of Assets.

By far the most difficult part of the job of presenting the "assets" of a corporation is their "valuation." This is because "value" is a word of many a connotation and there are many methods of valuation even in the same context or for the same purpose. In the words of Professor Bonbright, "both the concepts of value and the techniques of its proof are decidedly influenced by the specific purpose for which the valuation is made."[24] Valuation of a company's assets for the purposes of the existing shareholders and potential investors, of the management, and of creditors and third parties entering into transactions with it should of necessity involve differing criteria as their objectives are not identical, but as the accounting profession is mainly charged with the function of preparing corporate financial records, the conventional practices of that profession have by and large come to govern the valuation of assets for the purpose of balance-sheet presentation. The profession has in the main adopted the standard of historical-cost to the corporation with the market-value being substituted in some instances where it is lower than

the historical cost. The following table indicates the classification of assets and their "valuation" for balance-sheet purposes according to conventional accounting principles.

Balance-sheet Valuation of Assets : Accountancy Principles

I CURRENT ASSETS	
1. Cash and cash items immediately available to the company.	Does not present any major problem of valuation
2. Notes receivable (i.e. due on notes from trade debtors in the usual course of business.)	must be valued at the estimated figure of amount likely to be collected; uncollectibles must also be estimated.
3. Accounts receivable (book debts due from trade debtors in the usual course of business).	same as above.
4. INVENTORIES (i.e., stock in trade or merchandise held for sale, raw materials to be used for production, materials put into the process of production, supplies or goods that aid in completion of the finished product.)	Present difficult problems of valuation. There are several recognized methods of valuation (e.g. FIFO, FILO, actual cost, simple average cost, weighted average cost, market value, gross profit, lower of market or cost methods). Depending upon the method used, inventory valuation can vary considerably.
5. Marketable Securities (being temporary, short-term investments of cash available for current operations which are readily or quickly encashable).	usually valued at cost, but indicating parenthetically the market value which may be above or below cost.
6. Others (e.g. accrued rent receivable, accrued interest receivable).	

II INVESTMENTS (relatively permanent or long-term, such as in real estate, shares or debentures, etc.) 1. Securities of affiliates or subsidiaries. 2. Advances to affiliates or subsidiaries. 3. Others.	usually valued at cost, indicating parenthetically the market value which may be above or below cost.
III FIXED ASSETS (i.e., those used in business, like land, buildings, machinery, equipment, furniture, fixtures, etc.)	Valued in the balance sheet on the basis of original cost of purchase or acquisition. This figure may be far removed from present market value or liquidation value. The figure will include commissions and brokerages paid in the acquisition of the property, expenditure to renovate or repair, interest on money borrowed to acquire the property, etc. Where such assets are acquired in exchange for the company's shares over-valuing the assets, the problem of valuation becomes even more complex and aggravated. It must be seen that if the market value of the assets declines, the balance sheet valuation at cost will be misleading unless the company writes down the figure to reflect current value. If the market value appreciates, companies will have every temptation to write up the figure to create a surplus.

It must be mentioned that the balance sheet statement of the value of fixed assets attempts usually to reflect the diminution of the value of assets like machinery, equipment, building, etc., by an annual "depreciation expense" charge to the income account and a balancing credit to a negative asset account entitled "depreciation reserve" or "accumulated depreciation". This, however, does not necessarily mean that a reserve fund is set apart to make good the depreciation in the value of the fixed

assets. All that this book-keeping technique does is to record in the balance-sheet an estimate of a reduction in the value of the assets below their original cost. Though this reduction is shown as an expense in the income account, this "expense" is in fact incurred without an outlay of funds.[25] There are several methods of computing "depreciation" for the purpose.

IV INTANGIBLE ASSETS ACQUIRED FOR CONSIDERATION. (e.g., patents, copyrights, license-privileges, lease-holds)	Presented at cost. If the intangible will last only for a limited duration, a negative asset entry is made to an assets account to accumulate the decrease in cost and a corresponding "expense" entry is made in the income account. If the intangible is not of a limited life, no such amortization is made: e.g. the goodwill of a business purchased.
V DEFERRED CHARGES AND PREPAID EXPENSES, ORGANIZATIONAL EXPENSES, COMMISSIONS AND EXPENSE ON THE ISSUE OF SHARES; UNAMORTIZED BOND DISCOUNT.	Though these moneys have already been parted with by the company in advance (e.g., prepaid insurance premia or rent for a period of years), they are shown in the balance sheet as "assets" in so far as they relate to the future years. They are not assets in the sense that they are encashable. For a creditor wishing to proceed against the assets, these are no "assets" at all.

From the above chart it should be evident that the balance-sheet figure of the value of the assets will quite often not reflect the actual "wealth" of the company which may be more or less. Many of the figures are based on estimates which are at times purely conjectural or based on principles of accountancy over which there is no uniform practice, e.g. valuation of inventory. Some of the technical "assets" may be

no assets at all from the point of view of creditors. Quite often assets are valued at original cost which may be far above the market price where the asset had been acquired in times of inflation or if the market for such assets falls. Besides the risk of diminution in the value of the assets due to depreciation or other causes exists.

Indeed the statement of the total assets in the balance sheet may be misleading to one uninitiated into the mysteries of double-entry book-keeping. As was observed by the United States Court of Claims, "the mere fact that the balance sheet states the assets of a corporation to be given sum is no evidence that such value actually exists, as many persons have found to their sorrow."[26] We have been warned that

> "A stockholder or a creditor should not, upon examination of a balance sheet, conclude automatically that because the total of the asset values exceeds the total of the liabilities, there is a shareholders' equity in the amount of the excess, or that there is at least complete assurance that the liabilities will be paid in full. Nothing could be farther from the truth. If a creditor wishes actually to determine, as closely as possible, whether the liabilities can be liquidated in full, he should attempt to view the balance sheet, so far as the assets are concerned, at their liquidation values, which may be considerably different from the values determined on the basis of original cost. It is a well accepted business proposition that assets frequently shrink in the face of forced sale, while liabilities remain constant."[27]

We may pause here to notice the differing approaches of the economist and the accountant. The economist uses the word "capital" to describe all the material wealth at the disposal of the corporation which it may employ for the further production of wealth, i.e. profit or gain, whether contributed by shareholders or loaned to it by other persons for a short or long period of time. He includes within it all

economic values, including intangible ones such as good-will acquired by the corporation in the course of its normal operations. He recognises the "going concern value" which he values on the basis of estimated future receipts. He takes into account such variables as the purchasing power of money and the phenomenon of interest. In contrast, the accountant does not take into account all economic values and he excludes items which cannot be given a money value. He ignores items such as goodwill, obtained by the corporation without specific outlay of funds and is little concerned with "going concern value." He is content with valuation of assets on the basis of their historical cost and takes no note of variations in the purchasing power of money. It is not necessary at this stage to examine in detail the practical implications of these differing concepts of "capital" of the economist and the accountant. It is sufficient to note that the differences in their concepts of capital are significant and substantial.

B. Share Capital and Stated Capital.

The terms "share capital" or "stated capital" represent the juristic conception of capital which is entirely different from those of the economists and the accounts. Aptly it is also called "legal capital." It refers to the shareholders' contribution, wholly or in part, to the corporation.

In jurisdictions which do not authorise no-par value shares, its definition is simple. It means the product of the number of shares multiplied by the par value, i.e. the aggregate par value of all the

shares. The amount of capital mentioned in the charter is the authorised amount of share capital. To the extent that the shares have been subscribed to and allotted, it is the issued share capital. To the extent of the consideration received for the issued shares, the share capital is said to be paid-up and the remainder is unpaid capital. The excess of consideration over the par value is share premium amount. If shares are issued (as permitted by law) below par, they are said to be issued at a discount. In any case as the par value is an arbitrary figure, the amount of share capital is equally an arbitrary figure. It connotes the minimum amount of consideration for which the shares may ordinarily be issued. The distinction between share capital and share premium amount is not economic, but legal, in nature.

With the advent of the no-par value shares, the description "stated capital" took the place of share capital in the American and Canadian jurisdictions. The origin of this description can be seen in the early no-par statutes. The pioneering New York statute of 1912[28] required the charter to state the amount of capital with which the company intended to carry on business computed on arbitrary valuation of $5 ("or a multiple thereof")[29] for each no-par share authorised to be issued. Until this stated amount of minimum capital was received by the company in cash or in property at its "actual" valuation, it was forbidden to commence business or incur debts. Thus, the "no-par" shares had to have a "stated" value for computing minimum paid-up capital. Besides they were given an arbitrary value, usually $100, for the purpose of fixing the license and franchise taxes.[30] When no-par shares were intro-

duced into Canada by the Dominion Statute of 1917, the New York precedent was naturally followed.[31] The concept of "stated amount of minimum paid-up capital" disappeared quite early. The Act of 1917 was amended in 1924 and "stated capital" was defined to mean the aggregate par value of outstanding par-value shares plus "the aggregate amount of the consideration for the issue and allotment" of no-par shares outstanding from time to time.[32] The stated value for no-par shares also disappeared except where it still survives as a method of computing incorporation fees or taxes or as an optional provision.[33]

We shall consider the definition of "stated capital" in modern American and Canadian statutes.

The Canada Corporations Act provides that where the "authorised capital" consists of no-par shares, wholly or partly, then "the paid up capital of the company shall, with respect to /such no-par/ shares, be an amount equal to the aggregate amount of the consideration received by the company for such of the shares as are issued . . . ."[34] The Ontario and Manitoba Acts instead speak of issued capital which, so far as no-par shares are concerned, is the amount of consideration for which the outstanding no-par shares have been issued.[35] Quebec has a definition of paid-up capital identical with that of the Dominion statute.[36] The New Brunswick statute lays down that "/t/he amount of capital shall not be less than the aggregate amount of the consideration for the issue and allotment" of the outstanding no-par shares plus the total par value of outstanding par shares, subject to a minimum of $500.[37] The Companies Act of Prince Edward Island provides that the capital of a company

shall be (1) at least equal to the total par value of outstanding par-shares plus the aggregate amount of consideration received by the company for outstanding no-par shares and such amounts as may from time to time be transferred to capital by by-law of the company; or (2) the total par value of outstanding par value shares plus a stated value (of $1 or more as specified in the letters patent) for each outstanding no-par share.[38]

Saskatchewan and British Columbia are the only two provinces which allow allocation to surplus of a portion of the consideration for no-par shares in some special circumstances.[39] The Saskatchewan Act provides that with respect to no-par shares the capital of the company shall be "an amount at least equal to the aggregate amount of the price or consideration paid to the company on or such of those shares as are issued, together with such amounts as may from time to time be transferred to such capital by ordinary resolution, and the memorandum shall state that the capital shall be so computed."[40] The provision in the British Columbia statute is identical.[41]

In sum, the Canadian Acts do not use the expression "stated capital" in their present companies Acts. On the other hand it is still used in the American statutes.

The Model Act defines[42] and uses the expression "stated capital" which may be thus expressed mathematically:

Stated Capital = (a) the aggregate par value of all the issued par shares;

+ (b) the aggregate amount of consideration for all issued no-par shares less that part of it allocated to 'capital surplus' as permitted by the law;

+ (c) any other amounts transferred to stated capital whether upon the issue of a share dividend or otherwise; and

— (d) all reductions as have been effected in a manner permitted by law.

Item (c) deals with transfers to stated capital from the surpluses. It contemplates capitalization not only by way of share dividends[43] but even without the issue of shares as dividend.[44]

The Uniform Act does not use the expression "stated capital", but employs the old ambiguous phrase "capital stock".[45] It defines the 'capital' of a company as "the portion of its assets acquired as consideration for shares allotted and that portion of its assets which has been treated as payment for shares allotted as stock dividends."[46] It defines 'capital stock'[47] as the sum of "[a] the aggregate amount of the par value of all allotted shares having a par value, including such shares allotted as stock dividends, and (b) the aggregate of the cash, and the value of any consideration other than cash, determined as provided in this Act, agreed to be given or rendered as payment for all allotted shares having no par value, plus such amounts as may have been transferred from surplus upon the allotment of stock dividends in shares having no par value." If any part of the consideration for no-par shares is allocated to surplus, the Act requires that the amount "shall be shown on the books of the corporation as a separate item designated 'paid-in surplus'."[48] It may be noted that the Uniform Act gives different connotation to 'capital' and 'capital stock'.

The New York and California statutes define and use the expression 'stated capital'.[49] The Delaware Law does not use the expression "stated capital" or "capital stock", but provides for the "Determination of the amount of capital" and simply uses the term "capital".[50]

It must be evident that the "share capital" or "stated capital" is a mere numerical figure unlike the assets which are property. There is no problem of "valuation" of share capital or stated capital, whereas assets present complex problems of valuation. The stated or share capital denotes one of the sources (viz. the shareholders) from which the corporation derived a part of its cash or other property in exchange for its shares, but does not indicate the total amount of consideration received by it, as part of the consideration might have been treated as surplus for purposes of accounting.

The paid-up capital and surpluses are usually shown in the balance-sheet as a liability of the corporation along with its debts, though a corporation is in no sense a debtor to capital. Uncalled or unpaid capital is not shown as an asset or liability in Anglo-American accountancy practice, though it is in continental practice.[51] The Canada Corporations Act expressly declares that uncalled share capital, or calls made but not paid, are not "accounts receivable."[52]

C. Debt and Equity.

The expression "loan capital" or "debt" refers to amounts which the company has borrowed on a short or long term basis. The distinction between share capital and loan capital is very much blurred because of the modern law's recognition of "redeemable" shares, "irredeemable

debentures," "income bonds," and other securities partaking of some of the characteristics of both, but yet the differences are important. Loan capital or debt is in the strict sense a liability of the company and the holders of debt-securities are its creditors.

The figure set out as "liabilities" in the balance-sheet does not generally include the contingent or prospective liabilities, or liabilities which are unascertained or sounding only in damages, except perhaps by way of a footnote: e.g., the potential liability of the company as a guarantor, any liability that may arise out of a litigation against the company. Lease transactions are also not reported in the balance-sheet as obligations to creditors, except by way of foot-notes, though the rentals are recurring obligations of the company to the lessors.[53] This may in part contribute to the growing popularity of lease financing in recent times.[54]

It should therefore be noted that the term "debt" is narrower than the expression "liabilities," and that the balance-sheet presents only the debts of the corporation and not all its liabilities. Besides the balance-sheet groups under liabilities the paid-up capital and surpluses which are not truly the liabilities of the corporation.

The term "equity" is also used in a wide variety of senses. It may mean the assets of the corporation after payment of its debts. These belong to the shareholders and are referred to as the owners' equity. Common and preferred shares are called equity capital as distinct from debts or loan capital. The English Act uses the term "equity share capital" to mean "issued share capital excluding any part thereof which, neither as respects dividends nor as respects capital, carries any right

to participate beyond a specified amount in a distribution."[55] The Indian Act uses it to denote ordinary or common share capital. Because of these differing connotations of the term, we shall avoid its use as far as possible.[56]

D (a). The Balance Sheet Relations.

The balance sheet portrays the "total assets" of the corporation at a given time and balances it against its "debts," "paid-up share capital or stated capital" and "surpluses." We may express these in the following mathematical equations:

$$\text{Total Assets} = \text{Total Debts} + \left\{\begin{matrix}\text{Share/ Stated} \\ \text{capital (paid-up)}\end{matrix}\right\} + \text{Surplus}$$

$$\text{Total Assets} - \text{Total Debts} = \text{Net Assets}$$

$$\text{Net Assets} - \text{Stated Capital} = \text{Surplus}$$

$$\text{Surplus} = \text{Earned Surplus} + \text{Unearned or Capital Surplus}$$

For brevity we may write these together thus:

$$\text{Assets} = \text{Debts} + \underbrace{\text{Stated Capital} + \text{Earned Surplus} + \text{Capital Surplus}}_{\text{Net Assets}}$$

It should be emphasised that though a corporation derives its assets (i) by receipts from its shareholders as consideration for shares allotted to them, (ii) by receipts from its creditors, (iii) from earnings and other gains, (iv) from other sources, it does not keep its assets in water-tight compartments so as to preserve the identity of the sources out of which they were acquired. Assets from all sources form one mass. The balance-sheet does not classify assets on the basis of their origin, but on the basis of their liquidity.

D (b). Accountancy Terminology of the American Corporation Statutes.

Unlike the corporation statutes of the rest of the common-law world, the American statutes have the singular distinction of employing accountancy terminology in formulating their financial rules. They define "assets", "net assets", "capital surplus" and "earned surplus" and use them in laying down the law of dividend, reduction of capital, etc. We shall briefly notice here the accountancy terminology of the Model Act and the Uniform Act in particular.

UNIFORM ACT: We have seen above the Uniform Act's definition of "asset", "capital" and "capital stock". The Act does not specifically define "net assets", "earned surplus" or "capital surplus". But it contains detailed accounting rules as well as rules for computation of the fund available for the payment of dividends.[57]

MODEL ACT:[58] The Model Act defines "net assets", "surplus", "capital surplus" and "earned surplus", but does not define "asset". It lays down no guidelines for the valuation of assets and authorises the directors to rely on the book value of the assets of the corporation.[59] We shall state these definitions of the Model Act in the form of the following equations:

Net Assets[60] = Total Assets (not defined) excluding Treasury Shares[61] — Total Debts (not defined)

Net Assets — Stated Capital (defined[62]) = Surplus

Surplus — Earned Surplus (defined[63]) = Capital Surplus

All surplus, other than earned surplus as defined, is categorized as 'capital surplus'.

NEW YORK: The New York Business Corporation Law defines "net assets" as "the amount by which the total assets exceed the total liabilities."[64] Two variations from the Model Act are apparent in this definition: (i) the word used is "liabilities" and not "debts", but the definition takes care to explain that "[s]tated capital and surplus are not liabilities." (ii) Treasury shares are not excluded from total assets.[65] "Surplus" and "capital surplus" are defined in the same way as in the Model Act, but "earned surplus" is defined somewhat differently which we shall notice in detail in a later chapter on dividends.[66]

Many American statutes of today use these accountancy terms. Some have attempted to improve upon or refine the definitions of the Model Act with a view to remedying the likely discrepancy between the book value of assets and their market value. It is not here proposed to examine these variations,[67] but references to some of them will be made in our future discussion of specific problems in the law of corporation finance.

PART 2 : THE RAISING OF CAPITAL

CHAPTER 5

THE CAPITALIZATION OF CORPORATIONS

When we speak of the "capitalization" of a corporation, we mean the structure of its financing and hence the sources of its assets. These sources are usually the contributions of the shareholders towards the shares issued to them, borrowings and retained earnings. The principal concerns of this chapter are the adequacy of capitalization, the implications of equity and debt financing, and the use of shares without par value.

It is an elementary proposition that the sounder the capitalization of a corporation, the sounder it is as an economic enterprise and the safer it is for those who deal with it. No one would dispute that without adequate capital the chances of successful operation of a business are remote. The method of financing the company is no less important. Top-heavy debt-financing with a low substratum of equity capital may deprive the company of leverage and lead it to disaster. But prudent debt financing could be of great benefit to the company. Again, the structure or shape of the assets is equally important. If all the resources of a company are locked up in fixed assets, it will soon find itself without working capital and face the risk of commercial or equitable insolvency.

Unfortunately this is not an area in which the law could prescribe formulae for sound business financing. Nor can it remain indifferent to the dangers of unsound financing of corporate enterprises which it has

blessed with limited liability. This chapter examines the legal attitudes to adequate and proper capitalization in the various jurisdictions.

A. THE PROBLEM OF INADEQUATE CAPITALIZATION

Inadequate capitalization is a hazard to creditors and a danger to the enterprise itself. One would therefore expect that the law would play a regulatory role of great importance in this area and ensure that a corporation raises capital reasonably adequate for the purpose for which it has been incorporated.

The English Limited Liability Bill of 1855 did, as we have seen, originally envisage that companies should have a minimum capital of £20,000, that each share should have a minimum par value of £25, and that at least three-fourths of the nominal capital should be subscribed and that at least one-fifth of the par value of each share should be paid up before final registration of the company was granted.[1] All these were intended as safeguards against the creation of "mere gambling bubbles." When the Bill was enacted, the minimum capital requirement was abandoned and the minimum par value for shares was reduced to £10, but the provisions regarding subscribed and paid-up capital were retained. As the Act required that the deed of settlement should be executed by at least twenty five subscribers, this meant that every company should have a minimum subscribed share capital of £250 and a minimum paid up capital of £50. But the Act of 1856, which was the triumph of laissez faire, abandoned the requirements of minimum par value and minimum payment for subscribed shares; it also reduced the minimum number of subscribers

from 25 to 7. Until the amending Act of 1900 there was no statutory restriction on the allotment of shares or commencement of business. This led to the mischief of companies proceeding to make allotment of their shares upon wholly inadequate subscription merely for the purpose of recovering the preliminary expenses incurred by the promoters. To put an end to this mischief, the Amending Act of 1900 imposed restrictions on allotment of shares and commencement of business.

The Act of 1900[2] imposed restrictions on allotment "of any share capital offered to the public for subscription" and on commencement of business or exercise of borrowing powers.[3] However, the Act, which introduced the concept of "minimum subscription", did not prescribe the basis on which the amount of the minimum subscription was to be fixed and left it to the discretion of the promoters of companies. The practice grew up of fixing it arbitrarily as the subscription of seven shares — which had in any case to be subscribed as the memorandum had to have seven signatories, each of whom had to subscribe for at least a single share — thus defeating the purpose of the statute.[4]

The Companies Act of 1929 put an end to this evasion by specifically describing the items which should be included in fixing the amount of minimum subscription. It was not to be an arbitrary figure. The present Companies Act re-enacts these requirements. A public company having a share capital which invites the public to subscribe for its shares must specify in its prospectus particulars as to[5]

"(a) the minimum amount which, in the opinion of the directors, [67]
must be raised by the issue of those shares in order to pro-

vide the sums, or, if any part thereof is to be defrayed in any other manner, the balance of the sums, required to be provided in respect of each of the following matters:-

(i) the purchase price of any property purchased or to be purchased which is to be defrayed in whole or in part out of the proceeds of the issue;

(ii) any preliminary expenses payable by the company, and any commission so payable to any person in consideration of his agreeing to subscribe for, or of his procuring or agreeing to procure subscriptions for, any shares in the company;

(iii) the payment of any moneys borrowed by the company in respect of any of the foregoing matters;

(iv) working capital; and

(b) the amount to be provided in respect of the matters aforesaid otherwise than out of the proceeds of the issue and the sources out of which those amounts are to be provided."

Such a company should not allot its shares unless within 40 days after the first issue of the prospectus, the amount of minimum subscription (i.e., the minimum amount required to meet the above items of expenditure) thus stated in the prospectus "has been subscribed, and the sum payable on application [which should be not less than 5% of the nominal amount of the shares] for the amount so stated has been paid to and received by the company."[7]

The following observations may be made on the English provisions:

(i) The minimum-subscription restriction as to allotment of shares

applies only to "share capital of a company offered to the public for subscription" and only to the first allotment of shares offered to the public for subscription.

(ii) An allotment in contravention of the restriction is not void, but is only irregular and voidable at the instance of the allottee within the time prescribed by the Act.[8]

Again, such a company may not commence business or exercise borrowing powers unless shares held subject to the payment of the whole amount thereof in cash have been allotted to an amount not less in the whole than the amount of minimum subscription and a certificate entitling the company to commence business — called the trading certificate — has been obtained from the registrar as provided by the Act.[9] Contravention of this restriction is punishable by fine for each day during which it continues.

It should be noted that these restrictions on allotment of shares and commencement of business or exercise of borrowing powers do not apply to private companies. They could therefore be avoided by first registering a private company and then converting it into a public company. In the case of public companies not inviting the public to subscribe for their shares, the Act does not require any minimum subscription, though such companies have to file a statement in lieu of prospectus and obtain a trading certificate as provided by the Act.

In sum, the English law does not require a minimum capital except in the case of public companies inviting the public to subscribe for their shares and even in that exceptional case the requirement can be easily avoided.

The American corporation statutes often prescribe an arbitrary amount to be received by a corporation for the issuance of its shares before it may transact business or incur debts. Such minimum paid-up capital requirement varies from jurisdiction to jurisdiction, but none sets it higher than $1,000. Some do not require any minimum subscribed or paid-up capital (e.g., California, New York, Pennsylvania) and some leave it to be fixed by the charter.

The Uniform Act contemplated that a corporation should have a minimum amount of paid-in capital "in cash or other property taken at a fair valuation" before it may proceed to "incur any debts or begin the transaction of any business, except such as is incidental to its organization or to the obtaining of subscriptions to or the payment for its shares."[10] It required that a corporation should before commencing business or incurring debts have the minimum capital fully paid-in and that the board should file with the appropriate recording authority an affidavit vouching such payment. Contravention of these requirements rendered the "officers who participated therein and the directors, except those who dissented therefrom and caused their dissent to be filed at the time in the registered office of the corporation, or who, being absent, so filed their dissent upon learning of the action," severally liable for the debts and obligations of the corporation arising from transactions carried out in such contravention.

The Model Act enjoins that "A corporation shall not transact any business or incur any indebtedness, except such as shall be incidental to its organization or to obtaining subscriptions to or payment for its shares,

until there has been paid-in for the issuance of shares consideration for the value of at least one thousand dollars."[11] However, the liability of the directors for contravention is much lighter than under the Uniform Act. If the restriction is contravened, the directors who assented to such contravention are "jointly and severally liable to the corporation for such part of one thousand dollars as shall not have been received before commencing business", but such liability is terminated when "the corporation has actually received one thousand dollars as consideration for the issuance of shares."[12] The Model Act does not provide for public filing of an affidavit of compliance with the minimum capital requirement or for a trading certificate. It does not impose any fine on the directors even for wilful contravention of the restriction.

In short, the minimum capital requirement, if there is one, in the American statutes is arbitrary and unrelated to the objects or scope of the corporation. Moreover, it is ineffective. Recognizing this, it has now been proposed to eliminate this requirement from the Model Act.[13]

The American courts have attempted to make good the legislative failure to safeguard against the launching of inadequately capitalised corporations. In Automotriz Del Golfo De California S.A. de C.V. v. Resnick[14] (hereinafter referred to as the Automotriz case) the California Supreme Court disregarded the juristic personality of the corporation and held personally liable individuals who carried on business in its name without making any attempt to provide it with adequate capital for its business. A Mexican corporation brought action against Resnick and

two others (Cowan and Cowan) to recover the price of automobiles sold to the California corporation of which the three were directors and officers. The California corporation had never issued shares or applied for a permit to issue shares, thus escaping the clutches of the California Commissioner of Corporations, but transacted automobile business of a volume ranging between $100,000 to $150,000 a month. The funds required to operate the business were "advanced" by two of the directors (the Cowans) who thus assumed the posture of creditors of the corporation. The business became bankrupt and the Mexican vendors sought to hold the three individuals personally liable.

The court held that the failure to issue any stock or to apply for permission to do so and the creation and operation of a corporation with little or no capital, as well as the manner in which the business was conducted, warranted the disregarding of the corporate veil and the finding that the defendants were doing business as individuals.[15] The court quoted with approval the following passage from BALLANTINE ON CORPORATIONS:[16]

> "If a corporation is organized and carries on business without substantial capital in such a way that the corporation is likely to have no sufficient assets available to meet its debts, it is inequitable that shareholders should set up such a flimsy organization to escape personal liability. The attempt to do corporate business without providing any sufficient basis of financial responsibility to creditors is an abuse of the separate entity and will be ineffectual to exempt the shareholders from corporate

debts. It is coming to be recognized as the policy of the law that shareholders should in good faith put at the risk of the business unincumbered capital reasonably adequate for its prospective liabilities. If the capital is illusory or trifling compared with the business to be done and the risks of loss, this is a ground for denying the separate entity privilege."

Equitable and just as this approach is, it must be admitted that it amounts to judicial imposition of an adequate-capital requirement as a pre-condition for the granting of limited liability to shareholders where the legislature has not chosen to do so. In the absence of legislative initiative, the judicial rule is some safeguard for corporate creditors, but is not entirely satisfactory. American courts have shown readiness to disregard the corporate veil when it is abused as a cloak for fraud or illegality.[17] It is, however, difficult to say whether the principle underlying the Automotriz case would apply to a statute modelled on the Model Act which limits the liability of directors to the unpaid amount of minimum paid-up capital prescribed by the Act.

No Canadian jurisdiction prescribes a minimum subscribed or paid-up capital. In many of them a company can commence business upon incorporation and incur debts without any restriction whatever. The Dominion, Ontario, Alberta, New Brunswick, Prince Edward Island, Manitoba, and Nova Scotia statutes belong to this category. British Columbia and Saskatchewan follow the English model.[18]

Until the amendments of 1964, Quebec forbade a company to "commence its operations or incur any liability before ten per cent of

its authorised capital has been subscribed and paid for."[19] Contravention of this restriction rendered the directors personally liable for the liabilities of the company incurred thereby. If the company had no-par value shares, then the letters-patent had to set out the amount of capital with which the company would carry on business and this amount had to be $5 or multiples thereof for each no-par share, the total being not less than $500. Such companies were forbidden to commence business or incur debts until the amount had been fully paid.[20] These and other restrictive provisions were repealed in 1964 and the present Quebec Law is in accord with the Ontario and Dominion statutes in this respect.[21]

The securities laws in the United States and Canada make good this deficiency to some extent. We have seen that the California Securities Law empowers the Commissioner to refuse a permit on the ground that the proposed plan of business of the corporation or the proposed issuance of securities is not "fair, just and equitable." The Ontario Securities Commission is authorised to reject a prospectus if the proceeds from the issue together with the other resources of the company "are insufficient to accomplish the purpose of the issue stated in the prospectus." But it should be recalled that the O.S.C. has no jurisdiction over "Securities of a private company issued by the private company if the securities are not offered for sale to the public."

APPRAISAL

The Jenkins Committee observed that "Although we would favour in principle a statutory minimum paid up capital we have reluctantly come

to the conclusion that its purpose would be too easy to evade and we cannot, therefore, recommend it."[22] Some witnesses expressed the view before the Committee that under-capitalization is a major cause of business failures[23] and that a statutory minimum paid-up capital in cash would to some extent remedy this situation. Other witnesses argued that while such a provision would be desirable in principle, yet it would be relatively easy to evade as "it would be difficult, if not impossible, to prevent a company once formed with a statutory minimum of cash, from returning the cash to the promoters either in exchange for assets, such as goodwill, or by way of loan, or in some other way."[24]

If the conclusion of the Jenkins Committee were sound, it would follow that the requirement of minimum subscription in the case of public companies which invite the public to subscribe for their shares is equally an exercise in futility and should be scrapped. It is respectfully submitted that if a principle is sound, every effort should be made to overcome the difficulties in the way of its implementation.

As undercapitalization is a hazard to creditors as well as the enterprise itself, the law should devise measures which aim at the raising by companies of a minimum of capital which is not arbitrary but is adequate for the purposes for which the company has been incorporated. A minimum paid-up capital requirement of a $1,000 or less, as the American statutes prescribe, is not wholly satisfactory, but the remedy is not to eliminate it[25] or require another arbitrary amount.[26] The remedy is to impose upon the promoters the duty to fix and specify in the memorandum the amount which they in good faith and after due inquiry

believe that the corporation would need to carry on its objects set out in its constitutional document.

In the opinion of the writer all limited companies should be required to specify in their charter the minimum amount of capital which should be raised and which, in the opinion of the promoters, would be adequate to enable the company to pursue the purposes for which it is to be incorporated.[27] Personal liability should be imposed on the promoters and directors if the company becomes insolvent within one year of its commencement of business, if inadequate capitalization is one of the principal reasons for the company's failure. It should be immaterial whether the minimum capital is raised in cash or other property so long as the company has received assets of equivalent value.

B. EQUITY CAPITAL AND LOAN CAPITAL

Does the law regulate in any way the character of a company's capitalization? If not, should it do so? More specifically, should the law require that a company raise any part of its capital by the issue of shares or that there be any proportion between share capital and loan capital?

Almost all the jurisdictions afford nearly complete freedom to companies to determine their mode of capitalization. The English Acts require the charter to specify nothing more than the amount of authorised nominal capital and its division into shares of fixed amounts. The American and Canadian statutes require more details about the capitalization to be given in the charter.

But neither the English nor the Canadian Federal Acts require that any part of the authorised capital need be issued except for a single share for each of the subscribers to the memorandum or applicants for the letters patent as the case may be. There is no statutory obligation in the English or Canadian jurisdictions that any part of the capital requirement should be raised by the issue of shares; a company may do so by issuing debentures or borrowing otherwise.

The American jurisdictions on the other hand often prescribe, as we have seen, a minimum paid-up capital, ranging between $200 to $1,000, as a condition precedent to commencement of business or incurring of debts. For example, the Model Act requires the charter of every company to contain a statement that the corporation will not commence business "until consideration of the value of at least one thousand dollars has been received by the issuance of shares"[28] and forbids a company to transact any business or incur any indebtedness (except such as shall be incidental to its organization or to obtaining subscriptions to or payment for its shares), "until there has been paid in for the issuance of shares consideration of the value of at least one thousand dollars." In these jurisdictions, therefore, the prescribed minimum capital should be raised by the issue of shares, and not otherwise. In contrast, in English law a private company need have only two subscribed shares and a public company seven; and in Canada any company need have only three subscribed shares; and the par value of the shares can be as low as the company pleases. It should be recalled that important American jurisdictions, such as New York, California and Pennsylvania, do not, unlike

the Model Act and like the English and Canadian statutes, require a minimum paid-up share capital.

We have seen that American courts have shown readiness to treat inadequate capitalization as a factor warranting the disregard of the corporate entity and holding the individuals behind the corporate cloak personally liable as if they were members of a partnership enterprise.[29] In the Automotriz case,[30] discussed earlier, the California corporation never issued shares, but carried on substantial business with the funds "advanced" by two of its three directors. The California Supreme Court found it appropriate to disregard the corporate veil and hold the three directors personally liable.

Cases such as these are instances in which a handful of entrepreneurs set up a corporate framework to carry on a business, but attempt to take advantage of the non-requirement by the law of a minimum share capital. They seek to assume the posture of creditors of the corporate entity, and as such entitled to claims against it, and not investors in the corporate equity whose investment would be liable for the corporate debts. The American courts have rightly thwarted such ingenious attempts to reap the profits of the business without risk.

A landmark decision reflecting the willingness of American courts to look warily at thin capitalization is the well-known decision of the United States Supreme Court in Taylor v. Standard Gas Co.[31] in which the Court laid down the so called "Deep Rock doctrine." The facts, very much simplified, may be stated as follows: The Deep Rock Oil Corporation (a Delaware corporation) was a subsidiary of the Standard Gas & Electric

Company which owned its entire voting stock. Its affairs were grossly mismanaged through many years by the holding company and in course of time the subsidiary became indebted to the holding company in an enormous sum. The subsidiary became bankrupt and in a reorganization proceeding, the Supreme Court held that no scheme of reorganization ought to be approved unless the shares to be awarded to the holding company were subordinated to those awarded to the preferred shareholders of the bankrupt subsidiary, thereby giving them a preferential position over the holding company in the assets of the reorganized subsidiary, and unless the preferred shareholders were given at least an equal voice in the management of the reorganized subsidiary. The subsidiary was from the outset "insufficiently capitalized, was top heavy with debt and was in parlous financial condition" and the holding company "so managed its affairs as always to have a stranglehold upon it."[32] The stranglehold was employed for the benefit of the holding company in utter disregard for the welfare of the subsidiary and its hapless preference shareholders. The United States Supreme Court held that "by . . . section [77B of the Federal Bankruptcy Act], the court, in approving a plan, was authorised and required, as a court of equity, to recognize the rights and the status of the preferred stockholders arising out of [the holding company's] wrongful and injurious conduct in the management of [the subsidiary's] affairs."[33] In the reorganization of the subsidiary the Court was of the view that "Equity requires the award to preferred stockholders of a superior position in the reorganized company."[34]

There is also a tax reason for the resort to debt-capitalization rather than equity-capitalization. Interest paid by the company on advances or loans are deductible as expense for income-tax purposes, but not dividends paid to shareholders. The tax savings resulting from the debt-structure are substantial. And equally substantial is the loss of tax revenue to the government. To combat this problem, the United States Treasury Department has contended that "funds loaned by a sole or majority stockholder or by all stockholders proportionately to an under-capitalized corporation are in effect stock and should be treated as such for tax purposes"[35] — that is, the so called "interest" paid for the purported "advances" should not be deductible by the corporation and that it is in fact dividend paid to the stockholder.

The difficult question in all these cases is whether the garb of creditor worn by one supplying funds to a corporation is genuine, and the underlying transaction a genuine lending transaction, or whether it is a camouflage designed for purposes of escaping tax liability or defeating the claims of others who may deal with the corporation. The answer to this will of course depend upon the facts and circumstances of each case.

Debt-financing has its advantages and disadvantages. The interest paid on the debt is deductible as an expense for determining the income-tax liability of the company and results in tax-saving for the company. Equity-financing does not afford this advantage. There are tax advantages to the investor in loan-capital compared to one investing in equity-capital, as in the former case he will not be taxed on the return of his principal

by the company, whereas a company cannot ordinarily return equity-capital and every payment made by the company will be a dividend taxable as income to him.[36] Another advantage of debt-financing is that the debt-securities seldom carry voting-rights which leaves the control in the hands of the existing voting shareholders. But this advantage may also be gained by issuing non-voting shares, usually preference shares. Besides, though debt-securities may not be able to vote at the company's meetings, yet the indenture creating the debt may, and often do, impose severe restraints on the corporate management and activities and confer considerable powers of intervention upon the indenture trustee. This may be a greater restraint than the voting rights conferred on shares. The advantage that debt securities do not carry voting rights may not therefore in practice mean very much. Another disadvantage of debt-financing is that usually debts have a fixed maturity for repayment of the principal and the interest on them is payable whether the company is earning a profit or suffering a loss. Failure to pay the interest or principal on time may lead to the winding up of the company. Shares are on the other hand eligible for a dividend only if profits are made and dividends are declared. A company can of course issue income bonds on which interest is payable only if the company has an income or profit.

Companies should therefore be afforded the freedom to weigh these advantages and disadvantages and choose the method of financing best suited for their needs and circumstances. Indeed all financing decisions involve the making of business judgments under conditions which are both uncertain and complex, but their objective is "to ensure the use of the

optimum volume and combination of resources in order to maximize the creation of economic value by an enterprise."[37] In other words the goal of financial decisions is to achieve an optimal financial structure which would maximize the market value of a company and minimize its cost of capital.[38] The goal is more easily stated than implemented by a correct decision because the variables and imponderables are too many to permit the formulation of simple and infallible decisions. As Professor Ezra Solomon observes,[39]

> "A unique 'correct' solution for the entire set of financing decisions probably exists but our understanding of the parameters of the very large number of inter-relationships involved is still too small to permit the formulation of a truly general solution which has operational meaning. In any case, such a solution has not been put forward in the literature thus far . . . ."

The decision whether a company should resort to equity financing, or debt financing, or plough back its earnings will therefore have to depend upon the cost of the capital in each case. But that cost can be measured only on the basis of estimates which are themselves subject to "unmeasurable degrees of [economic and political] uncertainty" in the "real world."[40]

It is of course prudent for lawyers not to rush in where even the economists fear to tread. But neither can escape completely the necessity of facing the problem. Businessmen have to make these decisions and take the risk of unsound judgment. The science of economics seeks rational steps to arrive at sound judgments. But both the businessman and the economist look at the question mainly from the point of view of minimization of the cost of capital. But the lawyer's concern is

much wider. He is concerned with the resulting intra-corporate structures and hierarchies and their fairness; he is concerned with their impact on the public interest, including the tax revenues, and on those who deal with the enterprise entity in business transactions. With goals more pragmatic and tools perhaps less scientific, he is often compelled to resort to rough and ready techniques. The requirement of a minimum paid up capital found in the American statutes is an example of this arbitrary technique. Arbitrary though it may be, it is not necessarily absurd. It is possible to think of other alternatives. The law can require that the proportion of equity financing to debt financing should be at least in the ratio of the working capital to the amount of minimum subscription. We have advocated that the English concept of minimum subscription deserves to be extended to all limited companies and that concept includes working capital. Or the law may prescribe an arbitrary ratio between equity and debt capital. Surely the law should not be left helpless against the creation of companies such as the Automotriz corporation of California.

C. NO-PAR VALUE SHARES

No-par shares are generally unknown outside the United States and Canada. In Britain and most of the Commonwealth countries companies are given the freedom to fix a par value, but a par value they must have, however low it may be. Most continental countries on the other hand prescribe a minimum par value. Most American jurisdictions permit no-par as well as par value common and preferred shares. All Canadian jurisdictions permit no-par common shares, but many of them

do not permit no-par preference shares having a preference as to capital or no-par shares subject to redemption or purchase for cancellation.

In this section we shall examine whether there are reasons why no-par shares are more desirable than par value shares.

It will be shown in a later chapter that the no-par device does not always afford immunity from watered-stock liability.[41] We shall not here discuss the merits or defects of the no-par stock device in the context of stock-watering.

The no-par stock device has strong supporters even outside the American continent. Professor Gower has taken the stand that no-par shares should be not merely optional, but made compulsory and the sole kind of shares permitted by the law.[42] He argues that (i) it is undesirable to permit companies to have par and no-par shares at the same time and that (ii) between these two kinds of shares "clearly no-par is more logical and infinitely the more simple."[43] His reasons for the first are:

> "[I]t is only by making them compulsory that simplicity and comprehensibility can be achieved. If both par and no-par exist side-by-side investors will have to learn to understand both and confusion is likely to become worse confounded. The legislation will have to deal with both and will itself become more complicated still. Companies will issue par-shares or no-par shares according to what suits <u>them</u> best and those who want to mislead will continue to do so. I therefore incline to the view that a legal system should either allow par shares or no-par but not both."

Levy has also expressed the view that a jurisdiction should permit either par value shares or no-par value shares, but not both.[44] The writer is of the same opinion, but not for the reasons given by Gower. No jurisdiction in the United States or Canada has made no-par shares mandatory or exclusive, and there is little evidence to suggest the prevalence of investors' confusion or statutory drafting problems. The writer is of the opinion that basically different philosophies underlie the two concepts of shares — as will be shown later in this section — and for that reason a jurisdiction should choose between them and not permit both.

Gower's suggestion of mandatory no-par shares is not confined to common shares, but applies to all kinds of shares including shares liable to redemption or purchase for cancellation.[45] The Gedge Committee which recommended the introduction of no-par shares in England was of the opinion that no-par common shares should alone be authorised and that too on an optional basis.[46] Gower gives the following reason for his view that no-par shares are more logical than par value shares:[47]

> "[To encourage investment in companies by a wider range of people], [t]he first thing to do is to help them understand what a share is. And what it is is an aliquot part or share in a business the value of which fluctuates with the value of the business. All this would be simple enough but for the fact that, for purely historical reasons, we insist that some fixed value $1, $10, £1, should be attached to it. This value may not represent its true worth or price even at the date of its issue, for it may be, and

> often is, issued at a premium. It is highly unlikely to represent its value later on. If the company has done well it will be worth more; if the company has done badly it will be worth less. Its value, and its price on the market, may vary from nothing to infinity. But we go on calling it a ten-dollar or £1 share. Can we wonder that the unsophisticated investor thinks that he has a bargain if he buys a $10 share for $6 and that he has been done if it costs him $15? Moreover, this arbitrary and quite unnecessary par value causes particular confusion in schemes of arrangement and capital reduction. And then it is not only unsophisticated investors who have had the wool pulled over their eyes. Judges have too!"

In other words, par value is deceptive, arbitrary, meaningless, and unnecessary. Gower, as a one-man Commission on Ghanian Company Law revision,[48] embodied his views in a draft Companies Code which he prepared for Ghana.[49]

The argument that par value is deceptive and misleading has long been advanced by those who have advocated its abolition. Professor Victor Morawetz, one of the chief sponsors of the pioneering New York no-par statute of 1912, commended the policy of that statute on the ground that[50]

> "[i]t recognizes that shares in a corporation represent only aliquot interests in its capital, whatever that may be, and that their nominal or par value is no indication of their actual value or of the actual capital of the corporation. It requires the amount of the actual capital of a corporation formed under the law to be

> stated in the certificate of incorporation, and imposes a severe penalty upon the directors in case of the creation of indebtedness before receiving the prescribed capital. Thus it furnishes to the creditors and to the public generally a measure of protection greater than that furnished by the generally prevailing incorporation laws."

It should be noted that the modern no-par statutes no longer require that the entire stated capital as specified in the charter must be raised before a corporation may incur indebtedness. Thus the protection to creditors that Morawetz was speaking of — and the kind that exists in the Continent even though no-par shares are not permitted — does not now exist in any of the no-par jurisdictions of the United States or Canada. All that has happened is that instead of a nominal <u>amount</u> of authorised share capital, the modern no-par statutes permit a nominal <u>number</u> of authorised no-par shares to be specified in the charter.

It is therefore hardly convincing to be told that the nominal number of authorised no-par shares is any more real and illuminating, or any less illusory and deceptive, than the nominal amount of authorised capital. It would seem to be a mere exaggeration to contend, as Gower and the other protagonists of no-par shares before him have done, that the nominal par value is misleading for the unsophisticated investor. Referring to the criticism that the "dollar sign [of par value shares]. . . lulls the investor into a sense of security and self-satisfaction"[51] Dewing, who himself generally favours no-par shares, observes: "I hardly think the dollar sign is as deceptive as these writers seem to imply."[52]

The main function of the nominal par value is to fix the minimum value of the consideration which the company should receive for the allotment of the shares concerned and to fix the amount of liability of the allottee of the share to contribute to the company's capital in response to calls made on him when the company is a going concern and as a contributory in the event of winding up. In this sense the nominal par value is anything but deceptive. But the law has quite often been ineffective in enforcing this main function of the par value. Thus, for example, the law has been ineffective in preventing stock-watering by allotment of shares for over-valued non-cash consideration. Again the par value is not deceptive when used as the yard-stick for measuring the right to dividend or voting.

Par value is certainly deceptive if an investor would mistake it to be the worth of the share. It is doubtful whether an average modern investor is so naive. The willingness of a modern investor to pay a premium of $99 or even $999 for a share of a nominal par value of $1 is ample evidence that he is not labouring under the misconception that the true worth of the share he is buying is just a dollar.

Whether the share has a par value or has no par value, anyone who intends investing in the shares or contemplates giving credit to the company will not, if he has elementary business sense, rely on the nominal value of the shares, but will want to satisfy himself about the company's earning potential and prospects, its credit record, the worth of its assets, and the competence and integrity of its management. If a company allots its shares for over-valued consideration, the creditor

or investor will suffer in the same way if he had relied on the company's valuation of its assets, whether or not the shares allotted have a par value. There is nothing in the presence or absence of a par value in such cases to help or harm him, to illumine or deceive him. Of course the argument of the protagonists of no-par shares is that they would eliminate the need or temptation to over-value non-cash consideration, but it is doubtful whether this hope is warranted by actual experience.

The par value may indeed serve a useful role in the case of a prospective investor. If he is called upon to pay a premium, he is not likely to do so without convincing himself that the premium is well worth paying. If the shares are offered at a discount, he has at least the intimation that all has not been going too well with the company. The absence of a par value may not ex facie give him any indication as to whether the company is prospering or struggling for survival. Of course the supporters of the no-par device argue that the absence of a par value will compel the investor to make a more careful investigation of the company's position and prospects. But the no-par stock may help a company to conceal its business set-backs except from the inquiring eyes of the sophisticated investor. The absence of a par value may sometimes be no less deceptive than the presence of one.

The par value is an indication, even if only as a useless historical fact, of the minimum value of the consideration which a company originally received, or at least ought to have received, for the issuance of its shares.

It is submitted that the choice between par value and no-par shares is in fact a choice between whether the legal system should require companies to set out in their charter the minimum price for the issuance of each unit of their capital or leave them free to determine the price from time to time at their pleasure. Many Continental systems statutorily prescribe such minima; the English system affords companies the freedom to fix a minimum themselves in their charter; the no-par system dispenses with the need to fix any minimum. This choice is indeed a choice between different degrees of laissez faire or enablingism.

No-par shares can be issued at any price the company may deem fit from time to time. Sometimes the statutes require a stated value to be specified in the charter above which they cannot be issued unless the charter is amended and in these cases the stated value operates as the maximum price. Many modern no-par statutes do not require a stated value to be specified in the charter. In the case of par value shares the par value operates as the minimum price below which the shares cannot ordinarily be issued. A company whose par value shares have a market value below par will not be able to raise additional capital by the issue of additional shares at par and if it cannot issue its shares at a discount, it will be forced to borrow to meet its additional requirements or be tempted to circumvent the restriction by inflating the value of the consideration received for their issuance. If the shares do not on the other hand have a par value, it is argued that it need not resort to borrowing or stock-watering, but it can issue the shares at any suitable price in its discretion. Professor Morawetz advanced this argument in support

of the New York no-par statute of 1912.[53] This justification for the no-par share device is not wholly convincing as the same result could be achieved by a statute authorising the issue of par value shares at a discount by a company in the special case where (i) its shares have a market value below par, (ii) the company is in genuine need of further capital and (iii) there are reasonable prospects for its financial recovery if such further capital could be raised. The English Acts have for long had a provision for such contingency with the safety devices of shareholder and court approval.[54] If the policy behind the prohibition of the issue of par value shares at a discount, except in special circumstances is sound, then it would seem irrational for the same statute to permit the issue of another group of shares at any price the company deems fit without any restriction, check or control over the exercise of that discretion. It is a contradiction in legislative policy to forbid a company to issue one group of shares below a fixed minimum price and to permit another group of shares to be issued at any price from a cent upwards. It is therefore submitted that, as suggested by Gower and Levy, a jurisdiction should choose to permit only par value shares (as the English, Indian, most Commonwealth, and Continental jurisdictions do) or only no-par shares (as Gower's Ghanian Company Code does), but not both (as the American and Canadian jurisdictions do). As observed earlier, the choice is really one between requiring and not requiring companies to set a minimum price for the issue of their shares. As the writer has suggested that companies should be required to specify in their charter the minimum capital that they would need to go into business,

it is really immaterial, if that suggestion is accepted, whether the par or no-par device is chosen for structuring the corporate capital.

In any case it would be a mistake to suppose that the no-par device has any extraordinary merits which cannot be attained by the employment of the par value device.[55] Both have their merits and defects and both can be made deceptive. As it was remarked half a century ago, "[s]o long as the struggle for wealth, power and commercial supremacy persists, it is too much to hope that mere legislative fiat can effectively prevent chicanery, deception and fraud; and so with respect to [par value and no-par] stock . . ., no human ingenuity can, by any device, successfully prevent exploitation by unscrupulous promoters of unworthy and unmeritorious enterprises."[56] The writers of these words were, however, of the opinion that "legislation which permits the issuance of stock having no par value is a step forward in the direction of business morality, if for no other reason than that it promotes the expression of the truth."[57] It is difficult for the writer to see how the expression of no-par value is the same as the expression of the "truth" — the true value — or how it by itself enhances the prospect for business morality or honesty.[58] The real protection for investors is a vigilant financial press and a responsible profession of investment dealers and counsellors. The unsophisticated investor will not be protected by only removing the par value for shares.

In the opinion of the writer no-par shares should be made mandatory in the case of closely-held corporations. This will facilitate the use of the capital structure to allocate control among the participants

in any way they desire without regard to their contribution to the corporate capital. In the case of publicly-held companies, they may be afforded the choice to have either no-par shares or par value shares, but not both. This should apply equally to preference shares as well as common shares, whether or not they are liable to redemption or purchase for cancellation.

CHAPTER 6

EQUITY CAPITAL : COMMON AND PREFERRED SHARES

We have seen that the company statutes of most jurisdictions give almost unfettered freedom to companies to fix the amount and character of their capital. In this section we shall notice the freedom afforded to companies to classify their shares and attach different rights to different groups of them and to vary or abrogate these class rights.

A. FREEDOM TO CLASSIFY SHARE CAPITAL

Historically speaking, the practice of dividing share capital into different classes has long been in vogue in England and preference shares were used as a method for raising additional capital for unfinished railroads. Even in the middle of the sixteenth century there are instances of English companies issuing preference shares.[1] In the United States the vast majority of corporations had only one class of shares down to 1880 and division of shares into more than one class was resorted to only in exceptional circumstances such as a financial crisis or a feud among shareholders or other necessity which compelled discrimination among shareholders. It was during the half century from 1883 to 1933 that the division of shares into two or more classes became more common in America. American corporations resort to a variety of debt-financing devices rather than issuing a variety of classes of shares, but

the English practice is the reverse.

English companies enjoy complete freedom to divide their shares into as many and as varied classes as they please. The classification and the class-rights need not be spelled out in the memorandum, but a company may do so if it so prefers. If the memorandum spells them out, they are less easily alterable than if they are attached to the shares by or in pursuance of the articles of association, as we shall notice later.[2] Nor is it necessary that the authority to classify should be contained in the memorandum; it is enough if the articles do so. Even if the articles do not, they can be altered at any time to confer such power on the company. In Andrews v. Gas Meter Co.[3] neither the memorandum nor the articles of the company as originally framed authorised the company to issue shares with any preferential or other special rights. In 1865 the company altered its articles to give itself the power and then issued noncumulative preference shares carrying a preferential right to dividend at 5% per annum. As late as 1896 the validity of the issue of these preference shares was questioned before the courts, surprisingly by the preference shareholders. The company had been prosperous and had a large amount of undistributed earnings. The preference shareholders who were eager for a share in the accumulated profits claimed that "the company had no power to create a preference between different classes of shares, and that consequently the preference shareholders were entitled to rank as ordinary shareholders." The ordinary shareholders of course were understandably anxious to uphold the validity of the issue of the preference shares entitled to no more than the 5% preferential dividend.

At the trial, Kekewich, J., held that the creation of the preference shares was ultra vires and that their holders did not, therefore, have the status or rights of shareholders, whether preference or ordinary.[4] After this frightful turn of fortune, the preference shareholders abandoned their claim on appeal to the status of ordinary shareholders, but were anxious to establish their claim to be preferential shareholders entitled to a preferential dividend at 5%.

Reversing the trial court, the Court of Appeal upheld the issue of the preference shares and the alteration of the articles for the purpose.[5] The freedom of English companies to issue, subject only to their memoranda of association, preference shares was firmly established by the decision of the Court of Appeal in Andrews v. Gas Meter Co. An English company may issue preferred and other special shares acting in pursuance of the authority conferred on it by its memorandum of association or articles of association, as originally framed or as subsequently amended. English companies have issued a wide variety of classes of shares — preference shares carrying dividend-preference, asset-preference in winding up, cumulative or noncumulative preferential rights, participating or nonparticipating rights; different classes of ordinary shares; and deferred (or management or founders') shares. Since the Act of 1929 the preferred shares may also be issued as redeemable, if authorised by the company's articles, out of profits or out of the proceeds of a fresh issue of shares.[6] Indeed the theoretical possibilities for classification of shares "is limited by only the total number of shares,"[7] and "a company is entitled to issue shares conferring any rights it thinks fit,

and it only has to express its intention for this to be carried out."[8]

American corporation statutes afford almost equal facility and freedom for classification of shares, except that the charter has to set out the number of shares of each class, their par value (if any), the designation of each class, a statement of the preferences, limitations and relative rights in respect of the shares of each class; and if the shares of any preferred or special class is to be issued in series, then the designation of each series and a statement of the variations in the relative rights and preferences as between series insofar as the same are to be fixed in the charter, and a statement of any authority to be vested in the board of directors to establish series and fix and determine the variations in the relative rights and preferences as between series.[9] On the other hand, it is not necessary in the case of an English company to set forth all these details in the memorandum or even articles of association, and they may be specified in any other document (e.g. a prospectus) under which they are issued.

The Canada Act requires that an application for letters patent should specify the classes into which the authorised capital is to be divided and the number of shares of each class,[10] and

> "where there are to be two or more classes of shares, the preferences, rights, conditions, restrictions, limitations or prohibitions, if any, attaching to each class of shares; and if any class of shares that is to have attached thereto preferred rights as to dividend is to be issued in series . . . , either

(i) the designations, rights, restrictions, conditions and limitations, attaching to the first series of such class, and a statement that the directors are authorised to fix from time to time before issuance the designation, rights, restrictions, conditions and limitations attaching to the shares of each subsequent series of such class, or

(ii) a statement that the directors are authorised to fix from time to time before issuance the designation, rights, restrictions, conditions and limitations attaching to the shares of each series of such class."

Accordingly, the Act provides that the letters patent and supplementary letters patent of a company may authorise "shares of more than one class and for any preferred, deferred or other special rights, restrictions, conditions or limitations attaching to any class of shares," "the issuing of preferred shares with par value subject to redemption or purchase for cancellation [subject to prescribed conditions]," and if any class of shares is to have preferred rights as to dividend, for their issuance in series.[11]

But unlike the English or American jurisdictions, the Canada Act and the present Indian Act impose some restrictions on the classification of shares.

The Canada Act enjoins that "In no case shall the shares of a company of any class . . . be issued or allotted with voting rights in such a way as to attach to any other class or classes of shares the exclusive right to control the management of the company by the election or re-

moval of the board of directors or otherwise."[12] But this does not forbid a company to issue, if authorised by its letters patent or supplementary letters patent, preferred shares carrying preferential voting right exercisable in a stated event only, even if in that stated event the preferred shares would thereby have an exclusive right to control or manage the company.[13]

The Indian Act forbids the issue of deferred shares or the classification of common shares by public companies. All shares which are not preference shares are designated "equity shares" and the Act forbids discrimination among equity shares in any respect — voting rights, dividends, return of capital in a winding up, and others. Statutory voting right at general meetings is conferred on cumulative and non-cumulative preference shares in specified cases, viz. on all matters directly affecting the rights attached to them and in cases of default in payment of dividends for a prescribed length of time. The equity shares have voting rights on all matters placed before the general meetings at all times. Disproportionate voting right is also forbidden. Preference shares have to carry preferential right both to dividend and to repayment of capital in winding up, though these rights may or may not be cumulative or participating.

To sum up, all jurisdictions permit classification of shares with greater or lesser freedom, but none prescribes to what extent if any, the issued share capital of a company should consist of common shares.

Why should we afford freedom to companies to classify their share capital and issue shares carrying different rights in respect of dividends, voting, repayment in winding up, etc.? We have seen that down to 1880 a vast majority of American companies managed to exist with just one class of shares carrying uniform rights in every respect. What are the reasons for the subsequent popularity for the classification of shares and discrimination among them in respect of their rights?

One reason for classification of shares is to make them attractive for different kinds of investors. Preferred shares with a limited dividend is likely to appeal to those investors who would rather be contented with a lesser return than face a higher risk inherent in common shares. Cumulative and participating rights are added attractions for investment in preferred shares. Common shares which contribute the risk capital usually carry exclusive voting rights and the opportunity for substantial return on the investment if the company is successful.

A company which has not been a financial success and whose shares are therefore selling at a discount may, if it wants to raise additional capital in the hope of improving its fortunes, have to offer incentives and attractions in order to find buyers for its new shares. That shares could not be issued at a discount was one of the main reasons why companies resorted to the issue of preferred shares carrying preferential right to dividends and capital in winding up as a means to raising much needed additional capital. If shares cannot be issued in different classes and with different rights, such companies will be obliged to resort to debt-financing with all its adverse consequences.

Yet another reason for classification of shares is to retain control in the hands of the existing shareholders while raising additional capital by issuing the new shares with no or restricted voting rights but with preferential right to dividend and assets. Thus it became possible to retain control in the hands of a small amount of common capital by denying voting rights to the holders of huge amounts of preference capital.[14]

Classification of shares was also found to be a useful technique in corporate reorganizations. In the reorganization of embarrassed companies, it was found often possible to persuade creditors to accept noncumulative preference shares in the reorganized enterprise in lieu of their claims. The creditors who were thus offered a choice between getting nothing in a forced liquidation and accepting the preference shares in the hope of better days for the corporation naturally opted for the latter.[15]

It is therefore evident that there are circumstances and justifications warranting classification of shares. This being conceded, we should at once recognize the need for protecting the class-rights from unjust infringement by those having control over the company's management.

B. HOW SECURE ARE CLASS-RIGHTS? THE PLIGHT OF THE PREFERENCE SHAREHOLDERS.

We have seen that companies enjoy great measure of freedom in dividing their shares into different classes and attaching preferential or other special rights or disabilities to them. Indeed the permutations and combinations of preferential or special rights that a company may attach

to a class of shares are infinite. These preferential rights of varying degrees are offered as inducements to prospective investors. How secure are these rights? Are they inviolable or are they only illusory? Does the law ensure that the expectations created by them in a holder are not frustrated by the ingenuity or selfishness of others or taken away or abridged without his consent? We shall investigate this question in respect of the various jurisdictions in the following pages. We are not, however, examining here the canons of construction adopted by the courts to determine the rights attached to a class where the documents in pursuance of which the shares have been issued do not unambiguously express the rights attached to them and the court is called upon to interpret the ambiguous terms. These have grown in a way least beneficial to special classes of shares. For example, the early English view was that the special rights of a class were in addition to the general rights enjoyed equally by all shares save insofar as the latter have not been expressly excluded[16] — the doctrine of prima facie equality of shares. The modern view is that the expressed special rights are prima facie exhaustive and exclude general rights.[17] The fluctuating fortunes of the preference shareholders in this respect are not traced here.[18] We assume that the special rights are clearly and unambiguously attached to a class of shares and examine how far these rights are secure from violation without the individual assent of a particular shareholder.

1. The English Position

As a general rule the alterability of the preferential or special rights of a class of shares will depend upon whether the rights are

attached to the class by the memorandum of association or by or in pursuance of the articles. If the rights are set out in the memorandum, they cannot be varied or abrogated[19] except to the extent provided in the memorandum itself.[20] An example of this exception is Underwood v. London Music Hall, Ltd.[21] The memorandum of the company authorised 6,000 7% cumulative preference shares of £5 par each and an equal number of ordinary shares of the same par value. The entire capital was issued and outstanding. The company desired to increase its capital. The memorandum provided that "any increased capital of the company may . . . have any special privilege or advantage, or may be deferred, and may be issued on such special conditions as to priority or postponement, either for dividends or repayment of principal, or as to voting power, and generally in such terms as the company may from time to time determine." The board resolved to place before the general meeting a resolution to increase the capital of the company by the creation of 4,000 additional preference shares ranking pari passu with the existing preference shares and an equal number of additional ordinary shares. One of the directors who held preference shares brought action for a declaration that "it was ultra vires for the company to increase its authorised capital by creating preference shares ranking in priority to or pari passu with" the existing preference shares. Upholding the creation of the preference shares, the court observed that the existing preference shares "are subjected, by the memorandum itself, to the risk of having increased capital placed in front of or along-side them."[22]

If the special class rights are attached by or in pursuance of the articles, the position is fundamentally different from attaching them by the memorandum. The articles are freely alterable at any time by special resolution unlike the memorandum which is unalterable except to the extent expressly permitted by the company statute. The question therefore confronted the courts whether the special class-rights attached by the articles could be subsequently altered or abrogated by amending the articles as permitted by the company statute. The early unwillingness of the courts to permit the use of the statutory power to alter the articles to vary or abrogate class rights of outstanding shares can be witnessed by Hutton v. Scarborough Cliff Hotel Co. (No. 2),[23] decided in 1865. The memorandum of the company specified the authorised capital to be £120,000 divided into 12,000 of £10 each. Of these only 5,717 shares were subscribed for and allotted. The company passed a special resolution at an extra-ordinary general meeting authorising the directors to issue the unsubscribed for shares with a right to 7% preferential dividend. The plaintiff shareholders objected to the issue of the shares with preferential right. The Vice Chancellor and on appeal Lord Chancellor Wrestbury held that the company could not issue the unsubscribed for shares as preference shares, but left open the question whether the company could alter its articles as provided by the statute[24] so as to give itself the power to issue preference shares. Having lost the first round of the battle, the company exercised the power contained in its articles to increase its capital and issue the shares as preference shares. Vice Chancellor Kindersley held that the power conferred by the Act upon companies to alter their articles applied

only to such by-laws which related to their "management" and that it could not be exercised so as to "alter the very constitution and the nature of the company." In other words the general power conferred by the Act to alter by-laws was yet not unlimited in scope. To vary the rights of shares by altering the articles is to vary the very constitution of the company, for "the intention of all parties to the original contract [contained in the memorandum] was, that the shareholders should stand pari passu in respect of dividends" and so the creation of the preference shares was a breach of that contract. According to the Vice Chancellor, there is an implied stipulation, in the absence of contrary provisions in the memorandum, that all shareholders stood on equal footing as to the receipt of dividends and it is a breach of contract to create shares with unequal dividend rights in the absence of original authorisation in the memorandum.

This approach is based on the logic that the rights of a shareholder are contractual in nature and that they cannot be modified or abrogated without the consent of the individual shareholder in the absence of a stipulation authorising it in that contract or explicit statutory authorisation of such unilateral change.[25]

This philosophy of the inviolability of the contractual special or preferential rights without the specific consent of the individual shareholder gave place before long to the logic that these rights were inherently susceptible to the possibility of variation or abrogation as prescribed by the governing statute without the specific assent of an individual shareholder. In British and American Corporation v. Couper[26] Lord Macnaghten

expressed his dissent from the decision in Hutton v. Scarborough Cliff Hotel Co. (No. 2) and in another couple of years it was over-ruled by the Court of Appeal in Andrews V. Gas Meter Co.[27] discussed earlier.

(a) Variation or Abrogation of Special Rights By Amendment of Articles

Under the English Act the articles are alterable at any time by a special resolution and the altered or added by-law is as valid as if it were one of the original by-laws of the company.[28] As preference shares are quite often denied voting rights, the question arises whether the articles can be altered at the instance of the voting shares so as to vary or abrogate the special rights of a class of nonvoting shares, or whether the special rights are inviolable without the individual or collective assent of the holders of such shares. The English Act does not afford us a direct answer to this question as it has no provision expressly conferring mandatory voting rights either to vote on all resolutions placed before the general meeting which directly affect their special rights or to vote at a class meeting on such resolutions.[29] As the articles are freely alterable by special resolution passed by voting shares, it is possible to argue that class rights attached by or in pursuance of the articles are always subject to the statutory power of the company to alter its articles in any way, such alteration being as effective as if it were originally contained in the by-laws of the company. If this view were correct, the special rights of a nonvoting class of shares are liable to alteration without the consent of their holders and are at the mercy of the voting shares. They cannot be heard to complain because "it is by contract that they are

excluded [from voting] — it is part of the bargain with them. They were content to take their shares subject to the regulations of the company, although they knew that those regulations might be altered by the votes of the persons whose votes they could not influence . . . by taking part in the voting themselves."[30] The only remedy of the unfortunate class shareholder would be to persuade the court to intervene to protect him by establishing that the conduct of the controlling shareholders is fraudulent or oppressive.[31]

On the other hand Professor Gower advocates the view that class rights cannot be altered except with the consent of the individual shareholder, unless the articles provide expressly for their alteration by the assent of a prescribed majority of shareholders of the class — that is, a "majority clause." According to this view the contractual rights of a shareholder cannot unilaterally be varied by the company in the absence of express provisions in the articles empowering the company to do so.[32] But this raises the further question whether a "majority clause" could be introduced in the articles by their amendment to enable the company to vary the class rights of outstanding shares issued before the majority clause was inserted.[33] Even if this is possible, Gower's view has the merit that it would, if correct, afford greater measure of protection for class rights. For according to his view (i) class rights can be varied only in accordance with a majority approval as provided for by the majority clause[34] and (ii) even if a majority thus assents, a minority of 15% or more of the issued shares of that class who did not consent to or vote in favour have judicial recourse for their protection as provided

by section 72 of the English Act.[35] Gower therefore concludes that in English law

> "class rights enjoy a considerable measure of protection and are removed from the power of the majority even if they are able to force through a special resolution. If set out in the memorandum the rights cannot be varied or abrogated under section 23; if set out in the articles they can only be varied or abrogated with the consent of a majority of the class in accordance with a majority clause to that effect in the articles and, even then, 15 per cent of the holders can apply to the court under section 72 to disallow the variation."[36]

Though a mechanical interpretation of the English Act would perhaps support the first view, it is submitted that Gower's view is sounder and it is desirable to provide for statutory class voting right whenever the rights of a class are sought to be varied or abrogated. Regulation 4 of Table A should be enacted as a section in the body of the Act which, together with section 72, would then be a valuable safeguard for class rights. Even if, under the law as it is, class assent is necessary as suggested by Gower, companies are still free to fix the required majority in the articles as they please and nothing prevents the company fixing it at a simple majority of the votes cast.

Protection of class rights is also weakened due to the failure of the English Act to tackle the problem specifically. As we have seen it fails to provide expressly for mandatory class voting right and the result is that the existence of the right is left to inference. Even if the articles

contain a majority clause in cases of variation or abrogation of class rights, we have no guidance from the statute to determine when there is such a variation or abrogation. And the courts have by restrictive interpretation of the words "abrogate or vary" narrowed the scope of even the existing protection for class rights. Greenhalgh v. Arderne Cinemas, Ltd.,[37] is a recent example of such restrictive judicial interpretation. There the court held that the voting right of a class was not "abrogated or varied" even though it was adversely "affected" to such a degree as to be rendered worthless. The plaintiff had come to the rescue of a private company in financial distress only to find himself subsequently in difficulties. The capital of the private company incorporated in 1936 consisted of 26,295 outstanding ordinary shares and 4,705 unissued ordinary shares, each of a par value of 10s.[38] The plaintiff was persuaded to advance money to the cinema company to pay off its debts upon the company agreeing to give him a controlling interest in the share capital. This was done by the company issuing to him the unissued shares subdividing them into 2s. shares with the same voting right as the existing 10s. shares. Within a few weeks of this arrangement in 1941, the plaintiff's relationship with the company and its directors became strained, resulting in chancery suits of which the present case was the latest. The company resolved in 1943 by a narrow majority to split each of its outstanding 10s. shares into five 2s. shares carrying equal voting and other rights along with the 2s. shares issued to the plaintiff in 1941. The result of this stock split was that "the votes carried by the 1941 2s. ordinary shares would be completely swamped by the very much larger

number of votes carried by the 1943 2s. ordinary shares."

The articles of the private cinema company gave class voting rights whenever the rights attached to a class were to be "varied." The plaintiff claimed that the proposed stock-split of 1943 fell within this by-law so as to give him class-voting right. Vaisey, J., as well as the judges of the Court of Appeal, was willing to regard the 2s. shares issued to the plaintiff in 1941 as a "class"[39] different and distinct from the 10s. shares, though both were "ordinary"shares, but held that the stock-split of 1943 did not "vary" the voting rights of the 1941 2s. shares even though it "most materially affected" those rights. He accepted the contention of the company that "you do not vary the rights of a class of shares by the operations effected upon other classes of shares." The plaintiff was therefore not entitled to class voting right under the majority clause of the articles. The court had sympathy for him, but no help to offer; he should have taken better legal advice. The 1941 2s. shares did not take away the company's right to subdivide the 10s. shares, thus increase their voting rights fivefold and upset the voting equilibrium between the two classes of shares. The Court of Appeal unanimously affirmed. In the result, what cannot be done directly, e.g. reducing the voting right of the 2s. shares, can be achieved indirectly, e.g. by increasing the votes of other shares. One is reminded of the old story in which a person was asked to make a line shorter without erasing any part of it and, wise as he was, he achieved the end by drawing a longer line next to it! The court drew a line between directly "varied" and indirectly "affected" (however substantially) and excluded

the applicability of the majority clause.

Of course the majority clause may, deliberately or unwisely, confer class voting right more widely to include cases where class rights are not only "varied" but are just "affected." In White v. Bristol Aeroplane Co., Ltd.,[40] (hereinafter referred to as the Bristol Aeroplane case) and in In re John Smith's Tadcaster Brewery Co., Ltd.,[41] (hereinafter referred to as the Tadcaster Brewery case) the articles of the companies provided that "All or any of the rights or privileges attached to any class of shares forming part of the capital for the time being of the company may be affected, modified, varied, dealt with, or abrogated in any manner with the sanction of an extraordinary resolution passed at a separate meeting of the members of that class." Such an article would seem to enlarge the scope of class voting right, but the Court of Appeal restricted its scope by drawing a distinction between a case where what is affected is "the rights themselves" and where it is merely the "enjoyment of the rights" and holding that the class right given by such a by-law applied only if the former was affected and not where only the latter was affected.

In White v. Bristol Aeroplane Co., Ltd., the company which had an issued capital consisting of £600,000 5% cumulative preference stock of £1 each and £3,300,000 ordinary stock, proposed to increase its capital by capitalising its profits and distributing to the ordinary shareholders new preference shares of a value of £660,000 of the same par value as and ranking pari passu with the existing preference shares.[42] Thus the new preference stock to be created would outnumber the existing

preference stock and be held by the common shareholders, giving the latter a majority in any class meeting of the preference shareholders. The existing preference shareholders objected to such increase of capital and claimed that they were entitled to vote as a class on the resolution under the majority clause referred to earlier which gave them class voting right whenever their class rights were "affected . . . in any manner." Reversing Danckwerts, J., who had upheld the objections of the preference shareholders, the Court of Appeal preferred to give a restricted meaning to the word "affected" and held that in this case the substance of the rights of the preference shareholder was not affected, but only their enjoyment. Evershed, M.R., remarked that "there is to my mind a distinction, and a sensible distinction, between an affecting of the rights and an affecting of the enjoyment of the rights, or of the stockholders' capacity to turn them into account . . . ."[43]

The same principle was applied in the Tadcaster Brewery case when the company proposed to increase its capital by capitalizing its profits and issuing new common shares to its existing ordinary shareholders. This would not affect the position of the preference shareholders in a class meeting as in the Bristol Aeroplane case. But as the articles conferred voting right on the preference shares at general meetings whenever dividends were in arrears and in respect of certain resolutions such as for winding up and reduction of share capital, the new ordinary shares would have the effect of substantially augmenting the majority of the ordinary shareholders. The Court of Appeal, reversing Danckwerts, J., held that the preference shareholders were not entitled to vote under

the majority clause as a class on the resolution to increase the share capital by the issue of share-dividends.

The dilemma of the courts in these cases is obvious. The word "affect" is of a very wide ambit and, if given a liberal interpretation, would cover any act or transaction of the company which may in any way touch or affect the value of any of the privileges attached to a class of shares and consequently they would be able to exercise a right of veto over almost every act or transaction of the company. To adopt such a liberal interpretation would run "counter to the ordinary conception of the relationship between preference and ordinary shareholders in a company . . . ."[44] But the courts have drawn such subtle distinctions in construing verbose majority clauses in such a way that class voting may become unavailable even in cases where the legitimate expectations of a class of shareholders are being frustrated without their consent. If they are not entitled to vote as a class, nor are they entitled to the protection of section 72 of the English Act which empowers the court to disallow a variation or abrogation which would unfairly affect the class. The aggrieved class shareholder will then be left with the only remedy of attacking it on the ground that it is a fraud on or oppression of the minority, but the onus will be so heavy upon him that his chances of persuading the court to intervene will be very slender indeed.

These cases demonstrate the need (i) for statutorily conferring class voting rights and (ii) for spelling out in the statute the specific instances in which alone such class voting right may be exercised. As we shall see the American Model Act does both and sets a good example to follow.

(b) Variation or Abrogation of Class Rights in A Reduction of Share Capital.

Another common instance of affecting special class rights is found in corporate reduction of share capital. The subject is discussed in detail in a later chapter and we shall deal with it only briefly here to indicate the hazards faced by preference shareholders in these cases. Reduction of share capital may affect preference shareholders in a variety of ways. (1) When the company is prosperous, it may be advantageous to return the preference capital if the amount is in excess of the company's needs or can be raised more cheaply from other sources. If this could be done without the consent of the individual preference shareholder, (i) he may be deprived of a good investment opportunity which has been giving him an attractive return and an equally attractive alternative investment opportunity may be hard to find; and (ii) the company may be able to pay off his investment at par at a time when his shares may have a market value above par. (2) When the company is running at a loss, preference capital may be reduced by writing off losses to it, thus affecting their preferential right to dividend and their asset-preference in the event of winding up. It is therefore obvious that a company's decision to reduce its capital and the mode of doing so are matters of concern to the preference shareholder. We shall therefore examine what, if any, are the legal safeguards available for his protection.

First, should an English company obtain the assent of its preference shareholders as a class to a proposed reduction which affects their special rights? The English Act provides for reduction of share capital

in any way by the company passing a special resolution and obtaining judicial confirmation thereof as provided,[45] but does not speak of resolution at a class meeting where the proposed reduction would affect the substance of the special class rights of shares. Class conflicts are inevitable where the rights of one class can be adversely affected without its assent at the instance of another class of shares. In In re Mackenzie & Co., Ltd.,[46] the company which had an issued share capital of £ 137,560 consisting of 5,300 preference shares (entitled to 4% cumulative preferential dividend, but no asset-preference in liquidation) and 1,578 ordinary shares, each of a par value of £20, proposed to reduce its capital by cancelling £5 paid up on each share as having been lost and by returning £3 paid up on each such share as being in excess of the company's needs. The articles provided that the "special rights, privileges and advantages attached to any class of shares" might be "altered or modified, dealt with, or affected, in any manner whatsoever" only with "the sanction in writing of the holders of two-thirds of the issued shares of that class." The company resolved to reduce its share capital without obtaining the sanction of the preference shareholders and the question arose whether such sanction was necessary to effect the reduction. Astbury, J., held that the sanction of the preference shareholders need not be obtained in the circumstances. Presumably he was of the opinion that their right to preferential dividend was not "altered or modified, dealt with, or affected, in any manner whatsoever" by the reduction of share capital. Presumably his lordship was not bothered by the result of the reduction, viz., that "under this reduction the Ordinary

shareholders gave up nothing, whereas the Preference shareholders sacrificed a large fraction of their annual dividend for the benefit of the Ordinary shareholders."[47] In re Mackenzie & Co., Ltd., was referred to by Lord Greene, M.R., in support of his decision in the Greenhalgh case (discussed earlier) and was described as the "founding authority in cases of this sort" by Evershed, M.R., in the Bristol Aeroplane case in which he used it in aid of his interpretation of the word "affected."[48]

It would seem to follow that the question whether in a reduction of share capital different classes of shareholders are entitled to vote or assent as a class will depend upon the wording of the modification of rights clause of the articles construed in the light of the Mackenzie & Co., Greenhalgh, Bristol Aeroplane, and Tadcaster cases discussed above.

In addition to the protection of a modification of rights clause of the articles, the preference shareholders or a minority of them have available, at least in theory, two further safeguards. (i) If the majority prescribed by the modification of rights clause assents to a reduction involving a variation or abrogation of their rights, a nonassenting minority holding at least 15% of the issued shares of the class may apply to the court under section 72 of the Act. The court can disallow the variation or abrogation if it is satisfied that it would unfairly prejudice the holders of the shares of that class.[49] Thus judicial recourse is available to an objecting minority. (ii) Even if class voting is not available, there is the over-all protection in the requirement of judicial confirmation of every resolution for reduction of share capital.

The judicial role and attitude in reduction cases is therefore highly relevant in assessing the legal protection of class rights under the English system. English courts have, however, been traditionally unwilling to interfere in the internal affairs of companies except where fraud or oppression is shown.[50] The courts have also thrown the burden of establishing fraud or unfairness upon those who impugn the action of the company or the majority of the class. The objecting shareholders have often been unsuccessful in discharging this burden. We may refer here to a few cases illustrative of the English judicial attitude.

In re Welsbach Incandescent Gas Light Co.,[51] decided by the Court of Appeal in 1903, is a striking illustration. The memorandum of the company divided the authorised capital into (i) preference shares with fixed 5% per annum cumulative preferential dividend and with asset-preference in winding-up, (ii) ordinary shares and (iii) deferred shares, but authorised the modification of class rights as provided by the articles. The articles conferred class voting right on resolutions to modify class rights. The company which had lost a considerable part of its capital sought to reduce its share capital accordingly by writing off the amount paid up on each class of shares and also proposed to alter its capital structure. Under the new capital structure, there were to be only two classes of shares, preferred and common. Over one-third of the existing preferred capital was to be converted into common shares; all the deferred capital was also to be converted into common shares. The United States Debenture Corporation which held preferred shares opposed the company's petition for confirmation of the reduction of share capital on

the ground that the scheme was unfair, inequitable and confiscatory as it compelled that corporation to accept common shares for part of the preference shares held by it and deprived it of arrears of accrued cumulative preferential dividend. But a large majority of the preference shareholders assented to the alteration of their class rights. The Court of Appeal, affirming Buckley, J., overruled the objection of the United States Debenture Corporation and sanctioned the company's scheme. According to Vaughan Williams, L.J., "after all these modifications might have been brought about and have bound the preference shareholders, even though there had been no scheme for reduction of capital,"[52] and the fact that a large majority of the preference shareholders had assented to the modification of their rights did show that they regarded it as a fair scheme.

Indeed preference shareholders who objected to a scheme of reduction of share capital which was prejudicial to their special rights have almost invariably met with failure in the English courts. The cases on the subject are discussed at length in a later chapter and it will be noticed there that the courts have seldom sat in judgment over the decision of the majority of the shareholders at a class meeting or a general meeting. In Bannatyne v. Direct Spanish Telegraph Co.[53] the court allowed the company which had suffered a capital loss to write off £5 out of the amount paid up on each of its 6,000 10% cumulative preference shares (carrying preferential right to dividend only but not to assets in winding up) as well as on each of its 13,000 common shares of the same par value, even though the result was to reduce by half the quantum (but not the rate per cent) of the dividend on the preference shares without in

any way affecting the rights of the common shares. In In re Mackenzie & Co.,[54] discussed above, the court held that this could be done by the company without the assent of the preference shareholders even though the articles gave them the right to vote as a class on resolutions which sought to alter, modify, deal with or affect their special rights, privileges and advantages in any manner whatsoever.

Indeed there appears to be no reported or unreported case in which the court has refused to confirm a reduction on the ground of unfairness. Where a majority of a class assents under a modification of rights clause, it would virtually be impossible for the dissenting minority to establish unfairness except where the majority can be shown to be benefitted by the modification in their capacity as holders of shares of other classes in the company or otherwise. In re Old Silkstone Collieries, Ltd.,[55] (hereinafter referred to as the Silkstone Collieries case), decided by the Court of Appeal in 1953, is a rare instance in which the preference shareholders were successful in persuading the court to refuse to confirm a reduction on the ground that their assent at a class meeting had not been obtained as provided by the articles. The decision is particularly striking in view of the failure of the preference shareholders in Scottish Insurance Corporation, Ltd. v. Wilsons & Clyde, Ltd.,[56] and Prudential Assurance Co., Ltd. v. Chatterley-Whitfield Collieries, Ltd.,[57] decided by the House of Lords under similar circumstances. In both these cases, discussed at length in a later chapter, the preference shareholders' objection to a return of their paid up capital by the companies upon their nationalisation in 1946 on the ground that they

were deprived of an investment yielding attractive return was unsuccessful. In the Silkstone Collieries case the colliery company which was nationalised in 1946 had at the time two classes of nonparticipating preference shares besides common shares. The company did not intend to continue its business after the nationalisation like the Chatterley-Whitfield Collieries company, nor did it decide to pay off the preference capital forthwith like the Wilsons & Clyde coal company. It decided to go about its voluntary liquidation gradually mainly with a view to preserving the potential right to compensation of all classes of shares under the nationalisation statute. In 1950 it paid off 50% of the preference capital; then in 1951 another 25%; obtaining on both occasions the class-assent as the repayment was not in strict accordance with their class rights, the first preference shares being entitled to repayment of their capital in priority to all other classes of shares. In 1953 the company sought confirmation by court of a reduction of share capital by paying off the remainder of the preference capital and extinguishing the preference shares, as the directors were now of the view that their rights under the nationalisation statute were in fact of no monetary value. Confirmation of this reduction was opposed by a number of preference stockholders of both classes on the grounds that the proposed reduction was unfair, that their class-assent had not been obtained as required by the articles, and that the directors' circular recommending the third reduction was misleading. Reversing Vaisey, J., the Court of Appeal held that as the class-assent of the preference shareholders had not been obtained as required by the articles, the reduction ought not to be confirmed. The

articles gave class-voting right whenever "the special rights attached to any class" were to be "modified or abrogated." The Court of Appeal held that the effect of the resolutions of 1950 and 1951 for reducing the share capital by repaying 50% and 25% of the preference capital respectively was to create a new special right and that therefore the total elimination of the preference capital without the approval of the preference shareholders was incompetent. The resolutions of 1950 and 1951 stated that notwithstanding the reduction on each occasion, the preference should continue to be entitled to their claims under the nationalisation statute. The court took the view that the incorporation of this statement in the resolutions had the effect of attaching a special right to the preference shares, whatever be the worth or nature of the statutory right under the nationalisation Act, which special right can be varied or abrogated only with their class-assent as provided in the articles.

It must be stressed that in the Silkstone Colliery case presumably the objection was not to the repayment of the preference capital without the class-approval of the preference shareholders under a modification of rights clause in the articles. In the Wilsons & Clyde and Chatterley-Whitfield coal companies cases the preference shares carried equal voting rights with the ordinary shares and the articles did not provide for separate class voting for modification of class rights. The Old Silkstone Colliery company case seems to suggest that share capital can be reduced by returning preference capital without their class-approval, even if the articles contain a modification of rights clause. In that case the court held that the class-approval was necessary under the modification

of rights clause in the company's articles because the court found that a special right had become attached to them, viz. to preserve their existence to enable their holders to make their claims under the nationalisation statute, whatever be their worth. But for this special circumstance, the court would have been obliged to follow the precedents of the House of Lords unless it be that it had found that the majority was acting fraudulently or oppressively. Evershed, M.R., did express the opinion that the scheme of reduction was not fair or equitable and would not be confirmed by the court, as the company had twice represented to the preference shareholders that they would be enabled to make their claims under the nationalisation statute, whatever their worth, and had solicited their support on that footing to the reductions then proposed, and particularly that of the first preference shareholders to a scheme which was not in strict accordance with their first priority to repayment of capital in the winding up of the company.[58] The court did intimate that it would in its discretion refuse to confirm a reduction of capital which is unfair or inequitable to any class of shares, notwithstanding that no special rights of that class would thereby be varied or abrogated and hence their class-approval was not required for effecting the reduction. But there is no case, earlier or subsequent, in which the court declined confirmation of a reduction on the ground that it was unfair or inequitable to a class of shareholders.

(c) Variation or Abrogation of Class Rights in a Recapitalisation or Reorganization of a company under section 206 of the English Act.

Under sections 206 to 208[59] of the English Act the court is empowered to sanction a compromise or arrangement between a company and its shareholders or any class of them, or between a company and its creditors or any class of them, if a three-fourths majority (in value) of the shareholders or class of shareholders, or creditors or class of creditors, present and voting in person or by proxy, agree to the compromise or arrangement. If sanctioned by the court, the arrangement or compromise binds all the shareholders, creditors and the company. The scope of these provisions is very wide and a complete reorganization of a company's share and loan capital can be carried out under them.[60] The "arrangement" includes "a reorganization of the share capital of the company by the consolidation of shares of different classes or by the division of shares into shares of different classes or by both these methods."[61] The provisions are available for the reconstruction or reorganization of a company as well as the amalgamation of two or more companies.[62] They are available for the reconstruction of going concerns as well as the reorganization of companies which are being wound up. The rights of any class of shareholders can be varied in pursuance of them even if the rights are embodied in the memorandum[63] and by it expressly made unalterable. Even the liability of the shareholders in respect of their shares can be increased without their individual consent — which it is impossible to do by an ordinary amendment of the memorandum or articles.[64] Even the rights of debentureholders and other creditors

can be modified without their individual assent.[65]

The Act seeks to protect the creditors and members by the requirement of class-approval. It ensures that full information is given to them about the proposed compromise or arrangement and its effect upon them. The requirement of judicial approval is intended as an overall safeguard to prevent abuse and to protect in particular minority shareholders or creditors who do not assent to a proposed scheme of compromise or arrangement. The courts have been vigilant to satisfy themselves that the company has scrupulously complied with the statutory requirements before sanctioning a scheme of arrangement or compromise.[66] To give a recent example, in Rankin & Blackmore, Ltd.,[67] decided by the Scottish Court of Session in 1950, it was held that meetings held by a private company — which had only eight members in all — to obtain the assent of classes of shareholders to a scheme of arrangement which proposed to convert its outstanding preference shares into ordinary shares and to cancel arrears of dividend amounting to £37,500 which had accrued due on them were irregularly held as no explanatory statements in terms of section 207 of the English Act of 1948 were sent along with the notices summoning the meetings. In other words the court will not treat lightly the requirement designed to ensure that full and proper information is made available to those invited to assent to a scheme of arrangement or compromise.[68]

If the statutory requirements have been duly complied with, what more should the court be satisfied about before sanctioning a scheme of arrangement or compromise? Lord Lindley stated the role of the court thus in

In re Alabama, New Orleans, Texas and Pacific Junction Ry. Co.,[69] (hereinafter cited as the Alabama Ry. case):

> "[W]hat the Court has to do is to see, first of all, that the provisions of [the] statute have been complied with; and, secondly, that the majority has been acting bonâ fide. The Court also has to see that the minority is being overridden by a majority having interests of its own clashing with those of the minority whom they seek to coerce. Further than that, the Court has to look at the scheme and see whether it is one as to which persons acting honestly, and viewing the scheme laid before them in the interests of those whom they represent, take a view which can be reasonably taken by businessmen. The Court must look at the scheme, and see whether the Act has been complied with, whether the majority are acting bonâ fide, and whether they are coercing the minority in order to promote interests adverse to those of the class whom they purport to represent; and then see whether the scheme is a reasonable one or whether there is any reasonable objection to it, or such an objection to it as that any reasonable man might say that he could not approve of it."

A few years later Lindley, L.J., had another opportunity to define the judicial role in In re English, Scottish and Australian Chartered Bank thus:[70]

> ". . . [T]he Court does not simply register the resolution come to by the creditors or shareholders as the case may be. If the creditors are acting on sufficient information and with time to

consider what they are about, and are acting honestly, they are, I apprehend, much better judges of what is to their commercial advantage than the Court can be.[71] I do not say it is conclusive, because there might be some blot in a scheme which had passed that had been unobserved and which was pointed out later.

"While, therefore, I protest that we are not to register their decisions, but to see that they have been properly convened and have been properly consulted, and have considered from a proper point of view, that is, with a view to the interests of the class to which they belong and are empowered to bind, the Court ought to be slow to differ from them. It should do so without hesitation if there is anything wrong; but it ought not to do so, in my judgment, unless something is brought to the attention of the Court to shew that there has been some material oversight or miscarriage."

More recently, Maugham, J., stated in In re Dorman Long & Co., Ltd.,[72] that the duty of the court is (i) to see that the resolutions were passed by the prescribed majority in value and number at a meeting or meetings duly convened and held — upon which depends the jurisdiction of the court to confirm the scheme; and (ii) to see whether the proposal was such that "an intelligent and honest man, a member of the class concerned and acting in respect of his interest, might reasonably approve" — upon which the court exercises its discretionary power to confirm or reject the scheme. That case is a good example of how astute the court is to satisfy itself that a class approval is given with full know-

ledge of all relevant facts which are likely to influence a reasonable man in deciding to accede to or reject a proposed scheme. In that case the scheme involved a drastic alteration of the rights of debenture-holders. The court held that the explanatory circular sent out by the directors "was not sufficient in the particular circumstances of this case, and it was in one respect misleading"[73] and that therefore the scheme should not be confirmed "even if it were made out (and I am not clear that it has been made out) that the requisite majority was obtained at the meeting to which the debenture stockholders were summoned."[74] His lordship stressed the duty of the court to scrutinize the circular very carefully in such cases.[75] It must be noted here that the Companies Acts, including that of 1929, did not impose any obligation on companies to send out any explanatory circulars at all, but many companies did send them, regarding it as a good practice. It is the present English Act which for the first time requires that every notice summoning a meeting to obtain the assent of creditors, or shareholders, or any class of them, for a compromise or arrangement under section 206, should be accompanied by a statement "explaining the effect of the compromise or arrangement and in particular stating any material interests of the directors of the company, whether as directors or as members or as creditors of the company or otherwise, and the effect thereon of the compromise or arrangement, insofar as it is different from the effect on like interests of other persons."[76]

The courts have made no distinction with regard to the criteria for confirmation whether a scheme of arrangement or compromise was

with creditors including debentureholders or with shareholders or any class of them. Nor have they applied a legal test of absolute priority to determine the fairness of a proposed scheme, but have only sought to satisfy themselves that the majority has acted honestly and reasonably in assenting to it. As most of the schemes were to vary the rights of creditors and as the same principles apply to schemes for varying the rights of shareholders, whether or not the company is under winding up, we shall illustrate the English judicial approach by the decision of the Court of Appeal in the Alabama Ry. case.[77] The company sought the sanction of the court to a proposed arrangement or compromise with its creditors under the provisions of the Joint Stock Companies Arrangement Act, 1870.[78] Omitting details, the relevant facts may be thus stated. The company had issued and had outstanding £1,500,000 6% first debentures payable to bearer and repayable in 1907 on which the unpaid interest had accumulated up to 21½%. Under the proposed arrangement their holders were to receive in exchange for every £100 of debenture debt and the 21½% interest accrued thereon, £50 of new first debentures carrying interest at 5% (i.e., 1% less) repayable in 1940 (i.e. 33 years later), £70 of new 5% second debentures also repayable in 1940, and a cash payment of £1.10s. The meeting of the debentureholders called to approve the scheme was attended "by very few people" — 101 persons holding a total of a third of the debentures, of whom 90 persons holding over three-fourths voted for the scheme and the rest against. Of these 11 dissenters, two who held

debentures to an amount of £10,000 each opposed the confirmation by the court of the scheme of arrangement. Of the 90 who voted for the arrangement, some held a considerable amount of shares and some second debentures and as such stood to gain by the scheme which halved the amount of first debentures, reduced their interest by 1% and postponed their repayment by 33 years. Lindley, L.J., observed that this was a circumstance which "would necessarily induce the Court to look with caution and care at the effect of what was done at the meeting."[79] His lordship described the role of the court in confirming such schemes to be "to look at the thing fairly as a whole and consider what there is in the state of this company which renders a scheme necessary at all, and what will be the effect of the scheme upon the first debentureholders, and then see whether it was one which a majority of the first debenture-holders could reasonably consider advantageous to them." These words clearly indicate that his lordship did not regard the role of the court to be one of rubber stamping the majority's decision. Examining the details of the scheme,[80] his lordship concluded that "if you look at it from a commercial point of view, and not from a lawyer's point of view, [the first debentureholders] are in a decidedly better position by this scheme than [they] would be if things were left alone." These words clearly show that he would not adopt an absolute legal standard, but would rather be guided by the consideration whether a reasonable person could in good faith regard the scheme as commercially advantageous to his class as a whole.[81] This is the attitude that has consistently been adopted by the English courts in determining whether or not a proposed scheme

should be confirmed.

This approach is essentially sound, but needs further safeguards to be devised for adequate protection of shareholders and creditors. First, the consent of three-fourths in value of all the creditors or shareholders belonging to the class should be required and not merely the affirmative vote of three-fourths of those present and voting in person or by proxy. This will deny one group the benefit of the apathy of those belonging to another group whose rights are sought to be changed by a proposed scheme. Secondly, companies should be required to seek and obtain independent expert opinion on the merits of a proposed scheme before approaching the shareholders or creditors for their assent.[82] Most shareholders and creditors do not possess expert knowledge in complicated financial matters. Nor is the court possessed of such skills. The readiness of shareholders and creditors to assent to schemes adversely affecting them is evidence of their ignorance, fear and helplessness. If the two safeguards suggested above are provided for, then the decision of the majority should, it is submitted, prevail in the absence of fraud and the minority should not be allowed to insist upon their absolute priority.[83]

(d) Variation or Abrogation of Class Rights by Recapitalisation of a Company Under Section 287 of the English Act

A solvent company may change its capital structure and vary or abrogate class rights by deciding to go into voluntary liquidation after selling the whole or part of its business or property to another company — usually a new company formed for the purpose — in exchange

for shares in the transferee company. Such a sale or transfer, and hence such recapitalization and variation or abrogation of class rights, can be carried out by a special resolution of the company and without the need for judicial confirmation or class-assent under section 287 of the English Act. Such a sale or arrangement is binding on all the members of the company, but any member who did not vote in favour of the resolution is given appraisal right. He is given the right to communicate to the liquidator his dissent in writing within seven days of the passing of the resolution and require him either to abstain from carrying the resolution into effect or to purchase his interest at a price to be determined by agreement or by arbitration in the manner provided by that section. Creditors' rights cannot be affected under the section and they will have to be paid their claim in the voluntary winding up. If an order is made within a year for winding up the company by or subject to the supervision of the court, the special resolution will become invalid unless sanctioned by the court.[84]

In In re Consolidated South Rand Mines Deep, Ltd.,[85] the court intervened at the instance of minority shareholders to prevent an unfair scheme from being carried out under section 161 of the Act of 1862 (now section 287). The facts of the case may be simplified and stated as follows. The Estate Company was the owner of 388,390 out of the 525,000 issued shares of the South Rand company and also owed the latter £62,000. By its majority vote special resolutions were passed to wind up voluntarily the South Rand company and to carry out a scheme to consolidate the South Rand company and the Estate company into a

new company. South Rand company was to be allotted 131,250 10s. fully paid-up shares of the new company, i.e. shares of a nominal value of £65,625. The assets of the South Rand company consisted of liquid assets of £85,915 (including the debt of £62,000 owed it by the Estate company) and 773 mining claims which it had acquired for £425,000. In other words South Rand company was to receive shares of a nominal value of £65,625 for assets worth £487,000. The scheme was supported by the Estate company (which was its author) which held 388,390 out of South Rand company's 525,000 issued shares; of the remaining 136,610 shares, 94,549 voted against it, a mere 5,476 voted in its favour, and 36,585 did not vote. The court held that to allow the scheme of amalgamation to be carried out would be to enable the holder of the majority of shares (the Estate company) "to appropriate, if not the whole, a considerable part of South Rand Company's property" and that to prevent such "positive injustice" to the minority shareholders an order for the compulsory winding-up of the South Rand company should be made.[86] In other words, the court will intervene to prevent an abuse of the statutory provision and will not leave the minority shareholders to the appraisal remedy provided by the section.

The appraisal remedy is often an inadequate and ineffective remedy for the protection of minority shareholders. It should be mentioned that companies have sometimes employed the threat of resorting to voluntary winding up under these provisions in order to induce or compel a class to agree to a variation of their rights under some other method.[87]

If, however, a scheme is fair, the dissenting shareholder will have to be contented with the appraisal remedy. Of course he cannot be compelled to take shares in the new company. But if he refuses to take the new shares, his only alternative is to require the company to buy him out as provided by the Act.[88] In determining fairness once again the courts have tended to uphold majority opinion honestly and reasonably arrived at.

2. The American Approach

We have seen that American statutes generally require that the preferences, limitations and relative rights of different classes of shares should be specified in the charter itself. The effect of stating them is not to make them unalterable as is the case of setting them out in an English memorandum, unless they are expressly made unalterable, for the American charter is amendable very much like the English by-laws. The English articles are freely alterable without judicial confirmation;[89] so are the contents of the American charter. The Model Act, for example, empowers a corporation to amend its charter "in any and as many respects as may be desired, so long as [the charter] as amended contains only such provisions as might be lawfully contained in original [charter] at the time of making such amendment."[90] More specifically it authorises that "if a change in shares or rights of shareholders, or an exchange, or reclassification or cancellation of shares or rights of shareholders is to be made," the charter may be amended to include "such provisions as may be necessary to effect such change, exchange, reclassification or cancellation." Not content with the enunciation of such

a general power of charter amendment, the Act proceeds to spell out in detail all the permissible changes. In short the scope for amendment of an American charter under such a statute is no less than the scope for the alteration of the English by-laws.

In contrast, the early nineteenth century American corporation statutes were stringent in permitting charter amendments and they seldom made provision for charter amendments to effect variation of class rights. The Delaware Act of 1899 contained only a general provision for amending charters and only in 1917 it specifically authorised amendments to vary preferential or other class rights.[91] Indeed such amendments seem to have been rare prior to 1920. It may also be recalled that down to 1880 the vast majority of American corporations had only one class of shares.[92]

As the judicial attitude of the State courts toward corporate recapitalizations involving variation of shareholder-rights and of the Federal courts toward corporate reorganizations under the Federal statutes is fundamentally different,[93] we have to consider the two separately. We shall first consider the state law and then the federal law. We shall find that often the State-court decisions closely accord with the English pattern which we have examined, but the federal courts have firmly adopted a standard of absolute priority.

(a) In The State Jurisdictions

Early American decisions intimate that the courts were far from enthusiastic to permit the variation or abrogation of class rights without the consent of the individual shareholder, even though a large majority of his class assented to the change, and the courts resorted to the doctrine

of vested right and constitutional arguments in justification of such conclusion. But the modern trend is to uphold the majority decision as binding on the minority in the absence of fraud. We shall trace this change of attitude briefly.

When the State legislatures amended their general incorporation statutes to authorise corporations to vary class-rights by altering their charters, the courts held that such power could not be availed of by a corporation whose charter was issued under the Act when it did not permit such charter amendments. To reach this result they resorted to the aid of the well-known Dartmouth College case[94] decided by the United States Supreme Court in 1819. Dartmouth College was a private corporation created by a charter granted by the British Crown in 1769 and the question arose whether the State of New Hampshire could, after the Revolution, alter the charter in a material respect without the consent of the corporation by an Act of the State legislature. The Court held that the charter constituted a contract between the state and the corporation, that the United States Constitution protects contracts against alteration by the state, and that therefore any such Act was unconstitutional and void. It may be noted that the case did not involve the rights of shareholders inter sese at all, nor was it an action by a shareholder against a corporation to restrain it from altering his rights. But its rationale was resorted to for the conclusion that the state could not by an amendment to its corporation statute effect a change in a charter so as to enlarge or alter the powers of the corporation under its original charter, if at the time when the charter was issued the statute did not

reserve the power to do so.

Even if the incorporation statute reserves such power, as most American Acts now do, the question still remains whether a power of charter amendment conferred by the statute could be used by the corporation to alter the rights of an issued share without the consent of its holder. Many courts, e.g. New Jersey,[95] held that it could not be used thus to alter unilaterally or vary existing contractual relationship between the corporation and its shareholder without the consent of the latter. Pronik v. Spirits Distributing Co.,[96] decided by the New Jersey Court of Chancery in 1899 is a good illustration. The company had issued preference shares as authorised by its charter. The New Jersey Act of 1893 empowered the corporation to amend its charter at any time with the assent of a majority in interest of the shareholders and provided that "such amended certificate shall take the place of the original certificate of incorporation, and shall be deemed to have been recorded and filed on the date of the recording and filing of the original certificate." The corporation sought to reduce the preferential dividend by a charter amendment which had been assented to by the holders of more than two-thirds of all the stocks issued by the company, common as well as preferred. A dissenting preferred shareholder sought to enjoin the alteration of the charter for the purpose. The court held that the company could not by means of a charter amendment modify or restrict a contractual right of the preferred shareholder without his assent, unless the right to do so had been expressly reserved in the contract of allotment of the shares. Referring to the statutory power of the corporation to

amend its charter, Emery, V.C., said:[97]

> "In my judgment, these general powers of amendment of the [charter], which originally fixed the relation of stockholders inter sese, do not confer the power of altering the previous contract of the company itself with the stockholders as to the rate of dividend which was created by a stock certificate or contract of the company . . . and which reserved no power in the company to change. Such alteration would impair the obligation of contract created by the stock certificate issued under the company's charter."

According to the Vice Chancellor, the contractual rights of a shareholder cannot be altered by amending the charter, even if such charter amendment is authorised by the statute, but can be altered only if the contract of allotment itself reserves the power to do so. The New York courts, however, adopted a more liberal view that a shareholder's contractual rights were inherently subject to the corporation's statutory power to amend its charter and that therefore he could not complain if his rights were varied as a result, unless the corporation had abused its power.[98] In other words, according to the New York decisions, the contractual rights of the holders of shares issued under a charter at a time when the company had statutory power to amend the charter are always subject to the overriding statutory charter-amending power of the corporation and hence are always defeasible. This view has been increasingly accepted by the courts in many American jurisdictions.[99]

Courts were particularly reluctant to permit companies to use their statutory power of charter-amendment to wipe out accumulated

arrears of dividend which had accrued on cumulative preference shares. They attempted to draw a distinction between rights which are in the nature of vested property interests and rights which are merely contractual and held that the former could in no case be affected by charter-amendment even if the latter were permissible. Holding that arrears of cumulative preferential dividends which had accrued due were vested property rights, the courts held that they could not be divested by charter-amendment, unless the individual shareholder assented to it. Morris v. American Public Utilities Co.,[100] decided by the Delaware Court in 1923, is a good example of this approach.[101] The corporation, incorporated in 1912, had two classes of shares, both equal in number, one class being common shares and the other class being entitled to 6% cumulative preferential dividend and redeemable at a premium of 5% over their par value. The dividends on the preferred shares fell into arrears which accumulated to a total of 24% up to April 1, 1923. The corporation thereupon sought to amend its charter to change its capital structure (but without altering the amount of authorised capital), by creating 3 new classes of preferred shares — viz. (i) a class of first preference shares (called "prior preferred stock") entitled to 7% cumulative dividend from April 1, 1923, asset-preference in winding up, and redeemable at a premium of 10% above par; (ii) second participating-preference shares, with dividend preference next to the first preference shares from April 1, 1923, and redeemable at a premium of 5% above par; and (iii) last - preference shares entitled to cumulative preferential dividend at 6% and redeemable at par. The existing preference shares were given the option

to be exchanged for the first and second new preference shares upon payment of extra-cash or to be treated for all purposes to be the new 6% last preference shares. This restructuring of the share capital subordinated the old preference shares to two new superior preferred shares, wiped out the 24% accumulated accrued dividend on them, and took away the right to vote which they hitherto possessed in equality with the ordinary shares. Under the new scheme the common shares were alone given voting rights generally on all matters.

The charter amendment received the affirmative vote of 27,851 out of 44,659 existing preferred shares and 21,512 out of 28,240 common shares. The Act prescribed that the charter could be amended by a majority vote of the class of shares and of all voting shares. Only 417 preferred shares and no common share voted against the charter amendment. The preferred shareholders who voted against the amendment brought action for a declaration that the charter amendment was void.

Except in respect of the wiping out of the accumulated cumulative dividend the court upheld the recapitalization in all other respects. The Chancellor held that the old preference shareholders could not complain if under the new capital structure they found above them two other superior classes of preference shares, or if their redemption price was reduced, or if they were stripped of their voting rights, for all these rights were enjoyed by them under a charter which was liable to be changed at any time by the process prescribed by the statute.

The Chancellor, however, held that "the attempt to destroy the right of an objecting preferred stockholder to accrued and unpaid divi-

dends cannot be sustained."[102] This is based on the rationale that the accrued dividends in such a case are not a mere "preference", but a vested property interest.[103] In many cases American courts have treated arrears of cumulative dividends to be in the nature of debts owed by the company to the shareholder and a vested property interest of the shareholder.[104] The Chancellor reasoned that section 26 of the then Delaware General Corporation Act only permitted the alteration of the "preferences" given to one or more class of preferred shares, provided that the holders of a majority of the shares of that class assented to such alteration. An amendment to wipe out accrued cumulative dividends was not one to alter or change the "preferences",[105] but the deprivation or destruction of a vested right which was not authorised by the statute. Accumulated cumulative dividend "is analogous to a dividend which has been declared on common stock but unpaid"; though it cannot be sued for as in the case of a declared dividend, yet "it has matured and constitutes just as much a present, vested right, and when the occasion arises is entitled as much to be protected in an appropriate manner."[106] The court would not allow other people to "take from a man his vested property right against his will,"[107] in the absence of statutory provisions plainly indicating an intention to permit it. The Chancellor distinguished English precedents[108] on the ground that the by-laws of the companies in those cases authorised the modification of the "rights and privileges" of any class of shares, whereas the Delaware Act authorised only the modification of the "preferences" of any class of shares.

As a result of this decision the Delaware legislature amended the state corporation statute in 1927 to permit charter-amendments to alter not only the "preferences" but also "special rights" attached to a class of shares. The Delaware court, however, did not match the statutory change with a liberal construction in so far as the elimination of accrued arrears of cumulative dividends was concerned.[109] Thus in Keller v. Wilson & Co.[110] the question arose whether the company incorporated in 1925 and which had issued different classes of shares could take advantage of the 1927 amendment to the Delaware Act to wipe out accrued arrears of preferential dividend. The court held that the company could not do so and that vested property rights could not be destroyed by statutory authority conferred on corporations subsequent to the vesting of the rights. The court would not give retroactive efficacy to the amending statute so as to render the cumulative preferential right a defeasible one ab initio.

But this protection of the "vested property interest" in accrued arrears of cumulative preferential dividend has been for all practical purposes defeated by Delaware decisions upholding mergers or consolidations which had the effect of wiping out such arrears. The Havender case[111] decided by the Supreme Court of Delaware in 1940, approved of one way to get over the Keller obstacle. The corporation in the Havender case took advantage of the merger provisions of the Delaware Act. Ever since the General Corporation Law was adopted in 1899, the Act had provided for merger or consolidation of two or more corporations by a two-third vote of the stockholders of each corporation, the objecting

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shareholders being given appraisal right.[112] By an amendment of 1937 the Act authorised the consolidation or merger of a wholly owned subsidiary with the parent corporation. The corporation in the Havender case had 17,747 7% outstanding cumulative preference shares on each of which dividends had accumulated to the extent of $29. It decided to merge with its wholly owned subsidiary and under the scheme each of the old preference shares was to be exchanged for new preference and common shares in the consolidated company, the arrears of cumulative dividend on the old shares being wiped out in the process. Dissenting preference shareholders challenged the validity of the wiping out of the accrued arrears of preferential dividends. The Court upheld the corporations's action, reversing the court below which, relying upon the Keller case, had held that the purported merger was no more than an unauthorised attempt to extinguish the accumulated arrears of preferential dividends. Though the court distinguished the present case from the Keller case, for all practical purposes "Havender broke Keller's back."[113]

The Shanik case[114] decided by the same court the next year also shows that the Keller obstacle is not unsurmountable. There the corporation, incorporated in 1926, had an issued and paid up capital of $5,750,000, consisting of a paid-up common capital of $750,000 (200,000 common shares each paid up to $3.75) and a paid up preference capital of 5 million dollars (100,000 preference shares with a paid up value of $50 each). The preference shares carried the right to cumulative preferential dividend at 4% per annum, asset-preference in liquidation of the value of $50 plus arrears of dividend, were convertible into common shares at the holder's

option and were redeemable at $55 plus arrears of dividend. By 1938 the corporation had lost over half of its capital in its operations and arrears of dividends amounting to $31 per share had accumulated on the preference shares. That year the corporation resolved to reduce its capital by writing off $27 out of the $50 paid up on each preference share and by substantial reduction of the paid up common capital as well. It also resolved to create a class of prior preference shares and new common shares, to convert the old outstanding common shares into the new common shares in the ratio of 5:2, and give the option to the holders of the old preference shares either to accept in exchange one new prior preferred share and 3 new common shares for each of the old preference shares held by them or to continue to hold the old preference shares with their existing rights.[115] The new prior preferred shares were to have a value of $20, right to cumulative dividend at 2% per annum after January 31, 1941, were to be redeemable at the company's option after January 1, 1942, at the price of $35 plus accrued dividends, and were to have a liquidation preference of $25 plus accrued dividends. They were to rank first in their preferential rights over all other shares of the company including the old preference shares which might continue to be outstanding. The result was that an old preference shareholder who exchanged his shares for the new prior and common shares lost his claim to the accrued arrears of dividend (of $31 per share) on his old preference shares. If he continued to hold his old preference shares, he would find that his preferences had become postponed until after the newly created prior preferred shares. About ninety per cent of the old preference

shares were exchanged by their holders for the new shares. A dissenting old preference shareholder impugned the manoeuvres of the company. The court upheld the recapitalization on the ground that the right to accrued preferential dividend was not destroyed and that they were given the option to continue with all their original rights, though they were subordinated to a new class of prior preferred shares.[116]

The modern American statutory trend is to allow corporations full freedom to alter their charters, but protect class rights by conferring class-voting rights whenever a charter-amendment would infringe those rights.[117] The Model Act is typical of them and it expressly authorises charter amendment to "cancel or otherwise affect the rights of the holders of the shares of any class to receive dividends which have accrued but have not been declared."[118] The judicial trend is also in step with this attitude that the majority should prevail, even if their decision is not entirely "fair", so long as it is not "fraudulent".[119]

Thus in Franzblau v. Capital Securities Co., Inc., decided by the Superior Court of New Jersey in 1949, Judge Stein remarked that "The fairness or unfairness of corporate action may not be considered where the action is in exercise of a power conferred upon the corporation by the Act under which it was organized."[120] Though he made so sweeping a statement, the judge examined the scheme and satisfied himself that the plan of recapitalization of the company was "not only fair but decidedly advantageous to the preferred stockholders." Under the plan preference shares of a par value of $30 carrying preferential right to dividend at 7% per annum cumulatively and on which accrued arrears of dividend

amounted to over $36 per share due to non-payment for 17 years were to be converted into preference shares of a par value of $50 carrying cumulative preferential right to dividend at 5% per annum and the dividend arrears on them were to be wiped out. It was assented to by the holders of a large majority (over 86%) of the preference shares at a class meeting and it was attacked by a nonassenting shareholder on the ground that it was inequitable and unfair. The court held that such reconstruction wiping out arrears of cumulative preferential dividend with a two-thirds majority consent of the class was authorised by the 1926 amendment[121] of the New Jersey Act and distinguished on this ground the pre-1926 decisions invalidating reconstructions wiping out accrued arrears of cumulative preferential dividends. Judge Stein also observed that "With matters of business policy and discretion, exercised in good faith, the court will not interfere."[122]

To obtain redress in equity the objecting shareholder should establish fraud and not merely unfairness. Matteson v. Ziebarth,[123] decided by the Supreme Court of Washington in 1952, is a good example. A scheme for the merger of the Ziebarth corporation with a new corporation (Snowy Corporation) organized by its controlling shareholder provided that the minority shareholder of Ziebarth would receive redeemable preference shares in Snowy. The design of the merger plan was to buy out the minority shareholder if he dissented to the merger plan as provided by the appraisal statute of the State, and if he did not dissent and chose to accept the redeemable shares, then to redeem the shares and thus eliminate him. The entire scheme was devised to bring about the sale of all

the assets and shares of Ziebarth to a third corporation which was willing to buy it only on that condition and in that case was also willing to employ the controlling shareholder on a substantial salary. Ziebarth had been a financial failure and there was no better way of disposing of it, but the minority shareholder was obstructing its consummation claiming a larger share of the price than was offered to him. The State statute gave appraisal right to a non-assenting shareholder in such cases, if within 20 days after notice of the meeting called to vote on the merger he objected in writing and demanded payment for his shares, failing which he would be bound by the corporate action as if he had voted in favour of it. The objecting minority shareholder voted against the merger, but failed to make the demand in writing. The Washington court held that where such appraisal remedy is provided by the statute, it is "exclusive as to unfairness or breach of fiduciary duty short of actual fraud,"[124] provided that the facts concerning such unfairness or breach of fiduciary duty were known to the aggrieved shareholder at the time of the shareholders' meeting at which the corporate action was sanctioned. In other words, the objecting minority shareholder who complains of unfairness, of which he knew at the time, should have availed himself of the appraisal remedy provided by the statute which is his only and exclusive remedy in such cases.[125] He can impugn the scheme only in cases where he was unaware of the unfairness at the time or where the majority was acting fraudulently.[126] The court held that the minority shareholder had not succeeded in discharging the heavy burden placed upon him of showing fraud.

It would therefore seem to follow that when the statute provides for appraisal right, the objecting minority shareholder has the option either to assent to a transaction which he regards as unfair or sever his connections with the corporation by exercising his appraisal remedy. If he prefers to assent and stay on, he may find himself with redeemable preference shares in the place of his old common shares only to be promptly redeemed and gotten rid of. Justice Grady, dissenting, pointed out that the decision of the court would "open the way to a new method of freezing out minority shareholders merely because they disagree with the majority on questions of corporate policy."[127]

Current American attitude can be illustrated by the following words of an eminent lawyer.[128]

> "'Fairness' is an elusive standard. Where the statutory power exists, there is no clear and certain test by which the chancellor can allow its exercise for some purposes and disallow its exercise for others. The quest for 'fairness' also leads the chancellor into new fields where he is normally not expert. It places on him the heavy burden of solving complex economic problems in order to formulate a judgment as to the soundness, and hence the fairness, of the proposed amendment. It is now recognized that where the legal power for a recapitalization exists, the question of fairness is not one for judicial examination."
>
> " Fairness raises a question of judgment, where opinions may differ endlessly, and the average businessman is not particularly equipped to know what someone else might conclude at a later date with further evidence."

With this it is interesting to compare Professor Dodd's eloquent plea to recognize that the problem of recapitalization is essentially the same as that of reorganization and that the "fair and equitable rule" worked out for the protection of senior security-holders in reorganizations should be made applicable to recapitalizations as well.[129] The trend in the American States has definitely been away from Dodd's hopes and toward the English approach. The English judges have, however, purported to scrutinize such transactions to prevent unfairness, but in practice they have tended to begin the scrutiny with a strong presumption that what a majority has assented to cannot prima facie be regarded as unfair. American courts seem to intimate that they would refuse to entertain the objection of unfairness, as distinguished from fraud, once the requisite majority has given its assent. But presumably, all that this means is that the American courts will not entertain the objection that a scheme of recapitalization is unfair because it is not in strict accordance with the absolute priorities of the different classes of shares. Presumably the American courts would deem it fraudulent if a scheme discriminates among shareholders of the same class,[130] or prefers shareholders over creditors,[131] or the assenting majority of a class stands to gain (unlike the minority) in another capacity,[132] or adequate and timely information has not been made available to the shareholders called upon to assent.[133] Though the American statutes do not provide for confirmation by court (as the English Act does in the case of reduction of capital or a reorganization or recapitalization under section 206, etc.), or a judicial recourse (as section 72 of the English Act does), an aggrieved shareholder in the

American jurisdictions can seek redress in equity and the failure of the statutes to provide for judicial recourse expressly does not in practice seem to make any difference. What is striking is that neither the English courts nor the American state courts have adopted an absolute legal standard to test the fairness of recapitalization schemes. Indeed class-voting right is more extensively available under the American statutes than under the English law and when class-assent is required, American statutes prescribe an absolute majority of all the shares held or even a larger majority of all shares whereas the English Act requires only a special majority of those present and voting in person or by proxy.

To sum up, variation or abrogation of class rights can be effected in the American states by (i) charter-amendment, including reduction of stated capital;[134] (ii) merger or consolidation,[135] including one with a wholly owned subsidiary or a new company incorporated for the very purpose; and (iii) sale of all or substantially all assets to another corporation. Appraisal right is usually available in the case of merger or consolidation, and in the case of sale of assets. In English law appraisal right is available only under section 287, but not under section 206 or other sections which we have discussed.

The judicial trend in both England and the American state jurisdictions is one of permissiveness rather than restriction in enabling companies to restructure internal relationships by majority decisions of different classes of shares.

The securities laws, however, sometimes subject recapitalizations and reorganizations to administrative control. The California Securities

Law forbids, as we have seen, any issuer to offer or sell in California any security issued by it (i) in connection with any change in the rights, preferences, privileges, etc., of outstanding securities, or (ii) in any exchange of securities by an issuer with its existing security-holders exclusively, or (iii) in any exchange in connection with any merger or consolidation or purchase of assets in consideration of the issuance of securities, unless the security is qualified for sale by permit granted by the Commissioner, or it is an exempt security or relates to an exempt transaction. The Commissioner will subject the reorganization or recapitalization to California's traditional "fair and equitable" standard.[136] On the contrary cases of voluntary reorganization are exempted under the federal Act of 1933, provided that no commission or remuneration is paid or given in connection with the exchange of securities.[137] Suffice it to say that the securities statutes may in some jurisdictions subject voluntary reorganizations to a fair and equitable standard.

(b) The Federal Approach

(i) Introduction

Unlike the State courts the American federal courts have steadfastly applied the test of absolute priority in determining the fairness of corporate reorganization schemes under Chapter X of the federal Bankruptcy Act, its predecessor section 77B, and before that in equity consent receiverships which were first employed to reorganize the bankrupt railroad companies in the mid-nineteenth century. The Supreme Court cases in which the test of absolute priority was applied by the Court involved the question of the validity of plans of reorganizations which affected the

rights of bondholders and other creditors. Lower federal courts and the S.E.C. have held that the test of absolute priority is applicable in reorganization cases between the holders of preferred shares and common shares as well and "these cases seem to imply that the preferred shareholders are entitled to receive the full equivalent of their dissolution preferences before the common shareholders can receive anything."[138]

We shall briefly trace here the standard of absolute priority as evolved by the United States Supreme Court with regard to variation of creditors' rights in the reorganization of companies under Chapter X of the federal Bankruptcy Act and its predecessors.

In America as well as in England the rights of debentureholders and other creditors are alterable by majority assent just in the same way as shareholders' rights, blurring the traditional distinction between "creditors" and "owners" of the corporation.[139] The courts as well as the legislatures have tended to favour the power of the majority of creditors to impose their will upon the minority.[140]

As class shareholder rights can be varied only in accordance with a majority clause or express statutory provisions, so the rights of debentureholders and other creditors can be varied in either way. Quite often debenture trust-deeds or other instruments creating the debt provide for alteration of the bondholders' rights with the assent of a specified majority.[141] If the debenture-deed contains such a modification of rights clause, variation of the debentureholders' rights can be effected without judicial sanction. A dissenting minority will not be entitled to judicial review, for example, under section 72 of the English Act as that section

applies only to variation of class shareholder rights under a majority clause,[142] and his only remedy will be to attack the majority's action as a fraud on the minority which of course is a hard task to succeed in.

Creditors' rights can be varied or abrogated under section 206 of the English Act[143] which, as we have seen, is an omnibus section of very wide scope under which the recapitalization of a solvent company as well as the reorganization of an insolvent company can be effected. The rights of debentureholders and other creditors, whether of a going concern or a company being wound up, can be varied or abrogated, just as the rights of classes of shareholders, under its provisions. All that is necessary is that "a majority in number representing three fourths in value of the creditors or class of creditors" present and voting either in person or by proxy at a meeting of the creditors or class of creditors should assent to the variation or abrogation of their rights and the scheme should receive the sanction of the court.[144] In sanctioning such schemes the English courts have drawn no distinction between arrangements for varying shareholders' rights and those for varying creditors' rights and have applied a uniform criterion: viz. majority assent is prima facie evidence of the fairness of the scheme, but if the court is satisfied that it is in fact unfair to a class of shareholders or creditors, it would not sanction it. The test is whether the majority has been fair and reasonable in regarding the scheme as commercially advantageous to the class as a whole. We have discussed the English decisions in some detail when we considered the variation of class shareholder rights and it is therefore unnecessary to repeat them here.

The English Act provides for the voluntary winding up of solvent and insolvent companies — called members' voluntary winding up and creditors' voluntary winding up respectively.[145] The Act empowers the liquidator in a voluntary winding up "to make any compromise or arrangement with creditors or persons claiming to be creditors, or having or alleging themselves to have any claim, present or future, certain or contingent, ascertained or sounding only in damages against the company, or whereby the company may be rendered liable." If it is a voluntary winding up by members of a solvent company, the liquidator can exercise his power only with the sanction of an extraordinary resolution of the company. If it is a voluntary winding up by creditors of an insolvent company, he can exercise the power only with the sanction of the court or the committee of inspection (and if there is no such committee) of a meeting of the creditors.[146] Any such arrangement entered into between a company about to be, or in the course of being, wound up voluntarily and its creditors is binding on the company if sanctioned by an extraordinary resolution and on the creditors if acceded to by three fourths in number and value of the creditors, but any creditor or contributory is given the right to appeal to the court[147] within three weeks from the completion of the arrangement, in which case the court has the power to "amend, vary or confirm" the arrangement as it thinks just.[148] Thus reorganization of a company under voluntary winding up, whether by members or by creditors, can be carried out by majority assent.

Reorganization of a company under winding up by court can be effected under section 206 of the English Act — the omnibus provision.[149]

The English Act empowers the liquidator in a winding up by the court to make any compromise or arrangement with the sanction of the court "with creditors or persons claiming to be creditors, or having or alleging themselves to have any claim, present or future, certain or contingent, ascertained or sounding only in damages against the company, or whereby the company may be rendered liable."[150]

In short the English Act makes ample provision for reorganization of solvent and insolvent companies, whether or not they are under winding up. But the English courts have upheld the decisions of the majority, if reasonably and honestly made, and have never applied a test of absolute priority.

Most American jurisdictions do not have a provision on the pattern of the English section 206, but about a dozen do. The Uniform Act followed the English precedent on all fours.[151] The Delaware Act authorises that the charter of a corporation may provide for such modification of the rights of creditors and shareholders by majority assent.[152] Half a dozen Acts have followed the example of the Uniform Act and another half a dozen that of the Delaware Act. Apart from these jurisdictions American corporation Acts have not chosen to enact reorganization statutes of general application affecting creditors' rights.[153] But even in the jurisdictions which have such provisions, it would appear that, unlike in Britain, they have only been rarely invoked to modify the rights of the creditors of a going concern.[154] These statutes do not indicate the criteria or standard the courts should apply in sanctioning such schemes; they do not even require that the schemes should be fair and equitable to merit

judicial approbation. For diverse constitutional and other reasons, which we need not concern ourselves with, these state reorganization statutes have not, unlike section 206 of the English Act, been resorted to in any marked degree for the modification of creditors' rights.[155]

Modification of creditors' rights have been carried out in the reorganization of corporations by proceedings under the Federal Bankruptcy Act and the law has been developed by federal courts and administrative agencies on a firm and fundamental doctrine of strict priority, fairness and feasibility of the reorganization plans. The machinery for reorganization is now provided by Chapter X introduced into the Federal Bankruptcy Act in 1938.[156] The standard for approval of reorganization schemes had already been evolved by the judicial process and Chapter X provides the machinery to ensure that the standard will be effectively implemented. We shall consider first the standard the courts require that a scheme should measure up to and secondly, the machinery to enforce it.

(ii) The Standard of Absolute Priority

The standard of absolute priority evolved by the federal courts may be traced conveniently from Northern Pacific Railway Company v. Boyd (hereinafter referred to as the Boyd case),[157] decided by the United States Supreme Court in 1913. The facts of the case were complex and somewhat unusual, but they may be simplified and stated thus: In the reorganization of an insolvent company which had secured bondholders, unsecured creditors and shareholders, the claims of the unsecured creditors were ignored on the ground that the assets of the company were

insufficient even to meet the claims of the secured creditors. But the shareholders were allotted shares in the reorganized company. The scheme was attacked by a single unsecured creditor.[158] The Court by a majority of five[159] to four[160] was of the opinion that[161]

> "Any arrangement . . . by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights of either class of creditors comes within judicial denunciation."

In other words, the shareholders of the company cannot be given rights in the reorganized company while the unsecured creditors are given none. Such preference of the shareholders is a violation of the superior position of the creditors and of the rule that "The original contribution of the capital stock was subject to the payment of debts" and that the "property [of the corporation] was a trust fund charged primarily with the payment of corporate liabilities." There can be no shareholders' participation in the reorganized company so long as any creditor is excluded from it without his individual assent.

The Court rejected the argument that the assets of the company were insufficient to pay even the secured creditors in full and that therefore the unsecured creditors had no reason to complain if the secured creditors were willing to agree to the shareholders' participation in the reorganized company. The Court did so on policy grounds which it stated thus:[162]

> "In saying that there was nothing for the unsecured creditors the argument assumes the very fact which the law contemplated

> was to be tested by adversary proceedings in which it would have been to the interests of the stockholders to interpose every valid defense. If, after a trial, a sale was ordered, they were still interested in making the property bring its value, so as to leave a surplus for themselves as ultimate owners. Even after sale they could have opposed its confirmation if the bids had been chilled, or other reason existed to prevent its approval. In the present case all these tests and safeguards were withdrawn. The stockholders who, in lawfully protecting themselves, would necessarily have protected unsecured creditors, abandoned the defense that the foreclosure suit had been prematurely brought."

That is, the temptation to defeat the rights of unsecured creditors by collusion between the secured creditors and shareholders has to be guarded against. To forbid the shareholders to have an interest in the reorganized company so long as the claim of any creditor remains unsatisfied is the best safeguard for the rights of creditors. If the assets of the company are in fact insufficient to pay even the secured creditors in full, then there is no equity of the shareholders left for which new shares could be allotted to them in the reorganized company. If on the other hand the assets were in excess of the secured debts, the unsecured creditor is entitled to the benefit of such excess. In either case there is no justification to permit an arrangement which preserves the rights of shareholders and sacrifices that of the unsecured creditor or creditors. The Court pointed out that the stockholders could retain an interest in the

reorganized company by issuing to the unsecured creditors income bonds or preferred shares on equitable terms.

The dissenting judges would not favour a hard and inflexible rule that "every plan of reorganization which in any way includes stockholders of the reorganized company is for that reason alone to be regarded as an illegal withholding from creditors of corporate property which should go to the payment of corporate debts," but that "every case should stand upon its own facts, and the remedy be shaped to do justice and equity in the particular case."[163]

This extraordinary case[164] gave birth to the rule of "full or absolute priority". Section 77B of the Bankruptcy Act enacted in 1934[165] to provide for the reorganization of most types of corporations (other than railroad corporations which were governed by section 77 enacted the previous year), empowered the court to confirm a plan of reorganization if it is satisfied that it is "fair and equitable."[166] In Case v. Los Angeles Lumber Products Co., Ltd.,[167] decided by the United States Supreme Court in 1939, the Court held that the words "fair and equitable" meant the standard of absolute priority as laid down in the Boyd case. The Court laid down[168] that the question whether a plan of reorganization is "fair and equitable" within section 77B is one of law and that, if a plan of reorganization is not "fair and equitable" as a matter of law, it cannot be approved by the court even though it has been assented to by the prescribed majority of the classes of security holders. In other words, the assent of even a great majority of the security holders is not the sole test for determining whether a scheme of reorganization is

fair and equitable, but the court must use its own informed and independent judgment to determine it. Reversing the courts below, the Supreme Court held at the instance of dissenting bondholders the scheme of reorganization to be not "fair and equitable" even though it had been assented to by approximately 92.81% of the face amount of the bonds, 99.75 of the Class A stock and 90% of the Class B stock. The scheme of reorganization of the company envisaged that the existing common shares would receive in exchange new common shares in the reorganized company and that the bondholders would receive 5% noncumulative participating preference shares carrying asset-preference in winding-up and voting rights. The company was hopelessly insolvent both in the equity and bankruptcy senses and the amount it owed its bondholders was more than four times the value of its assets.[169] The Court held that in the circumstances the scheme of reorganization which gave the shareholders 23% of the assets and voting power in the reorganized company without requiring of them any fresh contribution toward the capital was not fair and equitable.

In the Case case the Supreme Court of the United States reaffirmed that for a scheme of reorganization to be regarded as fair and equitable, it should conform to two well-settled principles: (i) The shareholders' interest in the corporate property is subordinate to the rights of creditors.[170] (ii) The scheme should not seek to protect the inferior rights of the shareholders at the expense of the prior rights of the creditors of any class.[171]

The Court observed that to accord the creditor his full right of priority against the corporate assets where the debtor company is insol-

vent, the shareholders' participation in the reorganized company "must be based on a contribution in money or money's worth., reasonably equivalent in view of all the circumstances to the participation of the stockholder."[172]

The Court's decision is not only important for its positive affirmation of the rule of full and absolute priority, but also for clarifying what are not relevant in judging whether a scheme is fair and equitable.

The court of first instance had held that the continuance of the old shareholders in the reorganized company was beneficial because they were familiar with the operation of the company, they could provide continuity of management and that they were men of influence and financial standing in the community. The Supreme Court held that none of these contributed to the assets of the company or constituted legal justification for the issuance of the new shares to them in contravention of the rule of full and absolute priority. The Court remarked that "The rigorous standards of the absolute or full priority doctrine of the Boyd case will not permit valueless junior interests to perpetuate their position in an enterprise on such ephemeral grounds."[173]

The court of first instance had held that in an immediate liquidation of the company "the bondholders would receive substantially less than the present appraised value" of the debtor corporation and that therefore the scheme was likely to prove more beneficial to them. The Supreme Court held that "The fact that the bondholders might fare worse as a result of a foreclosure and liquidation than they would by taking a debtor's plan under § 77B can have no relevant bearing on whether a proposed

plan is 'fair and equitable' under that section."[174]

The court of first instance had held that the value to the bondholders of maintaining the debtor company as a going concern and avoiding litigation with the old stockholders justified the inclusion of the latter in the reorganization scheme. The Supreme Court refused to recognize the nuisance or strategic value of the old stockholders as justifying the issuance of shares to them in the new company.

In short the court will not regard a scheme as fair and equitable if it dilutes the creditors' priorities. The scheme of reorganization of an insolvent company should exclude shareholders from any interest except to the extent that they furnish fresh consideration for the interest given them in the reorganized company.

Soon after the Case case the Supreme Court found an opportunity in Consolidated Rock Products Co. v. Du Bois[175] (hereinafter referred to as the Du Bois case) to stress the importance of valuing the enterprise by a capitalization of prospective earnings in determining whether a proposed reorganization plan is in accordance with the absolute priority rule and whether it is feasible. The reorganization plan envisaged the consolidation of the Consolidated Co. and its two wholly-owned subsidiaries. The bondholders of the subsidiaries were to receive bonds for half the amount of their claims and preference shares for the other half in the newly formed company. The preference shareholders were to receive an equivalent amount of common shares in the new company. The common shareholders were to be given the right to purchase one new common share for every five shares of old common held by them. The Supreme

Court upheld the Circuit Court of Appeals' reversal of the District Court's confirmation of the scheme of reorganization for the following reasons: (i) There was no valuation data before the court to enable it to determine the fairness of the plan of reorganization. The District Court had made no determination of what assets were subject to the payment of the respective claims.[176] Without a valuation of the assets of each of the three companies, it would be impossible to resolve the issue of absolute priorities. (ii) No effort was made to value the whole enterprise by a capitalization of prospective earnings. Such valuation would be needed to determine the feasibility as well as the fairness of the plan of reorganization.[177] The Court observed:[178]

> "Whether or not the earnings may reasonably be expected to meet the interest and dividend requirements of the new securities is a sine qua non to a determination of the integrity and practicability of the capital structure. It is also essential for satisfaction of the absolute priority rule of Case v. Los Angeles Lumber Products Co. .... Unless meticulous regard for earning capacity be had, indefensible participation of junior securities in plans of reorganization may result."

(iii) The plan of reorganization envisaged the wiping out of accrued interest due to the bondholders and therefore did not fulfil the criterion of "full and absolute priority." Further it gave the bondholders new income bonds carrying reduced rate of interest for half of their principal and gave them preference shares for the other half. The Court remarked: "Full compensatory provision must be made for the entire bundle of rights

which the creditors surrender."[179]

In short, the creditors are entitled to "absolute priority." It is not enough for the reorganization scheme to preserve their "relative priority." They are entitled to such absolute priority both for their principal and the interest due thereon. The absolute priority rule does not, however, mean that bondholders cannot be given inferior grades of securities or even securities of the same grade as are given to junior interests.[180] But if they are called upon to make any sacrifice in their position of absolute priority, the scheme should adequately compensate them for any loss they are thereby put to. Any scheme which does not accord full and absolute priority or adequately compensate for any detraction from it is not fair and equitable. Until the Du Bois case, some courts had held that relative priority was enough for a scheme to be fair and equitable, but the Supreme Court totally rejected this view.

The standard of absolute priority evolved by the Court might have turned out to be an enormous burden on the judges to evaluate complicated schemes, but this was happily avoided by Chapter X of the Bankruptcy Act enacted in 1938 in the place of section 77B. Chapter X provides the court with very effective and competent assistance in this arduous task. But for this procedural reform, it might have proved to be very difficult to implement the standard. Section 77B provided the court and the shareholders with no means to ascertain independently the facts and figures to examine the fairness or feasibility of a reorganization plan. This serious defect was rectified by the new Chapter X.

(iii) Implementation

Chapter X provides for three important procedural steps to ensure the effective implementation of the standard of absolute priority. First, it requires that in cases involving the reorganization of corporations of substantial size, independent trustees be appointed whose function it will be, among others, to formulate a plan of reorganization. Secondly, the plan has to be approved by the court before it is submitted to the security holders for their approval or rejection. This ensures that the court will exercise its independent judgment and not merely rubber-stamp the majority decisions. Thirdly, the judge is provided with the assistance of the S.E.C. In cases where the indebtedness of the corporation exceeds three million dollars the judge is required to seek the advisory opinion of the S.E.C. on all plans of reorganization which he deems worthy of consideration; in other cases he may do so. The judge may also request the S.E.C. to participate in the proceedings to provide independent, expert assistance. The S.E.C. also may take the initiative and seek the permission of the court to participate in such proceedings. The role played by the S.E.C. by its participation and expert opinions has been mainly instrumental in implementing the judicial test of fairness and feasibility. In fact in both the Case and Du Bois cases the Court sustained the positions urged in the amicus curiae briefs filed by the S.E.C. In examining the feasibility, the economic soundness and workability, of a plan the S.E.C. has carefully scrutinized[181]

> "the adequacy of working capital, the relationship of funded debt and capital structure to property values, the adequacy

> of corporate earning power in relation to interest and dividend requirements, and the effect of the new capitalization upon the company's prospective credit."

Unlike the court, the S.E.C. is adequately staffed with lawyers, accountants and analysts to carry out its function.

In conclusion, it is evident that the federal approach to reorganizations is strikingly different from the states' approach and the English. The latter accepts the rule of the majority and intervenes only when the majority is acting unfairly or fraudulently. The federal approach tests fairness by legal standards and not by the reasonableness or good faith of the majority decision. From the point of view of the dissenting minority, and particularly the unsecured creditor, indeed the federal approach affords the greatest protection.

Two justifications have been advanced in favour of an absolute test of fairness in preference to a rule of the majority. First, as reorganization plans are drawn up by the managements, and as managers are more likely to own shares rather than bonds and to be dependent upon the goodwill of the shareholders to retain their managerial positions in the reorganized enterprise, they are likely to draw up schemes which will benefit junior interests at the expense of the superior rights of senior security holders, in particular the unsecured creditors.[182] Secondly, creditors and bondholders who assent to unfair reorganization schemes which compel them to make unjust sacrifices are often ill-informed, unable to find competent disinterested committees to act for them, and are impelled by the anxiety to obtain a resumption of interest payments.[183] We

shall evaluate the merits of the two fundamentally different approaches in the section on appraisal later.

3. The Canadian Patterns[184]

(a) The Memorandum Jurisdictions

Not all the memorandum jurisdictions follow the English model exactly, but all of them bear some affinity to it. Saskatchewan[185] and Nova Scotia[186] provide for a modification of rights clause in their Table A like the English Act.[187] British Columbia and Alberta contain sections in the body of their Acts dealing with the subject. Nor is the language used identical in all these statutes and the words "vary" or "abrogate" do not find a place in a number of them. The British Columbia Act provides that "no special rights attached to any issued shares shall be prejudiced or interfered with except with the consent of the members holding not less in the aggregate than three-fourths thereof, given either in writing or by special resolution passed at a separate meeting of such members."[188] According to the Alberta Act the preferential rights attached to a class of shares by the memorandum can be "interfered with" (a) only by a resolution to vary the class rights passed by a majority in number of that class and holding three-fourths of the share capital of that class and (b) such amendment can be effected only by a special resolution of the company confirmed by an order of the court.[189] In any other case, the class rights may be varied according to the terms (if any) of issue of the shares of that class. In the absence of any such term they can be varied "by a special resolution confirmed by an order of the court, with the consent in writing of the holders of three-fourths

of the issued shares of that class, or with the sanction of an extraordinary resolution passed at a separate general meeting of the holders of the shares of that class."[190] In brief, judicial confirmation is necessary in every case unless the terms of issue of the shares provide for the modification of the rights attached to them. The Alberta Act also provides[191] that a company may issue its shares with preferred or other special shares only "without prejudice to the special rights previously conferred on the holders of existing shares in the company."

The British Columbia and Saskatchewan statutes also contain provisions on the model of English section 72 entitling a non-assenting minority of the holders holding not less than 15% of the issued shares of the class to apply for judicial review.[192] But the Nova Scotia and Alberta Acts have no such provision. None of the Acts lays down the criteria for judicial confirmation or disapproval of a proposed variation of class rights which has received the assent of the requisite majority.

It is not clear how far the language of these statutes which employ words such as "prejudiced" or "interfered with" or "dealt with" has the effect of excluding the application of the Greenhalgh, Bristol Aeroplane and other English cases denying the right to assent as a class to the affected class of shareholders.

Like the English Act all these memorandum jurisdictions require judicial confirmation of a reduction of share capital.[193]

All of them have an omnibus provision like section 206 of the English Act providing for compromises and arrangements between a company and its shareholders or classes of them and its creditors or classes

of them by a three-fourths majority consent and the sanction of the court.[194] Just like the English Act, none of them throws light on the criteria by which the court should be guided in granting or denying confirmation, Moreover, none of them has, unlike the English Act,[195] an express provision about the explanatory statement and the information that should be furnished to the shareholders or creditors called upon to assent to an arrangement or compromise.

The English Act specifically provides in section 208 for the carrying out of a reconstruction of a company or the amalgamation of two or more companies by a compromise or arrangement under section 206. The court is given wide powers under that section to authorise every matter necessary to secure that the reconstruction or amalgamation is fully and effectively carried out. The parallel provisions of the Canadian statutes[196] apply only to schemes under which the undertaking or property of a company is to be transferred to another company,[197] and these Acts provide separately for amalgamation of two or more companies,[198] as the American statutes do.[199] Among them Saskatchewan provides for the amalgamation of "two or more companies <u>having the same or similar objects</u>," but British Columbia and Nova Scotia do not thus restrict the scope of amalgamation between companies.[200] All the three jurisdictions require judicial approval of the amalgamation before it can become effective. None of them provides for appraisal right for the dissenting shareholders of either company proposing to amalgamate. The Saskatchewan Act requires that the agreement to amalgamate should (a) be approved by a three-fourths majority of the votes cast at special general meetings of

the shareholders of the companies and (b) consented to by creditors representing two-thirds in amount of the debts of each company, before the approval of the court is sought. The British Columbia Act requires that the amalgamation agreement should (a) be approved by special resolution of each amalgamating company and (b) also be approved by resolution or consented to in writing by the holders of not less than three-quarters of the shares of each class or kind in each amalgamating company that has two or more classes or kinds of shares, but does not provide for approval by creditors who are therefore left to raise their objections, if any, before the court when the companies seek the sanction of the court. The Nova Scotia Act is in accord with the Saskatchewan Act in respect of shareholders' approval and does not confer class-voting rights. It is in accord with the British Columbia statute in not requiring creditors' approval.

The court therefore occupies a very important position[201] in supervising and regulating amalgamations, whether it is carried out under sections 206 and 208 of the English Act or under the Canadian statutes of memorandum jurisdictions. Do the statutes prescribe any guidelines for the discharge of the responsibility entrusted to the courts? The Saskatchewan Act requires the court to "hear and determine all matter, having regard to the rights and interests of all parties including the dissenting shareholders or creditors." The British Columbia Act is to the same effect except that it requires the court to have regard to the interests not only of the dissenting creditors and shareholders of each company, but also of "any other person affected thereby." The

Nova Scotia Act is in similar language. The powers of the English court sanctioning an amalgamation under section 208 would appear to be wider as the court is authorised to make provision for dissenting creditors and shareholders.

The American Model Act confers the right on shareholders to vote as a class if a plan of merger or consolidation contains any provision which, if contained in a proposed charter-amendment, would entitle such class of shares to vote as a class.[202] The dissenting shareholder is given appraisal right[203] and there is no provision for judicial approval of the merger or consolidation agreement. Indeed in most jurisdictions the appraisal right is the exclusive remedy, if the statutory requirements have been duly complied with, in the absence of fraud or bad faith.[204] The rights of creditors are in no way impaired by a merger or consolidation including any liens they have against the property of the concerned corporation.[205] In contrast the Canadian memorandum jurisdictions follow the English precedent of judicial sanction rather than provide for appraisal right for dissenters.

(b) The Letters-Patent Jurisdictions

In the letters-patent jurisdictions the application for letters-patent has to specify not only the authorised capital and its division into shares, but also the classes (if any) into which they are to be divided, the number of shares of each class, and the preferences, restrictions, conditions, limitations, or prohibitions (if any) attaching to each class.[206] In turn the Secretary of State or Provincial Secretary or other authorised official issues the letters-patent embodying these particulars.[207]

All the Acts provide for alteration of the share capital of a company by amending the letters-patent. Under the Canada Act any alteration of share capital by (a) subdivision or consolidation of shares, (b) classification or reclassification of no-par shares, (c) conversion of par value shares into no-par shares and vice versa, (d) increase of capital and (e) cancellation of unissued shares can be effected only with the sanction of at least two-thirds of the votes of the holders of each class of shares thereby affected cast at a special general meeting of shareholders called for the purpose and confirmed by supplementary letters-patent.[208] Alteration of share capital in any other way (except reduction) which would affect class rights needs the unanimous consent of the class-shareholders, unless it is otherwise provided in the letters-patent or supplementary letters-patent which attached the class rights.[209]

Under the Manitoba Act the letters-patent can be altered so as to "delete or vary any preference, right, condition, restriction, limitation or prohibition attaching to any class of shares or to create shares ranking in priority to or on a parity with an existing class of shares" only by a two-thirds majority vote "of the holders of that class of shares affected . . . present at a meeting duly called for that purpose."[210] It will be seen that this provision confers class voting rights to a much wider extent than is available under the English law. Ontario's provision which is in similar language is even stricter in that it requires the unanimous consent of the holders of the preference shares of the class or classes affected, or of the holders of at least 95% of the class with none dissenting after having been given 21 days notice of the proposed application for

supplementary letters-patent.[211] But the letters-patent or the supplementary letters-patent by which the class rights have been attached may authorise such variation with a two-thirds majority.[212] The new Ontario Bill substantially re-produces these provisions.[213]

The Quebec Act contains no provision for class-assent in cases of amendment of letters-patent varying class rights.

All the Acts provide for reduction of capital in any way by supplementary letters-patent. These provisions are modelled on the English sections except that the Secretary of State or Provincial Secretary is substituted for the court with regard to confirmation of the reduction.[214] The Manitoba Act requires that a company seeking supplementary letters patent "decreasing authorised or issued capital" should establish to the satisfaction of the Provincial Secretary that the decrease will not render the company insolvent and, if required by him, that there are no creditors who object to the reduction.[215] Ontario's provisions are identical.[216]

Quebec's reduction provisions are similar in language to that of the memorandum jurisdictions and the English, except that the Provincial Secretary takes the place of the court.[217]

The Quebec Act provides for compromises and arrangements between a company and its shareholders or creditors (or classes of them) with the sanction of the court in much the same way as the English section 206.[218] In addition it specifically provides for amalgamation of two or more companies "having the same or similar objects" with the sanction of the Provincial Secretary.[219] No appraisal right is available

to the dissenting shareholder.

The Canada Act has more extensive provisions for compromises and arrangements.[220] A new section providing specifically for the amalgamation of any "two or more companies incorporated under this Act, including holding and subsidiary companies" was introduced into the Canada Act by the amending Act of 1964-65.[221] The amalgamation has to receive at least three-fourths of the votes of each class of shares of the companies, but a dissenting minority holding 10% or more of the shares of any class is given the right to seek judicial review within a prescribed time. The court is empowered either to annul the agreement to amalgamate or dismiss the complaint of the minority. If no such application is made to the court by a dissenting minority, the Secretary of State may issue letters patent confirming the amalgamation agreement.

The Ontario Act provides for arrangements between a company and its shareholders or classes of them by three-fourths majority consent and with the sanction of the court.[222] But the provision does not include compromises or arrangements between a company and its creditors or classes of them. The new Ontario Bill substantially reproduces these provisions, but in a neater way.[223] The Ontario Acts have had special provisions for amalgamation of companies ever since 1897. The Ontario Companies Act, 1897,[224] authorised that

> "Any two or more companies incorporated under the laws of this Province and having objects within the scope of Act may, in the manner herein provided, unite, amalgamate and consolidate their stock, property, businesses and franchises, and may enter into all contracts and agreements therewith necessary to

such union and amalgamation."

The procedure prescribed was that the amalgamation should receive "two-thirds of the votes of all the shareholders of each such companies"[225] at shareholders' meetings and confirmation by the Lieutenant-Governor in Council by letters-patent. No judicial confirmation was required. The Act of 1897 contained no provision for arrangements, compromises or reorganizations. The amalgamation provisions of 1897 have appeared substantially in the same way in every subsequent Ontario Companies Act and the present Act provides that "Any two or more companies, including a holding and subsidiary company, having the same or similar objects may amalgamate and continue as one company."[226] The new Ontario Bill omits the restrictive words "having the same or similar objects"[227] and safeguards class rights specifically[228] by requiring the unanimous consent in writing of the holders of the shares of each class, or of the holders of 95% of the issued shares of such class after having been given 21 days notice without any one of the holders dissenting in writing to the company, unless the charter has provided for the variation by a lower majority, being not less than two-thirds of the votes cast at a class meeting. Neither judicial confirmation nor appraisal right for dissenters is provided for by the Act. Under the new Bill the Minister has only to be satisfied that each of the amalgamating companies is not insolvent and is required to issue a certificate of amalgamation upon the company filing articles of amalgamation as provided by the Act.[229] Thus he is invested with no judicial or quasi-judicial authority to disallow an amalgamation on the ground that it is unfair to a minority of shareholders

and he would seem to be left with no discretion in the matter.

To sum up, all the letters-patent jurisdictions provide for the safeguard of class approval whenever the rights of a class are sought to be affected. In view of the language employed in these statutes, the application of English decisions is in some cases clearly precluded and in others doubtful. But these jurisdictions often substitute the Provincial Secretary or other government authority for the court for sanctioning the corporate action and give him no specific guidance for the exercise of his discretion. Even if the courts have no "enviable reputation as the defenders of dissenters,"[230] it is doubtful whether a government department can be expected to fare any better. As the opinions of the minister or government department are not systematically published,[231] as are the judgments of the courts, and as the proceedings before them are unlikely to be conducted in the open as normal judicial proceedings, it is not easy to know the criteria and standards applied by them in exercising their discretion to affirm, reject or modify a corporate decision at the instance of a dissenting minority.

Under the English Act, as we have seen, appraisal right is given in a reconstruction by members' voluntary liquidation under section 287. The English Act does not provide separately for amalgamations. Amalgamations can be carried out under section 287 and both consolidations and mergers conveniently effected[232] by winding up the company or companies concerned voluntarily. The dissenting shareholder in such a case will be entitled to appraisal right if he dissents in the manner and within the time prescribed in the Act, but the amalgamation can be effected

without obtaining judicial sanction. Alternatively, amalgamations may also be effected by a compromise or arrangement under section 206 entered into or made with a view to amalgamating two or more companies and in this case judicial sanction is necessary but the dissentient shareholder cannot demand that he be bought out. Thus in every amalgamation the minority has the protection, for what it is worth, of appraisal right or the court's supervision.[233] American statutes invariably provide for appraisal right for shareholders dissenting to a merger or consolidation, but do not require judicial or other sanction. The Canadian memorandum jurisdictions generally require judicial sanction and do not confer appraisal right on dissenting minorities. Only Alberta[234] and Newfoundland[235] have provisions corresponding to English section 287, but no other Canadian jurisdiction. In the letters-patent jurisdictions, not only is appraisal right not conferred on dissenting shareholders, but often the approval of a government department is substituted for that of the court. Under the new Ontario Bill, even this protection has been weakened in that the minister has little discretion left once the amalgamation complies with all the prescribed statutory procedures. In short, the dissenting or minority shareholders have no greater protection in the Canadian jurisdictions than in England or the American states; indeed, their position may be even more vulnerable.

Neither the Ontario nor the Canada Act provides for compromises or arrangements between a solvent company and its creditors including debentureholders. The Companies Creditors Arrangement Act of 1933, a Dominion statute, provides for compromises and arrangements between

an insolvent company and its creditors. The Canada Act integrates the provisions for arrangements with creditors under the Act of 1933, the Winding-Up Act and the Bankruptcy Act, in its provisions for compromises or arrangements between a company and its shareholders or creditors or classes of them.[236] An insolvent Provincial company can make a compromise with its creditors only under the federal 1933 Act.

English decisions have been followed extensively in Canada with regard to the duties of the court called upon to sanction a reorganization or a reconstruction.[237]

The Quebec Securities Act exempts from its registration requirement the issuance, distribution or sale by a company of its securities exclusively to its existing security-holders, provided that no commission or remuneration is paid or allowed in connection therewith and provided that the company gives notice to the Q.S.C. "indicating the date, amount, nature and conditions of the proposed issue, distribution or sale" and the Commission has informed the company that it does not object to its doing so.[238] In other words, the company need not register as a security-issuer unless the Commission requires it to do so upon such notice.

The Ontario Securities Act exempts from registration a trade "in a security whether of its own issue or not that is distributed or issued by a company to holders of its securities as incidental to a bona fide reorganization or winding-up of such company or distribution of its assets for the purpose of winding-up its affairs," provided that no commission or other remuneration is paid or given to others in respect of such distribution or issuance. It also exempts a "trade in a security of a com-

pany that is exchanged by or for the account of such company with another company or the holders of the securities of such other company in connection with a consolidation, amalgamation, merger or reorganization of either company or in connection with a take-over bid as defined in [the Act]."[239]

These exemptions, which may be contrasted with the provisions of the California Securities Law, take away from the administrative control of the securities commissions many cases of recapitalization or reorganization. It may be recalled that the United States Securities Act of 1933 also exempts voluntary reorganizations not involving the payment of a commission or other remuneration.[240] Referring to this exemption in the United States Act Professor Louis Loss has observed:[241]

> "The philosophy of this exemption is not altogether easy to understand in view of the skepticism which the legislative history reflects concerning voluntary reorganizations. The . . . rather weak explanation [given for it] in the conference report indicates that the exemption may represent little more than a horse-trade compromise between the two houses [of the United States Congress]."

It may be observed that the Quebec and Ontario exemptions are wider than the American. Under the U.S. Act it is necessary for the exemption to apply that the offering must be by way of "exchange" to the existing security-holders. The Ontario and Quebec exemptions are not so restricted. Secondly, the U.S. Act's exemption applies only where the issuer of the securities is one and the same. The Ontario exemption makes it very clear that it applies to securities offered or issued by a company to its existing security-holders, whether or not they are of its own issue.

4. Appraisal and Conclusions

The doctrine of absolute priority adopted as a test of fairness by the United States Federal courts has not been generally embraced in the state jurisdictions of that country and is unknown in the English, Canadian and other Commonwealth jurisdictions which have examined fairness by the test whether the majority have acted reasonably and honestly in consenting to a recapitalization or reorganization, regarding it as commercially advantageous to the class as a whole. The choice between the test of absolute priority and the test of majority rule is really a philosophical one: should the majority be given the power to bind the entirety, including an unwilling minority, to a variation or abrogation of the rights and privileges of that class as a whole? The American federal philosophy circumscribes the power of the majority by the qualification that the scheme should do no violence to the absolute priorities between the different classes. Thus, for example, the majority of the creditors cannot by their consent bind the minority to a scheme which postpones the rights of creditors to existing junior interests. In other words, absolute priority is a "fundamental right", as it were, of every individual corporate security-holder and no majority decision is valid and binding on the minority, if it violates that fundamental right. Obviously such a rule provides the greatest measure of protection for the individual shareholder or creditor.

No such fundamental right is recognized outside the United States federal courts. The English law authorised the modification of the rights of the creditors of a company under winding-up by three-fourths majority

vote of creditors present in person or by proxy by the Joint Stock Companies Arrangement Act of 1870[242] long before it authorised similar arrangements between a company and its shareholders or classes of them. Prior to that Act of 1870 it was impossible for a majority of creditors to bind the minority.[243] Even today under the English law a creditor's promise to his debtor to waive in part or in whole his claim against the debtor is as such not binding on the promisor, is a nudum pactum and a legal nullity.[244] The Act of 1870 was indeed a departure from the common law philosophy and was based on commercial convenience. It is to the spirit of the Joint Stock Companies Arrangement of 1870 that all the Canadian statutory provisions as well as those of England can be traced. Indeed "That spirit is one of compromise."[245] The courts called upon to supervise reorganizations and recapitalizations were therefore concerned with the reasonableness and good faith of the compromise and did not impose absolute legal standards from outside.

Notwithstanding weighty criticism of the judicial role in England and the American States and notwithstanding the weighty admiration received by the American Federal doctrine of absolute priority, the writer is of the opinion that the multifarious interests involved in a corporate enterprise must be left free to regulate their relationships and destinies, subject only to the commonweal, on democratic principles and norms of fairplay. The law should encourage honest compromises without imposing absolute criteria founded upon a sacrosanct concept of property.

The function of the law and the judges should mainly be to ensure (i) (a) that those called upon to assent to a scheme are afforded full knowledge of all relevant information, (b) are fully apprised of the sacrifices demanded of them, both in themselves and in relation to others, (c) have the opinion of disinterested experts on the necessity and propriety of the reorganization or recapitalization; and (ii) that the democratic process is not abused as a tool for fraud or oppression or self-aggrandizement. The law of recapitalization and reorganization should be reformed to meet these ends adequately. It should (i) define the specific instances in which class approval is mandatory; (ii) provide for the assent of a three-fourths majority in value of all outstanding securities of the affected class, and not merely those present and voting in person or by proxy, to approve of the scheme; (iii) provide for a court-appointed expert to report on the scheme before the approval of the security-holders is sought, and (iv) ensure that full and frank information is made available to the security holders invited to assent to the scheme. With these safeguards the democratic process can be expected to work fairly and satisfactorily in the best interests of all.

CHAPTER 7

THE WATERED STOCK PROBLEM

> "[L]awyers or professors who think the watered stock problem has become theoretical need only examine the current reports to find danger lurking for the careless draftsman." BAKER & CARY, CASES AND MATERIALS ON CORPORATIONS, 792-93 (2d unabridged ed. 1959).

The watered-stock problem means the inflation or over-valuation of the consideration for the issuance of shares by a corporation. It is resorted to in practice to carry out a surreptitious issue of shares at a discount, but may occur unintentionally as well, and is the result of a deliberate or inadvertent over-valuation of the non-cash consideration for the issuance of shares by a company. To the extent that it has occurred, the capital raised is illusory. This chapter examines how far the various jurisdictions have provided safeguards against its occurrence.

A. INTRODUCTION: CONSIDERATION FOR THE ISSUE OF SHARES

Consideration consisting of money or money's worth is required in all jurisdictions for the allotment by a company of its shares, whether with or without par value. This means that a company cannot make a gift of its shares; nor can it waive the consideration due for their allotment. Correspondingly, the allottee of the shares is liable to pay for them and cannot escape that liability by anything short of such payment.

The English company statutes and those patterned on their model have never found it necessary to embody expressly this basic requirement or even to specify negatively what are not good consideration for the allotment of shares. But ever since 1867 the English Acts have required companies which allot shares "as fully or partly paid up otherwise than in cash" to file with the registrar of companies within one month after such allotment the contract in writing (or, in case the contract is not in writing, the particulars as prescribed) constituting the title of the allottee to the allotment, together with any contract of sale or for services or other consideration in respect of which the allotment was made.[1] Beyond this indication that the consideration may be other than cash, there are no statutory provisions defining the nature of non-cash consideration for which shares may be allotted. Can a company accept a promissory note or promise of future service as good consideration? We have no guidance to this and similar questions in the English Acts.

In contrast the American statutes usually contain specific provisions as to the kind and quantum of consideration. The constitutions of several states have provisions relating to consideration for the issuance of shares.[2] The Model Act provides that

> "The consideration for the issuance of shares may be paid, in whole or in part, in money, in other property, tangible or intangible, or in labor or services actually performed for the corporation . . . . Neither promissory notes nor future services shall constitute payment or part payment, for shares of a corporation."[3]

The Uniform Act qualifies "services" with the restriction that they must be necessary.[4] Some state statutes even spell out the kind of consideration with greater specificity.[5] The New York Business Corporation Law provides[6] that the

> "Consideration for the issue of shares shall consist of money or other property, tangible or intangible, or labor or services actually received by or performed for the corporation or for its benefit or in its formation or reorganization or a combination thereof . . . . Neither obligations of the subscriber for future payments nor future services shall constitute payment or part payment for shares of a corporation."

Canadian statutes contain specific provisions more elaborate than the English but less than the American counterparts. The Dominion Act indicates that the consideration may be payable in cash or "in property or past services."[7]

Details relating to the consideration for the issuance of shares which are statutorily spelled out in America, and to a lesser degree in Canada, have been left to judicial determination by the English statutes. But it must be observed that decisions have arrived substantially at the same conclusions as the American and Canadian statutory law.[8]

Two observations may be made in connection with the rule that the consideration for the issuance of shares may consist of cash or kind and that a company may not give away its shares as a gift or for illusory consideration. First, all jurisdictions recognize and permit the capital-

ization of surpluses by the issue of share dividends, or "bonus shares" as they are called in the English jurisdictions. These shares are not issued by way of gift, though the allottee does not directly pay for them in cash or kind. Secondly, in America the notion has existed that no-par shares could be allotted without any consideration.[9] This is attributable to the practice of issuing as "bonus stock"[10] no-par shares as fully paid and non-assessable in a package with senior securities with a view to making the latter more attractive. This notion appears to be misconceived.[11] The Model Act clearly requires that the consideration for no-par shares as well as par value shares must be expressed in dollars.[12] It may be safe to conclude that with respect to the requirement of consideration for the allotment of shares there is no difference between par and no-par shares.

With this brief introduction we shall now proceed to examine two important problems with regard to the raising of capital, viz. (1) the issue of par shares at a discount and (2) the issue of shares for an over-valued non-cash consideration, or the so-called problem of watered-stock.

B. ISSUE OF PAR SHARES FOR CASH AT A DISCOUNT

The English Acts have never expressly enjoined companies from issuing their shares at a discount, but that result was reached by judicial interpretation of the statutes and thereafter the statutes have enabled the issue of shares at a discount under rigidly defined circumstances and conditions.

The leading authority — though not the first to reach that conclusion[13] — is the decision of the House of Lords in The Ooregum Gold Mining Co. of India, Ltd. v. Roper.[14] The Ooregum company which was confronted by the prospect of failure and which direly needed additional capital to extricate itself out of its difficulties issued preference shares of a par value of £1 each at a discount of 75% at a time when its outstanding common shares of the same par value were saleable in the market only at a discount of 87½%. In other words, the issue at a discount was made in good faith and in the best interests of the company. What is more, the step proved to be a wise one, for the company not only got out of its troubles thanks to the additional capital raised, but became prosperous and the common shares attained a market value of twice their par value. Roper, who had purchased some common shares on the stock exchange, brought a representative action for a declaration that the allotment of the preference shares at a discount was ultra vires and that the original allottees of those shares were liable for the amount unpaid on them.

From the trial court up to the House of Lords all the judges were unanimous that the company could not allot its shares at a discount and that the allottees were liable for the unpaid amount of nominal value of the shares.[15] Lord Halsbury thus stated his reason in the House of Lords:[16]

> "[An agreement to take shares in a company] is an agreement to become liable to the company for the amount for which the share has been created. That agreement is one which the company itself has no authority to alter or qualify, and I am there-

> fore of opinion that . . . the company were prohibited by law, upon the principle laid down in Ashbury Company v. Riche,[17] from doing that which is compendiously described as issuing its shares at a discount."

What is even more important, one who takes an allotment of shares at a discount remains liable to the company for the unpaid amount of nominal value despite the company agreeing to treat the shares as fully paid up. He remains liable to pay calls up to that amount when the company is a going concern and as a contributory in the event of the winding-up of the company. Lord Herschell alone expressed the opinion that the liability should be confined to the latter case only. His lordship remarked:[18]

> "What [companies] cannot do is to exclude the liability, in case the company is wound up, to contribute to the extent unpaid on the shares for the benefit of the creditors. But what is to prevent the company from agreeing that, except in so far as the legislature has imposed the liability, they will not enforce any?"

The other law lords abstained from expressing any opinion on this view except Lord Watson who intimated his disagreement.[19]

The following salient features of the case deserve special mention:

(i) The decision to issue shares at a discount was made by a special resolution at an extraordinary general meeting of the company. "The special resolution so passed was duly confirmed."[20] In other words it was not solely decided upon by the board of directors.

(ii) The objection to the issue was not made by a creditor. Nor was the company financially embarrassed or being wound up. The issue at a discount had proved to be a turning point in the company's life and all its shares were selling in the market at a substantial premium.

(iii) The objection was raised by one who had become a shareholder about four years after the issue at a discount was made alleging that such issue "was ultra vires."[21]

(iv) At the time the issue at a discount was made the company was facing disaster and there was no other hope for raising additional capital except by such issue, as the outstanding shares were selling in the market at a price far below their par value.

(v) No fraud or bad faith was involved at any stage of the transaction and the company greatly benefitted by the issue.

The Ooregum case settled the law on the subject. It is ultra vires for companies to issue their shares at a discount — ultra vires in the sense of forbidden (in this case impliedly) by the statute. Good faith or benefit to the corporation is irrelevant in this context. The allottee of the shares is liable to the full extent of the par value of the shares. The rule is that "the liability of a member continues as long as anything remains unpaid upon his shares. Nothing but payment, and payment in full, can put an end to the liability."[22]

The arguments in the Ooregum case clearly show that an alternative way is available to a company faced with similar predicaments. It could issue new shares at a lower par value, by amending the charter

in the prescribed manner,[23] and with a right to a larger dividend.[24] The English Act empowered in 1928 the issue of shares at a discount under certain circumstances with the sanction of the court,[25] but the provision has rarely been made use of.[26]

We have seen that, according to the Ooregum case, the allottee of shares at a discount is nevertheless liable to pay up the full par value of the shares. But it would seem that in appropriate cases the court would help him to get out of such liability by rescinding the contract. This was the case in In re Almada and Tirito Company[27] where an allottee of 200 shares of a par value of £1 each at a discount of 90% succeeded in an action brought by him for the deletion of his name from the register of members and the recovery of one shilling per share which he had paid to the company. The equitable remedy of rescission will, however, be lost by delay or laches on the part of the allottee or by restitutio in integrum becoming impossible.[28]

While the Ooregum case established the rule that par value shares cannot be issued at a discount, its facts bear eloquent testimony to the need and justification for permitting companies to do so in appropriate cases. The Wrenbury Committee recommended in 1918 that provisions might be made in the Act to permit companies to issue their shares at a discount.[29] This was not done until the Companies Act of 1928. But the Act of 1900 authorised companies to pay "[u]pon any offer of shares to the public for subscription" a commission to any person in consideration of his subscribing or agreeing to subscribe or procuring or agreeing to procure subscriptions for the shares. There was no statutory limit

on the extent of such commission. All that was necessary was that the by-laws had to authorise the payment and specify the extent and this had to be disclosed in the prospectus.[30] In addition "usual" brokerages have always been permissible. In effect the teeth of the Ooregum decision had been pulled out by the legislative authorisation of unrestricted commission. Besides, as shares may always be issued for non-cash consideration, the Ooregum rule can easily be circumvented by the overvaluation of the consideration — a problem which will be considered later in this chapter. Moreover, the modern practice of issuing shares of low par value at substantial premia in effect frustrates the purpose of the Ooregum rule.

The present English Act permits: (1) the issue of shares at a discount under certain circumstances with the sanction of the court;[31] (2) the payment to a limited extent of commission to the subscribers and procurers of subscriptions for shares;[32] and (3) usual brokerages.[33]

In contrast many American jurisdictions have traditionally forbidden the issue of par shares at a discount. So does the Model Act when it provides that "Shares having a par value may be issued for such consideration expressed in dollars, not less than the par value thereof, as shall be fixed from time to time by the board of directors."[34] Only seven American jurisdictions — California being one of them — permit in some circumstances the issue of par value shares at a discount.[35] The Canadian jurisdictions, letter-patent as well as memorandum, are in line with the general American pattern.[36] The Dominion Act provides in language which is perhaps cumbrous that where par value shares are

allotted for cash, the amount of cash shall be "at least equal to the product of the number of shares allotted and issued multiplied by the nominal or par value thereof."[37]

It is perhaps somewhat strange that jurisdictions which permit no-par shares issuable at a flexible price should in the case of par value shares rigidly insist upon their issue at their par value. The issue at a discount may be beneficial to the company, and consequently to its creditors and shareholders. It may be the only way for a financially embarrassed company whose shares are selling below par value to raise the much needed additional capital to revitalize itself without resorting to the hazardous technique of borrowing. The risks inherent in such issues could to a large extent be safeguarded against by appropriate provisions for publicity. The English device of judicial approval ensures that the permission to issue shares at a discount is not abused. The issue of par shares for cash at a discount presents far fewer difficulties from the point of devising safeguards for creditors and shareholders than the issue of shares for overvalued non-cash consideration. In the latter case the detection of the overvaluation may be exceedingly difficult to an outsider and even a shareholder, whereas in the former case no serious problem of detection of the issue at a discount arises.

It is submitted that the English Act is more practical than the Canadian and most American jurisdictions in permitting the issue of par value shares at a discount subject to safeguards. The Indian Act follows the English precedent with one modification, viz. that the discount ought not to exceed 10%, unless a higher percentage is in any special case

permitted by the Central Government.[38]

Two observations may be made in this context. First is the accounting for shares issued at a discount. The English accountancy practice is to show the paid-up capital (or the called up capital if a call has actually been made) as a balance-sheet liability and not the aggregate par value of all the issued shares (unless of course the shares are fully paid-up or called-up). Correspondingly, the uncalled capital is not shown as a balance-sheet asset.[39] Accounting for shares issued at a discount, therefore, presents no problem. Nor will anyone be misled, if the balance-sheet discloses by a footnote that the shares have been issued at a discount as permitted by the law and are not partly paid shares subject to future calls. It is submitted that the law should require such specific disclosure.

The Canada Act, in its definition of "accounts receivable", makes it clear that that expression does not include "uncalled share capital of the company or calls made but not paid."[40] This may mean that a balance-sheet prepared in accordance with the Act should only portray the actually paid-up share capital. The Act, however, does not authorise the issue of par value shares at a discount, but even if it should, there will be no difficulty about accounting.

The Continental accountancy practice seems to be "to show the whole issued capital as a liability and the uncalled liability of the members as an asset." As Gower observes, this does give a clearer picture of the actual position of the company.[41] As the Continental laws do not authorise the issue of shares at a discount, the problem of accounting

for shares issued at a discount will not arise.

The definition of "stated capital" in the Model Act includes, in the case of par value shares, the aggregate par value of all such shares issued.[42] If the par value shares are only partly paid, the stated capital will include the paid-up as well as uncalled or unpaid capital in their case. If this stated capital is shown on the liabilities side of the balance-sheet, uncalled or unpaid capital will have to be included among the assets, as on the Continent. The Model Act, like Continental laws, does not authorise the issue of shares at a discount. If, however, an Act modelled on the Model Act permits the issue of par value shares at a discount, accounting for such discount may give rise to differing practices. An American work on accountancy refers to two practices, viz. (i) to debit the discount on the assets side of the balance sheet as a deferred charge, as is often done in the case of organizational expenses, or (ii) to show the discount as a deduction from net worth on the liabilities side of the balance-sheet, and expresses a preference for the second alternative.[43]

The California Corporation Law authorises companies to issue par value shares as fully paid-up at less than par, if the board determines that such shares cannot be sold at par.[44] It, however, takes care to define stated capital so as to exclude the amount of such discount.[45]

In sum, it is submitted that if a statute authorises the issue of shares at a discount, it should take care to preclude the discount from being shown as a deferred charge on the assets side of the balance sheet, for it is in no sense an asset.[46] California's definition of stated capital

is a good example to follow to achieve this end.

Secondly, the effect of an unauthorised issue of shares at a discount should be spelled out in the Act. The allottees should normally be held liable on the shares to the full extent of the par value, but in appropriate cases the court must be authorised to rescind the allotment, e.g. where the company is solvent and the allottee acts promptly. In addition the directors authorising the issue in contravention of the law must be held liable to the company for the loss caused to it.

It may, however, be added that the rule forbidding the issuance of shares at a discount means very little in practice so long as companies are allowed the freedom to fix the par value of shares as low as they please. The rule has validity only insofar as it will ensure the raising of share capital to some degree.[47] It makes no sense where a company statute prescribes neither a minimum share capital nor even a minimum par value for shares.[48]

C. ISSUE OF SHARES FOR NONCASH CONSIDERATION: THE WATERED STOCK PROBLEM

We are faced with far more formidable difficulties where shares are issued for noncash consideration. Cash consideration presents no problems of valuation, whereas noncash consideration presents enormous problems of valuation.

When par value shares are issued for noncash consideration, we have the one and only problem of the valuation of the consideration as the par value operates as the minimum price below which the shares

ought not ordinarily to be issued. Thus the par value affords some protection to the existing shareholders against the dilution of their equity. But even the issue at par may adversely affect them when the shares have a higher market value and they are afforded no pre-emptive right to purchase the new shares. On the other hand if the shares have a market value below par, there is the need to issue the shares at a discount. If the law forbids the issue of shares at a discount, or imposes too many restrictions, there is an inevitable temptation to circumvent it by overvaluation of the noncash consideration. The English statute does provide, as we have seen, for the issue of shares at a discount for noncash as well as cash consideration. But even so, the temptation to avoid compliance with the conditions and restrictions by the simple trick of overvaluing the noncash consideration strongly exists. Such over-valuation may be deliberate, but it may be also accidental, or due to an honest error of judgment.

The problem of over-valuation of noncash consideration acquires a new dimension in the case of no-par shares which lack a bench-mark determining the minimum price at which they may be issued. When no-par shares were first introduced, it was anticipated that they would end the temptation or need to over-value noncash consideration and hence the watered stock problem.[49] We have, therefore, to examine whether this expectation has been in fact realised in Canada and the United States or whether the no-par device has only made it easier to water the stock and escape liability by helping to conceal the "water".

It ought to be emphasised here that though the effect of overvaluation of noncash consideration is to render the stock issue one at a discount, there is an important difference between it and the issue of shares for cash at a discount. While the former may occur deliberately or unwittingly, the latter is always a knowing and deliberate act. Shares cannot be issued for cash at a discount unwittingly. It is easier to conceal the former than the latter. Therefore despite their similarities, the problems of judicial control in the two cases are not identical.

The problem of watered stock is essentially a problem of valuation of noncash consideration, but it is not always so. In many reported cases there was little doubt that the valuation was not an honest error of judgment, but purely arbitrary and whimsical. We shall show in the following pages that the courts have generally failed to distinguish between an unwitting overvaluation made under the reasonable belief that the valuation was sound and hence bona fide, and a deliberate overvaluation not made, however, with a fraudulent intention and in that sense bona fide.

Yet another complexity in most cases of watered stock is that the valuation of noncash consideration is made for the company by the very persons (or their dummies) to whom the shares are to be allotted. Thus promoter-vendors who sell their property to a company which they have promoted for that very purpose have a strong motivation to overvalue the consideration. Again, those who are in control of a company and are to be rewarded for their services to it by an issue of its shares may be tempted to overvalue their services.

In short, the watered stock problem is a composite problem involving within it a number of complicated issues, but having a common consequence, namely, inflating the value of the assets of the company. It may more aptly be called the watered assets problem. We shall here examine the techniques adopted by different jurisdictions to tackle this problem.

1. The English Approach

The English statutes have never attempted to combat stock-watering beyond certain measures designed for publicity. As mentioned earlier one such measure is that every company which allots shares "as fully or partly paid up otherwise than in cash" must file with the registrar of companies within one month after such allotment the contract in writing — or, in case the contract is not in writing, the prescribed particulars — constituting the title of the allottee to the allotment together with any contract of sale, or for services or for other consideration in respect of which the allotment was made.[50] It must be noted that failure to comply with this requirement will not by itself invalidate the allotment or render the allottee liable to pay the full par value in cash,[51] but is punishable with a fine. The only publicity value of this requirement is to enable anyone concerned to know that the company has allotted shares for noncash consideration, but it will not by itself warn him of any overvaluation of such consideration. To discover that he must have made his own investigation. The courts have held that "a general description of the nature of the consideration was sufficient without setting out . . . all the particulars."[52] Another publicity requirement

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is that every prospectus issued by the company must disclose the "number and amount of shares and debentures which within the two preceding years have been issued, or agreed to be issued, as fully or partly paid up otherwise than in cash, and . . . the consideration for which [they] have been issued or are proposed or intended to be issued."[53] The same kind of disclosure is required in a statement in lieu of prospectus to be filed by public companies which do not publish a prospectus.[54] Similar disclosure has to be made in the annual return to be filed with the registrar annually.[55] All these publicity requirements only ensure disclosure of the fact that shares have been issued for noncash consideration, but they do not require disclosure of the mode of valuation of the consideration or the market value or the cost at which the allottee had acquired them. It is submitted that these publicity provisions are utterly inadequate to put anybody upon guard.

Nor have the courts been more zealous than the legislature in protecting investors and creditors against stock-watering. They have not only generally tended to uphold the valuation placed by the board upon noncash consideration, but declined to interfere unless it was shown that the valuation was made mala fide. The extreme lengths to which this philosophy of noninterference has been pushed may be witnessed by the decision of the Court of Appeal in In re Innes & Co., Ltd.[56]

In that case two brothers who owned a not-too-prosperous business joined six others to promote a company to take over the business. The brothers wanted a price of £6,000[57] for their business and were willing

to take half of it in cash and the remaining half in shares of the company. It was agreed between the promoters that the vendors would sell their business to the proposed company for £25,000, out of which £3,000 was payable to them in cash and the remaining £22,000 by the allotment to them or their nominees of 2200 shares of £10 par each credited as fully paid up, that the vendors would nominate their six collaborators for the allotment of 300 shares each out of these 2,200 shares, that another 100 of these would be used to reward those who might bring business to the company, and that the six collaborators would each take 50 shares to be paid for wholly in cash so that the vendors might be paid the cash price payable for the business. This scheme was carried through by incorporating a private company with a share capital of £25,000 divided into 2,500 shares of £10 par value each, all issued and paid up, but without a penny of working capital, and a business of an estimated value of £6,000. Within twenty five months the ill-fated company incurred debts amounting to ten times the value of its assets and had to be wound up. The liquidator sought to hold the directors of the company — one of the two brothers and three of the six collaborators — liable on the shares which had been allotted to them as fully paid up without their paying a penny in cash or kind to the company.

There was no allegation of fraud against the directors and they contended that they were justified in distributing the capital of the company in accordance with the arrangement which had unanimously been agreed upon between the only eight shareholders of the company and which agreement had duly been registered with the registrar of compan-

ies. They argued that (1) "[t]here was no disappointment of creditors, because the agreement filed shewed the true state of the facts" and that (2) the shares were not allotted by the company to the collaborators in pursuance of any contract with them, but that they were allotted to them on the nomination of the vendors. Significantly, they did not contend that the business was worth £25,000 to the company or anybody else.

The liquidator contended that the respondents had not paid for the shares in meal or in malt, that they had made a gift of the shares to themselves, that they were liable for having paid £25,000 for property known to them to be worth only £6,000, that the registration of the agreement did not relieve them of their liability to pay to the full extent the nominal value of the shares, that the issue of the shares was an unauthorised issue at a discount and hence ultra vires and incapable of ratification even by the unanimous consent of all the shareholders.

Kekewich, J., upheld the claim of the liquidator and held that respondents were liable as contributories for the amount unpaid on their shares. He was of the opinion that the agreement or arrangement was a sham and that the issuance and allotment of the shares to the collaborators as the nominees of the vendors was tantamount to their allotment at a discount of 100%. This eminently sound conclusion clearly perceives that the overvaluation in this case was not a mere error of judgment, but a conscious and deliberate manipulation, though without fraudulent intention. His judgment was, however, unanimously reversed by the Court of Appeal. The reasoning of the appellate court was this: There was no fraud alleged in the transaction. The 2,200 shares were part

of the consideration for the business purchased by the company. This contract of purchase had not been impeached by the liquidator or shown to be a colourable transaction. Mere inadequacy of the consideration is not sufficient to invalidate the purchase. The parties were acting honestly in what they conceived to be in the best interests of the company.

This unfortunate decision in effect permits companies to attach any arbitrary valuation to noncash consideration and present such value in their books and balance sheet as the worth of the assets. It shows a way to water stock without incurring liability therefor. It is submitted that it is a misconception to assume that the rule that the price is a matter for the buyer and seller to agree upon in their wisdom is applicable to a situation such as the present. If it is possible, as the Innes case held, for a company to allot shares of a par value of £25,000 for a noncash consideration which it regards as worth only £6,000, it is difficult to see why the same shares cannot be issued for a cash consideration of £6,000. The Innes decision runs counter to the basic philosophy underlying the Ooregum case[58] that the shareholder is liable to the company for whatever remains unpaid to the company towards the par value of the shares issued to him and that it is ultra vires of a limited company to release a shareholder from an obligation to pay up his shares without receiving payment in money or money's worth. There was very little justification in the Innes case for the incorporators to do what they did. There were no outstanding shares of the company selling at a discount. If the object of the incorporators was to allocate control between themselves in a certain way, they could have achieved that end

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by conferring special voting rights on some shares or by voting agreements and it was unnecessary to resort to deliberate overstatement of the value of the business acquired. It is idle to say that the creditors are not misled in such cases because of the publicity requirement, for the contract filed with the registrar is unlikely to spotlight on the inflation of the value of the noncash consideration.[59]

The Innes case demonstrates the failure of the court to distinguish between an honest valuation which turns out to be excessive and a deliberate overvaluation without fraudulent intention. The former is common and the courts have quite properly refused the invitation to substitute their judgment aided by a 20-20 hindsight for that of the businessmen who did not have that advantage when they made the valuation.[60] But the Innes case belongs to the latter category. There is little justification — commercial or otherwise — for permitting a deliberate overvaluation, even if it is made with the most innocent of intentions. Though in both cases the directors act bona fide, such common categorization does not render them identical situations. It is submitted that the proper test is: "Is the valuation honest?" and not "Is the deliberate overvaluation nonetheless honest?" It is submitted that the decision in the Innes case has applied the fallacious test and facilitates stock-watering.[61] The decision of Kekewich, J., at trial is the preferable one.[62]

2. The American Approach

The American statutes have somewhat more detailed provisions than the English Act with regard to the consideration for the issuance of shares, and yet measures to prevent stock-watering are often inadequate. Most of the statutes provide that the valuation placed on noncash consideration by the board of directors shall be conclusive in the absence of fraud in the transaction and leave it to the courts to decide what constitutes fraud.[63] Variations do exist as to the circumstances in which the board's valuation may be impeached. In Nevada even a fraudulent valuation is conclusive on all except the then existing shareholders and creditors; in some proof of deliberate overvaluation is necessary; in some others proof of overvaluation, whether deliberate or unintentional, will suffice; in yet others reasonable care tests are applied.[64] But no statute attempts to prescribe the criteria for valuing noncash consideration.

American judicial approach to the problem is generally the same as the British approach. Where a valuation has been made bona fide, the courts will not interfere, even if it could be shown to be in fact excessive. In Coit v. North Carolina Gold Amalgamating Co.,[65] the United States Supreme Court declined to intervene as the trial court had found that "the valuation was honestly and fairly made." There the owners of a mining business decided to incorporate a company to take over the business. Their average estimate of the value of the business was $137,500 and they transferred the business to the company for $100,000. A judgment creditor of the company who could not obtain satisfaction from the company which had by then become insolvent sought unsuccess-

fully to hold the vendor-shareholders liable for unpaid subscription alleging that the valuation of the business at $100,000 was far in excess of its actual worth.

Some American courts have applied stricter standards than the Supreme Court and have insisted that "when shares are paid for in property, the value of the property must actually equal the amount of the shares given for it, regardless of any question of fraud, fraudulent intent, or the honest opinion of the shareholders as to its worth."[66] This approach is founded on the argument that to protect creditors, the relevant criterion is the actual value of the property and not what the directors or the shareholders thought it was worth. This is known as the "true value" rule.

There are American decisions which hold that knowing or deliberate overvaluation is constructive fraud.[67] We have seen that this view did not prevail with the English Court of Appeal in the Innes case[68] which held that actual fraud is necessary to impeach valuation and even deliberate overvaluation. There are American decisions which hold like the Innes case, that directors are free not only to value in good faith, but even consciously overvalue in good faith.[69]

Thus we have jurisdictions which require good faith valuation and nothing more; others which do not tolerate deliberate overvaluation; others which do not tolerate any overvaluation, deliberate or not; yet others which require not only honesty, but valuation based upon a due examination of the elements of value.[70] These variations reflect varying attitudes toward the problem of stock-watering.[71]

The securities statutes and their enforcement by the administrative agencies have had a salutory effect in controlling stock-watering in Ameri

The possibilities for stock-watering at the promotional stage of a corporation are effectively checked by the disclosure requirements of the federal Act of 1933. Schedule A of the Act, following the English precedent, requires the registration statement to set out, inter alia, "any amount paid within two years preceding the filing of the registration statement or intended to be paid to any promoter and the consideration for such payment." These disclosure requirements are no more elaborate than those of the Fourth Schedule of the English Act. For instance, the English schedule requires every prospectus to disclose the "number and amount of shares and debentures which within the two preceding years have been issued, or agreed to be issued, as fully or partly paid up otherwise than in cash, . . . and the consideration for which those shares or debentures have been issued or proposed or intended to be issued." The American schedule contains no equivalent disclosure requirement in the case of shares allotted for noncash consideration. But the role of the S.E.C. in ensuring that disclosures are full and adequate in every case and its powers to issue an order suspending the effectiveness of a registration statement make the American legislation a far more potent weapon in practice to protect the interest of the investor. The administrative agency has ensured that the true character of a promotional operation is fully and clearly presented in every case and that a corporation and its promoters do not get away with superficial accounts shedding inadequate light[72] or with misleading accounts.[73] It must, however, be

recalled that the S.E.C.'s jurisdiction does not extend to securities and transactions exempted under the Act of which non-public offerings are important. It is in close or private companies that stock-watering is liberally resorted to. In these cases stock-watering has to be controlled under the State Blue Sky laws, but we have seen that the scope and effectiveness of these statutes vary tremendously.

3. The Canadian Approach

The watered stock problem received the attention of a Royal Commission whose recommendation resulted in important amendments to the Dominion Companies Act of 1934. The Commission's report suggested two measures:[74] (1) the creation of "an Investment and Securities Board . . . to review the proposed capital structure of all companies incorporated under the Dominion Act and desiring to issue bonds or stock to the public. . . . [T]he Board would pass on all issues of bonds or stock after thorough investigation . . . and would . . . give careful consideration to the proper relation that bonds or stock to be issued, bear to the company's assets." This recommendation was never implemented. (2) "it should be made illegal for directors, promoters, etc., to issue fully paid-up shares unless the company receives for these shares, adequate consideration in cash, property, or services. The duty of investigating and determining the adequacy of such consideration, where such adequacy is involved in any litigation, should be placed squarely on the Courts . . . . If the decision of the Courts should be that adequate consideration was not given, then the liability for the balance

of the consideration unpaid should attach to the directors concerned, if it could be shown, (a) that such directors had knowledge of the inadequacy of the consideration, or (b) failed to take reasonable steps to ascertain the adequacy of the consideration." Even this recommendation was not fully implemented.[74 a] The Report, however, did not indicate the criteria to determine the "adequacy".

As a result of the Report the Companies Act of 1934 was extensively amended in 1935. Most of these amendments have lasted until the present day and in some respects have been further refined and elaborated.

Under the present Dominion Act shares with or without par value "shall not be allotted as fully paid up except for a consideration payable directly or indirectly in property or past services that the directors in good faith determine by express resolution to be in all the circumstances of the transaction the fair equivalent of the cash consideration" for which they could have been allotted.[75] In addition a summary procedure is made available to enable the board to apply to the court ex parte for the approval of their determination.[76] In other words, noncash consideration must be valued in good faith. Similar provisions are found in the provincial statutes.[77]

Canadian courts have, unlike the English Court of Appeal in the Innes case, tended to disapprove deliberate overvaluation and to treat it as giving rise to watered stock liability irrespective of any fraud. A good example of this is the Ontario decision in Toronto Finance Corporation Ltd., and Cook v. Banking Service Corporation, Ltd.[78] The Banking Service Corporation which promoted the Toronto Finance Corporation con-

tracted with the latter, acting through a board named and selected by itself (i.e., Banking Service), under which Toronto Finance allotted a large number of fully paid up shares to Banking Service in consideration of the latter raising capital and rendering other services for Toronto Finance. The contract was made on the assumption that, as the newly formed Toronto Finance had no assets, and hence its common stock had no market value, its shares could be allotted by reference to their actual value rather than their par value. The trial court found that the parties intended to and did agree that the shares of Toronto Finance could be issued at a discount. Both the trial court and the appellate division held that, as the parties acted under the erroneous assumption that the par value of the shares was not an element to be considered in fixing the consideration for the issue of the shares, they did not direct their minds to the problem of valuing the services which were to form the consideration for the allotment of the shares and that, therefore, the agreements to allot the shares could not be regarded as honestly entered into on the basis that the services had or would have to the company a value equal to or greater than the par value of the shares to be allotted.[79] It is submitted that this approach is sound.

But, unlike the American jurisdictions and Britain, where generally the watered-stock liability is to hold the allottee liable as if the shares were not fully paid up, in Canada it has been suggested in Hood v. Caldwell[80] that in Ontario, a letters-patent jurisdiction, the only remedy in such cases, when the company is a going concern, is rescission and "not the establishment of a liability for the par value of the shares." The

logic underlying this suggestion is that, unlike the English Act, the Ontario Act does not contain "a distinct provision making a shareholder liable for the amount unpaid on the stock" and that the liability for any amount unpaid on the stock is enforceable only in the liquidation of the company. This was the view of Hodgins, J.A., in the Appellate Division of the Supreme Court of Ontario.[81] It may be noticed that this view is in conformity with Lord Herschell's opinion in the Ooregum case.[82]

The judgments in Hood v. Caldwell illustrate the difficulties and complexities presented by watered-stock cases. Two owners of a partnership business formed a company under the Ontario Act to take over the business. Three-fifths of the company's common shares were allotted to them as the price for the business transferred to the company. In this way control over the company was retained by the partners. The needed working capital was raised by issuing preference shares having a preferential right to dividend only. To make these preference shares attractive, the remaining common shares were reserved to be issued as "incentive bonus". In the next half a dozen years, the company's business prospered significantly, thanks to the working capital of about $36,000 contributed by the preference shareholders.

Twelve of the preference shareholders brought action in their individual capacities to set aside the agreement under which the vendors of the partnership business received a majority of the company's common stock alleging that the aggregate par value of the shares that they received was far in excess of the worth of the business that they sold to the company. They contended that the issue of the shares to the vendors was

ultra vires, having been made at a discount in violation of the law. In another action a single shareholder sought the removal of his name from the list of shareholders and for a refund of the money he had paid toward the shares allotted to him.[83]

In the Appellate Division two judges held that the contract in pursuance of which the shares had been allotted to the vendors had not been shown to be fraudulent, nor was the consideration paid for the shares illusory on its face.[84] According to them, even if the consideration was illusory, the remedy was not to set aside the contract under which the shares were allotted to the vendors, but to make the vendors liable for the difference between the aggregate par value of the shares allotted to them and the real worth of the consideration supplied by them to the company. In any event the Chief Justice was of the view that the shareholders had become disentitled to the remedy that they sought because of acquiescence and laches.

Three other judges were of the opinion that the consideration was illusory and that the allotment to the vendors was at a discount.[85] But two of them held that the plaintiff shareholders had acquiesced too long in the transactions which they impugned. The third, Ferguson, J.A., was alone in holding that the allotment was ultra vires and void, and that, therefore, it must be set aside.

In the result four out of the five judges held that the plaintiffs could not succeed.

The Supreme Court of Canada affirmed, but the judges greatly differed in their opinions. Duff and Brodeur, JJ., agreed with Ferguson,

J.A., that the issue of the shares to the vendors was made at a discount, hence ultra vires and must be set aside. It is submitted that to set aside the issue of shares is not in every such case the appropriate remedy. The allottee may have nothing to regret about it if the company is in financial embarrassment and he may even welcome the opportunity to escape watered stock liability to the creditors of the company.

Davies, C.J., observed that on the merits he would have held for the plaintiffs had it not been for their long acquiescence.

Anglin, J., was of the view that the plaintiffs, as individual shareholders, could not sue for rescission of a contract entered into by the company with the vendors, but he left open the question whether the company or its creditors would be entitled to some other relief. It is submitted that if this view that individual shareholders have no locus standi to impeach the transaction is correct, it would follow that they cannot be held to be guilty of laches or acquiescence either.

Mignault, J., was alone in agreeing with the Chief Justice of the Ontario Court that the consideration for the allotment of the shares to the vendors was not illusory.

The judgments in Hood v. Caldwell show the difficulties in deciding the appropriate remedy for watered-stock cases. Is it to set aside the issue of the water-stock? Is it to hold the allottees liable as if for unpaid subscriptions and thus remove the "water" from the stock? Who can impugn an issue of shares on the ground that it is watered? Have the shareholders locus standi to do so when the company is a going concern? If they have, will laches or acquiescence disentitle them to the

remedy? Or are such laches and acquiescence irrelevant? Can a creditor impugn the allotment when the company is a going concern? These are some questions spotlighted by that case and on which the statute of no jurisdiction sheds any light.

In Hood v. Caldwell the learned judges did not appreciate the facts in the same way even on the issue of fraud. While Meredith, C.J.O., was "unable to find anything in the case to warrant a finding that the agreement was a fraudulent one", Hodgins, J.A., of the same court could find "no honest intent in the transfer." Hood v. Caldwell is sufficient to dispel any hope that the good faith test alone will be any effective check against stock watering.

Under the Ontario Securities Act the Director of the O.S.C. has the power to prevent any person from trading in a security, where such trade will be in the course of primary distribution to the public, if it appears to him that "an unconscionable consideration has been paid or given for promotional purposes or acquisition of property."[86] This provision does give the O.S.C. the necessary power to control stock-watering in the case of all companies making a "primary distribution to the public." The Quebec Act requires a permit from the Q.S.C. in such cases and the Commission has unfettered discretionary powers in granting or denying a permit.[87] In addition both Acts forbid any person or company to trade in securities without registering with the Commission of the province and here again the Commissions have wide powers.[88] The Ontario Act, however, exempts from registration any trading in the securities of a private company. No such exemption is made by the Quebec Act.

These provisions of the securities statutes provide, in the cases to which they apply, the means for controlling stock-watering. Indeed the regulation by the administrative agencies is a more satisfactory solution to the watered-stock problem than the regulation by the judicial process. The good faith test applied by the judges is an inadequate weapon to tackle a complicated problem.

D. NO-PAR SHARES AND THE WATERED STOCK PROBLEM

We have seen that when no-par shares were introduced it was hoped that they would end the need or temptation to overvalue noncash consideration and thereby end the vexatious watered-stock problem. More than half a century of American and Canadian experience must help us to know whether that hope has been realized. The rarity of reported watered-stock cases in these countries — they are rare in Britain too — gives the prima facie impression that it has been. But we must not ignore the possibility that such cases may be rare because the legal remedies are ineffective or the law is weighted in favour of those who indulge in stock-watering. For instance the good faith rule itself is so weighted and those who challenge the good faith must shoulder the onerous burden of proving bad faith. We have seen how this rule has made it almost impossible to challenge the valuation of directors except in cases of illusory or fraudulent transactions. This is obviously the reason why watered stock cases are rare in England, though no-par shares are not permitted in that country.

Where the case is one of the issue of no-par shares for overvalued noncash consideration, it is even more difficult for the plaintiff to succee for he has not only to prove that the directors dishonestly overvalued the consideration, but also that the no-par shares issued for that consideration were thereby watered. As no-par shares do not have a bench-mark like par value shares, it is perhaps easier to conceal the "water" in the shares. We may illustrate these difficulties by reference to some American cases.

In the famous Piggly Wiggly case[89] the vendor-promoters of a company sold to it a license, which they had bought for a price of $1,000, to operate stores under the name of "Piggly Wiggly" and received from the new-born company all its 15,000 no-par voting stock. At this stage, therefore, the worth of each no-par share was $1,000/15,000, i.e. 6 and 2/3 cents. Using the same corporate mechanism they disposed of these shares at prices of $10 and more for a total amount of 100,000 dollars — that is, at a profit of 9,900%.[90] The only asset that the company itself got by the issue of the shares was the right to use a trade name. Thereafter it raised its working capital by the issue of non-voting preferred stock at par.

The company claimed that the money paid for the no-par shares by the various purchasers and which went into the pockets of the promoters must be restored to its treasury. The action failed. The New Jersey Court of Chancery stated the reason for its decision briefly:[91]

> "There was a full bona fide consideration for the sale by the company [to the promoters] of the 15,000 shares of

> the capital stock of no par value .... Had this stock had a par value, and had stock of par or face value exceeding the value of the rights purchased been issued, a different question would arise."

It must be obvious that if the law should require (as the Model Act does) that no-par shares must be given a dollar value before their allotment, the temptation or need to overvalue the noncash consideration is almost as strong as in the case of par value shares.

Another striking illustration is the case of G. Loeweus & Co., Inc. v. Highland Queen Packing Co.[92] The facts of this case may be simplified for our purpose here and stated thus. A and B who were the owners of a business worth $1,500 owed C $950 on a note. The Packing Company was formed to take over the business and the indebtedness of A and B. The company allotted 100 shares to A and 100 shares to B and undertook their liability on their note to C in consideration of the business transferred by them to it. The company allotted 100 shares to C in consideration of $1,050 paid by him in cash and the discharge of the $950 due to him on the note. The price of each no-par shares was fixed at $20, presumably calculated on the basis that C had furnished a consideration of $2,000 for the 100 shares issued to him. The company soon became insolvent and the receiver sought to recover from A and B what he claimed to be the difference between the consideration for the 200 shares issued to them (viz. $4,000 calculated at $20 each for the 200 shares) and the actual consideration supplied by them to the company (viz. $1,500 being the worth of their business less $950 being their debt taken over by the company).[93]

Without any discussion of the merits of the case or the principles of law, the court held that the meaning of the fixing of the price of the no-par shares at $20 each was not clear and that the parties "did not intend that $6,000 should be paid in, additional to the transfer of the business."[94]

If an independent board had fixed the price of each no-par share at $20 each, the company had parted with shares worth $6,000 for a consideration worth only $1,600. The court could, therefore, arrive at the decision it did only by regarding the price so fixed as meaningless. The other alternative is to assume that an independent board of the company thought that a consideration worth only $550 to A and B was worth $4,950 to the company. But this alternative does not appear to be the decision of the court.

This case is yet another example of how the capital structure is often arbitrarily manipulated in order to suit a desired allocation of control rather than to reflect the value of the assets of the company. Judicial decisions have only blessed such practice. The courts have failed to insist that allocation of control must be achieved by attaching different voting rights or other ways rather than by attaching meaningless par or stated values to shares.

The Piggly Wiggly and Loeweus cases show that the no-par device has not eliminated the watered stock problem, but has made stock-watering easier, at the same time more difficult to detect, and has made it more difficult to attach watered stock liability.

The decision in Johnson v. Louisville Trust Co.[95] is yet another good illustration. Two persons (Tietjen and Bell) obtained an option from the Louisville Trust Company to buy certain plants and assets. The trust company agreed with them to accept toward the price of the properties half of the authorised preference shares, a quarter of the authorised no-par common shares, and $100,000 in mortgage bonds of a company to be formed by them. They formed the company and sold their option to it. The new company bought the properties from the trust company in accordance with the terms of the option and gave the vendor-promoters its remaining (3/4) no-par stock for the option. The vendor-promoters also lent the new company its working capital. In a year the new company became bankrupt with unsecured creditors claiming $220,000 and having assets worth $7,000 to pay them with. The trustee in bankruptcy sought to hold the trust company and its two optionees (the vendor-promoters) liable, as for unpaid stock, on the shares of the company which they had received. The court held that there was no fraud in the valuation of the properties or the option, and that, therefore, they could not be made liable.

These decisions seem to bear out William Cook's indictment of no-par stock, soon after they were introduced in America, that "[s]tock without par value looks like a skillfully devised scheme to issue a maximum of watered stock at a minimum risk. It conceals the amount of 'water'. It is stock that dares not state on its face how much money or property it represents."[96] Watered stock is particularly a creditors' hazard; no-par device only seems to aggravate it and it certainly does

not end the possibility of stock watering.[97] In the words of Professor Bonbright,[98]

> "The removal of par value, to be sure, takes away the necessity of an equivalence between the assets on the one hand and the face value of the stock on the other hand. But it leaves us with a problem of a reasonable valuation of the assets on the corporate balance sheet. Creditors and shareholders may no longer be deceived by a fictitious par value; but they may still be deceived by a fictitious asset value."

Professor Bonbright emphasised the need "to develop the . . . law of no-par stock, so that it will not remain, as it tends to be at present, a device for depriving innocent investors of all protection against the wiles of unscrupulous promoters."[99] There is little evidence that there has been any such development, except to the extent that the securities laws afford protection.[100]

Most of the American and Canadian statutes contain a provision to the effect that all no-par shares "shall be deemed fully paid and non-assessable on receipt by the company of the consideration for the issue and allotment thereof, and the holder of such shares shall not be liable to the company and its creditors in respect thereof."[101] It has been argued that such non-assessability clause precludes any watered stock liability, or any other liability in respect of the shares. In Norton v. Lamb[102] the Supreme Court of Kansas rejected this contention when it was raised by an allottee of 2,000 no-par shares of a stated value of $1 specified in the company's charter who had paid only $1,000 and was sued

by the trustee in bankruptcy to recover the balance of $1,000. Another case where the court rejected the contention was Livingston v. Adams.[103] There the trustee in bankruptcy of a company which collapsed within a year of its incorporation sought to hold the promoters liable for allotting to themselves no-par stock in consideration of property worth $335 transferred by them to the company and commencing business when the company's charter provided that before it might begin business it must have a minimum capital of $5,000 ($2,000 in cash and the rest in kind). The trustee demanded that they should pay to the company the difference ($5,000 minus $335 = $4,665). In the circumstances the case could be regarded as one in which the promoters inflated the value of the noncash consideration worth $335 to $5,000 — a genuine case of stock-watering. The promoter-vendors relied on the non-assessability clause in the Missouri Act,[104] but the court rejected this contention and held them liable. The court remarked that it was a settled doctrine that "unpaid subscriptions to the stock of a corporation constitute a trust fund for the benefit of its creditors, which may not be given away or disposed of by it, without consideration or fraudulently, to the prejudice of creditors "[105] and that this trust fund doctrine applied equally to "non-par value stock corporations."[106]

In these two cases, however, the courts could fix the value of the no-par stock by some yard-stick, viz. the stated value in the charter or the minimum capital specified in the charter of the company. The position will be very different and difficult if a company statute does not require any stated value for no-par stock, or prescribe or require any minimum capital, or the issue is made by a going concern to raise

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additional capital.

In conclusion it is submitted that the no-par share device as it now obtains has not eliminated stock watering; it has only made it more difficult to enforce watered stock liability. Whether the stock to be issued has a par value or has no par value, the consideration for which they are issued has always to be valued for balance-sheet and other accounting purposes. There is no escape from this necessity for valuation; equally there is no escape from the risk of over-valuation. The law cannot eliminate the possibilities for over-valuation due to honest error in judgment, except at too minute an administrative control and too great an expense and hardship. The law should, however, aim at preventing knowing or deliberate over-valuation, whether or not it is made with the intention to deceive or mislead any person. Whether a valuation is deliberately excessive is easier to test than whether it was made in good faith or bad faith. In any case it cannot be said that the no-par device has eliminated all possible reasons or temptations for knowing over-valuation of noncash consideration. It surely was intended to eliminate one cause for over-valuation, viz. to issue par value shares at a discount when they cannot be sold at par. The English and California statutes show that it is not a formidable problem to authorise companies to issue their par value shares at a discount in special circumstances. Moreover, the widespread use of the low-par share makes it in fact unnecessary to issue shares at a discount in practice. Furthermore, if a no-par statute requires a stated value to be attached to such shares in the charter or a dollar value to be given before they are issued (e.g., the Model Act), in effect it is equivalent to the requirement of a par value.

The watered-stock problem arises in two kinds of situations. First, promoters who employ their time and talent in floating a company seek to have control over it and a substantial share in its assets and profit without regard to the exact money value of their contribution to the company. The issue of non-voting shares and senior securities with limited right in income and assets is one device resorted to by promoters with this end in view. The other is to over-value their contribution and this is done when the first is not possible or is inadvisable. The no-par device by itself does not eliminate the room for this motive of the promoters. Secondly, in a close corporation the associates are more interested in allocating risk, control and profit among themselves by mutual agreement rather than in strict accordance with their contributions to the corporate capital. They look upon the capital structure or share capital not as a reflection of their respective contribution to the enterprise, but as a reflection of their agreement to allocate, risk control and income. In fact to them a valuation of their respective contributions is not as important as the allocation of these elements of their joint enterprise. Such allocation in any desired manner can be effected by classification of shares, the use of nonvoting shares or voting agreements, and other devices, but unfortunately these possibilities are not always taken advantage of. Instead of arranging a capital structure suitable for their desired allocation in consonance with the value of the assets brought into the enterprise, the parties have often manipulated the value of the assets to fit the capital structure agreed to between them. This can be seen in many watered stock cases involving private companies. Such stock-watering is misguided, in contrast to the first in which it is delib-

erate. In other words, in neither case is stock-watering an inevitable consequence of the requirement of a par value for shares. There are deeper causes for the over-valuation of assets and it is naive to suppose that the no-par device will by itself eliminate any of them. A promoter who has not contributed much beyond his promotional services, but yet wants a substantial part of the control and income of a corporation, when all the needed funds have to be raised from others, has every temptation to over-value his services, whether or not the capital is made up of par value or no-par shares.

The following example from an annual report of the S.E.C. illustrates this possibility.[107] The controlling shareholders of a non-American corporation which had been formed to explore for sulphur under a concession from a foreign government organized a Delaware corporation to acquire all the shares of the former. They were allotted 800,000 shares of common stock in the new corporation in exchange for their holding in the old corporation. They were given another 80,000 shares for their promotional services. In all this gave them over two-thirds of the voting stock in the new corporation which they had brought into existence. They were also to receive $100,000 in cash and a royalty of $1 per short ton of sulphur produced for the assignment by them to the new company of certain rights of unproven value which they had in the concession and which had cost them less than $13,000. The amount was to be paid to them out of the proceeds of an issue of 400,000 shares of common stock to be made at $1 per share. The purchasers of all these shares would receive less than a third of the total voting stock. The S.E.C. made

sure that these promoters' interests were disclosed in the prospectus, but did not forbid the issue itself. Obviously the no-par device helped the promoters to give themselves two-thirds of the voting shares without having to establish that they contributed consideration equal to two-thirds of the common capital. Perhaps, should the law insist on a par value, the promoters would have had to justify the issue of two-thirds of the common stock to them by showing that they had contributed an equivalent value of consideration. If they had resorted to over-valuation for the purpose, the S.E.C. could have found it out and prevented the issue of the shares altogether. The absence of a par value dispenses with the necessity that the consideration for the issue of 880,000 shares to the promoters and 400,000 shares to others should be proportionate which will be necessary at least up to the extent of the par value if they were par value shares.

Indeed, in In the Matter of Thomas Bond, Inc.,[108] the S.E.C. issued a stop-order in respect of a registration statement of a Delaware corporation, organized by Mr. Bond to take over the manufacture of a cosmetic according to a formula developed by him, on the ground that the formula had been arbitrarily valued. The company had issued 150,000 class B shares of 50 cents par each to Mr. Bond in exchange for his formula. It seems doubtful to the writer whether Mr. Bond would have valued his formula any more "truthfully", if he had used the no-par device instead of the 50 cent shares.

E. APPRAISAL

The attempt to combat stock watering has been generally half-hearted and ineffective.[109] This is due to a greater or lesser adherence to the laissez-faire philosophy, a reluctance to interfere in the internal affairs of corporations, and to the difficulties inherent in the valuation of property.

The strongest objection to stock watering, and therefore the foremost reason why effective measures must be devised to check it, is that it is tantamount to the falsification of the balance-sheet presentation of the value of the assets of the company. It defeats the very purpose of the legal requirement of the balance sheet to be published by public companies, viz. the protection of investors and creditors.

It may legitimately be queried whether it is not for the company and its vendor or supplier to determine the value of the consideration and whether it is proper for the law to interfere with their judgment. Normally consideration is the concern of the parties to a contract and the law carefully refrains from inquiring into its adequacy or inadequacy. It may, therefore, be asked: why should the law bother itself about the good faith of the transaction or the fairness or reasonableness of valuation of the consideration when a company allots its shares in exchange for property or services?

There are significant differences between an individual buying property or services at whatever price he in his wisdom or whim may deem fit and a company acquiring property or services in exchange for its shares. A "company" is a collectivity of interests and claims (which

are not infrequently conflicting) functioning through agents who are to a large extent free from supervisory control. The act of a company is a matter of immediate concern to its shareholders and creditors. Though a company is a legal "person" like a human individual, the freedom which the law may afford a human being to buy goods or services even at a whimsical price will be inappropriate to a company. Moreover, the peculiar situation of a promoter who launches a company selling his own property or services to his creature which can only see through his eyes and act by his hands has no exact parallel in the case of a human individual. Besides, in an ordinary transaction of sale the seller does not retain proprietory rights in the buyer after the transaction is completed, but the vendor of property to a company for shares becomes thereafter the shareholder of the buyer-company and thus acquires proprietory rights. It is, therefore, impossible for any system of law to authorise a company to buy property or services to be paid for in its shares at whatever price its board of directors may arbitrarily or whimsically deem fit.[110] Of course the directors must have the freedom to acquire property or services for the company at a price which they as men of business determine in good faith to be the reasonable price having regard to all the circumstances of the transaction and the law must ensure that they conform to this standard. It must be admitted that this standard is more easily stated than enforced. For "value" is an elastic concept with connotation varying from cost to the seller or supplier to the worth to the buyer. Courts do not have the equipment to determine value scientifically and the legislatures have carefully refrained from spelling out criteria for

valuation. Again good faith or honesty is a mental element the presence or absence of which is difficult to prove. It is, however, submitted that good faith must in this context denote not mere subjective good faith, but "commercial good faith" or honest belief based on reasonable grounds. But unfortunately the courts have so whittled away the significance of the good faith requirement that they have, as the English Court of Appeal did in the Innes case, condoned and even sanctioned arbitrary overvaluation provided only that it is not fraudulent.[111]

Besides, in watered-stock cases the courts have tended to treat alike valuation by promoters of their own services or property rendered or transferred to the company of their creation and valuation by an independent board of directors of noncash consideration for the issue of shares. In both types of cases the courts have applied the good faith test identically. It is submitted that in the former case the courts must more readily, closely and carefully scrutinize the valuation while in the latter a presumption in favour of the directors that they acted in good faith will be appropriate. Duff, J., addressed himself to this aspect in Hood v. Caldwell and observed:[112]

> "[P]romoters who own property get up a company to take the property and allot qualifying shares to themselves and nominees who are entirely under their control and appoint a board of directors entirely under their control, and then go through the form of an agreement between themselves and the company, taking the share capital of the company in consideration of the transfer of the property. In the economic sense, such a transaction is not

> a sale . . . . The price is fixed by the fiat of the vendors, and therefore the considerations which have led the courts to hold that where there is a real sale entered into between the promoters and persons acting independently of them for the company, the price paid in shares is presumptive evidence of the value of the property which, in the absence of fraud or some kind of unfair dealing, the courts will not go behind, have no sort of application whatever. If in such circumstances it is made plain that the so called consideration is merely nominal or patently derisory, I think the court should not be slow to draw the proper conclusion and to press that conclusion to its logical result."

The fiduciary nature of a promoter's relation to the company in the formation of which he has taken part is well-recognized in law.[113] While it is possible that a company may buy property from an outsider at an exorbitant price foolishly or negligently, how could the same happen in the case of a purchase from a vendor-promoter? It is not suggested that a promoter ought to sell his property to the company at his cost price, but it is submitted that he should only be allowed to sell it at such price which it would fetch if he had sold it to any other person. This objective test must be applied in determining whether the consideration is overvalued. The exorbitance of the price paid to the vendor-promoter must itself be treated as evidence of the absence of an "honest intent in the transfer."

In conclusion it is submitted that in all cases of promoter-vendors the court must address itself to the question whether the valuation of the noncash consideration is a fair reflection of the probable market price of the property or services — an objective test. In all cases of third party vendors, the sole question is the honesty of the valuation, in the absence of fraud or collusion — a subjective test. It is regrettable that the decided cases of the various jurisdictions do not clearly distinguish between these two instances. In Erlanger v. New Sombrero Phosphate Company[114] the House of Lords did emphasise the duty of promoters to provide the company which they were promoting to take over their business or purchase their property with a truly independent board which could act in the best interests of the company. Presumably an "independent" board chosen by the promoters will ensure a fair valuation. It is submitted that in such cases the courts must examine the fairness of the valuation rather than the "independence" of the board.

We have also seen that the present statutory law in all jurisdictions is deficient in regard to the remedies for stock watering. The law is satisfactory insofar as it enables the liquidator to treat the watered stock as not fully paid up and to hold the allottees liable to contribute to the extent of the "water". The position must, however, be clarified to preserve this liability even after they have transferred these shares to other persons, irrespective of the length of time that may have intervened.

It is true that creditors do not necessarily rely on the subscribed capital or the book value of the assets of the company in extending it credit but base their decision on other criteria such as the earning capacity of

the company, the efficiency and integrity of the company's management, and the market value of the assets. Nevertheless in determining the policy of the law the relevant inquiry is not whether potential creditors actually rely on balance sheet figures, but whether they would be misled if they did so rely. And there could be no doubt that they would be so misled if the value of the assets as stated in the company's accounts is a gross exaggeration of the market value. Whether one agrees or disagrees with the trust fund doctrine of corporate capital and whether or not reliance upon corporate capital by creditors is a fiction, there can be little justification for exposing creditors to the possible risk springing from a deliberate overvaluation of noncash consideration.

Where the present laws are particularly deficient is in respect of remedies for stock-watering when the company is a going concern and is not faced with bankruptcy. Stock-watering is not only a creditors' hazard, but also shareholders' and investors'. Where there are existing shares at a time when new shares are issued for inflated consideration, it must be obvious that the existing shares are thereby diluted. This result will occur whether or not the shares have a par value, but it can be more easily accomplished with no-par stock. This danger has been pointed out time and again specially with reference to no-par shares. As Bonbright said, the use of the no-par device "opens the way for fraud upon shareholders by making possible the issue of new shares for insufficient consideration."[115] While the par value assures the existing shareholders, at least in some measure, that future stock issues will not be made below the par value, the no-par device takes away even this assurance.

The law should enable shareholders to obtain redress where stock-watering has already occurred as well as to prevent such stock-watering from occurring. Where stock-watering has already occurred, but the company is solvent, the court must order the rescission of the allotment to the extent of the amount of inflation of the noncash consideration. As the company is solvent this will not hurt creditors, but by such rescission the rights of the other shareholders will be adequately protected. Or in case the court so deems fit, the allottees of the watered stock may be held liable for unpaid subscriptions. The statutes must alternatively provide for either of these remedies to be given at the discretion of the court depending upon the circumstances of each case. To order the rescission of the entire transaction, as was done in the Erlanger case, may be appropriate only in the earliest stages after the formation of a company.

As a preventive measure for the protection of existing shareholders, they may be given pre-emptive right, i.e. the right to purchase any new issue pro rata. Another measure is the recognition of a right in the existing shareholders to insist, irrespective of any pre-emptive right, that any new issue not be below a fair value — what Professor Berle called the "rule of equitable contribution".[116] Professor Bonbright suggested that these remedies "should be retained in full force when shares are issued without a par value" and further strengthened by statutory provisions. He said:[117]

> "Possibly the right of existing stockholders to their proportional shares in new issues should not be allowed to be waived by the charter or by anything less than the unanimous vote of

the shareholders. Possibly there should be a definite stipulation that when shares are issued to outsiders the consideration must not be less than the full market value, and that dissenting stockholders may demand an independent appraisal."

There are two prevailing patterns with regard to pre-emptive right: (1) No pre-emptive right is available unless the charter or by-laws expressly confer it on the shareholders; (2) Pre-emptive right is available unless it is specifically denied or restricted by the charter or by-laws. There is a growing trend towards the first pattern which is somewhat more unfavourable to the shareholder. Thus Table A of the English Acts from 1862 to 1929 contained a clause conferring pre-emptive right. Therefore the right existed unless a company chose to deny it by suitable by-law. Table A of the present Act has conspicuously omitted this provision. This means perhaps that there is no pre-emptive right unless it is conferred by suitable by-law. The position under the Canadian Dominion Act,[118] as well as the provincial statutes, appears to be the same as the present English law in this respect. Under the Delaware Act pre-emptive rights may be denied or limited by the charter. Presumably, in the absence of such denial or limitation, the right exists. In California there is no pre-emptive right unless it is expressly conferred by the charter. Some statutes like that of New York recognize the right to varying degrees, but permit the charter to provide differently. Suffice it to say that nowhere is the right mandatory. In fact the right is commonly denied whenever shares are issued for noncash consideration. Generally speaking,

the right of pre-emption is not available to shareholders to protect them from the risk of subsequent dilution of their equity by the issue of new shares for inflated consideration or no-par shares for an unfair consideration.[119]

India alone has provided a mandatory pre-emptive right, which is renounceable in favour of third parties, but the right is available only to the equity (common) shareholders and not to the preference shareholders. The common shareholders may, however, waive their right at a general meeting and give directions to the company to dispose of the shares otherwise.[120] The effect of this provision is that an existing company cannot allot its new shares for a noncash consideration except with the approval of the shareholders at a general meeting.[121] A few exceptions are recognized, but these do not include the allotment of shares for property or services.

According to the rule of equitable contribution, an issue of shares cannot be made in a way prejudicial or unfair to the rateable equity of the existing shareholders. That is, any new issue of shares ought not to be made inequitably to the present shareholders where the latter are denied pre-emptive right. Any shareholder wronged by the violation of this principle has an equitable action. This principle has been asserted by Professor Berle,[122] but its application outside the American states is unknown. Minnesota alone gives statutory recognition and forbids the issue and allotment of shares, whether par or no-par, upon a valuation of the noncash consideration which is "unfair" to the existing shareholders.[123] Levy observes that "[t]he equitable remedy as given by some

courts in the U.S.A. is operative only in exceptional cases, and even then is very difficult to obtain. These difficulties and especially the relatively exorbitant expenses involved makes this remedy in practice illusory."[124]

It is submitted that the principle of equitable contribution must be given statutory recognition as the best safeguard for shareholders and effective and inexpensive procedure must be provided for its enforcement — like investigation by the appointment of inspectors.[125] The writer is not in favour of mandatory pre-emptive right in the case of publicly held companies as it strengthens unduly the position of entrenched shareholders and impedes the dispersal of shares and the wider participation of the public in a successful corporate enterprise. Pre-emptive right is more in tune with the concept and role of close companies.

CONCLUSION[126]

1. The statutes must impose the duty on directors to value noncash consideration for which shares are to be issued acting as reasonable men of affairs would, if they were acquiring the property or services for their own beneficial ownership.

2. The statutes must require that in the case of no-par shares a dollar value must be assigned to them before they are issued.

3. The statutes must forbid directors to issue shares at a price which is unfair to existing shareholders.

4. Where shares have been issued for overvalued consideration, any shareholder must be afforded the right to seek redress in a court of law. The court must be empowered at its discretion either to require the allottees to pay up the shares as if they were not fully paid up or to order the cancellation of a proportionate part of the issue depending upon the circumstances of the case.

5. An administrative remedy must be provided to enable any shareholder to obtain expeditious and inexpensive redress.

6. It must be made a punishable offence to deliberately overvalue the consideration and thus falsify the balance sheet.

7. Where shares are issued to promoters for a noncash consideration, the onus must be placed upon them to justify the valuation. In other cases the good faith valuation of the directors must be binding upon all concerned.

8. Publicity provisions on the model of the English Act must be enacted concerning every issue of shares for noncash consideration,[127] whether by a public or private company.

PART III : THE MAINTENANCE OF CAPITAL

CHAPTER 8

REDUCTION OF SHARE CAPITAL

We have seen that a corporation has assets derived from different sources and that "share capital" or "stated capital" refers to one such source. Share capital or stated capital does not necessarily mean the entire contribution made by shareholders as consideration for the shares issued to them as the statutes permit companies to treat as surplus or premium (a) the excess of the consideration over the par value of shares having a par value and (b) a part of the consideration for no-par shares. Share or stated capital is therefore a legal concept devoid of economic significance and is quite arbitrary in nature. It pays undue importance to the nominal par value without regarding it as just a minimum price for the issue of a share. The law might have more meaningfully defined share capital as the amount for which a company issues its shares and thus eliminated the artificial distinction between "share capital" and "share premium amounts". One would have expected that the introduction of the share without par value would have produced the salutary effect of obliterating that meaningless distinction. But habits die hard and even a new innovation is forced to conform to familiar ideas and moulds. Thus we find that the no-par statutes began conferring freedom on companies to allocate a part of the consideration for the issue of no-par shares to paid-in surplus. The old "par value" now became "stated value" for no-par shares; and the change is from tweedledum to tweedledee! The result is, as it

were, a "flexible par value" instead of a rigid par value and a flexible stated capital instead of a rigid share capital. Unfortunately the policies of flexibility and rigidity co-exist with cumbersome effect in the North American jurisdictions.

Suffice it to say, share or stated capital is a legal concept. The balance sheet shows the "value" of a company's assets ascertained according to conventional accounting practices and the quantum of contributions made by different sources in the creation or acquisition of those assets.

A. MEANING OF REDUCTION OF SHARE CAPITAL

If share capital is a mere numerical figure, what is meant by the reduction of share capital? All the statutes prescribe the procedure for reduction of share capital. To recall our equation of the balance sheet, at any given point of time Assets = Debts + (Issued) share capital + Earned surplus + Unearned surplus. Let us assume that the uncalled liability of the shareholders is included among the assets and that the entire issued share capital including unpaid capital is shown as a liability. Though it is not the Anglo-Canadian accountancy practice, it gives a clear picture of the position of the company and is in accordance with the Continental practice.[1]

Reduction of share capital means, therefore, a debit or charge to the share capital account. When will this be necessary? First, if the assets have become diminished in value, for whatever reason, a company may want to debit the loss to share capital. If it has no surplus avail-

able, a company may have no alternative but to debit it to the share capital or show the loss separately in a deficit account as a "capital surplus deficit" or "earned surplus deficit". The latter will have to be done if the law forbids a charge to share capital and there is no surplus available to which it could be debited. Of course the use of the words "surplus" and "deficit" together in "capital surplus deficit" or "earned surplus deficit" does sound incongruous, but American literature employs the combination. If there is an earned or unearned surplus, the company may want to keep the surplus intact, by-pass the surplus accounts, and debit the loss or diminution to the issued share capital. If a statute forbids a debit to share capital, then the company will have to debit the loss to one of the surplus accounts. Secondly, a company may want to reduce its assets by making a distribution to its shareholders and debit the payments to the issued share capital as in the first case. Thirdly, a company may want to waive its claim against its shareholders to uncalled or unpaid subscriptions, and thus reduce its assets and charge the reduction to the issued share capital. In all these three cases there is or will be a reduction of assets credited to the assets side of the balance sheet and a charge to issued share capital on the liabilities side of the balance sheet. In short, there is or will be a reduction of assets.

The law would have conduced to clarity if, instead of omnibus provisions for reduction of share capital, it had specifically regulated these three instances and given us a clear answer to the following questions:

i. Can a company waive, wholly or in part, its claim to unpaid subscriptions due by its shareholders and thus reduce its issued share

capital? If so, subject to what conditions and requirements?

ii. Can a company distribute any part of its assets to its shareholders and charge such payments to its issued share capital? If so, subject to what conditions and requirements?

iii. Under what circumstances, if any, can a company write off a loss or diminution in the value of its assets by charging it to issued share capital?

iv. When is a company free, or not free, to by-pass its earned or unearned surplus account and make a debit directly to its issued share capital account?

Much of the confusion that surrounds the law in this area, and particularly the law of dividend, is attributable to its failure to face these questions and abdication of its responsibility in favour of the business community.

Finally, attention needs to be drawn to the one case of reduction of share capital not involving a reduction of assets. This is where a company wants to reduce its issued share capital and thereby convert a part of it into surplus — sometimes called the "reduction surplus". Quite often a company will want to carry out this metamorphosis with a view to an eventual distribution or other reduction of its assets. Many jurisdictions draw no distinction between earned and unearned surplus. The creation of a reduction surplus is therefore a liberation of the share capital for future distribution.

It may be added that this chapter is not concerned with the reduction of authorised share capital by the cancellation of unissued shares.

B. TECHNIQUES OF REDUCTION

Whether the reduction of capital is by way of return of assets or due to a loss of assets, or otherwise, the question arises: how can the reduction be effected?

We shall first consider par value shares. In the case of par value shares,

Issued share capital = Aggregate par value of all shares issued
= paid up capital + unpaid capital

The issued share capital may be reduced either

(1) by reducing the par value of the shares without reducing the number of issued shares: e.g.

(a) by reducing or extinguishing the unpaid capital alone;

(b) by reducing or extinguishing the paid up capital alone;

(c) by reducing both the unpaid capital and the paid up capital.

or

(2) by reducing the number of issued shares which is done by extinguishing both the paid up and the unpaid capital and then by cancelling the shares.

When the capital is comprised of no-par shares, we have seen that the issued no-par share capital is the amount of aggregate consideration for which the shares have been allotted, less any part of it allocated to surplus if permitted by the relevant statute. The capital may be reduced in this case by reducing the stated or given value of the shares or by exchanging them for new no-par shares deemed to be issued for a lesser

stated value. Or the number of no-par shares issued may be decreased by cancelling some of them.

These do not exhaust all possible modes of reduction and are only illustrative.

C. PROCESS OF REDUCTION

1. English law

(a) Statutory Developments

Provisions for the "Reduction of Capital and Shares" were first introduced in England by the amending Act of 1867.[2] The Act of 1862 contained none for the purpose, though it did for increasing the capital by the issue of new shares, for consolidating and dividing the capital into shares of larger par value ("the reverse stock-split" as it is known in America), etc.[3] While permitting reduction for the first time the Act of 1867 designed strict safeguards for the protection of creditors and shareholders. First, a company could reduce its capital only if it was authorised to do so by its by-laws, as originally framed or as altered.[4] A special resolution had to be passed for effecting the reduction. The resolution would not become effective unless it was confirmed by an order of the court upon a petition presented by the company. "[E]very Creditor of the Company who at the Date fixed by the Court is entitled to any Debt or Claim which, if that Date were the Commencement of the winding-up of the Company, would be admissible in proof against the Company" was entitled to object to the proposed reduction. The court was empowered to confirm the reduction subject to any terms and

conditions it deemed fit to impose, if it was satisfied that with respect to every creditor entitled to object to the reduction, either his consent to the reduction had been obtained, or his debt or claim had been discharged or had determined, or had been secured as prescribed by the Act. The court's order had to be registered with the registrar whereupon the reduction became effective. The company had thereafter to append to its name the words "and Reduced" for such period as the court fixed.

For over a hundred years these safeguards have been substantially preserved in every English Act until the present day.

It may be noted that neither the Act of 1862 nor that of 1867 used the expression "share capital". The Act of 1862 used the language, "to increase . . . capital, or to consolidate and divide . . . capital", and the Act of 1867 used the words, "Reduction of Capital and Shares" and not reduction of "share capital". The language of the reduction provision of the Act of 1867 is so significantly different from its twentieth century version that it is worth quoting:

> Reduction of Capital and Shares.
>
> Power to Company to reduce Capital. 9. Any Company limited by Shares may, by special Resolution, so far modify the Conditions contained in its Memorandum of Association, if authorized so to do by its Regulations as originally framed or as altered by special Resolution, as to reduce its Capital; but no such Resolution for reducing the Capital of any Company shall come into operation until an Order of the Court is registered by the Registrar of Joint Stock Companies, as is herein-after mentioned.

This was changed to its modern form only in the Act of 1908.[5]

Doubts persisted whether the Act of 1867 authorised the reduction of paid up capital which had already been lost. In 1877 Jessel, M.R.,

came to the reluctant conclusion in In re Ebbw Vale Steel, Iron and Coal Company[6] that it did not, even though the company was not seeking to return any part of its assets to its shareholders or extinguish or diminish their liability in respect of unpaid capital, but merely wanted to write off to the paid-up capital a loss in the value of its assets due to depreciation. The company's assets consisted of coal and iron mines and their value had depreciated due to the "great fall which had then taken place in the value of iron and coal." The Master of the Rolls felt that the case did not fall within the scope of the reduction provisions of the Act of 1867 because the company here was not seeking to reduce capital, which is the case contemplated by that Act,[7] but it, having already lost capital, was seeking to record a fait accompli. He said:[8]

> "This is not an actual reduction, because the capital has been lost. It is merely acknowledging that to be lost which is lost .... /P/art of the capital has gone already: it has been reduced by a very unpleasant process. It requires no resolution of the company to do that."

Jessel, M.R., thus drew a sharp distinction between (1) a company reducing capital by returning assets to shareholders or by extinguishing or diminishing their liability in respect of unpaid capital and (2) a company writing off to share capital a reduction which had already otherwise occurred. The Master of the Rolls clearly pointed out the practical distinction between the two cases in the following words:[9]

> "/I/f you are reducing the liability of shareholders ... it is quite reasonable that the actual existing creditors should be allowed to object to such a proceeding; but when you are doing nothing of the kind — when, at the time you are proposing to effect the nominal reduction, you are leaving the actual existing creditors with every

> remedy they previously possessed, it surely would be monstrous that a creditor should be allowed to object to that with which he has no concern. It is utterly immaterial to the actual creditors whether or not you reduce the nominal [10] capital of the company. They have all the existing assets of the company, and they have all the existing liabilities [11] to fall back upon."

Jessel, M.R., used the above argument to show by a process of reductio ad absurdum[12] that the Act of 1867 did not contemplate to include within the scope of its reduction provisions cases of writing off of capital already lost without the company returning its assets to its shareholders or exempting them, wholly or in part, from their liability for unpaid capital.

Parliament acted immediately to amend the Act of 1867 in order to bring within the scope of the reduction provisions situations like the Ebbw Vale Company case and to clarify that "the power to reduce capital conferred by that Act shall include a power to cancel any lost capital, or any capital unrepresented by available assets . . . ."[13] The Act of 1877 also made it clear that the creditors did not have a right to object to a reduction which did not involve a return of assets to the shareholder or his exemption to any extent from liability in respect of unpaid capital, but empowered the court to direct otherwise in any special case.[14]

It would have been much better if the legislature had chosen to enact a separate section dealing specially with writing-off of losses, both capital and revenue, not only with reference to share-capital, but also with respect to earned and other surpluses. This would have considerably lessened the difficulties with which the courts have had to struggle in developing the law of dividend which we shall be discussing in a later chapter.

The present Act permits reduction of capital "in any way"[15] — a phrase which was first introduced in the English Act of 1908. The basic approach to reduction, including the requirement of judicial confirmation, has remained unchanged till this day. We may sum up the creditors' right to object to a reduction thus:

(1) "Creditors" have a right to object whenever the reduction involves either diminution of liability in respect of unpaid capital or the repayment to any shareholder of paid-up share-capital, but the court may in the special circumstances of a particular case deny this right to any class or classes of creditors.

(2) "Creditors" do not have a right to object where the reduction does not involve any such diminution of unpaid capital or paid-up capital, unless the court otherwise directs in any special case.

The policy underlying the English law of reduction of capital has been thus stated by Lord Watson in Trevor v. Whitworth:[16]

> "The effect of these statutory restrictions [on the power of limited companies to reduce capital] is to protect the interests of the outside public who may become their creditors .... [T]he effect of these statutory restrictions is to prohibit every transaction between a company and a shareholder, by means of which the money already paid to the company in respect of his shares is returned to him, unless the Court has sanctioned the transaction. Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of business."

The effects of this prohibition of reduction of capital without judicial sanction are:

(1) A company cannot waive, wholly or in part, its claims to unpaid subscriptions, except by following the reduction process prescribed by the Act and thus obtaining the confirmation of the court.

(2) A company cannot return any part of its assets to any shareholder, whether under the guise of dividend or otherwise, if such payment is, or has, to be debited to the share capital account except by following the prescribed reduction procedure. We shall in later chapters examine two corollaries of this rule, viz. (1) that dividends ought not to be paid out of capital and (2) that a company ought not to purchase, or provide financial assistance for the purchase of, its own shares.

(3) The third question, viz. the writing-off of losses to share capital, presents considerable difficulties. We use the word "loss" here in the sense of any diminution in the value of the assets of the company however caused. Such diminution might result from depreciation, depletion, destruction, consumption, trading losses, market decline, or other reasons. In these cases the loss in the value of the assets is a fait accompli. It should be obvious that if this diminution appears in the assets side of the balance sheet, a corresponding diminution has to be shown in the net worth section, either under the head of share capital or some head of surplus, if any, on the liabilities side of the balance sheet. When a company has no surplus, it is inevitable that the loss must fall on the share capital. But suppose the company has accumulated earnings and the company suffers a loss due to the destruction of

some machinery or other fixed assets. Should the loss be written off to the earned surplus or can the company write it off to share capital keeping intact its surplus available for dividend? Suppose a company has suffered trading or revenue losses for a number of years and then makes a profit on the revenue account. Should the old losses be made good out of the current income? Many such difficult questions arise with regard to writing off of losses and we shall consider them in a later chapter, as they are intimately connected with the law of dividend. We shall show that the state of the law is not wholly satisfactory with regard to writing off of losses. If a company wants to reduce its share capital by writing-off losses, it could certainly follow the reduction process prescribed by the statute, but the law of dividend has so developed in England as to render it often unnecessary for a company to take the trouble of reducing its share capital at all.

The English technique, therefore, is to permit reduction of share capital "in any way" and leave it to the companies to determine the mode and extent of such reduction, but to subject the whole process to judicial scrutiny, control and approval. The court is given the role of the guardian of the interests of creditors, shareholders generally, minority shareholders in particular, the different classes of existing shareholders, and the public who may become in future shareholders or creditors of the company. Thus the role of the court is crucial in the English reduction process. The court has complete jurisdiction to permit or refuse to permit a reduction or to permit it subject to such terms and conditions as it may deem fit to impose. It is, therefore, to the decisions of the

courts that we must look in order to find the attitude of the English law with regard to the reduction of corporate capital.

The reduction provisions were extended to share premium amounts in 1947.[17] Prior to 1947 a company was free to distribute such amounts as dividend or otherwise. Under the present Act they have to be transferred to a specially named "share premium account" and may be put only to such use as is expressly spelled out by the Act (e.g. to write off preliminary expenses or the expenses of any issue of its shares or debentures; to provide for the premium payable on the redemption of any redeemable preference shares or of debentures) or capitalised by the issue of share dividends.[18] The share premium amounts may not be reduced in any other way except by following the procedure prescribed for the reduction of share capital.[19] Share premium amounts are treated on par with share capital. This is a wise policy decision long overdue and has been followed in India.[20]

(b) The Judicial Role.

Reduction of capital, however effected, involves considerable difficulties in adjusting the interests of the shareholders inter se, such as the protection of the minority against the majority and the protection of one class against another. The English statutes have amply safeguarded the interests of creditors by giving them the right to object to a reduction which involves a diminution of unpaid capital or return of paid-up capital. But the protection of shareholders is not equally well-safeguarded. For instance non-voting shares and minority shareholders

have no statutory protection given them and the statutes have never required that a reduction must be uniform or equitable or that it must be voted on by different classes of shareholders separately. In contrast to the English statutes the present Companies Act of India confers a statutory right on preference shares to vote on resolutions for the repayment or reduction of the share-capital of a public limited company.[21] It is submitted that this is a desirable safeguard for non-voting shares. In the absence of specific provisions in the English statutes for the adjustment of the interests of the shareholders inter se, we shall examine the judicial decisions dealing with such situations. Interestingly, but not surprisingly, many a reduction has met with shareholders' objection rather than that of creditors.

A reduction of preference capital by writing off losses to it is bound to affect adversely their preferential dividend right when the company is a going concern and their right to repayment of capital in the winding up. A reduction of preference capital by returning paid up preference capital may deprive them of a good investment in a profitable enterprise. In both cases a reduction of capital is a matter of concern to the holders of preference shares. We shall examine how far the courts have protected them against an unjust deprivation of their legitimate expectations and interests.

(i) Reduction of Share Capital by Returning Paid-up Share Capital.

In British and American Trustee and Finance Corporation v. Coupe[22] the corporation registered in England carried on business in England and

the United States and had English and American shareholders. For practical reasons[23] the company decided to close down its American business, pay off the paid-up capital of the American shareholders (that is, buy their shares) as being in excess of the wants of the company, cancel those shares and reduce the share capital to that extent. A solitary shareholder objected and the court of first instance as well as the Court of Appeal refused to confirm the reduction holding that "a company could not reduce its capital by paying off some of its shareholders unless all shareholders of the same class were dealt with alike" and that the court has no power to confirm the reduction.[24] The House of Lords reversed. Lord Herschell, L.C., pointed out that the statutes imposed no "limitation of the power of the Court to confirm the reduction, except that it must first be satisfied that all the creditors entitled to object to the reduction have either consented or been paid or secured.[25] His lordship articulated the policy of the law thus.[26]

> "There can be no doubt that any scheme which does not provide for uniform treatment of shareholders whose rights are similar, would be most narrowly scrutinised by the Court, and that no such scheme ought to be confirmed unless the Court be satisfied that it will not work unjustly or inequitably. But this is quite a different thing from saying that the Court has no power to sanction it."

Lord Watson was of the view that[27]

> "Apart from the interest of creditors, the question whether each member shall have his share proportionately reduced, or whether some members shall retain their shares unreduced, the shares of others being extinguished upon their receiving a just equivalent, is a purely domestic matter . . . ."

British and American Trustee and Finance Corporation v. Couper is a clear authority for the proposition that equality of treatment of all shares, or even shares of the same class, is not a sine qua non for a reduction to be regarded as equitable and fair.[28] Lindley, L.J., had thought that when a company sought to return paid-up capital as being in excess of its needs, it ought not to "prefer one shareholder to another of the same class as himself by buying up his shares."[29] The judges of the lower courts therefore concluded that the court had no jurisdiction to sanction a reduction which involved the paying off and extinction of some shares only of the company. But the House of Lords made it clear that no such restriction on the discretion of the court was imposed by the statute. As Lord Watson observed:[30]

> "Specific directions are given for the guidance of the Court with the view of protecting the interests of creditors of the petitioning company, but in so far as concerns the interests of its members, I do not find a single expression in the Act tending to indicate that the discretion of the Court to grant or refuse such an application does not extend to every possible mode of reducing capital."

The House of Lords clearly and categorically reiterated the complete discretion of the courts in confirming or refusing a reduction but shed little light on the criteria by which the courts should be guided in the exercise of that discretion. The decision indicates that (1) the court would regard the technique of reduction as a purely domestic matter and (2) would refuse to sanction a reduction at the instance of a shareholder only if he shows that "any injustice would follow to himself or any other member of the company."[31]

British and American Trustee and Finance Corporation v. Couper did not involve any conflict between different classes of shareholders. But there are cases in which such conflict acutely presented itself before the courts. We shall notice the English judicial approach where a reduction by repayment of capital is opposed by the holders of a class of shares.

Scottish Insurance Corporation, Ltd. v. Wilsons & Clyde Coal Co., Ltd.[32] (hereinafter referred to as the Wilsons & Clyde case) and Prudential Assurance Co., Ltd. v. Chatterley-Whitfield Collieries, Ltd.,[33] (hereinafter referred to as the Chatterley-Whitfield case), both decisions of the House of Lords rendered in 1949, are cases in which the preference shareholders unsuccessfully objected to a return of their capital. In both cases the colliery business carried on by the companies in England by the two coal companies was nationalised by the Coal Industry Nationalisation Act, 1946. In both cases the insurance companies were holders of preference shares in the coal companies concerned.

In the Chatterley-Whitfield case, the coal company, a private company incorporated in 1891, upon nationalization of its English business, intended thereafter to continue its operations in Eire and Northern Ireland, but found that its capital requirements were much less and therefore decided to reduce its share capital by repaying its entire preference capital at par. Its issued capital of £400,000 consisted of 20,000 ordinary shares and 20,000 preference shares all of a par value of £10. The preference shares carried preferential right to cumulative dividend at 6% per annum and to return of capital in the winding up, but without participating rights in the surplus profits or assets. The effect

of the nationalisation was to leave the company with liquid assets far in excess of its needs and hence the company's decision to reduce its capital by returning the entire preference capital. The company had throughout been successful and lucrative. A special resolution was passed at a meeting of the company for reducing the share capital from £400,000 to £200,000 by returning to the holders of the preference shares the capital paid up on them.[34] Confirmation of the reduction was opposed by two large holders of preference shares[35] on the ground that they would be deprived of their potential right under the nationalisation statute to receive more than the par value of their shares as compensation. Reversing the court of first instance, the Court of Appeal, Evershed, L.J., dissenting, confirmed the reduction. Lord Greene, M.R., gave the reasons thus:[36]

> "The company's reduced business was unlikely in the future to earn the large profits which it had earned before nationalisation. The business answer of what it should do in those circumstances did not admit of doubt: a company whose preference capital did not 'earn its keep' would be guilty of financial ineptitude if it did not pay it off so far as its resources and the law allowed it to do so. It was a clearly recognized principle that the court, in confirming a reduction by repayment of surplus capital would require the payment off in the first instance of capital entitled to a priority in a winding-up .... On the other hand no such principle had ever been recognized as that it was unfair to pay off a preference shareholder and thus deprive him of his contractual expectation of dividend."

Evershed, L.J., dissenting, displayed greater concern for the loss of a good investment for the preference shareholder. According to him it might have been all right to return the preference capital "In normal times, when the holder of a high yielding preference share could easily

find a similar investment," but "conditions today were notoriously abnormal, and the holder of a six per cent. preference share would have the utmost difficulty in finding a comparable investment."[37]

The court was also not persuaded that under the vague and ambiguously worded Nationalisation Act there was any reasonable prospect of the preference shareholders receiving anything more than the par value of their shares. The facts of the Wilsons & Clyde case were similar.[38]

The importance of the two decisions of the House of Lords lies in that they place the onus of proof upon the dissenting shareholders to establish that the proposed reduction of capital is unfair or inequitable.

It is submitted that the propriety of a reduction of capital by repayment of the preference capital should be decided upon business considerations of the company as an enterprise entity and not exclusively by a consideration of the special interests of any group of shareholders. When a company finds itself with capital in excess of what it can profitably utilize, it should be enabled to unload itself of that part of its capital which is the most uneconomical to retain. This is essentially a business decision and companies should be given the freedom to make this decision so long as they do not abuse the freedom to frustrate the legitimate rights of any group of shareholders.[39] Viewed in this light, the decisions of the House of Lords are sound.[40]

(ii) Reduction of Share Capital by Writing Off Losses.

When a company wants to reduce its capital by writing off losses which have already occurred, we have seen that creditors do not ordinarily have the right to object to the reduction. The Act specifically permits

companies to "cancel any paid-up share capital which is lost or unrepresented by available assets."[41] It is now well-settled that in such cases the court will require prima facie evidence of the loss.[42] The reasons for this are: (1) to ensure that under the pretext of writing off a loss, the company does not in fact create a surplus and distribute it to the shareholders by carrying it to the profit and loss account;[43] and (2) to protect the shareholders in general, and the minority shareholders in particular. As Lord Parker of Waddington observed in Caldwell & Company, Limited v. Caldwell,[44]

> "When the reduction of capital is based on the ground that the capital has been lost or is unrepresented by available assets, it is, though not necessary, at any rate wise and prudent to insist on some evidence of the fact."

His Lordship thus stated his reason for the need for such caution:[45]

> "If no such prima facie evidence were forthcoming it might well be that the special resolution had been passed under the influence of some mistake or misrepresentation as to the true facts, and it would be unfair to the minority, if not also to the majority, of the shareholders to confirm a reduction voted under such circumstances. Further, inability to produce some such evidence might well suggest want of bona fides in the matter. If capital not really lost or unrepresented by available assets were cancelled, it might be possible thereafter, by some adjustment of the figures in the company's balance-sheet, to carry the amount so cancelled to profit and loss account, and so indirectly return paid-up capital, thus affecting the rights of creditors."

In this case a private limited company sought to reduce its paid-up capital of £50,000, consisting of 50,000 shares of £1 par value each, to £37,500, composed of the same number of shares but of a par value of 15s. each, by cancelling capital to the extent of 5s. in respect of each share. The company had suffered loss due to an extensive fire

which compelled the cessation of its business until the buildings and machinery were restored to working order. The reduction was objected to by a solitary shareholder while all the other shareholders favoured it.

In Bannatyne v. Direct Spanish Telegraph Company[46] — the first case in which the court was faced with the question — the telegraph company which had suffered substantial loss due to the breakdown of one of its cables sought the sanction of the court to write off £5 of the paid-up amount on each of its 6,000 preference and 13,000 ordinary shares, all of the same par value of £10, and thus reduce its capital by the amount of the loss.[47] The by-laws of the company had ever since its incorporation authorised it to reduce its capital at any time by special resolution and for the purpose alter the amount and denomination of its shares. The confirmation of the reduction was opposed by the preference shareholders who contended that the loss should fall on the common shareholders only. The preference shares carried a right to preferential dividend at 10% per annum, but no preferential right to capital.[48] They were successful before Bacon, V.C., in the court of first instance. The Vice Chancellor thought that to allow the ordinary shareholders to carry out such a reduction of the paid-up value of the preference shares "would be a wholesale recipe and a mode of cheating preference shareholders for the benefit of the ordinary shareholders" and "would be to raise the ordinary shares from shares worth, perhaps, a farthing apiece to shares which would get as good a dividend as the preference shares."[49] Evidently he felt that any such reduction which would diminish the amount of preferential dividend in the future ought not to be allowed.

The Court of Appeal reversed. Cotton, L.J., observed:[50]

> "If there was a winding up, the capital being partly lost, the preference shareholders and the ordinary shareholders must bear the loss rateably between them, because these shares were constituted without any preference as regards capital, though they had preference as regards dividend. Then if that is so, and there is a loss of capital, in consequence of which there is a reduction made in the capital of the company by reducing the nominal amount of the shares, that must be borne not only by the ordinary shareholders but also by the preference shareholders . . . ."

Referring to the contention of the preference shareholders that the company was contractually bound to pay them dividend at a fixed 10% of the par value of £10 and that this amount of dividend could not be reduced even if the par value were reduced from £10 to £5, he observed that they ought, and ought to be deemed, to have known and taken into consideration when they purchased the preference shares that the by-laws of the company empowered it to reduce its capital, as well as that the statute permitted companies to reduce the share capital if authorised to do so by their by-laws as originally framed or as altered by special resolution.[51]

On the judicial policy in confirming a reduction of share capital, Cotton, L.J., expressed the view[52] that, though the court is satisfied that the creditors are duly protected, yet it is not bound to confirm the reduction, but that "the Judge, when the matter is brought before him, if he sees it bears hardly on those who do not consent, may take that into consideration, and ought not to sanction a scheme simply because the creditors, who must be looked to, are dealt with properly, and have no ground of complaint."[53]

In Bannatyne v. Direct Spanish Telegraph Co.[54] the preference shareholders lost the first round of the battle. Preference capital as well as ordinary capital is liable for reduction under the statutory authority conferred on companies, provided only that the by-laws permit such a reduction. And the by-laws themselves are liable to alteration at any time so as to confer such power on the company.

In In re Barrow Hæmatite Steel Company[55] the company's by-laws contained no power to reduce capital at the time when the preference shares were issued by it in 1872 and 1876, but in 1885 the by-laws were amended to enable the company to reduce the capital by cancelling lost capital or capital unrepresented by available assets. North, J., held that the preference capital was not immune from reduction merely because at the time they were issued the by-laws did not authorise reduction of capital. He said:[56]

> "[P]ower had already been given by the Act to the company to reduce its capital, if the articles provided for it, and, therefore . . . the persons who took the preference shares agreed to take shares in a company which, by the Act, were reducible, if the company in general meeting should pass special resolutions authorizing a reduction, and should amend their articles accordingly."

As in the Bannatyne case, here also the preference shares carried cumulative preferential right to dividend only. The company sought to reduce uniformly its preference capital as well as ordinary capital by 25% on the ground that capital to that extent had been lost. The reduction was opposed only by a minority of the preference shareholders.[57] All the arguments which they could muster to distinguish the case from the Bannatyne case were rejected by North, J. Dealing with the judicial

policy in refusing or confirming a reduction, he said:[58]

> "I think the Judge is bound to see that no injustice is done to the shareholders, and that the proposed reduction is fair. If, for instance, I found that an attempt was being made to reduce all the shares alike, when, by reason of some contract, the preference shares ought not to be reduced at all, it is clear that under such circumstances I should have a right to refuse to sanction the resolution. But, in the absence of anything unfair and inequitable, I do not think that I have any discretion to exercise."

Is it not unfair to preference shareholders who are entitled only to a fixed (though cumulative) percentage of dividend without participation right in the surplus profits to be saddled with losses to an equal extent with the ordinary shareholders? North, J., answered this question in the negative and said:[59]

> "I do not think . . . the non-sharing in profits and the sharing in loss are in principle exactly alike. The preference shareholders bargained that they would not share in increased profits, and the corresponding bargain is that they shall not receive less in case the profits of the company diminish. If the profits diminish they will still receive their 8 per cent. or 6 per cent., as the case may be, even if there is not enough to pay a penny to the ordinary shareholders, and if there is not enough in any one year to pay the preference shareholders in full, the profits of subsequent years are to be devoted towards doing so, before the ordinary shareholders can receive anything."

Is it not unfair that the reduction of non-voting preference capital should be decided upon by the votes of the ordinary shareholders? North, J., again answered in the negative. He said:[60]

> "[I]t is by contract that they are exclused — it is part of the bargain with them. They were content to take their shares subject to the regulations of the company, although they knew that those regulations might be altered by the votes of the persons whose votes they could not influence — at any rate directly — by taking part in the voting themselves."

Though the reduction in this case was to be effected uniformly on all shares, North, J., made the following observations on the question of equality of treatment:[61]

> "[T]here is nothing in the Act which requires that the reduction should be spread, either equally or rateably, over all the shares in the company. The Act provides for the reduction of the capital, and the capital of the company may be reduced, for instance, by one-fourth, either by reducing the shares all round by one-fourth, or by reducing half of them by half, and the other half not at all .... The reason for the reduction in the present case is that a loss has been sustained. The rule to be adopted in applying the reduction to the shares is, that the reduction must be borne by those shares upon which the loss sustained ought to fall. If, by contract among the shareholders, some of the shares are primarily liable to bear the loss to the relief of others, those are the shares upon which the reduction should be made. If, on the other hand, all the shares ought to bear the loss, the reduction ought to be applied to them all, either equally according to the figures, or rateably, if the shares happen to be of different amounts, and in my opinion, the law is clear, that the reduction to be made must be primâ facie equal, according to the position of the parties, and primâ facie it must be made on all the shares of the company, unless there is some express provision to the contrary.[62]"

Twelve years later the company again sought the court's approval to reduce its capital, this time by a uniform 50% reduction of the prevailing par value of all the shares.[63] On this occasion the petition of the company was opposed by a very large majority of the preference shareholders. The company sought to reduce the capital on the ground that the capital had become lost or unrepresented by available assets because its assets had diminished in value. Cozens-Hardy, J., dismissed the petition holding that the company had not satisfied him of the loss of capital. It appeared that the company had an earned surplus of £90,000 and another £40,000 to the credit of a reserve account, but yet wanted

to write off an alleged loss to the share capital account. The company was also making large and increasing profits year after year notwithstanding the alleged loss of its capital and its products were well-known in the market. Cozens-Hardy, J., thought that the surplus amounts as well as the good-will must be regarded as available assets for the purpose of the reduction. Presumably his lordship was influenced by the fact that the company had been making substantial profits, and paying dividends out of it, and that the only effect of permitting the reduction of the par value of the preference shares by half would be to diminish by half their share in such profits, which he felt was not fair and equitable.

In the twelve years between the first reduction in 1888 and the second attempted reduction in 1900, the law of dividend had undergone marked developments. Until Lee v. Neuchatel Asphalte Company[64] was decided in 1889, it was generally believed that no dividend could legally be paid unless and until lost capital had been replaced. But that decision and that of Verner v. General and Commercial Investment Trust[65] in 1894 laid down that "a trading profit may be applied in payment of dividends notwithstanding a depreciation in the fixed capital of the company."[66]

Taking note of this development of the dividend law, Cozens-Hardy, J., remarked:[67]

> "Even if the fact of the loss . . . had been established, I should not have thought it right to confirm the reduction. What is the necessity for the reduction? The company is making large and increasing profits from its trading . . . . It has paid, and, having regard to decisions

> which are binding upon every Court short of the House of Lords, it has properly paid, dividends out of such profits notwithstanding the loss of capital .... The earning capacity of the company will not be in any way increased by the reduction of the capital, and I do not think that in dealing with two classes of shareholders I ought to make an unnecessary reduction for the avowed purpose of relieving the ordinary shareholders from the burden of preferential interest. At the present moment there are arrears of the cumulative preferential dividend, the whole or greater part of which may be speedily paid off out of profits. The annual preferential charge is in round figures 24,000 l., subject to which all the profits go to the ordinary shareholders. The proposal is that the ordinary shareholders should in future take all the profits, subject to a preferential charge of 12,000 l. only. In substance it is a proposal by the ordinary shareholders to deprive the preferential shareholders of 12,000 l. a year for the benefit of the ordinary shareholders, without any necessity for so doing and without any advantage to the company as a whole. This does not strike me as fair and equitable."

This view of Cozens-Hardy, J., while it protects the interests of preferential shareholders from a reduction of their dividend under the guise of a reduction of capital, marks a departure from the attitude of North, J., a dozen years earlier with regard to the same company and points to the need to have regard to the earnings of the company where preference shares are involved in a reduction of capital. On appeal the Court of Appeal affirmed the decision of Cozens-Hardy, J., on the ground that the evidence did not prove a loss of capital to the extent alleged in the resolutions passed by the company, but carefully avoided expressing an opinion on the points of law raised by his lordship. Lord Alverstone, C.J., remarked on the judgment of Cozens-Hardy, J.:[68] "I do not understand him to have decided anything adverse to a pro ratâ reduction of capital in a proper case, nor that simply

because the company were paying dividends there could not be a reduction .... I do not understand him as saying that upon different material a reduction of the capital of this company could not be justified ...." Vaughan Williams, L.J., cautioned that "It must not be assumed that, if I had been hearing this case by myself, I should have thought that the evidence of the loss was insufficient, and I feel some doubt whether Cozens-Hardy, J. really decided the case on that ground."[69]

It is submitted that where a company is earning large profits and the only effect of permitting it to reduce capital on the ground of loss is to diminish the share of profits of the preference shareholders, the court ought to permit the reduction only upon the condition that the company should proportionately increase the percentage of preferential dividend upon the reduced par value of the preferred shares.[70] Thus the safeguard which Cozens-Hardy, J., contemplated for the preference shareholders may be achieved without forbidding a company to record a fait accompli, viz. a reduction which has already occurred, or — to use the words of Jessel, M.R., in In re Ebbw Vale Steel, Iron and Coal Company, in "merely acknowledging that to be lost which is lost."[71] Where a reduction has in fact occurred, it would be anomalous not to permit the company to record what has happened. It is indeed necessary to permit the company to reduce the capital, while at the same time safeguarding the preferential dividend. Unfortunately the courts have not seen the possibility of achieving both these ends simultaneously in appropriate cases.

The trend of the judicial decisions in England has been to regard the technique of reduction a matter of domestic concern for the company to determine for itself and to refrain from interfering unless it is shown to be unfair or inequitable. In Poole v. National Bank of China, Ltd.,[72] all the courts including the House of Lords unanimously allowed the banking company which had suffered a loss to reduce its capital by writing off the whole amount paid or credited as paid on all its 750 founders' shares of a par value of £1 each while at the same time writing off £3 per share out of £8 paid up on each of its 40,453 common shares of a par value of £10 each.[72a] The confirmation of the reduction was opposed by the holders of 44 of the founder' shares.[73] The Lord Chancellor (Lord Loreburn) thus set out the judicial norm for confirmation of such reduction:[74] "The only question is whether it is unfair .... /I/t is no part of the business of a Court of justice to determine the wisdom of a course adopted by a company in the management of its own affairs." Lord Macnaghten deprecated the growing tendency to narrow and restrict the power of companies to reduce their capital[75] and pointed out that "The power conferred by the Act of 1867 is perfectly general. Any restriction upon it not authorised by the Act of 1867 or the Act of 1877 is calculated, I think, to lead to inconvenience and expense and to hamper and embarrass companies in the conduct of their domestic affairs."[76] With regard to the jurisdiction of the court in cases of reduction, Lord Macnaghten said:[77]

> "I was surprised to hear it argued . . . that the Court has no jurisdiction to entertain a petition for the reduction of capital unless it be proved that the capital which

> the company proposes to cancel is lost or unrepresented by available assets .... The condition that gives jurisdiction is not proof of loss of capital or proof that capital is unrepresented by available assets, or that capital is in excess of the wants of the company. The jurisdiction arises whenever the company seeking reduction has duly passed a special resolution to that effect."

In Poole v. National Bank of China, Ltd., the reduction was opposed by the holders of 44 out of a total of 750 founders' shares which were held by a public company and two individuals; the company proposed to pay the dissentient shareholders the par value of their shares out of profits because the continued existence of the founders' shares would stand in the way of the company raising further capital. Taking the circumstances of the case into consideration the court felt justified in disregarding the opposition of a small minority of deferred shareholders.[78] Lord Macnaghten laid down the following guidelines where the interests of creditors are not involved:

(A) The only questions to be considered are — (a) ought the court to refuse its sanction to the reduction out of regard for the interests of those members of the public who may be induced to take shares in the company? (b) is the reduction fair and equitable as between the different classes of shareholders? (B) It is not material, when the interests of the public are not concerned, whether a proposed reduction is exactly commensurate with the loss actually proved. "So far as the loss is actually proved, the case is one of those cases specifically mentioned in the Act of 1877. So far as the reduction goes beyond the actual loss, it is within the general power conferred by the Act of 1877. [There is] no objection to it if it is a prudent and businesslike measure, not unfair

to any shareholder and not detrimental to the public."[79]

The legislative and judicial trend has been toward liberalization in permitting reduction of corporate capital.[80] The interests of creditors are safeguarded by statutory provisions. The interests of different classes of shareholders and the public are left to be safeguarded by the courts. The courts have applied vague standards of "fairness" with reference to the specific circumstances of each particular case.[81]

(iii) Reduction of Capital in Voluntary Reorganizations

It is perfectly possible for a company to seek reduction of its capital, even though no capital is to be repaid as being in excess of the wants of the company, or cancelled as being lost or unrepresented by available assets, or no unpaid capital is to be extinguished. A good illustration of such an instance is the decision of the House of Lords in Carruth v. Imperial Chemical Industries, Ltd.[82] The directors of a prosperous and successful company put forward a scheme in good faith and in the general interests of the company to reorganize its capital structure. The scheme was to eliminate 21,736,564 issued deferred shares of a par value of 10s. each by issuing to the holders of these shares one ordinary share of £1 par for every four of their fully paid up deferred shares.[83] This involved a reduction or cancellation in some form of 5 s. paid-up on every deferred share — an aggregate reduction of £5,434,141 of paid-up deferred capital. None of this capital had been lost, or was unrepresented by available assets, or was proposed to be paid off to the holders of these shares as being in excess of the wants of the company. All that the company was seeking to achieve by

such reduction was to simplify its share structure by readjusting the respective rights of ordinary and deferred shareholders and merging these two classes of shares into one class.[84] 63,000 shareholders held both ordinary and deferred shares, 17,000 held deferred shares only, and 65,000 held ordinary shares only. The total number of shareholders (including the holders of preference shares) was in excess of 180,000.

Opposition to the reorganization and the consequent reduction came from deferred shareholders who were dissatisfied with the 4:1 ratio for the conversion of deferred shares into ordinary shares. Some deferred shareholders resisted the confirmation of the reduction by the court. One of the objections raised was that the reduction was not based on any loss of assets or repayment of excess capital, but the House of Lords, relying on its earlier decision in Poole v. National Bank of China, Ltd.,[85] discussed earlier, had no difficulty in rejecting this contention and held that the by-laws of the company authorised it to reduce its capital in any manner permitted by the statute and that the statute permitted reduction in any way.

On the question whether the reduction was fair Lord Maugham observed:[86]

> "I think the fairness or unfairness of the scheme as a whole, including the reduction, is not a matter for the discretion of the . . . judge in a technical sense, but is a matter to be decided on the evidence. The question in this case depends on the view which should be taken as to the future commercial success of the company. We are not entitled to substitute our own views for those of the directors and experts who have given evidence. Considerable importance must be attached to the unanimous opinion of the directors . . . ."

Lord Blanesburgh arrived at the same conclusion but by a different analysis. He addressed himself to the question whether, in a case not involving a writing off of loss or repayment of excess capital, it is proper to confine the incidence of the reduction to one class (here deferred) of shareholders only. He pointedly formulated the question thus: "Which class of shares in this Company . . . is to be charged with a reduction so exotic that it merely cancels capital credited to a share in which its holder is solely interested in order that the same capital may be transferred to a credit in which he is only fractionally concerned?"[87] In other words, the question is "whether the reduction thrown exclusively on the deferred shares was as a separate incident in accord or not with the proper burden of these shares in contrast with the other shares in the Company."[88] His lordship concluded that the imposition of the entire burden of the reduction upon the deferred shares was not a "regular" reduction, that is, in accord with the legal rights of those shareholders. He therefore held that such an irregular reduction would not be confirmed by the court unless the deferred shareholders had duly assented to it or unless the company had affirmatively established that the reduction, though irregular, was nevertheless, in the return received by these shares under the scheme, fair and equitable to their holders.[89] Dealing with the question whether the deferred shareholders had duly assented to the reduction, his lordship came to the conclusion that though they had consented to the reduction of capital, yet they had not agreed to the incidence of the entire reduction being laid exclusively upon their shares.[90] He observed that "only by the clearest words and

in full knowledge of their rights will a class be held bound by a resolution which it is suggested modifies or extinguishes these rights."[91] It follows that such a reduction to which the deferred shareholders had not assented, could be confirmed only if it was affirmatively established that the reduction was nevertheless fair and equitable. Relying upon independent expert testimony, his lordship concluded that the scheme was fair to the deferred shareholders.[92]

We may summarise the result of the English decisions thus:

(1) A company may reduce its capital in any way, subject to the statutory requirements and subject to judicial confirmation.

(2) The court will not confirm a reduction which is shown to be unfair or inequitable to any class of shares.

(3) A reduction is not necessarily unfair merely because it is not uniform or proportionate in respect of all classes of shares.

(4) A reduction is not unfair merely because it has been resolved upon solely by the votes of a class of shares other than that to which the reduction applies.

(5) It would appear that even a single shareholder can oppose the confirmation of a reduction on the ground that it is unfair.[93]

To sum up, the judicial role in reduction cases has been minimal. The courts have required prima facie evidence of loss before allowing companies to charge losses to share capital. Otherwise they have tended to regard reduction of share capital as matters of domestic concern meriting judicial noninterference in the absence of fraud or bad faith. The legislature has contented itself with fully protecting creditors and leaving

the rest to judicial surveillance. In the result, the English law has adopted a liberal policy in permitting reduction of share capital.

Appraisal of the English Law of Reduction of Share Capital: The commendable aspect of the English law of reduction is the full protection it affords creditors when a company seeks to make a distribution of its assets to its shareholders in partial liquidation or waive its claim to any extent to unpaid subscriptions due or payable by its shareholders and charge the issued capital account. But otherwise it fails to recognize the very complex problems underlying such reductions and adopts a simplistic treatment of the subject. It evinces little concern for the non-voting shareholders. It fails to protect preference shareholders from the reduction of their capital so as to diminish their quantum of dividend at a time when the company has suffered no diminution in its earnings. It fails to clarify when a company may charge a loss to its share capital by-passing its earnings or earned surplus or capital surplus accounts. It fails to confer mandatory voting right to all shares on resolutions to reduce share capital. The legislature has shifted its burden to the courts, the courts to the managements, and managements have understandably favoured the voting shares through whose favour they have won their office and through whose mercy alone they can continue in that office. In the result, the preference shareholders have been reduced to the unenviable position in which they share the hazards of creditors as well as equity shareholders without the advantages of either. The omnibus treatment of varied circumstances in which a reduction of share capital may be desired by a company or may become necessary under a

broad statutory provision has only served to obscure the substantial issues involved in these cases and to hinder the development of sound and proper principles in the law of corporation finance in general.

2. The American Prototype.

The American jurisdictions do not follow the English device of judicial confirmation of corporate reduction of capital to safeguard the diverse interests of creditors, senior securities, minority shareholders, prospective investors, and others who may be prejudiced by such reduction. In America, therefore, the safeguards for these groups are often spelled out in the statute itself and the result is more detailed statutory provisions, less flexibility, and perhaps less effective protection for such diverse interests.[94] Reduction can always be effected by shareholder action — at times by simple majority and at others by a special majority vote of the holders of shares entitled to vote. With this general background, let us consider the statutory patterns in the American jurisdictions.

(a) The Model Act

We have seen that the Model Act defines[95] "stated capital" as the sum of (i) the aggregate par value of all issued par value shares (which means the paid-up as well as the unpaid amount on these shares), (ii) the aggregate consideration received for no-par shares[96] except that part of it allocated to paid-in surplus as permitted by the Act,[97] and (iii) additional amounts transferred to stated capital from surplus accounts,[98] less (iv) all reductions as permitted by law.[99]

The Model Act contemplates four possible instances and modes of reduction of stated capital.

First, a corporation may redeem or purchase its redeemable shares subject to the provisions of the Act.[100] Upon such redemption the shares become automatically cancelled and the stated capital is thereafter "deemed to be reduced by that part of the stated capital which was, at the time of such cancellation, represented by the shares so cancelled."[101] Such redemption or purchase is, however, permissible only if the corporation is, and will remain, commercially solvent and its net assets will not be reduced below the aggregate amount payable to the holders of shares having prior or equal rights to the assets of the corporation upon involuntary dissolution. There is therefore a limit to the diminution of assets by this kind of reduction of stated capital.

Secondly, a corporation may repurchase or reacquire any of its shares, whether or not they had been issued as redeemable.[102] Such reacquired shares may be retained by the corporation as treasury shares in which case the stated capital remains unaffected. But the reacquired shares may be cancelled by the board at any time and upon filing a statement of cancellation with the secretary of state the stated capital is reduced pro tanto.[103] This kind of reduction of stated capital is also subject to the same limit as in the first case.

Thirdly, if the stated capital exceeds the aggregate par value of issued shares having a par value, and the amount of consideration received for the issue of no-par shares and allocated to stated capital, then the stated capital can be reduced to the extent of such excess by the affirma-

tive vote of the holders of a majority of shares entitled to vote thereon, provided that no charter amendment or cancellation of shares is involved.[104] This is obviously an instance of limited application.

Last, but most important of all, is the case of reduction of share capital by charter amendment. This will be the case whenever the reduction is to be effected by a diminution of the par value of shares having a par value, or by a voluntary reorganization involving a reclassification of shares or other recapitalization, or cancellation of shares. The Act authorises corporations to amend their charter "from time to time, in any and as many respects as may be desired."[105] Such amendments can be effected without judicial or administrative control and all that is needed is that the amendment should receive the affirmative vote of the holders of two-thirds of the shares entitled to vote thereon.[106] The Act confers mandatory class-voting right, as we have seen, in specified cases of charter amendments.[107] Three points may be observed here: (i) The secretary of state has no discretionary powers to disallow a charter amendment which has been carried out in compliance with the provisions of the Act. (ii) There is no provision for publicity of a reduction of stated capital thus effected.[108] (iii) There are, as will be seen, restrictions on the distribution of the surplus created by the reduction of stated capital. It may be pointed out here that a reduction of stated capital by reducing the amount of stated capital represented by issued no-par shares can be effected, it seems, only by a charter amendment by exchanging them for new no-par shares deemed to be issued for a lesser amount.

There can be no reduction of stated capital in any other way. The Comment to the Model Act provision makes it clear that "Even if, as a result of operation or otherwise, the net assets of the corporation fall below the amount of stated capital . . . the stated capital is not thereby reduced."[109] If the corporation wants to write off an impairment of the stated capital, it should take the necessary steps for effecting a reduction of stated capital. Otherwise the impairment will have to be debited to a surplus account and shown as an earned or unearned surplus deficit.

(b) The Uniform Act

We have seen that the Uniform Act defines "Capital Stock" to mean the aggregate par value of all outstanding shares having a par value and the aggregate value of the consideration for the allotment of no-par shares, including shares issued as dividend in both cases.[110]

To effect a reduction of capital stock, first the corporation should pass a resolution adopted by the vote of the holders of two-thirds of the voting power of all shares, cast in person or by proxy, or by such vote as prescribed by its charter.[111] Secondly, no reduction could be made which would "reduce the fair value of the assets of the corporation to an amount less than the total amount of its debts and liabilities plus the amount of its capital stock as so reduced." A document, called the articles of reduction, stating that the fair value of the assets will not thus become diminished should be filed with the Secretary of State. The reduction becomes complete if the Secretary finds it to be in conformity with the law — which means that the Secretary may look

into the fairness of the valuation of the assets — and issues a certificate of reduction, but any reduction which would reduce the fair value of the assets below the level specified above will be inoperative notwithstanding the issuance of the certificate.

This is the one and only procedure for reduction of capital under the Uniform Act and it requires the approval of shareholders having voting rights.

The Uniform Act, however, confers appraisal rights on dissenting shareholders to a greater extent than the Model Act. The dissenting shareholder is entitled to be bought out in such cases. This right, however, cannot be asserted if the corporate assets which would remain after such payment would be less than the aggregate amount of the corporation's debts and liabilities, exclusive of capital stock.[112]

Thus, it would seem that under the Uniform Act a purchase by a corporation of its own shares could be effected only by the prescribed procedure for reduction of stated capital or where a shareholder is entitled to appraisal right.

(c) New York Statute

New York's Business Corporation Law[113] follows the Model Act with some modifications. It provides for reduction of stated capital by charter amendment,[114] but requires only a majority vote and imposes a limit upon such reduction, viz. that "No reduction of stated capital shall be made by amendment unless after such reduction the stated capital exceeds the aggregate preferential amount payable upon involuntary liquid-

ation upon all issued shares having preferential rights in assets plus the par value of all other issued shares with par value."[115]

The board is authorised to reduce stated capital by eliminating from it amounts previously transferred to it from surplus by the board and not allocated to any designated class or series of shares, or by eliminating any amount of stated capital represented by issued shares having a par value which exceeds the aggregate par value of such shares, or by reducing the amount of stated capital represented by issued no-par shares except where the consideration for the no-par shares had been fixed by the shareholders[116] in which case the board's power in this respect is restricted.[117] Here again stated capital cannot be reduced below the limit specified in the preceding paragraph in connection with reduction by charter amendment.

Subject to the solvency requirement, corporations are authorised to reacquire their shares out of surplus and in some cases out of stated capital.[118] Shares reacquired out of stated capital have to be cancelled by the board; in other cases, the board may cancel them or retain them as treasury shares. When they are cancelled by the board, the stated capital is pro tanto reduced.[119] In this respect New York follows the Model Act.

(d) Delaware Statute

The Delaware General Corporation Law[120] permits the reduction of capital by shareholder action and the only restriction upon the extent of the reduction is that the corporation should retain assets "sufficient to pay any debts, the payment of which shall not have been otherwise

provided for."[121] The one significant aspect of the Delaware statute in this context is its requirement of publicity whenever capital is reduced. Notice of the reduction should be published "for three weeks successively at least once in each week, in a newspaper published in the county in which the registered office of the corporation is located." Failure to do so renders the directors "jointly and severally liable to any creditors of the corporation who shall suffer loss by reason of the noncompliance" and the shareholders similarly liable up to "the amount of such sums as they may respectively receive of the amount so reduced."[122]

(e) California Statute

The California General Corporation Law[123] forbids the reduction of stated capital below the aggregate amount of the liquidation preferences upon involuntary liquidation of preferred shares with or without par value to remain outstanding after such reduction and the aggregate par value of all par value shares without liquidation preference to remain outstanding after such reduction.[124]

One of the significant provisions of the California law relates to surplus created by reduction of stated capital. Such surplus should be transferred to a special reduction surplus account.[125] A distribution or withdrawal of reduction surplus ought not to be made unless the board of directors determines in good faith that by such distribution or withdrawal the corporation will not be rendered unable to satisfy its debts and liabilities when they fall due and that the assets of the corporation after such distribution or withdrawal taken at their "fair present value" will at least equal one and one quarter times its debts and liabilities.[126] Even

if this condition is met, such distribution or withdrawal of reduction surplus can be made only in the manner specifically provided for in the statute.[127]

Any surplus, including reduction surplus, may be applied to eliminate any deficit arising from losses or diminution in value of the assets of the corporation, subject to disclosure as required.[128]

It is also noteworthy that the reduction should be approved by the "vote or written consent of the holders of a majority of outstanding shares regardless of limitations or restrictions on voting rights.[129]

We may now briefly indicate the American position on the reduction of stated capital (i) by extinguishing or diminishing unpaid capital, (ii) by distributions to shareholders charged to stated capital and (iii) by charging losses to stated capital. The latter two are dealt with in detail in the following two chapters.

(1) Waiver by a company of unpaid subscriptions in whole or in part: Any such waiver in the case of par value shares will necessarily involve a charter amendment as the par value of the shares will have to be correspondingly decreased, or the shares exchanged for new shares of lesser par value and then cancelled, or exchanged for no-par shares and then cancelled. In other words, the par value or the number of shares will have to be altered. There will be a consequent reduction of stated capital, as paid-up as well as unpaid capital are included in "stated capital" in the case of par value shares. Almost all the jurisdictions authorise such reduction of capital by the decrease of the par value of shares by amending the charter of the company. California

appears to be the only jurisdiction which does not permit a reduction of stated capital by the reduction of unpaid subscriptions in respect of outstanding par value shares or by the reduction of the number of shares without par value.[130]

(2) Distribution of Assets to be charged to Capital: We shall first consider this aspect under the Model Act.

The stated capital can be reduced at any time by suitable charter amendment involving shareholder action. What is important is that by such reduction a capital surplus can be created and distributed in partial liquidation (though that description is not now used by the Model Act) to the shareholders in cash or property.[131] The restriction upon such distribution for the protection of creditors is that the company ought to be, and remain, "solvent" after the distribution.[132] There are other restrictions for the benefit of shareholders and for the protection of any special rights of any class of shares. They are: (1) Such distribution must be authorised by the charter or by the vote of the holders of at least two-thirds of the outstanding shares of each class, whether or not the charter confers the right to vote upon them with respect to the matter.[133] (2) No accrued cumulative preferential dividends on senior stock must be in arrears.[134] (3) Such distribution is forbidden if it would reduce the remaining net assets below the liquidation preference of senior stock in the assets of the company.[135] (4) The distribution must be clearly disclosed as one from capital surplus.[136] The reduction surplus may, like any capital surplus, be applied by the board of directors (without specific authorisation by the charter or by the shareholders)

to pay the cumulative preferential dividends, provided that (i) the corporation is, and will, remain solvent, (ii) there is no earned surplus, and (iii) the source of the distribution is disclosed. In short, reduction surplus is treated on par with share premium amounts or other capital surplus.

A corporation is, therefore, permitted to distribute its assets to its shareholders in partial liquidation until it reaches the turning point where the next step will render it insolvent. To permit them to drain their assets by voluntary return to shareholders just up to the danger level without any judicial or quasi-judicial control is, it is submitted, unsound policy. The solitary statutory safeguard for creditors that the corporation must, and must continue to be, "solvent" is no real safeguard at all, for no creditor would feel comfortable to find the corporation racing toward the brink of insolvency. As it has been rightly pointed out, "Nor does capital offer any protection in the absence of a meaningful limit on reduction. Furthermore, in as much as few jurisdictions require consideration of 'actual' or 'fair' value in determining the availability of a surplus for distribution purposes, inflated book values may render the statutory protection completely hollow."[137] This basically unsound policy underlies other financial provisions of the Model Act, as we shall notice later.

Some jurisdictions provide greater safeguards for creditors than the Model Act. Unlike the Model Act which permits distribution in partial liquidation until the remaining assets are of a value at least equal to liabilities, California requires, as we have seen, that the remaining

assets must be of a value of at least one and a quarter times the liabilities, and a few others that they must be at least twice the amount of liabilities.[138] But these jurisdictions are only a few in number. On the other hand many jurisdictions fail to protect even the liquidation preferences of senior stock in the assets of the corporation and "overlook the fact that a distribution from reduction surplus more closely resembles a liquidation,"[139] but treat it as if it were the payment of ordinary dividend out of profit.

To sum up, the safeguard for creditors is inadequate in the American jurisdictions in striking contrast to the English provisions. That the distribution of a reduction surplus will be illegal where the company is already insolvent, or is thereby rendered insolvent, is meagre protection for creditors, as it will often be very difficult for them to obtain redress against the directors who will be well-shielded by their reliance in good faith on the book value of the assets of the company.[140] American courts have generally refrained from scrutinizing the necessity or propriety of corporate reduction of capital.

In later chapters we shall concern ourselves with the corollary problems of payment of dividend out of capital and purchase of its own shares by a corporation.

(3) Writing off losses to stated capital: The Model Act requires that losses must be written off to earned surplus, and only after it is exhausted to capital surplus.[141] In this respect the Model Act differs from the English law, as judicially evolved. The defect with the English system is that it permits the payment of dividends out of current income

without making good capital and revenue losses which had been written off to capital. We have suggested elsewhere that the minimal remedy for this is to require the company to disclose that the dividend is paid out of current earnings without repairing impaired capital. Under many modern American statutes such disclosure will be necessary. But the American statutes, though they require that the earned surplus must be exhausted before the capital surplus is applied to the elimination of any deficit arising from losses, yet permit companies to reduce their stated capital in order to create a reduction surplus and distribute such surplus in partial liquidation. The anomalous result of this is that whereas the law requires impaired capital to be repaired out of earned surplus, it at the same time permits such repaired capital to be impaired to the limit of bare solvency in order to create a reduction surplus which may be distributed to the members in partial liquidation. We shall return to this problem of writing off of losses in the chapter on dividends.

The American jurisdictions have left creditors to protect themselves, but have purported to safeguard the assets-preference of senior stock in a winding up. But it should be obvious that to the extent the creditors' claims are not fully safeguarded, any such purported safeguard for senior stock is only illusory, for the preferential claims of shares can be asserted in the event of a winding-up only if any surplus assets remain after the claims of creditors are satisfied.

3. The Canadian Approach.

The Dominion statute follows closely the English statutes in its provisions for the reduction of capital, except that the reduction must be confirmed, not by the court, but by the Secretary of State by the issue of supplementary letters patent.[142] The procedure to be followed before the Secretary of State is the same as the procedure to be followed in respect of a petition before the English court for confirmation of a reduction. The Secretary of State has the same powers as the English court in confirming or refusing to confirm a reduction. In brief, the Dominion Act affords as much protection as the English Act when it provides that "When the proposed reduction of capital involves either diminution of liability in respect of unpaid capital or the payment to any shareholder of any paid-up capital, and in any other case if the Secretary of State so directs, every creditor of the company who at the date of the petition for supplementary letters patent is entitled to any debt or claim that, if that date were the commencement of the winding up of the company, would be admissible in proof against the company, is entitled to object to the reduction."[143]

Quebec has substantially the same provisions.[144] As can be expected, the memorandum jurisdictions also follow the English precedent including its requirement of judicial confirmation of the reduction.[145]

Ontario and Manitoba have somewhat different provisions, but as in the Dominion and Quebec jurisdictions, the reduction can be effected only by obtaining supplementary letters patent. The Acts require that the company should establish to the satisfaction of the Provincial Secretary

that "after the decrease the company will be solvent" and should, if required by him, establish to his satisfaction that "there are no creditors who object to the application" for supplementary letters patent.[146]

It is not necessary to examine here these statutes in detail. Suffice it to say that almost all of them are substantially in accord with the English approach towards reduction of share capital. Some modern trends may, however, be noted here.

The federal Act was amended by an Act of 1964-65 to enable companies to issue preference shares with par value which are liable to be redeemed or purchased for cancellation out of capital, provided that the redemption or repurchase should not be made at a premium of more than 20% of the par value.[147] Upon such redemption or repurchase, the shares become extinguished and the issued and authorised capital reduced accordingly. No supplementary letters patent are necessary in such cases to effect the reduction.[148] The proposed Ontario Business Corporations Act has heavily borrowed from the New York Business Corporation Law and reference to it will be made in the following chapters.

CHAPTER 9

PURCHASE BY A CORPORATION OF ITS SHARES

The so-called "purchase" by a corporation of its shares is but one special instance of return of assets by a company to its shareholder. In this case the shareholder gives up in return his membership rights in respect of the shares so "purchased". If such a return of assets is, or has to be, charged to share capital, which will be the case where the company has no surplus available to make the purchase, it is obvious that it involves a reduction of share capital. On the other hand if the purchase is made out of current income or accumulated profits or any capital surplus, it is equally obvious that there need be no reduction of share capital, provided that the law would recognize the company as the holder of those shares. The English law does not allow a company to purchase its own shares or to hold its own shares and has not evolved a concept of "treasury shares". This precedent is followed generally in the Commonwealth jurisdictions. The American jurisdictions have on the other hand permitted companies to purchase their shares. In this chapter our main inquiry will be: what are the risks inherent in allowing companies to purchase their shares and how can they be safe-guarded against?

1. The English Approach.

The locus classicus on the subject all over the Commonwealth is Trevor v. Whitworth[1], decided by the House of Lords in 1887, which held that a company cannot validly buy its own shares. We shall first consider two earlier decisions of the Court of Appeal to indicate the judicial views which had existed on this question before the House of Lords finally resolved it in Trevor v. Whitworth.

The first is Hope v. International Financial Society[2] (hereinafter referred to as the Hope case) decided by the Court of Appeal in 1876. The International Financial Society, Ltd., registered in 1863, had an issued capital of £1,500,000, consisting of 150,000 shares each of a par value of £10 and paid-up to half the par value. By 1876 the company was in an embarrassed state and a section of the shareholders wished to withdraw from it and for that purpose to have it wound up. But a majority of the shareholders were opposed to the idea of winding up the company. The directors therefore recommended a plan to apply a considerable part of the cash and easily convertible assets of the company to purchasing the shares of those who wished to retire from the undertaking and were of the opinion that the disposable funds of the company would be sufficient to purchase up to two-thirds of the issued shares.

At a general meeting of the company a special resolution was passed authorising the board to purchase from any shareholder willing to sell such number of shares not exceeding 100,000, the shares so purchased not to be re-issued without the authority of a general meeting.

Only four shareholders opposed this resolution. One of them who held five shares[3] brought action on behalf of all the shareholders other than the directors for an injunction to restrain the directors from acting upon the resolution and applying any money belonging to the company for the purchase of its shares.[4]

Neither the charter nor the by-laws of the company empowered it to buy its shares.

Bacon, V.C., and the Court of Appeal held for the plaintiff shareholder. The Vice Chancellor stated the law thus:[5]

> "The law I take to be plain, and covered by many cases, that it is not competent to a company to take the moneys which have been subscribed for its capital for the purpose of buying up the shares of that company."

He pointed out that in this case such purchase was sanctioned neither by the charter nor the by-laws of the company, nor was such a power conferred by the statute, except under the conditions imposed by the Act of 1867 for reducing capital. He therefore concluded:[6]

> "Having regard to the articles and the memorandum of association, to the Act of Parliament, and to the cases which have been decided,[7] I cannot think that it is a legitimate application of these assets of the company, which are not wanted . . . for any present purposes of business, to expend them in the purchase of those shares."

Though no creditor objected to the company buying its shares, the Vice Chancellor voiced concern for the interests of creditors when he said:[8]

> "If companies could [expend their moneys to buy their own shares], it would be easy for companies not intending to act honestly . . . to dispose of the whole of the assets of the company in favour of selected shareholders, exhaust the whole of the funds, and leave the creditors unpaid."

He therefore felt that it was the right and duty of a shareholder to see that the moneys of the company were applied to its legitimate purpose and to interfere to prevent an improper application of the funds.[9]

In the Court of Appeal, counsel for the company contended (i) that if the reacquired shares were not re-issued, there was no reduction of capital, but only a reduction of assets, and (ii) that there was no trafficking in the shares, even if the shares were re-issued, as there was no intention of making a profit by the purchase and re-sale of the shares. Counsel for the shareholder contended that if the directors intended to re-issue the repurchased shares, it would be an ultra vires trafficking in the company's shares as the company was not authorised to do so by its memorandum and that if they intended to extinguish the re-purchased shares, it would be an unlawful reduction of capital contrary to the provisions of the Act of 1867.

The Court of Appeal affirmed the Vice Chancellor.[10] James, L.J., observed that the transaction recommended by the directors was just "a scheme to divide the assets between the shareholders under the guise of the company's purchase of the shares — a device, in fact, to evade the provisions of the law regulating the reduction of capital."[11]

The Act of 1867 which for the first time provided for reduction of capital and shares purported to enable companies limited by shares to "so far modify the Conditions contained in its Memorandum of Association . . . as to reduce its Capital."[12] It spoke of "capital" and not share capital and gave the impression that the prescribed procedure was to be followed only when the memorandum of association was to be

amended to change the share capital specified in it. Therefore the counsel for the company argued that the Act of 1867 applied only to cases of alteration of authorised capital. According to this view if the reacquired shares were to be extinguished, there would be a reduction of authorised capital which could be done only as provided by the Act of 1867, but if they were to be re-issued there would be no such reduction of the authorised capital and hence no need to comply with the Act of 1867. The Act was susceptible of such construction which would lead to the absurd result that a company was only under an obligation to keep its nominal (authorised) capital intact, but was free to return its real (paid-up) capital to its shareholders. The courts refused to make such an absurd construction. Brett, J.A., construed the Act of 1867 to mean that a company ought not to reduce its "issued capital" without judicial confirmation.[13] According to his lordship, if the reacquired shares were not intended to be reissued, then they were inevitably extinguished, thus reducing the issued capital; if on the other hand they were to be re-issued, it was a trafficking in shares not authorised by the memorandum and hence ultra vires.[14] But this leaves open the question: suppose the memorandum of a company authorises it to traffick in its shares and the company repurchases its shares in order to re-issue them; is such a purchase a reduction of capital?

The second case is In re Dronfield Silkstone Coal Company,[15] decided by the Court of Appeal in 1880. The by-laws of the company incorporated in 1867 authorised its directors to purchase from time to time for the company any shares in the company at such prices as they

thought reasonable and to deal with them in the same way as if they were unissued shares. The by-laws authorised that the purchase price might be paid out of any asset of the company and that the shares purchased might be transferred to the name of the company or any other persons as determined by the directors. The company had been formed to take over a colliery business formerly carried on by one Ward in partnership with another. The issued capital of the company was £40,000 made up of 1,600 shares of £25 each. Ward was allotted 500 of these shares toward the price payable to him. Differences having arisen by 1872 between Ward and the other directors as to the conduct of the business, it was agreed that Ward would sell his shares to the company and sever his connection with it. The company resolved unanimously[16] at a general meeting to buy the shares and thereafter the purchase was carried out.[17] The company carried on its business in a prosperous way for a few years afterwards, but then became embarrassed and was ordered to be wound up in 1879. The liquidator placed Ward's name on the list of contributories, whereupon Ward applied to the court to have it removed.

Jessel, M.R., held that the authority conferred by the by-laws on the company to buy its shares was inconsistent with the charter (memorandum) as the latter did not authorise such trafficking in shares and was therefore invalid. This would by itself be sufficient to dispose of the case, but the Master of the Rolls nevertheless examined the larger question whether such power, if conferred by the memorandum itself, would be valid. He was clearly of the view that it would be

invalid and gave the following reasons: (i) It is repugnant to the provisions of the Companies Act, 1862, that a company should be a member of itself.[18] (ii) The purchase by a company of its shares inevitably reduces its capital. Counsel for Ward had contended, like the counsel for the company in the Hope case, that section 12 of the Act of 1862[19] only forbade a company to "alter the terms of the memorandum as to the nominal amount of the capital." Rejecting this argument the Master of the Rolls remarked:[20]

> "It would be a very singular result if that were so, because it would come to this — the company may destroy the whole of its real capital without altering its nominal capital amount .... [T]he section must apply to the issued capital, and not merely to the nominal capital; and it has always been so treated so far as I know .... The provisions of the section, I admit, are difficult to construe if you read them word by word, but I do not think they are so difficult to construe if you look at the meaning of the whole of the Act as to the formation of these companies. If they are to be taken to apply only to the amount of the nominal capital, I must say that the Acts of 1867 and 1877 are the most extraordinary legislative productions I ever saw. But if you read the section the other way, and say that it means that the conditions in the memorandum relate to the issued capital, then the subsequent Acts are perfectly intelligible."

Then the Master of the Rolls pointed out that the word "capital" as used in section 9 of the Act of 1867[21] meant "trading capital" and not merely the "nominal capital".

Sound as the statutory interpretation of the Master of the Rolls was, it did work, as he himself admitted, great hardship on the shareholder who had bona fide severed ties with the company only to find after seven long years that he was sadly mistaken and under law the transaction was a nullity.

The Court of Appeal reversed,[22] and disagreed with the views of the Master of the Rolls in entirety. First, the articles did authorise the company to buy its shares, but this did not mean that they authorised the company to traffic in its shares. Secondly, that power was not abused here to enable a shareholder to escape liability or for any other improper object. Thirdly, "there has been no reduction of capital as fixed by the memorandum, there has merely been a purchase of shares which can be re-issued."[23] Hope v. International Financial Society was distinguished on the ground that there was in that case a scheme for restoring capital to the shareholders, but "there was nothing of that kind here, nor was there any purchase as to interfere with the business."[24]

The Dronfield Coal Company case is an example of a circumstance in which a company, especially a close company, may genuinely need the power to purchase its shares. The Hope case points to the other extreme when such a power may be used by a company on a wide scale so as to denude itself of its assets and interfere with its business. The law may either draw a line and prescribe the conditions and circumstances in which the directors may purchase the shares of the company, or it may require judicial confirmation in every case and not trust the directors or the shareholders to exercise the power in the interest of the company. In Trevor v. Whitworth where a shareholder claimed in competition with other creditors of the company under winding-up the price due to him for the shares sold by him to the company, the House of Lords declared beyond doubt that the English law had conformed to

the second alternative. In other words a company can purchase its shares only as a mode of reducing capital by complying with the provisions of the Act of 1867.[25] The judges of the Court of Appeal[26] had on the other hand rested their decision upon that of the same court in the Dronfield Coal Company case. The House of Lords agreed with the decision of the Court of Appeal in the Dronfield Coal Company case refusing to make Ward a contributory in the circumstances of that case, but disapproved of the views of the learned judges on whether a company could purchase its shares, but preferred the reasoning of Jessel, M.R., on that question.

The facts in Trevor v. Whitworth[27] were simple. James Schofield & Sons, Ltd., was a company incorporated under the Act of 1862 to carry on the business of flannel manufacturers with a capital of £150,000 divided into 15,000 shares of £10 each. As in the Dronfield Coal Company case, one of the by-laws of this company empowered it to buy "any share" from "any person willing to sell it" and "at such prices, not exceeding the market value thereof, as the board think reasonable". Another by-law empowered the board to sell, dispose of, or extinguish the shares bought at their discretion. But the power to purchase its shares was not embodied in the charter of the company. After 1875 there was no longer a market for the company's shares. From then on the company bought as a matter of course the shares of any member who wished to sell. Though the company was steadily going from bad to worse, trading at a loss, and had not paid any dividend after the year ending 31 December 1877, yet it continued to buy its shares

— and this not at the market price, for market there was none, but at the amount actually paid up on them. The company borrowed the cash needed to purchase the shares.

In 1884 the company went into liquidation. By then it had purchased 4,142 out of its 15,000 issued shares. Of the repurchased shares 3,609 were entered in the register in the name of a non-existing firm. The remaining 533 shares — to which the present case related — were entered in the register in the name of a director. They had belonged to deceased Whitworth and were sold by his executors to the company in 1880. The company paid £505 in cash for them and the unpaid balance of £2,800 was treated as a loan by Whitworth to the company. Whitworth's executors claimed for this amount in the liquidation of the company. The official liquidators of the company took out a summons to determine whether the claim ought to be allowed.

Counsel for the liquidators contended that (1) the purchase of its shares by a limited company was ultra vires and invalid, irrespective of "whether there is or is not power given in the memorandum of association", that in any case no such power was given to the company by its charter and hence the authorisation by the by-laws was invalid; and that (2) the purchase was a reduction of capital contrary to the provisions of the Companies Acts.

Counsel for the respondent executors contended that (1) the by-laws must be so construed as to authorise such purchases as would be consistent with the charter and that (2) here the purchase was made to keep the company a family concern and thus incidental to the carrying

on of the business of the company.

Upholding the liquidators the Vice Chancellor held that the claim against the company ought not to be allowed. The Court of Appeal reversed, following its decision in the Dronfield Coal Company case, and held that the respondents were entitled to rank in competition with the creditors of the company.[28] The House of Lords reversed the Court of Appeal and restored the order of the Vice Chancellor. Lord Herschell adopted the same reasoning as that of Brett, L.J., in the Hope case: if the company had acquired the shares intending to re-issue them, then it was trafficking in its shares which was ultra vires as it was not authorised by the company's memorandum; if it had acquired them in order to retire them, then it was reducing its capital contrary to the provisions of the Act. Describing the judgment of the Court of Appeal as startling, his lordship said:[29]

> "The creditors of the company which is being wound up, who have a right to look to the paid-up capital as the fund out of which their debts are to be discharged, find coming into competition with them persons who, in respect only of their having been, and having ceased to be, shareholders in the company, claim that the company shall pay to them a part of the capital."

Referring to the scheme of the Companies Act, his lordship said that it was designed to assure those dealing with a limited company that[30]

> ". . . the whole of the subscribed capital, unless diminished by expenditure upon the objects defined by the memorandum, shall remain available for the discharge of its liabilities. The capital may, no doubt, be diminished by expenditure upon and reasonably incidental to all the objects specified. A part of it may be lost in carrying on the business operations authorised. Of this all persons trusting the company are aware, and take the risk. But I think they have a right to rely, and were

> intended by the legislature to have a right to rely, on the capital remaining undiminished by any expenditure outside these limits, or by the return of any part of it to the shareholders."

His lordship stressed that sections 8 and 12 of the Act of 1862 were intended to protect the creditors "who had a right to look to the moneys subscribed as the source out of which the companies' liabilities to them were to be met" and pointed out that "the stringent precautions to prevent the reduction of the capital of a limited company, without due notice and judicial sanction, would be idle if the company might purchase its own shares whole, and so effect the desired result."[31]

Answering the contention that a company might want to buy its shares for some reason desirable in the interest of the company, he said that it made no difference to the creditors what the object of the purchase was. "The result to him is the same. The shareholders receive back the moneys subscribed, and there passes into their pockets what before existed in the form of cash in the coffers of the company, or of buildings, machinery, or stock available to meet the demands of the creditors."[32] He was also of the view that the purchase of shares in order to keep the company a family concern, as was claimed in this case, was not for a legitimate purpose, that the funds of the company could not be used for that end, and that the directors must themselves buy the shares or find other suitable buyers in such a case.[33] Lord Watson agreed with Jessel, M. R., (in the Dronfield Coal Company case) that it was inconsistent with the essential nature of a company that it should become a member of itself. He said:[34]

> "It cannot be registered as a shareholder to the effect of becoming debtor to itself for calls, or of being placed on the list of contributories in its own liquidation. Accordingly, when a company buys and holds its own shares, the device is sometimes resorted to of taking the transfer to a nominee, who is entered in the register, and holds the shares as trustee for the company, which undertakes to indemnify him from future calls. In that case, if the company goes into liquidation before its capital is fully paid up, the trustee is liable personally as a contributory for the amount then unpaid; but the amount withdrawn is never restored, and calls made upon the shares whilst the company is a going concern bring no additions to its capital."

Lord Macnaghten emphatically declared that "the notion of a limited company taking power to buy up its shares is contrary to the plain intention of the Act of 1862, and inconsistent with the conditions upon which alone, Parliament has granted to individuals who are desirous of trading in partnership the privilege of limiting their liability."[35] His lordship went a step further than what the case required to express his opinion that even "if a power to purchase its own shares were found in the memorandum of association of a limited company, it would necessarily be void."[36] He pointed out that the Act of 1867 applied even if capital was to be returned to a single shareholder only: "payment of capital to any one shareholder is just as much a reduction of capital, just as detrimental to the interests of creditors, as the payment of the same amount among all the shareholders rateably. It is none the less a payment off of capital . . . because the shareholder to whom the payment is made renounces in return the right to participate in the joint stock of the company."[37] His lordship was fortified in his conclusion by the analogy of statutory companies governed by the Companies Clauses Act of 1863.[38]

We may pause here to make a few comments on these decisions. First, the courts were concerned in all these cases with embarrassed companies and none of them was a company, with the powers conferred by its memorandum, seeking to purchase its shares out of funds which it had ready and available for payment of dividends. Secondly, the view that a company cannot be a member of itself has been justified on the ground that it cannot be made a debtor to itself for calls or made a contributory in its own liquidation, both of which assume that the shares concerned are partly paid-up. The argument completely fails if the shares are fully paid-up and the law would allow a company to be the holder of its own fully paid-up shares. If a company buys the shares out of its profits and maintains its issued capital intact, all the arguments advanced by the learned judges justifying a total ban on companies repurchasing their shares will fail. The judges have, it would appear, proceeded not on a narrow philosophy of maintenance of issued capital, but on a larger principle that the entire assets must be kept intact except insofar as they may be lost in the ordinary course of the business of the company. The same approach is evident in the development of the law of dividend as we shall notice in the next chapter. The assets of a company can only be employed for the purposes of its business; any other application is ultra vires; they may be lost in the pursuit of the authorised objects; but they ought not to be reduced otherwise except with the sanction of the court. Thus, we have seen that Jessel, M.R., construed the word "capital" as used in the Act of 1867 to mean "trading capital" or "real capital" and the expression "share capital" as used in the Act

of 1862 to mean issued as well as authorised capital. The word "capital" is much wider than "share capital" and it is "capital" in the larger sense that should not be reduced. "Capital" in this larger sense will include all the assets of the company other than its "income" or "profit". Even before the advent of the modern limited company, the purchase by a railway company of its shares was characterised by Parker, V.C., in The London & Birmingham Extension, etc., Railway Company, ex parte Carpenter's Executors,[39] as a "misapplication of the funds of the company, tending . . . to destroy the very object for which the money had been put into the hands of the directors" and as "a breach of trust in the application of the funds of the company." If it were the policy of the English law that all the assets of a limited company must be kept intact, except in so far as it may become lost in the ordinary course of its business, and no part of it should be returned to the shareholders except with judicial confirmation, the English decisions can be supported, but the Companies Acts have not clearly enunciated such a policy. And ever since the Act of 1908 it seems evident that the statute aims only at the maintenance of issued share capital.

The view has also existed that the legal effect of the purchase by a company of its shares is to extinguish the shares. This was so stated in In re Sovereign Life Assurance Company,[40] decided by the Court of Appeal in 1892. The insurance company was formed in 1845 under the Joint Stock Companies Regulation Act of 1844.[41] The liability of its members was unlimited.[42] Its capital consisted of 50,000 issued shares of a par value of £10 each and paid up to a quarter of the par

value. In 1860 the company obtained a private Act of Parliament authorising it "to invest its own moneys in the purchase of its own shares." Between 1860 and 1876 the company bought[43] in the open market 8,781 of these partly paid up shares.[44] In the beginning they were transferred to and registered in the name of trustees for the company, but in 1881 they were transferred to the name of the company itself. Before the end of that decade the company went into compulsory liquidation.

The official liquidator took out a summons for leave to place the company on the list of contributories in respect of the 8,781 shares and to obtain an order for a call of £7 10s. per share, contending that the effect of the purchase "was, and is, to increase proportionately the liability of the remaining shareholders while the company was a going concern, and of the contributories under the winding up." Chitty, J., rejected it as "fanciful and unsound" and held that "the effect of the purchase, whether in the name of trustees or of the company, was necessarily to extinguish the shares. The purchase in the name of the trustees was an extinguishment in equity, and the transfer of the shares to the company . . . was an extinguishment in law and equity."[45] The Court of Appeal unanimously affirmed and Lindley, L.J., observed that the purchase by a company of its shares necessarily "involves the purchase of a part of the capital for the benefit of the holders of the rest of the capital — i.e., it involved a reduction of capital . . . . A reduction of capital is a necessary consequence of a statutory power enabling a company to invest its assets in the purchase of its own shares."[46]

In brief, the English law failed to develop a concept of treasury shares so familiar to the American law. However, in 1929 Parliament permitted companies to issue redeemable preference shares, but imposed a number of conditions.[47] Under the present Act such redeemable preference shares (i) may be redeemed only if they are fully paid up; (ii) may be redeemed only out of (a) the profits of the company which would otherwise be available for dividend or (b) the proceeds of a fresh issue of shares made for the purpose of the redemption; (iii) where they are redeemed otherwise than out of the proceeds of a fresh issue, the company must transfer out of its profits to a reserve fund, to be called "the capital redemption reserve fund", an amount which would otherwise have been available for dividend equal to the aggregate par value of the shares; and (iv) the premium, if any, payable on redemption must have also been provided for out of the profits or share premium account of the company. The capital redemption reserve fund may be capitalised by the issue of a share-dividend, but may not otherwise be reduced except by the procedure for reduction of paid-up share capital.[48] It may be noted that the English Act does not permit the redemption of preference shares generally, nor does it permit the conversion of preference shares already issued into redeemable preference shares.[49] In other words, preference shares can be redeemed only if they had been issued as redeemable. Nor can they be issued as redeemable at the option of the allottee or the holder.

If the English law only aims at maintenance of assets by companies of a value equal to their issued capital, it is difficult to see why the law

should not permit companies to buy their common shares as well as their preference shares, whether issued as redeemable or not, subject to similar safeguards. Indeed in such a case a company may even be permitted to buy its partly paid up shares, provided it would freeze its distributable surplus to the extent of the full par value of the reacquired partly paid up shares, and the frozen surplus may be released and rendered distributable to the extent that the shares are reissued. But no demand for a change of the rigid rule in Trevor v. Whitworth came even from the businessmen and it remains the law to this day on the subject.

Exceptions Recognized By the English Act to the Rule that a Company cannot Purchase its Own Shares:

To the rigid rule that a company cannot purchase its own shares, there are now two statutory exceptions. They are: (i) Under section 210 — a section which was first introduced in 1947 and became popular in a short time — the court is empowered to order a company to purchase its own shares from a member of the company, and reduce, if need be, the company's capital, upon a petition by such member claiming that the affairs of the company are being conducted in a manner oppressive to him, whether alone or along with other members. The court may make such order if it is of the opinion that the complaint is true and that it warrants the winding up of the company as just and equitable, but yet to order such winding up would unfairly prejudice the member or members. A purchase under an order of the court is akin to a purchase with the confirmation of the court; in both cases the purchase is subject

to judicial control and scrutiny.[50]

(ii) Section 54 of the English Act authorises companies to provide funds "in accordance with any scheme for the time being in force . . . for the purchase of, or subscription for, fully paid shares in the company or its holding company, being a purchase or subscription by trustees of or for shares to be held by or for the benefit of the employees of the company, including any director holding salaried employment or office in the company."[51] This is the only genuine exception to the rule in Trevor v. Whitworth recognized by the English law.

2. The American Approach

In striking contrast to the English law as settled by the House of Lords in Trevor v. Whitworth,[52] most American corporation statutes expressly authorise companies to purchase their own shares subject to prescribed conditions and all of them recognize the validity of such purchases. The American experience in this field is therefore rich and valuable.

(a) Model Act

The Model Act authorises companies "to purchase, take, receive or otherwise acquire, hold, own, pledge, transfer or otherwise dispose of its own shares,"[53] but imposes restrictions on the exercise of this power.

The fundamental restriction is that such a purchase ought not to be made if the corporation is insolvent (i.e., unable to pay its debts as they become due in the usual course of its business) or will thereby

be rendered insolvent.[54] An identical restriction is imposed on payment of dividends by companies.[55] It must be understood that the discussion which follows assumes that this condition has been met.

Though a company may reacquire any of its shares, the Model Act draws a distinction between reacquisition of (a) shares which are by the terms of their issue redeemable and (b) shares which have not been issued subject to such terms. The reacquisition in either case is permissible only subject to the condition that the corporation is, and will remain, solvent.

The distinctions between the reacquisition of redeemable shares and other shares are:

Firstly, when a company redeems or purchases its redeemable shares, they cease to be issued shares and revert to the status of "authorised but unissued shares." In other words the issued or stated capital is reduced thereby, but not the authorised capital. The Model Act declares that "the redemption or purchase shall effect a cancellation of such shares" and requires that a statement of cancellation should be filed with the Secretary of State. The charter may, however, provide that the reacquired redeemable shares should not be re-issued. If so, upon the reacquisition the redeemable shares are extinguished, reducing both the authorised and issued capital.[56]

On the other hand the reacquisition by a corporation of any of its other shares results in their becoming "treasury shares". They continue to be issued shares, but they cease to be "outstanding shares."[57] The Model Act, however, empowers the board to cancel at any time reacquired

shares. If the board does so, they cease to be issued shares and revert to the status of authorised but unissued shares. A statement of such cancellation should be filed with the Secretary of State whereupon the issued or stated capital becomes reduced accordingly.[58]

In brief, the redemption or purchase of redeemable shares does not make them treasury shares; it reduces stated capital in every case. Any other reacquired shares may be retained by the corporation as treasury shares and the stated capital is not reduced by such reacquisition alone.

Secondly, in the case of redeemable shares the price paid for their redemption or purchase can be debited to stated capital to the extent of the stated capital represented by them at the time of such redemption or purchase. This follows from the fact that the inevitable effect of redemption or purchase of redeemable shares is to reduce the stated capital pro tanto. Of course any premium payable upon the redemption should be defrayed out of surplus only. In other words the fact that the company has no surplus does not by itself preclude it from redeeming its redeemable shares. We may contrast here the English law. The English Act permits only redeemable preference shares. Under the Model Act preference and common shares may be issued as redeemable. Under the English Act redeemable preference shares may be redeemed only out of profits which would otherwise have been available for dividend or out of the proceeds of a fresh issue of shares made for the purpose. The Model Act permits redemption out of stated capital.

In the case of other shares the Model Act specifically provides that their reacquisition can ordinarily be made only to the extent of any available surplus. Such reacquisition can always be made to the extent of "unreserved and unrestricted" earned surplus. But if the charter (or the affirmative vote of the holders of two-thirds of the shares entitled to vote thereon) so authorises, the purchase or acquisition may also be made to the extent of unreserved and unrestricted capital surplus. We can reasonably assume that the incorporators who draw up a charter in a "Model Act jurisdiction" will not fail to confer power on the corporation to purchase its shares out of capital surplus.

It must also be recalled that a company may, by appropriate shareholder action, reduce stated capital. The reduction surplus thus created is a capital surplus. In the result all shares, whether redeemable or not, may be directly or indirectly redeemed or purchased out of stated capital.

Thirdly, the Model Act enjoins that when shares, other than redeemable shares, are thus redeemed or acquired, the earned or capital surplus should be "restricted" to the extent that such surplus is used "as the measure of the corporation's right to purchase its own shares."[59] This provision in the Model Act calls for two comments: Comment 1: It gives rise to difficulties in the accounting for such transactions. Under the Act the stated capital is not reduced by such purchase so long as the shares are held in treasury. Thus the price paid for them has to be credited to an asset account, say to cash which is usually the case. A corresponding debit has to be made. If it is made to the earned sur-

plus or capital surplus account, then one is at a loss to know whether the Act in addition requires the earned or capital surplus to be "restricted" as aforesaid. If it does, its purpose is far from clear. Maybe the design of the Act is that the corresponding debit should be made to the assets account itself by showing the treasury shares as assets (acquired by the expenditure or decrease of cash assets). This view has been advocated by Hackney and seems plausible.[60] The surplus is "restricted" (and not reduced) as long as the reacquired shares are kept in treasury and shown as assets. If the treasury shares are cancelled, a credit is made to assets, a debit to stated capital, followed by the removal of the "restriction" on surplus. Much could be said in favour of this view. But unfortunately this does not seem to be fully compatible with the exclusion of treasury shares in its definition of net assets.[61] Another writer disagrees with Hackney that treasury shares must be shown as assets and according to him the surplus account should be "debited" and "restricted" and commends this double adverse effect as desirable.[62] This view could be supported only if one viewed it as intended to deter corporations from repurchasing their shares, but unfortunately there is nothing to indicate that such was the policy of the framers of the Model Act. In sum, the Model Act is far from a model of perfection in this respect to the accountant who is seeking its help to decide upon the proper method of accounting for the treasury shares. That it is poorly drafted is evident from the confusion it has engendered even to experts. There are three ways in which accounting for treasury shares may be recorded: (i) As suggested by Hackney,

show the treasury shares as assets and "restrict" any surplus pro tanto so long as the shares remain in treasury. (ii) Do not show treasury shares as assets; debit their purchase price to surplus. In this case there is no need for restricting the surplus. In cases (i) and (ii) the stated capital is kept intact despite the reacquisition of the shares. (iii) Allow the debit to be made to stated capital and restrict the surplus to the extent to which, and as long as, the stated capital is and remains thus impaired by the repurchase. It would seem that the accountants even in America have followed generally the third method.[63] Whatever be the choice, the statute should employ language appropriate to the choice made and not, as the Model Act does, leave the matter enigmatic.

Comment 2: It will be wrong to conclude that the Model Act's requirement that repurchases of non-redeemable shares should be made only out of surplus and that surplus should be "restricted" is aimed at the maintenance of stated capital. Far from it. As we have seen the surplus itself may be the result of a reduction of stated capital. Secondly, the board can,[64] as pointed out earlier, cancel the treasury shares at any time and thus reduce the stated capital as well as liberate and free the "restricted" surplus from that restriction. Thus a company with even a small earned surplus, or failing that even a small capital surplus created by reduction of stated capital, can reacquire any number of shares so long as it does not propose to keep the reacquired shares in treasury and is prepared to cancel them. The only limit to this is the brink of bankruptcy.

A company is forbidden to redeem or purchase its redeemable shares (i) when it is, or would thereby become, insolvent or (ii) which would reduce the net assets below the aggregate amount payable to the holders of shares having prior or equal rights to the assets of the corporation upon involuntary dissolution.[65] In the case of a purchase or acquisition of non-redeemable shares, only the first is mentioned, but not the second, in the section of the Act authorising such purchases.[66] It is not clear why this omission has been made. The Act forbids companies to make distributions to its shareholders out of capital surplus in cash or property if it would "reduce the remaining net assets of the corporation below the aggregate preferential amount payable in the event of voluntary liquidation to the holders of shares having preferential rights to the assets of the corporation in the event of liquidation."[67] It is, therefore, not easy to understand why the Model Act fails to show concern for holders of shares having preferential or equal rights to the assets of the corporation when it purchases its shares other than redeemable shares.

The Model Act authorises a corporation to purchase its shares for the purpose of (a) eliminating fractional shares, (b) collecting or compromising indebtedness to the corporation, and (c) paying dissenting shareholders entitled to appraisal right under the Act.[68] The only restriction upon such purchases is existing or resulting insolvency.

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only. The Act does not require that the capital surplus can be used only in the absence of earned surplus.

In conclusion it is submitted that the Model Act's treatment of share repurchases by corporations is far from satisfactory.

(b) Other American Statutes.

(i) New York

The New York law differs in some respects from the Model Act in its provisions for the redemption of redeemable shares or purchase of other shares by a corporation. It specifically provides that a corporation cannot issue shares which it is bound to redeem at the option or demand of the holder, unless it is an open-end investment company. It also forbids companies, other than such investment companies, to issue or redeem redeemable common shares, unless it has at the time outstanding a class of common shares that is not subject to redemption.[69]

Redeemable shares may be redeemed either out of stated capital or out of surplus. Other shares may be purchased out of surplus; they may also be purchased out of stated capital if the purchase is made to eliminate fractional shares, to collect or compromise indebtedness, or in cases where the shareholder is entitled to appraisal right.[70] Shares redeemed or purchased out of stated capital should be cancelled. Those bought or redeemed out of surplus need not be cancelled, unless the charter so requires, and may be retained as treasury shares. But the board is empowered to cancel treasury shares at any time.[71]

Cancellation of shares effects a pro tanto reduction of stated capital. Such shares revert to the status of authorised but unissued shares. If the charter forbids their re-issue, then the authorised capital is also reduced by the cancellation.[72]

Where the shares have been purchased or redeemed out of surplus and retained as treasury shares, it will be observed that the New York law does not speak about restricting or freezing the surplus as the Model Act does. This has important significance. In such cases the surplus is permanently reduced, but the stated capital remains intact. The Act provides expressly that "Neither the retention of the reacquired shares, nor their subsequent distribution to the shareholders or disposition for a consideration shall change the stated capital."[73] If the treasury shares are disposed of, the consideration should be credited to capital surplus, except that it may be credited to earned surplus to the extent to which earned surplus was reduced at the time of the acquisition of such shares.[74] If the treasury shares are cancelled or retired by the board, the stated capital is of course pro tanto reduced, but this reduction surplus has to be credited to capital surplus. Certainly these provisions of the New York law are superior to the Model Act's in their precision and clarity and make the method of accounting for treasury shares reasonably certain.[75]

Though a "surplus" can be created by the reduction of stated capital, we have seen that the New York law expressly declares that "No reduction of stated capital shall be made . . . unless after such reduction the stated capital exceeds the aggregate preferential amount payable

upon involuntary liquidation upon all issued shares having preferential rights in assets plus the par value of all other issued shares with par value."[76] Like the Model Act, the New York law also forbids all redemptions and purchases of shares if the corporation is, or will thereby become, insolvent.

(ii) California

The California Corporations Code forbids a company to purchase or redeem shares issued by it or by its holding companies when "there is reasonable ground for believing that the corporation is unable, or by such purchase or redemption, will be rendered unable, to satisfy its debts and liabilities when they fall due, except such debts and liabilities as have been otherwise adequately provided for." It also forbids a company to redeem shares "if there is reasonable grounds for believing that the net assets would be reduced thereby to an amount less than the lowest aggregate liquidation preferences of shares to remain outstanding having prior or equal claim to the assets."[77] Subject to these basic prohibitions the Code authorises share repurchases and redemptions.

A corporation may purchase its shares (or those of its holding company) out of stated capital for the purpose of eliminating fractional shares, compromising a debt or claim, redeeming redeemable shares at prices not exceeding the redemption price, or in connection with the appraisal rights of shareholders. In these cases a corporation may instead use its surplus, earned or unearned, for the purpose. If the purchase is made out of stated capital, the shares revert to the status of authorised but unissued shares and the stated capital may be reduced

pro tanto by a resolution of the board. If the purchase is made out of earned surplus or paid-in surplus, the stated capital should be left unchanged, whether the shares are retained as treasury shares or are retired, unless the company takes proceedings for reducing the stated capital as prescribed by the Code.[78]

A corporation may also purchase any of its (or its holding company's) shares out of its earned surplus, or out of surplus resulting from the reduction of its stated capital.[79] If the earned surplus is used for the purpose, the stated capital should be kept undiminished, whether the shares are retained in the treasury or retired, unless appropriate steps for the reduction of stated capital are taken.[80]

Purchase of shares out of reduction surplus can be made only subject to the following conditions: (i) If there is only one class of outstanding shares, such purchase should be authorised by the vote or written consent of the holders of two-thirds of such shares other than those to be purchased. (ii) If there is more than one class of shares outstanding, then the board may authorise the redemption of (a) redeemable preference shares (at prices not exceeding the redemption price thereof) or of (b) any other preferred shares upon reasonable and non-discriminatory terms at a price not exceeding the lowest liquidation preference of the shares.[81] This is, however, subject to the basic provision that such use of reduction surplus should not render the corporation unable to satisfy its debts or reduce its net assets taken at their "fair present value" to less than one and one-quarter times the debts and liabilities of the corporation.[82] Before a company may thus

use its reduction surplus, either for share repurchases or other distributions, it has to file a sworn statement at least 14 days earlier with the Secretary of State affirming that the basic condition mentioned above will be complied with.[83]

In short, the California Code fully recognizes that the "reduction surplus," as a species of unearned surplus, has characteristics vitally different from paid-in surplus or other contributed surpluses.

(iii) Delaware

The Delaware Act authorises, like the Model Act, corporations to "purchase, receive, take, or otherwise acquire, own and hold, sell . . . and otherwise deal in and with its own shares," but forbids a corporation to purchase its shares when its capital is impaired or would thereby be impaired.[84] It does not provide safeguards for senior stock, when junior shares are repurchased by a corporation. It also confers carte blanche on corporations to redeem, purchase, or retire "preferred or special stock."[85] Whenever preferred or special stock is redeemed or purchased out of capital, the capital is reduced pro tanto. If the redemption or purchase is made out of surplus, the board is authorised to "retire" the shares and thereupon the capital is correspondingly reduced. There are no restrictions whatever upon a corporation purchasing or redeeming its preferred or special stock. Indeed the Delaware Act is far more permissive than even the Model Act in allowing share repurchases.

(iv) The Uniform Act

It would seem that under the Uniform Act a repurchase by a corporation of its shares can be effected in any case only by complying with the requirements for reduction of "capital stock" explained in the last chapter.

3. Canada

Canadian jurisdictions have generally followed the English law as settled in Trevor v. Whitworth. But now the Dominion statute authorises the issue of letters patent or supplementary letters patent empowering companies to issue par value preferred shares liable to redemption or purchase out of capital, provided that the price of such redemption or purchase does not exceed one and a quarter times the par value of the shares and provided that the company is solvent at the time and will remain solvent after the acquisition.[86] Ontario and Manitoba are two other jurisdictions authorising the acquisition of preferred shares out of capital.[87] It may be recalled that Canadian jurisdictions do not permit no-par preferred shares. Nor do they permit callable common shares. The three jurisdictions mentioned above permit redeemable preference shares, but unlike the English law they permit redemption out of capital. The Ontario Act, by permitting the redemption of preferred shares at the option of the holder, facilitates the formation of open-end investment companies.[88] In the federal jurisdiction such companies were formed by adopting ingenious devices despite the fact that even preferred shares

could not be made redeemable at the option of the holder which is the case under the English law even today.[89] The Ontario Act restricts the redemption price to "a price as near as may be to the actual value thereof."[90] The Dominion Act was amended in 1965 to provide for special "mutual fund shares".[91] Most Canadian mutual fund companies are incorporated under the Dominion statute. A Select Committee of the Ontario Legislative Assembly — the Lawrence Committee — has recommended that Ontario follow the Federal example and provide specifically for "mutual fund shares" in order to facilitate the incorporation of mutual fund companies.[92]

Ontario is also most likely to become the first Canadian jurisdiction to permit companies to purchase their common shares out of surplus.[93] The Lawrence Committee has recommended the abolition of the rule in Trevor v. Whitworth and the enactment of provisions on the model of the New York Business Corporation Law.[94]

4. Appraisal of the American Experience in Authorising Companies to Purchase Their Own Shares.

We may begin with a basic question of semantics: What is meant by the purchase by a company of its own shares? The purchase, so called, is merely the retirement or withdrawal of one or more of the participants in the corporate capital upon the corporation returning him his share in or contribution to the capital and is akin to the retirement of a partner from a partnership firm. The terminology of sale and purchase of its shares by a corporation is the result of the legal concept

of corporate shares as in the nature of movable property or goods. Professor Paton has remarked:[95]

> "Strictly speaking, a corporation doesn't 'sell' its own stock; when a company is engaged in the process of raising capital it is not selling anything. Similarly, when corporate funds are paid to a shareholder to retire his beneficial interest — whatever the mechanics of the transaction — the corporation is not 'buying' anything. It would be just as reasonable to talk of the payment of a company's note at the bank as 'buying' the note as it is to regard a payment made to a retiring shareholder as the purchase price of an investment. The paid note and the stock certificate acquired are both worthless, as a new note and a new certificate would be required in the event that a new loan was negotiated and funds were raised through reissue of the shares."

Shares are really choses in action. The language, "purchase" by a corporation of its own shares, is not harmful and is in fact convenient. But it has led to the idea that "treasury shares" constitute corporate assets, just in the same way as a purchase by a company of the securities of other corporations. It is now being increasingly recognized that this is misleading and that a treasury share is "merely evidence of the fact that outstanding proprietorship claims have been reduced."[96] Every acquisition by a company of its own shares is a pro tanto diminution of its assets for the time being and the law must, preferably, require that it be shown in the books and balance-sheet not as an asset but as a diminution of the net assets.

We shall next examine the problems that have been created by the purchase by corporations of their shares and the solution that have been found for them in America. It may be mentioned at the outset that the federal securities Acts and their administration, and the private actions which have been allowed to redress damage caused by the violations

of the prohibitions imposed by these statutes and the rules framed by the S.E.C. under them, have had a salutory effect in curbing some of the major abuses inherent in repurchases of shares by corporations.

The federal Acts have ensured publicity to a corporation's dealings in its own shares.[97] The Act of 1934 provides, as we have seen, for initial disclosure of information by companies whose securities are to be listed on a national securities exchange and, by an amendment of the Act in 1964, this has been extended, with exceptions, to other companies with total assets exceeding one million dollars and any class of "equity" security-holders numbering 500 or more.[98] The Act contains further provisions to ensure that this disclosed information is kept reasonably current.[99] Besides annual and semi-annual reports for that purpose, the occurrence of any "unusual event of immediate interest to investors," including any change in the number of outstanding securities due to repurchase by a corporation of its shares, has to be reported. Moreover, section 16(a) of the 1934 Act, as amended in 1964, requires directors, officers, and others owning more than 10% of any class of equity security of such issuer, to file with the S.E.C. within 10 days after he becomes such director, officer, or over 10% equity security-holder, a statement of the amount of all equity securities of such issuer of which he is a beneficial owner. He should also thereafter report within 10 days of the close of each calendar month his ownership of such shares at the close of the month and such changes in his ownership as have occurred during the month. These disclosure requirements will bring to light all repurchases by a corporation of its outstanding shares, including such repurchases from its directors, officers, and over 10%

equity security-holders.[100]

When the reacquired shares are to be re-issued, the S.E.C. has treated such resale of treasury shares as equivalent to a new issue and required re-registration under the 1933 Act. This will necessitate the company having to make disclosures as required by that Act in its re-registration statement and prospectus. Thus once again the corporation will be subject to the S.E.C.'s power and control to make full disclosure of all material information. It has been claimed that "the delay and loss of anonymity resulting from the registration requirement render unfeasible any regular program of repurchase and resale" and that thus the " 'trafficking in shares' — one of the feared abuses underlying the English prohibition of repurchasing — is effectively discouraged."[101] This claim is perhaps over-optimistic, but these disclosure requirements are indeed salutory in the cases to which they apply.

(1) One of the foremost of the problems which the courts have had to face is the abuse by the management of the corporation's power to repurchase its shares. To be sure, the power can be exercised only for a legitimate corporate purpose. It will be an improper exercise of the power, if the purpose, direct or indirect, is to vest, perpetuate or bolster control in the hands of the incumbent management,[102] or of the controlling group, or to "bail out" one or more shareholders. Seemingly simple and obvious, the application of this principle has not been easy in all cases.

For instance, is it legitimate for the incumbent management to employ corporate funds to acquire its own shares in order to thwart the

efforts of a take-over bidder who has launched on a drive to buy the shares of the corporation with a view to gaining control over it? In other words, is an incumbent management entitled to defend its control at corporate expense against a "raider"? The courts have upheld such defence provided that the management is in good faith seeking to defend its "policies" as distinguished from "mere control".[103] This criterion is so nebulous that in practice it would be well-nigh impossible to challenge the claim of any incumbent management that its expenditure of corporate assets was motivated by its zeal to defend its policies rather than by its anxiety to keep itself in saddle.[104] Cheff v. Mathes,[105] the most recent in a line of decisions of the Supreme Court of Delaware upholding such expenditure, is a good example. The company purchased its shares at a price in excess of the prevailing market price from a "raider" who had acquired a large number of them in the open market and whose purchase was regarded by the incumbent management to be a threat to its policies and even to the very existence of the corporation. Reversing the court of first instance, the Supreme Court upheld the purchase. The "raider" made a profit for himself, the management retained their control, and the shareholders were the losers. Such deals are usually worked out between the incumbents and the insurgents without reference to the other shareholders and this is far from satisfactory. The hair-splitting distinction between defence of policy and defence of control can hardly protect the shareholders and hardly prevent a management from abusing the power to keep itself in office.[106]

If it can be established that the management has abused the power to repurchase the shares, the corporation will be entitled to sue them under state law for breach of fiduciary duty owed it by them. Any non-selling shareholder may institute a derivative suit to enforce that right of the corporation. Whether the corporation can sue them in a federal court for a violation of the S.E.C. Rule 10b-5, and whether a shareholder's derivative action will lie to enforce that right, are more difficult to answer. Where the violation of the S.E.C. rule amounts to a breach of fiduciary duty remediable by an action under state law,[107] jurisdictional conflict may arise, but it would appear that the federal action is not precluded in such cases.[108] If so, the S.E.C. rule will be an additional and more potent weapon in controlling abuse of the power by the managements.[109] But the federal courts seem to be somewhat disinclined to encourage such derivative actions.[110] This reluctance of the federal courts is perhaps attributable to the impreciseness of the disclosure requirement under Rule 10b-5 in the case of repurchase of shares by corporations. If the S.E.C. makes explicit rules as authorised by the amending Act of 1968, discussed later, we can expect that the derivative actions under the rule will become an effective protection for the repurchasing corporation and its nonselling shareholders against the insiders who make a corporation improperly to buy its shares. In such derivative actions it will, however, have to be shown that the improper purchase caused damage to the corporation, e.g. payment of too high a price for the shares. If the repurchase has caused no such damage to the corporation, but only benefitted it, the derivative action for the

violation of the rule would be fruitless.[111]

(2) The management may buy shares for the company from a shareholder without disclosing to him facts which, if he had known, might have affected his decision to sell his shares to the corporation. Does the company owe him the duty to make disclosure of material facts which may affect his decision to sell his shares? This is a difficult question to answer with precision.

First let us examine the attitude of the law towards insiders' trading in the securities of their corporation. The well-established English rule was laid down in Percival v. Wright,[112] viz. the directors do not occupy a fiduciary relationship in respect of individual shareholders. This means that directors are free to "gamble in their company's securities with legal impunity."[113] The English rule prevails in most jurisdictions of the Commonwealth. The same view has been taken in many American state jurisdictions and it has been held in several cases that the insider is under no duty to make disclosure of facts known to him by virtue of his position as such insider and unknown to the shareholder.[114] But this position has been modified in some jurisdictions to impose such duty on directors and officers under special circumstances, such as merger, consolidation, sale of corporate assets, etc. — the so called "special circumstances exception."[115] No such exception is recognized in English law.

The Securities Exchange Act contains one explicit provision to regulate insider-trading. It renders an insider accountable to the corporation for any profits realized by him "from any purchase and sale,

or any sale and purchase, of any equity security . . . within any period of less than six months . . . irrespective of any intention on [his] part . . . in entering into such transaction of holding the securities purchased or of not repurchasing the security sold for a period exceeding six months."[116] This somewhat arbitrary curb on short-swing profit is the only explicit Congressional attempt to regulate insider-trading and it does not turn upon whether the insider failed to make disclosure of material facts known to him.

Section 10(b) of the Act of 1934 and the S.E.C. Rule 10b-5[117] forbid, as we have seen, "any person" to use or employ, in connection with the sale or purchase of "any security" (whether listed or not) any manipulative or deceptive device. The S.E.C. rule includes among such forbidden devices any act, or practice, or course of business which operates, or would operate, as a fraud or deceit upon any person, and any misstatements or misleading omissions of material facts. Insiders who trade in their companies' securities without disclosing material facts known to them by virtue of their access to inside information have been held to be in violation of the prohibition contained in the federal Act and the rule.[118]

The S.E.C. and the courts have, as can be expected, included in the phrase "any person" the corporation which purchases or sells its own shares. Thus it is a misleading omission of a material fact if a corporation reacquires its shares without revealing that its earnings had sharply increased in the preceding year and consequently the market value of the shares had become enhanced far above the price at which

it was reacquiring the shares.[119] The knowledge of the directors or officers will be treated as the knowledge of the corporation and like any other insider the corporation will have to divulge material information, i.e. information which is likely to affect the judgment of an average prudent investor or influence the market for the stock.

In sum, the extension of the insider trading rules to corporations reacquiring shares has succeeded in fastening liability for nondisclosure of material facts upon the corporation. But the perennial problem as to what information is material enough to require disclosure by the insider[120] or the corporation still remains and can be answered only with reference to the particular circumstances of each case.[121]

For instance, should the corporation disclose the reason or purpose for the acquisition of its shares? A corporation may want to buy its shares to fund a stock option plan, or retirement plan, or employee benefit plan, or just to get rid of an irksome opposition, or just because the shares are available for purchase at a price below what the company regards to be their true worth. Thus the purchase may be an isolated transaction or part of a systematic plan. Again, can a corporation remain incognito while buying its shares or is its identity a material information which the selling shareholder is entitled to know? Does this depend on whether or not the corporation makes the purchase on a stock exchange or privately from a shareholder? Should it disclose business plans which are still in the preliminary or tentative stage only?

(3) If companies are authorised to repurchase their shares, it is possible that an insider may make the company buy his shares at a

price in excess of what is obtainable in the market, or at a time when they have no outside market at all.[122] This problem can be effectively dealt with by holding the corporate insider accountable to the company for the benefit reaped by him by abusing his fiduciary position towards the company. If he takes advantage of inside information, e.g. that the company's business performance has been unsatisfactory and that the market for the shares will consequently suffer, and takes advantage of this knowledge to bring about the purchase of his shares by the corporation, it would seem that the corporation can, like any other purchaser from him, hold him liable for violation of S.E.C. Rule 10b-5.[123] If so, this right of the corporation may also be enforced by any shareholder by a derivative suit.

(4) Systematic participation by companies in the sale and purchase of their securities, which is quite common in America, has an undoubted impact on the stock-market operations in such securities.[124] The S.E.C. has sought to counteract the possibilities for market-price manipulation afforded by large scale purchase by corporations of their own shares by invoking the aid of the securities statutes of 1933 and 1934.

If a company which issues shares is afforded the freedom to repurchase shares at the same time when it is making a distribution of its shares, it should be obvious that it would be able to manipulate and artificially maintain the price at the level it desires by counteracting the free operation of the forces of supply and demand. We have seen that section 10(b) of the federal Act of 1934 forbids the use by any person of any manipulative or deceptive device in contravention of S.E.C. rules

and regulations and section 9 deals with specific practices of unlawful manipulation of security prices. Section 9, however, leaves it to the S.E.C. to determine by rules how far operations for stabilizing security prices may be permissible. Acting under these provisions the S.E.C. has sought to prevent price manipulation by an issuing company during a distribution and has framed Rule 10b-6 (see footnote)[125] to prohibit such repurchases — even for employee benefit plans unless the S.E.C. grants an exemption — by a corporation and its underwriters during a "distribution" of shares.

The S.E.C. has also sought to regulate or prevent a company from repurchasing its shares at a time when it is engaged in acquiring other business concerns for a price payable in its own shares valued according to the market price at a specified period, as such repurchases have the effect of boosting up the market price of the shares and thus reducing the number of them required to acquire the concerns. The S.E.C. has treated the acquisition of new concerns by a company in exchange for its own shares as a "distribution"of its shares and thus sought to prevent or restrict it from repurchasing its shares during the pendency of such distribution.[126]

(5) The Trend Toward Tighter Federal Control of Share Repurchases By Corporations in America: The most important step to regulate and control the purchase by a corporation of its shares has been introduced by the amending Act of 1968.[127] The amendment authorises the S.E.C. to adopt such rules and regulations in respect to purchases by an issuer of equity securities registered under section 12 of the federal Act of 1934

or by a registered closed-end investment company of its own securities as it may deem necessary or appropriate in public interest or for the protection of investors, to define such acts and practices as are fraudulent, deceptive, or manipulative, and to prescribe means reasonably designed to prevent such acts and practices. Such rules and regulations may require the issuer to provide the holders of equity securities of such class with such information relating to the reasons for such purchase, the source of funds, the number of shares to be purchased, the price to be paid for such securities, the method of purchase, and such additional information as the S.E.C. deems necessary or appropriate in the public interest or for the protection of investors, or which the S.E.C. deems to be material to a determination of whether such security should be sold. The Act explains that a "purchase by the issuer" includes "a purchase by or for the issuer or any person controlling, controlled by, or under common control with the issuer, or a purchase subject to control of the issuer or any such person."

This amendment enables the S.E.C. to consolidate and expand the law already developed by it to exercise a greater measure of control over repurchases of shares by companies.

The United States Congress was obviously impressed with the need to empower the S.E.C. to regulate share repurchases. The House Report points out:[128]

> "Corporate repurchases of their own stock have become increasingly important. According to a recent study corporations listed on the New York Stock Exchange repurchased more than 26,600,000 of their own shares in 1963, at a cost of more

than $1.3 billion. The number of shares purchased in this manner in 1964 was 5,800,000 at a cost of $274 million.

Corporate repurchases of their own securities may serve a number of legitimate purposes. For example, they may result from a desire to reduce outstanding capital stock following the cash sale of operating divisions or subsidiaries, or to have shares available for options, acquisitions, employee stock purchase plans, and the like, without increasing the total number of shares outstanding. Repurchase programs, however, may also be utilized by managements to preserve or strengthen their control by counteracting tender offers or other attempted takeovers, or may be made in order to increase the market price of the company's shares. Whatever the motive behind a repurchase program, if the repurchasals are substantial [129] they will have a significant impact on the market price of the security. The shareholders of a company and other persons interested in the market price of its stock should have full information regarding the company's activities and intentions in repurchasing its own stock."

(6) Informal Control By the S.E.C. — "Government by Suggestion": It appears that the S.E.C. has also exercised informal control over corporations contemplating large scale repurchase programme and has suggested that they limit their open-market purchases to 10% of the monthly trading volume in their stock in order to reduce the effect of such purchases.[130] Similarly the Commission appears to have exerted pressure to deter insiders' participation in corporate reacquisitions.[131]

5. Conclusion

To sum up, the power to purchase its shares could be exercised by a corporation for legitimate purposes, but it is capable of being abused. It could be abused by insiders to perpetuate their control; it could be abused to manipulate or bolster the operations in the stock-

market; it could be abused by the majority to gain an unfair advantage over the minority; it could be abused by the management to favour some shareholders to the prejudice of other shareholders; it could be abused by insiders to reap a benefit for themselves. What is therefore important is to define the circumstances in which the power may be exercised and to provide safeguards against possible abuses. It is submitted that the general American pattern of authorising companies — which in this case means the board of directors — generally to purchase their own shares is not a satisfactory approach. The North Carolina Business Corporation Code sets a good precedent in requiring prior shareholder authorisation before a corporation may buy its shares either on an organized stock exchange or on a non-pro-rata basis from its shareholders and in requiring disclosure to the shareholders prior to such authorisation of the specific purpose of the proposed purchase.[132] Moreover, any jurisdiction proposing to follow the American example of allowing companies to purchase their shares should heed the role played by the S.E.C. in this respect in America and provide safeguards against abuses which that body has served to prevent.

These potential abuses are not the only problems to be faced by any jurisdiction which wishes to authorise companies to repurchase their shares. Even more importantly, the law should specify the source out of which the purchase may be made — earnings, earned surpluses available for dividend, capital surpluses, and the share capital itself.

Of these perhaps the least objectionable source is earnings or earned surplus. We may therefore begin with the inquiry: what are the

objections to, or risks involved in, permitting companies to repurchase their shares out of profits which are available for distribution as dividend? These objections and risks will equally apply to such purchases out of capital or capital surpluses and there may be additional risks and objections to be reckoned with.

(i) Repurchase Out of Earned Surplus or Current Earnings:

The English law of dividend has developed, as we shall see in the next chapter, independently of any hard and fast doctrine of maintenance of assets. Consequently, all the objections from the point of view of the creditor to the payment of dividends out of current earnings or earned surplus without making good an impairment of share capital will apply mutatis mutandis to the repurchase of shares out of such funds. But it can be argued that if the one is tolerated by a system of law, there is no reason why the other should be frowned upon, as the risk to the creditor is no more and no less in the one case than in the other. But this approach ignores the fact that payment of dividend is in its fundamental nature different from a repurchase of shares, the latter being in the nature of partial liquidation. While the law may permit payment of dividend out of current earnings despite an impairment of capital for pragmatic reasons, it is doubtful whether the same reasons hold good for permitting share repurchases despite impairment of capital. It is submitted that, whatever be the position with regard to payment of dividend, a company ought not to be permitted to buy its shares unless its net assets exceed the amount of share capital. In other words, a balance sheet surplus test should be applied in determining whether, and

the funds out of which, a company may repurchase its shares.

We shall now examine the adverse effects of a purchase by a corporation of its shares upon shareholders generally and upon different classes of shareholders.

First let us take the simple case where a company has only one class of uniform shares and it seeks to exercise its authority to purchase its shares and to do so entirely out of its earnings. It should be obvious that any such purchase will reduce the assets of the company, at least for the time being, while the liabilities will remain the same. If the company is immediately wound up, those who continued as members may receive less than what was paid to those whose shares were bought off. If the management has the freedom to choose between the shareholders in repurchasing the shares, this could be abused to favour one or more of the shareholders to the prejudice of the others, particularly when the companies' affairs are encountering rough weather. In other words, there is the risk of favouritism to be safeguarded against. Similarly, the price at which the shares are to be acquired is a matter of concern to those shareholders whose shares are not bought, as it could result in an inequitable distribution of earnings or surpluses, at least for the time being. Moreover, purchase of shares may adversely affect the prevailing voting position of the shareholders. For example, if A owns 45 out of 100 issued shares, all with equal voting rights, and the remaining are held by others, and the company acquires 11 of those others' shares, A will gain absolute control over the company at no expense to himself.[133] Thus even in the simplest situation, the purchase

by a corporation of its own shares presents problems.

The problems become aggravated in a two or more class situation. Let us take a company with two classes of shares, viz. common shares and cumulative preferred shares having asset and dividend preference. If the company could purchase its common shares out of its earnings, the senior shares will face two risks: (i) their preferential right to dividend may be effectively thwarted as the available profits may be exhausted in repurchasing the common shares and (ii) their preferential right to assets may be defeated, the purchase of the common shares in effect postponing the rights of the "preferred" shares.[134] These risks have been provided against in the American jurisdictions (i) by forbidding the repurchase of the junior shares if it would leave the net asset below the liquidation preferences of the senior shares and (ii) by forbidding the repurchase of junior shares when arrears of dividend are du on the senior stock.[135] More effective safeguard will be where a company can embark upon the purchase of junior shares only with the consent of the holders of senior shares.

(ii) Repurchase Out of Capital Surplus or Share Capital:

More serious difficulties are presented if repurchases are permitted out of capital surplus or share capital. Under the Model Act such purchases out of capital surplus are liberally permitted. All that is needed is charter authorisation or the approval of the holders of two-thirds of the voting shares. If a company has no surplus, earned or capital, it may resort to the method of reducing its stated capital and thus create a "reduction surplus" which belongs to the family of "capital surplus".

It may then repurchase its shares out of such reduction surplus. What then is the safeguard for creditors? The solitary safeguard is that a purchase is forbidden if the company is insolvent (in the equity or commercial sense) or will thereby be rendered insolvent. What is significant is that the Model Act even permits a company to keep its earned surplus intact and repurchase its shares out of capital surplus (if so authorised by its charter or by the holders of two-thirds voting shares). In brief, every facility is afforded by the Model Act for repurchase by companies of their shares.

These Model Act provisions are, in permitting unrestricted and uncontrolled freedom to corporate managements to purchase the shares of the corporation, utterly irresponsible to the protection of the shareholders, creditors and the corporation itself as an economic enterprise. Any jurisdiction which intends to authorise corporate share repurchases ought to be wary in following the Model Act's example.[136] It is true that under the Model Act so long as treasury shares are not cancelled or reissued the earned or capital surplus as the case may be is pro tanto frozen and rendered unavailable for dividend, but this safeguard vanishes as soon as the shares are reissued or cancelled. Hence the only limit to corporate repurchase is "insolvency" in the equitable or commercial sense and this is hardly a commendable example to be followed in the Commonwealth jurisdictions with their stringent philosophy toward reduction of share capital. It is submitted that the Model Act is unwise in treating alike the "reissue" and "cancellation" of treasury shares for the purpose of removing the restriction on the frozen surplus. While it

is justifiable in the case of "reissue", it ought not to be permitted in the case of "cancellation", unless the cancellation is effected in conformity with the provisions for reduction of share capital. It may be recalled that the English Act on the other hand specifically provides that the "capital redemption reserve fund" created upon the redemption of redeemable preference shares can be reduced only in the same way as share capital.[137] It has been well-pointed out about the provisions of the Model Act dealing with repurchase of their shares by corporations that "the ultimate effect is . . . to make virtually all assets available for share purchases, until the corporation is no longer able to pay its debts as they mature."[138] In the opinion of the writer this is a dangerous policy to espouse and any jurisdiction which wishes to emulate the Model Act must make a careful scrutiny of the soundness of that policy before it copies wholesale the financial provisions of that Act.

To revert to the basic question, should the law enable companies to purchase their shares? Should the Commonwealth jurisdictions follow the American lead in this respect?

The Jenkins Committee specifically examined this question and reached the conclusion that "there is no justification for the general abrogation of the familiar rule that a limited company may not buy its own shares; indeed, we think that the rule should be expressly stated in the Act."[139] Undoubtedly this conclusion was strengthened by the fact that there was no demand for such a power from the British corporate interests. On the contrary the idea of conferring a general power on companies to repurchase their shares appears to have met with opposition

from "the relatively few witnesses who offered any evidence on this matter."[140]

It must, however, be stressed here that an English company can purchase its shares by following the reduction procedure prescribed by the statute and obtaining the confirmation of the court. In many cases the courts have sanctioned a reduction of (issued) share capital by the acquisition by a company of its own shares. The case of British and American Trustee and Finance Corporation v. Couper,[141] discussed earlier,[142] is one such instance. An English company may repurchase its shares, i.e. return its capital, subject to judicial approval just as it can reduce its share capital only subject to judicial approval.[143] American corporations can, however, do both without any such fetter on their freedom.

In the opinion of the writer the English approach is as restrictive as the Model Act's approach is permissive. It is difficult to see why companies should not be permitted to purchase their shares out of funds available for dividend, provided that the capital is not impaired and will not thereby be impaired and provided that the interests of shareholders, and different classes of shareholders, are duly protected.

The Lawrence Committee in Ontario has decided to part company with the English approach[144] and to follow the New York Business Corporation Law in its provisions authorising corporate repurchase of their shares.[145] The Committee, however, recognizes "the distinction which differentiates a purchase by a company of its own common shares at values which reflect the net worth of the company from the purchase

or redemption of preference shares at prices which equate the amount paid up thereon plus a premium of a limited amount" and therefore recommends that the power "shall be exercised only by the directors acting in good faith and in the best interests of the company."[146] The Committee has also recommended that companies must be required to disclose in their balance sheets (or a note thereto) "the dates of purchase and sale by the company in the year of any equity shares carrying voting rights under all circumstances and the prices at which such purchases and sales were made."[147]

The Ontario Business Corporations Act Bill, which received its first reading in the provincial legislature on the 17th of May, 1968, incorporates these recommendations. As Ontario will be the first Canadian jurisdiction to permit the purchase by a company of its common shares, we may briefly notice here the salient provisions of the bill in this respect:

(i) A corporation may purchase its common shares only out of surplus. The term "surplus" is left undefined, but its scope is made clear from the provision of the bill dealing with "the statement of surplus" which has to be laid before every annual general meeting along with the balance sheet and profit and loss statement.[148] In two instances the bill permits the purchase of common shares out of capital and they are: (a) for eliminating fractional shares and (b) for collecting or compromising indebtedness to the corporation.[149]

(ii) Such purchase is forbidden if the corporation is insolvent, or will thereby be rendered insolvent, in either the commercial (equity) or in the bankruptcy sense.[150]

(iii) Every such purchase must have been authorised by an express resolution of the board of directors acting in good faith and in the best interests of the corporation.[151]

(iv) When common shares are purchased out of surplus, they may be cancelled by the board, resulting in a reduction of the authorised and issued capital and in making good the reduction in the surplus which had occurred by the purchase. Or the board may, acting in good faith and in the best interests of the corporation, resell the shares, in which case the proceeds will be credited to surplus.[152] Thus it can be seen that in Ontario, as in the American jurisdictions, a company can, if the bill becomes law, repurchase its common shares until it reaches the point of either commercial insolvency or bankruptcy insolvency whichever may occur sooner, provided only that the board of directors have been making the repurchasals in good faith and in what they conceive to be in the best interests of the company. It is submitted that such permissiveness is fraught with dangers.

(v) The bill also permits the charter of a company to authorise redeemable special shares, whether or not carrying preferential rights over common shares, redeemable at the option of the corporation at a price stated in or determined by the charter of the company for their redemption. The bill contains elaborate provisions regulating the redemption of such redeemable special shares and the only restriction on their redemption is existing or resulting insolvency.[152a] Upon the redemption of these shares, they are automatically extinguished and the authorised and issued capital reduced correspondingly.[153]

(vi) The most salient provision with regard to the purchase and reissue by a company of its common shares is the one which equates the corporation to an "insider" in respect of such purchase and reissue.[154]

SUMMARY

1. Companies should be allowed to repurchase their fully paid up common shares, as well as any other kind of shares, only out of the funds of the companies available for distribution as dividend.
2. But in no case should a company be permitted to buy its shares if (a) its share capital is impaired or (2) it is, or will by such purchase be rendered insolvent either in the bankruptcy sense or the equity sense of that expression.
3. Purchases out of capital or quasi-capital funds or capital surpluses ought not to be permitted, except subject to judicial or administrative control.
4. Purchases should be allowed only subject to the approval, accorded by special resolution, at a meeting of the holders of the class of shares to which the shares to be acquired belong, as well as the holders of every other class of senior shares. The board must be required to disclose to the meetings the reason or purpose of the acquisition. The meetings must resolve whether the reacquired shares should be extinguished or reissued.

5. To the extent that the shares are repurchased out of surplus available for dividend, the surplus must be frozen and treated as quasi-capital. The restriction must be removed pro tanto upon the re-issue of the shares, but not upon their cancellation.

6. A company reissuing its repurchased shares, or repurchasing its issued shares should be subject to the same duties of disclosure, etc., as an "insider" to the person to whom it sells or from whom it buys the shares.

7. Treasury shares must not carry voting or dividend rights, but must be treated as authorised and unissued shares.

8. The statutory provisions authorising share repurchases and the reissue of treasury shares should be drafted with due consideration for the methods of accounting and with a view to avoiding room for divergent accounting practices, if possible.[155]

CHAPTER 10

DIVIDENDS* AND MAINTENANCE OF CAPITAL

> "It is easy to lay down as an abstract proposition that you must not pay dividends out of capital but the application of that very plain proposition may raise questions of the utmost difficulty in their solution." per Earl of Halsbury, L.C., in Dovey v. Cory, [1901] A.C. 477, 487 (H.L.).

1. English Law

The English company statutes have never attempted to define "profit" or "income", nor to lay down guidelines for the determination of the funds out of which "dividends" could be paid by a company. Indeed they have never expressly forbidden the payment of dividend out of "capital". If the main function of a business corporation is to earn profits for its members, that function has been left unregulated by the statutory law. The courts have therefore had to shoulder the formidable responsibility of filling up this gap which involves difficult questions of policy and expert knowledge of economics and accountancy unaided in a large measure by legislative guidance. The result is a haphazard and somewhat unscientific growth of the law in what is perhaps the most important aspect of corporate enterprise. We shall in this section trace this judicial development of the English law of dividends.

The courts have had legislative guidance on the following three matters bearing upon the payment of dividends by companies, two of

which are of relatively recent origin:

(1) The first, and the oldest, of these is the basic injunction that a company ought not, except subject to judicial confirmation obtained by compliance with statutorily prescribed procedure, to reduce its "share capital".[1] We have explored earlier[2] the meaning of reduction of capital. From the basic rule that a company cannot reduce its capital the corollary has been deduced that "a company ought not to pay dividend out of its capital". This negative corollary has not conduced to clarity, for it is capable of at least two interpretations. First, it may mean that a company ought not to pay a dividend which would reduce the value of its remaining assets below the amount of its capital. Such an interpretation can be supported on a theory of maintenance of assets of a certain value. Secondly, it may mean that a company may pay a dividend only out of its earnings (income or profit) as distinguished from its capital. The judicial development has leaned heavily in favour of the second interpretation which is founded on no positive theory of maintenance of assets. Both interpretations involve great difficulties in their application, which we shall examine in the section on "Appraisal". For example, the first involves all the baffling complexities of valuation of assets and the second the equally baffling complexities of defining the meaning of "income".

(2) The second legislative guidance came in 1929 when the Act[3] of that year permitted companies for the first time to issue redeemable preference shares. The Act took care to ensure that such redemption did not reduce share capital by requiring that, except where the redemp-

tion was to be effected out of a special issue of shares made for the purpose, an amount equivalent to the par value of the redeemed shares should be transferred out of the company's "profits" to a "capital redemption reserve fund" which was to be unavailable for dividends and irreducible except by following the reduction procedure prescribed by the law.[4] This provision is clearly inspired by a philosophy of maintenance of share capital, but Parliament did not define the "profits" out of which the share capital was to be maintained.

(3) Thirdly, the Act of 1947 for the first time rendered share premium amounts unavailable for dividend.[5] They have to be transferred to a special "share premium account" and could be reduced, apart from a few permissible utilizations, only in the same way as share capital.

We shall in the following discussions use the term "income" or "earning" as synonyms of "profit". We shall show in the following pages that the English law of dividends as judicially developed is not founded upon a positive theory of maintenance of share capital and re-interpret the English decisions in terms of affording guidelines for the definition of income. We shall first trace the statutory developments of the nineteenth century.

(a) Statutory Developments

We have seen that limited liability was generally made available by the Act of 1855[6] but that the Act imposed a number of safeguards against any possible abuse of the newly conferred privilege. Of these safeguards two are of special interest in the present context: (1) The

Act rendered the directors jointly and severally liable if they declared and paid any dividend "when the Company is known by them to be insolvent, or any Dividend the Payment of which would to their knowledge render it insolvent . . . ."[7] (2) A company had to be dissolved if "it appears that Three Fourths of the subscribed Capital Stock of the Company has been lost, or has become unavailable in the Course of Trade . . . ."[8]

The consolidating Act of 1856[9] contained identical provision rendering directors liable for paying dividends in cases of existing or resulting insolvency,[10] but it made the loss of three-fourths of the subscribed capital into one of the grounds for winding up of the company by the court.[11] In other words, it was not obligatory that a company which had lost three-fourths of its subscribed capital must be dissolved; instead the court could at its discretion order the winding up of such a company. Table B of the Schedule to the Act — the forerunner of the famous Table A of the English and many Commonwealth companies Acts — which contained "Regulations for the Management of the Company", now provided that "No dividend shall be payable except out of the Profits arising from the Business of the Company."[12]

The Companies Act of 1862[13] (i) abandoned the provision for holding the directors liable for the payment of dividends in the case of existing or resulting insolvency and (ii) replaced the provision for judicial winding-up in cases of loss of three-fourths of subscribed capital by the modern "just and equitable" ground. Table A of the first schedule to the Act, which corresponded to Table B of the Act of 1856, however,

contained an identical provision forbidding the payment of dividend "except out of the Profits arising from the Business of the Company."

Ever since the Act of 1862, the English company statutes have remained the same way in these respects, except that the qualification "arising from the Business of the Company" applied to profits has disappeared from the corresponding article in Table A since the Act of 1908.[14] The omission of these words has enlarged the scope of the dividend fund by including profits from sources besides the business of the company.

Another important aspect of statutory development which has to be recalled here is that relating to reduction of capital, to which attention has been drawn earlier.[15] The amending Act of 1877 clarified the fact that the reduction process was available not only for returning capital to shareholders or reducing their liability for unpaid capital, but also for writing off to capital a reduction which had already otherwise occurred, e.g. due to losses.[16]

We may also note here the legislative provisions relating to the dividends of statutory companies. The Companies Clauses Act, 1845,[17] which applies to every company incorporated by special statute, provides:

Application of Capital

"That all the Money raised by the Company, whether by Subscriptions of the Shareholders, or by Loan or otherwise, shall be applied, firstly, in paying the Costs and Expenses incident thereto, and secondly, in carrying the Purposes of the Company into execution."[18]

Dividend not to be made so as to reduce Capital	"The Company shall not make any Dividend whereby the Capital Stock will be in any degree reduced: Provided always, that the Word "Dividend" shall not be construed to apply to a Return of any Portion of the Capital Stock, with the Consent of all the Mortgagees and Bond Creditors of the Company . . . ."[19]

It may be noticed that this Act forbade the payment of any dividend which will reduce the "Capital Stock". In the case of registered companies, the Acts forbade the payment of dividends except out of "profits".

(b) Case Law Developments — I

The duty of directors to act in conformity with the provisions of the instruments under which a company is organized in declaring and paying dividend was recognized by Kindersley, V.C., in Evans v. Coventry,[20] a case relating to an unincorporated joint stock insurance company decided in 1856. The company was established in 1820 under a deed of settlement to carry on the business of life and sickness insurance. The deed prescribed the manner in which and the circumstances under which dividends might be declared. No dividend was to be declared "until certain portions of the funds which are to be treated separately and appropriated separately shall amount to and shall continue at a certain sum." Even if this condition was fulfilled, only a dividend at 1% was permitted to be declared. The condition was never fulfilled, but the company declared and paid a dividend at 5% for many years, in order to give a false appearance of prosperity and attract business, despite audit reports showing that its affairs did not warrant such payment and warning that the concern was "in a very serious, alarming and ruinous

state." The company collapsed and ceased to do business in 1854.

One of the clauses of the company's deed stipulated that the "funds or property of the company for the time being remaining unapplied and undisposed of, and inapplicable to prior claims and demands . . . shall alone be answerable for the claims and demands of persons assuring with the company and the annuity creditors" and that the "proprietors at large of the company shall not be answerable, indirectly or directly, further or otherwise than as to their respective shares . . . ." — thus securing for the shareholders the protection of limited liability without incorporation of the enterprise.

Action was brought by some of the assured, representing themselves and 2,000 other insured persons, against the directors and other officers of the company to hold them liable, inter alia, "for any loss by reason of the default or neglect of any of the . . . defendants, and especially by the payment of dividends out of capital."

In holding that "all those who are directors were liable not only to refund those dividends which they themselves received in respect of their shares, but they are liable to refund all the dividends, as far as any of them were personally parties to the declaring of the dividends or concurred in it,"[21] Kindersley, V.C., observed:[22]

> "I believe them to have [declared the dividends] because they thought that, by this semblance of prosperity, they would induce other persons to become insured . . . [T]aking that to be their motive [and assuming] that they thought that they were acting for the general benefit of the company, it does appear to me a most improper and most unjustifiable mode of conduct . . . . It was, in fact . . . fraudulent towards any person who might be induced by that false semblance of prosperity to effect the insurance.

> It does appear to me that the directors had a duty, not only to the persons who were shareholders, but a duty to the persons who effected insurances in this society — a duty which imposed on them the necessity of not misapplying the funds of this society — that is, applying them in a way not justified by the terms of the deed."

Evans v. Coventry points out the duty of the directors to conform to the company's constitutional instruments in declaring and paying dividends and that the breach of this duty will not be condoned even if the directors had acted in good faith for what they regarded to be in the best interests of the company.

We have seen that Table B of the Act of 1856 and Table A of the Act of 1862 and its successors enjoin that dividends be paid only out of the profits of the company. It is the duty of the directors to conform to this requirement in declaring and paying dividends as it was the duty of the directors in Evans v. Coventry to comply with the stipulation in the deed of settlement of the unincorporated joint stock company. The question, therefore, in every case is: Is there a "profit" available for distribution as dividend to the shareholders? This question presents no difficulty in obvious cases where a company has been unsuccessful right from its start and has never made any profit, but in most other cases it presents extraordinary difficulties, especially in the absence of statutory guidelines to assist the courts. The absence of statutory provisions for reduction of capital until 1867 meant that under no circumstances could a company return its "capital" to its shareholders. The Act of 1867 permitted reduction of capital only with the sanction of the court. Thus we have two complementary rules: A company shall not pay a dividend

except out of its "profits"; nor shall it return its "capital" to its shareholders except with the sanction of the court obtained in the manner prescribed by the statute. We have, therefore, to find the tests to distinguish whether a certain fund which the company wants to distribute as dividend is in fact "profit", in which case it is free to do so, or is really "capital" in which case it does not have that freedom. We shall notice here some of these difficult situations which have come before the courts.

The well-known Stringer's Case,[23] decided by the Court of Appeal in 1869, is an early instance where the court was faced with the question whether a company which had purported to pay a dividend had in fact made any profit. The company had been formed in 1863 to pursue a very hazardous adventure, viz. to establish a special trade with the Confederate States of America, then under blockade by the United States as a result of the Civil War of 1861-65, and to run the blockade. Table A of the Act of 1862 which applied to the company forbade the payment of dividend except out of the profits arising from the business of the company. The Confederate Government entered into an arrangement with the company to become co-owners with the company of a number of ships and to join in the risks of running the blockade with cargoes of goods. Some successful and enormously profitable trips were made and some were unsuccessful. The company's issued capital was over £ 110,000 and all the shares were fully paid up.

In 1864 the directors recommended a dividend of 25% on the basis of a balance sheet brought down to the end of February of that

year. It showed among the assets of the company a large quantity of cotton lying in the territory of the Confederate Government and appropriated by that government for payment to the company, and a large debt due to the company from that government. The company borrowed the cash needed to pay the dividend from the Agra Bank, which advanced the amount only after examining the balance sheet and a statement of the affairs of the company which made true and complete disclosure. Stringer, the managing director, received £3,650 as his dividend.

With the defeat of the Confederate Government in the Civil War, the debt due to the company from the government became worthless and the cotton was also destroyed. The company was ruined and went into liquidation at the instance of a creditor. The Agra Bank was the principal creditor. The liquidator sought to recover from Stringer the dividend he had received in 1864 alleging that it had been improperly declared and in fact paid out of capital.

Malins, V.C., accepted these submissions, but held that the court had no jurisdiction under section 165[24] of the Act to order in winding-up proceedings the refund of dividend as claimed by the liquidator. The Court of Appeal differed and held that the court had such jurisdiction but that the facts of the case did not warrant its exercise. Selwyn, L.J., observed that[25]

> ". . . in the absence of any fraudulent intent as against the shareholders, or as against the creditors or the public, this Court ought not to be astute in searching out minor errors in calculations in an account honestly made out and openly declared."

He stated the general rule thus:[26]

> "[I]f . . . for the purpose of defrauding creditors or for any other improper motive a company has declared and paid a wholly delusive and improper dividend, and has thereby in effect taken away from their creditors a portion of the capital which was answerable for the debts of those creditors, . . . the Court would have full jurisdiction, and would exercise it by ordering the repayment of the money so improperly paid."

Giffard, L.J., remarked to the same effect:[27]

> "[W]here there has been what can be termed fairly a misappropriation of assets, that is, as against a creditor, . . . the creditor has a right in the winding-up to have those assets recouped; but . . . [the] dividend [in this case] is [not] in any sense a misappropriation as against . . . [the] Bank or any other creditor . . . ."

But the present case did not fall within that general principle because "no fraud on the shareholders can be . . . alleged . . . , because in this case a full and fair dividend was declared, and was paid or intended to be paid to all the shareholders equally, without any preference or priority. Neither was there any fraud upon the public intended or practised, nor even upon that part of the public who might be expected to become purchasers of the shares . . . . Neither is it . . . possible to say with justice that any attempt has been made . . . to commit any fraud upon the creditors . . . ."[28]

The Vice Chancellor had thought that only upon the termination of the war could the company ascertain whether its operations had been profitable or unprofitable. On this reasoning he concluded that the payment of dividends in 1864 was improper. The Court of Appeal rejected this reasoning.[29]

In Stringer's Case the crucial question was whether the directors were justified in treating the debt due from the Confederate Government and the cotton appropriated by that government toward payment to the company as "profit". The court took a pragmatic view and left it to the honest judgment of the directors. Once the directors honestly decide to treat it as profit, they may proceed to pay a dividend by borrowing the needed cash. The Court of Appeal unequivocally rejected the contention that the company must have the profits in its coffers before it could pay a dividend. Selwyn, L.J., remarked:[30]

> "If we were to lay down as a rule that there must be actually cash in hand or cash at the bankers of the company to the full amount of the dividend declared, we should be laying down a rule which . . . would be inconsistent with . . . the custom of all companies of this description, and also inconsistent with mercantile usage."

Stringer's Case involved one of the most important questions in the determination of income, viz, when does profit arise? Though conservative accounting practice has consistently maintained that "profit must not be anticipated" and that "no credit should be taken for profit before it is realized," yet in the valuation of book-debts (or accounts and notes receivable) this conservatism has been abandoned by the accounting profession and their valuation is made on the basis of the amount that the management estimates, anticipates or expects to collect.[31] Wherever such estimates or anticipation are involved, their determination has necessarily to be left to the good-faith judgment of those entrusted with the authority to make the decision. That is indeed what the Court of Appeal did in Stringer's Case. It is too wide to interpret that decision

as meaning that "The assessment of profit is in every case necessarily [a] matter of estimate and opinion."[32] Such interpretation would render the liability of directors for payment of dividends depend in every respect upon the subjective good faith of the directors. That this is not so is made obvious by Rance's Case[33] decided by the Court of Appeal very soon after Stringer's Case.

In Rance's Case an insurance company registered on the 13th of November, 1866, under the Act of 1862, having an issued capital consisting of 25,000 shares of a par value of £4 each paid up to half the par value, declared and paid a dividend of 10s. per share for the period ending June, 1867, when it had been in existence for only eight months. No profit and loss account was prepared by the board and none was presented to the general meeting at which the dividend was declared, but a preliminary balance-sheet was placed before the meeting. During the period the company's expenses amounted to double its premium receipts. However, it purported to have earned a profit under a single transaction with another insurance company whereby it took over the risks under some policies underwritten by that company for an agreed payment of £2,000 plus the premia received by that other company in respect of those policies. The preliminary balance-sheet showed this entire amount among the assets of the company, whereas it had received only half of it, another quarter it had allowed for the goodwill of the other company, and the remaining quarter was payable to it at a later time.[34] Treating this amount of £2,000 as "profit", the company declared and paid the dividend. The company did not last long thereafter

and went into voluntary liquidation in May, 1869. The liquidator took out a summons against Rance, one of the directors, to recover from him the dividend he had received on the ground that the dividend was paid out of capital and not out of the profits of the company.

The court had to face the difficult question: Was the declaration of the dividend fraudulent or was it a mere error of judgement?

Lord Romilly, M.R., dismissed the summons holding that, though the declaration of the dividend was not justified by the state of the company, yet it had not been proved that the directors had not acted bona fide. He defined fraudulent payment as one made with an awareness of the impropriety of making it in order to obtain a benefit for oneself.

The Court of Appeal reversed and upheld the liquidator's claim. James, L.J., remarked:[35]

> "To take the money which the company had received to answer risks, and to treat it as money capable of being divided as profits, without making any estimate of what the risks were in respect of which the money was paid, seems to me to be the most extravagant proceeding that I have ever heard of. The directors simply had before them the cash balance of the receipts and payments, and, without making the slightest provision in that account for anything whatever, they proceed out of that balance to declare this bonus . . . . A mere cash account or balance-sheet in such a company as this, presented in order to determine whether there had been a profit made, and for the purpose of declaring a bonus thereon, is . . . a fraudulent and delusive balance sheet."

Mellish, L.J., placed the burden of proving the propriety of the declaration of the dividend upon those who made such claim. He said:[36]

> "If directors choose to declare a bonus or dividend without making any account at all, and if shareholders choose to vote that dividend or bonus, knowing that they have got no account before them, knowing that the direc-

> tors do not even profess to have made a profit out of which that bonus or dividend can be declared, . . . under those circumstances it lies on the parties who contend that such bonus or dividend was properly declared, to show that is was made out of profits."

The decision suggests that where the accounts on the basis of which a dividend is declared are found to be "delusive", the court will throw the burden upon the directors to establish their bona fides. But where the accounts have been duly and properly made out, the court will not sit in judgment over the discretion exercised in good faith by the directors. The court will apply the good faith test with due regard to the circumstances of the case.

It is submitted that in Rance's Case it was not within the discretion of the directors to treat the $2,000 received to answer risks — even assuming that it had received the entire amount in cash — as profit in its entirety and that therefore their good faith in declaring and paying the dividend was immaterial, whereas in Stringer's Case the determination of the profits involved good faith judgment. Herein lies the distinction between the two cases.

Again, if a company has never had any income or earning, but purports to pay a dividend or interest, it is an obvious case of an unlawful return of capital and the plea of good faith on the part of the directors will not help them to escape liability.[37] In re National Funds Assurance Company[38] is an illustration of this simple variety. The insurance company which never made any profit paid "interest" to the holders of its share warrants for three years when it ultimately "lost nearly the whole of its subscribed capital, and . . . became hopelessly

insolvent." The liquidator took out a misfeasance summons against the directors to recover the misapplied amounts. Holding the directors liable, Jessel, M.R., said:[39]

> "The limited company trades upon the representation of being a limited company with a paid up capital to meet its liabilities. It is wholly inconsistent with that representation that the company, having its capital paid up, should pay it back to the shareholders, and give the creditors nothing at all."

Such obvious cases of payment out of capital are unlikely to arise often, nor do they present any difficulty when they do.

Nor is the case any different where a company which has no earnings borrows money and distributes it as "dividend". In re Alexandra Palace Company,[40] decided in 1882 by Fry, J., is an example of this kind. The company paid "dividends" to its preference shareholders from two sources: (i) from money specifically borrowed for the purpose, the lenders themselves being the holders of a substantial number of the preference shares, and (ii) from money received under a fire insurance policy in respect of the company's principal asset — the Alexandra Palace, a theatre — which had been destroyed by fire. In fact the preference shares were issued to rebuild the property destroyed by the fire. The prospectus inviting applications for the preference shares specified that "interest" would be paid on the capital paid-up on these shares during the reconstruction of the theatre. One of the by-laws of the company provided that "All dividends and bonuses on shares . . . shall be made only out of the clear profits of the company," but another authorised the company to increase its capital by the issue of new shares

and attach to the new shares "any special privileges with reference to preferential, guaranteed, fixed, fluctuating, redeemable, or other dividends or interest, or otherwise, or any special conditions or restrictions."[41]

In the winding up of the company the liquidator sought to hold the directors of the company liable, by a summary misfeasance action under section 165 of the Act of 1862, to make good to the company moneys unlawfully returned to the shareholders under the guise of dividend.

Fry, J., rejected the contention that the payment of interest was justified on the ground that the additional capital for reconstructing the building would not have been forthcoming, except on the term that the preference shares would receive interest during the period of reconstruction. We have seen that the English Companies Act now provides for payment of interest in such special circumstances, but the Act of 1862 recognized no such exception. Nor was his lordship prepared to accept the argument that in this case "The dividends were not really paid out of capital. It is quite proper to debit to the capital account the interest on capital expended on works, such as buildings, so long as they are unproductive during the period of construction. The value of a thing is not merely the sum expended on it, but the interest which those sums would have produced had they been bearing interest during the period of construction."[42] Indeed such would have been the case if the company had borrowed the money needed for reconstructing the building, but the court was not prepared to treat the preference capital on the same footing

as borrowings and the preference shares as debentures. The court expressed the view that "the interest which would be payable on the new shares must be either dividend or in the nature of dividend, and that is payable only out of the profits of the company."[43] Once the court arrived at this conclusion, the other consequences logically followed. Money borrowed is not as such profit. Money received under an insurance policy is not profit but an indemnity.

The court, therefore, held that with regard to the payment out of the insurance money, it was a payment "directly, or, if not directly, circuitously abstracted from the assets of the company"[44] and that the directors were liable jointly and severally to make good the amount to the company with interest. With regard to the payment of dividend out of borrowed moneys, the court held that "the proper measure of compensation . . . is to direct the Respondents [directors], jointly and severally, to pay to the liquidator such a sum of money as will enable him to pay on all the debts proved in the winding up such a dividend as would have been payable on all the debts of the company, other than [the debts incurred for the specific purpose of paying the dividends], in case no proof had been made of [the latter debts]."[45] This conclusion on the borrowed moneys was based on the reasoning that the true effect of the borrowings was to increase the debts provable in the winding up of the company.[46] As the lenders in this case were aware of the purpose for which the moneys were borrowed by the company and were, as the holders of a large number of preference shares, also recipients of dividends, the court took care to declare that the order against the directors

"shall be without prejudice to the rights of the respondents against any creditors or shareholders of the company who were party or privy to these transactions, or any of them . . . ."[47]

Thus this case again proceeds on the simple rule of "no profit, no dividend" and explains that (i) moneys received as indemnity are not "profit" and (ii) moneys borrowed are not as such "profit".

One of the well-known decisions of this period is Flitcroft's Case,[48] decided by Bacon, V.C., in the Chancery Division ten days prior to the decision of Fry, J., in the same court in In re Alexandra Palace Company[49] just discussed, and subsequently affirmed unanimously by the Court of Appeal. The facts of the case were very simple. The Exchange Banking Company was incorporated in 1873. The directors declared and paid several dividends from 1873 to 1878, showing as assets in the balance sheets "a quantity of debts which they knew were not good, or at least did not know to be good, treating them as the actual assets of the company." The liquidator took out a misfeasance summons under section 165 of the Act of 1862 to recover from the directors the amounts paid out as dividends alleging that "no profit had ever been earned, and that all the dividends had been paid out of capital from the time of the incorporation of the company in 1873." This allegation was not denied by the directors[50] and the court, therefore, had no difficulty in following In re National Funds Assurance Company[51] and holding the directors liable. The decision is, therefore, of no particular value as laying down any rule for determining the fund available for dividend. But the observations of the learned judges are of interest here as they

show the judicial approach to the question of the propriety of payment of dividends.

It is interesting to observe Bacon, V.C., using the word "capital" not in the sense of share capital but in its widest connotation. He said:[52]

> "[T]hey had no means of paying a dividend; they never had any moneys arising except from two sources, one the contributions of the shareholders, the other such money as they might borrow on their own credit from the bankers. In either case it was capital, and capital only, that they had, and they had not the means of paying the dividends, if declared, without resorting to that capital . . . ."

The judgments in the Court of Appeal emphasise that it is a breach of their fiduciary duty owed to the company for directors to misapply the assets of the company by returning them to the shareholders. Cotton, L.J., said:[53]

> "The assets of a company are to be dealt with only for the purposes of its business. The application of the capital in paying dividends was therefore a misapplication, and the Court has power under section 165 to order a return of the moneys so expended."

Brett, L.J., said:[54]

> "In this case the directors paid away part of the capital of the company for purposes not authorised by the memorandum or articles of association. I cannot doubt that their doing so was a clear breach of trust."

Jessel, M.R., alone referred for the first time to the provisions of the Companies Act for reduction of capital and said:[55]

> "A limited company by its memorandum of association declares that its capital is to be applied for the purposes of its business. It cannot reduce its capital except in the manner and with the safeguards provided by statute, and looking at the Act 40 & 41 Vict.c.26, it is clearly against the intention of the Legislature that any portion of the capital should be returned to the shareholders

> without the statutory conditions being complied with. A limited company cannot in any other way make a return of capital."

All the learned judges of the Court of Appeal made it clear that not even the unanimous consent of all the shareholders with full knowledge of all the facts could authorise or ratify such payment. Jessel, M.R., stated the reason thus:[56]

> "One reason is this — there is a statement that the capital shall be applied for the purposes of the business, and on the faith of that statement . . . people dealing with the company give it credit. The creditor has no debtor but that impalpable thing the corporation, which has no property except the assets of the business. The creditor therefore, I may say, gives credit to that capital, gives credit to the company on the faith of the representation that the capital shall be applied only for the purposes of the business, and he has therefore a right to say that the corporation shall keep its capital and not return it to the shareholders, though it might be a right which he cannot enforce otherwise than by a winding up order."

Like Bacon, V.C., the judges of the Court of Appeal also seem to use the word "capital" in the wider sense of "assets" employed in the business rather than "share capital". Thus capital means all the assets of a company other than its income. That dividend may be paid only out of income means negatively that dividend shall not be paid out of capital. It is doubtful whether at this stage the judges would have seen any distinction between share capital and capital surplus. To them both would have simply meant capital. Flitcroft's Case also seems to relate the established principles of the law of dividend to the doctrine of ultra vires as propounded by the House of Lords in 1875 in Ashbury Railway Carriage and Iron Company v. Riche,[57] though it did not specifically mention that case. It is ultra vires to employ the assets of a

company for a purpose other than its authorised objects and such ultra vires act cannot be ratified even by the unanimous consent of all the shareholders. Indeed there is no need to refer to the reduction provisions of the Companies Act to arrive at or bolster up the conclusion that dividends ought not to be paid out of capital.

Though Flitcroft's Case does not throw much light on the treatment of bad debts in the determination of profits, it does seem to intimate that debts which are known or believed to be uncollectible ought not to be shown as assets in the balance-sheet of the company. This, it may be observed, is in accord with sound modern accounting practice. In Flitcroft's Case the debts had become worthless, the acceptances for them having been dishonoured. In such a case the bad debts must be written off by crediting the account receivable and by decreasing the net worth through debiting the expense account, i.e. by reflecting the loss in the income statement. This practice is preferable to by-passing the income statement and directly debiting a surplus account, as "uncollectibles are essentially a part of the cost of doing business on a credit basis."[58]

Professor Yamey has observed that "A single unifying idea runs through the decisions in dividend cases before the year 1889. This idea was premised on the view that the provisions of the Acts regarding the capital of a company, and more especially its reduction, made it clear that the legislature would have frowned upon any dividend payment which would have left the company with a sum of assets less in value, than its nominal paid-up capital."[59] It is doubtful whether such a "unifying idea" clearly runs through them. First, almost all the decisions have expressly

followed in the footsteps of Evans v. Coventry,[60] a case decided long before the reduction provisions appeared in the company statutes and which related to an unincorporated joint stock insurance company. The unifying idea seems to be that it is a misapplication — that is, an application contrary to the charter of the company — for the company to employ its assets other than its income in the payment of dividends. Most of the decisions make no reference to the reduction provisions of the Act introduced in 1867. They have proceeded to hold the directors liable for their breach of duty in failing to act in accordance with the by-laws of the company forbidding the payment of dividends except out of the profits arising from the business of the company. In almost all the cases there were obviously no such profits and the directors did not even deny that there were no profits. There was no case before the courts in which the company claimed to have made a "profit" despite a loss of its "capital". Such a possibility will arise only when a company seeks to by-pass its income statement and write off a loss or diminution in the value of its assets directly to its capital, or fails to write it off at all.

(c) Case Law Developments — II

Is it possible for a company to have a "profit" available for dividend and at the same time to have suffered a loss or diminution of "capital"? In other words, should every loss or diminution of capital be made good before a company may pay a dividend? The court was confronted with this question in Lee v. Neuchatel Asphalte Company,[61]

decided by Stirling, J., in the Chancery Division in 1887 and affirmed by the Court of Appeal in 1889. The case (herinafter referred to as the Neuchatel Company case) forms an important landmark in the development of the English law of dividends.

The Neuchatel Asphalte Company was incorporated in 1873 as a limited company to take over the business properties and assets of six companies, one of which (the Neuchatel Rock Paving Company) had a sole concession granted to it by the Government of Neuchatel to work certain asphalte mines for a period of 20 years (from 1867 to 1887) and the other five held subconcessions. The selling companies received shares in the newly formed company. All the common shares and a majority of the preference shares were allotted as fully paid up to the sole-concessionaire company; the five subconcessionaire companies received a minority of the preference shares as fully paid up. The allotment of the fully-paid up shares did not reflect the value of the assets contributed by the companies, but was designed to represent their respective proportionate interests in the amalgamated venture as agreed between them.[62] In short, it was an instance of watered-stock. The new company thus came into existence by the amalgamation of the six companies, with a nominal share capital bearing no relation to its assets and with "no money passing". The total issued shares of the new company (the Neuchatel Asphalte Company) was 80,000 common shares and 33,700 preference shares, each of a par value of £10, making up a total issued and paid-up capital of £1,137,000.

The Neuchatel Company became entitled to work the concession for about 14 years (from 1873 to 1887). Finding the concession burdensome the company negotiated a fresh one and the government agreed in 1878 to extend the concession to the end of 1907 — by which the company gained the right to work the mines for another 20 years after 1887, — to cover a wider area and upon more favourable terms, the company paying £8,000 for this concession. This renegotiated concession benefitted the company to the tune of £40,000.

The Neuchatel Company paid its first dividend only for the year ending 1879 and that only to the preference shares. Then dividends were paid for the years ending 1881 to 1883, again to the preference shareholders only.

For the year ending 1885 the accounts showed a substantial surplus and the directors proposed to pay a dividend to the preference shareholders. This was approved by the general meeting. The plaintiff who held 628 ordinary shares (and only 16 preference shares) sought an injunction to restrain the company and its directors from paying a dividend as proposed, alleging that the company did not really earn any profit in 1885 and that[63]

> "The property of the company is of a wasting nature. Its concession has depreciated in value by reason of the quantity of rock extracted and sold, the lapse of time, and the loss of capital . . . . Neither in the accounts for 1885, nor in any previous account, has the company been properly debited with this depreciation, but nearly the whole of the moneys received for asphalte sold have been treated as available for distribution, so that the company is in effect returning to its shareholders in the shape of dividends a portion of the capital they had subscribed."

Counsel for the company contended that there had been not only no loss of capital, but that the company was now richer in assets than when it was formed, as the concession was now for a longer period and embraced a larger area.[64] There was also evidence that there was more asphalte in the mines than could be extracted during the period of the concession. They also argued that[65]

> "There is a distinction . . . between fixed capital, or the amount sunk in the purchase of the undertaking, which cannot be paid away, and circulating capital, which stands upon a different footing."

Stirling, J., and the Court of Appeal held for the company, but for different reasons. Stirling, J., reasoned as follows: (1) There was no evidence of the value of the assets received by the new company at the time of its formation or of the value of the shares issued by it. "[I]n the absence of evidence it cannot be assumed that the value of the assets transferred to the . . . company amounted to the par value of the shares [issued by it]."[66] This approach is indeed somewhat surprising, for it really means that the court will not presume that the shares issued by a company for non-cash consideration are not watered. Perhaps it is a pragmatic recognition of the scant respect paid by companies and directors to the nominal par value of shares — a convincing reason to do away with the par value thus rendered meaningless. (2) "[U]nless it can be shewn that, after payment of the dividend, the assets now belonging to the . . . company will fall short of those belonging to the company at the time of its formation, it cannot . . . be said that the dividend is being paid out of capital."[67] This clearly shows that Stirling,

J., thought that there ought to be no deterioration of the value of the assets originally put into the business. On the facts of the present case he found that there was no such deterioration. About the exhaustion of the mine by its working he said:[68]

> "It is true that 230,000 tons have been extracted from the mines; but the amount remaining available for the extraction is . . . no less than 1,340,000 tons. There is no probability that that amount can or will be got during the existence of the present concession."

About the effluxion of time of the concession, he said:[69]

> "[T]he question is, is the present concession at the present time of less value than was the concession taken over by the . . . company [in] 1873? The present concession is for a longer period, extends over a wider area, and is held on more favourable terms than the former."

Stirling, J., did not doubt that "capital" must be kept intact, but he did not use that word in the sense of the nominal share capital. He was satisfied that in the present case it was. He stated the law thus:[70]

> "[S]o long as the capital remains intact, and the current receipts exceed the current expenditure, both according to the general law and under the provisions [of the by-laws of the company], it rests entirely with the shareholders to decide whether the excess shall be divided among them or set apart as a reserve fund for replacing wasting assets, and the Court has no power to interfere with their decision however foolish or imprudent it may seem to be."

It is, however, intriguing to know how the learned judge came to the conclusion that the assets of the company had appreciated in value in 1885 when he had no evidence before him of their value in 1873, unless it be by a process of educated guessing and by accepting testimony which agreed with it and rejecting that which did not.

In the Court of Appeal counsel for the shareholder contended that there "can be no profits unless the capital is kept up to the original amount" and that "the nominal amount of the share capital must be taken as the value of the capital when the company was formed, and the value ought to be kept up to that amount." Counsel for the company and the directors vigorously contested this contention and argued:[71]

> ". . . it would be a bold proposition to say that a company cannot pay a dividend unless its assets are worth as much as they were at first. Can it be contended that before a railway company can pay a dividend it must revalue its undertaking? Suppose, owing to a fall in the price of iron a railway is not worth nearly as much as it was at first, can it be urged that the company can declare no dividend until it has laid by enough to make up the difference . . . ? "Then as to the . . . point, that the company must keep up its assets to a value equal to the nominal amount of its capital, there is no authority that shews a company to be under such an obligation."

Lord Justice Lindley's judgment in this appeal is extremely important as it forms the basis of much of the future development of the English law of dividends where capital has been lost. First he looked into the provisions of the Companies Act and deduced the following conclusion:[72]

> "[T]he Companies Acts do not require the capital to be made up if lost. They contain no provision of the kind. There is not even any provision that if the capital is lost the company shall be wound up,[73] and I think this omission is quite reasonable. The capital may be lost and yet the company may be a very thriving concern."

In support of the wisdom of the law in adopting such a policy, he gave the following example:[74]

> "[S]uppose a company is formed to start a daily newspaper; supposing it sinks £250,000 before the receipts from sales and advertisements equal the current expenses, and supposing it then goes on, is it to be said that the company must come to a stop,

> or that it cannot divide profits until it has replaced its £250,000, which has been sunk in building up a property which if put up for sale would perhaps not yield £10,000? That is a business matter left to businessmen. If they think their prospects of success are considerable, so long as they pay their creditors, there is no reason why they should not go on and divide profits, so far as I see, although every shilling of the capital is lost .... [T]he contrary view ... is to be traced to this, that there is a sort of notion that the company is a debtor to capital .... The company is not a debtor to capital; the capital is not a debt of the company."

It will be seen that the example is a general one and not pertaining to a wasting company.

Addressing himself specifically to the special case of companies with wasting property, he said:

> "It is obvious with respect to such property, as with respect to various other properties of a like kind, mines and quarries and so on, every ton of stuff which you get out of that which you have bought with your capital may, from one point of view, be considered as embodying and containing a small portion of your capital, and that if you sell it and divide the proceeds you divide some portion of that which you have spent your capital in acquiring. It may be represented that that is a return of capital. All I can say is, if that is a return of capital it appears to me not to be such a return of capital as is prohibited by law."[75]
>
> "If a company is formed to acquire and work a property of a wasting nature, for example, a mine, a quarry, or a patent, the capital expended in acquiring the property may be regarded as sunk and gone, and if the company retains assets sufficient to pay its debts, ... there is nothing whatever in the Act to prevent any excess of money obtained by working the property over the cost of working it, from being divided among the shareholders, and this in my opinion is true, although some portion of the property itself is sold, and in some sense the capital is thereby diminished. If it is said that such a course involves payment of dividend out of capital, the answer is that the Act nowhere forbids such a payment as is here supposed."[76]

While it is not easy to quarrel with the learned judge's view that "the Acts do not require the capital to be made up if lost" and that there is nothing in the Acts "which precludes payment of dividends so long as the assets are of less value than the original capital",[77] one is not convinced in what sense capital is "lost" when a mining company, for instance, takes out of the mines "every ton of stuff" and why it is not possible to treat the proceeds of sale as partly capital and partly profit. There may be other justifications for not requiring wasting assets companies to make such allocation, but Lord Lindley was not basing his decision upon any such justification. Perhaps the learned judge felt that the function of such allocation is beyond the possibility of judicial supervision. Referring to the Act he said:[78]

> "[Y]ou find next to nothing about profits or dividends. There is nothing at all in the Acts about how dividends are to be paid, nor how profits are to be reckoned; all that is left, and very judiciously and properly left, to the commercial world. It is not a subject for an Act of Parliament to say how accounts are to be kept; what is to be put into capital account, what into an income account, is left to men of business."

It is respectfully submitted that this is tantamount to defining "profit" as that which the businessman regards as profit and the consequence of such a definition will be that directors can only be held liable for an improper payment of dividend or restrained from making such a payment if it can be shown that they have acted or are proposing to act fraudulently or mala fide. It is far from desirable to leave this vital function of determining the funds available for dividend to the management without legislative guidelines or judicial supervision. That has unfortun-

ately been the result of the English decisions on this subject. Lindley, L.J., was evidently impressed that the statutory silence with regard to accounting principles and the determination of profit was a deliberate legislative policy to leave them to businessmen. He said:[79]

> "There is nothing in the Acts to shew what is to go to capital account or what is to go to revenue account. We know perfectly well that businessmen very often differ in opinion about such things. It does not matter to the creditor out of what funds he gets paid, whether he gets paid out of capital or out of profit net or gross. All he cares about is that there is money to pay him with, and it is a mere matter of book-keeping and internal arrangement out of what particular fund he shall be paid. Therefore you cannot say that the question of what ought to go into capital or revenue account is a matter that concerns the creditor. The Act does not say what expenses are to be charged to capital and what to revenue. Such matters are left to the shareholders. They may or may not have a sinking fund or deterioration fund, and the articles of association may or may not contain regulations on those matters. If they do, the regulations must be observed; [80] if they do not, the shareholders can do as they like, so long as they do not misapply their capital and cheat their creditors. In this case there need be no such fund, consequently the capital need not be replaced; nor, having regard to these articles, need any loss of capital by removal of bituminous earth appear in the profit and loss account."

To sum up, according to Lindley, L.J., a company whose capital has become impaired, may distribute as dividend the excess of its current receipts over current expenses, without making good out of it the impaired capital; such a company is under no statutory obligation to maintain assets either equal to its nominal share-capital or the original value of those assets, but it must retain assets of a value sufficient to pay its debts. No attempt is, however, made to explain whether this solvency requirement is used in the equity sense, or the bankruptcy sense, or both. The

learned judge was, however, careful to add the caveat that "I hope I am not inadvertently, certainly I am not intentionally, laying down any rule which would lead people to do anything dishonest either to shareholders or creditors."[81]

Lopes, L.J., was of the same view. He said:[82]

> "It is said by the Appellant [shareholder] that a company is not at liberty to pay a dividend unless they can show that their available property at the time of declaring the dividend is equivalent to their nominal or share capital.
> "In my opinion such a contention is untenable. Where nominal or share capital is diminished in value, not by means of any improper dealing with it by the company, but by reason of causes over which the company has no control, or by reason of its inherent nature, that diminution need not, in my opinion, be made good out of revenue. In such a case a dividend may be paid out of current annual profits, out of profits arising from the excess of ordinary receipts over expenses properly chargeable to the revenue account, provided there is nothing in the articles of association prohibiting such an application, and provided it is done honestly.
> "The capital and the revenue accounts appear to me to be distinct and separate accounts, and, for the purpose of determining profits, accretions to and diminutions of the capital are to be disregarded."

He was also emphatic that a wasting assets company is, in the absence of such a requirement in its by-laws, under no obligation "to create a reserve fund out of revenue to recoup the wasting nature of capital", for the very scheme of an undertaking which is in its inherent nature wasting is that "there should be a gradual exhaustion of material; the wasting is the business of the company, and without such gradual exhaustion there would be no revenue."[83]

Neither Lindley, L.J., nor Lopes, L.J., referred to or rested his decision on the fact that there was no diminution in the value of the

assets of the Neuchatel Company, but only an appreciation — the ground on which Stirling, J., decided in favour of the company and its directors. Cotton, L.J., alone referred to this feature of the case.[84]

Lord Lindley's process of reasoning can be summed up as follows: (1) A company is under no statutory obligation to make good out of current profits any impairment of capital before paying a dividend. (2) A wasting assets company has inevitably to consume, and thus lose, its capital to produce its current revenue. (3) This loss need not be made good by a depletion reserve set apart out of the revenues. It would appear that Lindley, L.J., considered the second and third propositions as just an application of the first proposition to the special case of wasting assets companies. Thus, the general rule is that "the Companies Acts do not require the capital to be made up if lost."[85] Lopes, L.J., qualified the "loss" and observed that lost capital need not be made good if, and only if, the loss was not due to any improper dealing by the company with its capital, but "by reason of causes over which the company has no control, or by reason of its inherent nature . . . ."[86] Cotton, L.J., did not enunciate a general rule, but confined himself to the special case before him and agreed that a wasting assets company need not make good the capital consumed in the production of its revenues.[87]

It must be remembered that the controversy in the Neuchatel Company case was between the ordinary shareholders and the preference shareholders. The ordinary shareholders would suffer if a dividend is paid on preference shares despite an impairment of capital, for not only do they get nothing when the company is a going concern and does not

make adequate profits to pay them, but also in the winding up upon a return of capital. If on the other hand every impairment of capital has to be made up, the preferential right to dividend of the preference shares may be defeated to the advantage of the ordinary shares. The English judges have always left this conflict of interest to be resolved by the shareholders themselves and have refrained from interfering in such internal matters in the absence of fraud or mala fides. They have taken the view that it is an internal matter as to how profits are to be divided and dealt with[88] and that the court ought not to interfere with the discretion exercised in good faith by the directors.[89]

The Neuchatel Company case had many special features. First, the aggregate par value of the fully paid up shares originally allotted bore no relation to the value of the assets received by the company. Secondly, the court had no evidence before it of the value of the assets at the time of the allotment of the shares. Thirdly, the company was a wasting assets company. Fourthly, the rights of creditors was not in jeopardy. Fifthly, the value of the assets had increased by a fortuitous renegotiation of the concession. It was in such a unique case involving no loss in the value of the assets of the company that Lindley, L.J., laid down the general rule that capital need not be made up if lost. In the years that followed the learned judge found many opportunities to expound and explain this proposition.

A few comments on the Neuchatel case are called for here. There is an apparent inconsistency between that case[90] and Flitcroft's Case. In Flitcroft's Case the Court of Appeal indicated that bad debts

should be reflected as loss in the income statement and that is the modern accountancy practice. In the Neuchatel case, Lord Justice Lindley was emphatic that lost capital need not be made up out of revenue and the Court of Appeal held that the diminution in the value of assets due to the working of wasting property need not be made good out of revenue receipts. This means that the income statement may be by-passed and that the depletion loss need not be reflected in it. Does this mean that a "loss" due to bad debts belongs to an exceptional category? Flitcroft's Case was not referred to by the judges and was not even cited by counsel in the Neuchatel case and in a short period of seven years it appears to have been forgotten or ignored. It may perhaps be distinguished that the one case involved bad debts and the other depletion of wasting assets. But if a company is under no legal duty to make up lost capital, how does it matter whether the loss is due to bad debts or depletion or deterioration or any other cause?

Insofar as the Neuchatel case lays down that a wasting assets company is not as a matter of law bound to set up depletion reserves to compensate for the gradual erosion of the wasting asset, such a rule can be justified on the special character of the undertaking of such companies — viz. that it "is in its inherent nature wasting" and that such "wasting is the business of the company, and without such gradual exhaustion there could be no revenue".[91] This special character of wasting asset companies has been recognized expressly in some Canadian and American jurisdictions, as we shall notice later in this chapter. The policy reason for not insisting upon their maintaining a depletion reserve

has been neatly stated by Professor Finney thus:[92]

> "[D]epletion on such wasting assets as mines, oil wells, and timber lands need not be deducted to determine the amount of dividends which may be legally paid. The theory of the law is that stockholders and creditors, knowing the nature of the business, should realize that the receipts from sales are in part profits and in part a return of investment. If the return of investment were not legally distributable among the stockholders, the corporation will be obliged to hold the funds until the exhaustion of the property. This might be advisable if the corporation expected to acquire and operate another similar piece of property, but not otherwise. The law, therefore, allows the corporation to follow the financial policy best suited to its plans, assuming that the creditors are not injured, because of their knowledge of the nature of their business. "After setting up a depletion reserve in order to compute the net profit, the corporation may pay a dividend equal to the profits and the depletion."

We have seen that counsel for the Neuchatel Company and the directors suggested a distinction in this context "between fixed capital, or the amount sunk in the purchase of the undertaking, which cannot be paid away, and the circulating capital, which stands upon a different footing."[93] Neither Lindley, L.J., nor Lopes, L.J., rested his decision on any such distinction. Cotton, L.J., seemed to recognize the distinction when he remarked that "if the articles authorise not a mere division of profit but a division of capital (using 'capital' in the proper sense of the word — by which I mean permanent assets, and assets not to be expended in providing for the profit earned by the company), such a provision will be ultra vires and void."[94]

(d) Case Law Developments — III

The next landmark in the development of the English Law of dividend is the decision of the Court of Appeal of 1894 in Verner v. General and Commercial Investment Trust[95] in which Lindley, L.J., had an opportunity to expound and explain the rule that "the Companies Acts do not require the capital to be made up if lost" which he laid down in the Neuchatel case. This time the company involved was not a wasting assets company, but an investment company.

The Investment Trust company had a paid-up share capital of £600,000 — consisting of 60,000 fully paid-up shares, later converted, as provided by the company's charter, as to one half into preferred stock carrying noncumulative preferential right to 5% dividend payable out of the profits of each year and as to the other half, into deferred stock; and debenture stock of £300,000 bearing interest at 4% per annum. This entire amount was invested by the company in shares and securities authorised by its charter.

For the financial year March 1, 1893, to February 28, 1894, the income received by the company from its investments, after payment of the interest on the debenture stocks and all expenses, amounted to over £23,000. But at the same time some of its investments had turned out to be utterly worthless and the market value of most of the others had declined, resulting in the diminution in the value of its assets by at least £250,000.

One of the directors (called "trustees" in the company's by-laws) instituted this test action on behalf of himself and the stockholders against

the company and its other directors to determine whether under the circumstances a dividend could lawfully be declared and moved for an injunction to restrain the defendants from declaring and paying any dividend in respect of the year. He contended that (1) "A company has no profit available for dividends unless its balance-sheet shows a profit — that is, after making good any depreciation in capital" and (2) dividends could not be paid where there has been a loss of capital, unless the company took advantage of the provisions of the Companies Act of 1877[96] to effect a reduction of its capital by cancelling any capital lost or unrepresented by available assets.[97]

The question raised by the case was: "[T]here being a loss in respect of capital . . . and a gain in respect of receipts over expenditure . . . , can a dividend be declared?"[98]

Stirling, J., did not conceal the fact that but for the Neuchatel case, he would have concluded from the capital reduction provisions of the Companies Act of 1862, as amended in 1867 and 1877, that before a company whose capital had been lost or become unrepresented by available assets to any extent could distribute its current income as dividend, it must obtain the sanction of the court to a reduction of capital. But he felt that such a view was inconsistent with the principles laid down by the Neuchatel case which was binding upon him. Applying the criteria laid down in that case, Stirling, J., held that (i) the investments of the Investment Trust were "permanent assets" within the meaning ascribed to that phrase by Cotton, L.J.;[99] (ii) any diminution arising in their value "not from any dealing with them by the company itself, but from

their own inherent nature" need not be made good out of current income; and (iii) the creditors were amply provided for,[100] and that therefore the payment of the dividend was lawful.[101] The learned judge, however, added that he based the decision "on the peculiar nature of the constitution of this particular company" and that in the present case the company was not an ordinary trading company.[102]

The Court of Appeal unanimously affirmed the decision of Stirling, J., Lindley, L.J., in a joint judgment for A.L. Smith, L.J., and himself, reiterated his views in the Neuchatel case. He also explained the scope and purpose of the Acts of 1867 and 1877. We have seen[103] that it was the Act of 1867 which for the first time enabled a company to reduce its capital by complying with the prescribed procedure and obtaining judicial confirmation, that Jessel, M.R., held that the Act authorised reduction of capital by repayment of capital or diminution of unpaid capital, but not by writing off capital lost or unrepresented by available assets,[104] and that the amending Act of 1877 was passed to make the reduction provisions applicable to such cases of writing off of losses. But for the Neuchatel case, Stirling, J., would have construed the Act of 1877 as a deliberate measure designed to enable companies to pay a dividend on reduced capital where capital had become lost, and inferred that, unless it was done, dividend could not lawfully be paid so long as capital remained impaired.[105] Lindley, L.J., on the other hand took the view that the provisions of the Acts of 1867 and 1877 were enabling and not mandatory and said:[106]

> "[Those Acts] provide for the reduction of the nominal capital mentioned in the memorandum of association. They do not render it obligatory on a company which has lost some of its capital to reduce the nominal amount mentioned in the memorandum. There are advantages in doing so, and the Acts were passed to enable limited companies to obtain these advantages, but there is nothing in these Acts, any more than in the Act of 1862, which prevents a company which has lost part of its capital from continuing to carry on business and declaring and paying dividends. A law forbidding this may well have been considered by the Legislature far too rigid, and in their desire to check dishonest and reckless trading Courts must be careful not to put tighter fetters on companies than the Legislature has authorised."

It will be seen that Lindley, L.J., speaks of the reduction of "the nominal amount mentioned in the memorandum", whereas we are really concerned here primarily with a reduction of paid up capital.[107] When paid-up share capital has been lost or has become unrepresented by available assets, the question is whether this loss must be made good out of the excess of current receipts over current expenses. Lindley, L.J., held that a company was under no obligation to do so. Nor is a company under a legal obligation to reduce the capital by following the procedure prescribed by the statute, but it may do so, if that suits its convenience. His lordship, however, added that even if the capital was not so reduced formally, yet the "capital lost must not appear in the accounts as still existing intact. The accounts must shew the truth, and not be misleading or fraudulent."[108] If this is so, then in the balance sheet the loss must be debited to paid-up share capital on the liabilities side and the income statement need not reflect this loss and may be by-passed. Lindley, L.J., made it clear that it is not a precondition for the payment of dividends that capital must be kept up intact.

He said:[109]

> "The law is much more accurately expressed by saying that dividends cannot be paid out of capital, than by saying that they can only be paid out of profits. The last expression leads to the inference that the capital must always be kept up and be represented by assets which, if sold, would produce it; and this is more than is required by law."

Lord Justice Lindley did not dispute that dividends ought not to be paid out of capital, but where capital is lost and a dividend is paid out of current income, he argued with impeccable logic that "It is obvious that dividends cannot be paid out of capital which is lost; they can only be paid out of money which exists and can be divided."[110] He left no room for ambiguity in his exposition of the law on the subject which he stated thus:[111]

> "There is no law which prevents a company from sinking its capital in the purchase or production of a money-making property or undertaking, or in dividing the money annually yielded by it, without preserving the capital sunk so as to be able to reproduce it intact either before or after the winding-up of the company.
> "A company may be formed upon the principle that no dividends shall be declared unless the capital is kept undiminished, or a company may contract with its creditors to keep its capital or assets up to a given value. But in the absence of some special article or contract, there is no law to this effect; and, in my opinion, for very good reasons. It would, in my judgment, be most inexpedient to lay down a hard and fast rule which would prevent a flourishing company, either not in debt or well able to pay its debts, from paying dividends so long as its capital sunk in creating the business was not represented by assets which would, if sold, reproduce in money the capital sunk. Even a sinking fund to replace lost capital by degrees is not required by law."

His lordship cautioned, however, that it did not follow from the above remarks "that dividends may be lawfully paid out . . . regardless of the

debts and liabilities of the company."[112] For the first time his lordship attempted to state the rule in terms of "fixed" and "circulating" capital thus:[113]

> "[F]ixed capital may be sunk and lost, yet the excess of current receipts over current payments may be divided, but . . . floating or circulating capital must be kept up, as otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law."

As in this case, the shares and securities were acquired by the Investment Trust as investments and not for the purpose of trading them for profit,[114] they were to be classified as "fixed capital". If they had been acquired for trading for profit, then they would be classifiable as "circulating capital". In the former case any loss in their value need not be made good out of the revenues[115] and in the latter case they ought to be. It may be recalled that in the Neuchatel case counsel for the company invoked the distinction between "fixed" and "circulating" capital and argued that though a company could not pay away the former, it was free to distribute the latter.[116] In this case Lord Justice Lindley invoked the distinction for a different end: the former need not be made good if lost; the latter must be kept intact. It seems doubtful to this writer whether the learned judge meant to lay down a hard and fast rule that "circulating" capital must always be kept intact. If circulating capital (say, cash or inventory) had been lost by theft or due to destruction by fire, his lordship would not have perhaps held that such loss must be made good out of current receipts any more than the loss of fixed capital. All that he appears to have laid down is that when revenue is

produced by the employment of circulating capital, the value of the capital employed (which is part of the cost of production) must be subtracted from the gross receipts in order to determine "income" or "profit", which is indeed an elementary proposition, as "otherwise it will enter into and form part of such excess, in which case to divide such excess without deducting the capital which forms part of it will be contrary to law." Lindley, L.J.'s statement met with approval in the House of Lords before the end of the century, as we shall see in the case to be discussed next.

In In re National Bank of Wales, Ltd.,[117] Lindley, M.R., found another opportunity to reiterate his views first enunciated in the Neuchatel case; on appeal (sub. nom. Dovey v. Cory) the House of Lords had its first opportunity to examine the validity of those views but allowed it to slip by.

In the winding-up of the National Bank of Wales, Ltd., the liquidator (Dovey) took out a misfeasance summons[118] against one of the former directors, John Cory, to recover moneys which he alleged had been paid out of capital under the guise of dividends or interest during the time he was a director.[119]

The National Bank of Wales, Ltd., was a limited banking company formed in 1879. John Cory became a director of the company in 1884 and resigned that office before the end of 1890. In the winding up of the company which followed in the next few years[120] it was discovered that the debts of the company exceeded its assets by £41,000 which could be paid only by a call on the shareholders in respect of the uncalled capital of the company.[121] The whole of the paid-up capital of £225,000

had been lost. This loss was attributable to the following two reasons: (1) Bad debts: Large sums advanced to customers and directors had proved to be irrecoverable or their recovery had become doubtful, but these were shown in the balance-sheets as good assets with only a minor allowance for uncollectibles, and large dividends were paid out of current income without deducting the bad debts and providing adequately for doubtful debts; and (2) in any year when expenses exceeded receipts, such losses were written off to share capital and were not made good out of the income in subsequent years.[122] In their reports to the shareholders the directors unjustifiably stated that they had made provisions for bad and doubtful debts, whereas they had not.

Wright, J., came to the conclusion that the dividends had in fact been paid out of capital on the view that "it must be an essential part of sound banking to make . . . adequate provision for bad or doubtful debts. If such a provision is not made, capital must be lost, and dividends paid must be regarded as paid out of capital, because there is no other fund except borrowed money from which they can be paid."[123] In other words, to distribute current earnings without deducting bad debts and without making adequate reserve for doubtful debts is, according to Wright, J., in effect payment of dividend out of capital. He held that John Cory was guilty of negligence and misconduct equivalent to fraud and hence liable to repay the amounts wrongfully paid out as dividends.

The Court of Appeal reversed. Lindley, M.R., delivered the judgment of himself, Romer, L.J., and Sir F.H. Jeune. The Master of the Rolls did agree that[124]

> "The cause of loss [of the entire paid-up capital] is to a great extent attributable to the fact that a large number of debts due to the bank by its customers have turned out to be bad; and large sums advanced to directors and owing by them are irrecoverable . . . . [L]arge dividends have been paid for a number of years as if the bank was flourishing, whilst in truth, if its affairs had been properly conducted, the large dividends declared and paid ought never to have been recommended by the directors.
> "There can be no doubt that the shareholders were grievously deceived by the reports and balance-sheets laid before them, and no one can be surprised at their anger with their directors . . . ."

But he disagreed that the dividends were paid out of capital and observed:[125]

> "[T]he dividends were not in fact paid out of any part of the money forming the paid-up nominal capital of the company, but were paid notwithstanding the loss of such capital, and without making it good. What was done was this: the accounts were made up annually. Such losses incurred during the year as the directors recognized as losses were written off or provided for by carrying sums of money over to a reserve fund, and the balance of the receipts in each year over the outgoings in the same year, after making some allowance for bad debts and deductions for sums carried over to the reserve fund, were treated as profits of that year, and were distributed as dividends. Losses written off in one year were not brought forward the next year, so as to diminish the profits of that year, but were simply ignored, a fresh start being made every year, and dividends being paid out of the excess of the annual receipts over the annual expenses. The effect of this was to throw all bad debts, written off and not provided for by an increase of the reserve fund, on to the capital; to diminish the paid up capital year by year, and nevertheless keep paying dividends out of the excess of the annual receipts over the current expenses . . . . [T]his method of procedure, if long continued, would ultimately exhaust the paid-up capital of the company, and the first disastrous year in which the current outgoings exceeded the current incomings would produce a great embarrassment. Such a mode of dealing with a company's assets, however reprehensible, must nevertheless not be confounded with paying dividends out of the paid-up capital of the company."

The logic of this argument is perhaps unassailable. Dividends may not be paid out of capital; but this does not mean that dividends cannot be paid unless the paid-up capital is intact. If the capital is lost in one year, the next year's income does not represent what has been lost. Indeed it is impossible to pay dividends out of capital which has been lost.[126] Current income is, therefore, in no sense capital and is fully available for distribution as dividend. And no reference was made to Flitcroft's Case — not even by counsel for the liquidator!

From the Neuchatel case to the present one under discussion Lord Lindley was guided by one pragmatic and businesslike approach, viz. it is impracticable and undesirable to forbid companies to pay dividends until they make good out of their current revenue every diminution in the value of their assets representing their capital. It is prudent business policy to make good such losses, if not all at once, at least gradually; but there is no law which compels such prudence.[127]

However, the Master of the Rolls added a caveat:[128]

> "We are certainly not prepared to sanction the notion that all debts incurred in carrying on a business can be properly permanently charged to capital; and that the excess of receipts over other outgoings can be afterwards properly divided as profit as if there had been no previous loss. No honest competent man engaged in trade or commerce would carry on business on such a principle. But, excluding cases in which every one can see that a particular debt or outlay cannot be reasonably charged to capital, it may be safely said that what losses can be properly charged to capital, and what to income, is a matter for businessmen to determine, and it is often a matter on which the opinions of honest and competent men will differ . . . ./[129]/ There is no hard and fast legal rule on the subject.

> "[I]f expenses or payments are obviously improperly charged to capital, and are so charged simply to swell the apparent profits, and to make it appear that dividend may properly be declared, dividends declared and paid under such circumstances cannot be treated as legitimately paid out of profits, and can no more be justified than if they were paid out of capital.[130]

Though the Master of the Rolls was of the opinion that in this case dividends were not paid out of capital, yet he was of the view that the directors were liable for placing misleading balance-sheets and profit and loss accounts before the shareholders which concealed the truth that the paid-up capital was being constantly diminished by bad debts and contained the falsehood that proper provision was being made for such bad and doubtful debts. He came to the conclusion however that John Cory himself acted neither fraudulently nor negligently and hence could not be held liable for the misleading balance-sheets and income statements.[131] We are not here concerned with the details of this conclusion.

The liquidator appealed to the House of Lords. The House affirmed the Court of Appeal, but did not find it necessary to decide whether in this case the dividends were paid out of capital and left the question for future consideration. It decided the case on the sole ground that Cory was not guilty of any breach of duty as a director.

It is significant to note that Lindley, M.R., did not examine whether the loss was of "circulating" or of "fixed" capital — a distinction which he made in Verner v. General and Commercial Investment Trust to determine whether the capital should be kept intact. The writer suggested that the learned judge did not lay down a rigid rule that circulating capital must always be kept intact, but drew the distinction

only to emphasise that the circulating capital must be severed from the total revenues generated by it in computing profit. In the present case some circulating capital was lost and therefore there is no question of deducting it out of the revenues produced by other circulating assets. But Lord Davey referred with approval to Lord Justice Lindley's statement in the Verner case that "fixed capital may be sunk and lost, and yet . . . the excess of current receipts over current payments may be divided, but . . . floating or circulating capital must be kept up" and felt that Lord Lindley had departed from it in the present case. It is submitted that this is based on a misunderstanding of the true significance of the distinction drawn by Lord Justice Lindley in Verner's case.[132]

On the basic question with which we are concerned here, viz. whether lost capital should be made good out of current revenues, the only contribution of the House of Lords was to inject a note of doubt and uncertainty. Lord Chancellor Halsbury, referring to the view of the Court of Appeal, expressed reluctance to discuss the question, as in his opinion it did not arise here, but wanted to make it clear that he should not be supposed "to adopt a course of reasoning as to which I am not satisfied that it is correct."[133] His lordship observed:[134]

> "I doubt very much whether such questions can ever be treated in the abstract at all. The mode and manner in which a business is carried on, and what is usual or the reverse, may have a considerable influence in determining the question what may be treated as profits and what as capital. Even the distinction between fixed and floating capital, which may be appropriate enough in an abstract treatise like Adam Smith's "Wealth of Nations," may with reference to a concrete case be inappropriate.
> "On the other hand, people put their money into a trading concern to give them an income, and the sudden stoppage

> of all dividends would send down the value of their shares to zero and possibly involve its ruin; on the other hand, companies cannot at their will and without the precautions enforced by the statute reduce their capital. But what are profits and what is capital may be a difficult and sometimes an almost impossible problem to solve."[135]

Lord Davey was more forthright in expressing his disagreement with the views of the Court of Appeal and said:[136]

> "I desire to express my dissent from some propositions of law which were laid down in the Court of Appeal . . . . The learned judges seem to have thought that a joint stock company, incorporated under the Companies Acts, may write off to capital losses incurred in previous years, and may in any subsequent year, if the receipts for that year exceed the outgoings, pay dividends out of such excess without making up the capital account. If this proposition be well founded, it appears to me that a company whose capital is not represented by available assets need never trouble itself to reduce its capital, with the leave of the Court and subject to the other conditions imposed by the Act of 1877, in order to enable itself to pay dividends out of current receipts."

The law of dividend thus entered the 20th century in an atmosphere of doubt and uncertainty. In 1918 the Court of Appeal reiterated in Ammonia Soda Company, Ltd. v. Chamberlain[137] the line of authorities beginning with the Neuchatel case and declined to consider the dicta of the law lords in Dovey v. Cory as in any way affecting their validity. The Ammonia company made no profit for almost three years after its incorporation but began earning thereafter. Dividends were paid out of these subsequent earnings without making good out of it the "losses" suffered during the three formative years. These losses consisted of debit entries of £19,028 made to the profit and loss account, out of which £13,721 was for estimated depreciation on a percentage basis but there was no evidence of such actual depreciation. The remaining

amount was for expenses — directors' fees and mortgage and debenture interest. The company purported to write off a major part of these losses by revaluing the assets at a higher figure.[138] The Court of Appeal unanimously upheld the trial court and held that there was no obligation on a limited company not to distribute as dividend "the clear net profit of its trading unless its paid-up capital is intact or until it has made good all losses incurred in previous years." Swinfen-Eady, L.J., (who had appeared as a counsel for the director John Cory in the Dovey v. Cory litigation right from the court of first instance to the House of Lords) analysed the distinction between "fixed" capital and "floating" capital and pointed out — it is submitted, accurately — the distinction between them in the following words:[139]

> "The terms 'fixed' and 'circulating' are merely terms convenient for describing the purpose to which the capital is for the time being devoted when considering its position in respect to the profits available for dividend. Thus when circulating capital is expended in buying goods which are sold at a profit, the amount so expended must be charged against, or deducted from, receipts before the payment of any profits can be arrived at. This is quite a truism, but it is necessary to bear it in mind when you are considering what part of current receipts are available for division as profit."

The Ammonia Soda case does not lay down any new principle; it merely swept away the clouds of doubt cast upon the law by the law lords in Dovey v. Cory and reiterated that a company was under no obligation "to recoup any lost capital before dividing net profit subsequently earned."[140]

(e) Case Law Developments — Loss of Capital and Dividends: Summary and Comments.

We may sum up the law as settled by the Court of Appeal decisions from Neuchatel to Ammonia Soda as follows:

(1) The Companies Acts do not require the capital to be made up if lost, whether the loss is due to depletion, depreciation, trading losses, or otherwise.[141]

(2) What losses and expenses can properly be charged to capital and what to income is a matter for businessmen to determine acting in good faith.

(3) The loss of capital must, however, be disclosed in the balance-sheet. Failure to do so will render the balance-sheet deceptive and misleading, for which the directors will be held liable if the nondisclosure is due to any breach of duty on their part.

(4) Dividends may be paid out of current income despite loss of capital; but dividends may not be paid out of capital. In other words —

(a) It is not a condition precedent to the payment of dividends that the company retain assets worth as much as they were at first or the nominal amount of paid-up share capital; and

(b) The paid-up capital of a limited company cannot lawfully be returned to the shareholders under the guise of dividends or otherwise, unless the statutory requirements for reduction of capital have been complied with.

(5) It is a condition precedent to the payment of dividends that the company retain assets sufficient to pay its debts. (Presumably this

includes debts presently due as well as those becoming due in the future.)

(6) The value of circulating assets employed in producing the current revenues must be deducted out of those revenues to determine current income.

It will be seen that the English law as judicially developed does not define income as the balance-sheet surplus, i.e., the excess of the net assets over the amount of the paid-up share capital. On the other hand it is the credit balance in the profit and loss account. When the income statement may be by-passed and a debit or credit entry made to the proprietorship account is left to the honest judgment of businessmen.

In the opinion of the writer, the English law has adopted a pragmatic and businesslike approach in not adhering to any theory of maintenance of assets as a pre-condition for payment of dividends. The credit for this must in a large measure go to Lord Lindley. Professor Gower argues that "If . . . the principle of maintenance of capital is to be applied effectively, the law should insist that dividends are not paid if the effect would be to reduce the value of the total assets below that of the liabilities and capital [i.e. paid-up share capital plus share premium account (if any) plus capital redemption reserve fund (if any)]."[142] This view, it is submitted, is based on the mistaken assumption that the concept of capital is intended to set "a measure of net assets which must be maintained,"[143] which in turn is based on the provisions of the Act for the reduction of capital. It is one thing to say that a company ought not to voluntarily reduce its capital — by returning its paid-up capital to the

shareholders or by diminishing or extinguishing unpaid capital — and it is a totally different thing to contend that every loss of capital, whether due to depletion, depreciation, market conditions, trading losses, or unforeseen calamities, must be made good out of profit and the capital thus preserved intact. The former is statutory law; the latter, the courts have told us, is not. Mistake arises because of the assumption that from the rule that "capital ought not to be reduced" it follows inevitably that "the capital ought forever to be preserved intact and undiminished". The creditors as well as the shareholders of a corporation have little direct control over the management of the enterprise and they alike take the risk of loss of the corporation's capital. As limited liability protects the absentee owner, the rule that capital should not be voluntarily reduced protects the creditor. Beyond that protection, both undertake the risk that the enterprise may lose its capital in the course of its trading or business. It is submitted that the English law of dividend is not based on any positive theory of maintenance of capital, but is only subject to the negative rule that a dividend ought not to be paid out of capital.

Of course this raises the very pertinent question asked by Stirling, J., and Lord Davey: why then was the Act of 1867 amended in 1877 to enable companies to reduce their capital which is lost or unrepresented by available assets? Lord Lindley's answer that it is not a mandatory provision but is only an enabling provision which the company may take advantage of if it suits its convenience is, though plausible, not wholly satisfying. In the opinion of the writer the Act of 1877 was an ill-thought out measure passed in hasty response to the decision of Jessel, M.R.,

in In re Ebbw Vale Steel Co., that the Act of 1867 did not apply to a case where capital has already been lost.[144] Where capital has been lost and thus become reduced, it is firstly meaningless to require a company to obtain judicial confirmation "to reduce the capital" — which in this context merely means "to acknowledge that as lost which has been lost." Secondly, it is illogical to combine such an instance with voluntary reduction of capital, e.g. by returning capital in excess of the wants of the company. It is submitted that "loss of capital" must be distinguished from "voluntary reduction of capital" and the present reduction provisions must be confined to the latter case only. The former must be regulated separately and it must be made obligatory for companies (i) to reduce their paid-up capital to the extent that such loss has not been made good out of income, (ii) to disclose it in the balance sheet, (iii) to specifically draw the attention of the shareholders to the fact that such loss has occurred, and (iv) to give public notice of the loss. Such a mandatory provision will have a salutary effect. A company which wants to avoid the publicity can do so only if it is capable of making good, and willing to make good, the loss out of income. If complied with, it will inform the creditors and warn the shareholders. The present provisions are almost useless in that a company is under no obligation to comply with them in the case of a loss of capital. This is far from satisfactory. In the opinion of the writer mandatory provisions must be introduced in cases of loss of capital and the directors should be made liable if they abuse the provision to create a false surplus to pay dividend with. With such safeguard the need for judicial confirmation,

and indeed even the approval of the shareholders, will be unnecessary in this case and can be done away with.

In the opinion of the writer the rule that "capital need not be made good if lost" is, however, too wide and unsatisfactory in that it sanctions the income statement to be by-passed in the case of every loss, however caused. It is here that reform of the law is called for. Lord Lindley himself was not "prepared to sanction the notion that all debts incurred in carrying on a business can be properly permanently charged to capital,"[145] but gave no indication as to when they may be so charged and when they ought not to be. Capital may be lost due to the wasting nature of the assets of a company, or depreciation or wear and tear of fixed assets, bad and doubtful debts, fall in market value of the assets, accidental destruction of the assets, or trading losses. To lump all these cases of diminution in the value of assets under the common rubric of "loss" of capital and to treat them alike and allow companies to ignore them and divide current income among shareholders is, it is submitted, undesirable. Nor is it impossible to lay down rules governing such situations without unduly fettering the hands of the management. We shall examine in the section on "Appraisal" whether different kinds of losses could and should be treated differently for this purpose.

(f) Case Law Developments — IV : Capital Appreciation

We may now examine the judicial attitude in the converse case where the assets have appreciated in value. We have seen that diminution in the value of assets need not be made good out of current income

before a dividend may be paid. The present question is, can accretions to the value of assets be utilized as profit for the declaration and payment of dividends? In Lubbock v. British Bank of South America[146] Chitty, J., answered this in the affirmative where the accretion had been actually realized by the company. The company which had a paid-up capital of £50,000 sold one of its undertakings in Brazil whereby it obtained a surplus of £205,000 in excess of the paid-up capital. The question whether this surplus was available for dividend was tested in a friendly action by a shareholder. Chitty, J., held that the accretion to capital was profit. It should be mentioned that this decision is in conflict with the dictum of Lopes, L.J., in the Neuchatel case that "for the purpose of determining profits, accretions to and diminutions of capital are to be disregarded" and that it was contrary to principles and practice to treat an increase in value of the capital as profit.[147] Chitty, J., made no reference to this dictum though his attention was drawn to it.[148] But the Lubbock decision was referred to with approval by Lord Lindley in Verner v. General and Commercial Investment Trust.[149]

What will be the position where the appreciation has not been realized, but has only been estimated to have occurred? Can this estimated and unrealized appreciation — the so-called "revaluation surplus" — be treated as profit available for dividend? This question has not yet been specifically decided by the courts and academic opinion is divided on it. The editors of the twentieth edition of PALMER'S COMPANY LAW have expressed the view that "Only in most exceptional

cases in which no doubt exists on the permanent character of the accretion — this is a difficult test to satisfy — would the transfer of the net surplus to the profit and loss account and its distribution as dividend appear to be admissible, although . . . even in these cases it would be an undesirable course to adopt."[150]

This, however, does not mean that the appreciation in the value of the assets ought not in any case to be taken into account. In Ammonia Soda Co., Ltd. v. Chamberlain[151] Peterson, J., expressed the view that it is proper "to utilize the increase in the value of a fixed asset for the purpose of getting rid of a debit which represents loss of paid up capital."[152] He remarked pointedly:[153] "The paid-up capital is represented by both fixed and circulating capital, and it seems somewhat arbitrary that circulating capital may be shown at its true value while fixed capital must not." Similarly, it may be proper to utilize an increase in the value of a fixed asset to eliminate any past depreciation or deficiency in the value of any asset. If a depreciation reserve fund had been set up out of profit and subsequently the assets appreciate in value, the reserve fund may be pro tanto wiped out.[154] All this, however, need not mean that unrealized appreciation is a fund available for payment of dividend.

In Dimbula Valley (Ceylon) Tea Co., Ltd. v. Laurie[155] where one of the questions for determination was whether it was permissible in law for a company to capitalize a surplus resulting from an estimated revaluation of fixed assets, when authorised to do so by its by-laws, Buckley, J., held emphatically that it was. He formulated his reason-

ing as follows: (i) As a general rule only that which could be distributed in dividends can be capitalized (capital redemption reserve fund and share premiums being statutory exceptions of an "artificial character").[156] (ii) A surplus arising from "a revaluation of unrealized fixed assets" can be lawfully distributed as dividend[156a] (iii) Therefore it could be capitalized as well. All this is premised on the condition that "the valuation is not open to question". It is submitted that, while there can be no objection to the capitalization of revaluation surplus, if due safeguards for different classes of shareholders are provided, yet to allow the estimated appreciation to be distributed as profit should be forbidden on grounds of public policy and treated in the same way as share premium amounts and capital redemption reserve fund.[157] We shall revert to this question in the section on "Appraisal".

2. United States : Statutory Patterns

(i) The Model Act

The Model Act provides for two kinds of payments to the shareholders out of the assets of a corporation , viz. (i) dividends and (ii) distributions from capital surplus[158] (hereinafter referred to as simply "distributions"), and draws a sharp distinction between them. "Dividends" may be declared by the board from time to time and paid by the company subject to any restrictions imposed by the charter of the company. "Distributions" on the other hand may be made only if they are specifically authorised by the charter or by the affirmative vote

of the holders of a majority of the outstanding shares of the corporation.[159] It is necessary to study the provisions relating to such "dividends" and "distributions" together for a proper understanding of the scheme of the Act.

One basic rule common to both dividends and distributions is that neither kind of payment should be made by a company when it is insolvent or would by such payment be rendered insolvent — the term "insolvent" being here used in the commercial or insolvency sense of inability to meet debts as they mature. We shall in the future refer to this requirement as the solvency test or the insolvency test. In the following discussions it will be assumed that this requirement has been met by the company seeking to make the dividend or distribution.

DIVIDENDS: The Act provides for (i) cash and property dividends[160] and (ii) stock dividends.[161] The present chapter is confined to the former and the term "dividend" here means only cash or property dividend.

"Dividends may be declared and paid", enjoins the Model Act, "only out of the unreserved and unrestricted earned surplus of the corporation"[162] and defines the expression "earned surplus."[163] This means that dividends should not be paid out of (i) capital or capital surplus, (ii) any reserve or reserves created out of earned surplus, and (iii) any part of the earned surplus which is for the time being restricted. Of these, the second and third may be quickly disposed of. The board has authority to create reserves out of earned surplus; it has equal authority to abolish the reserves so created.[164] Earned

surplus will become restricted in so far as it is used as the measure of the corporation's right to purchase its shares, but this restriction will disappear to the extent that the shares so purchased are disposed of or cancelled.[165] Thus both these fetters on a company paying dividends out of earned surplus are not of any great significance and may be ignored in the present discussion.

To the general rule that dividends can be paid only out of earned surplus the Act recognizes two exceptions: (i) The board may pay cumulative preferential dividends out of capital surplus if at the time the corporation has no earned surplus[166] and provided that the corporation is solvent.[167] This is the only distribution of dividend out of capital surplus permitted by the Act. Such distribution must be identified as a payment out of capital surplus. (ii) A corporation engaged in the business of exploiting natural resources (i.e., a wasting assets corporation) may, if so authorised by its charter, declare and pay dividends in cash out of its depletion reserves, but it should disclose the payment to be such and the amount per share paid out of such reserve.[168]

The Model Act not only provides that dividends may be paid only out of earned surplus, but also that any deficit arising from losses, however incurred, must be first written off to earned surplus.[169] These provisions sound extremely stringent. But the stringency has been relaxed by an alternative provision introduced in 1965 to permit the payment of dividends out of "the unreserved and unrestricted net earnings of the current fiscal year and the next preceding fiscal year taken as a single period" — the so-called "nimble dividends".[170] If this alternative pro-

vision is taken advantage of, current earnings need not be first applied to eliminate any existing deficit, whether due to capital losses or revenue losses. The stringency has also been diminished by the liberality of the provisions relating to the application of capital surplus.

First, after the earned surplus is exhausted in writing off of losses, any further deficit in the earned surplus account may be reduced or eliminated by applying capital surplus (including reduction surplus). Thereafter any income of the company can be treated as part of the earned surplus without making good the stated capital or capital surplus reduced by applying it to wipe out the earned surplus deficit. The Model Act's definition makes this clear when it lays down that[171]

> "Earned surplus" means the portion of the surplus of a corporation equal to the balance of its net profits, income, gains and losses [172] from the date of incorporation, or from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital [173] or otherwise, after deducting subsequent distributions to share holders and transfers to stated capital [174] and capital surplus [175] to the extent such distributions and transfers are made out of earned surplus.

It is, therefore, obvious that the existence of an earned surplus does not always imply that the original stated capital has been preserved intact by making up all deficiencies that may have occurred. The definitions in the Act may mislead us into thinking so, as "surplus" under the Act means "the excess of the net assets . . . over . . . stated capital."[176]

But "stated capital" means "stated capital as reduced in accordance with the Act" and not necessarily the original stated capital; and stated capital may be reduced by writing off losses to reduction surplus when a company has no earned surplus available.

Secondly, capital surplus (including reduction surplus) is available for making distributions to shareholders. We have seen that it is available for paying cumulative preferential dividends, and for writing off losses in the absence of earned surplus. In addition the Model Act empowers the board to distribute from time to time to the shareholders out of the capital surplus of the corporation a portion of its assets, in cash or property, if authorised to do so by its charter or by the affirmative vote of the holders of a majority[177] of the outstanding share of each class, whether or not they are entitled to vote thereon according to its charter, but subject to the following conditions:[178]

(1) no such distribution should be made at a time when the corporation is insolvent (equity sense), or if such distribution will render it insolvent;

(2) no such distribution should be made if cumulative dividends accrued on preference or special shares are in arrears:

(3) no such distributions should be made to the holders of any class of shares which would reduce the remaining net assets of the corporation below the aggregate preferential amount payable in the event of voluntary liquidation to the holders of shares having preferential right to the assets of the corporation in the event of such liquidation.

Lest a company should in fact make a distribution or payment out of capital surplus and pass it off as a dividend out of earned surplus, thus creating an illusion of prosperity, the Model Act takes care to require that whenever such distribution or payment is made, it should be identified and disclosed as one out of capital surplus and the amount per share disclosed to the shareholders receiving the same concurrently with the distribution.[179] This is commendable, but is, in the opinion of the writer, inadequate. As "capital surplus" is an omnibus name given to all surpluses other than earned surplus and embraces surpluses as varied as reduction surplus and revaluation surplus, it is submitted that companies must be required to disclose the composition of their capital surplus before and after the payment in detail.

It must be noted that "distributions" of capital surplus may be made keeping the earned surplus intact or in addition to dividends out of earned surplus.

It may also be noted that the dividends and distributions provisions of the Model Act have undergone terminological and substantive changes within the past decade and have tended to become more liberal. We may sum up the changes thus: (i) In 1965 alternate provision was introduced to permit nimble dividends; (ii) the requirement that distributions out of capital surplus must, in the absence of authorisation by the charter, be authorised by the holders of at least two-thirds of the outstanding stock was reduced to a bare majority in 1962; (iii) the language "distributions in partial liquidation" was changed to "distributions out of capital surplus" in 1959. (iv) Direct distribution of stated capital in partial liquidation

was permitted prior to 1959, but this was deleted in the amendment of that year. This is the only restrictive change made.

What then is the Model Act's test for determining the fund available for dividend? We have seen that the Act ordinarily permits payment of dividends out of earned surplus only; they cannot be paid out of capital or capital surplus, but distributions may be made out of capital surplus subject to the prescribed conditions. William P. Hackney has, after a close analysis of the provisions of the Model Act, observed that "it seems that the Model Act is not a balance-sheet type statute; earned surplus is a figure to be determined by adding together all net profits, gains, and losses over the period of time provided for in the Model Act definition [of earned surplus]" and that the Model Act "utilizes the aggregate income-statement of arriving at earned surplus."[180] He concludes that "It . . . seems that the Model Act dividend source embodies a marked shift from the consistent balance-sheet pattern of American dividend statutes which has been developing for the last fifty years."[181] While most American statutes made no distinction between one kind of distribution and the other, and hence between earned and unearned surplus, the Model Act has introduced such a distinction. It becomes therefore necessary to distinguish that part of the surplus which is earned surplus from that which is capital surplus. For this purpose the Act has chosen the income-test. The earned surplus is independently calculated from income statements. It is deducted from the total balance sheet surplus to arrive at capital surplus.[182] The Model Act has not chosen the possible alternative of independently calculating the several capital surpluses and

deducting them out of the total surplus to arrive at earned surplus. There is much to be said in favour of the Model Act's choice in this respect and it is in keeping with the modern trend to regard the main function of accounting to be the "fairest possible presentation of periodic net income" and to regard the balance-sheet "merely as a connecting link between successive income statements."[183] But this involves the definition and computation of "income." But the Model Act gives us no guidance as to when a receipt should not be credited to the income account but must be credited to capital surplus, nor when disbursement should be debited to the expense account and not to capital surplus. Nor does it throw light as to how unrealized gains and losses should be treated. It lays down no principles about depreciation. Presumably all this is left to the accountants. The Model Act has superimposed upon the traditional balance-sheet surplus test the income-test in order to determine earned surplus, but it has not spelled out the income-test with precision and therefore has not made its application any easier.

(ii) Other Statutes

The Model Act was not the first to restrict the payment of dividends to earned surplus, but it was the first to attempt a definition of that expression. California, Michigan, Minnesota and Oklahoma had all provided that dividends could be paid only out of earned surplus, but they also permitted dividends out of current net earnings.

But the general pattern of American dividend statutes has, ever-since Ohio's General Corporation Act of 1927, been to permit dividends out of the total surplus of the corporation. Some of them in addition

permitted dividends out of current net earnings.

This balance-sheet surplus test of the Ohio Act was adopted in the Uniform Act (1928).[184] The Uniform Act has also the distinction of spelling out expressly the method for estimating the fund for payment of dividends.

Prior to 1927 the American statutes restricted payment of dividends to "profits" — as Table A of the English Acts has done to this day — and often bolstered this with a prohibition of impairment or reduction of capital stock. The Uniform Act departed from this "profits" approach and provided for a balance-sheet surplus test; the Model Act has completed the circle by adopting an earned-surplus test.

We shall briefly set out here the dividend provisions of the Uniform Act as illustrative of the balance-sheet surplus test which was in vogue before the advent of the Model Act pattern, and then those of New York, Delaware and California.

(a) Uniform Act

The Uniform Act lays down the balance-sheet surplus test for payment of dividends thus:[185]

> "No corporation shall pay dividends . . . in cash or property, except from the surplus of the aggregate of its assets over the aggregate of its liabilities, including in the latter the amount of its capital stock, after deducting from such aggregate of its assets the amount by which such aggregate was increased by unrealized appreciation in value or revaluation of fixed assets."

Revaluation surplus is thus expressly excluded from the funds available for cash or property dividend, but stock dividend may be declared from

such surplus. The Act requires that unrealized appreciation should be shown on the corporation's books as a separate item from paid-in surplus and surplus profits.[186]

The Act also requires that in valuing the assets of the corporation, the board should "determine and make proper allowance for depreciation and depletion sustained, and losses of every character." It also enjoins that "Deferred assets and prepaid expenses shall be written off at least annually in proportion to their use as may be determined by the board of directors."[187]

The Uniform Act expressly excludes the following from the funds available for dividend:[188]

(a) any profit on treasury shares before resale;

(b) unrealized profit due to increase in valuation of inventories before sale;

(c) the unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds, or obligations are readily marketable, in which case they may be taken at their actual market value; and

(d) the unaccrued or unearned portion of any unrealized profit in any form whatever.

The Act does not require a wasting assets corporation to set up depletion reserves. Such a company may pay dividends "from the net profit arising from its business without deduction of such depletion, subject, however, to the rights of shareholders of different classes."[189]

The Act also spells out the liability of directors and shareholders for payment of dividend in contravention of the above provisions.[190]

Reduction of capital by shareholder action is permitted subject to the condition that "the proposed reduction will not reduce the fair value of the assets of the corporation to an amount less than the total amount of its debts and liabilities plus the amount of its capital stock as reduced."[191] From this it would follow that the "capital stock" could be reduced up to the limit of bare solvency in the bankruptcy sense.

(b) New York Business Corporation Law

The New York Business Corporation Law continues the principle of its predecessor, the Stock Corporation Law, that cash or property dividends may be paid out of any kind of surplus, provided that the corporation is solvent and will remain solvent. Thus it makes no distinction between earned and unearned surplus. It provides that "Dividends may be declared or paid and other distributions may be made out of surplus only."[192] This is in accord with the Uniform Act. But following the example of the Model Act, it provides for disclosure whenever such payments are made, in whole or in part, from surpluses other than earned surplus. It also follows the Model Act's provision in the case of wasting assets corporations to enable them to pay dividends in excess of their surpluses, but safeguarding the liquidation preferences of senior shares.[193]

Like the Model Act it permits earned surplus to be computed either from the date of formation of the corporation or "from the latest

date when a deficit was eliminated by an application of the corporation's capital surplus."[194]

Again like the Model Act it provides for reduction of stated capital giving rise to a capital surplus.[195]

It also authorises capital surplus to be applied for the elimination of any deficit in the earned surplus account upon approval by vote of the shareholders.[196]

Attention needs to be drawn here to the provisions of the Penal Law of New York. The Penal Law of 1909 which was in force until 1 September 1967 made it a misdemeanour[197] for a director of a corporation to concur "in any vote or act of the directors of such corporation, or any of them, by which it is intended:

1. To make a dividend, except from surplus, and in the cases and manner allowed by law; or,
2. To divide, withdraw, or in any manner pay to the stockholders, or any of them, except as provided or permitted by law, any part of the capital stock of the corporation; or to reduce such capital stock without the consent of the legislature; or
3. To discount or receive any note or other evidence of debt in payment of an instalment of capital stock actually called in, and required to be paid, or with intent to provide the means of making such payment; or,
4. To receive or discount any note or other evidence of debt with intent to enable any stockholder to withdraw any part of the money paid in by him on his stock; or,
5. To apply any portion of the funds of such corporation, except surplus, directly or indirectly, to the purchase of shares of its own stock, except as provided or permitted by law."

These provisions have been substantially re-enacted in the new Penal Law of 1965 which became effective on the 1st of September 1967. The new Law declares that "A person is guilty of misconduct by corporate official when:

1. Being a director of a stock corporation, he knowingly concurs in any vote or act of the directors of such corporation, or any of them, by which it is intended:
   (a) To make a dividend except in the manner provided by law; [etc.]." [198]

(c) Delaware Corporation Law

The Delaware Act authorises the board to declare and pay dividends [199] "either (1) out of its net assets in excess of its capital . . . , [200] or (2) in case there shall be no such excess, out of its net profits for the fiscal year then current and/or the preceding fiscal year." The Act forbids payment of dividends if the capital has been diminished "by depreciation in value of its property, or by losses, or otherwise, to an amount less than the aggregate amount of the capital represented by the outstanding stock of all classes having a preference upon the distribution of assets," unless such deficiency is made good.

The Delaware Act makes no distinction between earned surplus and capital surplus for the purpose of dividend payments, nor does it require disclosure if dividends are paid from sources other than earned surplus.

(d) California General Corporation Law

The California Law authorises [201] corporations to pay dividends out of the following sources subject to the conditions set out against each:

(a) earned surplus;

(b) net profits earned during the preceding accounting period: The preceding accounting period should not be less than six months nor more than one year in duration. Such nimble dividend may be paid even though the net assets of the corporation amount to less than the stated capital, but no such dividend should be paid if the net assets amount to

less than the aggregate amount of stated capital attributed to shares having liquidation preferences until such deficiency is made good. In other words, nimble dividends are permitted only after the liquidation preferences of shares are provided for.

(c) paid-in surplus: If any outstanding shares are entitled to preferential dividend, paid-in surplus can be used only for paying such preferential dividend. Dividends paid out of this source should be specifically identified to be such to shareholders receiving them.

(d) reduction surplus: Both the conditions mentioned above in the case of paid-in surplus apply equally to reduction surplus. In addition the statute recognises the true nature of a "dividend" out of reduction surplus to be a distribution of assets in partial liquidation and regulates such distribution to safeguard the respective rights of different classes of shareholders.[202]

(e) The statute forbids the payment of dividends out of the unrealized appreciation in the value of its assets, or from earned surplus representing profits derived from an exchange of assets unless and until such profits have been realized or unless the assets received are currently realizable in cash.

The Act permits wasting asset corporations to pay dividends out of their revenues, "if adequate provision is made for meeting debts and liabilities and the liquidation preferences of outstanding shares and notice is given to shareholders that no deduction or allowance has been made for such depletion."[203]

The Act forbids the payment of dividends "when there is reasonable ground for believing that thereupon the corporation's debts and liabilities would exceed its assets, or that it would be unable to meet its debts and liabilities as they mature."[204]

3. Canada : Statutory Patterns

(i) The Dominion Act

The Canada Corporations Act enjoins that "No dividend shall be declared when the company is insolvent or . . . that will impair the capital of the company,"[205] but leaves the expression "insolvent" undefined. It makes the directors of the company jointly and severally liable to the company and its creditors for the debts of the company then existing or thereafter contracted to the extent of the amount of dividends paid in contravention of this injunction.[206]

The Price Spreads Commission had recommended that companies should be forbidden to pay dividends out of book surpluses created by the writing up of asset values.[207] This recommendation was not implemented in those terms, but instead was made part of the solvency test and the Act prescribes that "in determining the solvency of the company . . . no account shall be taken of any increase in the surplus or reserves of the company resulting merely from the writing up of the values of the assets of the company, unless such writing up was made more than five years before the date of the declaration of the dividend."[208] It has been suggested that this does not preclude a solvent company from writing up the value of its assets and paying dividends out of such unrealized appreciation.[209]

The Price Spreads Commission also recommended that "when the management of a company have become aware of the serious impairment of the capital of that company, they should be required forthwith to inform the directors of that fact, who shall be under obligation, immediately to call a meeting of shareholders and put the above situation before them."[210] Though this recommendation is somewhat ambiguous in that it does not explain when an impairment of capital is "serious", its purpose is laudable in that it is designed to inform the shareholders of the diminution in the value of their contribution to the corporate assets to a dangerous level. When this recommendation was implemented,[211] the directors were enjoined to call a special general meeting of the shareholders, if in their opinion "such impairment of its capital renders the company insolvent," for the purpose of making full disclosure to the shareholders of the nature and extent of such impairment of the capital of the company.[212]

Thus it will be seen that no attempt is made to define the fund available for the distribution of dividend. It is doubtful whether the provisions lay down in any respect a law different from the English law as judicially developed. It should be noted that the rule is that a company should not pay a dividend if it will impair its capital. The rule is not that a company whose capital is impaired should not pay a dividend so long as it remains so impaired. This is tantamount to the English rule that dividends should not be paid out of capital. If it were the intention of the framers of the Act to embrace a philosophy different from the English law of dividend, such intention is not evident from the language of the statute.[213]

The Act lays down expressly a special exception in the case of wasting assets companies. It authorises a company "at least seventy-five per cent in value of the assets of which are of a wasting character, or any mining company" to pay dividends "out of its funds derived from the operation of the company", notwithstanding that the paid up capital of the company may be thereby reduced or impaired, provided that such payment "does not reduce the value of its remaining assets so that they will be insufficient to meet all the liabilities of the company then existing exclusive of its paid-up capital."[214]

(ii) Quebec

The Quebec Act forbids the declaration of any dividend "which will impair the capital of the company"[215] and enacts an exception to this rule in the case of wasting asset companies.[216] It renders the directors liable, like the Dominion statute, for the declaration or payment of any dividend "when the company is insolvent, or any dividend the payment of which renders the company insolvent or impairs the capital thereof." Thus the Quebec Act goes no farther than the Dominion Act and is even less comprehensive.

(iii) Ontario

The Ontario Act is substantially in agreement with the Dominion and Quebec statutes, except that it uses the expression "diminish" the capital in the place of "impair" the capital.[217] It also enacts the exception in favour of wasting asset companies.[218]

The proposed Ontario Business Corporations Act continues substantially these existing provisions.[219] It is unfortunate that the reform

of the law of dividend did not receive any attention of the Lawrence Committee on whose recommendations the proposed legislation is founded.[220]

(iv) Other Provinces

British Columbia, Nova Scotia and Newfoundland follow the English pattern. The rest, like the federal statute, lay down the tests of insolvency and impairment of capital. Manitoba alone defines the term "insolvent".[221] The exception in favour of wasting asset companies is also found in a number of them.[222]

To sum up, the Canadian statutes have made no effort to lay down guidelines to determine the fund available for dividend and the English precedents have been generally followed in this country.

4. India — Statutory Pattern

The present Companies Act of India has introduced two important changes in the dividend provisions.[223] First, it spells out the details to be set out in the profit and loss account.[224] Secondly, it provides that dividends may be declared and paid[225] for any financial year only out of the profits of the financial year, or out of the undistributed profits of any previous financial years, after providing for depreciation for the concerned year or years in accordance with the provisions of the Act.[226] The manner of calculation of depreciation is also indicated by the Act.[227] It may be recalled that the Jenkins Committee Report expressed the view that such depreciation reserve must be made mandatory.[228] It is now

obligatory for Indian companies to set apart a reserve fund for depreciation.[229] Subject to these special statutory provisions, the English precedents are generally applicable in India.

5. Appraisal and Conclusions

Introduction

Professor Bonbright came to the conclusion after a careful study of the American dividend law that "the application of the rules restricting the payment of dividends is in a crude state. Many of the most important problems derive no light either from the cases or from the statutes."[230] These words are as true today as they were when they were first uttered three decades ago; they are as true of the dividend laws of Britain and the Commonwealth as they are of the American jurisdictions. If the law of dividend is the most important in the realm of corporation finance, it unfortunately is also the most neglected. There has been little attempt to clarify policies and issues; little attempt to formulate principles and rules.

The complexity of the task of regulating the payment of dividends by statutory provisions cannot be exaggerated. The words "profit", "income," and "earnings" are words of many connotations. Economists and accountants do not agree with one another, nor even among themselves, upon their meaning. The difficulty of measuring income is aggravated because the correlative concepts of "capital" and "value" are equally complex and equally the subjects of conflicting views. The word

"capital" may mean "capital assets" — the machinery, inventory, buildings, and the rest — employed in the corporate business. In this sense it denotes the res. Or it may be used in the sense of "capital value" — that is, the value of the capital assets employed in the business, whatever the word "value" may mean in this context. In this sense "capital" denotes a quantum. From a lawyer's point of view, capital means the stated capital or issued share capital — often an arbitrary figure. Similarly, value has meant different things to different people and has different meaning for different purposes. Accountants have used historical cost as the yard-stick to measure value; sometimes they have used the market price. Economists have used the word "value" to denote purchasing power, cost of production, utility value and esteem value. Not surprisingly, lawyers and legislators dread to tread on these complex questions and they have some justification for running away from the problem of attempting to regulate the payment of dividends and for leaving it to the businessmen.

There are numerous concepts of income or profit for the law to choose from and we shall consider a few of them here.

A. CONCEPTS OF PROFIT OR INCOME

1. The Equity Change or The Increased Net-Worth Concept of Income: This concept defines "the income of a corporation in a given year as the amount the corporation can distribute to the owners of equity in the corporation and be as well off at the end of a year as at the beginning."[231] A corporation is considered to be as "well off" at the end of

a year as at the beginning if the value of the owners' equity (i.e., the value of the net-worth or net-assets) at the end of the year equals the value at the beginning of the year.

It, therefore, follows that income, according to this theory, is the change in the value of the net-worth of the corporation, any distributions to the owners during the year being added back into the year-end equity.[232]

If dividends are restricted to positive equity-change, it may be noted that we will be aiming at the preservation of the value of the net-worth. Under this theory the word "capital" is used to denote the value of the net-worth.[233] The capital or net-worth is a fund of value; income is a flow of value measured by the increase in the value of the net-worth.

This theory takes into account "all changes in the values of all assets, fixed as well as current" and makes no distinction between realized and unrealized gains and losses.[234] For this purpose it has to be clarified whether the enterprise should be valued every time as an organic whole or whether every individual asset should be valued separately and the values added up.[235]

Economists who are the principal advocates of this theory of income do not, however, agree among themselves on the modes of valuation of the net-worth, or even on the concepts of capital and income.

Despite the theoretical merits of this concept of income, it has not found its way except to a very limited extent into any dividend statute on account of the practical difficulties involved in applying it.[236]

2. "Cash Receipts Minus Cash Disbursements" Concept: Unlike the first theory which takes into account every change in value of the net-worth, the "cash receipts minus disbursements" theory tends toward the other extreme and ignores completely any change in the values of non-cash assets. According to it the income of a period "is measured by the cash receipts during that period, from the sale of its products or services minus its cash disbursements other than to its proprietors."[237] Hence it is unnecessary to value the non-cash assets at all. All that is needed is to count the cash received and the cash disbursed. In cash disbursements again no distinction is made between capital outlays and ordinary operating expenses.[238] This crude mode of determining profit has not been accepted in any jurisdiction, but some of its characteristics, e.g. ignoring any change in the value of fixed assets, can be found in many of them.

3. The Accounting Concept of Income: There is no single unified "accountants' theory" of income. We have only the accounting practices in the recording and reporting of assets and income. These accounting practices are not always self-consistent.

The accounting practices seem to be an amalgam of the equity-change and cash-receipts-minus-disbursements concepts of income. Accountants do not value the enterprise as an organic whole but take into account the "value" of the separate assets and add them up together. Whereas the equity-change theory takes into account all changes in the value of all assets, whether fixed or current, whether realized or unrealized, the accountants record the value of different assets in different ways.

They record the value of fixed assets at their historical cost and do not recognize any change in their market value, until and unless the assets are disposed of when they take into account the realized gain or loss. In this respect they agree with the cash-receipts-minus-disbursements theory. They do not reckon changes in the purchasing power of money. They purport to take into account depreciation and calculate it with a view to amortization of the historical cost. In the result the accountants' presentation of the value of fixed assets has no relevance to the present; it is a record of the past, viz. the price at which the assets were originally acquired by the company as amortized by the accountant's technique of depreciation "reserve". The accountants value current assets differently. Accounts and notes receivable are valued at the amount of cash anticipated from the realization of the debts. This is a departure from the usual accounting conservatism against anticipation of income. In Stringer's Case[239] the English Court of Appeal upheld such valuation. Accountants, however, make provision for bad debts based upon statistical estimates. It should be mentioned that in valuing account receivables, accountants do not take into account discounts allowed, costs of realization and interest until realization, and therefore the valuation is excessive to this extent.[240] When a sale is made on credit, the accountants "recognize" a profit as soon as the sale is made and do not wait until the price is realized.[241] That is, they recognize the profit when the company becomes entitled to receive a flow of cash and do not wait until the flow actually occurs. They anticipate that the flow will occur in due time, but provide against possible default by the debtors.

The accountants' valuation of accounts receivables, therefore, conforms to the "equity-change" theory of income and departs from the "cash-receipts-minus-disbursements" theory.

In the case of inventories, which also fall under the category of current assets, accountants generally refuse to recognize a profit or gain, if the value of the inventory has increased, e.g. a rise in market prices, but the increase has not been realized by the company. In this respect they are treated in the same way as fixed assets; in both cases profit should not be anticipated by assuming what would be gained by a sale of the asset at the time. Here the accountant rejects the equity-change theory of income completely. In the case of accounts receivable the corporation is a creditor entitled to recover a sum of money from its debtor and the accountant is prepared to anticipate that this flow of cash will occur and hence willing to adopt the equity-change concept of income. But in the case of unrealized appreciation in the value of fixed assets and inventories, the corporation is not a creditor entitled to a flow of cash from a debtor and has not, by the mere fact of the increased market value, become entitled to receive a flow of cash from a debtor; and in such circumstances the accountant refuses to imagine or assume a flow of cash and rejects the equity-change concept of income.

In brief, the accountants do not regard every increase in value as in itself a profit. The increase should have ripened into a receipt of cash, or at least the right to receive the cash from a debtor, before the accountant would be prepared to count it as profit. He would not count the chickens before they are hatched.

While the accountant would not count unrealized appreciation in the value of inventories and would be prepared to ignore unrealized diminution in the value of fixed assets, he, however, takes into account unrealized diminution in the value of inventories. Here he seems to follow the equity-change theory to this limited extent. As inventories are ordinarily meant for sale, a fall in market price is taken by him into account and he values inventories at "cost or market, whichever is lower."

The accountant departs from the equity-change theory whenever a subjective determination of value has to be made, i.e. a determination based upon opinion or estimate; he follows it when no subjective judgments are involved. It may be said that in fact the accountant generally makes no valuation at all and does not regard it his function to make valuations.

It is, therefore, not difficult to see that the accountant and the economist approach the determination of profit with different attitudes. To the accountant, there can be no profit until a sale takes place; to the economist every increase in net worth is income. Many economists would value the business as a whole by capitalizing anticipated earnings; the accountant values each separate item of asset, some on historical cost basis, some on anticipated realization, and some on market price when it is below cost.

There are undoubtedly imperfections and difficulties in applying the accounting concept of income. The "cost or market" rule is not as simple in its application as it may appear at first sight.[242] The accountant's valuation of stock or inventory still under the manufacturing

process (i.e., work-in-progress) presents even greater difficulties. Professor Ronald S. Edwards, an economist, concludes that from the point of income-measurement, the prevalent accounting practices are "inadequate and confused." He observes:[243]

> "Accounting at present lacks an income concept. It is useless to say that income is the figure we arrive at after applying our valuation rules, when the rules themselves are not agreed."

If the accountant does not embrace the net-worth-increase theory of income in its entirety, neither does he adopt wholly the cash-receipts-minus-disbursements theory. In fact he appears to follow the latter method modified somewhat by the former. Professor Bonbright calls the amalgam "the prorated-receipts-and-disbursements" concept.[244] Whereas the cash-receipts-and-disbursements theory looks only into the inflow and outflow of cash, the accountant takes into account anticipated inflow of cash from concluded credit sales and from other account receivables. In outflow of cash, he takes into account estimated depreciation of fixed assets, estimated bad debts, and the estimated fall in value of inventory. So to speak, he applies a corrective to the cash-inflow-outflow method of determination of income by means of the prorating devices, but these are neither scientific nor consistent. Similarly, the accountant does not regard all the cash received in a year as the income of that year, nor all the cash expended in a year as the expenditure of that year, but purports to spread them over a period of years to which he considers them relevant and applicable.

B. THE FUNCTION OF THE LAW

Unlike the economist or the accountant, the lawyer is not interested in the determination of income as an end in itself or in the theoretical soundness of the methods of measurement. To him the goals and policies which the law should seek and achieve are even more important; the legal rules relating to dividend should effectively implement these policies and attain the goals. Unfortunately the law in this area is unclear in its goals and as a result the rules for regulating dividends are haphazard. We should, therefore, first clarify our goals and then proceed to model the law of dividend in a manner that effectuates them best. In the words of Professor Sidney S. Alexander,[245]

> ". . . [T]he ultimate criterion governing the definition of income is the purpose to be served . . . . The question of which procedure to use cannot . . . be settled on the basis of principle, but only on the basis of which procedure works best for the purpose in hand. One method is superior to the other if it works better, and an appeal to general principles may obscure the issues of social philosophy or practical expedience which govern the choice. Income for any purpose must be so defined as best to serve the general welfare and the interests of those concerned. When those interests are in conflict the issue must be resolved by a comparison of the merits of the various claims and interests, and not by a recourse to a 'true' concept of income, independent of the ends served by the use of the income measurement."

In other words, the basic question is: why should the law attempt to define income or profit? It is no answer to say that we have to do so for the purpose of determining the dividend fund, for such an answer merely begs the question and raises the same question in a different form, viz. why should the law lay down rules for the determination of the dividend fund and why should the law restrict dividends to profit or

income? What is the objective of the law in forbidding dividends out of capital? In essence, the need to define profit or income arises from the concern of the law to protect and reconcile the interests of different groups involved in a corporate venture.

C. CLARIFICATION OF GOALS

We are here attempting to clarify and prescribe a common policy for a large number of related problems in the law of corporation finance. Why does the law require corporate charters to specify the capital as well as the objects of the proposed company? Why do we impose restrictions on a company reducing its capital? Why do we forbid a company to waive, in whole or in part, its claim to unpaid subscriptions? Why does the law impose restrictions upon companies returning capital to its shareholders? Why do we regulate or forbid purchase by a corporation of its shares? Why are we concerned with the problem of watered-stock? Why do we have provisions for minimum capital or minimum subscription of some kind or other? In short, what is the role we assign to "capital" in the corporate form of business organization?

The law does not bother itself with any of these questions in the case of partnership or sole proprietorship enterprises. The entrepreneurs and those who deal with them are left free to regulate their relationships in a large measure by contractual arrangements between themselves. On the other hand the corporate form of business has introduced many changes which are almost revolutionary. First is the limited liability of the investor in the corporate capital. This immunity from liability beyond

a certain limit can be obtained as a matter of law and is not dependent upon the consent of the corporate creditor. While such limitation of liability protects the shareholder, it deprives the creditor (present and potential) of the protection he has in the unlimited liability of a partner or a sole proprietor. The creditor who finds the corporation bankrupt has no recourse against the shareholders, millionaires though they be. Secondly, the shareholders' liability to pay unpaid subscriptions is to his company and not directly to the creditors. This immunity from personal liability is again achieved as a matter of law — the law conferring a personality upon the corporation. Thus the creditor of a corporation is denied the protection springing from the personal liability of the debtor. The third is the severance of the ownership (of shares) and the control (of the enterprise). Barring the case of the closely-held corporation, the investors' control over the day-to-day operation of the enterprise is very small. It therefore becomes necessary to protect the investor from the management. The corporate shareholder has become a mere purchaser of income, a mere "petitioner for the wages of capital." The management is virtually omnipotent in the corporate power structure. Fourthly, the investors do not belong to one homogeneous group, but often form sub-groups with conflicting interests. Among them there could be those holding voting shares and those holding non-voting shares; those holding preference shares and those holding common shares; those holding preference shares with or without cumulative rights or participating rights; those holding preference shares carrying preferential right to dividend or to asset in liquidation or both. It becomes necessary to safeguard

the interests of these conflicting groups. Last, but not least, there are the workers who toil for the company and depend upon its continued existence and prosperity for their employment; and there are the consumers and the general public.[246] Any policy in respect of corporate enterprise in general, and corporate finance in particular, should reckon with these conflicting interests and balance as far as possible their respective claims.

The goal of the law of dividend, and indeed the law of corporation finance, should be to reconcile and protect these conflicting claims. Unfortunately, the legal rules do not appear to be founded on any clear policy perspectives. The task of reconciling these conflicting claims is no doubt an uneasy one, but the laws of almost all the jurisdictions have failed not in the implementation of a policy but to have a well-defined policy at all.[247]

The rules of the law of dividend and other distributions to shareholders, of reduction of capital and repurchase of shares, should, it is submitted, be formulated with due regard to:

i) "the interests of employees and customers in the financial soundness" of business corporations — a consideration traditionally ignored by the law;

ii) the interest of creditors, especially unsecured trade creditors;

iii) the interest of shareholders in general in the preservation of the worth of their investment;

iv) the interests of the holders of preference shares and non-voting shares;

v) the interests of minority shareholders; and

vi) the interests of future and potential investors and creditors, i.e., to protect them from being misled about the prosperity of the corporations in which they contemplate investment or with which they propose to deal.[248]

D. EXTANT STATUTORY AND DECISIONAL PATTERNS

1. The English Approach

The English law of dividend is the judicial development by the process of interpretation of the time-honoured and seemingly simple rule that dividends may be paid only out of "profit." This rule has appeared in the optional ("optional" in the sense of binding unless expressly excluded by contrary provisions) by-laws contained in the first schedule to the English Acts (Table B of the Act of 1856 and Table A ever since the Act of 1862). Until the Act of 1908 — by which year all the leading English dividend precedents had been decided — the word "profit" was qualified by the restrictive phrase "arising from the business of the company" but since that Act it has been omitted.

The English courts have endeavoured, therefore, to answer a single question in dividend cases: is the fund out of which the company has paid or seeks to pay a dividend its "profit"? The courts have applied two complementary rules, viz. (i) dividend can be paid only out of "profit" and (ii) dividend ought not to be paid out of "capital." The word "capital" as used in the English cases of the 19th century perhaps refers to all the

assets[249] of the company other than those that could properly be considered its profit and not merely to the amount of share capital. Hence there was no need to distinguish between capital and capital surplus, or the various kinds of capital surpluses. All that is not profit is capital — the economic capital. When the Act of 1867 provided for the first time for "reduction of capital"[250] in language which was far from clear, the judges would appear to have given the word "capital" its economic meaning, viz. that which is not profit, and invoked it in support of the rule that dividends out of capital cannot be authorised even by the company's charter. After the doctrine of ultra vires acquired its definite form in the Ashbury case[251] the injunction that dividend should not be paid out of capital was also supported by the doctrine of ultra vires: "capital" could be used only in furtherance of the authorised objects of the company and paying dividend was not such an object. It was only the Act of 1908 which changed the language from "reduction of capital" to its modern form "reduction of share capital."

If the English courts had defined "profit" as the increase in the value of "capital", and thus aimed at the preservation of the value of the net-worth, they would have evolved a concept of income very close to the economists' equity-increase theory. But that did not happen. The task of differentiating "profit" from "capital" was too complex for the judges to undertake without any statutory guidance. Inevitably the courts chose to rely on the good faith judgment of businessmen. And those were the heydays of laissez faire. The state of statutory law relating to company accounts was far from helpful to the judges in

undertaking the task. It was not until the Act of 1929 that the contents of balance-sheets were regulated by the company statute, though the Act of 1907 required that the balance-sheet should be included in the annual return. It was only in 1929 that the directors were required to place the profit and loss account and the balance-sheet before the company in general meeting. It is only the present English Act (the Act of 1948) which for the first time lays down regulations with respect to the contents of the profit and loss account.[252] Even today the Act does not spell out guidelines for the determination of profit. The task of filling up these vast gaps involving difficult considerations of policy issues fell on the judges.

Many early cases were simple ones where a company had no earnings of any kind, or where it had been running at a loss throughout, or where dividends were declared and paid contrary to the constitutional documents of the company. However, not all cases were so simple. Stringer's Case[253] raised the difficult question of the treatment of accounts receivable (here the money due from the Confederate States of America during the Civil War) in the determination of "profit". Rance's Case raised even more difficult problems.[254] In Flitcroft's Case the court examined the propriety of a company calculating its profits without taking into account bad debts.[255]

The Neuchatel series of cases gave English law of dividend its distinctive character by divorcing the determination of profit from a positive theory of maintenance of capital. They established the present doctrine, viz. that where part of the capital has been lost, the revenue

produced by the remaining capital is profit available for dividend and does not represent any part of the lost capital; the revenue need not be applied to restore the lost capital. The Companies Acts only forbid a company to reduce its capital voluntarily by returning it to the shareholders or by waiving its claim to unpaid subscriptions; they do not require that capital lost otherwise should be made good. It is true that dividends may be paid only from profit and not out of capital, but the revenues generated by the remaining capital after a part of it has been lost is profit and not capital. Lord Lindley who was the author of this approach could not have been ignorant of the fact that this reasoning would puzzle any average businessman. Presumably he was influenced by the special nature of a corporate business enterprise and felt that it would be unfair to the shareholders to make them wait until every loss or diminution of capital (i.e., the value of the net-worth) was made good out of revenues. Presumably he felt that the creditors' interest did not require such a stringent rule and that they were adequately protected by the requirement that a company should be and should remain solvent in order to make a lawful dividend. The risk of loss of capital in the ordinary course of trade or natural course of events must, according to Lord Lindley's approach, be borne by all those concerned in the corporate venture, whether as investors or as creditors. To require that capital in the sense of the value of the net-worth should be preserved intact would protect the creditors' "cushion" to the undue prejudice of the shareholders' "bread". Lord Lindley was indeed reconciling the conflicting interests of creditors and shareholders — the former's for security and

the latter's for a return on their investment. In the writer's opinion this approach is basically sound but needs refinement to discriminate clearly between different kinds of losses of "capital" — depreciation, depletion, bad debts, trading losses, destruction of capital assets — and clarify when companies may and when they should not by-pass the income statement.

Under the English pattern we find two divergent trends existing simultaneously with respect to maintenance of capital. The statute forbids a company to reduce its share capital without judicial confirmation obtained in accordance with the prescribed procedure; since 1948 it forbids dividends and distributions out of paid-in surplus (share premium amounts) except in a very limited way; it requires the profits to be frozen and rendered unavailable for dividend to the extent that redeemable preference shares have been redeemed except out of the proceeds of a fresh issue of shares made for the purpose of the redemption. Case-law forbids a company to pay dividends out of capital and to repurchase its shares. All this is founded on a philosophy of maintenance of net-worth or maintenance of assets of a value at least equal to the issued share capital. But the Lee v. Neuchatel Company series of cases have grafted an important exception to this general philosophy, viz. that capital, if lost, need not be made good before current revenues may be distributed as dividend.

2. The American Approach

(a) The Balance-Sheet Surplus Test

Ever since the Ohio Act of 1927, the common American test for determining the dividend fund is the balance-sheet surplus test.[256] The test was adopted by the Uniform Act of the next year. According to this test, the excess of the net assets or the net-worth over the "stated capital" is "surplus" and dividends may be paid out of such surplus. It may be noted that in this approach the lawyer's concept of capital — the stated capital — assumes importance and the test prima facie aims at the maintenance of net assets of a value at least equal to the amount of stated capital. The dividend fund includes earned surplus as well as unearned or capital surplus. There can be no surplus so long as the stated capital is impaired and therefore every impairment of stated capital should be made good before a dividend can be paid to the shareholders. This test is, therefore, also called the "capital impairment" test.

It should be evident that this test is markedly different from the English approach which does not link the determination of the dividend fund to the nominal or paid-up capital. The surplus test imposes no restrictions on the payment of dividends out of paid-in surplus or any other capital surplus. Indeed the distinction between earned and capital surpluses is irrelevant.

The theory of maintenance of stated capital, however, becomes illusory because most of these jurisdictions permit corporations to reduce their stated capital at any time without any external control and without

any restriction. Thus stated capital does not mean the original stated capital, but the stated capital as reduced from time to time. By such reduction a surplus can be created out of which dividends can be paid. This is indeed impairment of stated capital as it originally stood — an impairment legalized by compliance with the prescribed reduction process.

Besides, any theory of maintenance of assets of a value at least equal to the amount of stated capital can only be as sound as the rules for the valuation of the assets. That is, the statute should regulate what ought or ought not to be taken into account in valuing assets and on what basis the valuation should be made. The Uniform Act does pay some attention to this aspect, but most statutes do not.

The surplus test and the profits test prima facie appear to be fundamentally different. The surplus test "says nothing as to profits" and "purports to make the whole question of the legality of dividends depend on a balancing of asset values against liabilities."[257] The profits test says nothing about surplus and would seem to involve "only such a comparison between asset values and liabilities as may be required for the purpose of measuring income."[258] Bonbright points out the following differences which the two tests seem to imply: (i) The surplus test would appear to take into account the increase or decrease in the value of all assets, whether the asset is fixed or current and whether the increase or decrease is a realized or unrealized gain or loss. The profit test on the other hand does not take into account every increase or decrease in the value of all assets; particularly it ignores unrealized diminution or appreciation in the value of fixed assets. (ii) Where shares

have been issued at a discount, the surplus test would appear to require that this deficit be first made good before the earnings can be distributed as dividend. The profit test would not seem to require such capital deficit to be made good. (iii) Share premium amounts are surplus available for dividend under a surplus test. It is arguable whether they could properly be called profit for the purpose of a profit-test.

But the courts have, as Bonbright points out,[259] tended to treat the two tests as if they were synonymous and inter-changeable. For instance, share premium amounts have been held to be "profit" under a profit-test and "surplus" under a surplus-test. Similarly, the courts have declined to treat unrealized appreciation or diminution of the value of fixed assets to be "profit" for the purpose of a profit-test or "surplus" for the purpose of a surplus-test. The confusion of the two tests is of course attributable to the adoption by the courts of the accountants' rules for the valuation of assets or calculation of profits. In the result the two tests have to a large extent worked alike in the determination of the dividend fund.

It should be noted that the American courts have in applying the profit-test, however, rejected the philosophy contained in the Neuchatel series of English cases that earnings of the current accounting period can be used for dividend distribution despite an existing deficit from operating or other losses.[260] Lord Lindley's rule in the Neuchatel series of cases is not a logical inevitability, nor was it accepted in England without scepticism. American states have for long endeavoured to "preserve among the corporate assets some equivalent for the original

contribution received by the corporation in exchange for its shares of stock"[261] by forbidding the payment of dividends when the stated capital is impaired and by restricting dividend to balance-sheet surplus.[262] Lord Lindley's philosophy is of course repugnant to the balan ce-sheet surplus (that is, capital impairment) test. It should, therefore, be noted that the English profit-test is significantly different in this regard from the American profit-test.

To sum up, though the surplus-test is predicated upon a theory of maintenance of stated capital, the theory is defeated because of traditional accounting rules relating to valuation of assets and because of the ease with which stated capital can be reduced. Such reduction surplus could be applied to wipe out existing deficits as well as to pay dividends. For the effectiveness of the rule, the law should clarify when an increase or decrease in the value of an asset should or should not be taken into account for the purpose of determining surplus, but most jurisdictions have left this decision to the accountants. The test is even less meaningful in the context of the modern low-par share capitalization.

(b) The Profit-Test

The profit-test is far older than the surplus-test. The rule was codified in different forms in different statutes. Thus dividends were permitted only out of "profits", "profits earned by the business", "accumulated profits", "actual net earnings", "actual legitimate net earnings", "net profits actually acquired", "profit actually earned and on hand", "net profits properly applicable thereto", or other more or

less vivid phrases.[263] Many statutes buttressed this rule by further injunctions that capital or capital stock ought not to be impaired by the payment of dividend or that dividend ought not to be paid out of capital or capital stock. But neither the statutes nor the decisions interpreting them are helpful in unravelling the mysteries of that perplexing word "profit."

Several American statutes authorise dividends out of net profits of the current year, or out of the current year's and that of the preceding year, as an alternative source to surplus. Delaware permitted dividends out of current profits irrespective of past losses by an amendment to the Delaware General Corporation Law in 1927.[264] The amendment permitted dividends out of the "annual net profit" as an alternative source to "surplus", that is, "net assets in excess of . . . capital." By an amendment of 1929 the alternative source of annual net profits was extended to the net profits of the preceding fiscal year as well as the current fiscal year. This example is now followed in the Model Act by an alternative provision introduced in 1965. New Jersey, which is the pioneer in enablingism, was the first to allow such "nimble dividends" out of annual net profits as an alternative source to surplus.[265] Such permission to pay nimble dividend despite an impairment of capital brings the American law of these jurisdictions close to the English pattern.

(c) The Model Act Test or The Earned Surplus Test

The Model Act defines earned surplus and restricts dividends to such surplus. Earned surplus is arrived at by taking into account the income statements continuously from a given point of time. The divi-

dend fund is arrived at from successive income statements beginning with the inception of the corporation or "from the latest date when a deficit was eliminated by an application of its capital surplus or stated capital or otherwise."[266] Hence the earned surplus test is the projection of the profit-test over a period of time. Like the profits-test its point of reference is the income-statements considered as a continuous account, and not the balance-sheet.

But the Model Act leaves many difficult questions unanswered. As Hackney has observed, the definition of earned surplus in the Model Act "certainly describes the figure which appears on a corporate balance sheet beneath capital and capital surplus," but "as a statutory dividend test, it must do more than describe the end product; it must prescribe the method of computation to be used to ascertain that figure."[267] It is here that the Model Act's earned surplus test has failed to achieve anything better than the time-honoured profit-test, but suffers from all its shortcomings.

For example, can there be an earned surplus when the stated capital is impaired? The answer to this question would seem to be in the affirmative. The total surplus of a corporation may be composed of a positive earned surplus and a deficit in the capital surplus account, i.e. the total surplus can be less than the earned surplus. Dividend can be paid out of the earned surplus without making good the "capital surplus deficit".[268] This is a departure from the surplus-test under which there can be no surplus so long as the stated capital remains impaired and the stated capital has not been reduced as provided by

the statute to wipe out the impairment.

From this it follows that the question when and whether the earned surplus account may be by-passed and a direct charge made to the capital surplus account becomes very important. Equally important is the question when the earned surplus account should be by-passed and a direct credit to the capital surplus account be made. Unfortunately the Model Act does not enlighten us adequately on these questions. While the definition of earned surplus seems to intimate that operating losses should be charged to the income account, the position with regard to other kinds of losses (such as depreciation, bad debts, destruction of fixed assets) is not clear.[269]

If dividends can be paid out of earned surplus despite a capital surplus deficit, it follows that the Model Act does not espouse the philosophy of maintenance of stated capital. Besides an earned surplus deficit can be written off by the application of capital surplus; such capital surplus can be created by the reduction of stated capital; and therefore, in effect, the earned surplus deficit may be written off to stated capital. Moreover, capital surpluses of all kinds including reduction surplus are available for "distribution" to shareholders and for repurchase by a corporation of its shares.

We may, therefore, conclude that the American dividend laws are not premised upon a strict theory of maintenance of stated capital; indeed coupled with their provisions for distribution of capital surplus, they are even more lax than the English law which imposes stringent restrictions on reduction of share capital, forbids a company to repur-

chase its shares, forbids dividends out of share premium amounts and capital redemption reserve fund, etc.

We shall now examine the application of these different approaches of the Anglo-American dividend laws to particular situations relating to the determination of the dividend fund.

E. SPECIFICS OF THE DIFFERENT APPROACHES TO THE DETERMINATION OF THE DIVIDEND FUND

1. Paid-in Surplus or Share Premium Amounts

The present English Act forbids the payment of dividends out of share premium amount and treats it on a par with capital in most respects. It is indeed contributed capital; to treat it as "profit" will do violence to the common understanding of that word. Previously the courts permitted companies to treat the premium amount as if it were profit. The English Act has now recognized the true nature of share premium amounts. It permits the paid-in surplus to be capitalised by the issue of share-dividends, or used to write-off the preliminary expenses of the company or the expenses of, or the commissions paid, or discounts allowed on, any issue of shares or debentures of the company. But the paid-in surplus may not otherwise be reduced except by compliance with the provisions of the Act relating to the reduction of share capital.[270]

As early as 1935 the Price Spreads Commission in Canada recommended that payment of dividends out of share premium amounts should be forbidden and that the full consideration received by a company

by the issue of shares, with or without par value, should be regarded as capital.[271] But no Canadian statute forbids the payment of dividends out of paid-in surplus. Many of them, however, do not now permit companies to allocate to surplus any part of the consideration for the issue of no-par shares.[272]

In almost all American jurisdictions share premium amounts are available for dividend. Even under a profit-test the courts have held that they are profit available for dividend.[273] Almost all the American jurisdictions permit corporations, with greater or lesser restrictions, to allocate to surplus part of the consideration received for the no-par shares. Under the Model Act, such premium amount is not earned surplus and is, therefore, not available for ordinary dividends, but is capital surplus available for "distributions", subject to the restrictions imposed by the Act, and for dividends to cumulative preference shares in the absence of earned surplus.[274]

In the opinion of the writer the question whether dividends should be permitted or forbidden out of share premium amounts is not as important as the question whether companies should be afforded the freedom — which they now enjoy — to create paid-in surpluses without legal regulation. Companies have the freedom to fix the par value of shares and the freedom is exercised to fix it at very low amounts for the sole purpose of enabling them to credit to surplus a large portion of the consideration received for their issuance. They enjoy the freedom in law to issue the shares at any premium as they please. Thus the par value of a share may be a dollar and its issue price a thousand dollars; the

dollar goes to share capital or stated capital and $999 to the share premium amount. The no-par device has increased the freedom to allocate the consideration to surplus and stated capital. It is submitted that the law should fix a ceiling upon the premium — say, 25% of the par value or 25% of the consideration received for no-par shares. This will have the salutary effect of inhibiting the resort to very low par value for shares for the sole purpose of creating vast paid-in surpluses.

The writer sees no justification for permitting the issue of par value shares above par and at the same time forbidding companies to credit any part of the consideration received for no-par shares to paid-in surplus, as many Canadian statutes do.

2. Realized Capital Gains

All jurisdictions seem to agree that realized appreciation of capital assets is available for dividend. It is regarded as profit under a profit-test and is certainly surplus for a surplus-test. The term "profit" is now given the wider connotation of profit arising from the business operations of the company as well as non-operating or non-trading gains.[275] It is possible to argue that trading profit alone should be available for dividend and that the accretions to the value of capital assets should be treated as capital or capital surplus, even after they are realized.[276] In fact corporate bond indentures do often define net income available for dividends in such a way as to exclude altogether gains and losses resulting from the disposition of capital assets.[277] Modern legislative and judicial policy has, however, sanctioned the pay-

ment of dividends out of realized capital gains and it is, therefore, not proposed to canvass the contrary view here.

3. Unrealized Appreciation or Surplus Created By Write-Up of Assets:[278]

There is much difference of opinion and controversy with regard to payment of dividend out of unrealized appreciation in the value of the assets, whether fixed or current, of a corporation — the so-called revaluation surplus. It is in such controversial and complicated areas that we look for legislative guidance and it is exactly in such instances that the legislatures often prefer to remain silent, thereby shifting the responsibility to the courts.[279]

The accounting profession is generally hostile to the payment of dividends out of revaluation surplus as it is against making subjective determinations and prefers cautious conservatism in this respect. The American Uniform Act adopts the policy that unrealized profits should not be treated as funds available for dividend in cash or property, but may be capitalized by share-dividends. The English and Commonwealth statutes are generally silent on the question. The American Model Act also prefers to be silent on the question.[280] The Canadian federal statute forbids unrealized appreciation of fixed assets to be taken into account in determining the solvency of the company until the expiration of five years after the revaluation. The opinion has been expressed that a solvent Canadian dominion company may declare and pay dividends out of unrealized appreciation in the valuation of assets.[281]

The policy with regard to unrealized appreciation in the value of fixed and current assets as a dividend source should, it is submitted, be statutorily clarified. The American Uniform Act sets a good precedent to follow by allowing share-dividends and not cash or property dividends out of revaluation surplus. In Ammonia Soda Co. v. Chamberlain[282] the English court held that revaluation surplus could be applied to write off depletion or depreciation, but in the opinion of the writer even this is not free from the objection made against payment of dividends from unrealized appreciation.[283]

While it is true that from the point of view of economic theory there could be no reason why unrealized appreciation should not be treated as profit as much as realized appreciation, it is submitted that from a practical point of view it is undesirable to permit cash or property dividends out of revaluation surplus, because such revaluation may vary with the foot of the appraiser. Further, it would be dangerous to revalue some assets and not others; it may be impractical to revalue all the assets. The risk of overvaluation definitely exists which may dilute the shareholders' equity even if no dividend is paid out of it; and if a dividend is paid, the capital may thereby be impaired.

The Price Spreads Commission in Canada observed that the practice of writing-up fixed and intangible assets "has given rise to much abuse" and remarked:[284]

> "It is possible for a company to write up an asset, thus creating against the new asset value a surplus account; then dividends paid in cash may be charged against the surplus. This practice simply means that dividends are paid when the company's position does

> not warrant it. Accordingly, we are of the opinion that all increases in surplus or reserves which result from an increase in asset values (as a consequence of write-ups, appraisals, etc.) should be regarded as capital surplus, that is incapable of having dividends, directly or indirectly, charged against them."

The writer agrees with this opinion of the Commission. It is also submitted that even where revaluation surplus is applied to making share dividends, companies must be required to disclose the source of the dividend so that the shareholders may not be misled into thinking that their lucrative company was ploughing back its earnings.

4. Realized Capital Losses

The Lee v. Neuchatel series of cases render it unnecessary for an English company to make good out of earnings any loss of capital. The accounting profession permits fixed assets to be valued at cost, irrespective of any appreciation or diminution in their value. Under a balance-sheet surplus test, any impairment of stated capital will have to be made good unless the stated capital is reduced as provided by the relevant statute. Under a nimble-dividend statute, dividends can be paid without making good any impairment of stated capital. Under the Model Act again it would appear that dividends may be paid out of earned surplus despite a deficit in the capital account. Thus it would appear that except in the case of statutes which prescribe a balance sheet surplus test the result in the American jurisdictions will be no different from the English law in this respect.

The English law treats losses in the value of investments on the same footing as other capital losses and they need not be taken into account in determining the dividend fund. It was so decided in Verner v. General and Commercial Investment Trust.[285]

The state of the law in all jurisdictions is far from satisfactory in that they do not regulate when the income account may be by-passed and a loss directly charged to capital. We have suggested below that depreciation, bad debts, etc., which are realized losses should be reflected in the income statement.

5. Past Operating Losses

The English law would seem to make no distinction between one kind of loss and another and to permit the income account to be by-passed in every case. There are dicta in the judgments that circulating capital should be kept up, but loss of fixed assets need not be made good. But the meaning of this statement is not free from ambiguity and doubt.[286] Under the Uniform Act and other Acts adopting the surplus-test, every loss which impairs the stated capital should be made good. Under the Model Act the earned surplus account is a continuous account and this would imply that past operating losses should be made good out of current income before a dividend can be paid. In the opinion of the writer current operating loss of any year should be written off to accumulated profits, if any, and in the absence of accumulated profits should be, at the option of the company, written off to the capital account. It may be noted that the Model Act permits a deficit in the earned surplus account to be wiped

out by applying capital or capital surplus. If this step is taken, the earned surplus account is thereafter reckoned from the date on which the deficit was thus wiped out. Thus in effect the loss can be written off to even the stated capital. It would, therefore, appear that the result would be the same as under the English law.

6. Unrealized Losses

If unrealized gains are not divisible profit, the converse question arises whether unrealized losses or diminution in the value of assets reduce the divisible profit. In the case of unrealized diminution in the value of fixed assets, the answer is clearly in the negative in English law. The accounting practice is in accord with the law as fixed assets are valued at cost irrespective of any rise or fall in their value. American statutes are silent on the question, but it is believed that the position is the same.

In the case of inventory, however, unrealized loss is taken into account because of the accounting practice which values them at cost or market, whichever is lower.

7. Depreciation

Barring the Indian and a few American statutes,[287] the company statutes do not deal with depreciation in the context of the determination of the dividend fund. It is quite often difficult to say whether in any given jurisdiction a company is at all required by law to make provision for depreciation from its earnings.[288] At present it would appear that

depreciation is of importance only as an expense item deductible for income-tax purposes from the earnings, but that it does not as a matter of law diminish the funds available for dividend. The policy of the law in regard to depreciation, it is submitted, needs to be clarified. Indeed the word "depreciation" is a word of many connotations on which the accountants and economists have vast differences of opinion.[289]

The traditional accounting concept of depreciation is that of "allocating the cost of facilities to the revenues produced by them"[290] — that is, to amortize the cost of depreciable assets by spreading these costs over the period of their useful service. Accordingly, depreciation is a measure of property exhaustion and should be taken into account in determining periodic income.

There are several techniques of making such cost allocation: the simple and popular "straightline method" (i.e., dividing the original cost over the estimated life of the property in equal amounts), the "unit output method" (i.e., dividing the original cost on the basis of the estimated total production or service), and others.

Whatever be the concept of depreciation and whatever the method of measuring it, the underlying policy is that of maintenance of capital — using the word "capital" in its broader sense of the assets employed in the corporate venture. It is submitted that companies should be required not only to provide for depreciation out of their earning, but also for obsolescence[291] in view of the rapidity of modern industrial inventions.

The chief defect of the accounting practice in computing depreciation is that it is made on the basis of historical cost. It ignores the

impact of inflation which renders the original "dollar" and the current "dollar" so different in their purchasing power that they become as different as the dollar of one country is from that of another country, though called by the same name. Traditional accounting practice has ignored economic depreciation in favour of an arbitrary technique of amortizing historical cost. In the result, under inflationary conditions — which plague most countries today — depreciation computed on the basis of original cost results in under-depreciation and consequently overstatement of profits.[292] Unfortunately, the effort to introduce corrections which take into account price-level changes has not met with success even in the United States.[293] It is not within the scope of this thesis to suggest law reform in this respect, though the writer agrees with the view that "The ideal object of depreciation policy is to recover each year a sufficient number of current dollars to equal that year's capital consumption in terms of original dollars,"[294] and that depreciation policy ought to aim at the maintenance of the purchasing power of the capital invested in the company.[295] For our purposes it is sufficient to observe that despite conventional depreciation-accounting, profits are likely to be overstated due to inflationary monetary conditions.

There are those who advocate that depreciation must be conceived of as a provision for replacement and computed on the basis of replacement cost. This would appear to involve practical difficulties and to be unsuitable in many cases.[296] Those who favour this view would consider depreciation to be more than mere amortization of cost.

It is hardly necessary to emphasise that if understatement of depreciation will result in overstatement of profits, nonreckoning of depreciation would result in gross overstatement of profits and overpayment of dividends. It is submitted that the law should regulate this aspect in the determination of the dividend fund as the understatement or nonreckoning of depreciation will inevitably distort the genuine earnings of the corporation.[297]

8. Depletion — Wasting Asset Companies:[298]

There is wide agreement among many jurisdictions that wasting asset corporations belong to a special category.[299] They are not required to preserve their capital intact before they may distribute their revenues as dividend. It would seem that the cash-receipts-minus-disbursements theory of income is applied in their cases. They are not usually required to set up depletion reserves and if they are, they are allowed to pay dividends out of such reserves.

Such special treatment of "wasting asset" or "asset consuming" companies is perhaps justifiable; at any rate it is useless to debate its soundness at the present stage of the development of the law. But the law calls for several reforms in its details. First, companies which fall into the special classification of wasting asset companies should be specifically defined and enumerated in the statute. It may be advisable to provide for special registration of these companies within the framework of the company statutes. Such special status should be afforded only to those wasting asset companies which are organized exclusively

to exploit a single asset and are to be wound up after the asset is exhausted. There is no justification to extend this privilege when a wasting asset company intends to continue or expand its operations by acquiring and exploiting other wasting assets or by engaging in other businesses.[300]

Secondly, it should be ensured that those who deal with such companies are informed of their special nature, e.g. by requiring them to add at the end of their names the words "specially limited" or the like. Thirdly, the asset-preference of any class of shares in the winding-up of the company needs to be safeguarded. If wasting asset companies could return capital to the common stockholders as part of dividend, the asset-preference of the preferred shares loses all meaning. Perhaps such companies should not be permitted to issue preference shares carrying what is in effect deceptive preferential rights to the assets in a winding-up.

The Model Act requires depletion reserve to be set up, but permits dividends to be paid from them if so authorised by the corporation's charter. It is not, however, clear whether such payment is one from earned surplus or whether it is a case of "dividend" out of capital surplus. In the case of distributions out of capital surplus, the Model Act protects preference shareholders (i) by forbidding such distributions to the holders of any class unless all cumulative dividends accrued on all preferred or special class of shares entitled to preferential dividend have been fully paid and (ii) by forbidding such distributions to the holders of any class of shares which would reduce the remaining net assets of the

corporation below the aggregate preferential amount payable in the event of voluntary liquidation to the holders of shares having preferential right to the assets of the corporation in the event of liquidation.[301] It is not clear whether the preference shareholders of wasting asset companies enjoy similar protection when dividends are paid out of depletion reserves; probably they do not. It seems to the writer that there is no justification for ignoring the special interests of the preference shareholders in wasting asset companies.[302]

9. Bad Debts[303]

Companies should be required to estimate probable losses due to bad debts and to provide for them by crediting the estimated amount to accounts receivable (on the assets side) by a "credit Reserve for Bad Debts" entry and debiting them to a bad debts expense account, thus recording a decrease in net-worth. This bad-debts expense account should be shown in the profits and loss account so as to diminish the profit available for dividend. If the account or note receivable account becomes uncollectible, it should be written off. Failure to write off bad debts, or to provide against probable bad debts, would result in overstatement of the funds available for dividend. Flitcroft's Case is an example of this kind.

It must be noted that provision for bad debts, as well as depreciation, requires the exercise of discretion and judgment and cannot entirely be regulated by statutory prescriptions. But the responsibility for exercising the discretion and making the judgment must be placed on the board of directors.

10. Fall in Value of Good-Will

When goodwill is shown as an asset valued at the price paid for it when the business to which it relates was acquired by the company, any fall in value of such goodwill should, it is submitted, be taken into account in determining the divisible profit.[304]

11. Organization and Preliminary Expenses

Companies should be required to write off preliminary and organizational expenses shown as assets in the balance-sheet by regular annual charges to the profit and loss account.[305] The American Uniform Act requires that "Deferred assets and prepaid expenses shall be written off at least annually in proportion to their use as may be determined by the board of directors."[306]

12. Watered Stock and Dividends

Where par value shares have been issued for an over-valued consideration, the question arises whether the earnings of the corporation should be applied to making good the difference between the inflated value and the true value of the consideration, i.e. the "water." It may be recalled that this question was raised in the Neuchatel case.[307] The courts have generally interpreted the rule, that capital should be kept intact and not used to pay dividends, to refer to the actual value of the assets of the company rather than the nominal value of the shares issued in return for them,[308] and thus freed such companies from the obligation to apply their earnings to undo the stock-watering before payment of divi-

dends. The English law of dividends has, as we have seen, grown independently of any positive theory of maintenance of capital and does not link "profit" to "surplus." Therefore a company could have a profit despite an impairment of capital. The watered-stock problem, therefore, does not interfere with the determination of income; it can at any rate be conveniently overlooked. This will be equally true of American jurisdictions authorising nimble dividends.

The same result was reached by the New Jersey Court of Errors and Appeals in Goodnow v. American Writing Paper Co.[309] The relevant statute, the New Jersey Act of 1904, enjoined that "The directors of a corporation shall not make dividends except from its surplus or from the net profits arising from the business of such corporation, nor shall it divide, withdraw, or in any way pay to the stockholders, or any of them, any part of the capital stock of such corporation, or reduce its capital stock except as authorised by law." The court held that the corporation could pay dividends either out of its surplus or out of its net profits arising from its business. It was, therefore, immaterial that, owing to the issue of shares for an over-valued consideration, there was in reality no surplus; the corporation could still declare and pay dividends out of its net profits. The court also construed the words "capital stock", as the English court construed the word "capital" in the Neuchatel case, to mean the capital actually contributed and not the nominal amount of issued capital as measured by the par value of the shares. It thus reached the conclusion that the corporation did not violate the provision of the section that the "capital stock" should not be withdrawn

or paid back to the shareholders. Moreover, as in the Neuchatel case, here again the court found that "the value of the present assets exceeded the value of the actual assets with which the company began business."

Whether the rationale of this decision will be applicable to a statute like the Uniform Act which prescribes the surplus-test without the net-profits alternative, is debatable.[310] It is even more difficult to state the position under the Model Act.

In brief, the law of dividend does not deter stock-watering; stock-watering does not interfere with the payment of dividends. The widespread use of no-par shares perhaps renders the question less important from a practical point of view in the American and Canadian jurisdictions. Whatever be the reason, such cases seem to be rare in recent times.

The issue of par value shares at a discount (when permitted by law) raises an identical question, viz. whether the discounts allowed should be written off to income. It is submitted that the law should impose such an obligation.

13. Dividends and Distributions Out of Capital Surplus

The present English Act expressly forbids payment of dividend out of share premium amounts. When redeemable preference shares are redeemed otherwise than out of the proceeds of a fresh issue of shares made for the purpose, a capital redemption reserve fund has to be set up out of the profits and this fund is also unavailable for dividends. Both these funds are treated as quasi-capital. They can be reduced only by the procedure prescribed for the reduction of share capital.

But they may be capitalised by the issue of share dividends. Apart from these two special cases, the question in every case is whether a given fund out of which the company pays or seeks to pay a dividend is "profit" or "capital." The English Acts do not distinguish between capital (in the sense of share capital) and capital surpluses (in the sense of unearned surpluses).

In American jurisdictions prescribing a surplus-test, generally no distinction is made between earned and unearned surplus and dividends may be paid from either. Some jurisdictions, however, impose restriction on payment of dividends out of paid-in surplus.

The Model Act is the first Act to draw a sharp line of distinction between earned surplus (always available for dividend) and capital surplus (ordinarily not available for dividends, but available for "distributions" subject to restrictions). The board may make distributions out of capital surplus, if authorised by the charter of the corporations or a two-thirds vote of each class of outstanding shares,[311] provided that the company is and will remain "solvent." The rights of cumulative preference shares and shares having preferential right to assets in the event of liquidation are, however, safeguarded. All such distributions out of capital surplus should be specifically disclosed to be such.

As capital surplus is defined by the Model Act to mean any surplus other than earned surplus,[312] and a surplus can be created by reducing stated capital by charter amendment, it is possible, as pointed out earlier, for a corporation to return all its assets except to the extent needed to keep it solvent. Similarly it can, as we have seen, repurchase

its shares and thus denude itself of its assets until it reaches the level of bare solvency. It is true that when share repurchases are made by a corporation using the earned or capital surplus as the measure of its right to repurchase the shares, the surplus is restricted to the extent of the capital represented by the shares repurchased and rendered unavailable for dividend so long as the shares remain in treasury, but the surplus can be freed from this restraint by cancelling or disposing of the treasury shares. Hence it follows that it is possible under the Model Act for a company to return its assets voluntarily to the shareholders so long as it is and remains solvent.

In the opinion of the writer "reduction surplus" should be made unavailable for dividends (even to cumulative preference shareholders) or other distributions and for share repurchases, except with judicial sanction, as such payments are payments in partial liquidation of the corporation. The English example, which has worked well in Britain and the Commonwealth, has much to commend it and the writer strongly favours it. Insofar as the Model Act and the American statutes which are based on it do not distinguish between reduction surplus and other kinds of capital surpluses, they ignore altogether interests other than those of the immediate shareholders.[313] The writer is also opposed to setting free surplus frozen upon repurchase of shares by the corporation cancelling the treasury shares. The Model Act, as well as many American statutes, in effect repudiate the concept of stated capital as a cushion for creditors.

Whether distributions should be permitted out of other kinds of capital surpluses is a question on which jurisdictions may differ. But

with the low-par shares of today, there is justification for the law to accord special treatment for share premium amounts. The law should either totally forbid dividends out of paid-in surplus or impose a ceiling on the premium at which par value shares may be issued and the allocation to surplus of the consideration received for the issue of no-par shares. This will render the low-par device unattractive as a tool for the creation of artificially huge surpluses. It is indeed necessary for the law to pay attention to discouraging the issue of shares of very low par values at high premiums.

14. Protection of Creditors

It seems to be common to all jurisdictions that a company should not pay a dividend when it is insolvent, or would by such payment be rendered insolvent. The English Act of 1855 which introduced limited liability did contain such an express provision.[314] Many American and Canadian statutes still do. But the English Acts have ceased to contain this requirement since the Act of 1862. The Indian Act and several American statutes, notably Delaware, do not expressly prescribe the rule. However, there can be no doubt that it is a basic norm of the dividend law of every jurisdiction.

Even when the rule is embodied in a statute, quite often the term "insolvent" is left undefined, as is the case in several Canadian jurisdictions. Among the jurisdictions which define the term, some define it in the commercial or equity sense (of inability to pay debts as they become due in the usual course of business)[315]; some in the

bankruptcy sense of the amount of debts exceeding the value of the assets; and others in both senses.[316]

It is submitted that (i) this rule which is a minimal protection for creditors, should be expressly contained in the statute; (ii) insolvency should be defined both in the equity and bankruptcy senses; and (iii) guidelines for the determination of solvency and insolvency should be prescribed by the statute.

A good guideline for determining insolvency is contained in the winding-up provisions of the English Act. It provides as one of the grounds for compulsory winding-up of companies that "the company is unable to pay its debts,"[317] and proceeds to explain that[318]

> "A company shall be deemed to be unable to pay its debts —
>
> (a) if a creditor, by assignment or otherwise, to whom the company is indebted in a sum exceeding fifty pounds then due has served on the company, by leaving at the registered office of the company, a demand under his hand requiring the company to pay the sum so due and the company has for three weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditors; or
>
> (b) if . . . execution or other process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part; or
>
> * * *

> (d) if it is proved to the satisfaction of the court that the company is unable to pay its debts, and, in determining whether a company is unable to pay its debts, the court shall take into account the contingent and prospective liabilities of the company."

It may be noted that paras. (a) and (b) of the section lay down presumptions of commercial or equity insolvency;[319] and para. (d) deals with bankruptcy insolvency.[320] These provisions can suitably be adapted for the law of dividend. If a company may be compulsorily wound up for these reasons, it is only appropriate that the company should be forbidden to pay dividends for the same reasons.

In determining whether a company is insolvent in the bankruptcy sense, the book values of the corporation's assets should not be the relevant criteria. The directors should be required to take into consideration the going concern value of the corporate venture and "the present fair saleable value"[321] of such of its assets which could be sold in the event of liquidation. The valuation of assets by the accountant in drawing up the balance sheet does not adopt either of these criteria and is, therefore, from the point of view of the creditor, no valuation at all. It takes no account of any change in the historical cost of fixed assets other than an arbitrary depreciation which fails to take note of price-level changes. It shows preliminary and organizational expenses, such as incorporation fees, legal fees and costs of financing, as assets. It sometimes even shows among assets "early operating deficits and possibly also interest on funded debt not earned during /the/ developmental years."[322] It may

include the value of the consideration paid for goodwill in relation to any business acquired by the company, but take no further note if its value diminishes. From the creditors' point of view these assets may be worth nothing at all.

The Model Act expressly protects a director who assented to the declaration and payment of a dividend or other distributions by the corporation, if he "relied and acted in good faith upon financial statements of the corporation represented to him to be correct," and if "in good faith in determining the amount available for any such dividend or distribution he considered the assets to be of their book value."[323] It is submitted that it is unsound to permit directors to rely on book values when they are the only persons in a position to judge the disparity between the book values of the assets and their market values.

The duty must be imposed upon directors to satisfy themselves before declaring or recommending a dividend that (i) the company is able to meet the current demands upon it and has not defaulted in meeting them and that (ii) the existing and probable assets of the company would be sufficient to meet its debts and liabilities, presently due as well as becoming due in the future, contingent and prospective. They should be made liable for not exercising due care and skill in thus satisfying themselves. The writer is of the opinion that this will cause no unreasonable burden on the office of director, but enhance its responsibility. Even so, it will be difficult to hold directors liable for errors of judgment, if they have acted bona fide and with due diligence. The solvency requirement is, therefore, not a complete or adequate safeguard

for creditors. Despite its inadequacy, it is a salutary norm for directors to heed before they proceed to declare and pay a dividend and should be made as efficacious as possible.

Reform of the law of dividend is long overdue. Such reform should be undertaken in the comprehensive context of all allied problems of corporate finance, including reduction of capital. On the state of the American state statutes Professor William Paton makes the following indictment: "Most statutes are founded on archaic concepts, are couched in muddy language, and show little evidence of an understanding of the fundamentals of corporate accounting and finance."[324] But the remedy that he suggests is worse than the disease when he remarks that "if the whole structure [of the state statutes bearing on corporate capital, earnings, and dividends] were swept away it would be a blessing."[325] According to him the statutory provisions are based on the unfounded assumption that "investors and their elected representatives don't know enough to run the corporate enterprise and make the essential operating and financial decisions without special legislative guidance."[326] The writer is of the opinion that the law suffers from a lack of proper legislative guidance and needs to be reformed, not to eliminate legislative controls but to make them more effective.

A recent issue of TIME magazine has — justifiably, it is submitted — made the following indictment against law and accountancy in a full page item entitled "Cooking the Books to Fatten Profits":[327]

"There are dozens of legal ways in which companies can juggle their books to inflate profits. The most common objectives are to camouflage a poor earnings performance, to help lift the price of common stock, and to promote — or fend off — mergers. Many conglomerate corporations owe their recent ascendancy at least in part to such practices. The trend has spread confusion among security analysts and investors; it has fired acrimonious debate among businessmen and accountants; it has provoked concern among regulatory authorities.

"Accounting practices, on which laymen rely as a warrant of truth, have grown increasingly elastic. Tax laws give companies great latitude in deciding how to treat both assets and costs that affect profits. Frequently, companies quite legally report results one way to the public and another to the tax collector.

"An increasingly popular stratagem is for companies to reduce the rate at which they write off — that is, deduct from their taxable income — the cost of new facilities. The results can be astonishing.

* * * * For Trans World Airlines, depreciation changes converted what would have been an $11.5 million loss from airline operations into a $9.1 million pre-tax profit.

"Confusion has arisen despite — and partly because of — a seven year effort by the American Institute of Certified Public Accountants to standardize corporate reporting.

"No wonder ordinary investors are baffled. Even professional security analysts have some trouble figuring out how some companies have really performed . . . . Obviously, the accountants must produce some tougher yet simpler rules for reporting. Their failure to do so has helped to promote the very thing that they hoped to discourage: a speculative fever, fired up by reports of earnings that look fatter than they really are."

Surely these strong words do not support Professor Paton's plea that the law should stay away from this area and leave the responsibility to the investors and the businessmen.

F. SUMMARY OF CONCLUSIONS

1. The law of dividend should be founded upon an over-all policy of maintenance of assets of the value of the shareholders' investment in the corporate enterprise — that is, maintenance by the corporation of net assets of a value at least equal to the shareholders' investment — with one exception to this rule indicated later. The time-honoured rule that "no dividend shall be paid which will impair the capital of the company" will serve this policy, provided that we define "capital" to mean the total investment made by the shareholders in the company in respect of the shares issued to them. "Capital" should be defined to refer to the total consideration received or to be received by the company for the allotment of its shares. "Capital" thus defined will include the paid-in surplus in respect of the issued shares. It is in this sense that the word "capital" is hereinafter used; and not in the sense of share capital or stated capital.

2. Dividends or distributions out of share-premium amounts (except to the extent indicated above), reduction surplus and capital redemption reserve fund (so long as the redeemed or repurchased shares have not been re-issued) should be forbidden, unless sanctioned by the court in proceedings analogous to reduction of share capital.

3. Profit should be defined to mean the excess of the value of the net assets over the amount of capital as defined in section 1 above. If revaluation of fixed assets is permitted, then companies should be required to revalue the shareholders' investment in current dollars.

4. Rules must be expressly laid down as to when the income statement should or should not be by-passed. In particular, depreciation and bad debts should be provided for out of income. Operating losses should be written off to earned surplus. But companies should be permitted to write off capital losses (other than depreciation and bad debts) to the capital account, provided that due publicity is given of such diminution of capital.

5. Special registration must be provided for in the case of wasting-asset companies as defined by the statute.

CONCLUSION

CHAPTER 11

SUMMING UP : THE NEED FOR A CLEAR POLICY FOR THE RAISING AND MAINTENANCE OF CAPITAL

The conclusion is inevitable that the spirit of laissez faire and "enablingism" has stood in the way of founding our laws on a rational policy for the raising and maintenance of capital. Obscurities of policy and ambiguities of terminology characterise the law of corporation finance to a greater or lesser extent in all jurisdictions. It is the responsibility of the law to lay down the rules of the game before the participants may be afforded the freedom to play each according to his skill and ability. This is no less true in the case of the corporate business enterprise. It is difficult to understand why the participants in a corporate enterprise should be left free to frame their own rules of the game and why the law should abdicate its regulatory function. The purpose of this chapter is to clarify our goals and appraise the extant patterns of prescriptions in the light of the goals.

A. CLARIFICATION OF GOALS

The clarification of goals in the context of a comprehensive reform of corporation law will have to take into account the totality of the role and position of the corporate enterprise in a given society, but we shall here restrict our attention wholly and solely to the function of

the corporate enterprise as an economic organization. Such a delimitation necessarily leaves us with a less than complete picture of all the relevant issues and perspectives, but it is perhaps inevitable in a study restricted to the traditional area encompassed by the companies Acts. We will do well first to indicate the issues and problems we exclude in thus delimiting the scope of our inquiry, vital and important though they are.

We shall be excluding altogether from our consideration antitrust policies which should be applied to corporate activities. Antitrust issues are of tremendous importance in the context of the modern corporation with enormous assets and with its control concentrated in the hands of a professional class of managers which is often a self-perpetuating oligarchy. The enforcement of a pro-competitive public policy presents difficulties of enormous proportions where the only competitors are a few giant-sized business corporations,[1] or where the competition is between giant and small-sized corporations. The enormous market power of the modern "metro-corporation" is often not amenable to the controls of the ordinary market forces — the "invisible hand"; instead they dominate and control the market forces themselves.

Nor shall we concern ourselves with the other consequences of the economic power of giant corporations.[2] For example, the wage pattern set by a giant corporation may have an impact on the wage levels in a whole industry and may produce inflationary pressures in the economy as a whole. A strike in a modern corporation may result in retrenchment of workmen in related enterprises, increase unemployment, and diminish public revenues. The consequences may transcend national

frontiers and may have international repercussions.[3]

Antitrust questions assume great importance particularly in corporate mergers and take-overs.[4] All these fall outside the scope of this study and our attention is limited to (i) the protection of public interest in the economic soundness of corporate business enterprise, (ii) the protection of shareholders and classes of them, and (iii) protection of creditors and classes of them.[5]

(i) Sound Capitalization

Sound capitalization, to begin with and at all times, is obviously a sine qua non for the protection of the public interest, including the welfare of the working classes and the economy as a whole, as well as shareholders and creditors. This must therefore be the foundation on which the principles of the law of corporation finance are formulated. Sound capitalization is one basic safeguard against business failures and even though it is not possible for the law to ensure that every corporation will be a financial success, yet it can provide broad measures to prevent business failures resulting from unsound capitalization. We use the term "capitalization" here not only in the narrow sense of the share capital structure, but in its wider connotation, viz, the composition of its entire assets and liabilities. Of course the company statutes cannot lay down guidelines for financial management as a whole, but it is possible to provide for some built-in safeguards: e.g., the rules for the determination of the dividend fund. Though business failures occur due to a wide variety of causes and circumstances, ranging from neglect and

fraud to incompetence and inexperience,[6] a prime cause is poor financial planning and management. As it has been pointed out,[7]

> "An analysis of unsuccessful businesses shows evidence of such weaknesses as insufficient working capital, over-extension of credit, overinvestment in inventory, excessive debt, and excessive withdrawals of profits. Yet, each one of these may be traced back at least one step: for example, insufficient working capital to lack of intelligent planning, overextension of credit to a tough competitive situation, or overinvestment in inventory to a misjudgment of future trends in demand. They may also be interrelated: for example, a possible relationship between excessive debt, excessive withdrawals of profits, and insufficient capital."

Prevention of business failures is at once a safeguard for the protection of all the interests involved in a corporate business enterprise.[8] The importance of the problem can be illustrated by the following statistics of business failures in Canada falling under the federal Bankruptcy and Winding-up Acts, not including the failures of individuals such as wage-earners, salesmen and executive personnel.

	Total		Ontario		Quebec	
Year	No.	Estimate in $'000	No.	Estimate in $'000	No.	Estimate in $'000
1957	2,213	79,863	630	31,349	1,359	37,266
1958	2,125	72,778	545	17,884	1,376	40,250
1959	2,229	95,786	658	34,156	1,366	50,034
1960	2,828	174,548	914	91,090	1,638	61,851
1961	2,659	116,520	932	48,352	1,450	49,133
1962	3,190	149,440	1,177	55,946	1,694	77,002
1963	3,677	195,602	1,389	84,260	1,987	91,467
1964	3,499	208,734	1,281	71,193	1,872	111,172
1965	3,295	393,650	1,248	258,934	1,748	107,182
1966	3,007	247,467	1,022	108,631	1,698	112,681
1967	2,631	218,063	893	60,422	1,446	123,457
1968 Jan. to Sept. (9 months)	1,874	138,872	692	51,037	921	65,388

Of the 3,007 business failures involving estimated liabilities of $247,467,000 in 1966, 323 were in the manufacturing industry (with a total liability of $42,121,000), 1,236 in trading (liability $57,482,000), 559 in construction (liability $38,902,000), 95 in finance, insurance and real estate (liability $62,427), 168 in transportation, communication and other utilities (liability $8,442,000), and 470 in service (liability $21,350,000) industries.[9]

The following are the statistics of American business failures for the period from 1957 to 1966.

Year	Total No. of concerns in business in '000	No. of failures	Rate per 10,000 concerns	Current liabilities in $'000	Average liability $
1957	2,652	13,739	52	615,000	44,784
1958	2,675	14,964	56	728,000	48,667
1959	2,708	14,053	52	693,000	49,300
1960	2,708	15,445	57	939,000	60,772
1961	2,641	17,075	64	1,090,000	63,843
1962	2,589	15,782	61	1,214,000	76,898
1963	2,544	14,374	56	1,353,000	94,100
1964	2,524	13,501	53	1,329,000	98,454
1965	2,527	13,514	53	1,322,000	97,800
1966	2,520	13,061	52	1,386,000	106,091

These figures of business failures in America are more comprehensive than the Canadian as they include concerns discontinuing business following assignment, voluntary or involuntary petition in bankruptcy, attachment, execution, foreclosure, etc., voluntary withdrawal from business with known loss to creditors; also enterprises involved in court

action, such as receivership and reorganization or arrangement which may or may not lead to discontinuance of business; and businesses making voluntary compromises with creditors out of court. It must be noted that the liabilities exclude long-term publicly held obligations and similarly the off-setting assets are not taken into account.[10] The Canadian statistics do not include failures, sales and seizures outside the federal Acts and are therefore not complete.[11] They also do not indicate the total number of firms doing business in any year and therefore it is not possible to compare the figures of one year with those of another.

We can classify the statistics of business failures in America by size of liability as follows:

	1955		1960		1965		1966	
Size of Liability	No. of failures	Current liability $'000	No. of failures	Current liability $'000	No. of failures	Current liability $'000	No. of failures	Current liability $'000
Under $25,000	7,197	72,361	8,572	92,241	6,074	70,611	5,501	66,84
$25,000 to $100,000	2,916	134,003	5,078	234,962	5,266	251,041	5,332	254,69
Above $100,000	856	243,016	1,795	611,427	2,174	1,000,014	2,228	1,064,12

Though the rate of business failures compared with the total number of businesses is insignificant in America, yet the annual number of failures and the aggregate current liabilities of the failed concerns are not in themselves insignificant. Of the 13,061 failures in 1966, the size of liability of 2,228 exceeded $100,000 each. In Canada, out of 2,631 business fail-

ures in 1967, the size of liability of 371 exceeded $100,000, of 358 ranged between $50,000 to $100,000, of 558 between $25,000 and $50,000, of 1,227 between $5,000 and $25,000, and only of 117 below $5,000. Of the 1,874 business failures in Canada in the first three quarters of 1968, the size of liability of 211 exceeded $100,000, of 242 between $50,000 and $100,000, of 428 between $25,000 and $50,000, of 914 between $5,000 and $25,000, and of only 79 below $5,000.[12]

The problem of business failures is not therefore so insignificant that it can be considered irrelevant in formulating the policies for prescriptions in the law of corporation finance. Quite often the chief victims of business failures are the unsecured creditors, employees and shareholders, but even the plight of the secured creditor is not always too safe. In the corporate sector of business with limitation of liability, the legal regulation of capitalization is some safeguard for creditors and shareholders. Though it is inadvisable for the law to regulate the conduct of business, yet broad measures are desirable to prevent inadequate capitalization, or dissipation of the assets of a corporation.

(ii) Protection of Shareholders

The protection of shareholders and classes of them is an equally important goal because corporate enterprise as an economic vehicle is dependent on the investors' confidence for its very survival and success. The law should aim at creating conditions conducive to the promotion of investors' confidence in the corporate form of organization of business.

The area of shareholder-protection is extremely wide in scope ranging from the protection of the public invited to become shareholders of a corporation to the protection of minorities and classes of shareholders. Great advances have been made in the United States in this area for obvious reasons. More than seventeen million persons held shares according to a 1962 count as against six and a half millions in 1952. In 1965 the figure was estimated to be 18 millions[13] and the number has continued to grow ever since. Besides there are "countless others" who participate in the market through mutual funds, pension trusts, insurance companies, banks and other financial institutions.[14] The investment trusts which have grown up only in recent decades were estimated in 1965 to have $30 billion worth of securities and these are owned by small shareholders in the length and breadth of the country.[15] Of the more than one million incorporated companies in America, about 2,500 are listed on national securities exchanges, somewhat over half of them being on the New York Stock Exchange. The securities of 26,000 others are quoted and have some degree of trading.[16] About 6,000 companies have 300 or more shareholders and comprise the bulk of the trading on the stock-exchanges or the over-the-counter markets.[17] Trading on the stock exchanges has increased from $28 billion to $75 billion in the decade from 1955 to 1965.[18] On the New York Stock Exchange there were 9 billion shares listed in 1965 which represented $500 billion valued at market quotations.[19] The registration statements filed with the S.E.C. during the fiscal year 1964-65 numbered 1,121 and involved $17 billions of public offerings, as against 514 registration statements involving public offerings of less than

$2\frac{1}{2}$ billion in the first five years of the Commission's life.[20] These staggering statistics are sufficient to justify the active role played by the S.E.C. in the field of investor-protection in that country. That its role has been effective in promoting investor confidence in the securities market is a great triumph of that administrative body. But the S.E.C. cannot obviously police all the million and more companies and its place has to be filled by the States' Securities administrators.

We are not here concerned with the whole gamut of investor-protection, but shall confine ourselves to the protection of the proprietary interest of the preference shareholders of a corporation and in particular their right to dividend and the protection of their investment. Thus we exclude from our concern any survey of prospectus requirements, proxy-rules, insider-trading, and other areas which are by themselves very important indeed. We are concerned (i) with the maintenance of assets as a means to the protection of the shareholders' investment and (ii) with the protection of the proprietary rights of classes of shareholders. To the latter belong the preferential right to dividend and to assets in winding-up of special classes of shares.

(iii) Protection of Creditors

Protection of unsecured trade and non-trade creditors is again an important goal as they are often the first casualties of business failures. A doctrine of maintenance of assets is a valuable safeguard for them. The philosophy that creditors should protect themselves with suitable stipulations in their contract with the debtor corporation is appropriate only in the case of institutional or professional lenders.

B. PROTECTION OF CREDITORS : AN APPRAISAL OF THE PREVAILING LEGAL DEVICES

We shall first examine whether the prevailing legal devices and institutions are adequate for the protection of the "creditors" of corporations. The word "creditor" is used here in its widest connotation to include secured and unsecured creditors, contingent and prospective creditors, and indeed every one who will be entitled to prove in the immediate winding up of a corporation. The American Uniform Fraudulent Conveyances Act defines a "creditor" as "a person having any claim, whether matured or unmatured, liquidated or unliquidated, absolute, fixed or contingent," and the United States Bankruptcy Act defines a "creditor" to "include anyone who owns a debt, demand, or claim provable in bankruptcy . . . ."[21]

The creditors' ultimate interest of course consists in the ability of the corporation to satisfy in full their claim to principal and interest when it becomes due. In other words, their main concern is that the corporation should have adequate liquid assets to meet their claim in full upon maturity and that it will have assets of sufficient value to satisfy their claim in the event of the liquidation or winding-up of the corporation. All their other interests are only incidental to this main concern. For instance, their interest in the sound management of the company extends only to the extent that the management will not, either due to incompetence, foolhardiness or dishonesty, dissipate or squander away the corporation's assets to their prejudice or detriment. They have no direct interest in

profit-maximization, as they have to gain little by increased profits and are only entitled to their fixed rate of interest.

What safeguards does the law provide to ensure that a corporation does not dissipate or squander away its assets to the detriment of its creditors?

Creditors have little control over the conduct of the affairs of the debtor corporation except to the extent that they have stipulated for and become entitled to such control under the provisions of a specific contract which they may have entered into with the corporation. Thus, they have no right conferred by law to elect or remove directors, or even attend the general meetings of the companies, or inspect their accounts or other books, or question the wisdom or propriety of the decisions of the management or shareholders.

The creditor's right is to sue for the amount due to him upon maturity, to attack fraudulent conveyances and preferences, and to petition for winding up of the company. But these rights are no greater than those of the creditor of any individual, partnership, or unincorporated associations whose liability for debts is unlimited. While extending the privilege of limited liability to corporations, the law has not chosen to enlarge the rights or powers of their creditors. The creditors of a limited company have nothing to look to for the satisfaction of their claims against their impalpable and invisible debtor who has no body to be kicked and no soul to be saved, except the assets of the legal person and they have no control over the disposition of those assets by the debtor corporation, save those which they have been wise enough to bargain for.

The doctrine of ultra vires which was conceived of as a protection for creditors as well as shareholders, as it sought to prevent the dissipation of a company's assets in the pursuit of unauthorised activities,[22] has been successfully frustrated by the modern omnibus objects clauses in charters,[23] and by statutory developments authorising all-purpose companies. Thus what was intended as a creditors' protection has paradoxically turned out to be a creditors' trap.[24] But even in its heyday the intended protection of the doctrine was only an incidental benefit to creditors as they could not institute actions to enjoin corporations from straying outside their authorised domain.[25] But even as an incidental protection, the doctrine did serve to evolve corporate norms which enured to the benefit of creditors. Thus it was ultra vires of a corporation to buy its own shares or pay dividends out of capital, because a corporation could not employ its capital or assets for unauthorised activities or purposes. The English courts used the doctrine in conjunction with the statutory injunction against reduction of capital so as to disable companies from assuming power in their charters or by-laws to purchase their own shares, or traffic in their shares, or pay dividend out of capital. Such acts cannot be made intra vires by assuming the power in the charter or by-laws, for it would amount to a power to reduce capital without judicial approval contrary to the statutory requirement. The "capital" of a company may become diminished or may even be lost in the pursuit by a corporation of its authorised purposes, but it should not be reduced in any other way involving the volition of the company unless the statutory procedure is complied with. In other words the English philosophy of maintenance of

assets is not a positive philosophy that a company should preserve intact assets of a value equal to the nominal amount of issued share capital, but a negative one, viz. that a company should not reduce the value of its assets below the nominal amount of its issued share capital by returning or distributing any part of it to its shareholders or by relinquishing its claim to unpaid subscriptions due by them. In fact the only distribution that a company may make to its shareholders without judicial sanction is dividends out of profits. The only test for that purpose is whether the company has a "profit". If there is a profit, a dividend is lawful irrespective of whether the assets of the company after the payment of the dividend will be greater or lesser in value than the amount of issued share capital. The dichotomy is between "profit" and "capital" and the question in every case is whether a given fund is the one or the other. Dividends out of profits are always lawful irrespective of the value of the capital provided that the capital is sufficient to pay the creditors. But distributions out of capital are never lawful unless authorised by the court, because the Act forbade "reduction of capital and shares" without confirmation by the court obtained by the company by complying with the prescribed procedure. Under such a theory the profits of a going concern belong to the shareholders and its capital is the security for creditors. Such an approach permits scope for the elimination of the concept of share capital altogether, if the norms for the determination of "profit" are clearly enunciated, but the English law missed that opportunity. It was only as late as 1947 that the law clarified that share premium amounts are not "profit" and even now there is no further illumination

available in the statute about the ingredients of profit. From 1908 the Act only forbade the reduction of "share capital" without judicial confirmation, which meant that the funds or assets of a company other than the part of it attributable to share capital could be reduced without judicial sanction. It followed then that profit meant that which was not share capital. Share premium amounts were therefore profits available for dividend. A company may distribute its profits as dividend even if the share capital is impaired, provided that the impairment is not due distributions made by the company or due to waiver by it of its claim to unpaid subscription. In the result there is no positive requirement that a company should preserve intact even the share capital before it may make a dividend or other distribution to its shareholders. In short the English law failed to evolve a theory of maintenance of capital because of its failure to evolve a theory of profit.

The English Act, however, has curtailed the scope for payment of dividends by forbidding such payments out of share premium amounts and from profits to the extent that redeemable preference shares have been redeemed otherwise than out of the proceeds of an issue of shares made for the purpose. This means that the English law aims at the maintenance of assets of a value at least equal to the value of the consideration received by it for the allotment of its shares except to the extent to which it has become lost otherwise than by the company's distribution to its shareholders or waiver of unpaid subscriptions.

In sum, we do not have a single unified theory of maintenance of capital, but a package of principles aimed at the preservation as far

as possible of the shareholders' contribution to the company's assets. But creditors are protected by the rule that dividends should not be paid if a company is, or will thereby be rendered, insolvent, and by the statutory right to object to a reduction by a company of its share capital, or share premium account, or capital redemption reserve fund.

The American statutes purport to follow a definite policy of maintenance of capital. We may illustrate this with reference to the Model Act. (1) The Act permits reduction of stated capital by charter amendment at any time, but neither court approval is necessary nor are creditors entitled to object to the reduction. (2) The surplus created by the reduction of stated capital is capital surplus. (3) Capital surpluses are available (a) for "distributions" to shareholders if authorised by the charter or by the requisite shareholder votes and (b) for payment of cumulative preferential dividends in the absence of earned surplus. The only requirement for the protection of creditors in such cases is that the company should be, and remain, solvent. (4) A deficit in the earned surplus account may be eliminated by the application of capital surplus or stated capital — i.e., even by impairing stated capital. (5) Dividends may be paid only out of earned surplus, but if a deficit in the earned surplus account has been eliminated by the application of capital surplus or stated capital, subsequent profit, income or gains can be treated as earned surplus available for dividend without making good the impairment of stated capital. The only safeguard for the creditors is that the company should be and remain solvent. (6) An alternative provision introduced in 1965 allows nimble dividends out of the earnings of the current fiscal year and the next preceding fiscal year taken as a

single period. (7) Share repurchases are permitted (a) from earned surplus and (b) from capital surplus subject to charter authorisation or the requisite shareholder votes. Again the safeguard for creditors is that the company should be and remain solvent. (8) Share repurchases out of stated capital are permitted for redemption or purchase of redeemable shares, for the purchase of shares of a holder entitled to appraisal right, for eliminating fractional shares, and for collecting or compromising indebtedness to the corporation. The safeguard for creditors is that such redemption or purchase can be made only if the corporation is and will remain solvent.

It follows that the Model Act follows a theory of maintenance of assets of a value sufficient to keep it "solvent" and this is regarded as sufficient to protect the interest of creditors. Solvency is defined to mean ability to pay debts as they become due in the usual course of business — i.e., the corporation should be, and remain, solvent in the commercial or equitable sense. This is of course satisfactory to the extent that it goes, but the interests of creditors whose claims have not yet matured can be protected only by ensuring that the company will have adequate assets to satisfy their claims when they mature. The Act purports to protect them by limiting dividends to earned surplus, distributions to capital surplus, and share repurchases to either kind of surplus. As capital surplus can be created by the reduction of stated capital and as an earned surplus might exist despite an impairment of stated capital, it is clear that the Model Act does not require companies "to preserve an amount of the assets of the corporation equal to the

legal capital as a safety margin for the benefit of creditors,"[26] but only to preserve sufficient assets to meet their debts as they accrue. In other words the Model Act does not espouse a philosophy of maintenance of stated capital, i.e. of assets of a value at least equal to the amount of the nominal stated capital.

In the opinion of the writer this approach of the Model Act is basically unsound for several reasons: (i) First, we know only too well that corporate accounts are not maintained in a way appropriate to reflect the current saleable value of the assets of a company which is the only kind of valuation of relevance to creditors, present and potential. In fact it has been repeatedly asserted that the accountant is not an appraiser and does not pretend or purport to be one. But yet the Model Act authorises the directors to base their decisions to make dividends, distributions or share repurchases by relying (in good faith of course) upon financial statements of the corporation represented to him to be correct by the president or officer of the corporation having charge of its books of account and in particular authorises directors to rely upon the book values of assets.[27] (ii) The policy of allowing freedom to companies to denude themselves of their assets to the barest limits of solvency may be justifiable only if thereafter the company will cease business and wind-up its affairs. If on the other hand the company intends to and does carry on business, the creditors are thereafter exposed to the entire risk of the business. If the business collapses, the loss will fall on creditors; if the business prospers with the creditors' moneys, the profits will entirely benefit the management and the shareholders; and the control

will continue to be with those who have little risk to face, but all benefits to enjoy. It is indeed surprising that the Model Act's example appealed to many American jurisdictions which revised and "modernized" their corporation laws in recent years, but a few have preferred caution while following in its footsteps. North Carolina has adopted a doctrine of maintenance of assets by a corporation of a value at least equal to twice the amount of its debts and Texas renders the directors liable to existing creditors in cases of distribution of reduction surplus which results in the corporation becoming insolvent.[28]

The inadequacy of the Model Act's provisions for the protection of creditors is too obvious and we may compare with them the provisions of the American Uniform Fraudulent Conveyance Act which are also intended for the protection of creditors in general.[29] The Uniform Act defines "insolvency" thus:

> "§ 2. — (1) A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."

Instead of the "present fair salable value" of the assets of the corporation, the Model Act prefers the "book value". Instead of the "probable liability" of the corporation, the Model Act concerns itself only with the present debts and ignores contingent and probable liabilities. In determining solvency for the purpose of the Uniform Act, book values are not conclusive evidence on the issues of saleable value of assets and, on the other hand, liabilities including probable liabilities must be considered even though they are not presently ascertained.[30] It is not clear to the

writer why the directors of a corporation should not be required to satisfy themselves that the corporation is not, and will not be rendered, insolvent in the sense in which that term is used in the Uniform Fraudulent Conveyance Act before they declare dividends or decide to make distributions and repurchases.

The Uniform Fraudulent Conveyance Act has been adopted in 24 States including New York and Delaware. These State statutes define "conveyance" to include "every payment of money, assignment, release, transfer, lease, mortgage or pledge of tangible or intangible property, and also the creation of any lien or incumbrance. The Acts declare when a conveyance is fraudulent and specify the rights of creditors whose claims have matured and those whose claims have not matured. The following are some examples of fraudulent conveyance under the Acts:

(i) Every conveyance made or obligation incurred with actual intent to defraud, delay, or hinder creditors, present or future, is fraudulent as to both present and future creditors.

(ii) Every conveyance made or obligation incurred without fair consideration[31] when the person making it or entering into it intends or believes that he will incur debts beyond his ability to pay as they mature, is fraudulent as to both present and future creditors.

(iii) Every conveyance made without fair consideration when the person making it is engaged or is about to engage in a business or transaction for which the property remaining in his hands after the conveyance is an unreasonably small

> capital, is fraudulent as to creditors and as to other persons who become creditors during the continuance of such business or transaction without regard to his actual intent.
>
> (iv) Every conveyance made or obligation incurred without fair consideration by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent.

A creditor as to whom a conveyance or obligation is thus fraudulent has the following remedies: (a) If his claim has matured he may (i) disregard the conveyance and attach or levy execution upon the property conveyed or (ii) have the conveyance set aside or obligation annulled to the extent necessary to satisfy his claim. (b) If his claim has not matured, he may sue (i) to restrain the defendant from disposing of his property or (ii) to have a receiver appointed to take charge of the property or (iii) to have the conveyance set aside or obligation annulled or (iv) for any other appropriate relief. Of course the creditor will have no remedy available against a bona fide transferee for fair consideration with knowledge of the fraud at the time of the purchase.

The substance of the Uniform Fraudulent Conveyance Act has also been incorporated in the United States Bankruptcy Act.[32] Section 67d of the Bankruptcy Act defines an "insolvent" in much the same way as the Uniform Fraudulent Conveyance Act and it reads:[33]

> "67d. (1) (d) a person is 'insolvent' when the present fair salable value of his property is less than the amount required to pay his debts."

If the debtor is adjudicated bankrupt, such fraudulent conveyances effected or fraudulent obligations incurred by him within the period specified in the Bankruptcy Act — usually one year prior to the filing of a petition initiating a proceeding under the Act by or against him[34] — are null and void against the trustee in bankruptcy, except as to "a bona fide purchaser, lienor or obligee for a present fair equivalent value."

The provisions of the Uniform Fraudulent Conveyance Act and the Bankruptcy Act apply to fraudulent conveyances made or fraudulent obligations incurred by corporations.[35] But the protection afforded by these Acts in the case of wrongful payment of dividends or other distributions or repurchase of shares is limited as they will amount to fraudulent conveyance only if at the time of payment or repurchase the corporation was insolvent or by such payment it was rendered insolvent. A conveyance made at a time when the corporation was solvent and which did not render it insolvent cannot be impeached even if it enhanced the hazard of creditors,[36] unless intent to defraud is shown.[37] The onus of proving insolvency will also have to be borne by the person who alleges that a conveyance was fraudulent.

Statutes to set aside conveyances made in order to delay, defeat, or defraud creditors can be traced back to the English Statute of Fraudulent Conveyances of 1570.[38] That Act condemned conveyances as fraudulent only when made with the intention to "hinder, delay or defraud" creditors. The merit of the American Uniform Fraudulent Conveyance Act is that in certain cases a conveyance is fraudulent without regard to the actual intention of the transferor and thus it eliminates the necessity

of presuming such intention as a matter of law as has been done in English and Canadian law.[39]

It is submitted that the Model Act is deficient in not defining insolvency in the same way as the Fraudulent Conveyance and Bankruptcy Acts and in not requiring the directors to satisfy themselves before declaring a dividend or making a distribution or share repurchase that the saleable value of the corporate assets are sufficient to meet its present and future liabilities. The onus must be squarely placed upon them to show that the corporation was solvent according to this standard at the time when they paid a dividend or made a distribution or repurchase. It will be unjustly onerous to place the onus on the plaintiff creditor to show that the corporation was insolvent at the time in view of the fact that ordinarily he has no access to the books and accounts of the company.

We may therefore conclude that the modern American statutes proceed on the philosophy that creditors should take care of themselves by stipulating for suitable terms to protect themselves at the time of extending credit to corporations. This is, however, possible only for institutional or professional lenders, but not in the case of trade creditors or others who have claims sounding in damages. We shall briefly notice the kind of protective covenants that are contained in bond and debenture indentures and other types of agreements for extension of credit in America. These will indicate the kind of safeguards which creditors consider necessary for the protection of their interests. It must, however, be mentioned that the covenants of a trust indenture are not always negotiated and bargained for between a corporation and each of its security-holders. In fact

"the indenture is almost never read by the security holders," other than the professional or institutional investor, and indeed few of them would understand it, even if they took pains to read that document.[40] The following are some examples of the covenants usually found in trust and debenture indentures for the protection of creditors:[41]

(i) Sinking fund provisions for the amortization of the debt, or part thereof, over the life of the issue — i.e., an orderly procedure for retirement of the debt;[42]

(ii) Provision for renewal or replacement of properties — i.e., to maintain the value of the security — and for maintaining the margin of the security by retiring debentures to an extent equivalent to the depreciation in the value of the security;[42a]

(iii) Covenants to maintain, preserve, and keep the properties of the corporation in good repair, working order and condition;[43]

(iv) Covenant to set aside from earnings each year proper reserves for renewals and replacements, obsolescence, depletion, exhaustion and depreciation;[43a]

(v) Covenants to keep true books of record and account, to file with the trustee balance sheets, income and surplus statements, and other pertinent financial statements, and furnish him with copies of all reports forwarded to stockholders or filed with the S.E.C. and such other information as may be prescribed from time to time by regulations of the S.E.C.[44]

(vi) Covenant to permit a representative of the trustee to inspect the books and properties of the company at all reasonable times upon request;[45]

(vii) Covenant to furnish such other data and information pertaining to the affairs of the company as the trustee may reasonably request.[46]

(viii) Covenant that working capital, i.e. the excess of current assets over current liabilities, should be maintained at a prescribed minimum level, or that the current ratio, i.e., the ratio of current assets to current liabilities, should be maintained at a prescribed proportion, or that the working capital should be maintained at least at a prescribed percentage of the funded debt;[47]

(ix) Covenant against the creation of additional debt — usually where the indenture relates to unsecured debentures;[48] and covenant against the creation of prior liens (popularly known by the misnomer "negative pledge");[49]

(x) Covenants restricting payment of dividends or purchase or retirement of shares;[50] Payment of dividends or other distributions is usually restricted to a portion of the earned surplus. Share repurchases are restricted often to amounts which would have been otherwise available for the payment of dividend. Further payments of dividends or other distributions are made conditional upon the company maintaining minimum ratios as prescribed by the indenture and not committing default of its covenants.[51]

(xi) Covenants extending such restrictions to the company's subsidiaries; and

(xii) Covenant against merger of the debtor company or sale or lease of substantially all of its assets.[52]

The above are only illustrations of the numerous provisions contained in debentures to "prevent the encumbering, dissipation, or use of company assets except in the orderly conduct of its business."[53] Certainly the philosophy of creditors is not one of "enablingism."

Of course it would be too difficult to anticipate every contingency and provide safeguards against them for the protection of creditors. Even if it were possible, it may be undesirable as it can be done only at the enormous cost of unduly fettering the hands of the management to the detriment of the creditors themselves as well as the shareholders and the corporation. Moreover, in many cases the indenture trustee may be able to detect violations of the covenants only ex post facto and too late. No remedy or redress may be available in such event against third parties who may have entered into transactions with the company unaware of the breach that it was committing of its contractual obligations. In the final analysis the protection of creditors is very much dependent on the credit of the borrowing company as a going concern — that is, upon its financial soundness — and the integrity of its management. While it would be undesirable, even if it were possible, for the law to prescribe rigid rules for the protection of creditors as are contained in these indentures, it is possible and proper that the law should, as far as possible, be founded on an over-all policy aimed at the prevention of the dissipation of a company's assets and the promotion of sound financial structures and decision-processes. This is even more

so when we bear in mind that not all creditors and prospective creditors, such as the suppliers of goods and services and the employees, are in a position to enter into indentures with the company binding it to restrictive covenants. If business corporations can tolerate restrictive contractual obligations intended for the protection of particular creditors, it is difficult to see why they should mind legal controls intended for the protection of creditors, shareholders and employees in general. The English requirement of judicial approval of reduction of share capital is a good example of such legal control, provided that the statutes will spell out the norms and guidelines for the exercise of judicial discretion. If the judicial process is dilatory and time consuming, administrative processes may be substituted therefor. But the philosophy that creditors should protect themselves by bargaining for suitable covenants and thus stipulating their own law ignores that not all corporate creditors will be in a position to look after themselves in that manner.

It must be mentioned that the British and other Commonwealth jurisdictions do not have statutes corresponding to the United States Trust Indenture Act of 1939 and therefore the legal protection afforded by that statute is not available in them. The Act of 1939 was the response of the United States Congress to the several abuses which existed and operated to the detriment of debt-security holders — e.g., broad exculpatory clauses which protected indenture trustees from liability even for their gross negligence and misconduct. In the absence of statutory regulation to ensure that the indenture trustee is both responsible and disinterested, it will be idle to hope that debt security holders can

adequately protect themselves by exercising their freedom to make contracts. Ontario alone has taken the first step recently to follow the American example and enact provisions in its proposed new business corporations statute on the model of the United States Trust Indenture Act.[54]

C. PROTECTION OF PREFERENCE SHAREHOLDERS: AN APPRAISAL OF THE PREVAILING LEGAL DEVICES

The shareholders of corporations are as much in need of legal protection as the creditors. Indeed in practice the distinction between the two classes of investors in corporate securities is very much blurred with the growth of the modern corporation. The classification of shares and the divorce between ownership and control have rendered the distinction merely legal and technical. It is hard to distinguish between income debentures, perpetual debentures and shares; between debentures and redeemable shares. Hybrid corporate securities have rendered obsolete the categorisation of shareholders and debentureholders as "owners" and "creditors." Both classes are at the mercy of the new breed of managerial class which wields "power without property." This development is inevitable in the modern economy. Power without property is not an undesirable development; but power without check or responsibility is dangerous. It is the proper function of the law of corporations to devise appropriate checks to ensure that the management is responsible and accountable to the various constituencies of the "little republics."

The securities laws and their administration in the United States and Canada have grown to be the bulwark of protection to the corporate security holders. Their main purpose is to regulate transactions in corporate securities with a view to promote investors' confidence in securities as forms of investment and in the securities markets. But the protection afforded by them is not unlimited. For instance the registration and prospectus provisions of the United States Securities Act of 1933 do not extend to non-public issues, to intra-state issues, and to the "exempted transactions" and "exempted securities" listed by the Act. The vast majority of corporate business enterprises are close or private companies. Besides corporate securities are often issued through private placements. These often fall outside the jurisdiction of the securities administrators. For instance, the Ontario Securities Act does not concern itself with private companies and the trading in their securities. It is to the corporation statutes that we have to look in order to find the structural safeguards for shareholders and creditors. In the United States the federal securities Acts apply to corporations created by state statutes and the securities issued by such corporations. As it has been observed, "the basic framework of the corporations with which the SEC is concerned — the basic structure of the relationships among those who manage and control the corporations and those who invest in their securities — is governed by State incorporation law."[55] The result of such federal regulation of state corporations is that "the application of provisions of federal law is in many cases dependent on state law."[56] For a smooth and efficient functioning of the two forces, it is necessary that their sources should work in harmony with a common

end and not neutralize each other by working at cross purposes. While the federal laws have progressed from regulation to more detailed regulation, the State laws in America have progressed from "enablingism" to greater enablingism to free the hands of managements.[57] That they can operate at times in opposite directions is quite possible. For example, many new state incorporation statutes contract the subject-matter jurisdiction of shareholders' meetings when the federal laws have, by the amendments of 1964, not only extended the proxy-rules, which prescribe the information to be made available to shareholders, to some unlisted companies, but also require such information to be made available to shareholders before the meetings even when their proxies are not solicited by the corporation — a step taken to prevent the evasion of the proxy-rules by selective proxy-solicitation or by no solicitation at all by corporations. In the result, if a shareholders' meeting is not necessary under State law for doing a corporate act, the federal proxy-rules do not apply.[58]

"Enablingism" or the "enabling Act" theory is not modern, but is just another version of laissez faire which has characterised the English company law ever since the Act of 1856 and which is still the predominant feature of Anglo-American incorporation laws. This theory treats the charter and by-laws as contractual documents and applies notions of freedom of contract to them and the relationships created by them. It proceeds on the assumption that it is no business of the State to interfere in intra-corporate matters and that they are the sole concern of promoters and shareholders. Allocation of risk, control and income is such an intra-

corporate matter to be decided upon by the concerned individuals or parties without external interference. Thus, "control" is an intra-corporate matter and therefore voting rights may be distributed in any way by the charter or by-laws. They may be denied to the vast bulk of shares, vested in a small group of founders' shares, and need not be equitably distributed. Consequently, important corporate acts, such as the declaration of dividend and appointment of directors, can be effected with the approval of a majority of the small group of holders of voting shares. If the holders of nonvoting shares are voiceless, it is just what they willingly agreed to by purchasing such shares.

It has, however, been recognized that laissez faire cannot always be allowed to reign supreme. The paternalistic Blue Sky laws in America and Canada bear witness to this awareness that freedom in order to be healthy has to be subjected to legal regulation against its abuse, i.e. the rule of law. Even outside the securities laws, this recognition is evident. For example, Ontario does not permit nonvoting common shares and the Dominion Act does not allow any one class of shares to have exclusive voting right under all circumstances. The Indian Act regulates the voting rights of shares in some detail. There are American statutes providing for mandatory cumulative voting for the election of directors. Indeed the federal control of corporate enterprise through the instrumentality of the S.E.C. and other federal administrative agencies in the United States has been so extensive and efficient as to cause concern to ardent protagonists of government nonintervention. It is submitted that a well-articulated policy of maintenance of assets is a necessary protec-

tion to the investors in the shares of companies and that its implementation is not repugnant to the spirit of free enterprise. If companies should have the freedom to allocate "income" as well as risk and control, and to create classes of shares with preferred and deferred rights to profit and assets, it is the function of the law to ensure that the freedom is not abused to defeat the legitimate interests and expectations of the investors in the different classes of shares. For the protection of the asset-preference of a class of shares it is necessary that the company should in the event of its winding up be left with enough assets to satisfy their claims after the prior claims of senior securities are met. In the case of noncumulative preference shares, dividends not declared in a year lapse forever and the law should protect them against the non-declaration of dividend by a company when it has enough profits available for the purpose without sufficient cause. In the case of cumulative preference shares, the cumulative right will be illusory unless the corporation has income to satisfy their claim when the company is a going concern, or will have sufficient assets to pay the accumulated arrears in the event of a winding up. It is not proper that the law should leave all these to be regulated by freedom of contract between the parties. We may illustrate here briefly the plight of the preference shareholders as a result of the policy of non-intervention in intra-corporate affairs which has guided our corporation laws.

(a) The Plight of the Noncumulative Preference Shareholder.

The plight of the holder of noncumulative preference shares with regard to dividend is far from enviable in any jurisdiction. As has been

observed, his "right is not to dividend but to preferential payment if and when a dividend is distributed."[59] If the dividends are not declared in any year, he can get nothing and is not entitled to claim it in any subsequent year.[60] He has no voice in the corporation's decision to declare or not to declare a dividend and is a helpless spectator, even if the corporation has a distributable profit available and has offered no justification for not declaring a dividend. Seldom is the right given to noncumulative preference shareholders obligating the company to pay a dividend whenever adequate profits exist. Thus their right to dividend is not only contingent upon the company earning a profit, but also upon the management and the voting shareholders being pleased to declare a dividend. The classic answer to their grievance is that they should have known what they were buying when they decided to invest in such shares. The corporation laws of all jurisdictions have chosen to stay out of this "intra-corporate" affair.

The American courts, however, attempted to protect such shareholders by holding that they "had a first claim to any net earnings of a corporation, during any single year, up to the amount of [the] noncumulative dividend," and that "if a corporation made net earnings, but failed to declare and pay them to the noncumulative dividend stockholder, the stockholder could subsequently claim that these net earnings, up to the amount of his dividend, should be paid to him before anything was declared and paid to common stockholders."[61]

The Supreme Court of the United States would, however, have none of such judicial nose-poking into intra-corporate affairs. The

Court rejected this line of reasoning in Wabash Ry. Co. v. Barclay[62] and held that "noncumulative dividends passed forever lapse." The railway company organized in 1915 had net earnings in most of the years, but it preferred to expend it on additions and improvements to its property and equipment rather than pay the dividend upon its 5% noncumulative preferred stock. These stockholders claimed that no dividend could be paid to junior classes of shares until the company had paid them the unpaid preferential dividends for prior fiscal years in which it had net earnings that might have been applied to them but were not. The Court, speaking through Mr. Justice Holmes, held that if the noncumulative dividends were not declared in any year, "the right for that year was gone." He reasoned that "If the right is extended further upon some conception of policy, it is enlarged beyond the meaning of the contract and the common and reasonable understanding of man."[63]

In short, intra-corporate relations are purely contractual in nature and the court's function is to enforce the contract. The only safeguard for the holders of such shares has to be sought from that contract and from the good sense of the management.[64]

(b) The Dividend Preference of Cumulative Preference Shares.

If the dividend preference of noncumulative preference shares is a right of uncertain value, that of the cumulative preference shares would prima facie appear to be safe and secure as all undeclared and unpaid dividends accumulate and do not lapse. Can these arrears be claimed in the winding up of the company if it goes into liquidation with the arrears unpaid?

Except where the dividends had been declared or where irrespective of a declaration the company is obligated to pay the dividend if profits are made,[65] English cases have held that the arrears of undeclared cumulative dividends cannot be claimed in a winding up.[66] In other words, to be entitled to claim undeclared cumulative dividends in a winding up, the right should have been, expressly or as a necessary implication, attached to them contractually and such a right will not be implied from the mere fact that the preferential right to dividend is cumulative. If so, cumulative preferential right to dividend is worthless in the event of the winding up of the company so far as undeclared dividends are concerned. Thus the risk of nondeclaration of a dividend is very real in the case of both noncumulative and cumulative preference shares; in the former case the undeclared dividend lapses annually and in the latter it accumulates and lapses together upon the winding up.

Recent English cases attempt to mitigate this hazard to cumulative preference shareholders by greater readiness to construe the by-laws of companies as giving them the right to claim undeclared dividends in the winding up,[67] but in the process the courts have been obliged to resort to fine distinctions which, as Gower remarks, "reflect no credit on the law."[68]

Even if arrears of cumulative preferential dividends are recoverable in the winding up, the further question arises whether they are recoverable only to the extent that the net assets represent the earned surplus which might have been distributed by way of dividend. Here again there is judicial uncertainty.[69]

In sum, the dividend-preference of cumulative as well as non-cumulative preference shares is far from safe and secure. They not only face the same risk as common shares, viz. that they cannot be paid a dividend if the company has no income, they face the further risk that despite the existence of profits, the company may declare no dividends for them. It has been aptly remarked that their right is not as much a right to the payment of a dividend as to prevent the payment of dividends to securities junior to them until they themselves are paid when the company is a going concern.[70] This should be poor consolation to the investor who looked for a safe investment in preference shares instead of the risk involved in venturesome common capital. The law has no help to offer to those who did not know to protect themselves. It will not interfere in intra-corporate affairs.

(c) The Asset-Preference of Preference Shares.

If the dividend rights of preference shares are precarious, how safe is their preferential right to repayment of capital in the event of winding up? Here again they are no less vulnerable. It should be obvious that in the event of winding up the claims of creditors have to be satisfied before their asset-preference can be claimed. Preference shareholders have ordinarily little control over the company incurring debts and liabilities. If the debts are incurred to expand the company's business and earn higher profits, the preference shares will gain nothing by the increased earnings, unless they have participating rights. If the debts are incurred to expand the business which subsequently meets with failure, the preference shareholders will find above them the superior claims of

the creditors. As Dewing has observed,[71]

> "The chief weakness of preferred stocks as investment securities lies in the ease with which an unscrupulous or improvident management may place bonds, notes, and bank debts ahead of an already existing issue of preferred stock sold originally on the assumption that there were no prior liens."

Ordinary share capital is often referred to as the risk or venture capital as distinguished from preference and loan capital and it is on this basis that the vesting of control in common shares by conferring voting rights primarily or exclusively to them is justified. But so long as the law fails to provide safeguards for the dividend and asset preference of the so-called preference shares, preference shareholders' risks are almost as great as those of ordinary shareholders. Flanked on either side by the creditors and the common shareholders, preference shareholders suffer the disadvantages of both with the advantages of neither. If preference shares are a hybrid of shares and debentures, they do not benefit their holders by the combination. It is submitted that here is an area in which the law should shed its inhibition to intrude into intra-corporate affairs and devise a framework in which the reasonable expectation of these security holders can be realized or at least not frustrated.

As Dewing points out, "If preferred shares are . . . to attain an investment standing, some kind of real and legally effective safeguards must be devised to protect their position" and he suggests appropriately that "The vitally important protection is that which safeguards them against the dissipation of the property of the business."[72]

The Model Act jurisdictions in America have paid attention to the protection of the asset-preference of preferred shares. The Model

Act forbids distributions from capital surplus (i) if accrued dividends on all cumulative preference shares have not been fully paid and (ii) if the distribution would reduce the remaining net assets below "the aggregate preferential amount payable in the event of voluntary liquidation to the holders of shares having preferential rights to the assets of the corporation in the event of liquidation."[73] But surprisingly no such restriction is imposed in the case of a corporation repurchasing its shares out of capital surplus.[74] Moreover, unless the criteria for the valuation of assets are agreed upon, rules for maintenance of assets of a prescribed value become illusory and unreal.

Every one of the fundamental concepts underlying our laws of corporation finance — "capital", "value", "profit", to mention only a few — is notoriously ambiguous and the accounting principles by which we measure them are imprecise. The rules of the law of corporation finance are not founded on any sound economic policy. A meaningful policy of maintenance of capital presupposes that the fundamental concepts are precise and clear and that there are definite rules to ensure the raising of capital in the first place. But our rules for the raising of capital are either a mockery or utterly ineffective. There is little safeguard against the formation of corporate bubbles and against stock-watering. The rules for the "maintenance of capital" are no better. Indeed we have failed to clarify its precise connotation, for the phrase may be, and is, used in widely differing senses — e.g. (i) maintenance of assets of a value sufficient to pay the debts in full (a) as they mature in the ordinary course of business or (b) in the event of liquidation;

(ii) maintenance of assets of a value sufficient to pay the debts in full and satisfy the asset-preference of special classes of shares in a winding up; (iii) maintenance of assets of a value at least equal to the nominal amount of issued share capital or stated capital; and (iv) maintenance of net assets of a value at least equal to the nominal amount of share capital or stated capital.

The raising and maintenance of capital is not an end in itself, but a means to promote the health and vitality of corporate enterprise as a form of economic activity. The aim is not merely to protect creditors by a "trust fund" doctrine of corporate capital, but the very enterprise entity in whose strength and survival many others have a direct or indirect claim or interest.

It is of course impractical to adopt a formula of maintenance of capital which will involve a continual "valuation" of the assets of a corporation and it is undesirable to subject corporate enterprises to continual regulation by governmental agencies. But it is necessary to evolve norms which will promote the preservation and prevent the dissipation of the assets of a corporation. "Enablingism" in the context of a well-structured and well-ordered institution will not enable any one or more groups, whether the management or the controlling shareholders, to defeat the legitimate interests and expectations of any other group among the corporate constituencies. It is the function and duty of the law to provide the framework and mechanism for such structure and order by formulating the rules of corporation finance upon a well-thought out policy for the maintenance of the economic capital (as distinguished from the "legal" capital) of business corporations.

(ii) maintenance of assets of a value sufficient to pay the debts in full and satisfy the asset-preference of special classes of shares in a winding up; (iii) maintenance of assets of a value at least equal to the nominal amount of issued share capital or stated capital; and (iv) maintenance of net assets of a value at least equal to the nominal amount of share capital or stated capital.

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NOTES

Notes to Foreword

1. The words "corporation" and "company" are here used interchangeably, the former being in predominant use in America and the latter in Britain and the Commonwealth. The American impact on Canadian terminology may be seen, for example, in the recent change in the nomenclature of the Dominion statute from Companies Act to Canada Corporations Act, R.S.C. 1952, c. 53, s. 1, as am. by Stat. Can. 1964-65, c. 52, s. 2 (effective 1 July 1965). Ontario made the switch over from the Companies Act to the Corporations Act in 1953. See the Corporations Act, 1953, Stat. Ont. 1953, c. 19 (effective 30 April 1954); now R.S.O. 1960, c. 71. This will be replaced by a proposed new Act to be called the Business Corporations Act. See Ontario Bill 125, 1st Session, 28th Legislature, which passed first reading on 17 May 1968.

2. "The word 'company' has no strictly technical meaning." Per Buckley, J., in In re Stanley, Tennant v. Stanley, [1906] 1 Ch. 131, 134. Similarly, "The term 'business corporation' has no precise technical significance." DAVIS, ESSAYS IN THE EARLIER HISTORY OF AMERICAN CORPORATIONS, Essay IV, 3 (Harvard Economic Studies, Vol. 16, 1917, re-issued 1965). (Note: Volume 16 consists of two books, separately bound, the first containing Essays I, II, and III, and the second Essay IV. Future references to the books are made as 1 DAVIS and 2 DAVIS).

3. HUNT, THE DEVELOPMENT OF THE BUSINESS CORPORATION IN ENGLAND 1800-1867, 158 (Harvard Economic Studies, Vol. 52, 1936) (hereinafter referred to as HUNT).

4. Id. 158 fn. 61.

5. American corporation statutes passed in the present decade are:

1961 New York Business Corporation Law effective 1 Sept. 1963.

1961 Utah Business Corporation Law effective 1 Jan. 1962.

1961 Wyoming Business Corporation Law effective 1 July 1961.

1962 Mississippi Business Corporation Law effective 1 Jan. 1963.

1962 South Carolina Business Corporation Law effective 1 Jan. 1964.

1963 Nebraska Business Corporation Law effective 19 Oct. 1963.

1964 Massachusetts Business Corporation Law effective 1 Oct. 1965.

1965 South Dakota Business Corporation Law effective 1 July 1966.

1965 Arkansas Business Corporation Law effective 31 Dec. 1965.

1965 Washington Business Corporation Law effective 1 July 1967.

1967 Delaware Revision Business Corporation Law effective 3 July 1967.

1967 Indiana Revision Business Corporation Law effective 3 July 1967.

1967 Montana Business Corporation Law effective 1 Dec. 1968.

1967 New Mexico Business Corporation Law effective 1 Dec. 1968.

For a list of corporation Acts passed since 1927, see FLETCHER, 1 CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS, 10 fn. 38 (1963 Revised Volume, 1968 Cum. Supp.).

Independent India enacted a wholly revised companies Act which became effective on 1 April 1956. It has been amended several

times since. The English Companies Act, 1948, 11 & 12 Geo. 6, c. 38, has been substantially amended by the Companies Act, 1967 (effective 27 July 1967). There has been a spate of company legislation in Canada: see the Table of Principal Current Statutes. Both France and Germany have enacted new companies statutes recently.

6. The enactment of the new German Aktiengesetz (AktG) in 1965 (effective 1 Jan. 1966) was preceded by a careful study of foreign corporation laws and some influence of the American corporation laws are apparent in a few instances. See Steefel & von Falkenhausen, The New German Stock Corporation Law, 52 CORNELL L.Q. 518, 519 (1967); Vagts, Reforming the Modern Corporation: Perspectives From the German, 80 HARVARD L. REV. 23 (1966).

7. Securities Act, 1933, 15 U.S.C. §§ 77a-77aa (1964); Securities Exchange Act, 1934, 15 U.S.C. § 78a et seq. (1964). (See the Table of Principal Current Statutes).

8. The Model Business Corporation Act (hereinafter cited as the Model Act) was prepared by the Committee on Corporate Laws (section of Corporation, Banking and Business Law) of the American Bar Association and first published in 1946. It was revised in 1950, republished with a few changes in 1953, supplemented by a cumulative addendum of changes and alternative and optional provisions in 1955, 1957 and 1959. Its avowed purpose is to serve as a model for modernizing the business corporation statutes of the state jurisdictions. References in these pages are to the text of the Model Business Corporation Act,

as revised in 1962, 1964 and 1965, printed in Volume 3 of the MODEL BUSINESS CORPORATION ACT ANNOTATED published by the West Publishing Company for the American Bar Foundation (hereinafter cited as the MOD. BUS. CORP. ACT ANN. or MOD. ACT ANN.). The Model Act must be distinguished from the Uniform Business Corporation Act explained in the next footnote.

9. The Uniform Business Corporation Act was adopted in 1928 by the National Conference of Commissioners on Uniform State Laws and appears in 9 UNIFORM LAWS ANNOTATED. In 1946 the commissioners withdrew it as a Uniform Act and renamed it as "Model Business Corporation Act". In 1958 the Commission withdrew it completely. The Act will be referred to as the Uniform Act in these pages.

10. General Corporation Law of the State of Delaware, enacted 10 March 1899, as amended up to and including the 124th General Assembly. Delaware Code, Title 8, Chapter 1 (as revised in 1967 by 56 Del. Laws, c. 50 (effective 3 July 1967). This Act is hereinafter referred to as the Delaware Act.

11. [New York] Business Corporation Law, 1961, effective 1 September 1961, as amended. All references are to McKINNEY'S CONSOLIDATED LAWS OF NEW YORK ANNOTATED, Book 6 (2 Vols.) (1963, 1968-69 Cumulative Annual Pocket Part). This statute is hereinafter referred to as the New York Act.

12. [California] General Corporation Law, [California] Corporations Code, 1967, Title 1, Division 1, as amended in 1968 (1968 Cumulative

Supplement to the Corporations Code). This Act is hereinafter referred to as the California Law.

13. [California] Corporate Securities Law, Cal. Stat. 1968, c. 88; Corporations Code, Title 4, Division 1 (effective 2 January 1969).

14. Uniform Securities Act, 1956, 9C UNIFORM LAWS ANNOTATED 86.

15. Canada Corporations Act, R.S.C. 1952, c. 53; am. Stat. Can. 1964-65, c. 52 (hereinafter referred to as the Canada Act).

16. [Ontario] Corporations Act, R.S.O. 1960, c. 71 as amended. See the Table of Principal Current Statutes. The proposed new Business Corporation Act is referred to as the New Ontario Act. The Act now in force is referred to as the Ontario Act.

17. [Quebec] Companies Act, R.S.Q. 1964, c. 271 (hereinafter referred to as the Quebec Act).

18. [Quebec] Securities Act, R.S.Q. 1964, c. 274; [Ontario] Securities Act, 1966, Stat. Ont. 1966, c. 142, am. Stat. Ont. 1967, c. 92.

19. See Fleischer, "Federal Corporation Law" : An Assessment, 78 HARVARD L. REV. 1146 (1965). The role of the federal laws and the federal Securities and Exchange Commission (hereinafter referred to as the S.E.C.) is discussed in Chapter 3.

20. The Model Act has been used as the basis of corporation statutes enacted since 1951 in over 20 jurisdictions. See MOD. ACT ANN., § 1 ¶4.02 (1966 Pocket Part).

21. See Arsht & Stapleton, Delaware's New General Corporation Law: Substantive Changes, 23 BUS. LAWYER 75 (1967).

22. Ibid.

23. This comparative study does not include Continental corporation laws.

Notes to Chapter 1

1. HOLDSWORTH, 8 A HISTORY OF ENGLISH LAW, 104, 195 (1925) (hereinafter referred to as 8 HOLDSWORTH).

2. Ibid.

3. Id. at 196. In France this was regulated by an Ordinance of Louis XIV of the year 1673 and recognized in Napoleon's Code de Commerce of 1807.

4. Id. at 195-97.

5. By the Limited Partnership Act, 7 Edw. 7, c. 24 (U.K. 1907). An attempt in 1818 to introduce it into England failed. See HUNT, op. cit. supra, 32. The Board of Trade ordered an inquiry into the law of partnership with a view to introducing the société en commandite into England, but the Report (the Bellenden Ker Report, P.P., XLIV, 1837-38, reprinted in the Report of 1844 as App. No. 1) observed: "[A]s to the expediency of introducing [a system of limited liability partnership], the opinion of those who must be considered as best able to form a judgment on this difficult and important question are at variance; by far the greater number of those who have been examined are decidedly unfavourable to its adoption under any circumstances whatever." After referring to the arguments of those in favour and against its introduction the Report concluded: "it has not been considered necessary in the present Report to do more than to advert to the leading arguments . . . for or against the adoption of the system, particularly

as it is clear that, where such a diversity of opinion exists, it would not be expedient to recommend the introduction of the measure, at least for the present, and until further information as to the practical operation of the law in other states has been obtained." Hunt mentions that the Report "frowned upon any such 'innovation'." (HUNT, 80). Horrwitz mentions that the Report recommended the introduction of limited partnership, but that nothing ensued: Horrwitz, Historical Development of Company Law, 62 L.Q. REV. 375 (1946). Neither Hunt nor Horrwitz seems to be quite accurate.

6. The French société en commandite was introduced into Ireland in 1782 by 21 & 22 Geo. 3, c. 46 (Irish). See HUNT, 52.

7. 8 HOLDSWORTH, 197

8. The concept that the universitas is a persona and a persona ficta was first expressed by Sinibaldus Fliscus, a contemporary of Bracton, who became Pope Innocent IV in 1243. See 3 HOLDSWORTH, 363-64 (1909); POLLOCK & MAITLAND, THE HISTORY OF ENGLISH LAW BEFORE THE TIME OF EDWARD I, 494, 502 (2d ed. 1898).

9. 8 HOLDSWORTH, 201-02. CARR (ed.), SELECT CHARTERS OF TRADING COMPANIES A.D. 1530-1707, introduction xi, xiv (1913) (hereinafter cited as CARR). To quote Blackstone, "[I]n England, the King's consent is absolutely necessary to the erection of any corporation, either impliedly or expressly given. The king's implied consent is to be found in corporations which exist by force of the common law, to which our former kings are supposed

to have given their concurrence; common law being nothing else than custom . . . . Of this sort are the king himself, all bishops, parsons, vicars, churchwardens, and some others; who by common law have ever been held (as far as our books can shew us) to have been corporations, virtute officii . . . . Another method of implication, whereby the king's consent is presumed, is as to all corporations by prescription, such as the city of London, and many others, which have existed as corporations, time whereof the memory of man runneth not to the contrary; and therefore are looked upon in law to be well created. For though the members thereof can show no legal charter of incorporation, yet in cases of such high antiquity the law presumes there was one; and that, by the variety of accidents which a length of time may produce, the charter is lost or destroyed. The methods by which the king's consent is expressly given, are either by act of parliament or charter. By act of parliament, of which the royal assent is a necessary ingredient, corporations may undoubtedly be created." (BLACKSTONE, 1 COMMENTARIES ON THE LAWS OF ENGLAND, 472-73) (first published 1765; 15th ed. 1809).

10. 1 BLACKSTONE'S COMMENTARIES, 473.

11. Warren, Safeguarding the Creditors of Corporations, 36 HARVARD L. REV. 509, 515 (1922-23).

12. E.g., 39 Eliz. 1, c. 5 (U.K. 1597-98) (Hospitals for the poor).

13. CARR, op. cit. supra n. 9, xvi, xvii.

14. Id. at xvii.

15. Berle & Means, Corporation, in 3 ENCYCLOPAEDIA OF SOCIAL SCIENCES, 414 (12th print. 1957) (hereinafter cited as the ENCYCLOPAEDIA).

16. 8 HOLDSWORTH, 212.

17. The charter of the Bank of England was granted pursuant to a statute of Parliament, viz. 5 & 6 Wm. & Mary, c. 20 (U.K. 1693-94).

18. SCOTT, 1 CONSTITUTION AND FINANCE OF ENGLISH, SCOTTISH AND IRISH JOINT STOCK COMPANIES TO 1720, 389, 397-98 (1912, 1951) (hereinafter referred to as SCOTT).

19. 8 HOLDSWORTH, 211-12; Berle in the ENCYCLOPAEDIA, 415.

20. "Innumerable companies were launched to carry out wild-cat projects, and amongst other promising undertakings may be noted the following: 'To make salt water fresh'; 'For fattening of hogs'; 'For a wheel of perpetual motion'; 'For importing a number of large jackasses from Spain'. Most of these companies were successful in getting subscribers. Perhaps the most important adventure was one entitled, 'For an undertaking which shall in due time be revealed'. Each subscriber to this company was to pay down two guineas, and afterwards to receive a share of one hundred guineas with a disclosure of the objects of the company. The public, to use a modern promoter's expression, was so much on the feed, that 1000 subscriptions were paid the same morning, with which the promoter disappeared in the afternoon." Napier in A CENTURY OF LAW REFORM, 383.

21. 8 HOLDSWORTH, 215.

22. 1 SCOTT, 337-38.

23. 8 HOLDSWORTH, 203. In Elve v. Boyton, [1891] 1 Ch. 501, at 507, Lindley, L.J., stated that while the Crown could incorporate any number of persons by a charter, it could not so incorporate them as to make them liable to any extent for the debts of the corporation. See also Warren, op. cit. supra n. 11, at 519:

> "If a legal unit, distinct from the human beings which are its members, is created with legal capacity for incurring obligations, and it does incur obligations, the members are (without more) not liable thereon because of the simple, but decisive reason that the obligation was incurred not by them but by a legal unit distinct from them. The members are not even liable to a limited extent. The corporation is liable, and it is the only legal unit that is liable. "There has never been a decision by an English court in violation of this principle."

Professor Warren observes that the impression given by Scott (1 SCOTT, 228, 270) that the members of a chartered corporation were liable for the debts of the corporation is erroneous. (p. 518)

In Edmunds v. Brown and Tillard, 1 Levinz 237, 83 E.R. 385 (1668), the plaintiff who had lent money to the company of Woodmongers sued two of its members to "charge them in their own right." The King's Bench non-suited the plaintiff.

In Salmon v. The Hamborough Company, 1 Ch. Cas. 204, 204, 22 E.R. 763 (1670-71), Dr. Salmon sued the company and its several members "in their natural Capacities" to recover £2,000 lent by him to the company. The company had been incorporated without any common stock. It was a regulatory company and its members dealt in clothes. The company was authorised by its charter to impose rates on the clothes exported by its members and poll tax on its members to defray its expenses. The annual revenue thus raised by the company was £8,000. As the company had no common stock, the plaintiff had no remedy at law for the debt. In fact the company, though served with process, would not appear. The plaintiff therefore filed a Bill in Equity to obtain redress. The members

who appeared demurred that they were not personally liable for the plaintiff's demands. The Court of Chancery allowed the demurrer and dismissed the Bill. The House of Lords reversed and made the following order: (1) That the Court of Chancery should reinstate the Bill and issue process on the corporation; (2) If the company appeared in response to the process, the court must determine the plaintiff's claim; if it did not, a decree must be passed against the company ex parte; (3) If the decreed amount was not paid within 90 days thereof, the court must order the company to make leviations on its members sufficient to satisfy the plaintiff's decree, and to collect it and pay it to the plaintiff. (4) If no such leviation was made, the court must issue process of contempt against the "Governor, Deputy Governor and Assistants of the . . . Company" personally; (5) In such a case a decree must be entered requiring the members in whom the power to make leviations was vested by the charter to make leviations upon every member of the company "as is to be contributory to such publick charge." (6) Members who failed to do so were similarly to be liable for contempt proceedings.

Professor Warren observes that "The Salmon case is authority for no wider proposition than that, if a corporation has power to make call upon its members for corporate purposes without limit as to the amount to be called, and if it has been accustomed to make such calls to pay its debts and has thereby gained credit, it will be required to exercise such power to satisfy its creditors." (p. 519).

24. Edmunds v. Brown & Tillard, 1 Lev. 237, 83 E.R. 385 (1668); Salmon v. The Hamborough Co., 1 Ch. Cas. 204, 22 E.R. 763 (1671).
25. 8 HOLDSWORTH, 204.
26. Id. at 204-05.
27. Id. at 205.
28. Ibid.
29. Id. at 202-05.
30. Id. at 218.
31. 1 SCOTT, 443-44.
32. 8 HOLDSWORTH, 213.
33. Id. at 214.
34. 8 & 9 Will. 3, c. 32 (U.K. 1696-97).
35. 8 HOLDSWORTH, 215.
36. Id. at 215-16.
37. Id. at 216.
38. Ibid.
39. 1 SCOTT, 60.
40. Id. at 158-59; 8 HOLDSWORTH, 216.
41. 8 HOLDSWORTH, 219; 1 SCOTT, 436-37. JOURNAL OF THE HOUSE OF COMMONS, xix 351.
42. 6 Geo. 1, c. 18 (U.K. 1720). LINDLEY, LAW OF COMPANIES 130-32 (5th ed. 1889). See R. v. Webb, 14 East. 406, 104 E.R. 658 (K.B. 1811), in which a prosecution for infringement of the Bubble Act failed where a joint-stock enterprise was formed by a deed of co-partnership entered into by 2,500 persons, admitting

of an increase in the number of partners to 20,000, under which a capital of £20,000 was to be raised by small subscriptions for the purpose of buying corn, grinding it, making bread, and dealing in and distributing flour or bread amongst the partners, under the name and firm of The Birmingham Flour and Bread Company, and under the management of a Committee.

43. 6 Geo. 4, c. 91 (U.K. 1825).

44. The Charter of 1606 granted to the Virginia Company empowered two groups of persons — one of London, the other of Bristol, Exeter and Plymouth — to establish two separate colonies. This charter did not expressly create a corporation. A second charter formally incorporated the Londoners. The other group was incorporated in 1620 with colonial territory to be named "New England in America". For fuller details on these charters see CARR, lxxiv et seq. It may be observed that while the East Indian and African grants contemplated only the establishment of trading centres, the American grants were designed for "abiding and populous settlements in a fair climate." (CARR, lxxxix).

45. Berle in the ENCYCLOPAEDIA, 415.

46. The following dates will be helpful to the reader:

1606	First Charter of Virginia.
1607	First Settlement in Virginia.
1620	First Settlement in Massachusetts.
1664	Taking of New Amsterdam (New York).
1775	Beginning of the Revolutionary War.
1781	Formation of the Confederation.
1783	Treaty of Peace with England. Independence of the United States recognized.
1787	Constitutional Convention in Philadelphia.

1788 The Constitution ratified by a majority of the States (9 out of 13).

1789 Beginning of the Federal Government; George Washington becomes the first President.

47. Baldwin, History of the Law of Private Corporations in the Colonies and the States, Essay 58 in 3 SELECT ESSAYS IN ANGLO-AMERICAN LEGAL HISTORY, 235, 240 (1909).

48. Baldwin, op. cit. supra, 241.

49. Ibid.

50. The charter of the Company of the Massachusetts Bay in New England incorporated Sir Henry Rosewell and others and conferred powers of local self-government. See CARR, lxxxvi.

51. Baldwin, op. cit supra n. 47, 241-42. Carr states that the charter was forfeited as a result of "serious complaints of illegal impositions, coining, appropriation of moieties and forfeitures, ill-treatment of royal officers, religious persecutions and breaches of the Navigation Acts." CARR, lxxxvi. A few years later a second charter was granted incorporating the territory into the "Province of the Massachusetts Bay in New England" with a Governor, a Deputy Governor, a Secretary and twenty eight Assistants." (CARR, ibid.)

52. Id. at 242.

53. Id. at 246.

54. There were a few "fully American, clearly corporate business associations" in the American colonies, but they were exceptional and insignificant. Of these two were wharf companies, one in Connecticut and the other in Massachusetts, three small water companies in Rhode Island, and one mutual fire insurance society in Pennsylvania. See 1 DAVIS, 22-25, 41-45, 87-90; 2 DAVIS, 5-6.

55. Baldwin, supra, at 245; 2 DAVIS, 5.

56. 2 DAVIS, 5-6.

57. Id. at 6.

58. Id. at 10, 11, 35.

59. The following were the only business corporations chartered between the Revolution (1775) and the Constitutional Convention of 1787:

(i) The Bank of North America chartered by Congress in 1781;
(ii) The Proprietors of Charles River Bridge in 1785;
(iii) The Mutual Assurance Co. (Philadelphia) in 1786;
(iv) The Massachusetts Bank in 1784; and
(v) The Associated Manufacturing Co. (N.Y.) in 1786. After 1787 the number rapidly increased.

60. 2 DAVIS, at 8.

61. Id. at 8-9.

62. Id. at 7.

63. Ibid.

64. Id. at 255.

65. Id. at 309.

66. Id. at 289.

67. Id. at 287.

68. Id. at 303-09.

69. Id. at 294.

70. Baldwin, supra, 250; 2 DAVIS, 25.

71. 2 DAVIS, 283, 293, 326-28.

72. Id. at 294.

73. Id. at 317.

74. Id. at 322.

75. Id. at 323.

76. Id. at 326.

77. Berle in the ENCYCLOPAEDIA, 415-16.

78. See supra, Foreword n. 6. On the new German law see Steefel & von Falkenhausen, The New German Stock Corporation Law, 52 CORNELL L.Q. 518 (1967). On the H.G.B. generally see SCHUSTER, THE PRINCIPLES OF GERMAN CIVIL LAW (1907). See also Fabricius, The German Companies Act of 1965, [1967] J. BUS. L. 274.

79. Berle in the ENCYCLOPAEDIA, 415-16.

80. Didier, The New French Legislation on Commercial Companies, [1967] J. BUS. L. 78.

81. HUNT, 13, 14. See R. v. Webb, supra n. 42.

82. Id. at 16-19.

83. Id. at 22-27.

84. Id. at 30.

85. Ibid.

86. Id. at 35, quoting from Annual Register (1824), p. 3.

87. Id. at 32, et seq.

88. 6 Geo. 4, c. 91 (U.K. 1825). See HUNT, 41. Parliamentary Papers, I (1825), No. 149.

89. HUNT, ibid.

90. HUNT, 58-60.

91. Ibid.

92. Limited partnerships originated in Italy and from there spread to Holland and other European countries. It was allowed in France by an ordinance of 1673. It was introduced into Louisiana by its Civil Code. It soon found its way into other American States.

93. HANSARD CXXXIX (1855), 327.

94. HUNT, 41-44.

95. 4 & 5 Wm. 4, c. 94 (U.K. 1834).

96. HUNT, 56 fn. 6.

97. Waugh v. Carver, 2 HENRY BLACKSTONE 235, 126 E.R. 525 (Common Pleas 1793). This rule was statutorily abrogated only in 1856.

98. 1 Vict., c. 73 (U.K. 1837). See HUNT, 83.

99. HUNT, 87. Act of 1837, s. 21.

100. 7 & 8 Vict., c. 110 (U.K. 1844) (hereinafter referred to as the Act of 1844). A Parliamentary Committee was appointed in 1841 "to inquire into the state of the laws respecting joint stock companies, with a view to the greater security of the public." For the immediate causes for the appointment of this committee see HUNT, 90. REPORT OF THE SELECT COMMITTEE ON JOINT STOCK COMPANIES, 1844, VII (1844), Evidence Q.Q. 2341 ff. (hereinafter referred to as the Report of 1844). The Bellenden Ker Report of 1837 appears in an Appendix to the Report of 1844.

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101. Joint Stock Bank Act, 1844, 7 & 8 Vict., c. 113, was passed to regulate banks. A separate Act for the winding-up of joint stock companies was also passed the same year: 7 & 8 Vict., c. 111.

102. Eng. Act of 1844, s. 25.

103. Ibid.

104. Between 1844 when the Act was passed and 1855 when the Limited Liability Act was passed, about 915 joint stock companies were registered for a variety of purposes under the Act of 1844. See HANSARD CXXXIX (1855), 320-21. Of these 723 were in existence in 1855.

105. Eng. Act of 1844, s. 25.

106. Eng. Act of 1844, s. 66.

107. For the various devices used to achieve limited liability see HUNT, 99-100.

108. HUNT, 104 et seq.

109. Id. at 106, 107.

110. Id. at 114, Table XI.

111. Id. at 116, fn. 5.

112. REPORT OF THE SELECT COMMITTEE APPOINTED TO CONSIDER AND SUGGEST MEANS OF REMOVING OBSTACLES AND GIVING FACILITIES TO SAFE INVESTMENTS FOR THE SAVINGS OF THE MIDDLE AND WORKING CLASSES, 1850 (XIX, P.P., # 508), p. iv. HUNT, 120.

113. 1851, XVIII P.P., #509.

114. Five Commissioners were against the introduction of limited liability partnerships. Three (Bramwell and Anderson, lawyers, and Hodgson, a merchant) were strongly in favour.

115. FIRST REPORT OF THE /FIRST/ MERCANTILE LAW COMMISSION, 1854 (XXVII P.P., #1791), App., 123-24. This report is hereinafter referred to as the Report of 1854.

116. REPORT of 1854, 35-38.

117. REPORT of 1854, supra n. 115.

118. HANSARD CXXXIV (1854), 764, 800. The resolution moved in the British House of Commons on 27 June 1854 read:

> "That the Law of Partnership, which renders every person who, though not an ostensible partner, shares the profits of a trading concern, liable to the whole of its debts, is unsatisfactory, and should be so far modified as to permit persons to contribute to the capital of such concerns on terms of sharing their profits, without incurring liability beyond a limited amount."

Mr. Collier moved the resolution to elicit the opinion of the House on a subject on which the members of the Royal Commission had keenly differed, rather than attempt to introduce a bill, and eloquently advocated the cause of limited liability.

119. See HANSARD CXXXIX (1855), 310-58, 1378-97, 1895-1923, 2025-52, 2123-31.

120. Under the Eng. Act of 1844 there was no requirement of minimum capital, but the liability of the members was unlimited.

121. Under the Eng. Act of 1844, there was no minimum par value requirement.

122. Under the Eng. Act of 1844 this was one-quarter.

123. Under the Eng. Act of 1844 there was no such requirement.

124. Horrwitz, Historical Development of Company Law, 62 L.Q. REV. 375, 380 (1946).

125. Id. at 380. See HANSARD CXXXIX (1855), 2025-52.

126. See HANSARD CXXXIX (1855), 2035-36.

127. Limited Liability Act, 1855, 18 & 19 Vict., c. 133 (U.K. 1855) (hereinafter referred to as the Eng. Act of 1855).

128. Eng. Act of 1855, s. 3.

129. The Cohen Committee upon whose REPORT (Cmd. 6659) the present English Act is based recommended the introduction of a minimum paid up capital, Board of Trade approved auditors, and prohibition of loan to directors. See the REPORT, paras. 57, 94 and 110.

130. 19 & 20 Vict., c. 47 (U.K. 1856) (hereinafter cited as the Eng. Act of 1856).

131. HANSARD CXL (1856), 124, 130, 131. Introducing the new measure (which became the Eng. Act of 1856), Mr. Lowe, Vice President of the Board of Trade, vindicated eloquently the policy of laissez faire thus:

> "We entirely repudiate as the basis of legislation the principle upon which the . . . Joint Stock Companies Act [of 1844] is founded — that it is in the power of the Government to prevent the institution of fraudulent companies. We do not believe that it is in the power of the Government to supersede the vigilance of individuals, who are actuated by the strongest personal interests to detect these frauds; and, although I do not mean to say that many frauds will not still continue to occur, I believe that is a necessary incident of a large commercial society, and that it is an evil which cannot be met or cured by way of anticipation by any legal enactment whatever."

(at p. 124).

132. Limited liability was, however, not granted to banking companies until 1858 when it was made available to them by 21 & 22 Vict., c. 91. Insurance companies had to wait for it till 1862. See HUNT, 136-38.

133. See HANSARD CXL (1856), 134. In New York the application was to be made to a court of justice. The English Act provided for application to the Board of Trade instead with a view to avoiding the publicity and expense involved in judicial proceedings.

134. It may be mentioned here that about 150 applications for registration of companies under the Eng. Act of 1855 were made of which only eight obtained limited liability. Many of them failed to pay up their capital. See HANSARD CXL (1856), 137.

135. HUNT, 140-43. Compulsory audits were reintroduced only in 1900 and the balance sheet requirement in 1907.

136. Eng. Act of 1856, s. 61.

137. Horrwitz, op. cit. supra n. 124, 384. Napier, The History of Joint Stock and Limited Liability Companies, in A CENTURY OF LAW REFORM, 392.

138. HUNT, 158.

138a. N.Y. Laws, 1811, c. 67, p. 111, which was a general incorporation statute for manufacturing companies. For a detailed account of American business corporations up to the outbreak of the Civil War, see DODD, AMERICAN BUSINESS CORPORATIONS UNTIL 1860 WITH SPECIAL REFERENCE TO MASSACHUSETTS (1954). American works on the law of business corporations began appearing early. The first

edition of ANGELL & AMES, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS AGGREGATE, was published in 1831; its second edition in 1843 and 11th edition in 1882. The English work on corporations by Kyd was of course published in 1793, but it dealt mainly with municipal corporations. An English work of the first half of the 19th century is WORDSWORTH, THE LAW OF JOINT STOCK COMPANIES (3d ed. 1842). Lindley treated the law of companies as part of the law of partnership from the first edition of his work in 1860 until the 5th edition in 1889 when he decided that it was time to devote a separate volume to the law of companies. But he still preferred to entitle the separate volume as A TREATISE ON THE LAW OF COMPANIES CONSIDERED AS A BRANCH OF THE LAW OF PARTNERSHIP and the same title was continued in the 6th edition of the work published in 1902. The first edition of the English work, BRICE, A TREATISE ON THE DOCTRINE OF ULTRA VIRES, was published in 1874. The English work, GRANT, LAW OF CORPORATIONS, was published in 1850.

139. Supra 24, 26.

140. LATTIN, THE LAW OF CORPORATIONS, 155 (1959) (hereinafter referred to as LATTIN).

141. Cf. the Illinois statute of this time which did not prescribe any such maximum or minimum. Ill. Rev. Stat. (1887), c. 32, s. 1. But shares had to have a par value of not less than $10 and not more than $100.

142. The Illinois statute, ibid., had a provision that all stock should have been subscribed before the corporation could commence business: §§ 3, 4.

143. Dodd, Statutory Developments in Business Corporation Law, 1886-1936, 50 HARVARD L. REV. 27, 32 (1936). Mass. Pub. Stat. (1882), c. 106, §§ 7, 46.

144. For similar provisions in the Illinois statute, see s. 58. The Illinois provision was more severe in this respect than that of Massachusetts as it made directors liable for all corporate debts and not for the amount of dividend paid only.

145. Dodd, supra n. 143, at 32. Mass. Pub. Stat., supra, s. 60.

146. Dodd, ibid. Mass. Pub. Stat., id., s. 61.

147. Dodd, op. cit. supra, 33. Mass. Pub. Stat., s. 42.

148. Cf. Ill. Rev. Stat., supra, s. 6 which gave very wide powers to the directors.

149. Mass. Pub. Stat., supra, s. 23.

150. Id. §§ 34, 37.

151. Id. s. 27. Dodd, op. cit., 33.

152. Dodd, op. cit., 30, 31.

153. Id. 29, 30.

154. Berle in the ENCYCLOPAEDIA, 418.

155. Id. at 417, 418.

156. Berle in the ENCYCLOPAEDIA, 421.

157. The General Corporation Law of New Jersey, N.J. Laws of 1896, c. 185. For the text of the Act as amended up to 1909 see DILL,

THE STATUTE AND CASE LAW OF THE STATE OF NEW JERSEY, (ed. of 1910).

158. See the Preface to the first edition (1898) of DILL, THE STATUTORY AND CASE LAW APPLICABLE TO PRIVATE COMPANIES UNDER THE GENERAL CORPORATION ACT OF NEW JERSEY, reprinted in the 2d edition (1899).

159. Dodd, op. cit. supra, 34, 35.

160. Illinois enacted a new corporation law in 1919 espousing the new philosophy. This was replaced by a new Act in 1933. On the Act of 1933 see Ballantine, A Critical Survey of the Illinois Business Corporation Act, 1 U. CHICAGO L. REV. 357 (1934).

161. Dodd, op. cit. supra, 35-37.

162. N.Y. Laws 1912, c. 351.

163. Del. Laws 1917, c. 113.

164. General Corporation Act, Ill. Laws 1919, p. 312.

165. Mass. Acts & Resolves, 1920, c. 349, s. 3.

166. See post p. 56.

167. General Corporation Act, 1927 and 1955.

168. Act of 1929.

169. Acts of 1931 and 1947.

170. Act of 1928.

171. Act of 1931.

172. Act of 1933.

173. Act of 1933.

174. Act of 1933.

175. Act of 1933.

176. The Delaware Act of 1915 as amended in 1929. See Berle, Investors and the Revised Delaware Corporation Act, 29 COLUMBIA L. REV. 563 (1929).

177. Ill. Laws 1933, p. 308; Ill. Rev. Stat. (1935), c. 32.

178. Kan. Laws 1911, c. 133.

Pennsylvania, Pen. Stat. (Purdon, 1936), tit. 70.

New York, N.Y. Gen. Bus. Corp. Law, art. 23A.

California, Calif. Gen. Laws, 1931, tit. 280.

Massachusetts, Mass. Acts & Resolves 1932, c. 290.

Illinois, Ill. Rev. Stat. (1935), c. 32, ss. 256, 261-65, 270.

179. Securities Act, 1933, Act of May 27, 1933, c. 38, 48 STAT. 74, 15 U.S.C. ss. 77a-77aa (1964). Securities Exchange Act, 1934, Act of June 6, 1934, c. 404, 48 STAT. 881, 15 U.S.C. ss. 78a-o, 78o-1-3, 78p-78hh-1 (1964).

180. Dodd, op. cit. supra, 52-58.

181. See supra 25-27.

182. 30 & 31 Vict., c. 131 (U.K. 1862).

183. Id. ss. 9-22.

184. Id. ss. 4-8.

185. Id. s. 23.

186. 40 & 41 Vict., c. 26 (U.K. 1877).

187. 42 & 43 Vict., c. 76 (U.K. 1879).

188. 43 Vict., c. 19 (U.K. 1880).

189. Id. ss. 3-6.

190. 43 Vict., c. 19, s. 7 (U.K. 1880).

191. 53 & 54 Vict., c. 62 (U.K. 1890).

192. 53 & 54 Vict., c. 63 (U.K. 1890).

193. 53 & 54 Vict., c. 64 (U.K. 1890).

194. 63 & 64 Vict., c. 48 (U.K. 1900).

195. Id. s. 1.

196. Id. ss. 4-8. The "minimum subscription" was introduced as a pre-requisite to a company commencing business, but the law itself did not fix the amount.

197. Id. ss. 9-11.

198. Id. s. 12.

199. Id. ss. 14-18.

200. Id. ss. 21-23.

201. 7 Edw. 7, c. 50 (U.K. 1907). This Act was based upon the recommendations of the Loreburn Committee, Cmd. 3052 (1906).

202. Id. s. 37 (4). This had already been facilitated by the House of Lords decision in Salomon v. Salomon & Co., Ltd., [1897] A.C. 22 (H.L.). In the same year was passed the belated Limited Partnership Act, 1907, 7 Edw. 7, c. 24.

203. Id. s. 9.

204. Id. s. 1, First Schedule.

205. Id. s. 2.

206. Id. ss. 10-19.

207. Id. ss. 19-23.

208. Id. s. 24.

209. Id. s. 38.

210. 8 Edw. 7, c. 69 (U.K. 1908).

211. 3 & 4 Geo. 5, c. 25 (U.K. 1913) and war measures during 1914-18. In 1918 the Wrenbury Committee made some recommendations: Cmd. 9138 (1918).

212. 19 & 20 Geo. 5, c. 23 (U.K. 1929). This was based upon the recommendations of the Greene Committee, Cmd. 2657 (1926).

213. 2 & 3 Geo. 6, c. 16 (U.K. 1939). This Act gives effect to the recommendations of the Bodkin Committee Report, Cmd. 5539 (1937) and the Anderson Committee Report, Cmd. 5259 (1936).

214. Borrowing (Controls and Guarantees) Act, 1946, 9 & 10 Geo. 6, c. 58 (U.K.)

215. 11 & 12 Geo. 6, c. 38 (U.K. 1948) based on the Report of the Cohen Committee, Cmd. 6659 (1945). These recommendations were implemented in the Act of 1947, 10 & 11 Geo. 6, c. 47 (U.K. 1947).

216. Cmnd. 1749 (June 1962).

217. See Schmitthoff, The Companies Bill and Company Law Reform, [1966] J. BUS. L. 106. Editorial, [1967] J. BUS. L. 2. The Bill also provides for closer supervision of the conduct of insurance companies.

218. 1967, c. 81 (effective 27 July 1967). See MAGNUS & ESTRIN, THE COMPANIES ACT 1967 (1967).

219. An Act to authorise the formation of Joint Stock Companies in Lower Canada for the Construction of Macadamized Roads, and

of Bridges and other works of like nature, 12 Vict., c. 56 (Provincial Statutes of Canada, 1849); An Act to authorize the formation of Joint Stock Companies for the Construction of Roads, and other Works in Upper Canada, 12 Vict., c. 84 (Prov. Stats. of Canada, 1849).

220. WEGENAST, THE LAW OF CANADIAN COMPANIES, 20 (1931) (hereinafter referred to as WEGENAST).

221. An Act to Provide for the Formation of Joint Stock Companies, for Manufacturing, Mining, Mechanical or Chemical Purposes, 13 & 14 Vict., c. 28 (Provincial Statutes of Canada, 1850).

222. An Act respecting the Judicial Incorporation of Joint Stock Companies for Certain Purposes, 23 Vict., c. 60 (Statutes of the Province of Canada, 1860).

223. An Act to authorise the granting of Charters of Incorporation to Manufacturing, Mining, and other Companies, 27 & 28 Vict., c. 23 (Statutes of the Province of Canada, 1864). The preamble to the Act stated that it was enacted to authorise the incorporation by letters patent of companies for manufacturing, mining and other purposes and to provide for certain general clauses applicable to all companies so incorporated. Before letters patent were issued applicants were required to prove that not less than one-half of the proposed capital had been subscribed in good faith and a prescribed part of it paid-up. See section 3 of the Act. See also WEGENAST, 21.

224. WEGENAST, 22. The Act preserved the personal liability of the shareholders to the creditors of the company to the extent of the amount unpaid on the shares held by them, but creditors could hold them liable only if execution against the company had been returned unsatisfied in whole or in part. See section 27.

225. Canada Joint Stock Companies Letters Patent Act, 1869, 32 & 33 Vict., c. 13 (one of the statutes passed in the second session of the First Parliament of Canada). Section 3 of the Act empowered the Governor in Council to grant a charter, by letters patent under the great seal, to any number of persons, being not less than five, who petitioned therefor, thereby constituting them and others who might become shareholders in the company, into a body corporate and politic, for any purpose or object to which the legislative authority of the Parliament of Canada extended, other than for the construction and working of railways, or for banking and the issue of paper money, or for insurance.

226. Canada Joint Stock Companies Clauses Act, 1869, 32 & 33 Vict., c. 12.

227. Stat. Can. 1877 (40 Vict., c.23).

228. Supra n. 223.

229. R.S.C. 1886, c. 119. The Companies Clauses Act appeared as c. 118 of this revision.

230. Stat. Can. 1902, c. 15 (2 Ed. 7).

231. R.S.C. 1906, c. 79.

232. Stat. Ont. 1874, c. 35 (37 Vict.).

233. WILLIAMSON, SECURITIES REGULATION IN CANADA, 12-13 (1960) (hereinafter referred to as WILLIAMSON).

Notes to Chapter 2

1. The articles of association of a company limited by shares may adopt all or any of the regulations contained in the famous Table A of the First Schedule to the English Act. If they are not adopted in entirety, they still apply to such companies to the extent that they are not excluded or modified by the company's articles of association. In the case of all other companies articles of association should be registered along with the memorandum. In other words a company, private or public, limited by shares need not file its own articles if it chooses to adopt in entirety Table A. See English Act, ss. 6, 8, 12, Sch. I Table A. See also B.C., ss.30, 171, Sch. I Table A; Alberta, s. 24, Sch. I Table A; Sask., ss. 18, 176, Sch. I Table A; and Nova Scotia, s. 18, Sch. I Table A.

2. The registrar's certificate is conclusive evidence that all the requirements of the Act in respect of registration and of matters precedent and incidental thereto have been complied with and that the association is a company authorised to be registered and duly registered under the Act. Eng., s. 15(1); B.C., s. 35; Alta., s. 26; Sask., s. 22; Nova Scotia, s. 26(1).

3. In Australia the corresponding requirement is 5 or more subscribers.

4. Sask., s. 19; Nova Scotia, s. 14(5). Contra B.C., s. 32; Alta., s. 24.

5. A minimum of three incorporators is commonly required, but the modern trend is to authorise a single incorporator. See 3 MOD.

ACT ANN., § 47 (Supp. 1966); N.Y., § 401; Delaware, § 101 (a); Penn., § 201; Ontario Bill, s. 4(1). California has not made this change.

6. Can., s. 8(3). This section requires that the applicants for letters patent should establish to the satisfaction of the Secretary of State "the sufficiency of the application and the truth and sufficiency of the facts therein set forth." To the same effect see Ont., ss. 3(1), 5-8; Que., s. 9; Man., ss. 8, 10, 12(2). Section 11(2) of the Manitoba Act declares that "The issue of letters patent, supplementary letters patent, certificate of registration, supplementary certificate of registration, licence or order by the minister or the refusal thereof is an executive act, and is in the absolute discretion of the minister." It follows that the Secretary of State or the Provincial Secretary has in law far wider discretion in issuing or denying letters patent than the registrar in the English prototype.

7. Ont. Bill, s. 4(1).

8. Ont. Bill, s. 5(1) (emphasis added).

9. INTERIM REPORT OF THE SELECT COMMITTEE ON COMPANY LAW (Ontario Legislative Assembly 1967) (referred to hereinafter as the LAWRENCE REPORT after the name of the Chairman of the Committee).

10. A German Aktiengesellschaft is formed by executing the articles of association, setting out the particulars required by the law, subscribed by not less than five persons, before a court or notar and by registering the company in the Handelsregister (Commercial

Register) which is kept with the lowest court of original jurisdiction at the proposed domicile of the company. It must be mentioned that the entire capital of the company must have been subscribed for and in the case of shares payable in cash paid up to the extent of not less than 25% of the par value and this fact must be certified to in the articles of association.

11. Eng., s. 426.

12. Model, §§ 25, 52. See MOD. ACT ANN., § 25 ¶ 4.

13. Id., § 25 ¶ 4.02.

14. Delaware, § 109. See the special provision in § 110 for "Emergency by-laws" in the event of a nuclear disaster or other catastrophe.

15. N.Y., § 601, am. L. 1965, c. 803, § 12 (effective 1 Sept. 1965).

16. So also Penn., § 304; California, §§ 500-502.

17. Can., ss. 92, 93.

18. Ont., ss. 67, 68. Ont. Bill, ss. 21-23.

19. Que., ss. 52, 54, 55, 60, 74.

20. Eng., s. 28(1); Can., s. 3(j); Ont., s. 1(f); Man., s. 2(o); B.C., s. 2; Alta., s. 2(aa); Sask., s. 3(o). The Société à Responsabilité Limitée was introduced in France in 1863 and the Gesellschaft mit beschränkter Haftung was introduced in Germany in 1892.

21. Delaware, §§ 341-356. Penn., §§ 371-386.

22. See McKINNEY'S CONSOLIDATED LAWS OF NEW YORK ANNOTATED, BOOK 6 (2 Parts), Appendix I, Analysis of Business Corporation Law

by Professor Hornstein (1963).

23. See O'NEAL, CLOSE CORPORATIONS (1958), Preface to 1968 cumulative supplement. (In future referred to simply as O'NEAL).

24. LAWRENCE REPORT, 14-17 (paras. 2.1.1 to 2.1.9).

25. Eng., s. 129. The definition is complicated, but we need not examine it here.

26. Eng. Act of 1967, s. 2 (effective 27 July 1967).

27. Latty, Why Are Business Corporation Laws Largely "Enabling"?, 50 CORNELL L.Q. 599, 618 (1964-65).

28. Long before the English Acts recognised the "private" company, the "one-man company" had received judicial approbation. Salomon v. Salomon & Co., Ltd., [1897] A.C. 22 (H.L.).

29. Model, § 31; N.Y., §§ 612 (a), 613; Delaware, § 212; Penn., § 504. California, § 2216, provides that "If there is only one class of shares outstanding which is not divided into series, or if there is only one series of shares outstanding, any limitation or restriction imposed on the voting rights of the shareholders shall be ineffective."

30. Model, § 55; N.Y., § 804; Penn., § 804; Delaware, § 242 (d) (2).

31. Model, § 67, N.Y., § 903 (a) (2); Delaware, § 251 (c). Also in the case of voluntary winding up of the corporation, Model, § 77; N.Y., § 1001.

    Also for sale or mortgage of assets, Model, § 72; contra N.Y., §§ 202 (a) (5), 911.

32. Can., s. 12(14).

33. REPORT OF THE ROYAL COMMISSION ON PRICE SPREADS (Ottawa 1935) (hereinafter referred to as the PRICE SPREADS COMMISSION REPORT). The Chairman of the Commission was Wm. W. Kennedy. The REPORT recommended that

> "steps should be taken to simplify the capital structure of corporations, by limiting the classes of shares that may henceforth be offered to the public, to common and preferred — without any of the numerous subdivisions that now so often confuse and mislead the investor, and facilitate the concentration of control in the hands of entrepreneurial groups. Allied to this provision would be a stipulation that every share offered, both common and preferred, should bear equal voting rights. Management shares should be prohibited." (p. 42, emphasis added).

This recommendation was not fully implemented. The Dominion statute permits "shares of more than one class" with "any preferred, deferred or other special rights, restrictions, conditions or limitations attaching to any class of shares." (s. 12(1)). With regard to voting rights the Act forbids shares of a class with exclusive right of control. It provides:

> Section 12(14). In no case shall shares of a company of any class, whether with or without par value, be issued and allotted with voting rights limited in such a way as to attach to any other class or classes of shares the exclusive right to control the management of the company by the election or removal of the board of directors or otherwise.
>
> Section 12(15). Nothing in subsection (14) prevents the issue, under authority or provision therefor by letters patent or supplementary letters patent, of any preferred shares to which are attached preferential voting rights, exercisable in a stated event only, although in the stated event, an exclusive right to control or manage is attached to or is incident to such preferred shares.

See also sections 102 and 103(2) of the Act.

The REPORT recommended equal voting right for all classes of shares. The Act in response forbids exclusive voting right to any one class of shares. It is obvious that the two do not mean the same. For instance the Act does not forbid disproportionate voting rights or contingent voting rights. FRASER & STEWART, COMPANY LAW OF CANADA, 189-90, 348-49 (5th ed. 1962).

34. Ground, Corporate Names and Capital Structure, in SPECIAL LECTURES OF THE LAW SOCIETY OF UPPER CANADA 1968 — DEVELOPMENTS IN COMPANY LAW, 13, 24 (1968).

35. Ont., s. 26.

36. Revised Regulations of Ontario 1960, Reg. 61, s. 27.

37. Ground, op. cit. supra n. 34, at 25.

38. Ont. Bill, s. 26(3), (4).

39. India has, in the first companies Statute enacted after her Independence, introduced important reforms with regard to classification of shares and voting rights of shares marking a significant departure from Anglo-American company laws. The changes were recommended by the REPORT OF THE COMPANY LAW COMMITTEE (INDIA, 1952) (para. 47) (familiarly known as the BHABHA COMMITTEE) to put an end to the creation of deferred shares with disproportionate voting rights — a practice which became widely prevalent in India after World War II and led to grave abuses and malpractices. Under the present Companies Act [of India], 1956, all shares other than preference shares are designated "equity" shares and should stand pari passu

in all respects including voting rights. All preference shares should have preferential right both to dividend and to return of capital in winding up and may also be given cumulative and participating rights. "Equity" shares are defined negatively as those which are not preference shares. The Act confers voting rights on preference shares on all matters directly affecting their interests including resolutions to reduce share capital and to wind-up the company. They are also given the right to vote on all matters placed before the general meeting if dividends remain unpaid for a specified period or more depending upon whether their rights are cumulative or noncumulative. Equity shares are entitled to vote on all matters placed before the general meeting at any time. The voting rights must be in proportion to the amount paid up on the shares. Private companies are not, however, bound by these restrictions. See Ind., ss. 85, 87-89, 90(b).

40. DRUCKER, THE NEW SOCIETY, 340, 342 (1950); see also DRUCKER, CONCEPT OF THE CORPORATION (1946).

41. Eng., Sch. I, Table A, Reg. 53.

42. Id., Reg. 54.

43. Eng., s. 141.

44. Eng., s. 136.

45. Eng., ss. 131(2), 135(1).

46. Eng., s. 134(c).

47. Can., ss. 92, 93; Ont., s. 67; Que., s. 88.

48. See Can., ss. 17, 26(1), 48, 49. These by-laws are also called special resolutions : see Can., s. 3(2). The Ontario Act defines a special resolution as "a resolution passed by the directors and confirmed with or without variation by at least two thirds of the votes cast at a general meeting of the shareholders or members of the corporation duly called for that purpose, or, in lieu of such confirmation, by the consent in writing of all the shareholders or members entitled to vote at such meeting." Ont., s. 1(j).

49. Can., s. 113. For a case of board resolution see s. 32. Ont., ss. 65, 66, 120(3) 243(1), 321(5), etc.

50. Que., ss. 74 (1), 84, 89.

51. Model, § 30 provides that "Unless otherwise provided in the [charter], a majority of the shares entitled to vote, represented in person or by proxy, shall constitute a quorum at a meeting of shareholders, but in no event shall a quorum consist of less than one third of the shares entitled to vote at the meeting." N.Y., § 608. Cf. Penn., § 503; Delaware, § 216; California § 2211.

52. E.g., Model, § 54 (charter amendment); § 67 (merger); § 71 (sale or mortgage of assets); § 77 (voluntary winding up). It has been proposed to change this 2/3 majority to a simple majority in all cases. Delaware, § 215 (merger).

53. E.g., Model, § 36A [optional] (Removal of directors); Delaware, § 242 (d) (1) (charter amendment), § 271. N.Y., § 803 (charter amendment), § 903 (merger).

54. Gower, Some Contrasts Between British and American Corporation Law, 69 HARVARD L. REV. 1369, 1391-92 (1956).

55. NEB. CONST. Art. XII, § 6. It became possible to issue preference shares with different par values only after a recent amendment to the constitution. See Israels, Problems of Par and No-Par Shares: A Reappraisal, 47 COLUMBIA L. REV. 1279 (1947).

56. Can., s. 12(6).

57. Ont., s. 27(4).

58. New Brunswick, s. 13(1)

59. Que., s. 13(1).

60. Alta., s. 77(1).

61. The Committee was appointed in 1952 under the Chairmanship of Mr. Montague L. Gedge, Q.C., to report upon the desirability of permitting the issue of no-par shares. The Committee's REPORT ON NO PAR VALUE SHARES, Cmd. 9112 (1954), recommended, by a majority of 7 to 1, in favour. For a review of that report see Schmitthoff, No Par Value Shares, [1954] BUS. L. REV. 93.

62. It appears that they were known in Italy and Belgium. See LEVY, 2 PRIVATE CORPORATIONS AND THEIR CONTROL, 596 (1950).

63. The [Dominion] Companies Act, R.S.C. 1906, c. 79, was amended in 1917 by 7 & 8 Geo. V, c. 25, s. 4, to introduce a new section 7B which authorised the issue of no-par shares.

64. R.S.Q. 1909, §§ 5957-6090, repealed and replaced by 1920, 10 Geo. V c. 72, which introduced article 5967a.

65. R.S.O. 1914, c. 178; am. 1924, c. 47, ss. 3, 4.

Notes to Chapter 3.

1. LOSS, 1 SECURITIES REGULATION, 32 (2d ed. 1961). The three volumes of this treatise are hereinafter referred to as 1, 2 or 3 LOSS.

2. LOSS & COWETT, BLUE SKY LAW, 19(1958) (hereinafter cited as LOSS & COWETT).

3. See In the Matter of Cady, Roberts & Co. (S.E.C. 1961), reproduced in JENNINGS AND MARSH, SECURITIES REGULATION, CASES AND MATERIALS, 828 (1963) (hereinafter cited as JENNINGS & MARSH).

4. See S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (2d Cir. 1968), 258 F. Supp. 262 (S.D.N.Y. 1966); S.E.C. v. Frank, 388 F. 2d 486 (2d Cir. 1968).

5. For a criticism of the development of a "federal law of corporations by implication" and for the view that such law should be enacted by Congress rather than be developed "ad hoc . . . stemming from the rules of the [S.E.C.]" see Ruder, Pitfalls in the Development of a Federal Law of Corporations By Implication through Rule 10b-5, 59 Nw. U.L. REV. 185 (1964-65). For the contrary view see Fleischer, "Federal Corporation Law": An Assessment, 78 HARVARD L. REV. 1146 (1965). We are, however, not concerned with the propriety or impropriety of such development. Recently Professor Louis Loss has remarked: "Some courts, I suggest, are playing with this atomic bomb called 10b-5 — however salutary it has been — without realizing its true potential." Loss,

The Opinion, in the Proceedings of the American Bar Association National Institute on the BarChris Case, 24 BUSINESS LAWYER 523, 535 (Jan. 1969).

6. Securities Act, 1933, 15 U.S.C. § 77a (1964).

7. Securities Act, 1933 § 17, 15 U.S.C. § 77q (1964). For the definitions of "security", "sale" and "issuer", see § 2 (15 U.S.C. § 77c). There are some exemptions from the registration requirement, but these do not apply to the anti-fraud provision.

8. THE WORK OF THE SECURITIES AND EXCHANGE COMMISSION (Published by the S.E.C., April 1961), reprinted in JENNINGS & MARSH, 1, 3. Professor Loss states that "Under the 1933 federal act, in principle, a promoter may ask the public to invest in a hole in the ground as long as he does not without supporting geological data describe it as a uranium strike." 1 LOSS, 57. Controversy exists whether the S.E.C. should be given greater powers to pass upon the "fairness" of securities issues. See Jennings, The Role of the States in Corporate Regulation and Investor Protection, 23 LAW & CONTEMP. PROB. 193, 211-12, especially fn. 10 on 211 (1958).

9. 15 U.S.C., § 78a (1964).

10. Act of 1934, § 10 (b), 15 U.S.C., § 78j (b) (1964).

11. Act of 1934, § 9 (15 U.S.C., § 78i).

12. For the wide definition of "equity security" see § 3 of the Act of 1934 (15 U.S.C. § 78c). It includes not only shares of every class or kind, but also any security convertible into shares and also

warrant or right to buy shares.

13. Act of 1934, § 16 (15 U.S.C., § 78).

14. Act of 1939 (15 U.S.C., § 77aaa).

15. Act of 1933, § 8 (15 U.S.C., § 77h).

16. Act of 1933, § 8 (15 U.S.C., § 77h).

17. Ibid.

18. Act of 1934, § 19 (15 U.S.C., § 78s).

19. Act of 1933, § 20 (15 U.S.C., § 77t);

    Act of 1934, § 21 (15 U.S.C., § 78u).

20. Act of 1933, § 19 (15 U.S.C., § 77s);

    Act of 1934, § 23 (15 U.S.C., § 78w).

21. Act of 1933, § 11 (15 U.S.C., § 77k). Cases brought under this section are few. For a recent case see Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968). For a discussion of this case see Heller, Weiss, Israels & Schwartz, BarChris : A Dialogue on a Bad Case Making Hard Law, 57 GEORGETOWN L.J. 221 (1968). See also the A.B.A. National Institute on the BarChris Case, supra n. 5.

22. Act of 1933, § 12 (15 U.S.C., § 77l).

23. Act of 1934, §§ 18, 20 (15 U.S.C., §§ 78r, 78t).

24. McClure v. Borne Chem. Co., 292 F. 2d 824 (3d Cir. 1961); Fischman v. Raytheon Mfg. Co., 188 F. 2d 783 (2d Cir. 1951); Kardon v. National Gypsum Co., 73 F. Supp. 798 (E.D. Pa. 1947). Kardon's case was the first case to allow a private action for violation of Rule x-10b-5. We are not concerned with the contro-

versy about the propriety of these extensions of private remedial action. See supra n. 5.

25. Act of 1934, § 10 (15 U.S.C. § 78j).

26. 17 C.F.R. § 240. 10b-5 (1964).

27. Per Chairman Cary in In the Matter of Cady, Roberts & Co., S.E.C. Release No. 6668 (S.E.C. Nov. 8, 1961).

28. 1 LOSS, 591-605. Act of 1933, § 3a (11) (15 U.S.C., § 77c(a)(11)).

29. 1 LOSS, 653-96. Act of 1933, § 4(2) (15 U.S.C., § 77d(2)). The Act does not define what constitutes public offering.

30. 1 LOSS, 641-53. Act of 1933, § 4(1) (15 U.S.C., § 77d(1)).

31. 1 LOSS, 605-59. Act of 1933, § 3(b) (15 U.S.C., § 77c(b)).

32. 1 LOSS, 573-84. Act of 1933, § 3 (a) (9) (15 U.S.C., § 77c(a)(9).

33. Act of 1938, § 12, as amended in 1964 (15 U.S.C. § 78l).

34. On the historical background of Blue Sky Laws see LOSS & COWETT, BLUE SKY LAW (1958).

35. Delaware enacted a one-paragraph statute in 1931 authorising the Chancellor to enjoin, at the instance of the Attorney-General, the fraudulent sale or exchange of securities. Even that was dropped from the Code of 1953. See 1 LOSS, 30.

36. McKINNEY'S CONSOLIDATED LAWS OF NEW YORK ANNOTATED, GENERAL BUSINESS LAW, §§ 352-359h.

37. 9C UNIFORM LAWS ANNOTATED 86 (1957 & 1967 Cumulative Annual Pocket Part). Its predecessor, the Uniform Sale of Securities Act (9 UNIFORM LAWS ANNOTATED 625 (1942)) promulgated in 1930 was withdrawn in 1943.

38. Armstrong, The Blue Sky Laws, 44 VIRGINIA L. REV. 713 (1958). Jennings, op. cit. supra, at 225 et seq.

39. 1 LOSS, 58.

40. California Statutes 1968, c. 88 (Corporations Code, § 25000 et seq.) (effective 2 January 1969).

41. See COMPANY CAPITALIZATION CONTROL: REPORT UPON EXISTING LEGISLATION IN CANADA AND ELSEWHERE PREPARED BY THE UNDER SECRETARY OF STATE [THOMAS MULVEY] (Ottawa, 1913) (hereinafter referred to as the MULVEY REPORT). See also WILLIAMSON, SECURITIES REGULATION IN CANADA (1960, 1966 mim. Supp.) (hereinafter cited as WILLIAMSON).

42. California Corporations Code, 1967, Title 4, Division 1.

43. For the definition of "company" see California, § 25003.

44. California, § 25500.

45. California, § 25008.

46. California, § 25009.

47. Jennings, The Role of the States in Corporate Regulation and Investor Protection, 23 LAW & CONTEMP. PROBS. 193, 213 et seq. (1958).

48. California, § 25507.

49. California, § 25508.

50. California, § 25502.

51. California, § 25510.

52. For a more detailed account of these see Jennings, op. cit. supra n. 47, 215-16.

53. Id. at 216-18. Half the blue-sky statutes contain no exemption for private offerings. See 1 LOSS, 66. The underlying theory of the California permit-system is thus stated by Professor Richard W. Jennings:

> "The theory is that every issue of securities offers an opportunity to create inequities among shareholders and that any general exemption would fail to give the protection which the minority or outside shareholders need. It is possible, for example, to shift voting power between classes of shares by means of a stock split, a reverse stock split, or a share dividend. Moreover, a share dividend of preferred on common might have the effect of diluting the interest of the preferred as regards dividends, redemption, liquidation, conversion, and other rights. Shifts in priorities may also be effected through share dividends. Accordingly, rather than relying upon the class or other voting provision in the general corporation statute, the Commissioner is vested with the power to review these transactions as to fairness. While, at first glance, these provisions may seem unduly to hamper legitimate business, experience has shown that enough cases arise where supervision is needed to justify the inconvenience."

54. California Stats. 1968, c. 88 (effective 2 January 1969) (hereinafter cited as the New Law).

55. Volk, The California Corporate Securities Law of 1968 — A Significant Change from Prior Law, 24 BUSINESS LAWYER 77 (Nov. 1968). Mr. Robert H. Volk is the present Commissioner of Corporations of the State of California. See also Sterling, California Corporate Securities Law of 1968 : Underwritings and Corporate Reorganizations, 23 BUSINESS LAWYER 645 (Apr. 1968); Note, Nonissuer Transactions Under the California Securities Law of 1968, 21 STANFORD L. REV. 152 (Nov. 1968).

56. New Law § 25111.

57. Id. § 25112.

58. Id. § 25113.

59. Id. § 25110.

60. Id. §§ 25113, 25160.

61. Id. §§ 25113, 25140.

62. Id. § 25140 (c).

63. For definition of issuer see New Law, § 25010.

64. See Volk, op. cit. supra n. 55, at 77-78. People v. Pace, 73 Cal. App. 548, 238 P. 1809 (1925).

65. "Nonissuer transaction" is defined by section 25011 as one which is not directly or indirectly for the benefit of the issuer.

66. New Law, §§ 25130-25133.

67. Id. § 25120.

68. Ibid.

69. Id. § 25140 (c).

70. Cf. the coordination procedure laid down by the Uniform Securities Act, § 303.

71. New Law, § 25107. The Commissioner is authorised to refuse to issue such permit unless he finds that the proposed plan of recapitalization or reorganization and the proposed issuance of securities are fair, just, and equitable to all security holders.

72. Id. § 25100(o).

73. BEVIS, CORPORATE FINANCIAL REPORTING IN A COMPETITIVE ECONOMY, 2,3 (1965).

74. See also New Law, §§ 25100(i), 25101, 25102(i), (k), 25104(c), (g).

75. Id. § 25102(h).

76. Id. § 25102(e).

77. Id. § 25104.

78. Id. § 25103.

79. Id. § 25105.

80. The reforms will hopefully reduce the workload of the California Division of Corporations substantially. See Volk, op. cit. supra n. 55, at 81.

81. For the historical background and generally see WILLIAMSON, SECURITIES REGULATION IN CANADA (1960, mim. supp. 1966) (hereinafter cited as WILLIAMSON).

82. WILLIAMSON, 8-9.

83. Id. 9-10.

84. Supra n. 41.

85. WILLIAMSON, 12-13.

86. A.G. for Manitoba v. A.G. for Canada, [1929] A.C. 260, [1929] 1 D.L.R. 369 (P.C.). See also Lymburn v. Mayland, [1932] A.C. 318, [1932] 2 D.L.R. 6 (P.C.).

87. Ziegel, Constitutional Aspects of Canadian Companies, in ZIEGEL (ed.), STUDIES IN CANADIAN COMPANY LAW, 149 (1967).

88. Stat. Ont. 1966, c. 142, am. 1967, c. 92.

89. REPORT OF THE ATTORNEY GENERAL'S COMMITTEE ON SECURITIES LEGISLATION IN ONTARIO (March 1965) (KIMBER REPORT).

90. R.S.O. 1960, c. 363.

91. Ont. Securities Act, 1966, s. 6.

92. Ont. Sec. Act, 1966, s. 1(1) 31. "Security" is defined by s. 1(1) 27.

93. For the constitutional validity of the statutory requirement in the case of non-Ontario companies see Lymburn v. Mayland, [1932] A.C. 318, [1932] 2 D.L.R. 6 (P.C.), distinguishing A.G. Manitoba v. A.G. Canada, [1929] A.C. 260, [1929] 1 D.L.R. 369 (P.C.)

94. Ont. Sec. Act, 1966, s. 7.

95. Id., s. 8.

96. Id., s. 19.

97. See Ont. Sec. Act, s. 1. — (1) 16.

98. Ont. Sec. Act, s. 35.

99. Ont. Sec. Act, s. 61.

100. Id., ss. 58, 19(2).

101. Id., s. 58(2)(b).

102. R.S.Q. 1964, c. 273, s.4.

103. Id., s. 14.

104. Id., s. 21.

105. Id., s. 20.

106. Id., s. 24.

107. Id., s. 50.

108. Mackenzie, Securities Legislation and Practice, in CURRENT DEVELOPMENTS IN COMPANY LAW, 21, 23 (McGill University Faculty of Law, 1966).

109. Ibid.

110. Eng., ss. 37-46.

111. Cd. 7779 (1895), para. 42, reprinted in MULVEY REPORT, 470 et seq. Thomas Mulvey inferred that this observation was made with reference to the Kansas Blue Sky Law. See REPORT, lxxxviii.

112. Id., s. 41.

113. Id., ss. 43, 44.

114. 6 & 7 Eliz. 2, c. 45 (U.K. 1958) (effective 23 Oct. 1958) (hereinafter referred to as the Eng. Act of 1958).

115. Eng. Act of 1958, s. 2(2)(b). Similarly the prohibition does not apply to issuing a prospectus by foreign companies to which s. 417 of the Companies Act applies or would apply if not excluded by ss. 417(5)(b) or 418 of the Companies Act. See also s. 16 of the Act of 1958 which authorises the Board of Trade to exempt certain dealers from the operation of the Act. The Board may exempt persons dealing in securities in the following ways:

(i) issuing any document which is, or is deemed to be, a prospectus within the meaning of the Companies Act;
(ii) making, or offering to make, agreements for, or with a view to, underwriting;
(iii) making invitations to persons to subscribe (a) for securities or purchase securities on the first sale thereof or (b) for the securities of the Govt. of U.K. or any other country or a statutory or municipal corporation;
(iv) transacting with a person as a principal whose business involves the acquisition and disposal, or holding, of securities.

The Board is also authorised to exempt the following persons:

(i) Persons whose main business is other than dealing in securities;
(ii) Persons doing the greater part of their dealing in securities in U.K. through the agency of a member of of a recognised stock exchange or dealers' association, or the Bank of England, a statutory corporation, or an exempted dealer, or a person acting in the capacity of

manager or trustee under an authorised unit trust scheme, or any one of more of them or his or their agent, or a licence holder.

116. For the remarkable success of the English system see Gower, Some Contrasts Between British and American Corporation Law, 69 HARVARD L. REV. 1369, 1381-82 (1956).

117. The sections apply to properties other than securities as well.

118. PALMER'S COMPANY LAW, 210.

Notes to Chapter 4

1. "Unhappily 'capital' is a word of many different applications [Cf. capital punishment, capital letter, capital ship, capital city, capital of a pillar, capital and labour, capital and income, and "capital!"], and even in the legal, economic and accounting senses with which we are concerned, it is used loosely and to describe different conceptions at different times, although its users do not always recognise the fact." GOWER, MODERN COMPANY LAW, 96 fn.1 (2d ed. 1957) (hereinafter cited simply as GOWER).

"The word 'capital' may have any one of at least three meanings — viz. (1) Nominal capital .... (2) Issued capital .... (3) Paid-up capital. In which one of these meanings it is used in the [English] Act, it is often very difficult to say: probably it is used sometimes in one and sometimes in another." BUCKLEY ON THE COMPANIES ACTS, 158 (13th ed. 1957, 1964 Supp.).

"The nominal capital is, strictly speaking, not 'capital' at all; it represents only an authority by the shareholders to the directors to create new capital by the issue of shares .... [T]he issued capital is [on the other hand] a reality and not merely an authority." PALMER'S COMPANY LAW, 263 (21st ed. 1968).

"[The phrase, 'loan capital'], though frequently used in business circles, is, in the eyes of a lawyer, a contradiction in terms. The term denotes the debentures and debenture stock issued by the company. The holders of these securities are creditors of the company and have not, as such, a contributory interest in the company in

the way that a member has." PALMER'S COMPANY LAW, 265-66.

2. The Model Act uses the expression "total assets" in defining "net assets" : § 2(i).

3. Uniform, § 1 XI.

4. "[C]orporation statutes usually provide that dividends shall not be paid 'out of capital', or 'shall not impair capital', or 'shall be paid only out of surplus'. The phrase 'out of' in these statutory formulas is not to be taken literally. Dividends of course are paid out of the cash funds of the corporation." AMORY & HARDEE, MATERIALS ON ACCOUNTING, 44 (3d ed. 1959).

5. Model, § 26; Penn., §. 501(B); N.Y., § 602; Delaware, § 211; California, §§ 2200-2201. The purpose of the meeting is only the election of directors.

6. Model, § 46; N.Y., § 624.

7. California, §§ 3000-3022, in particular § 3006; Penn., § 318.

8. Delaware, § 220.

9. Gower, Some Contrasts Between British and American Corporation Law, 69 HARVARD L. REV. 1369, 1380 (1956).

10. Proper books of account have to be maintained by companies showing, among others, its assets and liabilities, sales and purchases of goods, and receipts and expenditures, but they are open to inspection at all times by directors and not shareholders. Eng., s. 147; Can., s. 115.

11. Eng., ss. 148-57, Sch. VIII. Many important changes have been made in these provisions by the Act of 1967.

12. Can., ss. 116-21, 121A-121D.

13. Ont., ss. 83-85, 85a, 86-91; Ont. Bill, 159-68; Que., ss. 95, 111; B.C., ss. 156 et seq.; Nova Scotia, ss. 106, 108; Sask., 157 et seq.; Alta., ss. 121, 122, 124b.

14. Eng., s. 158.

15. Can., s. 121E. Ontario's s. 93 is almost to the same effect except that it does not mention the debentureholder.

16. Eng., s. 127.

17. Can., s. 121F.

18. Eng., s. 129, repealed by the Act of 1967, s. 2 and sched. 8, Part III.

19. Ont. Bill, ss. 159(1)(b), 171.

20. Sched. II of the Companies Act, 1967, requires that the balance sheet should separately identify "fixed assets," "current assets," and "assets that are neither fixed nor current."

21. Swinfen Eady, L.J., explained them as follows in Ammonia Soda Co., Ltd., v. Chamberlain, [1918] 1 Ch. 266, 286-87 (C.A.):

> The distinction between "fixed" capital and "circulating" capital is not to be found in any of the Companies Acts; it appears to have first found its way into the Law Reports in Lee v. Neuchatel Asphalte Co., where Lindley L.J. in his judgment adopted the expression which had been used by Sir Horace Davey in argument, derived from writers on political economy. It is necessary to consider the sense in which the expressions "fixed capital" and "circulating capital" were used in that case and in Verner's Case. What is fixed capital? That which a company retains, in the shape of assets upon which the subscribed capital has been expended, and which assets either themselves produce income, independent of any further action by the company, or being retained by the company are made use of to produce income or gain profits. A trust company formed to acquire and hold stocks, shares, and

securities, and from time to time to divide the dividends and income arising therefrom, is an instance of the former. A manufacturing company acquiring or erecting works with machinery and plant is an instance of the latter. In these cases the capital is fixed in the sense of being invested in assets intended to be retained by the company more or less permanently and used in producing an income. What is circulating capital? It is a portion of the subscribed capital of the company intended to be used by being temporarily parted with and circulated in business, in the form of money, goods or other assets, and which, or the proceeds of which, are intended to return to the company with an increment, and are intended to be used again and again, and to always return with some accretion. Thus the capital with which a trader buys goods circulates; he parts with it, and with the goods bought by it, intending to receive it back again with profit arising from the resale of the goods. A banker lending money to a customer parts with his money, and thus circulates it, hoping and intending to receive it back with interest. He retains, more or less permanently, bank premises in which the money invested becomes fixed capital. It must not, however, be assumed that the division into which capital thus falls is permanent. The language is merely used to describe the purpose to which it is for the time being appropriated. This purpose may be changed as often as considered desirable, and as the constitution of the bank may allow. Thus bank premises may be sold, and conversely the money used as circulating capital may be expended in acquiring bank premises. The terms "fixed" and "circulating" are merely terms convenient for describing the purpose to which the capital is for the time being devoted when considering its position in respect to the profits available for dividend. Thus when circulating capital is expended in buying goods which are sold at a profit, or in buying raw materials from which goods are manufactured and sold at a profit, the amount so expended must be charged against, or deducted from, receipts before the amount of any profits can be arrived at. This is quite a truism, but it is necessary to bear it in mind when you are considering what part of current receipts are available for division as profit.

It should, however, be noted that the learned judge's definition of "fixed" and "circulating" assets as parts of "subscribed capital" is not exact. If a company borrows a sum of money, the borrowed amount, if retained as cash, is "circulating capital" and if invested in machinery and plant is "fixed capital."

22. FINNEY, GENERAL ACCOUNTING, 194-95 (12th printing, 1949).

FERST & FERST, BASIC ACCOUNTING FOR LAWYERS, 48 (1965).

23. FINNEY, ibid. FERST & FERST, id., 32.

24. BONBRIGHT, 1 VALUATION OF PROPERTY, 4-5 (1937) (hereinafter referred to simply as 1 BONBRIGHT and 2 BONBRIGHT).

25. FINNEY, GENERAL ACCOUNTING, 269.

FERST & FERST, BASIC ACCOUNTING FOR LAWYERS, 50.

26. Oxford Paper Co. v. United States, 52 F. 2d 1008, 1010 (Ct. Cl. 1931).

27. FERST & FERST, op. cit. supra, 28. See also AMERICAN INSTITUTE OF ACCOUNTANTS, AUDITS BY CERTIFIED PUBLIC ACCOUNTANTS 10 (1950) : "Perhaps no class of information is so imperfectly appraised by its readers as that contained in financial statements . . . . Actually, the values of most items in financial statements cannot be measured exactly. By their nature, many of the amounts shown have to be approximations and represent the best estimates which those responsible for the statements can make. The items which, in part at least, are subject to approximation are among the most important in the financial statements."

28. New York Laws, 1912, c. 351.

29. These words were omitted by an amendment of 1920.

30. Cook, Shares Without Par Value, 7 AMERICAN BAR ASSOCIATION J. 534, 535 fn. 7 (1921); Wickersham, The Progress of the Law of No-par Value Stock, 37 HARVARD L. REV. 464, 471 (1924-25).

31. 7 & 8 Geo. 5, c. 25, s. 4 (Can. 1917).

32. The Companies Amending Act, 1924, 14 & 15 Geo. 5, c. 33, s. 5 (Can.). This became section 9 of the Companies Act, R.S.C. 1927, c. 27.

33. Man., ss. 28(5),(6),(7), 41(3); N.B., ss. 6(1)(e), 13(5), (6), (7); Ont., s. 24(3), (4); P.E.I., s. 4(1)(d)(i) & (ii); B.C., ss. 28(2), 53, 119.

34. Can., s. 12(7).

35. Ont., s. 30(2). See also Man., s. 40; Ont. Bill, s. 32.

36. Que., s. 13(2).

37. N.B., s. 13(8).

38. P.E.I., s. 4(1)(d)(i) & (ii).

39. Sask., s. 17; B.C., s. 29.

40. Sask., s. 16(1).

41. B.C., s. 28(1).

42. Model, § 2(j).

43. Model, § 40.

44. Id. §§ 17, 19, 53.

45. Uniform, § 1 X.

46. Id. § 1 XII.

47. Id. § 1 X.

48. Uniform, § 23.

49. New York, § 102(12); Penn., § 614; California, § 1900.

50. Delaware, § 154.

51. GOWER, 99 fn. 9.

52. Can., s. 3(1)(a).

53. Barker, Purposes for which Financing is Commonly Required, in BUSINESS FINANCING, 5, 10 (American Bar Association, 1963).

54. See Steadman, Chattel Leasing — A Vehicle for Capital Expansion, in BUSINESS FINANCING, 193. In the case of a company acquiring assets on conditional sale, the balance sheet will have to show an outstanding liability in the form of accounts payable. Acquiring it as a lessee eliminates this necessity. Of course the leased property is not shown as an asset of the corporation either.

55. Eng., s. 154(5).

56. The proposed new Ontario Act defines "equity share" as "any share of any class of shares of a body corporate carrying voting rights under all circumstances and any share of any class of shares carrying voting rights by reason of the occurrence of any contingency that has occurred and is continuing." Ont. Bill, s. 1(1) 13. The definition in the Ontario Securities Act, 1966, is to the same effect. Cf. the definition in the U.S. Securities Exchange Act of 1934, § 3(11): "The term 'equity security' means any stock or similar security; or any security convertible, with or without consideration, into such a security, or carrying any warrant or right to subscribe to or purchase such a security; or any such warrant or right; or any other security which the Commission shall deem to be of similar nature and consider necessary or appropriate, by such rules and regulations as it may prescribe in the public interest or for the protection of investors, to treat as an equity security."

57. Uniform, § 24.

58. See on the Model Act, Hackney, The Financial Provisions of the Model Business Corporation Act, 70 HARVARD L. REV. 1357 (1957).

59. Model, § 43.

60. Id. § 2(i).

61. Id. § 2(h).

62. Id. § 2(j).

63. Id. § 2(1).

64. N.Y., § 102(9). See also Penn., § 2(11); Delaware, § 154.

65. Hackney, op. cit. supra, at 1393, expresses the view, for reasons which we shall see in a later chapter on corporate purchase of its own shares, that the exclusion of treasury shares in the Model Act's definition of net assets "is definitely erroneous".

66. Post Chapter 10.

67. See Kummert, The Financial Provisions of the New Washington Business Corporation Act, 43 WASHINGTON L. REV. 337 (1967); Hackney, Accounting Principles in Corporation Law, 30 LAW & CONTEMP. PROB. 791 (1965).

Notes to Chapter 5

1. Supra p. 23.
2. 63 & 64 Vict., c. 48 (U.K. 1900).
3. Id. ss. 4, 6. Section 4 provided that no such allotment should be made unless "(a) the amount (if any) fixed by the memorandum or articles of association and named in the prospectus as the minimum subscription upon which the directors may proceed to allotment; or (b) if no amount is so fixed and named, then the whole amount of the share capital so offered for subscription, has been subscribed, and the sum payable on application for the amount so fixed and named, or for the whole amount offered for subscription, has been paid to and received by the company."
4. PALMER'S COMPANY LAW, 184 fn. 4 (21st ed. 1968).
5. English Act of 1948, Sch. IV, part I, para. 4; Act of 1929 (19 & 20 Geo. 5, c. 23), ss. 39, 94, Sch. IV, part I, para. 5.
6. The corresponding schedule of the Indian Act contains the following words: "in the opinion of the directors or of the signatories to the memorandum arrived at after due inquiry, must be raised...." Indian Act, Sch. II, part I, para. 5 (emphasis added).
7. Eng., s. 47.
8. Eng., s. 49.
9. Eng., s. 109(1), (3).
10. Uniform, §§ 7, 8.
11. Model, § 51.
12. Model, § 43(e).
13. See Willard P. Scott, Changes in the Model Business Corporation

Act, 24 BUSINESS LAWYER 291, 300 (1968), where it is observed: "With the change over the years in the value of the dollar, the reliance upon credit reports rather than corporate form and the changed methods of doing business, [it has been] concluded that the protection sought to be achieved [by section 51 of the Model Act] was illusory and that the provision served no useful purpose. Consequently, it is to be eliminated."

14. 47 Cal. 2d 792, 306 P. 2d 1, 63 A.L.R. 2d 1042 (Cal. Sup. Ct. 1957). See also Annotation, Inadequate Capitalization as Factor in Disregard of Corporate Entity, 63 A.L.R. 2d 1051-58 (1957).

15. Gibson, Ch. J., and 5 other judges took this view. One judge dissented.

16. Pp. 302-303 (Rev. ed. 1946). See also Ballantine, Corporations: "Disregarding the Corporate Entity" as a Regulatory Process, 31 CALIFORNIA L. REV. 426-27 (1943); Fuller, The Incorporated Individual: A Study of the One-Man Company, 51 HARVARD L. REV. 1373, 1381-83 (1938). See also Geisenhoff v. Mabrey, 58 Cal. App. 2d 481, 137 P. 2d 36 (1943); Shea v. Leonis, 14 Cal. 2d 666, 96 P.2d 332, 334; Carlesimo v. Schwebel, 87 Cal. App. 2d 482, 197 P. 2d 167, 174 (1948); Mosher v. Salt River Valley Water Users' Ass'n, 39 Ariz. 567, 8 P. 2d 1077 (1932); Shafford v. Otto Sales Co., 149 Cal. App. 2d 428, 308 P. 2d 428 (1957); Temple v. Bodega Bay Fisheries, Inc., 180 Cal. App. 2d 279, 4 Cal. Reptr. 300 (1960); Claremont Press Publishing Co., Inc., v. Barkdale, 187 Cal. App. 2d 813, 10 Cal. Reptr. 214 (1960). Cf. Dixie Coal Mining & Mfg.

Co. v. Williams, 221 Ala. 331, 128 So. 799 (1930).

17. For a full discussion see the Annotation, op. cit. supra, 63 A.L.R. 2d 1051-58.

18. B.C., ss. 40, 41, 44, 119, 121; Sask. ss. 35, 36, 38, 40-43, 121, 212.

19. Que. R.S.Q. 1941, c. 276, s. 24.

20. Id. s. 13 (1)(b), (5). See also ss. 54(1), 63.

21. R.S.Q. 1964, 271. See Joan Clark, Recent Developments in Quebec Companies Act, in CURRENT DEVELOPMENTS IN COMPANY LAW, 14-15.

22. JENKINS REPORT, Cmnd. 1749 (1962), para. 27.

23. A sample analysis made by the Board of Trade at the request of the Jenkins Committee disclosed that 20% of all private companies registered in 1954 had by mid-1961 gone into liquidation or had been struck off the register or were seriously in default in filing returns. Id. para. 20.

24. JENKINS REPORT, para. 27.

25. In the contemplated revision of the Model Act the minimum paid-up capital requirement is to be eliminated: Supra n. 13.

26. Gower has advocated a statutory minimum capital. Gower, Company Law Reform, 4 MALAYA L. REV. 36, 42-43 (1962).

27. Cf. Kahn-Freund, Some Reflections on Company Law Reform, 7 MODERN L. REV. 54, 57-58 (1944). See the German Aktiengesetz 1965, §§ 7, 8, which prescribe that "The minimum nominal amount of the share capital is one hundred thousand Deutsche Mark" and that "The minimum nominal amount of shares is fifty Deutsche

Mark." The entire share capital has to be subscribed before the corporation can come into existence: see §§ 28, 29, 36, 37.

28. Model, § 48 (g).

29. Supra pp. 114-16.

30. 47 Cal. 2d 792, 306 P. 2d 1, 63 A.L.R. 2d 1042 (Cal. Sup. Ct. 1957).

31. 306 U.S. 307 (1939), reversing 96 F. 2d 693 (10th Cir. 1938). See also Arnold v. Phillips, 117 F. 2d 497 (5th Cir. 1941), cert. den. 313 U.S. 583.

32. 306 U.S. 307, 315 (Roberts, J., delivering the opinion of the Court).

33. Id. at 322. Section 77B of the Bankruptcy Act provided that "A plan of reorganization . . . may include provisions modifying or altering the rights of shareholders generally, or any class of them, either through the issuance of new securities of any character or otherwise . . . ." See post p. 201 et seq.

34. Id. at 323. The Court referred to the "broader equitable principle that the doctrine of corporate entity, recognized generally and for most purposes, will not be regarded when so to do would work fraud," which has been applied in "appropriate circumstances to give minority stockholders redress against wrongful injury to their interests by a majority stockholder" and to the decision of the Court in Southern Pacific Co. v. Bogert, 250 U.S. 483 (1919), but rested its decision on the statutory power conferred on the court by § 77B of the Bankruptcy Act.

35. SEWARD, BASIC CORPORATE PRACTICE, 31 (4th ed. 1966). See also RABKIN & JOHNSON, FEDERAL TAXATION, § 35.01(3).

36. See SEWARD, op. cit. supra, 30-31.

37. SOLOMON, THE THEORY OF FINANCIAL MANAGEMENT, 18 (1963, 5th printing 1967).

38. Id. 139.

39. Id. 138-39.

40. Id. 31.

41. See infra Chapter 7.

42. For a similar view see DODD, STOCK WATERING, 301-303, 306 (1930). No-par shares were favoured by some members of the Company Law Amendment Committee of 1926 — the Greene Committee — Cmd. 2657 (1926).

43. Gower, Company Law Reform, 4 MALAYA L. REV. 36, 46 (1962).

44. LEVY, 2 PRIVATE CORPORATIONS AND THEIR CONTROL, 601.

45. Gower, op. cit. supra n. 43, 4 MALAYA L. REV. 46.

46. Cmd. 9112 (1954).

47. Gower, op. cit. supra n. 43, 45-46.

48. See the FINAL REPORT OF THE COMMISSION OF ENQUIRY INTO THE WORKING AND ADMINISTRATION OF THE PRESENT COMPANY LAW OF GHANA, 1961 (hereinafter referred to as GOWER'S GHANIAN REPORT). The Report contains a "Draft of a Bill Entitled the Companies Code, 1961) with commentaries on the code sections. (This will hereinafter be referred to as the Gower's Draft Code for Ghana).

49. Gower's Draft Code for Ghana, § 40.

50. Morawetz, Shares Without Nominal or Par Value, 26 HARVARD L. REV. 729, 731 (1912-13).

51. Hollen & Tuthill, Uses of Stock Having No Par Value, 7 AMERICAN BAR ASSOCIATION J. 579 (1921).

52. DEWING, 1 FINANCIAL POLICY OF CORPORATIONS, 64 note n (5th ed. 1953).

53. Morawetz, op. cit. supra, 26 HARVARD L. REV. at 730.

54. Eng. Act, s. 57. See Indian Act, s. 79 which is somewhat similar.

55. See Jackson, Some Random Reflections on No-Par Share Legislation, 7 CANADIAN BAR REV. 373 (1929).

56. Hollen & Tuthill, Uses of Stock Having No Par Value, 7 AMERICAN BAR ASSOCIATION J. 579, 582 (Nov. 1921), replying to Cook, Stock Without Par Value, id. 534 (Oct. 1921).

57. Hollen & Tuthill, ibid.

58. According to Dewing "The outstanding advantage of no-par stock is truth. No-par stock does not pretend to place a definite money value on the composite group of values — human and intangible as well as material — which the corporation takes over at its inception as its original stock-in-trade." 1 DEWING, 62-63. Dewing expresses the view that no-par shares are unsuitable for moneyed corporations — banks and insurance companies. Id. 65-66.

Notes to Chapter 6.

1. DEWING, 1 FINANCIAL POLICY OF CORPORATIONS, 123 note b and the references therein cited. See also GOWER, 327 fn. 40: "General permission for statutory companies to issue Preference shares was first conferred by the 1863 Act, s. 13, but from 1830 onwards the practice had been widespread under the authority of special Acts."
2. See post p. 145. See Eng. Act, s. 23(2); Ashbury v. Watson, 30 Ch. D. 376 (1885).
3. [1897] 1 Ch. 361 (C.A.)
4. He based his decision on Hutton v. Scarborough Cliff Hotel Co., 2 Dr. & Sm. 514, 521, 143 R.R. 263 (1865) (Kindersley, V.C.), aff'd 4 D.J. & S. 672, 143 R.R. 269 (C.A. 1865).
5. Lindley, A.L. Smith, and Rigby, L. JJ. The Court held that Hutton v. Scarborough was wrongly decided. Earlier Lord Macnaghten had expressed his dissent from Hutton v. Scarborough in British and American Corporation v. Couper, [1894] A.C. 399, 417 (H.L.).
6. Eng. Act of 1929, s. 46; Act of 1947, s. 71; Act of 1948, s. 58.
7. GOWER, 327.
8. Id. 334.
9. Model Act, § 48 (d), (e), (f).
10. Can., s. 7(2)(e), (i). See Ont., s. 18. — (1) 5, 6.
11. Can., s. 12(1), (1a), (1b); see also s. 59. Ont., ss. 27, 28. Que. s. 45.

12. Can., s. 12(14).

13. Can., s. 12(15).

14. See 1 DEWING, 132 and note o on that page.

15. 1 DEWING, 133-34.

16. Birch v. Cropper, 14 App. Cas. 525 (H.L. 1889). Cf. In re Bridgewater Navigation Co., [1891] 2 Ch. 317(C.A.). See also In re Esperela & Cattle Co., [1909] 2 Ch. 187.

17. Scottish Insurance Corp. v. Wilsons & Clyde Coal Co., [1949] A.C. 462 (H.L.), over-ruling In re Williams Metcalfe, Ltd., [1933] Ch. 142 (C.A.). Also Prudential Assurance Co. v. Chatterley-Whitfield Collieries, [1949] A.C. 512 (H.L.). These cases are discussed post Ch. 8. See also In re Isle of Thanet Electric Co., [1950] Ch. 161.

18. For a full account of these judicial developments see GOWER, 353-64.

19. Eng., s. 23(2). See Ashbury v. Watson, 30 Ch. D. 376 (C.A. 1885), aff'g 28 Ch. D. 56 (Kay, J.), in which the court held that a purported special resolution passed by the company in 1872 altering the rights attached to a class of shares by the memorandum (without providing for a mode of altering them) and acted upon by the company till 1883 without any objection being raised by any member of the company, was invalid and ineffective. (Esher, M.R., Baggallay and Fry, L.JJ.).

20. The memorandum may validly provide that the rights attached by it to the different classes may be altered in the manner prescribed by the articles. See In re Welsbach Incandescent Gas Light Co., Ltd.,

[1904] 1 Ch. 87 (C.A.).

21. [1901] 2 Ch. 309 (Cozens-Hardy, J.).

22. [1901] 2 Ch. at 313.

23. 2 Dr. & Sm. 521, 13 W.R. 1059, 143 R.R. 269 (1865). For the first stage of the case see 2 Dr. & Sm. 514, 13 W.R. 574, aff'g 4 D.J. & S. 672, 13 W.R. 631, 143 R.R. 263 (1865).

24. Eng. Act of 1862, s. 50.

25. For a similar approach on the other side of the Atlantic see Pronik v. Spirits Distributing Co., 58 N.J. Eq. 97, 42 A. 586 (N.J. Ch. 1899).

26. [1894] A.C. 399, 417 (H.L.).

27. [1897] 1 Ch. 361 (C.A.).

28. Eng., s. 10.

29. The decisional law is also scanty. See GOWER, 492.

30. Per North, J., in In re Barrow Hæmatite Steel Co., 39 Ch. D. 582 (1888) discussed post p. 300 .

31. For this view see PALMER'S COMPANY LAW, 288 (21st ed. 1968).

32. Just as the rights of a debentureholder or other creditor cannot ordinarily be varied except with his individual consent, unless the debenture trust deed or other instrument creating the debt expressly stipulates that the rights may be modified or abrogated with the consent of a prescribed majority of the debentureholders or creditors or classes of them. The courts will of course be astute in such cases to ensure that the variation is effected only in strict accordance with the prescribed procedure. See The Second Consolidated

Trust, Ltd. v. Ceylon Amalgamated Tea & Rubber Estates, Ltd., [1943] 2 All E.R. 567 (Ch. D. Uthwatt, J.).

33. For an affirmative answer to this question see In re National Dwellings Society, 78 L.T. 144 (1898).

34. See Eng., Sch. I, Table A, Regulation 4.

35. Until the English Act of 1948 the objectors had to apply under the section within 7 days after the date on which the resolution was consented or voted on. The Act of 1948 has extended this to 21 days.

36. GOWER, 493.

37. [1946] 1 All E.R. 512 (C.A.), aff'g [1945] 2 All E.R. 719 (Vaisey, J.).

38. The company had nonvoting preference shares also, but they are not relevant for the purpose which we are concerned with here.

39. See also Sovereign Life Assurance Co. v. Dodd, [1892] 2 Q.B. 573 (C.A.); In re United Provident Assurance Co., Ltd., [1910] 2 Ch. 477 (Swinfen Eady, J.).

40. [1953] Ch. 65 (C.A.) (Evershed, M.R., Denning & Romer, L.JJ.).

41. In re John Smith's Tadcaster Brewery Co., Ltd., John Smith's Tadcaster Brewery Co., Ltd. v. Gresham Life Assurance Society & anr., [1953] Ch. 308 (C.A.), reversing [1952] W.N. 501, [1952] 2 T.L.R. 853, [1952] 2 All E.R. 751 (Danckwerts, J.).

42. The bonus issue included also 2,640,000 ordinary shares of 10 s. each ranking pari passu with the existing ordinary shares, but we need not concern ourselves about it here.

43. [1953] Ch. at 74.

44. [1953] Ch. at 316-17, per Evershed, M.R.

45. English, ss. 66-71.

46. [1916] 2 Ch. 450. See also Bannatyne v. Direct Spanish Telegraph Co., 34 Ch. D. 287 (C.A. 1886); In re Barrow Hæmatite Steel Co., 39 Ch. D. 582 (North, J. 1888) and other cases discussed post Ch. 8.

47. GOWER, 537, where the author criticises the "desolating logic" of this conclusion.

48. [1953] 1 Ch. at 77.

49. English, s. 72; Act of 1929, s. 61.

50. Menier v. Hooper Telegraph Co., 9 Ch. App. 350 (1874); Gray v. Lewis, 8 Ch. App. 1049 (1873); Atwool v. Merryweather, 5 Eq. 464n. (1868); Mason v. Harris, 11 Ch. D. 97 (1879); MacDougall v. Gardiner (No. 2), 1 Ch. D. 13 (1875); Burland v. Earle, [1902] A.C. 83; Normandy v. Ind, Coope & Co., [1908] 1 Ch. 84; Allen v. Gold Reefs of West Africa, [1900] 1 Ch. 656.

51. [1904] 1 Ch. 86 (C.A.). See also The Oban & Aultmore-Glenlivet Distilleries, Ltd., 5 Session Cases 1140 (Scottish Court of Session, 1903); Last v. Buller & Co., Ltd., 36 Times L. Reps. 35 (Ch. 1919). In the last case Sargant, J., refused to grant an interlocutary injunction to restrain the company and its directors from holding a meeting of the company in order to cancel arrears of cumulative dividends amounting to £51,000 accrued on preference shares and to substitute a noncumulative dividend instead of a cumulative dividend.

52. [1904] 1 Ch. at 97. Vaughan Williams and Sterling, L.JJ., concurred with the views of Buckley, J., in the court of first instance, but unfortunately the judgment of the latter is unreported.

53. 34 Ch. D. 287 (C.A. 1886).

54. [1916] 2 Ch. 450.

55. [1954] Ch. 169 (C.A.). (Evershed, M.R., Jenkins and Fry, L.JJ.)

56. [1949] A.C. 462, 65 T.L.R. 354, [1949] 1 All E.R. 1068 (H.L.).

57. [1949] A.C. 512, [1949] 1 All E.R. 1094 (H.L.).

58. [1954] Ch. at 189-90. The Master of the Rolls also concluded that the directors' circular recommending the third reduction contained misleading statements. To the same effect, see James, L.J., at pp. 197-99.

59. Eng. Act of 1929, ss. 153, 154, 288; Act of 1908, s. 120, reproducing s. 2 of the Joint Stock Companies Arrangement Act of 1870. It was the Act of 1908 which for the first time provided for compromises or arrangements whether or not the company was in winding-up.

60. GOWER, 524. See In re Empire Mining Co., 44 Ch. D. 402 (North, J. 1890); Slater v. Darlaston Steel & Iron Co., [1877] W.N. 139, 165 (Jessel, M.R.); In re Alabama, New Orleans, Texas & Pacific Junction Ry. Co., [1891] 1 Ch. 213 (C.A.); In re English, Scottish & Australian Chartered Bank, [1893] 3 Ch. 385 (C.A.); In re Dynevor, Dyffryn, & Neath Abbey Collieries Co., 11 Ch. D. 605 (C.A. 1879); In re Wedgwood Coal & Iron Co., 6 Ch. D. 627 (Malins, V.C. 1877).

61. Eng., s. 206(6).

62. GOWER, 524-25.

63. City Property Investment Trust Corp., Ltd., [1951] Scots L. Times 371, 372.

64. Eng. s. 22.

65. GOWER, 524.

66. In re Dorman Long & Co., [1934] Ch. 635. GOWER, 539.

67. [1950] Session Cases 218.

68. See also Peter Scott & Co., Ltd., [1950] Session Cases 507, which also involved a private company; City Property Investment Trust Corp., Ltd., [1951] Scots L. Times 371. Cf. The Clydesdale Bank, Ltd., [1950] Session Cases 30, where in special circumstances the failure to comply with section 207 was not regarded as a defect in procedure. The practice of Scottish Courts is to refer such schemes to a reporter and to consider his report before confirming it. See GOWER, 545. See also Re National Bank, Ltd., [1966] 1 All E.R. 1006 (Ch. D.) where the court held that the company need not disclose under section 207 information which it is exempted by Sch. VIII, Part III, para. 23 of the Companies Act, 1948, from disclosing in its accounts.

69. [1890] 1 Ch. 213, 239 (C.A.), aff'g North, J.

70. [1893] 3 Ch. 385, 409 (C.A.). In In re English, Scottish and Australian Chartered Bank, Vaughan Williams, J., sanctioned provisionally a scheme though he felt that there were "very serious objections" to such scheme and that he would not have voted in its

favour if he were a creditor. Presumably he felt that the majority was not unreasonable in regarding it as commercially advantageous to the creditors as a whole (p. 399). He was also of the opinion that adequate information about the scheme was not made available to the creditors' meeting "to enable them to deal properly with the matter." (p. 400). It is indeed surprising that despite all his misgivings he felt constrained to sanction the scheme even temporarily. The Court of Appeal suffered from no such doubts. Lindley, L.J., remarked: (pp. 406-07)

> "I do not think it is just to say that this is a mere scheme to resuscitate the bank and not pay the creditors. If I thought that was the scheme, I should negative it without the slightest hesitation; but I think the true view of it is this, that it is a scheme for paying the creditors by resuscitating the bank, and I do not believe the creditors can get paid in any other way."

71. Professor Gower quotes this sentence only and remarks that it is a "facile but fatal rule first enunciated by Lindley, L.J. . . . ." (GOWER, 540). The sentences which follow show that Lindley, L.J., was only giving due weight to a decision of the majority and was not unprepared to go behind it in proper cases. Nor was he the first to enunciate the "fatal" rule. More than 25 years earlier Woods, V.C., observed in In re Agra and Masterman's Bank, L.R. 12 Equity Cases 509n, 511 (1866), thus:

> "/I/t would be a very rash step on the part of Court . . . to attempt to form an individual opinion as to what is thought right or wrong against the views of the very large body of those who are capable of judging and acting for themselves, and have formed a very decided opinion. In truth, the function of the Court seems reduced to seeing that everything has been fairly done and put before the

> creditors and shareholders, and that they have been informed of all that they ought to be informed of — that a decision has not been snatched by surprise, that there has been nothing which would induce the Court to say there has been either a surprise or fraud upon the persons sought to be affected by it, or that it is a case in which there ought to be a fresh investigation after the facts are known."

This has been the consistent attitude of the English courts to majority decisions.

72. [1934] Ch. 635, 656-57.

73. [1934] Ch. 635, at 670.

74. Id. at 673. As, however, the court was of the view that there was nothing in the scheme "which, if carefully explained, might not be approved by a business man acting reasonably in the matter," (p. 673), and that it was not such that the court would decline to approve if properly assented to by a sufficiently informed class, it held that the company could call a fresh meeting of the class and send out proper explanatory circulars to obtain their assent. The facts of this case were complicated and involved schemes of two companies which were to amalgamate. Maugham, J., held that proxies had also been improperly rejected at class meetings. For the sake of brevity we have omitted the facts relating to one of the two companies.

75. Id. at 665.

76. Eng., s. 207.

77. [1890] 1 Ch. 213 (C.A.), aff'g North, J.

78. Under sections 159, 160 of the Act of 1862, there was "a difficulty, if not impossibility, of majority of creditors binding minorities." (id. 236). The Act of 1870 removed this doubt or difficulty. It should be noted that the Act of 1870 applied only to compromises and arrangements with creditors of a company under winding up. It did not apply to reconstructions of going concerns or to restructuring share capital. The section attained its modern form only in 1908. Supra n. 59.

79. Id. at 240.

80. [1890] 1 Ch. 213, 242.

81. See also Bowen, L.J., at 243-45; Fry, L.J., at 247-48. Also see North, J., at 231.

82. In the recent case of Re National Bank, Ltd., [1966] 1 All E.R. 1006 (Ch. D., Plowman, J.), the banking company which did not want to disclose certain financial information which it is exempted from disclosing under the Companies Act, appointed a firm of Chartered Accountants to investigate and report about its financial position. They were given access to the exempt information and their findings and recommendations were included in the statutory statement sent to the shareholders.

83. For a critical discussion of the English approach see Gold, Preference Shareholders in the Reconstruction of English Companies, 5 U. TORONTO L.J. 282 (1944). Gold suggests examination of fairness by an administrative body like the American S.E.C.: id. 323. Scottish courts make a practice of referring such schemes to a reporter:

GOWER, 545. In the American context see Dodd, Fair and Equitable Recapitalizations, 55 HARVARD L. REV. 780 (1942).

84. Eng., s. 287(5). For detailed account see GOWER, 525-29. See also s. 209 and GOWER, 529-32 on take-over bids. Thus company I by acquiring a controlling interest in company II, either by buying its shares for cash or in exchange for its own shares or both, may use that control for acquiring the undertaking of company II under section 287. If it acquires 90% or more of the shares of company II, then it may buy out the minority under section 209.

85. [1909] 1 Ch. 491 (Swinfen Eady, J.).

86. See the observations of James, L.J., in Menier v. Hooper Telegraph Works, 9 Ch. 350, 353 (C.A. 1874).

87. GOWER, 529 fn. 70.

88. In re Imperial Mercantile Credit Association, L.R. 12 Equity Cases 504 (1871) (Bacon, V.C.).

89. Eng., s. 10.

90. Model, § 53. The section authorises the amendment of the charter from time to time so as:-

> "(f) To exchange, classify, reclassify or cancel all or any part of its shares, whether issued or unissued.
>
> (g) To change the designations of all or any part of its shares, whether issued or unissued, and to change the preferences, limitations, and the relative rights in respect of all or any part of its shares, whether issued or unissued.
>
> *** ***
>
> (i) To change the shares of any class, whether issued or unissued, . . . into a different number of shares of the same class or into the same or different number of shares . . . of other classes.

(j) To create new classes of shares having rights and preferences either prior or superior or subordinate and inferior to the shares of any class then authorised, whether issued or unissued.

(k) To cancel or otherwise affect the right of the holders of the shares of any class to receive dividends which have accrued but have not been declared.

(l) To divide any preferred or special class of shares whether issued or unissued, into series and fix and determine the designations of each series and the variations in the relative rights and preferences as between the shares of such series.

(m) To authorise the board of directors to establish, out of authorised but unissued shares, series of any preferred or special class of shares and fix and determine the relative rights and preferences of the shares of any series so established.

(n) To authorise the board of directors to fix and determine the relative rights and preferences of the authorised but unissued shares of series theretofore established in respect of which either the relative rights and preferences have not been fixed and determined or the relative rights and preferences theretofore fixed and determined are to be changed.

(o) To revoke, diminish, or enlarge the authority of the board of directors to establish series out of authorised but unissued shares of any preferred or special class and fix and determine the relative rights and preferences of the shares of any series so established."

91. See DODD & BILLYOU, CORPORATE REORGANIZATION, 490.

92. 1 DEWING 123, note b.

93. This difference is not always noticed by writers. See Mackinnon, The Protection of Dissenting Shareholders, in ZIEGEL (ed.), STUDIES IN CANADIAN COMPANY LAW, 507, 523 (1967).

94. Trustees of Dartmouth College v. Woodward, 17 U.S. (4 Wheaton) 518 (1819).

95. Note, Limitations of Shareholders' Rights by Charter Amendment, 69 HARVARD L. REV. 538, 541 fn. 26 and the cases cited therein.

96. 58 N.J. Eq. 97, 42 A 586 (N.J. Ch. 1899). See also Zabriskie v. Hackensack & N.Y.R.R., 18 N.J. Eq. 178 (N.J. Ch. 1867). Cf. the English case of Hutton v. Scarborough Cliff Hotel Co., discussed supra p. 147 .

97. 42 A. at 588. See also James v. Washburn Co., 94 N.E. 2d 479 (Supreme Judicial Ct. Mass., 1950).

98. Note, op. cit. supra, 69 HARVARD L. REV. at 541 fn. 24.

99. In Peters v. United States Mortgage Co., 114 A. 598 (Del. Ch. 1921) the court refused to restrain the corporation from altering materially the rights attached to preference shareholders. The Delaware Act not only conferred general power to amend the charter (like the New Jersey Act of 1893 : see the Pronik case discussed earlier), but further specifically authorised the variation of "the preferences given to one or more classes of preferred stock" by the majority vote of the class (the Act conferring mandatory class-voting right in such event). The Delaware court held that the alteration of the preferential rights of a class of shares was explicitly authorised by the Act and that therefore "one of the terms by which [the preference shareholder] holds his contract is that the same may be altered." (id. at 600). The preference shareholder ought not to complain as he ought to have known that the rights attached to his shares were alterable as provided by the Act.

100. 122 A. 696 (Del. Ch. 1923). See also Pennington v. Commonwealth Hotel Construction Corp., 17 Del. Ch. 394, 155 A. 514, 75 A.L.R. 1136 (1931).

101. The distinction between the right to arrears of dividend and other special rights is of course strained. See Judge Learned Hand's criticism of the "vested" concept in his dissenting opinion in Harr v. Pioneer Mechanical Corp., 65 F. 2d 332, 336 (2d Cir. 1933), cert. den. 290 U.S. 673 (1933). Also see Davison v. Parke, Austin & Lipscombe, Inc., 285 N.Y. 500, 508-09, 35 N.E. 2d 618, 622 (1941).

102. 122 A. at 701.

103. Id. at 703.

104. Roberts v. Roberts-Wicks Co., 184 N.Y. 257, 77 N.E. 13 (C.A. 1906); Colgate v. U.S. Leather Co., 73 N.J. Eq. 72, 67 A. 657 (Ch. 1907). Of course the preference shareholder is not a creditor so as to entitle him to sue for arrears of cumulative preferential dividends which have accrued, but not been declared. See American Steel Foundries v. Lazear, 204 F. 204 (3d Cir. 1913).

105. See Peters v. U.S. Mortgage Co., 114 A. 598 (Del. Ch. 1921).

106. 122 A. at 704.

107. Id. at 704-05.

108. The Oban & Aultmore-Glenlivet Distilleries, Ltd., 5 Session Cases 1140 (1903); Welsbach Incandescent Light Co., Ltd., [1904] 1 Ch. 87; Last v. Buller & Co., Ltd., 36 T.L. Rep. 35 (Ch. D. 1919).

109. In the case of mere contractual rights the courts were not conservative in giving full scope to effect modifications. See Davis v.

Louisville Gas & Electric Co., 16 Del. Ch. 157, 142 A. 654 (1928).

110. 21 Del. Ch. 391, 190 A. 115 (Del. Sup. Ct. 1936).

111. Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A. 2d 331 (Del. Sup. Ct. 1940) (Layton, C.J.) (hereinafter cited as the Havender case). The court discussed the case-law on the subject at considerable length. See also Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A. 2d 148 (Ch. 1943).

112. Like section 287 of the English Act.

113. Hottenstein v. York Ice Machinery Corp., 136 F. 2d 944, 951 (3d Cir. 1943).

114. Shanik v. White Sewing Machine Corp., 19 A. 2d 831 (Del. Sup. Ct. 1941), herein referred to as the Shanik case. See also Barrett v. Denver Tramway, 53 F. Supp. 198 (Del. 1944).

115. The original share structure was as below:

Common (authorised 400,000; issued 200,000) at $3.75 per share	...	$ 750,000
Preferred (authorised and issued 100,000) at $50 per share	...	5,000,000
Total paid up capital		5,750,000
Total loss up to the end of 1937 (operating losses during the depression years)		3,167,228.26
The value of the assets of the company by the end of 1937		2,582,771.74

Capital after reduction:

Preference (100,000 at ($50 minus $27))	2,300,000
Common	80,000
Surplus	202,771.74
Total	2,582,771.74

The reduced common capital was converted into 80,000 new common shares of $1 par each. The reduced preference capital continued to

consist of 100,000 shares but with a reduced paid up value of $23 each. 100,000 new prior preference shares of $20 par value each was created, as well as 420,000 new common shares of $1 each. As the old preference shares had a reduced stated value of $23 now, the option was given to exchange them for a new prior preference share of a par value of $20 each and 3 new common shares of $1 each.

It may be noted that the company which had a deficit of over three million dollars could by the capital reduction convert itself into a company with a surplus of over two hundred thousand dollars. It should also be noted that the company was not insolvent either in the equity or the bankruptcy sense.

116. See also Johnson v. Fuller, 36 F. Supp. 744 (D.C., E.D. Penn. 1940) and other cases cited by the court in the Shanik case, 19 A. 2d 831, at 836.

117. Section 55 of the Model Act, as amended in the 1957 Addendum, confers mandatory class-voting rights on the following charter amendments irrespective of whether or not the shares are entitled to vote thereon by the provisions of the charter:

> "(b) Increase or decrease the par value of the shares of such class.
>
> (c) Effect an exchange, reclassification or cancellation of all or part of the shares of such class.
>
> (d) Effect an exchange, or create a right of exchange, of all or any part of the shares of another class into shares of such class.

(e) Change the designations, preferences, limitations or relative rights of the shares of such class.

(f) Change the shares of such class . . . into the same or different number of shares . . . of the same class or another class or classes.

(g) Create a new class of shares having rights and preferences prior and superior to the shares of such class, or increase the rights and preferences of any class having rights and preferences prior or superior to the shares of such class.

(h) In the case of preferred or special class of shares, divide the shares of such class into series and fix and determine the designation of such series and the variations in the relative rights and preferences between the shares of such series or authorise the board of directors to do so.

*** ***

(j) Cancel or otherwise affect dividends on the shares of such class which have accrued but have not been declared."

118. See supra p. 176 and n. 90.

119. Gibson, infra n. 128, and the cases cited in footnotes 54 and 55 on page 296. Cf. Note, Limitations on Alteration of Shareholders' Rights by Charter Amendment, 69 HARVARD L. REV. 538, 543 (1956).

120. 64 A. 2d 644, 649 (Superior Ct. N.J., Ch. Div., 1949).

121. The company here was incorporated in 1927.

122. 64 A. 2d 644, 649 (N.J. Ch. 1949).

123. 40 Wash. 2d 286, 242 P. 2d 1025 (Sup. Ct. Wash. en banc 1952). But see Seagrave Corp. v. Mount, 212 F. 2d 389 (6th Cir. 1954) aff'g 112 F. Supp. 330 (S.D. Ohio 1953).

124. 242 P. 2d 1025, at 1033. Cf. the English case of In re Consolidated South Rand Mines Deep, Ltd., [1909] 1 Ch. 491, discussed supra pp. 174-75.

125. The court relied on Adams v. United States Distributing Corp., 184 Va. 134, 34 S.E. 2d 244, 162 A.L.R. 1227 (1945); Wick v. Youngstown Sheet & Tube Co., 46 Ohio App. 253, 188 N.E. 514 (1932); Pridmore v. Whiting Corp., 268 Ill. App. 592; Homer v. Crown Cork & Seal Co., 155 Md. 66, 141 A. 425 (1928); Wall v. Anaconda Copper Mining Co., 216 F. 242 (D.C. Montana, 1914).

126. E.g., Theis v. Spokane Falls Gas Light Co., 34 Wash. 23, 74 P. 1004 (1904); cf. Smith v. Flathead River Coal Co., 66 Wash. 408, 119 P. 858 (1911); Beutelspacher v. Spokane Savings Bank, 164 Wash. 227, 2 P. 2d 729 (1931).

127. 242 P. 2d at 1037.

128. George D. Gibson, How Fixed Are Class Shareholder Rights?, 23 LAW & CONTEMP. PROB. 283, 296-97 (1958). In Metzger v. George Washington Memorial Park, 380 Pa. 350, 110 A. 2d 425 (1955), the Supreme Court of Pennsylvania upheld a charter amendment which gave preference shares equal voting rights with common shares, whereas before the amendment they had no voting right except upon default of four semi-annual preferential dividends. The dissenting common shareholders impugned the validity of the charter amendment, but were not successful. The amendment was voted in favour by a majority of the common shareholders as required by Pennsylvania corporation law. See also the other cases cited in Gibson, id., at 291 fn. 43.

129. Dodd, Fair and Equitable Recapitalizations, 55 HARVARD L. REV. 780 (1942). The "fair and equitable" standard worked out in reorgan-

ization cases is discussed later. See Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939), 53 HARVARD L. REV. 713 (1940); Consolidated Rock Products Co. v. du Bois, 312 U.S. 510 (1941). See also generally DODD & BILLYOU, CORPORATE REORGANIZATION (1950).

130. Southern Pacific Co. v. Bogert, 250 U.S. 483 (1919).

131. Pepper v. Litton, 308 U.S. 295, 306-12 (1939).

132. See Mount v. Seagrave Corp., 112 F. Supp. 330 (S.D. Ohio, 1953), 212 F. 2d 389 (6th Cir. 1954).

133. Gibson, op. cit. supra, 23 LAW & CONTEMP. PROB., at 298, et seq.

134. Note, Limitations on Alteration of Shareholders' Rights by Charter Amendment, 69 HARVARD L. REV. 538 (1956). Also Note, Capital Stock Reduction as Affecting the Rights of Creditors, 47 HARVARD L. REV. 693 (1934).

135. Fuld, Some Practical Aspects of a Merger, 60 HARVARD L. REV. 1092 (1947).

136. The new California Securities Law of 1968, § 25120.

137. Supra Ch. 3.

138. Dodd, Fair and Equitable Recapitalizations, 55 HARVARD L. REV. 780, 786 (1942).

139. This legal distinction never exactly conformed to business reality which is that "creditors as well as stockholders, have their funds more or less permanently tied up with the fortunes of the business. They are both at the mercy of a management, wise or improvident,

honest or deceitful. Hence, there is the feeling that at the last analysis the stockholders and the creditors differ in their relative, not absolute, rights to participate in the corporate success or the corporate failure." 1 DEWING, 167.

140. Vaughan Williams, J., observed in the court of first instance in In re English, Scottish and Australian Chartered Bank, [1893] 3 Ch. 385, 392 (C.A.) thus: "The decisions of twenty years or quarter of a century ago shew the strongest possible feeling that one ought never to deprive any creditor of his common law right, and ought never to require him to give up anything to which he is by law entitled, at the will of the majority of the creditors, unless all the steps which are provided by the statute have been most carefully followed, and the tendency was to construe in the strictest possible manner any statute which gave the majority of creditors the right to impose their will upon the minority. But I do not think that any one who has followed the subsequent decisions — whether under the Companies Acts or the Bankruptcy Acts — will hesitate to say that the tendency of late has been rather to favour the power of the majority of creditors to impose their will upon the minority and to construe the legislation upon the subject with some freedom."

141. See e.g., The Second Consolidated Trust, Ltd. v. Ceylon Amalgamated Tea & Rubber Estates, Ltd., [1943] 2 All E.R. 567 (Ch. D. Uthwatt, J.).

142. GOWER, 489 fn. 46.

143. Eng. Act of 1929, s. 153.

144. The Joint Stock Companies Arrangement Act, 1870, 33 & 34 Vict., c. 104, provided only for such compromises and arrangements between a company under winding up and its creditors or class of creditors. The Alabama Ry. case, discussed supra pp. 171-73. arose under that Act. The present section 206 is available whether or not the company is being wound up and to compromises and arrangements between the company and its shareholders or any class of them.

145. Eng., ss. 278 to 310.

146. Eng., s. 303 (1)(a).

147. The section, however, makes no provision for notice to, or for meetings of, creditors.

148. Section 306. See also s. 315 in the case of winding up subject to the supervision of the court. Semble, the court cannot set aside the arrangement.

149. See In re Contal Radio, [1932] 2 Ch. 66.

150. Eng., 245 (1)(e). See In re Commercial Bank Corp. of India and the East, L.R. 8 Equity Cases 241 (1869), in which Lord Romilly, M.R., sanctioned a compromise between the contributories and the creditors of a company in liquidation assented to by a large majority of both classes under which the creditors were to accept 17s. in the pound. Only one of the creditors opposed the compromise. The court held that it had jurisdiction to sanction such arrangement under section 160 of the English Act of 1862 (which corresponds to the

present section 245) and make it binding on all the parties. The Master of the Rolls followed the earlier decision of the Judicial Committee of the Privy Council in Bank of Hindustan, China, and Japan, Ltd. v. Eastern Financial Association, L.R. 2 Privy Council Appeal Cases 489 (1869) in which the Judicial Committee confirmed a compromise between a company in liquidation and its contributories under sections 173 and 174 of the Indian Act of 1866.

151. Uniform, § 59. For the Commissioners' Note see 9 UNIFORM LAWS ANNOTATED 211-12.

152. Delaware, § 102(b)(2)

153. DODD & BILLYOU, CORPORATE REORGANIZATION, 483.

154. See Comment, State Reorganization Statutes, 49 YALE L.J. 1443 (1940). This comment points out that Wells & Wade, Inc. v. Unity Orchards Co., 186 Wash. 198, 57 P. 2d 1050 (1936), decided by the Supreme Court of Washington is the only reported decision directly involving one of these state statutes. There the court declined to sanction a compromise or reorganization which had the effect of preferring shareholders to creditors, even though it had been assented to by a large majority of creditors as prescribed by the Washington statute. The decision seems to be based on the ground that the dissenter's claim had accrued before the Act became effective and that the Act expressly excluded its application in such cases.

155. For an account of these diverse circumstances see ibid. Also see Note , Effect of National Bankruptcy Act on the State Insolvency

Statutes, 40 YALE L.J. 1090 (1940), where it is pointed out (at p. 1095) that the doubt whether state laws for the reorganization of insolvent corporations are suspended by the existence of Chapters X and XI of the Federal Bankruptcy Act "has cut down resort to these statutes and stunted their development."

156. The predecessor to Chapter X was Section 77B enacted in 1934. Section 77 enacted in 1933 dealt with the reorganization of bankrupt railroad corporations — to which corporations the American law owes the development of the law of corporate reorganization. Section 77B was of more general application.

157. 228 U.S. 482 (1913).

158. The undertaking of the company was sold to a new company (brought into existence for the purpose) in pursuance of a public sale in a foreclosure action.

159. The Court's opinion was delivered by Lamar, J.

160. The dissenting opinion was delivered by Lurton, J., and was concurred in by White, Ch. J., Holmes, J., and Van Deventer, J.

161. 228 U.S. at 505, quoting from Louisville Trust Co. v. Louisville Railway Co., 174 U.S. 674, 683-84 (1899).

162. Id. at 506.

163. 228 U.S. at 511.

164. The reorganization was attacked by the unsecured creditor more than a decade after it had been carried out. The delay was due to extraordinary circumstances.

165. 48 STAT. 912 (U.S. 1934).

166. Section 77B(f) required that "After hearing such objections as may be made to the plan, the judge shall confirm the plan if satisfied that (a) it is fair and equitable and does not discriminate unfairly in favour of any class of creditors or stockholders, and is feasible; [etc.]"

167. 308 U.S. 106 (1939), reversing 100 F. 2d 963 which aff'd 27 F. Supp. 501.

168. 308 U.S. at 114. Justice Douglas delivering the opinion of the Court said: (at pp. 114-15)

> "It is clear from a reading of § 77B (f) that the Congress has required both that the required percentages of each class of security holders approve the plan and that the plan be found to be 'fair and equitable.' The former is not a substitute for the latter. The court is not merely a ministerial register of the vote of several classes of security holders. All those interested in the estate are entitled to the court's protection. Accordingly the fact that the vast majority of the security holders have approved the plan is not the test of whether the plan is a fair and equitable one . . . . The contrary conclusion . . . would make the judicial determination on the issue of fairness a mere formality and would effectively destroy the function and the duty imposed by the Congress on the district courts under § 77B."

See also Taylor v. Standard Gas & Electric Co., 306 U.S. 307 (1937).

169. The assets were of a value of less than $900,000. Bondholders' claim for principal and interest amounted to about $3,800,000.

170. Louisville Trust Co. v. Louisville, N.A. & C. Ry. Co., 174 U.S. 674 (1899).

171. Boyd case, 228 U.S. 482 (1913); Kansas City Terminal Ry. Co. v. Central Union Trust Co., 271 U.S. 445 (1926), where the Court

said (at p. 455) that "to the extent of their debts creditors are entitled to priority over stockholders against all the property of an insolvent corporation."

172. 308 U.S. at 122.

173. 308 U.S. at 123. See also In re Barclay Park Corp., 90 F. 2d 595 (2d Cir. 1937).

174. Ibid.

175. 312 U.S. 510 (1941), aff'g 114 F. 2d 102 which reversed the District Court's confirmation of a reorganization scheme. The opinion of the Court was delivered by Douglas, J.

176. The affairs and assets of the companies had become commingled in pursuance of an operating agreement between the holding company and its wholly-owned subsidiaries.

177. 312 U.S. at 525.

178. Id. at 525-26. Observing that the appropriate criterion is potential earning capacity, the Court said: (p. 526)

> "/The/ criterion of earning capacity is the appropriate one /where/ we are dealing with the issue of solvency arising in connection with reorganization plans involving productive properties . . . . The criterion of earning capacity is the essential one if the enterprise is to be freed from the heavy hand of past errors, miscalculation or disaster, and if the allocation of securities among the various claimants is to be fair and equitable . . . . Since its application requires a prediction as to what will occur in the future, an estimate, as distinguished from mathematical certitude, is all that can be made. But that estimate must be based on an informed judgment which embraces all facts relevant to future earning capacity and hence to present worth, including, of course, the nature and condition of the properties, the past earning record, and all circumstances which indicate whether or not that record is a reliable criterion of future performance. A

sum of values based on physical factors and assigned to separate units of the property without regard to the earning capacity of the whole enterprise is plainly inadequate."

179. 312 U.S. at 528.

180. Du Bois case, 312 U.S. 510, 528; Kansas City Terminal Ry. Co. v. Central Union Trust Co., 271 U.S. 445, 455-56 (1926) (McReynolds, J., delivered the Court's opinion in this case.)

181. 10th ANNUAL REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, 141-52 (1944), reprinted in DODD & BILLYOU, CORPORATE REORGANIZATIONS, 25 et seq., at 39.

182. Dodd, Fair and Equitable Recapitalizations, 55 HARVARD L. REV. 780, 781 (1942). S.E.C. REPORT ON REORGANIZATION COMMITTEES (1938). This eight part Report brought to light many abuses. It resulted in the reform of the federal Bankruptcy Act in 1938 by the introduction of Chapter X and also in the enactment of the Trust Indenture Act of 1939.

183. Dodd, id., at 785.

184. Sask., Sch. I, Table A, Regulation 3, which closely follows its English counterpart.

185. R.S.N.S. 1967, c. 42, Sch. I, Table A, Regulation 11 which differs from the English Regulation and uses the verbose language "varied, modified, commuted, affected, abrogated or dealt with."

186. See in general Guest, Company Reorganization, in COMPANY LAW, 91 (Law Society of Upper Canada Special Lectures 1950); Menzel, Corporate Reorganizations and Amalgamations, in DEVELOPMENTS IN COMPANY LAW, 273 (Law Society of Upper Canada Special Lectures 1968).

187. Eng., Sch. I, Table A, Regulation 4 which uses the word "varied" only.

188. B.C., ss. 59 (emphasis added), 61, 62.

189. Alta., s. 48 (1) (a) (iii).

190. Alta., s. 78 (2).

191. Alta., s. 78 (1).

192. Sask., s. 60; B.C., s. 61. Section 61 of the B.C. Act applies only if the memorandum or articles contain a majority clause providing for variation of class rights. In other cases section 62 would seem to apply and the variation would require judicial confirmation.

193. Sask., ss. 63-68; Nova Scotia, ss. 52-62; Alta., ss. 48 (1) (b), (2), (3), 49-51; B.C., ss. 65, 66.

194. Nova Scotia, s. 117; B.C., s. 179; Sask., s. 187; Alta., s. 139.

195. Eng. s. 207. This provision was introduced only by the Act of 1948.

196. Alta., s. 140; Sask., s. 188; B.C., s. 180; Nova Scotia, s. 118. See also English, s. 209; cf. Nova Scotia, s. 119; B.C., s. 181; Alta., s. 138; Sask., s. 189. The English Act confers the right on the minority shareholder to demand that he be bought out, but the Canadian statutes only empower the 90% or above majority shareholder to expropriate the minority without conferring the power on the minority to require that they be bought out.

197. Cf. Eng., s. 287.

198. B.C., s. 178 (first introduced by 1960, c. 8, s. 14); Sask. s. 190 (first introduced by 1959, c. 33, s. 3); Nova Scotia, s. 120 (first introduced by 1960, c. 24, s. 3); Stat. Alta. 1959, c. 10, s. 7.

199. See Model, §§ 65-70. The Model Act makes a distinction between "merger" and "consolidation." The Canadian Acts use the word "amalgamation."

200. The Nova Scotia Act provides expressly that the amalgamation may also be of holding and subsidiary companies.

201. Cf. the unfortunate result reached in Norcan Oils, Ltd. v. Fogler, [1965] S.C.R. 36 (Sup. Ct. of Canada), which deprived the dissenting shareholder of judicial protection. For criticism of the decision see Mackinnon, The Protection of Dissenting Shareholders, in ZIEGEL (ed.), STUDIES IN CANADIAN COMPANY LAW, 507, 525-26.

202. Model, § 67.

203. Model, §§ 73, 74.

204. MOD. ACT ANN., § 74, ¶ 4.

205. Model, § 69(e).

206. E.g., see Can., s. 7(2)(e)(i); Ont., s. 18. — (1) 5, 6; Ont. Bill, s. 4 — 5, 6; Man., s. 23 (1)(e)(i). The Quebec Act does not require the application to set out classes and class-rights (see s. 7), but if the applicants want the letters patent to authorise the company to issue different classes of shares, then the application will have to set them out or the company will have to obtain supplementary letters patent later (see s. 45).

207. Can., s. 12; Ont., s. 27; Que., s. 45; Man., s. 31.

208. Can., s. 48(1), (3).

209. Can., s. 48(5).

210. Man., s. 43 (5) (emphasis added).

211. Ont., s. 33 (4).

212. Ont., s. 33 (5).

213. Ont. Bill, s. 175 (4).

214. Can., ss. 49-58.

215. Man., s. 44; also ss. 43 (1) (d), 45-48.

216. Ont., s. 34; also ss. 33 (1) (d), 35. Ont. Bill, ss. 175 (1) (e), 176 (3).

217. Que., ss. 55-62.

218. Que., ss. 46, 47. See also s. 48 which corresponds to English s. 209.

219. Que. s. 18.

220. Can. ss. 126, 127. See also s. 128 which corresponds to s. 209 of the English Act.

221. Can., s. 128A, introduced by Stat. Can. 1964-65, c. 52, s. 41.

222. Ont., s. 95. Only Ontario provides for the explanatory statement to be sent to shareholders corresponding to s. 207 of the English Act. See Ont., s. 95 (3).

223. Ont. Bill, ss. 179-181.

224. 60 Vict., c. 28, s. 102 (Ontario, 1897). This provision was an extension of the provision for amalgamation of building societies which Ontario has had ever since 1876. See 39 Vict., c. 32, ss. 12, 16 (Ontario, 1875-76); R.S.O. 1887, c. 169, ss. 76-81.

225. Cf. the present wording "two-thirds of the votes cast at each . . . meeting." Ont., s. 96 (3).

226. Ont., s. 96 (1).

227. Ont. Bill, s. 182 (1).

228. Ont. Bill, s. 182 (5), read with s. 175 (4).

229. Ont. Bill, s. 183.

230. Mackinnon, The Protection of Dissenting Shareholders, in ZIEGEL (ed.), STUDIES IN CANADIAN COMPANY LAW, 507, 529.

231. For an old publication dealing with the practice of the Department of the Provincial Secretary of Ontario, see DENISON'S MANUAL OF COMPANIES (2d ed. 1928). The book throws little light on the criteria applied by the Provincial Secretary in issuing supplementary letters patent confirming amalgamation agreements.

232. For a full account see PALMER'S COMPANY LAW, Chapter 71.

233. R.S.A. 1955, c. 53, s. 231.

234. For a comprehensive discussion of the subject see WEINBERG, TAKE-OVERS AND AMALGAMATIONS (2d ed. 1967).

235. R.S.Nfld. 1952, c. 168, s. 227.

236. Can., ss. 126, 127.

237. Re Western Canada Flour Mills, Ltd., [1945] ONTARIO W.N. 152 (Hogg, J.), following the Alabama Ry case, [1891] 1 Ch. 213, discussed supra p. 171 ; and Re English, Scottish, and Australian Chartered Bank, [1893] 3 Ch. 385. See also Carruth v. Imperial Chemical Industries, Ltd., [1937] A.C. 707 (H.L.); British and America Nickel Corp., Ltd. v. M.J. O'Brien, Ltd., [1927] A.C. 369.

238. Quebec Securities Act, s. 20 (e).

239. Ontario Securities Act, s. 19.

240. Supra , Chapter 3.

241. 1 LOSS, 573 et seq.

242. 33 & 34 Vict., c. 104 (U.K. 1870).

243. Supra, n. 78.

244. Foakes v. Beer, L.R. 9 App. Cas. 605 (H.L. 1884); Pinnel's Case, 5 Co. Rep. 117a (1602).

245. Gold, Preference Shareholders in the Reconstruction of English Companies, 5 U. TORONTO L.J. 282, 286 (1943-44).

Notes to Chapter 7

1. Eng., s. 52; Act of 1867, s. 25.

2. CALIFORNIA CONST. Art. XII, § 11.

   PENNSYLVANIA CONST. Art. XVI, § 7.

3. Model, § 18.

4. Uniform, § 15.

5. The Corporation Law of Delaware provides that the consideration "may be paid for, wholly or partly, by cash, by labor done, by personal property, or by real property or leases thereof . . . ." (§ 152). The California law, § 1109, provides: "No share of stock, with or without par value, shall be issued except in consideration of any or all of the following:

   (a) Money paid.

   (b) Labor done.

   (c) Services actually rendered.

   (d) Debts or securities cancelled.

   (e) Tangible or intangible property actually received by the issuing corporation.

   (f) Amounts transferred from surplus to stated capital upon the issue of shares as dividend.

   (g) Amounts transferred from surplus to stated capital upon a stock split, reverse stock split, reclassification of outstanding shares into shares of another class, conversion of outstanding shares into shares of another class, exchange of outstanding shares into shares of another class, increase in the per-share par value, or other change affecting outstanding shares, which results in an increase in the aggregate par value of the outstanding shares.
   *** " See also Penn., § 603.

6. N.Y., § 504 (a), (b).

7. Can., s. 12 (10a), (12).

8. For the English decisions see PALMER, 192-93.

9. Cf. Johnson v. Louisville Trust Co., 293 F. 857 (6th Cir. 1923) discussed post p. 260 .

10. Beware, not the British "bonus shares"!

11. Israels, Problems of Par and No-Par Shares : A Reappraisal, 47 COLUMBIA L. REV. 1279, 1283 and the cases cited in footnote 20 therein (1947). See also the Ontario decision in Re Manitoulin Quartzite, Ltd., [1933] 4 D.L.R. 132 (Ont. C.A.). The company purported to issue 4 no-par common shares for each preference share of $100 par subscribed. In the winding-up of the company the court held the allottees liable to contribute $2.50 for each no-par "bonus" share, being the price at which the company was authorised to issue them.

12. Model, § 17 paras. 1 & 2. A dozen or so states have a similar requirement in their corporation statutes: MOD. ACT ANN., § 17 ¶ 2.02.

13. See In re Almada and Tirito Company, 38 Ch. D. 415 (C.A. 1888). This case in effect overruled the decisions of Chitty, J., in In re Ince Hall Rolling Mills Co., 23 Ch. D. 545, n., and In re Plaskynaston Tube Co., 23 Ch. D. 543.

14. [1892] A.C. 125 (H.L.)

15. For a somewhat similar American case which reached a different decision mainly on the ground that the shareholders had acquiesced, see Bacich v. Northland Transp. Co., 242 N.W. 379 (Minnesota Sup. Ct. 1932).

16. /1892/ A.C. at 134.

17. 7 H.L. 653 (1875).

18. /1892/ A.C. at 143.

19. Id. at 138-39.

20. Id. at 127.

21. Id. at 128.

22. /1892/ A.C. at 145, per Lord Macnaghten.

23. Eng., s. 61.

24. /1892/ A.C. at 130.

25. Eng. Act of 1928, s. 47; present Act, s. 57. This section empowers a company to issue its shares at a discount if the following conditions are satisfied:

    (i) At least one year must have elapsed since the company became entitled to commence business;

    (ii) the shares to be issued must be of a class already issued;

    (iii) a resolution authorising the issue must be passed at a general meeting of the company and it must specify the maximum rate of discount at which they could be issued;

    (iv) the resolution must be confirmed by the court;

    (v) the issue must be made within one month of such sanction by the court, unless the court allows a longer time.

26. PALMER'S COMPANY LAW, 197; GOWER, 100 fn. 13.

27. 38 Ch. D. 415 (C.A. 1888). See supra n. 13 .

28. See In re Railway Time Tables Publishing Co., Ex parte Sandys, 42 Ch. D. 98 (C.A. 1898). The company whose articles purported

to authorise the issue of its shares at a discount allotted in January 1887 673 shares of £5 par at a price of 10 shillings each. At this time it was generally supposed that companies could issue their shares at a discount. This was doubted by the Court of Appeal in In re Addlestone Linoleum Co., 37 Ch. D. 191 (December, 1887). In January 1888 the allottee sued to have her name removed from the register of shareholders and for a refund of the amount she had paid for the shares. The Court of Appeal held that by her conduct she had assented to keep the shares and was therefore liable for the full par value.

29. Cmd. 9138 (1918). The Committee recommended that issue at a discount should be permitted only after the expiry of five years since the company commenced business and that the discount should not reduce the price of the shares to more than 5% below the market value of outstanding shares, and in any case the discount should not exceed 50% of the par value.

30. 63 & 64 Vict., c. 48, s. 8. Under the present Act the by-laws cannot authorise a discount of more than 10% of the issue price of the shares, but such discounts are permissible also in the case of shares not offered to the public for subscription : see s. 53.

31. Eng., s. 57. Supra n. 25. For a recent case see Derham & Allen, Ltd., [1946] 1 Ch. 31.

32. Eng. s. 53.

33. Eng. s. 53 (3).

34. Model, § 17 para. 1. See also § 20.

35. MOD. ACT ANN., § 17, ¶ 2.02 (2).

36. But "specially limited companies" are permitted to issue shares at a discount in some provinces. These are mining companies and their members are not, by virtue of their memorandum of association, personally liable for the amount unpaid on their shares. See Sask., ss. 149, 3 (s) and 6; British Columbia, s. 129.

37. Can., s. 12 (12) (a).

38. Ind., s. 79.

39. GOWER, 99 fn. 9.

40. Can., s. 3 (1) (a). Generally the Canadian accountancy practice seems to be the same as the British. SMYTH, THE BASIS OF ACCOUNTING, 107 (2d ed. 1966).

41. GOWER, supra n. 39.

42. Model, § 2 (j). § 2 (k) defines "surplus" as the excess of the net assets of the corporation over its stated capital.

43. FINNEY, GENERAL ACCOUNTING, 168-69 (1941, 12th print. 1949).

44. For full details see California, § 1110.

45. California, § 1900.

46. See Manne, Accounting For Share Issues Under Modern Corporation Laws, 54 Nw. U.L. REV. 285, 297-99 (1959)

47. The German law (§ 9) forbids the issue of shares "for an amount less than the nominal amount," but this is meaningful as it prescribes a minimum share capital of DM 100,000 and a minimum par value of DM 50 (§§ 7, 8).

48. In In the Matter of the Home Assurance Company of Canada (in liquidation), Patterson v. Burton, [1950] S.C.R. 578 (Supreme Court of Canada), the liquidator of the Assurance Company sued to hold the shareholders liable as contributories for an amount of $85 remaining unpaid on the shares of $100 par value held by them. The shareholders sought to escape liability alleging that the shares held by them for 15 years had been originally issued to them in violation of the Alberta Sale of Shares Act and that the allotments were therefore void. The Supreme Court of Canada, affirming the lower courts, held that "although the original contracts were void," yet "[b]y their acts, posterior to the impugned agreements, [the allottees] have agreed to become shareholders, and from their conduct independent binding agreements have resulted." The Court cited with approval In re Railway Time Tables Publishing Co., Ex parte Sandys, supra note 28. It must be added that in the Canadian case it would appear that the shares were not issued at a discount, but were partly paid-up shares. The Courts rightly rejected the efforts of the shareholders to take advantage of the noncompliance with the securities law by the company. Cf. McAskill v. North Western Trust Co., [1926] S.C.R. 412 (Sup. Ct. Can.).

49. Morawetz, Shares Without Nominal or Par Value, 26 HARVARD L. REV. 729, at 730 (1912-13). Victor Morawetz was one of the sponsors of the New York measure which introduced no-par shares in that state in 1912.

"The laws requiring the shares of stock to have a fixed par value and in many states to be sold at not less than par value have been responsible very largely for the so-called over-capitalization of industries and watering of corporate securities." BULLETIN OF THE INVESTMENT BANKERS ASSOCIATION, October 1920, reprinted in the CORPORATION JOURNAL, Jan. 1921, cited in Hollen & Tuthill, Uses of Stock Having No-par Value, 7 AMERICAN BAR ASSN. J. 580 fn. 5 (Nov. 1921). This article was a reply to Cook, Stock Without Par Value, id. 534 (Oct. 1921).

50. Eng. s. 52 (1) (b), (2). This was first introduced in the Act of 1867 (s. 25). Under the Act of 1867 an allotment of shares for noncash consideration could be made only in pursuance of a written contract filed with the registrar at or before the issue of the shares.

51. Under the Act of 1867 failure to comply with the requirement rendered the allottee liable to pay the full par value in cash. See BUCKLEY ON THE COMPANIES ACTS, 126. But this was repealed in 1900 and brought to its modern form.

52. BUCKLEY, 128 and the cases cited in fn. (n) on that page.

53. Eng., Sch. IV entry 8.

54. Id. Sch. V.

55. Id. Sch. VI.

56. [1903] 2 Ch. 254 (C.A.) (Vaughan Williams, Romer and Cozens-Hardy, L.JJ.), reversing [1903] 1 Ch. 674 (Kekewich, J.).

57. "That price was fixed as being in the opinion of the vendors the maximum which they could reasonably hope to obtain, and as being in the opinion of the gentlemen who were to form the company the proper price to pay." [1903] 1 Ch. 674, at 680.

58. [1892] A.C. 125 (H.L.).

59. In re Western Canada Oil, Lands, and Works Company (Carling, Hespeler, and Walsh's Cases), 1 Ch. D. 115 (C.A. 1875) relied upon by Romer and Cozens-Hardy, L.JJ., has little to do with stock-watering. That case was decided before the principle that shares could not be issued at a discount was settled in In re Almada & Tirito Co., 38 Ch. D. 415 (1888).

60. In re Heyford Co. (Pell's Case), 5 Ch. App. 11 (1869);
In re Baglan Hall Colliery Co., 5 Ch. App. 346 (1870);
Re Theatrical Trust, [1895] 1 Ch. 771;
Re Wragg, Ltd., [1897] 1 Ch. 796;
Gardner v. Iredale, [1912] 1 Ch. 700;
Hong Kong & China Gas Co. v. Glen, [1914] 1 Ch. 527;
Re James Pitkin & Co., [1916] W. N. 112.

Cases where the allottees were held liable were those where shares had patently been allotted without consideration: e.g., In re Eddystone Marine Insurance Co., [1893] 3 Ch. 9 (C.A.); In re White Star Line, Ltd., [1938] 1 Ch. 458 (C.A.).

61. For an American case which reaches the same conclusion as the Innes case see Taylor v. Walker, 117 F. 737 (N. Dt. Ill. 1902), aff'd. 127 F. 108 (7th Cir. 1903).

62. In In re White Star Line, Ltd., [1938] 1 Ch. 458, 476-78 (C.A.), the Innes case was regarded as laying down that the question whether the consideration is colourable or illusory was one of fact in each case. In that case a company accepted from a financially embarrassed shareholder (another company) deferred creditors' certificates — which were mere promises of deferred payment — under a court-approved scheme of arrangement with the latter by way of accord and satisfaction of a large amount due for calls. Thus both parties intended that the debts due for the calls were to be thereby discharged. The Court of Appeal held that though a debt due for calls could be discharged by accord and satisfaction, yet the consideration given by way of satisfaction must not be "a mere blind or clearly colourable or illusory." In this case it was held to be illusory, for it was well-known to all the parties concerned that it must be several years before the revenues of the debtor company (shareholder) would be sufficient to permit any payment of even the interest on the certificates and their value was, therefore, wholly speculative. On the contention of the shareholder-company that the contract of accord and satisfaction had not been impeached by the liquidator, the Court of Appeal said (pp. 477-78):

> "It was . . . strenuously argued before this Court that, unless and until the contract is impeached in an independent action for that purpose, any consideration which, on the face of the contract, is accepted by the company as money's worth, must be taken as money's worth until the contract is set aside. We are not prepared to hold that, if the facts are sufficiently plain, the Court is bound to insist on what, after all, in such

a case is a mere technical requirement — namely, that the contract for payment in what is represented as money's worth should be impeached in an independent action. If the true view of the contract in question is that the consideration accepted is a contract of deferred payment, with a liability for payment of interest in the meantime only out of contingent profits, it would seem obvious that the consideration is not "money's worth" to the amount of the sum for which the shareholder is immediately liable."

63. Model, § 18 para. 3; Uniform, § 17.

64. MOD. ACT ANN., § 18 ¶ 2.02.

65. 119 U.S. 343, 7 S. Ct. 231, 30 L. Ed. 420 (1886).

66. MOD. ACT ANN. § 17 ¶ 3.05 (1). See Van Cleve v. Berkey, 143 Mo. 109, 44 S.W. 743 (1898); Libby v. Tobey, 82 Me. 397, 19 A. 904 (1890); State Trust Co. v. Turner, 111 Iowa 664, 82 N.W. 1029 (1900); William E. Dee Co. v. Proviso Coal Co., 290 Ill. 252, 125 N.E. 24 (1919).

67. MOD. ACT ANN., § 18 ¶ 3.05 (3) (b). See Douglas v. Ireland, 73 N.Y. 100 (1878); Elyton Land Co. v. Birmingham Warehouse & Elevator Co., 92 Alabama 407, 9 So. 129 (1891); Kaye v. Metz, 186 Cal. 42, 198 P. 1047 (1921).

68. In re Innes & Co., Ltd., [1903] 2 Ch. 254 (C.A.).

69. Taylor v. Walker, 117 F. 737 (N.D. Ill, 1902); aff'd 127 F. 108 (7th Cir. 1903); Hobgood v. Ehlen, 141 N.C. 344, 53 S.E. 857 (1906); Diamond State Brewery, Inc. v. De La Rigaudiere, 25 Del. Ch. 257, 17 A. 2d 313 (Ch. 1941).

70. Donald v. American Smelting and Refining Co., 62 N.J. Eq. 729, 48 A. 771 (1901); Holcombe v. Trenton White City Co., 80 N.J. 122, 82 A. 618 (1912), aff'd 82 N.J. Eq. 364, 91 A. 1069 (1913); Tooker

v. National Sugar Refining Co., 80 N.J. Eq. 305, 84 A. 10 (1912).

71. For an excellent survey of the cases see DAVID L. DODD, STOCK WATERING (1930).

72. MacChesney & O'Brien, Full Disclosure Under the Securities Act, 4 LAW & CONTEMP. PROB. 133, 136 (1937).

73. In the Matter of Thomas Bond, Inc., 5 S.E.C. 60 (1939) extracted in BAKER & CARY, 1106 et seq. Mr. Bond promoted a company to buy the manufacturing business of a cosmetic product developed by him. The S.E.C. issued a stop-order on the ground, among several others, that the price to be received by him was arbitrarily fixed by him without arm's length bargaining and without reference to the cost of the formula to him. The shares in this case had a par value.

74. REPORT OF THE ROYAL COMMISSION ON PRICE SPREADS, 43-44 (Ottawa, 1935).

74a. The report advocated a stringent Dominion Act and it appears that even to the extent that its recommendations were implemented, it was done only reluctantly. See WILLIAMSON, 18, 19 fn. 30.

75. Can., s. 12 (10a)(b), (12)(b).

76. Id. s. 12 (13).

77. E.g., Ont., s. 31 (2), (4); Ont. Bill, s. 44 (under the proposed new Act partly paid shares can no longer be issued). Que., s. 42.

78. 57 Ontario L.Rep. 514 (1924), aff'd 59 O.L.R. 278 (App. Div. 1926), aff'd [1928] A.C. 333 (P.C.).

79. The Privy Council did not discuss this question as it came to the conclusion that the issue was invalid as it was in violation of the prohibition of the Ontario Act which forbade companies to issue their shares in payment of any commission, discount or allowance to any person in consideration of his subscribing or agreeing to subscribe for any shares in the company.

80. 50 Ontario L. Rep. 387 (1921), aff'd [1923] S.C.R. 488 (S.C.C.). Cf. In the matter of the Home Insurance Company of Canada (in liquidation), Patterson v. Burton, [1950] S.C.R. 578 (Sup. Ct. Can.), supra n. 48, which, however, was not a watered-stock case or one of issue of shares at a discount.

81. 50 O.L.R. at 405.

82. Supra p. 230.

83. There was another aspect of the case relating to the remuneration of the President, but with it we need not concern ourselves here.

84. Meredith, C.J.O., and Maclaren, J.A.

85. Magee, Hodgins, and Ferguson, J.AA.

86. Ont. Sec. Act, ss. 35, 61 (b).

87. Que. Sec. Act, s. 50.

88. Ont. Sec. Act, s. 6; Que. Sec. Act, ss. 16, 24.

89. Piggly Wiggly Delaware, Inc. v. Bartlett, 129 A. 413 (N.J. Ch. 1925).

90. Half of this profit was utilised for legitimate expenses, but even then the promoters' profit amounted to 4,850% on their investment of $1,000!

91. 129 A. at 418.

92. 125 N.J. Eq. 534, 6 A. 2d 545 (N.J. Ch. 1939).

93. Actually the receiver sought to hold A, B, and C liable for the deficiency, but we have modified the facts here for the sake of simplicity.

94. 6 A. 2d at 547.

95. 293 F. 857 (6th Cir. 1923).

96. Cook, Stock Without Par Value, 7 AMERICAN BAR ASSN. J. 534, at 535 (1921).

97. Bonbright, The Dangers of Shares Without Par Value, 24 COLUMBIA L. REV. 449, 468 (1924).

98. Preface to DAVID L. DODD, STOCK WATERING (1930), vi.

99. Ibid.

100. REPORT OF THE PRICE SPREADS COMMISSION (Ottawa 1935) suggested the abolition of no-par shares as an alternative remedy: p. 40.

101. E.g., Can., s. 12 (11); Model, § 18 para. 1.

102. 62 P. 2d 1311 (Kan. Sup. Ct. 1936).

103. 48 S.W. 2d 836 (St. Louis C.A., Miss., 1931).

104. Rev. Stat. Missouri 1929, c. 32, Article 16, § 5105. No-par stock was authorised in Missouri in 1921.

105. 48 S.W. 2d at 838, citing Fogg v. Blair, 139 U.S. 118, 35 L. Ed. 104; Liebke v. Knapp, 79 Mo. 22, 49 Am. Rep. 212.

106. Id. at 839.

107. 18th Annual Report of the S.E.C., p. 18 (1952), extracted in BAKER & CARY, 1104-05.

108. 5 S.E.C. 60 (1939), extracted in BAKER & CARY, 1106 et seq.

109. Kahn-Freund, Some Reflections on Company Law Reform, 7 MODERN L. REV. 54, 59 et seq. (1944).

110. George Wickersham, however, could see "no reason why the incorporators of an ordinary trading or business corporation should not ascribe any value as they please to property with which they propose to engage in business, for the purpose of fixing the capital stock, nor why they should not give an interest in that capital by the issue of certificates representing shares therein to those who may have promoted or brought about the organization, so long as they do not deceive the public or those who may have to deal with the company, either by misrepresentation or suppression of the facts." Wickersham, The Capital of a Corporation, 22 HARVARD L. REV. 319, 322 (1907).

111. See Tintin Exploration Syndicate, Ltd. v. Sandys, 177 LAW TIMES 412 (Ch. D. 1947) in which Roxburgh, J., set aside an allotment of shares by the Tintin Syndicate, Ltd., as a colourable transaction.

112. [1923] S.C.R. at 490.

113. Erlanger v. New Sombrero Phosphate Company, 3 App. Cas. 1236 (H.L. 1878).

114. 3 App. Cas. 1236 (H.L. 1878). In this case the promoters sold their property to their "captive" company at 100% profit without providing it with an independent board. The House of Lords, affirming the Court of Appeal, set aside the transaction. If this

is the only remedy in such cases, then upon the rescission of the contract, the only purpose for which the company is brought into existence — here to work the Sombrero island phosphate mines — would become impossible and the next step would be to wind up the company. This will be most undesirable where the company is carrying on its business with success. The remedy in such cases must, it is submitted, be to require the promoter-vendors to restore to the company, not the profit which they made as was alternatively claimed but was disallowed in the Erlanger case but, the difference between the amount of share capital which they received and the fair valuation of the property. Thereby they will be deprived of the unfair advantage which they gained from a "captive" company, but not a legitimate profit which they would have made if they had sold the property to anyone other than the company. Such a rule will discourage the promotion of companies by those whose design is to sell their property or service to it at a fancy price.

115. Bonbright, op. cit. supra, 24 COLUMBIA L. REV. at 457.

116. Berle, Problems of No-Par Stock, 25 COLUMBIA L. REV. 43 (1925).

117. Bonbright, supra n. 115, at 467.

118. FRASER & STEWART, COMPANY LAW OF CANADA 206 (5th ed. 1962).

119. The Model Act provides alternatively for either pattern. Model, §§ 24, 48 (h).

120. German law recognizes pre-emptive right which can be excluded only by a resolution at a general meeting carried with three-fourths majority.

121. Ind., s. 81, as am. in 1960.

122. See BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY.

123. MOD. ACT ANN. § 24 ¶ 2.02 (10).

124. LEVY, 2 PRIVATE CORPORATIONS AND THEIR CONTROL, 796-97.

125. Eng. ss. 164-175. On the popularity and effectiveness of this remedy, see Gower, Some Contrasts Between British and American Corporation Law, 69 HARVARD L. REV. 1369, 1387-89 (1956).

126. The German law takes great care to ensure that promoters make adequate disclosure to the company and that their valuation of noncash consideration is fair. (AktG., §§ 32-34) One safeguard is that the "promoters' report" (Gründungsbericht) — which they are required to make to the company's board of management (Vorstand) as well as to its supervisory board (Aufsichsrat) — must disclose in all cases, where they have transferred to the company in exchange for its shares or cash property acquired by them within two years preceding the promotion of the company, the cost at which they had acquired the property. The second safeguard is that in every case of allotment of shares for noncash consideration, an examination of the valuation by independent

auditors is required by the law and their report which must be registered is open to public inspection.

But it must be remembered that the German situation is different from the Anglo-American in an important respect. Under the German law the entire stated or legal capital (Grundkapital) set out in the charter (Satzung) has to be fully subscribed before the company will be registered. In other words the capital must be raised before the company can come into existence. It is not possible, as under the Anglo-American law, to incorporate the company and then seek the capital. Therefore the vendor-promoters who want not cash, but shares, in exchange, must conclude the transaction before the registration of the company. This gives an opportunity to the court to consider the report of the auditors, the promoters' report, as well as the reports of the board of management and the supervisory board on their examination of the promoters' report. If the registration court finds that the proposed company is to pay in cash or shares an inflated price for the property it is to receive in exchange, the court may refuse registration (AktG., § 38 (2)). In such circumstances it is evident that the opportunities for stock-watering are rather remote. It must also be obvious that after a company is registered, it can acquire property or services only for cash. The existence of two boards — one elected by the shareholders and exercising supervisory functions and the other appointed by it to manage the

company's business — may operate to prevent exaggerated cash prices being paid in such cases.

127. See the Uniform, § 18.

Notes to Chapter 8

1. GOWER, 99 fn. 9.

2. 30 & 31 Vict., c. 131, ss. 9-20. The Act of 1862 did not provide for reduction of capital, though it did for increasing share capital and for the consolidation and subdivision of shares.

3. Act of 1862, 25 & 26 Vict., c. 89, s. 12.

> Power of certain Companies to alter Memorandum of Association.
>
> Any Company limited by Shares may so far modify the Conditions contained in its Memorandum of Association, if authorised to do so by its Regulations as originally framed, or as altered by special Resolution in manner herein-after mentioned, as to increase its Capital, by the Issue of new Shares of such Amount as it thinks expedient, or to consolidate and divide its Capital into Shares of larger Amount than its existing Shares, or to convert its paid-up Shares into Stock, but, save as aforesaid, and save as is herein-after provided in the case of a Change of Name, no Alteration shall be made by any Company in the Conditions contained in its Memorandum of Association.

4. For the meaning of special resolution, see Act of 1862, s. 51.

5. Act of 1908, 8 Edw. 7, c. 69. The modern Acts use the expression "reduction of share capital" and do not any longer speak of "the modification of the conditions contained in the memorandum."

6. 4 Ch. D. 827 (1877). Jessel, M.R.'s judgment begins with these words (p. 831): "I am very sorry that I cannot accede to this application, which is a most reasonable one, and I have no doubt that if the Legislature amends the Act of Parliament some provision will be made for enabling the Court to do that which I think it cannot do at present."

Lord Macnaghten observed in British and American Trustee and Finance Corporation v. Couper, [1894] A.C. 399, 412 (H.L.),

that the decision of Jessel, M.R., in the Ebbw Vale case came as "a surprise to the profession at the time" and was "generally thought to have been incorrect."

Earlier, Cotton, L.J., remarked in Bannatyne v. Direct Spanish Telegraph Company, 34 Ch. D. 287, at 302, that "I am by no means prepared to say that I think the view [of Jessel, M.R., in the Ebbw Vale case] was the correct view."

Until the Ebbw Vale case, no doubt seems to have existed on the power of the court to sanction a reduction of paid-up capital. See In re Crédit Foncier of England, L.R. 11 Eq. 356 (Bacon, V.C., 1871).

7. On the object of the Act of 1867 Jessel, M.R., said (at p. 832): "The object of the Act was to enable companies which had started with a larger nominal capital than they wanted, and therefore had imposed on their shareholders liability to pay a much larger sum in the shape of calls than what was required, or could fairly be required, for the business of the company, to relieve the shareholder from a portion of that liability, and I think it had no other object."

8. 4 Ch. D. at 832.

9. Id. at 833.

10. Note that the phrase "nominal capital" is used in the sense of issued capital and not in the sense of authorised capital as in modern usage. Indeed, what a company has is real assets and nominal capital.

11. This presumably refers to the liability of shareholders in respect of unpaid capital.

12. For another argument to the same effect, see pp. 833-34 where he points out how the provision that a reduction can be confirmed by the court only if objecting creditors' claims are satisfied or otherwise determined or secured to the satisfaction of the court will be unreasonable to apply in the case of writing off of losses to capital.

13. Act of 1877, 40 & 41 Vict., c. 26, s. 3: "The word 'capital' as used in the Companies Act, 1867, shall include paid-up capital; and the power to reduce capital conferred by that Act shall include a power to cancel any lost capital, or any capital unrepresented by available assets, or to pay off any capital which may be in excess of the wants of the company; and paid-up capital may be reduced with or without extinguishing or reducing the liability (if any) remaining on the shares of the company, and to the extent to which such liability is not extinguished or reduced it shall be deemed to be preserved . . . ."

14. Act of 1877, s. 4 (1); Act of 1948, s. 67 (2).

15. English Act of 1948, s. 66.

16. 12 App. Cas. 409, 423-24 (H.L. 1887). Referring to the scheme of the Act, Lord Herschell said that it was designed to assure those dealing with a limited company that "the whole of the subscribed capital, unless diminished by expenditure upon the objects defined by the memorandum, shall remain liable for the discharge

of its liabilities. The capital may, no doubt, be diminished by expenditure upon and reasonably incidental to all the objects specified. A part of it may be lost in carrying on the business operations authorised. Of this all persons trusting the company are aware, and take the risk. But I think they have a right to rely, and were intended by the legislature to have a right to rely, on the capital remaining undiminished by any expenditure outside these limits, or by the return of any part of it to the shareholders." (id. at 415).

17. Act of 1947, s. 72 (1), (3), (5); Act of 1948, s. 56.

18. Eng., s. 56.

19. Eng., s. 56 (1).

20. Indian, s. 78.

21. Indian, s. 87 (2) Explanation. In India the voting rights of shares are entirely governed by the Act in the case of public limited companies. See ss. 86-90 of the Act.

22. [1894] A.C. 399 (H.L.).

23. The English business was managed by a board of directors in London. The American business was managed by some directors resident in America acting as a committee under the supervision of the London board. The board pursued a conservative and cautious policy but the committee advocated a bolder policy and demanded a freer hand. The result was a near deadlock. For a neat statement of how the deadlock was averted, see Lord Macnaghten's judgment at pp. 412-13.

24. The judgments of the lower courts are unreported. The courts relied on some observations of the Court of Appeal in In re Denver Hotel Co., [1893] 1 Ch. 495.

25. [1894] A.C. at 403.

26. Id. at 406.

27. Id. at 408.

28. Per Lord Macnaghten at pp. 415-16: "If there is nothing unfair or inequitable in the transaction, I cannot see that there is any objection to allowing a company limited by shares to extinguish some of its shares without dealing in the same manner with all other shares of the same class. There may be no real inequality in the treatment of a class of shareholders although they are all not paid in the same coin or in coin of the same denomination."

29. In re Denver Hotel Co., [1893] 1 Ch. 495, 506.

30. Per Lord Macnaghten, [1894] A.C. at 413: "It is for the company, and for the company alone, to judge of the prudence of the course proposed .... [I]t is for the company to determine, subject, of course, to the statutory provisions for the protection of creditors, whether its capital under the circumstances, and in view of the policy approved by the shareholders, is or is not in excess of its present wants."

31. [1894] A.C. at 411, per Lord Watson.

32. [1949] A.C. 426 (H.L.) (Lord Morton of Henryton dissenting), affirming the First Division of the Scottish Court of Session in Wilsons & Clyde Coal Co., Ltd. v. Scottish Insurance Corp., Ltd.,

/1948/ S.C. 360.

33. /1949/ A.C. 512 (H.L.), aff'g In re Chatterley-Whitfield Collieries, Ltd., /1948/ W.N. 367 (C.A.) (Lord Greene, M.R., and Asquith, L.J., Evershed, L.J., dissenting.)

34. 30,217 votes were cast for the resolution; 6,000 against it. All the shares carried equal voting right and there was no provision for separate class-voting.

35. The two dissenting shareholders held the 6,000 preference shares which were voted against the resolution.

36. /1948/ W.N. at 368.

37. Id. at 369.

38. In the Wilsons & Clyde case in which the House delivered judgment earlier the same day, the main difference was that the articles did not expressly deny the preference shares participating right in the surplus assets of the company in its liquidation. They carried the right to a fixed cumulative preferential dividend at 7% per annum without participating right in surplus profits. The dissenting law lord adopted the canon of construction that as all shares were prima facie equal, (Birch v. Cropper, 14 App. Cas. 525, 543 (H.L.1889), their rights were equal except insofar as they were expressly curtailed or excluded and that therefore the preference shares were entitled to participate in the surplus assets in a winding up. The rest of their lordships declined to adopt this construction and held that the expressly specified rights of the preference shares were exhaustive and, as participating right to surplus assets was not

given expressly, they were not entitled to it. The House approved In re Bridgewater Navigation Co., [1891] 2 Ch. 317 (C.A.) and overruled In re Metcalfe & Sons, Ltd., [1933] Ch. 142 (C.A.). The dissenting law lord was of the view that the reduction of preference capital at par which would deprive them of their participating right in the surplus assets in the winding up, was therefore neither fair nor equitable, and hence ought not to be confirmed. According to the rest of their lordships, they were not entitled to such participating rights. Unlike the coal company in the Chatterley-Whitfield case, the coal company in the Wilsons & Clyde case did not propose to carry on its business elsewhere even on a reduced scale, but was to be wound up. The Wilsons & Clyde Coal Co. was incorporated in 1876. At the time of its nationalisation its capital was as follows:

40,000 7% cumulative first pref. shares of £1 par each ...	£40,000
10,000 7% cumulative 2nd pref. shares of £1 par each ...	10,000
800,000 ordinary shares of £1 par of which 675,000 were outstanding	675,000
Total issued capital	£725,000

The company proposed to return the entire preference capital at par (i.e., £50,000) and half of the common capital (i.e., £337,500). The capital as reduced was £337,500. The resolution for the reduction was voted in favour 38 to 3. Confirmation of the resolution for reduction was opposed by 71 preference stockholders holding 45% of the preference stock.

But all the law lords including the dissenting Lord Morton of Henryton were of the view that the prospect of the preference shareholders receiving compensation above the par value of their

shares under the provision of the Nationalisation Act was too uncertain to have the effect of suspending the court's power to approve a reduction of capital.

39. In re Old Silkstone Collieries Co., Ltd., [1954] Ch. 169 (C.A.) reached a different decision and the Court of Appeal refused to confirm a reduction and distinguished the Wilsons & Clyde and Chatterley-Whitfield decisions of the House of Lords. This case is discussed supra p. 162 et seq.

40. Professor Gower has been very critical of the role of the English courts — in particular, the House of Lords — which according to him freely "rubber-stamp reductions of capital." He observes that "As a complete protection to the existing shareholders the court's discretion has . . . proved illusory." GOWER, 537-38.

41. Eng., s. 66 (1) (b). Paid-up share capital may be "lost" and therefore "unrepresented by available assets". But it may be "unrepresented by available assets" even though it is not "lost". The section covers both types of cases. See Re Hoare & Co. [1904] 2 Ch. 208; Re Floating Dock Company of St. Thomas, [1895] 1 Ch. 691. Also BUCKLEY ON THE COMPANIES ACTS, 159.

42. Caldwell & Co., Ltd. v. Caldwell, [1916] S.C. (H.L.) 120, [1916] W.N. 70. The company in this case was a private limited company. See also BUCKLEY ON THE COMPANIES ACTS 154. The English courts have refused to confirm a reduction in several cases on the ground that the loss of capital had not been shown. See Re Abstainers

and General Insurance Co., [1891] 2 Ch. 124; Re Barrow Hæmatite Steel Co., [1900] 2 Ch. 846; on appeal [1901] 2 Ch. 746. See also Re Pilsen Joel and General Electric Light Co., [1886] W.N. 203; Re Hoare & Co., [1904] 2 Ch. 208.

43. For an unreported case of this nature see BUCKLEY ON THE COMPANIES ACTS, p. 162 fn. (a). See also p. 155. If a company desires to return capital in partial liquidation, it must specifically seek the confirmation of the court for the reduction of capital in that way. The Act itself provides for the case where a company may want to "pay off any paid-up share capital which is in excess of the wants of the company." Eng., s. 66 (1) (c). See In re Tarapaca and Tocopilla Nitrate Co., Ltd., [1917] W.N. 356 (Younger, J.). The courts have liberally construed these words and held that the share capital may be in excess of the wants of the company if it can more cheaply borrow the money and for that reason prefers to return the capital. See Re Lamson Store Service Co., [1897] 1 Ch. 875; Re Nixon's Navigation Co., [1897] 1 Ch. 872; Re Thomas de La Rue & Co., [1911] 2 Ch. 361; Ex parte Western Sugar Refineries, Ltd., [1951] A.C. 625, [1951] All E.R. 881.

44. Supra n. 1, at p. 122.

45. Ibid.

46. 34 Ch. D. 287 (C.A. 1886).

47. The company had been advised "that they could not properly pay any dividend until they had accumulated money enough to restore

the cable, or had reduced their capital so as to make their nominal capital correspond with their assets." (id. at 289).

48. Bacon, V.C., refers to the preference shareholders as "creditors — the lenders of the money taking these £10 shares" (id. at 292). He thought that the company's contract with them cannot be altered by the decision of the ordinary shareholders and that to allow them to do so will enable "persons to form fictitious companies . . . . hold out a prospect to the preference shareholders, and then as they had got the money by means of the preference shares, they might resort to some expedient to cancel or reduce the amount of the capital, and so let in the ordinary shareholders, and let them take for all time through good years and bad years, so long as the concern lasted, the same share of profits as the preference shareholders would have been entitled to. It would be frightful if I should enable them to do that." (id. at 293).

49. Id. at 294.

50. Id. at 299-300.

51. 34 Ch. D. at 301-02.

52. Id. at 303.

53. Ibid. Fry, L.J., confined himself to the specific problem before the court and held that "the preferential capital was created subject to the right of reduction which was expressly provided for in the articles." (id. at 305).

54. 34 Ch. D. 287 (C.A. 1886).

55. 39 Ch. D. 582 (1888).

56. Id. at p. 597. See at pp. 597-99 the analogy drawn from Doman's Case, 3 Ch. D. 21 (C.A. 1876).

57. The company's issued capital was as follows:

150,000 ordy. of £10 par	....	£1,500,000
377 8% pref. of £100 par	....	37,700
50,000 6% pref. of £10 par	....	500,000
Total		£2,037,700

By a uniform 25% reduction the company sought to reduce its capital from 2,037,700 to 1,528,275. The opposition came from the holders of 114 out of the 377 (less than a third) 8% preference shares and 3800 of the 50,000 6% preference shares (less than one-tenth). Thus a vast majority did not object to the reduction. This factor obviously influenced the decision of the court. See id. at 603.

58. Id. at 602.

59. Id. at 602-03.

60. Id. at 603.

61. Id. at 594-95.

62. Citing Guiness v. Land Corporation of Ireland, 22 Ch. D. 349, 377 (C.A. 1882): In re South Durham Brewery Company, 31 Ch. D. 261 (C.A. 1885). Cf. Hutton v. Scarborough Cliff Hotel Co., 4 D.J. & S. 672, 143 R.R. 269 (C.A. 1865).

63. [1900] 2 Ch. 846, aff'd [1901] 2 Ch. 746 (C.A.). After the first reduction the capital was £1,528,275. By the second reduction it was to be made exactly half of that amount, i.e. £764,137 10s.

64. 41 Ch. D. 1 (1889).

65. /1894/ 2 Ch. 239.

66. /1900/ 2 Ch. at 856.

67. Id. at 855-56.

68. /1901/ 2 Ch. at 748-49.

69. /1901/ 2 Ch. at 749. See also Romer, L.J., at pp. 749-50.

70. For this view see THE ECONOMIST cited in Gold, Preference Shareholders in the Reconstruction of English Companies, 5 U. TORONTO L.J. 282, 307 fn. 95.

71. Supra n. 8.

72. /1907/ A.C. 229 (H.L.).

72a. The judgments of the lower courts are unreported.

73. Of these, a public company held 34 shares and two individuals held the remaining 10 shares.

74. /1907/ A.C. at 236.

75. The company's issued and paid-up capital was as follows:

40,453 ordy. shares of £10 par paid-up to £8	£323,624
750 founders' shares of £1 credited as fully paid	750
Total paid up capital	324,374
Surpluses (Capital + earned)	32,431
Total	£356,805
The value of assets on 31 Dec. 1903	213,939
Loss of capital	142,866

The company sought to write off this loss to the capital account thus:

By writing off to surplus	20,757
By extinguishing the founders' shares	750
By cancelling £3 out of the £8 paid up on each of the 40,453 ordy. shares	121,359
Total written off	£ 142,866

The retention of a surplus of £11,674 (that is, £32,431 minus £20,757) was necessary to support the credit of the company as a bank and to meet contingencies. The Court of Appeal affirmed the reduction upon the company undertaking that no part of this £11,674 would be applied by the company otherwise than for capital purposes. Lord Macnaghten referred to this as a tendency of the court to narrow and restrict the power conferred on companies by the statute to reduce their capital and expressly disagreed with its propriety. See [1907] A.C. at 240-41.

76. [1907] A.C. at 237.

77. Id. at 238-39. He expressed dissent from the observations of Buckley, J., in In re Anglo-French Exploration Co., [1902] 2 Ch. 845.

78. Referring to Poole v. National Bank of China, Lord Blanseburgh said in Carruth v. Imperial Chemical Industries Ltd., [1937] A.C. 707, at 742-43 (H.L.), discussed in the following pages of the text, thus: "[T]here is . . . no reported case in which that authority has since been invoked, and the difficulties involved in its application are well-understood. They were dwelt upon by Lord Wrenbury in each edition of his work subsequently edited by himself."

79. [1907] A.C. at 240.

80. But the court will not allow the reduction process to be abused. In In re Development Company of Central and West Africa, [1902] 1 Ch. 547 (Swinfen Eady, J.), the court refused to sanction reduction of capital by the cancellation of a class of £1 deferred shares, even

though it was supported by all the shareholders (including the deferred shareholders) and there were practically no creditors, because the company had agreed with the deferred shareholders to allot in exchange for each £1 deferred share 100 new ordinary £1 shares. The court held that the reduction scheme was one really to increase capital and to issue a part of the new shares at a discount of 99% which was wholly illegal.

81. See also Scottish Insurance Corporation, Ltd. v. Wilsons & Clyde Coal Co., Ltd., [1949] A.C. 462 (H.L.); Prudential Assurance Co., Ltd. v. Chatterley-Whitfield Collieries, Ltd. [1949] A.C. 512 (H.L.). Both cases have been discussed supra p. 294 et seq.

82. [1937] A.C. 707 (H.L.), affirming [1936] Ch. 587 (C.A.).

83. The proportion of 4 deferred shares for each ordinary share was formulated on the basis of the market price of the shares over a period of years.

84. The surplus thus arising was transferred to the credit of a capital reserve account created on terms which forbade its distribution as dividend.

85. [1907] A.C. 229 (H.L.).

86. [1937] A.C. at 770.

87. Id. at 743.

88. Ibid. (emphasis added).

89. [1937] A.C. at 744.

90. Id. at 749. On the way in which the extraordinary meetings were conducted, see pp. 752-57.

91. Id. at 746, citing In re Quebrada Railway, Land and Copper Co., 40 Ch. D. 363 (1888).

92. Id. at 751.

93. See Carruth v. Imperial Chemical Industries, Ltd., [1937] A.C. 707, [1937] 2 All E.R. 422 discussed above. See also section 72 of the English Act dealing with the variation of shareholders' rights.

94. See the following law review notes critical of the American method:

Note, Corporations — Rights of Creditors in Reduction of Capital Stock, 21 VIRGINIA L. REV. 562 (1934-35).

Note, Capital Stock Reduction As Affecting the Rights of Creditors, 47 HARVARD L. REV. 693 (1933-34). The note observes that "reduction laws [in America] seem generally to ignore creditors entirely or to set up formal safeguards of no real value" and commends the English system for fully recognizing and protecting the interests of creditors. (id. at 697).

Note, The Current Law Regarding Reduction of Capital : Its Methodology, Purposes and Dangers, 110 U. PENNSYLVANIA L. REV. 723 (1962). This note concludes that "Neither courts nor legislatures have faced the problem involved in the reduction of capital with any consistent awareness of the dangers which this procedure poses for shareholders or creditors." (p. 741). It regrets the "undue laxity of much of the present law" and suggests that the law must set a "more demanding standard". Presumably it does not favour the English system and regards it as "a cumbrous system

unnecessary in most cases so long as the standard set [by the law] is meaningful." It suggests on the other hand that the recording official must be required to ensure that the certificate of amendment "conforms to law."

Comment, Writing Down Fixed Assets and Stated Capital, 44 YALE L.J. 1025 (1935). The note makes many suggestions based on the English law to guard against the dangers of reduction.

95. Under the Model Act, § 2(j), "stated capital" is defined to mean the sum of (i) the aggregate par value of issued par value shares, (ii) the aggregate consideration for issued no-par shares less any part of it allocated to capital surplus as permitted by law, (iii) any amounts transferred to stated capital by the capitalization of surplus, and (iv) any other amounts transferred to stated capital otherwise than by such capitalization. A reduction of stated capital to the extent of item (iv) can be effected under § 63 of the Model Act by the votes of the holders of a majority of the shares entitled to vote thereon, provided that if asset-preferences in liquidation exist, then the reduction is permissible only to the extent of the excess over such premia payable in liquidation.

§ 63, last para., seems to be erroneously drafted. It provides that no reduction of stated capital "shall be made under this section which would reduce the amount of the aggregate stated capital of the corporation below the sum of (1) the aggregate amounts payable upon all issued preference shares (par and no-par) in the event of involuntary liquidation and (2) the aggregate par value of

issued common shares. This would seem to suggest that the stated capital could be reduced to any extent in respect of the amount of consideration received for no-par common shares provided only that they are not completely extinguished. That this is not the intention of the section is evident from the final comment on the section which reads thus (§ 63 ¶ 4):

"[Under the section] it is possible to reduce stated capital attributable to par value shares down to their par value or down to their preferential right on involuntary liquidation, whichever is greater; and to reduce stated capital attributable to shares without par value down to the consideration received therefor, except the part allocated to capital surplus or the preferential right to involuntary liquidation, whichever is greater." This makes it clear that it was not intended to permit reduction of the no-par common capital to any level. All that is permitted is that stated capital may be reduced if there is an excess in that account over the total par value of issued par value shares and the total consideration (not allocated to surplus) for no-par shares together with the premium, if any, payable in the winding up upon repayment of any capital. It is not necessary to pursue the kind of reduction of stated capital contemplated by section 63 of the Model Act any further here.

96. Model, § 17.

97. Id. § 19.

98. Id. §§ 17, 19, 40, 53.

99. Id. §§ 53, 61, 62, 63.

100. Infra Ch. 9 . Model, § 60.

101. Model, § 61.

102. Infra Ch. 9 . Model, § 5.

103. Model, § 62.

104. Model, § 63. MOD. ACT ANN. § 63 ¶ 4.

105. Model, § 53.

106. Model, § 54.

107. Model, §§ 17, 19.

108. The authors of the Model Act were of the opinion that such publicity served no useful practical purpose : MOD. ACT ANN., § 57.

109. MOD. ACT. ANN., § 63 ¶ 4.

110. Uniform, § 1 X.

111. Id. § 42. Appraisal rights are given to a dissenting shareholder in the following cases: (a) voluntary transfer of all its assets by a corporation, including their exchange for shares in another corporation; (§ 37); (b) charter amendment which changes the corporate purposes, extends the duration of the corporation, or changes the rights of the holders of any outstanding shares (§§ 38, 39, 40). See also section 48 for appraisal right in the event of merger or consolidation.

112. Ibid.

113. N.Y. Laws 1961, c. 855 (effective Sept. 1, 1963). References are to McKINNEY'S CONSOLIDATED LAWS OF NEW YORK ANNOTATED, (hereinafter referred to as simply N.Y.)

114. N.Y., §§ 801 to 806. The New York definition of stated capital is the same as that of the Model Act.

115. Id. § 806 (b) (3) as amended.

116. Under § 504.

117. Section 516.

118. Section 513.

119. Section 515.

120. Delaware Laws, c. 50 (effective July 3, 1967) (hereinafter cited simply as Delaware or Del.).

121. Delaware, § 244. See also § 243.

122. Id. § 244 (e).

123. California Laws 1947, c. 1038, Title I, Division 1 (hereinafter cited as California or Calif.).

124. Id. § 1904 (as am. by 1955, c. 287).

125. Id. § 1906.

126. Id. § 1907.

127. Id. § 1906.

128. Id. § 1910.

129. Id. § 1904.

130. California, § 3604 reads:

> "An amendment [of the charter] changing the aggregate par value of par value shares or the number of shares without par value shall not affect the stated capital of a corporation."

131. MOD. ACT ANN., § 64 para. 1, § 41.

132. Id. § 41 (a).

133. Id. § 41 (b).

134. Id. § 41 (c).

135. Id. § 41 (d).

136. Id. § 41 (e).

137. Note, The Current Law regarding Reduction of Capital : Its Methodology, Purposes and Dangers, 110 U. PENNSYLVANIA L. REV. 723, 735-35 (1962).

138. Note, op. cit. supra, at 735. The other states are Hawaii, Montana and South Dakota.

139. Id. at 736.

140. Id. at 736 et seq. "[T]he prospects of adequate creditor protection . . . seems very slim indeed."

141. MOD. ACT ANN. § 64 last para.

142. Can., ss. 49-58.

143. Id. s. 51 (1).

144. Que., ss. 55-62.

145. Sask., ss. 63-68; B.C., ss. 65, 66; Nova Scotia, ss. 52-61; Alta, ss. 48 (1) (b) - 51.

146. Ont., ss. 33 (1) (d), 34-36; Man., 43 (1) (d), 44-46.

147. Can., s. 12 (1a), introduced by Stat. Can. 1964-65, c. 52, s. 10 (1).

148. Can., s. 49 (3).

Notes to Chapter 9

1. 12 App. Cas. 409 (H.L. 1887).

2. 4 Ch. D. 327 (C.A. 1876).

3. He also claimed to be a creditor of the company, but the case was decided without reference to this claim.

4. [Omitted].

5. 4 Ch. D. at 331.

6. Id. at 332.

7. The V.C., however, cited none.

8. 4 Ch. D. at 331.

9. 4 Ch. D. at 332.

10. James, L.J., and Baggallay and Brett, JJ.A.

11. 4 Ch. D. at 335-36. In the Teasdale's Case, 9 Ch. 54, 58 (C.A. 1873), James, L.J., had observed that "There is no doubt that a company may give itself power to purchase its own shares, to take surrenders of shares, and to cancel the certificates of shares." Now he modified that statement and said:

> I am reported to have said in one, Teasdale's Case, that the power to purchase shares would be good. I am not quite sure whether that was not too wide a deduction from the cases to which I was then referring, and certainly it was not necessary for the decision of the case. But however that may be, when the company deals with an individual shareholder, and does what appears to be right under the circumstances, namely, to accept the surrender from the shareholder who cannot pay, and to release him from further liability, that might be good, although incidentally, and to a small extent it may be said to diminish the capital. Of course the diminishing of the capital would not be the object of an act of that kind, and it would not be the intention of the Legislature to interfere with ordinary matters of business of that kind. Those cases seem to me to afford no kind of colour for a transaction like this, in which out of 150,000 shares 100,000 shares might have been extinguished. I think, without refer-

ence to what passed at the meeting, the resolutions are, on the face of them, ultra vires, but I will refer to what took place at the meeting to this extent, that, independently of anything said or done by the solicitor or by the directors there, it seems to me very questionable, at least, whether any resolution passed at any meeting of shareholders would be a valid resolution if it was intended to result in their dividing the assets between them, or in their receiving some pecuniary consideration as a consequence of the vote which they were then passing.

12. 30 & 31 Vict., c. 131, s. 9:

Reduction of Capital and Shares.

Power to Company to reduce Capital.

Any Company limited by Shares may, by special Resolution, so far modify the Conditions contained in its Memorandum of Association, if authorized so to do by its Regulations as originally framed or as altered by special Resolution, as to reduce its Capital; but no such Resolution for reducing the Capital of any Company shall come into operation until an Order of the Court is registered by the Registrar of Joint Stock Companies, as is herein-after mentioned.

13. See the judgment of Brett, L.J., 4 Ch. D. at 340-41.

14. Id. at 340.

15. 17 Ch. D. 76 (C.A. 1880).

16. The meeting was attended by 9 shareholders who held 1589 out of the 1,600 issued shares and all of them voted for the resolution.

17. Ward was paid £5,000 for the 549 shares held by him, each paid up to half of their par value of £25.

18. 17 Ch. D. at 83.

19. 25 & 26 Vict., c. 89, s. 12:

Power of certain Companies to alter Memorandum of Association

Any Company limited by Shares may so far modify the Conditions contained in its Memorandum of Association, if authorized to do so by its Regulations as originally framed, or as altered by special Resolution in manner herein-after mentioned, as to increase its Capital, by the Issue of new Shares of such Amount as it thinks expedient, or to consolidate and divide its Capital into Shares of larger Amount than its existing Shares, or to

convert its paid-up Shares into Stock, but, save as aforesaid, and save as is herein-after provided in the Case of a Change of Name, no Alteration shall be made by any Company in the Conditions contained in its Memorandum of Association.

Memorandum of Association of a Company limited by Shares.

Section 8: Where a Company is formed on the Principle of having the Liability of its Members limited to the Amount unpaid on their Shares, herein-after referred to as a Company limited by Shares, the Memorandum of Association shall contain the following Things; (that is to say,)

(1) The Name of the proposed Company, with the Addition of the Word "Limited" as the last Word in such Name:
(2) The Part of the United Kingdom, whether England, Scotland, or Ireland, in which the registered Office of the Company is proposed to be situate:
(3) The Objects for which the proposed Company is to be established:
(4) A Declaration that the Liability of the Members is limited:
(5) The Amount of Capital with which the Company proposes to be registered divided into Shares of a certain fixed Amount:

Subject to the following Regulations:

(1) That no Subscriber shall take less than One Share:
(2) That each Subscriber of the Memorandum of Association shall write opposite to his Name the Number of Shares he takes.

20. 17 Ch. D. at 85-86.

21. Supra p. 285 .

22. Cotton, James and Lush, L.JJ.

23. 17 Ch. D. at 95.

24. Id. at 94.

25. 30 & 31 Vict., c. 131, ss. 9-20.

26. Cotton, Bowen and Fry, L.JJ.

27. 12 App. Cas. 409 (H.L. 1887).

28. The judgments of the Vice Chancellor and the Court of Appeal are unreported.

29. 12 App. Cas. at 414.

30. 12 App. Cas. at 415.

31. Id. at 416. To the same effect Lord Watson said (at pp. 423-24):

> "The effect of these statutory restrictions [on the power of limited companies to reduce the amount of their capital] is to protect the interests of the outside public who may become their creditors . . . . [T]he effect of these statutory restrictions is to prohibit every transaction between every company and a shareholder; by means of which the money already paid to the company in respect of his shares is returned to him, unless the Court has sanctioned the transaction. Paid-up capital may be diminished or lost in the course of the company's trading; that is a result which no legislation can prevent; but persons who deal with, and give credit to a limited company, naturally rely upon the fact that the company is trading with a certain amount of capital already paid, as well as upon the responsibility of its members for the capital remaining at call; and they are entitled to assume that no part of the capital which has been paid into the coffers of the company has been subsequently paid out, except in the legitimate course of business."

32. Ibid.

33. Id. at 417.

34. Id. at 424.

35. 12 App. Cas. at 433.

36. Id. at 436.

37. Id. at 438.

38. Id. at 438-39.

39. 21 L.J. Rep. (N.S.) Chanc. 835, 836 (1852).

40. [1892] 3 Ch. 279 (C.A.).

41. 7 & 8 Vict., c. 110 (U.K. 1844).

42. As yet limited liability had not been generally made available. But the policies issued by the company specifically limited the liability of the shareholders in respect of claims under the policies

to the amount unpaid on their shares. In other words, limited liability was in effect secured through special contract.

43. For prices ranging from £2 2s. 6d. to £2 13s.

44. The company was later re-registered under the Act of 1862, but that makes no difference for our purposes here.

45. [1892] 3 Ch. at 283.

46. Id. at 288.

47. Eng. Act of 1929, s. 46; present Act, s. 58.

48. For the difficulties in the application of this provision see BUCKLEY ON THE COMPANIES ACTS, 145-46.

49. In re St. James' Court Estate, Ltd., [1944] Ch. 6.

50. The court may also make such an order upon a petition by the Board of Trade in a case falling under section 169 (3).

51. The section prohibits a company to provide financial assistance for the purchase or subscription of its own shares, or the shares of its holding company, but permits a few exceptions.

52. 12 App. Cas. 400 (H.L. 1887).

53. Model, § 5 first para.

54. Id. last para. and § 2 (n); also § 60.

55. Id. § 40 para. 1.

56. Model, § 61.

57. Model, § 2 (h).

58. Model, § 62.

59. Model, § 5 para. 2.

60. Hackney, The Financial Provisions of the Model Business Corporation Act, 70 HARVARD L. REV. 1357, 1393 (1957). Hackney observes that the Model Act's provisions are "apparently inadvertently doubling the adverse effect caused by the purchase."

61. Model, § 2 (i): "Net assets" means the amount by which the total assets of a corporation, excluding treasury shares, exceed the total debts of the corporation."

62. Kessler, Share Repurchases under Modern Corporation Laws, 28 FORDHAM L. REV. 637, 641 fn. 15 (1959-60).

63. See FINNEY, GENERAL ACCOUNTING, 181-186 (12th print. 1949). Accounting under this method will be as below:

Before Repurchase

Net worth (Net Assets)		
Share Capital (1,000 shares of $25 par each, all issued, paid-up and outstanding)	$25,000	
Surplus	$15,000	
Total Net Worth		$40,000

After Repurchase

Net worth (Net Assets)		
Share Capital (1,000 shares of $25 par)	25,000	
In treasury 100 shares	2,500	
Outstanding, 900 shares	22,500	
Surplus		
Restricted — Cost of 100 treasury shares	2,500	
Unrestricted	12,500	
Total	15,000	
Total Net Worth		$37,500

64. Model, § 62.

65. Model, § 60.

66. Model, § 5.

67. Model, § 41 (d).

68. Model, §§ 5, 73.

69. N.Y., § 512.

70. N.Y., § 513.

71. N.Y., § 515.

72. Ibid.

73. N.Y., § 515 (c).

74. N.Y., §§ 515 (c), 517(a)(5).

75. Stanger, Comparative Accounting Treatment Mandated By the Model Business Corporation Aft and The New York Business Corporation Law Regarding Share Reacquisitions and The Related Effect on Surplus, 24 BUSINESS LAWYER 115 (Nov. 1968).

76. N.Y., § 806 (b)(3). Supra Chapter 8, n. 115.

77. California, § 1708.

78. California, §§ 1706, 1709, 1904.

79. California, § 1707 (c).

80. California, § 1709.

81. California, § 1906.

82. California, § 1907.

83. California, §§ 1908, 1909.

84. Delaware, § 160.

85. Delaware, § 243.

86. Can. s. 12 (1a), introduced 1964-65.

87. Ont., s. 27; Man., s. 34.

88. Ont., s.27 (3). On mutual funds in Canada see Williamson, Mutual Funds in ZIEGEL (ed.), STUDIES IN CANADIAN COMPANY LAW 452-75 (1967).

89. Williamson, op. cit. supra, at 458.

90. Ont., s. 27 (6).

91. Can. s. 12A introduced 1964-65.

92. LAWRENCE COMMITTEE REPORT (1967), Ch. 5, sec. 3.

93. Ibid. sec. 2.

94. N.Y., §§ 513-515.

95. PATON, CORPORATE PROFITS, 114 (1965).

96. AMORY & HARDEE, MATERIALS ON ACCOUNTING, 325 (3d ed. 1959).

97. Supra, Chapter 3.

98. Act of 1934, § 12, as am. in 1964.

99. Act of 1934, § 13, as am. in 1964.

100. The "over 10% beneficial owner of any class of equity security" is required to make further disclosures and is subjected to further controls by the amending Act of 1968, (Public Law 90-439, 82 Stat. 457, which amends sections 13 and 14 of the Act of 1934). These are designed to regulate take-over bids in general and cash-take-bids in particular.

101. Note, Corporate Stock Repurchases Under Federal Securities Law, 66 COLUMBIA L. REV. 1292, 1296-97 (1966).

102. Anderson v. Albert & J.M. Anderson Mfg. Co., 325 Mass. 343, 90 N.E. 2d 541 (1950); Bennett v. Propp, 187 A. 2d 405 (Del. Sup. Ct. 1962). Cf. English cases holding that the power to issue

shares must be used only to raise needed capital and not to influence voting rights: Hogg v. Cramphorn, Ltd. [1966] 3 W.L.R. 995; Piercy v. S. Mills & Co., Ltd., [1920] 1 Ch. 77; Punt v. Symons & Co., Ltd., [1903] 2 Ch. 506.

103. For a similar approach to proxy fight expenses, see Rosenfeld v. Fairchild Engine & Airplane Corp., 309 N.Y. 168, 128 N.E. 2d 291 (N.Y. C.A. 1955).

104. Cf. Lord Macnaghten's observations in Trevor v. Whitworth, 12 App. Cas. 409, at 435: "Can it be contended that when the policy of directors is assailed they may spend the capital of the company in keeping themselves in power, or in purchasing the retirement of inquisitive and troublesome critics?"

105. 199 A. 2d 548 (Del. Sup. Ct. 1964). See also Kors v. Carey, 39 Del. Ch. 47, 158 A. 2d 136 (Del. Ch. 1960); Martin v. American Potash & Chemical Corp., 33 Del.Ch. 234, 92 A. 2d 295 (Sup. Ct. 1952).

106. See also O'Neill v. Maytag, 339 F. 2d 764 (2d Cir. 1964). Cf. Ruckle v. Roto American Corp., 339 F. 2d 24 (2d Cir. 1964).

107. Ibid.

108. Note, op. cit. supra n. 101, 66 COLUMBIA L. REV. at 1311, et seq.

109. See Surowitz v. Hilton Hotels Corp., 383 U.S. 363 (1966).

110. O'Neill v. Maytag, 339 F. 2d 764 (2d Cir. 1964); Carliner v. Fair Lanes, Inc., 244 F. Supp. 25 (D. Md. 1965).

111. Hoover v. Allen, 241 F. Supp. 213 (S.D.N.Y. 1965). For a critical examination of this case see Note, op. cit. supra n. 101, 66 COLUMBIA L. REV. at 1314-15.

112. [1902] 2 Ch. 421.

113. Gower, Some Contrasts Between British and American Corporation Law, 69 HARVARD L. REV. 1369, 1384 (1956).

114. Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (Sup. Judicial Ct. of Mass. 1933). See the cases cited in BAKER & CARY, CASES AND MATERIALS ON CORPORATIONS, 559 (1959).

115. Strong v. Repide, 213 U.S. 419, 29 S.Ct. 521, 53 L.Ed. 853 (1909). BAKER & CARY, 559-61. In Kansas the courts have held the director or officer liable as if he were a trustee for individual shareholders: See Hitchkiss v. Fischer, 136 Kan. 530, 16 P. 2d 531 (1932), 46 HARVARD L. REV. 847 (1933); Blazer v. Black, 196 F. 2d 139 (10th Cir. 1952).

116. 15 U.S.C.A. § 78j.

117. Officially 17 C.F.R. 240.10-5.

118. Cady, Roberts & Co., 40 S.E.C. 907 (1961). Comment, Insider Liability Under Securities Exchange Act Rule 10b-5, 30 U. CHICAGO L. REV. 121 (1962); Ruder, Civil Liability under Rule 10b-5: Judicial Revision of Legislative Intent, 57 Nw. L. REV. 627 (1963); Kennedy, Problems As Officers and Directors, 18 BUS. LAW. 71 (1962); Cary, Israels and Loss, Recent Developments in Securities Regulation, 63 COLUMBIA L. REV. 856 (1963).

119. Ward La France Truck Corp., 13 S.E.C. 373 (1943). Note, 59 HARVARD L. REV. 769 (1946); Kohler v. Kohler Co., 319 F. 2d 634 (7th Cir. 1963); Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951); for a full discussion of the Transamerica litigation, see 3 LOSS, 1458-62. See also Rogen v. Ilikon Corp., 361 F. 2d 260 (1st Cir. 1966); List v. Fashion Park, Inc., 340 F. 2d 457 (2d Cir. 1965), cert. den. 382 U.S. 811 (1965); Note, op. cit. supra n. 101, 66 COLUMBIA L. REV. at 1298.

120. See Conant, Duties of Disclosure of Corporate Insiders Who Purchase Shares, 46 CORNELL L.Q. 53 (1960).

121. McNeil Kennedy, Transactions by a Corporation in its Own Shares, 19 BUSINESS LAWYER 319, 326-29 (1964).

122. Israels, Corporate Purchase of its Own Shares — Are There New Overtones?, 50 CORNELL L.Q. 620 (1965).

123. See Surowitz v. Hilton Hotels Corp., 383 U.S. 363 (1966).

124. Note, Corporate Stock Repurchases Under the Federal Securities Laws, 66 COLUMBIA L. REV. 1292 (1966): "The practice of reacquiring shares has been growing throughout the last decade, and has become a dominant market factor — rivalling even the influence of giant mutual funds and pension trusts." The note points out the role played by the S.E.C. to counteract this trend.

125. 17 Code of Federal Regulations (U.S.) 240.10b-6 reads:

> (a) It shall constitute a "manipulative or deceptive device or contrivance" as used in section 10 (b) of the Act for any person, (1) Who is an underwriter or prospective underwriter in a particular distribution of securities, or (2) Who is the issuer or other person

> on whose behalf such a distribution is being made, or (3) Who is a broker, dealer, or other person who has agreed to participate or is participating in such a distribution, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange, either alone or with one or more persons, to bid for or purchase for any account in which he has a beneficial interest, any security which is the subject of such distribution, or any security of the same class or series, or any right to purchase any such security, or to attempt to induce any person to purchase any such security or right until after he has completed his participation in such distribution . . .; (b) The distribution of a security (1) which is immediately exchangeable for or convertible into another security, or (2) which entitles the holder thereof immediately to acquire another security, shall be deemed to include a distribution of such other security within the meaning of the rule . . .; (e) The provisions of this rule shall not apply to any distribution of securities by an issuer to its employees, or to employees of its subsidiaries, or to a trustee or other person acquiring such securities for the account of such employees, . . .; (f) This rule shall not prohibit any transaction or transactions if the Commission, upon written request or upon its own motion, exempts such transaction or transactions, either unconditionally or on specified terms and conditions, as not constituting a manipulative or deceptive device or contrivance comprehended within the purpose of this rule." (Adopted August 15, 1955, and as amended up to November 20, 1964).

But under section 9 of the Securities Exchange Act stabilizing transactions are permissible subject to such rules and regulations as the S.E.C. may prescribe in public interest or for the protection of investors. On stabilization see 1 LOSS, 1583 et seq. (2d ed. 1961). See also the "Statement of Policy on the Pegging, Fixing and Stabilizing of Security Prices" (S.E.C.'s Securities Exchange Act Release No. 2446, dated March 18, 1940) reprinted in JENNINGS & MARCH, SECURITIES REGULATION : CASES AND MATERIALS, 626 et seq. (1963). See also Note, op. cit. supra n. 124, 66

COLUMBIA L. REV. 1292, 1298-1300.

126. S.E.C. v. Georgia Pacific Corp., CCH FED. SEC. L. REP. ¶91680 (S.D.N.Y. May 24, 1966) (consent decree); Genesco, Inc., id. ¶77354 (S.E.C. 1966) (informal agreement). See Note, op. cit. supra, 66 COLUMBIA L. REV. at 1298-1300.

127. New subsection (e) of Section 13 of the 1934 Act reads thus:

> "(e) (1) It shall be unlawful for an issuer which has a class of equity securities registered pursuant to section 12 of this title, or which is a closed-end investment company registered under the Investment Company Act of 1940, to purchase any equity security issued by it if such purchase is in contravention of such rules and regulations as the Commission, in the public interest or for the protection of investors, may adopt (A) to define acts and practices which are fraudulent, deceptive, or manipulative, and (B) to prescribe means reasonably designed to prevent such acts and practices. Such rules and regulations may require such issuer to provide holders of equity securities of such class with such information relating to the reasons for such purchase, the source of funds, the number of shares to be purchased, the price to be paid for such securities, the method of purchase, and such additional information, as the Commission deems necessary or appropriate in the public interest or for the protection of investors, or which the Commission deems to be material to a determination whether such security should be sold.
>
> "(2) For the purpose of this subsection, a purchase by or for the issuer or any person controlling, controlled by, or under common control with the issuer, or a purchase subject to control of the issuer or any such person, shall be deemed to be a purchase by the issuer."

Subsection (d), also introduced in 1968 by P.L. 90-439, relates to disclosure of information by cash-take-over-bidders. On these amendments and their legislative history, see U.S. CODE CONGRESSIONAL AND ADMINISTRATIVE NEWS, 1968, pp. 2767-71, 2997-3007.

128. H.R. 1711, of July 12, 1968, printed in U.S. CODE CONGRESSIONAL AND ADMINISTRATIVE NEWS, 1968, pp. 2997 et seq.

129. It has been pointed out that between 1961 and 1966 Genesco, Inc., accounted for as much as 75% of the trading in its own common stock on the New York Stock Exchange; that over half the companies listed on the N.Y.S.E. engaged in reacquisitions from 1954 through 1963, with the number increasing at an accelerating rate; that half of the group accounted for 79% of the total volume of open-market repurchases. See Note, op. cit. supra n. 124, 66 COLUMBIA L. REV. at 1295.

130. Note, op. cit. supra, at 1298.

131. Ibid. where an instance is cited in which a company bought over a million of its own shares in a ten-month period, causing a 75% rise in the market price of the shares. It then offered to buy another 1.2 million shares at a price near the market high and the directors announced their intention to tender approximately half of their 800,000 shares. The directors appear to have abandoned their plan in the last minute, presumably due to a timely suggestion from the S.E.C.

132. North Carolina Bus. Corp. Act, § 55-52.

133. STEVENS, CORPORATIONS, 279-80.

134. BALLANTINE, CORPORATIONS, 609 (rev. ed. 1946).

135. North Carolina General Statutes, § 55-52 (e) (3), (4) (Supp. 1959). Cf. the Model Act, § 41 (c), (d) for such restriction in the case of distributions in partial liquidation. But there are no such

restrictions in the case of repurchases of junior shares.

136. For a critical examination of the Model Act's share repurchase provisions see Kessler, Share Repurchases under Modern Corporation Laws, 28 FORDHAM L. REV. 637 (1959-60).

137. Eng., s. 58.

138. Kessler, op. cit. supra n. 136, at 650 fn. 41. See also footnote 45 on page 651. It is regrettable that the author did not choose to put these important criticisms of the Model Act's provisions in the body of the text, but relegated them to the footnotes.

139. JENKINS REPORT, paras. 167 et seq., Cmnd. 1749 (1962).

140. Ibid.

141. [1894] A.C. 399 (H.L.).

142. Supra p. 291 . See also In re Denver Hotel Company, [1893] 1 Ch. 495 (C.A.).

143. See also Scottish Insurance Corporation, Ltd. v. Wilsons & Clyde Coal Co., Ltd., [1949] A.C. 462 (H.L.) affirming [1948] S.C. 360 (Scot. Court of Session); Prudential Assurance Co., Ltd. v. Chatterley-Whitfield Collieries, Ltd., [1949] A.C. 512 (H.L.), affirming [1948] W.N. 367 (C.A.). Both these cases have been discussed supra p. 294 et seq.

144. LAWRENCE COMMITTEE REPORT, Ch. V, sec. 2.

145. N.Y., §§ 513-515.

146. LAWRENCE COMMITTEE REPORT, s. 5.2.10.

147. Ibid.

148. The Ontario Business Corporations Act Bill 125 of 1968.

149. Ont. Bill, s. 39 (2).

150. Ont. Bill, s. 39 (3) read with s. 2 (7).

151. Ont. Bill, s. 39 (4).

152. Ont. Bill, ss. 40 and 161 (2) 2.i.b.

152a. Ont. Bill, ss. 26, 27, 34, 35, 38. The bill also provides for mutual fund shares.

153. Ont. Bill, s. 38 (2).

154. Ont. Bill, ss. 41, 135-140.

155. Sprouse, Accounting for Treasury Stock Transactions : Prevailing Practices and new Statutory Provisions, 59 COLUMBIA L. REV. 882 (1959). See also Lerner & Solomon, Accounting and the Law Inter-twined : A Case Study of the Need for Uniform Accounting Principles, 56 GEORGETOWN L.J. 670 (1968).

Notes to Chapter 10

*This chapter deals only with dividends in cash or property, and not with stock-dividends.

1. Eng., ss. 66-71; Act of 1867, ss. 9-20.

2. Supra p. 36 .

3. Eng. Act of 1929, s. 46.

4. Eng. Act of 1948, s. 58.

5. Now Eng. Act of 1948, s. 56. Prior to the enactment of the section, it was held that there was no principle of law which prevented a company from paying dividends out of assets representing premiums received on the issue of shares. See Drown v. Gaumont-British Picture Corporation, Ltd., [1937] Ch. 402, [1937] 2 All E.R. 994.

6. The Limited Liability Act, 1855, 18 & 19 Vict., c. 133 (effective 14th August, 1855). See supra, Historical Introduction, pp. 21 et seq. Limited liability was made available to banking companies only in 1858 and to insurance companies in 1862.

7. Act of 1855, s. IX:

> If Dividends be made and Corporation insolvent, each Director consenting thereto liable.
>
> IX. If the Directors of any such Company shall declare and pay any Dividend when the Company is known by them to be insolvent, or any Dividend the Payment of which would to their Knowledge render it insolvent, they shall be jointly and severally liable for all the Debts of the Company then existing, and for all that shall be thereafter contracted, so long as they shall respectively continue in Office; provided that the Amount for which they shall all be so liable shall not exceed the Amount of such Dividend, and that if any of the Directors shall be absent at the Time of making the Dividend, or shall object thereto, and shall file their Objection in Writing with the Clerk of the Company, they shall be exempted from the said Liability.

8. Act of 1855, s. XIII:

> XIII. In the Case of any Company which has obtained a Certificate of Limited Liability, whenever, on taking the yearly Accounts of such Company, or by any Report of the Auditor thereof, it appears that Three Fourths of the subscribed Capital Stock of the Company has been lost, or has become unavailable in the Course of Trade, from the Insolvency of Shareholders, or from any other Cause, the Trading and Business of such Company shall forthwith cease, or shall be carried on for the sole Purpose of winding up its Affairs; and the Directors of such Company shall forthwith take proper Steps for the Dissolution of such Company, and for the winding up of its Affairs, either by Petition to the Court of Chancery, or by Exercise of the Powers of the Deed of Settlement, or by such other lawful Course as they may think most fit.
>
> Companies to be dissolved and wound up when Three Fourths of the Capital lost.

9. Joint Stock Companies Act, 1856, 19 & 20 Vict., c. 47 (effective 14 July 1856).

10. Act of 1856, s. XIV.

11. Act of 1856, s. LXVII (5).

12. Act of 1856, s. IX, and Sch., Table B, art. 63.

13. 25 & 26 Vict., c. 89 (effective 7th August 1862).

14. Eng. Act of 1908, 8 Edw. 7, c. 69, Table A, art. 97; Act of 1948, Table A, art. 116.

15. Supra Chapter 8.

16. We have seen that Jessel, M.R., had decided in In re Ebbw Vale Steel Co., 4 Ch. D. 827 (1877), that it did not apply to a case where capital had already been lost. See ante p. 285 .

17. 8 & 9 Vict., c. 16 (U.K. 1845).

18. Id. s. 65. For a similar provision see 8 & 9 Vict., c. 17, s. 68.

19. Id. s. 121. For a similar provision see 8 & 9 Vict., c. 17, s. 124.

20. 25 L.J. Rep. (N.S.) Chanc. 489, 8 D.M. & G. 835 (1856). The case involved several complicated and complex questions, but we are not concerned with all of them here.

21. 25 L.J. Rep. (N.S.) Chanc. at 501.

22. Id. at 500-01. For a similar conclusion with respect to the directors applying the funds of the company to buying up its partly paid up shares without any authority conferred by the deed of settlement to do so, the Vice Chancellor said (p. 501):

> The next question is, with respect to the buying up of shares. Now, there was no authority whatever in the deed for the directors to apply the funds of the company in the buying up of shares. Not only so, but by every share bought up they relieved some individual from a liability to pay up the rest of his contributions to that very fund and that very property which was to be charged with the payment to the persons effecting insurances. Having then a duty to persons insured, to preserve as much as possible the property which was liable to pay these insurances, they had no right to take on themselves to discharge any of those persons, or any of those shares of the property, from the liability to the persons insured; and to the extent that they have done so, they have made themselves liable; and it appears to me that they have made themselves liable not only to the extent of the monies of the society which they paid for the purchase of those shares (which, of course, they would be liable for), but for every share which they have bought up they are liable to stand in the shoes of the persons whom they may, by buying the shares, have discharged from liability, and to pay up the remainder of the unpaid portion of the capital which those persons would have had to pay if they had not been thus discharged. I do it, I need not say, with great reluctance, but I must hold the directors thus liable, because it was a dealing with the funds of the society in a manner utterly contrary to the whole scope of the deed, and the particular provisions of the deed, and dealing in both instances with the funds in a manner and from a motive which was not a proper, fair and just motive, because the purpose of buying up the shares was, that they should not get into the market and appear to be sold, because persons might be afraid of continuing in the society, and so the credit of the society would be damaged.

23. In re The Mercantile Trading Company (Ex parte The Official Liquidator), 38 L.J. Rep. (N.S.) Chanc. 698, 4 Ch. App. 475 (C.A. 1869). Reference to this case in the following footnotes are to the pages in the Law Journal Reports.

24. Act of 1862, section 165, reads as follows:

Power of Court to assess Damages against delinquent Directors and Officers.

165. Where, in the course of the Winding-up of any Company under this Act, it appears that any past or present Director, Manager, Official or other Liquidator, or any Officer of such Company, has misapplied or retained in his own Hands or become liable or accountable for any Monies of the Company, or been guilty of any Misfeasance or Breach of Trust in relation to the Company, the Court may, on the Application of any Liquidator, or of any Creditor or Contributory of the Company, notwithstanding that the Offence is one for which the Offender is criminally responsible, examine into the Conduct of such Director, Manager, or other Officer, and compel him to repay any Monies so misapplied or retained, or for which he has become liable or accountable, together with Interest after such Rate as the Court thinks just, or to contribute such Sums of Money to the Assets of the Company by way of Compensation in respect of such Misapplication, Retainer, Misfeasance, or Breach of Trust, as the Court thinks just.

25. 38 L.J. Rep. (N.S.) Chanc. at 706.

26. Id. at 703.

27. 38 L.J. Rep. at 708.

28. Id. at 703 per Selwyn, L.J.

29. Id. at 705-06 per Selwyn, L.J.

30. 38 L.J. Rep. (N.S.) Chanc. at 706.

31. See generally Edwards, The Nature and Measurement of Income, in BAXTER & DAVIDSON (eds.), STUDIES IN ACCOUNTING THEORY, 70, 83, 85 (2d ed. 1962).

32. BUCKLEY ON THE COMPANIES ACTS, 904 (13th ed. 1957).

33. In re County Marine Insurance Company, Rance's Case, 6 Ch. App. 104 (C.A. 1870).

34. This amount was never received by the company as the other company became insolvent.

35. 6 Ch. App. at 117-18. This shows that the court rejected the cash-receipts-minus-disbursements concept of income.

36. 6 Ch. App. at 122-23.

37. Jessel, M.R., said in In re National Funds Assurance Company, 10 Ch. D. 118, at 128 (1878):

> "As to saying that they did it bonâ fide, I think it is impossible to come to that conclusion; a man may not intend to commit a fraud, or may not intend to do anything which causists might call immoral, and he may be told that to misapply money is the right thing to do, but when he has the facts before him — when the plain and patent facts are brought to his knowledge — I will not dive into the recesses of his mind to see whether he believed, when he was doing a dishonest act, that he was doing an honest one. I cannot allow that man to come forward and say, 'I did not know I was doing wrong when I put my hand into my neighbour's pocket and took so much money out and put it into my own.' It is impossible in a Court of Justice to call a particular act a bonâ fide act simply because a man says that he did not intend to commit a fraud."

38. 10 Ch. D. 118 (1878).

39. Id. at 127.

40. 21 Ch. D. 149 (1882).

41. Id. at 151 (italics added).

42. 21 Ch. D. at 156.

43. Id. at 157. See also In re Sharpe, [1892] 1 Ch. 154. In 1929 companies were enabled, subject to several restrictions, to pay

with the previous sanction of the Board of Trade interest out of capital in cases where shares are issued "for the purpose of raising money to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period": Act of 1929, s. 54 (1); Act of 1947, s. 120 (3); Act of 1948, s. 65. The Indian Act has a similar provision. In such cases the interest paid may be charged to capital as part of the cost of construction of the work or building, or the provision of plant.

44. Id. at 161.

45. 21 Ch. D. at 161.

46. Id. at 158-59.

47. Id. at 161.

48. In re Exchange Banking Company, Flitcroft's Case, 21 Ch. D. 519, 52 L.J. Rep. (N.S.) Chanc. 217 (C.A. 1882), affirming 51 L.J. Rep. (N.S.) Chanc. 525 (1882).

49. 21 Ch. D. 149 (1882).

50. But they pleaded in defence the statute of limitation and some set-off with which we are not here concerned.

51. 10 Ch. D. 118 (1878).

52. 51 L.J. Rep. (N.S.) Chanc. at 528 (italics added).

53. 52 L.J. Rep. (N.S.) Chanc. at 220.

54. 52 L.J. Rep. (N.S.) Chanc. at 219.

55. Ibid.

56. Ibid.

57. L.R. 7 H.L. 653 (1875), reversing L.R. 9 Exch. 224 (1874).

58. AMORY & HARDEE, MATERIALS ON ACCOUNTING, 151 (3d ed. 1959).

59. Yamey, The Case Law Relating to Corporate Dividends, in BAXTER & DAVIDSON (eds.), STUDIES IN ACCOUNTING THEORY, 428 (2d ed. 1962). This is a revised version of the author's article, Aspects of the Law Relating to Corporate Dividends, which appeared two decades earlier in 4 MODERN L. REV. 273 (1941).

60. 25 L.J. Rep. (N.S.) Chanc. 489 (1856).

61. 41 Ch. D. 1 (C.A. 1889).

62. 41 Ch. D. at 9, per Stirling, J.

63. 41 Ch. D. at 5-6.

64. Id. at 7.

65. Id. at 7.

66. Id. at 9.

67. 41 Ch. D. at 9.

68. Id. at 10.

69. Ibid. The judge accepted evidence showing appreciation in value of the concession and rejected that showing diminution.

70. Ibid. (emphasis added).

71. 41 Ch. D. at 13.

72. Id. at 22.

73. Such a provision existed in the case of loss of three-fourths of the capital under the Acts of 1855 and 1856. See ante p. 385.

74. 41 Ch. D. at 22-23. (italics added).

75. 41 Ch. D. at 20.

76. 41 Ch. D. at 24 (emphasis added).

77. Id. at 23.

78. Id. at 21.

79. 41 Ch. D. at 25.

80. For such a case see Davison v. Gillies, 16 Ch. D. 347, n. (1879); cf. Dent v. London Tramways Company, 16 Ch. D. 344 (1880), both decisions of Jessel, M. R.

81. 41 Ch. D. at 26.

82. Id. at 26-27.

83. 41 Ch. D. at 27.

84. He thought that there was a distinction between a case where shares had been allotted for cash and one where they had been allotted for any other consideration. He said (at p. 10):

> "[T]he present case is very different from that of a company where money has been paid on all the shares. That case is open to very different considerations. Here all that was taken by the company from the first companies was their assets, and in my opinion those assets have increased in value . . . ."

He expressed the opinion that where shares had been allotted for noncash consideration —

> ". . . there is no obligation in any way imposed upon the company or its shareholders to make up the assets of the company so as to meet the share capital, where the shares have been taken under a duly registered contract, which binds the company to give its shares for certain property without payment in cash. Shares must be paid up in cash, unless under an agreement duly registered there is a contract to allot or give the shares for something different. If there is an arrangement of that kind, which is obviously delusive, it may be that, although it has been duly registered, the shareholders who have taken

the shares under it may, on proper proceedings being taken, be obliged to pay up in cash the difference between the value of their property and the nominal amount of their shares. But there is no suggestion that that ought to be done here, and in my opinion it would be wrong to say that a division among the shareholders of money which the company are not bound to apply in making up the nominal amount of their share capital is a return of capital." (p. 16)

85. 41 Ch. D. at 22.

86. Id. at 26.

87. Id. at p. 17:

> "[T]here is this firmly fixed, that capital assets of the company are not to be applied for any purpose not within the objects of the company, and paying dividend is not the object of the company, the carrying on the business of the company is its object. If this property was property of another nature, property which would not be reasonably or properly consumed in providing profit, the case would stand in a very different position. If there was a permanent property which would not be reasonably or properly so consumed, but the fruit of which only would be used in providing profit, then if the directors were to sell, or the shareholders were to authorise a sale of that, and then to declare a dividend out of the proceeds, that would clearly come within the case of Guinness v. Land Corporation of Ireland [22 Ch. D. 349], for it would be applying the capital of the company to a purpose which was not authorised. But here, for the purpose of getting the profit, there is necessarily a consumption year by year of part of the capital of the company."

88. 41 Ch. D. at 18, per Cotton, L.J., and at 27, per Lopes, L.J.

89. See supra Chapter 6.

90. In Bond v. Barrow Hæmatite Steel Co., [1902] 1 Ch. 353, at 367-68, Farwell, J., expressed the opinion that the Neuchatel case did not lay down as a universal rule "that no company owning wasting property need ever create a depreciation fund." According

to him the Court decided in that case "nothing more than the particular proposition that some companies with wasting assets need have no depreciation fund." He expressed the view that "It is for the Court to determine in each case whether a particular company ought, or ought not, to have such a fund." Quaere: when is this to be decided?

91. 41 Ch. D. at 27, per Lopes, L.J.

92. FINNEY, GENERAL ACCOUNTING, 272-73.

93. 41 Ch. D. at 7.

94. 41 Ch. D. at 19 (italics added).

95. [1894] 2 Ch. 239 (C.A.).

96. 40 & 41 Vict., c. 26.

97. [1894] 2 Ch. at 243.

98. Id. at 245, per Stirling, J.

99. Supra p. 417 .

100. [1894] 2 Ch. at 258-59.

101. "The interest on the debenture stock which constitutes the main liability of the company is provided for out of the income arising from the investments, and the capital of those investments at the present time appears amply sufficient for payment of the principal." per Stirling, J., [1894] 2 Ch. at 259.

102. Ibid.

103. Supra Chapter 8.

104. In re Ebbw Vale Steel Co., 4 Ch. D. 827 (1877).

105. See [1894] 2 Ch. at 248.

106. Id. at 267 (emphasis added).

107. The Act of 1867 spoke of "Reduction of Capital" and the modification of "the Conditions contained in its Memorandum of Association" for the purpose. See supra, p. 284 . Since the Act of 1908 this language has been abandoned and the Act provides for reduction of share capital in any way. The language of the Act of 1867 gives the impression that it applies only to cases where the authorised capital is to be reduced and Lindley, L.J., would seem to have laid down that the authorised capital need not be reduced, if part of the capital has been lost.

108. [1894] 2 Ch. at 267.

109. [1894] 2 Ch. at 266.

110. Id. at 265. Cf. Jessel, M.R., in In re Ebbw Vale Steel Co., 4 Ch. D. 827 (1877), supra p. 285 .

111. Ibid.

112. Id. at 266.

113. [1894] 2 Ch. at 266. See also his statement in In re National Bank of Wales, Ltd., [1899] 2 Ch. 629, at 670-71 (C.A.): "[I]t is obvious that circulating capital or any other money employed in earning returns, must be deducted from [such returns] in order to ascertain how much of them can be regarded as profit. If the returns do not exceed the money spent in procuring them (whether such money be called circulating capital or by any other name) there can be no profits; and no ingenious process of book-keeping can alter the fact."

114. Id. at 269, per Kay, L.J.

115. Kay, L.J., appears to have felt some diffidence on the question whether lost capital ought to have been replaced.

116. Supra p. 407 .

117. [1899] 2 Ch. 629 (C.A.), reversing Wright, J.: aff'd sub. nom. Dovey v. Cory, [1901] A.C. 477 (H.L.).

118. Under the Companies (Winding-up) Act, 1890, s. 10.

119. The chairman and general manager of the company were criminally prosecuted and convicted for fraud. John Cory was a brother of the chairman. The liquidator sought to hold Cory liable on two other counts of breaches of duty but we are not concerned with them here.

120. The facts have been simplified here.

121. The issued shares were all of a par value of £20 each, paid up to £10 only. The paid up capital was £225,000 and the uncalled capital was also £225,000. The uncalled capital was more than sufficient to meet the deficit of £41,000 to pay creditors. Understandably, the shareholders sought to hold the directors liable for this deficiency.

122. [1899] 2 Ch. at 640.

123. [1899] 2 Ch. at 640.

124. Id. at 666.

125. [1899] 2 Ch. at 668-69. The most regrettable aspect of this "reprehensible" conduct is that the shareholders seldom realize what is happening to their equity and are deceived into thinking

that their company is prosperous.

126. Id. at 669:

> "[P]aid-up capital which is lost can no more be applied in paying dividends than in paying debts. Its loss renders any subsequent application of it impossible. There was no such dealing with the paid-up capital of the company in this case as to amount to an illegal application of it. Further, it is not possible for the Court to say that the law prohibits a limited company even a limited banking company, from paying dividends unless its paid-up capital is intact."

127. Ibid.

128. Id. at 669-670.

129. Citing Gregory v. Patchett, 33 Beav. 595, 55 E.R. 499 (1864).

130. Citing Bloxam v. Metropolitan Rly. Co., 3 Ch. App. 337, 350 (1868); Rance's Case, 6 Ch. App. 104 (C.A. 1870), supra n. 33; In re Oxford Benefit Building and Investment Society, 35 Ch. D. 502 (1886); Leeds Estate Building and Investment Co. v. Shepherd, 36 Ch. D. 787 (1887); In re London and General Bank (No. 2), [1895] 2 Ch. 673.

131. He applied the standard of care and honesty laid down by Lagunas Nitrate Co. v. Lagunas Syndicate, [1899] 2 Ch. 392 (C.A.).

132. For similar misunderstanding that losses in circulating capital must be made good in every case out of subsequent income, see Yamey, op. cit. supra n. 59, in STUDIES IN ACCOUNTING THEORY, 434-35. Also see Bond v. Barrow Hæmatite Steel Co., [1902] 1 Ch. 438.

133. [1901] A.C. at 486.

134. Id. at 486-87.

135. Lord Macnaghten also wanted "to guard myself from being understood to assent to all the propositions supposed to have been laid down by the Court of Appeal . . . ." [1901] A.C. at 487. His lordship did not "think it desirable for any tribunal to do that which Parliament has abstained from doing — that is, to formulate precise rules for the guidance or embarrassment of business in the conduct of business afairs." (id. at 488). He felt that "There never has been, and there . . . never will be, much difficulty in dealing with any particular case" and doubted "the wisdom of attempting to do any more." (ibid.)

136. [1901] A.C. at 493.

137. [1918] 1 Ch. 266, 286-87 (C.A.).

138. The increase upon revaluation was by £20, 542 2s. 8d.

139. [1918] 1 Ch. at 286-87.

140. The Jenkins Committee has expressed the view that companies must be required to eliminate past revenue losses (but not losses of fixed capital) before profits of subsequent years are distributed. JENKINS REPORT, paras. 340, 341.

141. See also Re Kingston Cotton Mills Co. (No. 2), [1896] 1 Ch. 331 (depreciation in the value of the fixed capital could be ignored in computing the fund available for dividend); Wilmer v. McNamara, [1895] 2 Ch. 245 (depreciation of goodwill and of leaseholds).

142. GOWER, MODERN COMPANY LAW, 108 and f.n. 59 on that page (2d ed. 1957).

143. Ibid.

144. Supra p. 285 .

145. Supra p. 427.

146. [1892] 2 Ch. 198. See also Foster v. New Trinidad Company, [1901] 1 Ch. 208.

147. 41 Ch. D. at 26-27.

148. [1892] 2 Ch. at 200.

149. [1892] 2 Ch. at 200.

150. PALMER'S COMPANY LAW, 646 (20th ed. by Schmitthoff & Curry, 1959). In Bolton v. National Land & Colonization Co., [1892] 2 Ch. 124, a shareholder sought to restrain the company from paying a dividend out of its current earnings in the year 1885 on the ground that twelve years earlier (in 1873) the company had treated unrealized appreciation of assets as profit in the income account and similarly in 1882 (in the latter case to set off bad debts of £72,326 debited to the profit and loss account). Romer, J., refused to interfere in a judgment which is not all too clear but intimates that the case was not fairly raised by the pleadings. (see p. 133).

151. [1918] 1 Ch. 266, 275 (C.A.).

152. His lordship disagreed with expert testimony to the contrary.

153. In Bond v. Barrow Hæmatite Steel Co., [1902] 1 Ch. 353, 365, Farwell, J., said: "A company which has a balance to the credit of its profit and loss account is not bound at once to apply that sum in making good an estimated deficiency in value of its capital assets. It may carry it to a suspense account or to reserve, and if the assets subsequently increase in value the amount neither has

been nor will be part of the capital. If, therefore, a part of that balance is used in paying a dividend, that dividend is not paid out of capital . . . ."

154. Peterson, J., so observed in the Ammonia Soda case : [1918] 1 Ch. at 277.

155. [1961] Ch. 353.

156. [1961] Ch. at 372.

156a. Buckley, J., disagreed with a contrary decision of the Scottish Court of Session in Westburn Sugar Refineries, Ltd. v. Inland Revenue Commissioners, [1960] T.R. 105, [1960] S.L.R. 297, and thus expressed his reasons:

> "I can see no reason why, if the valuation is not open to criticism, this should not be so, or even why, in any case in which the regulations of the company permit the distribution by way of dividend of profit on capital account, a surplus so ascertained should not be distributed in that manner. After all every profit and loss account of a trading concern which closes and opens with a stock figure necessarily embodies an element of estimate. The difference between ascertaining trading profits by, amongst other things, estimating the value of stock in hand at the beginning and end of the accounting period, and ascertaining capital profits by comparing an estimated value of the assets with their book value, appears to me to be a difference of degree but not of principle. Moreover, if a company has fluid assets available for payment of a dividend, I can see nothing wrong in its using those assets for payment of a dividend, and at the same time, as a matter of account, treating that dividend as paid out of a capital surplus resulting from an appreciation in value of unrealised fixed assets. The proper balance of the company's balance-sheet would not be disturbed by such a course of action. The company would be left with assets of a sufficient value to meet the commitments shown on the liabilities side of its balance-sheet, including paid-up share capital. A company is not required by law to keep any part of its assets in any particular form. I do not say that in many cases such a course of action would be a wise commercial practice, but for myself I see no ground for saying that it is illegal."

157. See the JENKINS COMMITTEE REPORT, Cmnd. 1749 (1962), paras. 336-339. The Committee found nothing inconsistent in prohibiting the distribution of unrealized capital surplus by way of dividend but permitting the capitalization of such surplus by the issue of fully paid-up shares.

158. Prior to the amendment of section 41 of the Model Act in 1959 these distributions from capital surplus were described as "distributions in partial liquidation."

159. The Model Act makes a similar distinction between the purchase by a corporation of its shares out of earned surplus and capital surplus. See section 5 para. 1.

160. Model, § 40 (a), (b).

161. Id. § 40 (c), (d), (e).

162. Id. § 40 (a).

163. Id. § 2 (1).

164. Model, § 64 para. 1.

165. Id. § 5 para. 2.

166. It has been pointed out by a writer that "it would seem to be possible for a corporation to distribute all its earnings to common stockholders just prior to the dividend date on preferred stock and then pay dividends on the preferred out of capital surplus. Subsequent earnings can again be paid to the common, repeating the process." Hackney, The Financial Provisions of the Model Business Corporation Act, 70 HARVARD L. REV. 1357, 1384 fn. 126 (1957). See also Note, 65 HARVARD L. REV. 1203, 1215 (1952).

167. Model, § 41 last para.

168. Id. § 40 (b).

169. Model, § 64, para. 3.

170. Model, Alternative § 40 (a).

171. Id. § 2 (1).

172. Hackney remarks that it is not clear as to "what is meant by the Model Act definition's repetitive terms, 'net profits,' 'income,' and 'gains and losses.' . . . There is no indication of how the term 'gains' might differ in meaning from 'profits' or from 'income,' nor why the word 'earnings' is left out of the definition, nor why the word 'net' must precede 'profits' but not 'income,' 'gains,' or 'losses.' One is reminded that the State of Georgia prohibits dividends from profits which are not the 'actual legitimate net earnings.'" Hackney, op. cit. supra, at 1369. The Virginia statute defines "earned surplus" simply as the "balance of its net profits" and omits the words "income, gains and losses." VIRGINIA CODE ANN., § 13.1-2 (1956).

173. Hackney has observed that the "definition of earned surplus in § 2 (1) is apparently erroneous in indicating that a deficit may be eliminated by an application of stated capital." Hackney, op. cit. supra, at 1387 fn. 138. This is correct as section 64 only speaks of the elimination of a deficit by an application of the capital surplus. But as a reduction surplus (which is a capital surplus) can be created by reducing the stated capital, and such reduction surplus can be applied for eliminating deficits, we can say that the stated capital

is in fact applied for the purpose by the formal process of converting a part of it into capital surplus. Of course such conversion will require shareholder action.

174. Model, § 19.

175. Id. § 64.

176. Id. § 2 (k)

177. Prior to the amendment of 1962 the Act required at least two-thirds majority. Now this has been reduced.

178. Model, § 41. Prior to the amendment of 1959 the section used the description "distributions in partial liquidation" and permitted such distributions out of stated capital directly. After the amendment the description has been changed to "distributions out of capital surplus" and the Act does not permit distributions directly out of stated capital.

179. Model, § 41 (e).

180. Hackney, The Financial Provisions of the Model Business Corporation Act, 70 HARVARD L. REV. 1357, 1365-66 (1957).

181. Id. at 1367.

182. Such capital surplus may be a "capital surplus deficit". The earned surplus, in other words, may exceed the total surplus. See post p. 479 .

183. Id. at 1366. Texas Business Corp. Act, art. 2.40 (A) (Vernon's).

184. Uniform § 24.

185. Uniform, § 24 IV. Similarly it forbids stock dividends "except from the surplus of the aggregate of its assets over the aggregate

of its liabilities, including in the latter amount the amount of its capital stock."

186. Uniform, § 24 II.

187. Id. § 24 III.

188. Id. § 24 V.

189. Id. § 24 VII.

190. Id. § 25.

191. Uniform, § 41.

192. N.Y., § 510 (b).

193. Id. § 517 (1).

194. Ibid.

195. Id. §§ 801-806, 516, 515.

196. Id. § 517 (a) (4).

197. N.Y. Penal Law of 1909, § 664. See generally §§ 660 to 671 which contain the offences relating to corporations. The Law of 1909 is printed in an Appendix to McKINNEY'S CONSOLIDATED LAWS OF NEW YORK ANN., Book 39 (1967).

198. N.Y. Penal Law of 1965, § 190.35 (McKINNEY'S).

199. Delaware, § 170.

200. Capital is defined in section 154. Also see §§ 242-244.

201. California, §§ 1500-1503.

202. California, § 1906.

203. Id. §§ 1502, 1503.

204. Id. § 1501.

205. Can., s. 83 (2).

206. Id. s. 83 (5). See also s. 83 (6) which provides for exoneration from such liability in the case of a director who dissociates himself from such declaration of dividend and takes the steps prescribed by the subsection.

207. PRICE SPREADS COMMISSION REPORT, 40.

208. Can., s. 83 (2). See also Alta., s. 89 (2).

209. Bryden, The Law of Dividends, in ZIEGEL (ed.), STUDIES IN CANADIAN COMPANY LAW, 270, 302 (1967). See The King and A.G. of Saskatchewan v. Melicke, [1938] 2 W.W.R. 97.

210. REPORT, supra n. 207, 43.

211. Stat. Can. 1935, c. 55, s. 14.

212. Can., s. 95.

213. Cf. Massey v. Minister of National Revenue, [1940] 1 D.L.R. 225 (S.C.C.).

214. Can., s. 83 (4).

215. Que., s. 76 (1).

216. Id., s. 77 para. 1.

217. Ont., s. 61 (3), (4).

218. Id. s. 61 (5), (6), (7), (8).

219. Ont. Bill 125, ss. 141, 142.

220. For the liability of directors who voted in favour of or consented to the declaration of the dividend in contravention of sections 141 and 142, see section 124. A shareholder who receives such dividend may also be held liable within two years of the declaration at the instance of a creditor or shareholder as provided by section

124 (b). A director cannot escape liability unless he dissents to the declaration of the dividend. Even if he was absent at the concerned meeting, he should dissent within seven days after he becomes aware of the declaration of the dividend. See section 125 which is new.

221. Man., s. 2 (1) (i). The definition comprehends both the equity and bankruptcy senses. It reads:

> "insolvent", as applied to a corporation, means a corporation
> (i) that is, for any reason, unable to meet its liabilities to its creditors, as they generally become due, or
> (ii) the aggregate of the value of the assets of which is not, at a fair valuation, sufficient to enable it to meet all its liabilities to its creditors due or accruing due.

222. Alta., s. 91; Man., s. 74 (2).

223. Ind., ss. 205-207. Prior to the Act of 1956, the Indian Acts followed the English precedents and provided for these in Table A. See Eng., Table A, Clauses 116-122; Ind. of 1913, Table A, Clauses 97 et seq.

224. Ind., Sch. VI, Part II. Among the details to be disclosed is turnover.

225. The Indian Act contemplates only cash dividend or share dividend, but not property dividends. See s. 205 (3).

226. Ind., s. 205, as am. in 1960.

227. Id. ss. 205 and 350 as am. in 1960.

228. JENKINS REPORT, paras. 349, 397 (a).

229. Cf. Dent v. London Tramways Co., 16 Ch. D. 344 (1880);
Davison v. Gillies, 16 Ch. D. 347, n. (1879);
Re Kingston Cotton Mills Co. No. 2, [1896] 1 Ch. 331.

230. BONBRIGHT, 2 VALUATION OF PROPERTY, 972 (1st ed. 1937).

231. Sidney S. Alexander, Income Measurement in a Dynamic Economy, in STUDIES IN ACCOUNTING THEORY, 126, 139. The choice of one year's duration for measuring income is of course arbitrary.

232. Id. at 139.

233. Professor Ronald S. Edwards thus expresses the idea: "When we here use the expression 'net worth', we mean the worth of the business to the investors. The investors are a given group who have yielded up purchasing power to the business in exchange for rights whose value is the capital of the investors. Thus net worth and capital are synonymous." Edwards, The Nature and Measurement of Income, in STUDIES IN ACCOUNTING THEORY, 70, 110-11.

234. Professor Alexander's article, op. cit. supra n. 231, follows this theory. He bases valuation on the estimated future receipts and also takes into account the changes in the purchasing power of money.

235. Professor Alexander supports the first alternative. Professor Bonbright also points out that "the aggregate of the values of the separate assets of an enterprise is a meaningless figure — meaningless because the value of the whole is not measured by the sum of the values of the parts." 2 BONBRIGHT, 902, 677-82; also 1 BONBRIGHT, 76-82.

236. Professor Alexander's article, op. cit. supra n. 231, is an excellent account of the merits of this theory of income. On the practical and conceptual difficulties of this approach see Edwards, op. cit. supra n. 233, 114-16.

237. 2 BONBRIGHT, 989.

238. Ibid.

239. Supra p. 390 et seq.

240. Edwards, The Nature and Measurement of Income, in STUDIES IN ACCOUNTING THEORY, 70, 82-83.

241. Ibid.

242. Edwards, op. cit. supra n. 240, 87-88.

243. Id. at 109.

244. 2 BONBRIGHT, 902-06.

245. Alexander, Income Measurement in a Dynamic Economy (as revised by Professor David Solomons) in STUDIES IN ACCOUNTING THEORY, 126, 129-30.

246. Excellent American works have appeared in the past four decades on the role of the modern corporation: BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); BERLE, THE TWENTIETH CENTURY CAPITALIST REVOLUTION (1954); BERLE, ECONOMIC POWER AND FREE SOCIETY (1957); BERLE, POWER WITHOUT PROPERTY: A NEW DEVELOPMENT IN AMERICAN POLITICAL ECONOMY (1959); BERLE, THE AMERICAN ECONOMIC REPUBLIC (1963); DRUCKER, CONCEPT OF THE CORPORATION (1946); DRUCKER, THE FUTURE OF THE INDUSTRIAL MAN (1942); DRUCKER, THE PRACTICE OF MANAGEMENT (1954); DRUCKER, THE NEW SOCIETY (1950); EELS, THE MEANING OF MODERN BUSINESS (2d print. 1963); EELS, THE

GOVERNMENT OF CORPORATIONS (1962; 2d print. 1966); EELS & WALTON, CONCEPTUAL FOUNDATIONS OF BUSINESS (1961); EELS, CORPORATIONS GIVING IN A FREE SOCIETY (1956); EMERSON & LATCHAM, SHAREHOLDER DEMOCRACY : A BROADER OUTLOOK FOR CORPORATIONS (1954); GILBERT, DIVIDENDS AND DEMOCRACY (1956); LILIENTHAL, BIG BUSINESS : A NEW ERA (1953); MASON (ed.), THE CORPORATION IN MODERN SOCIETY (1959; 6th print. 1966). See also Harbrecht & McCallin, The Corporation and the State in American Law and Politics, 10 J. PUB. L. 1 (1961); Kaysen, The Social Significance of the Modern Corporation, 47 AMERICAN ECONOMIC REV. (PAPERS & PROCEEDINGS) 311 (1957); Ruder, Public Obligations of Private Corporations, 114 U. PENN. L. REV. 209 (1965); Berle, Corporate Decision-Making and Social Control, 24 BUSINESS LAWYER 149 (Nov. 1968); Hetherington, Fact and Legal Theory : Shareholders, Managers, and Corporate Social Responsibility, 21 STANFORD L. REV. 248 (Jan. 1969). Cf. Mazumdar, Modern Corporations and The Rule of Law, 114 U. PENN. L. REV. 187 (1965), reprinted from 10 INDIAN J. OF PUBLIC ADMINISTRATION 188 (1964).

247. In the words of Bonbright,

> "Various interests, partly conflicting, are thus seen to be concerned with the law of dividends as with other phases of corporation law. But the very diversity of these interests makes the establishment of wise rules of law extremely difficult; for a dividend policy best designed to protect creditors may be poorly designed to serve the interests of small common stockholders; and so on. No doubt this difficulty partly accounts for the unsatisfactory

nature of American dividend law and for the confusion of statutory and judicial rules on this point."

2 BONBRIGHT, op. cit., 915.

248. 2 BONBRIGHT, 915. Hackney, op. cit. supra n. 116, at 1365.

249. Including borrowed moneys. To use the language of the Companies Clauses Act, 1845, capital includes "all the money raised by the company, whether by subscription of the shareholders, or by loan or otherwise." Supra p. 386 .

250. Supra Chapter 8.

251. L.R. 7 H.L. 653 (1875).

252. Eng., Sch. VIII.

253. Supra p. 390 et seq.

254. Supra p. 394 et seq.

255. Supra p. 400 et seq.

256. Prior to 1927 the American jurisdictions generally codified the rule that dividend should be paid only out of profits and that no dividend should be paid if it would impair capital or when capital was impaired. The codification assumed different styles and forms in the different states. For details see Weiner, Theory of Anglo-American Dividend Law : American Statutes and Cases, 29 COLUMBIA L. REV. 461 (1929). See also Weiner, Theory of Anglo-American Dividend Law : The English Cases, 28 COLUMBIA L. REV. 1046 (1928); Weiner & Bonbright, Theory of Anglo-American Dividend Law : Surplus and Profit, 30 COLUMBIA L. REV. 954 (1930).

257. 2 BONBRIGHT, 916.

258. Id., 917.

259. Id., 918-20.

260. Hackney, op. cit. supra n. 166, 1372 and the cases cited in fn. 80 on that page.

261. Weiner, op. cit. supra n. 256, 29 COLUMBIA L. REV. at 461.

262. For example the New York statute of 1925 provided:

> "No stock corporation shall declare or pay any dividend which shall impair its capital or capital stock, nor while its capital or capital stock is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its shareholders, whether upon a reduction of the number of its shares or of its capital or capital stock, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities, including capital or capital stock, as the case may be."

It may be noted that the two parts of the section — the impairment of capital part and the surplus assets part — in effect mean the same. See 2 BONBRIGHT, 917.

263. Weiner, op. cit. supra n. 256, 29 COLUMBIA L. REV. at 474-75.

264. Weiner, The Amount Available For Dividends Where No-Par Shares Have Been Issued, 29 COLUMBIA L. REV. 906, 909 (1929).

265. The New Jersey Act of 1896 (P.L. 1896, p. 286) provided as follows:

> "No corporation shall make dividends, except from the surplus or net profits arising from its business, nor divide, withdraw, or in any way pay to the stockholders, or any of them, any part of its capital stock, or reduce its capital stock, except according to this act."

In 1904 this section was changed to read thus:

> "The directors of a corporation shall not make dividends except from its surplus, or from the net profits arising from the business of such corporation, nor shall it divide, withdraw, or in any way pay to the stockholders, or any of them, any part of the capital stock of such corporation, or reduce its capital stock except as authorised by law."

Comparing the two versions the Court of Errors and Appeals of New Jersey observed in Goodnow v. American Writing Paper Co., 69 A. 1014, 1015 (1908), aff'g 66 A. 607 (N.J. Ch. 1907), thus:

> "Under the Act of 1896 there was room to contend that the words 'net profits' were intended to be synonymous with the word 'surplus.' The language used was 'from the surplus or net profits.' Under the Act of 1904 this contention is no longer possible. The language used is 'from its surplus, or from the net profits.' The evident intent of the change is to point out two funds from which dividends may be made."

266. Model, § 2 (1).

267. Hackney, op. cit. supra n. 166.

268. This view is expressed by Mr. Hackney. Hackney, op. cit. supra n. 166, at 1371 n. 77. I wish to express my deep gratitude to Mr. Hackney for the readiness and enthusiasm with which he has responded to my queries and clarified my doubts with regard to the financial provisions of the Model Act.

269. Hackney, op. cit. supra n. 166, at 1373. For other such doubts see Hackney, at 1375-77.

270. Eng., s. 56.

271. PRICE SPREADS COMMISSION REPORT, 40.

272. Supra pp. 100-101.

273. Supra p. 476 .

274. In California it has been held that share premium amounts are "capital", and not "surplus", and hence could not be used for dividend. See Merchants' and Insurers' Reporting Co. v. Schroeder, 178 P. 540 (1918). The California statute was amended in 1917 and for a decision subsequent to the amendment see Dominguez Land Corp. v. Daugherty, 196 Cal. 453, 238 P. 697 (1925). This view is exceptional.

275. Lubbock v. British Bank of South America, [1892] 2 Ch. 198; Equitable Life Assurance Society v. Union Pacific R. R. Co., 212 N.Y. 360, 106 N.E. 92 (1914).

276. See Strachan, Economic and Legal Differentiation of Capital and Income, 26 L.Q.R. 40, 42 (1910).

277. Hackney, op. cit. supra n. 166, at 1375 n. 93.

278. 2 BONBRIGHT, 922-24.

279. In Randall v. Bailey, 288 N.Y. 280, 43 N.E. 2d 43 (N.Y.C.A. 1942) the New York Court of Appeals held that unrealized appreciation in the value of land was available for dividends under section 58 of the then New York Stock Corporation Law. For the text of the section which laid down a surplus-test see supra n. 262 . Randall v. Bailey contains a good note in page 283 of the report tracing the changes in the language of the dividend provision in that state from 1825 to 1923.

280. For the view that the Model Act's definition of earned surplus includes revaluation surplus, see Seward, Earned Surplus — Its Meaning and Use In The Model Business Corporation Act, 38

VIRGINIA L. REV. 435 (1952). For the view that such surplus will be treated as capital surplus under the Model Act, see Hackney, op. cit. supra n. 166, at 1381. Thus it will be available either for regular dividends or distributions.

281. Supra p. 453 and n. 209.

282. [1918] 1 Ch. 266. Supra p. 430 et seq.

283. Bonbright observed that this "case is a doubtful precedent even for English law, and a still more doubtful one for American law." 2 BONBRIGHT, 939.

284. PRICE SPREADS COMMISSION REPORT, 40.

285. [1894] 2 Ch. 239. Bonbright observes that this decision is "not a proper precedent for American law." 2 BONBRIGHT, 952.

286. Supra p. 423 .

287. The Uniform Act requires the board to "determine and make proper allowance for depreciation and depletion sustained and losses of every character." (§ 24).

288. 2 BONBRIGHT, 932-36. Bonbright cites early American cases holding that depreciation should not be deducted in computing net profits. For a United States Supreme Court decision to that effect see Eyster v. Centennial Board of Finance, 94 U.S. 500 (1876).

289. For an excellent account of the concepts of depreciation see Goldberg, Concepts of Depreciation, in STUDIES IN ACCOUNTING THEORY, 236. The word "depreciation" is used to denote (i) physical deterioration, (ii) fall in value, (iii) fall in price and (iv) cost allocation.

290. Blough, Depreciation — To Measure Income or To Provide Funds For Replacement? in STUDIES IN ACCOUNTING THEORY, 307.

291. Guaranty Trust Co. v. Grand Rapids, G.H. & M. Ry. Co., 7 F. Supp. 511 (W.D. Mich. 1931).

292. PATON, CORPORATE PROFITS, Ch. IV (1965).

293. Terborgh, Depreciation Policy and Price Level, in STUDIES IN ACCOUNTING THEORY, 324. Terborgh observes that there is a capital consumption of $5 to $8 billions a year in the United States due to understatement of depreciation: id. at 342.

294. Id. at 325. For the same view see PATON, op. cit. supra n. 292; Grady, Depreciation to Measure Income or to Provide for Replacement? in STUDIES IN ACCOUNTING THEORY, 317. Contra Blough, op. cit., at 313.

295. Of course this will mean a loss in income-tax revenue to the government which will have to be taken care of by suitable reforms in the tax structure.

296. Terborgh, op. cit. supra n. 293, at 326.

297. FOULKE, PRACTICAL FINANCIAL STATEMENT ANALYSIS, 520-22 (5th ed. 1961).

298. See 2 BONBRIGHT, 936-38.

299. See Weiner, op. cit. supra, 29 COLUMBIA L. REV., at 481-82.

300. The English Neuchatel Co. case, discussed supra, was decided in the absence of any special statutory provision for wasting asset companies and even without limiting the decision to the special nature of the company. The Neuchatel case has been followed in

American jurisdictions even in the face of the language of the state statute involved: e.g., Mellon v. Mississippi Wire Glass Co., 77 N.J. Eq. 498, 78 A. 710 (1910). In this case the court made no reference to the New Jersey statute which forbade companies to "divide, withdraw or in any way pay to the stockholders any part of the capital stock." Similarly, in the Goodnow case, the court of first instance relied on the Neuchatel case as a good precedent to follow without referring to the language of the New Jersey statute: see supra p. 478 n. 265 . Many American statutes now specifically regulate the payment of dividends in the case of wasting asset companies.

301. Model, § 40 (c), (d).

302. Many dividend cases relating to wasting asset companies are actions by preference shareholders. See the Delaware litigation in Wittenberg v. Federal Mining and Smelting Co., the three stages of which are reported in 133 A. 48 (Del. Ch. 1926), 138 A. 347 (Del. Sup. Ct. 1927), 138 A. 352 (Del. Ch. 1927). For a discussion of this and other cases see Weiner, op. cit. supra n. 256, 29 COLUMBIA L. REV. at 478-80.

303. 2 BONBRIGHT, 964-65.

304. On this see 2 BONBRIGHT, 939-44. Any unrealized appreciation in the value of the goodwill cannot, however, be treated as divisible profit: see Coleman v. Booth, 268 Mo. 64, 186 S.W. 1021 (1916).

305. 2 BONBRIGHT, 944-48. Rance's Case, 6 Ch. App. 104 (1870); Loan Society v. Evenson, 248 Pa. 407, 94 A. 121 (1915); Bowe v. Provident Loan Corp., 120 Wash. 574, 208 P. 22 (1922).

306. Uniform, § 24 III.

307. 41 Ch. D. 1 (C.A. 1889). See supra p. 404 et seq.

308. Id. at 16, per Cotton, L.J., quoted supra p. 417 .

309. 73 N.J. Eq. 692, 69 A. 1014 (Ct. Err. & App. 1908). For the same result see the Delaware case Peters v. U.S. Mortgage Co., 13 Del. Ch. 11, 114 A. 598 (1921).

310. Shaw v. Ansaldi Co., Inc., 165 N.Y.S. 872 (1917); Williams v. Western Union Telegraph Co., 93 N.Y. 162 (1883); Shields v. Hobart, 172 Mo. 491, 72 S.W. 669 (1902).

311. The Pennsylvania Business Corporation Law provides that "distributions in partial liquidation" out of unrestricted capital surplus may be made if "such distribution shall have been authorised by the prior affirmative vote obtained within one year of such distribution of the holders of at least a majority of the outstanding shares of each class whether or not entitled to vote thereon by the provisions of its articles."

312. The Penn. Bus. Corp. Law adopts the opposite course. It defines (§ 2) "earned surplus" to mean "the entire surplus of a corporation other than its capital surplus . . . ." It defines capital surplus as follows:

> "'Capital surplus' means capital contributed for or assigned to shares in excess of the stated capital applicable thereto (whether as a result of original issue of shares at

amounts in excess of their par or stated value, reduction in par or stated value after issuance, transactions by the corporation in its own shares, or otherwise) capital received other than for shares whether from shareholders or others, and amounts of surplus arising from revaluation of or unrealized appreciation in assets."

313. Bonbright thus wrote three decades ago:

> ". . . [U]nder the corporation laws of most states governing the reduction of capital, directors who wish to pay an otherwise illegal dividend may usually do so with impunity by securing, through the action of their shareholders, an amendment to the charter reducing the company's stated capital. And this opportunity, which is accompanied by no adequate safeguards on behalf of creditors and preferred shareholders, comes close to making a farce of American dividend law. But the farce is not perfect, since corporate directors dislike the unfavourable publicity attendant upon a statutory reduction of capital."

2 BONBRIGHT, 914. The Model Act perfects the farce by enabling corporations to escape such publicity as well. See supra p. 315 .

314. The section read:

> "If the directors . . . shall declare and pay any dividend when the company is known by them to be insolvent or any dividend the payment of which would to their knowledge render it insolvent, they shall be jointly and severally liable for all the debts of the company then existing, and for all that shall be thereafter contracted, so long as they shall respectively continue in office . . . to the amount of such dividend."

315. The Model Act defines "insolvent" in the equity sense: § 2 (n):

> As under section 40 of the Act a dividend can be paid only if there is an earned surplus, the Comment to that section points out that the corporation must also be solvent in the bankruptcy sense. Thus it is an express requirement under section 40 (a) that the corporation should be commercially solvent, and it is an implied requirement that it should also be solvent in the bankruptcy sense before it may pay a dividend.

It should be remembered that in 1965 a new § 40 (a) was introduced to permit nimble dividends, i.e. out of the "net earnings of the current fiscal year and the next preceding fiscal year taken as a whole." In these cases it would seem that a corporation may pay a dividend if it is solvent in the equity sense, even though it is not solvent in the bankruptcy sense. The change in the Comment to the section would seem to support this view. Further in determining surplus, the mode of valuation of assets is not prescribed by the Act. In particular, the assets may be "valued" according to conventional accounting practices, which is, as Bonbright has pointed out, "no valuation at all."

316. E.g., Man., supra n. 221.

317. Eng., s. 222 (e).

318. Eng., s. 223.

319. Re European Life Assurance Society, L.R. 9 Eq. 122 (1869); Re Agriculturist Cattle Insurance Co., Ex parte Spackman, 1 Mac. & G. 170 (1849).

320. BUCKLEY ON THE COMPANIES ACTS, 460.

321. See for instance the American Uniform Fraudulent Conveyances Act, § 2, which defines insolvency thus:

> "A person is insolvent when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured."

See also 13 Eliz., c. 5, the pioneering English statute enacted in 1570 to prevent fraudulent transfers.

322. 2 BONBRIGHT, 946.

323. Model, § 43.

324. PATON, CORPORATE PROFITS, 89 (1965).

325. Id. 88-89.

326. Id. 89.

327. TIME (CANADA EDITION), dated April 11, 1969, p. 72.

Notes to Chapter 11

1. We shall use the expression "giant corporation" to refer to large, publicly held corporations whose shares are widely dispersed among a very large number of shareholders: e.g., the American Telephone and Telegraph Company, General Motors, Standard Oil of New Jersey, General Electric. These corporations have been described as "endocratic corporations" to distinguish them from corporations controlled by stock-ownership which have been in turn named "exocratic corporations." See Rostow, To Whom and For What Ends is Corporate Management Responsible?, in MASON (ed.), THE CORPORATION IN MODERN SOCIETY, 46, 47, fnn. 1, 2 (6th print. 1966). It may be appropriate to call them "macro-corporations."
2. EELS, THE MEANING OF MODERN BUSINESS (2d print. 1963).
3. MASON (ed.), THE CORPORATION IN MODERN SOCIETY, op. cit. supra n. 1, contains the views of a collection of eminent American scholars on these issues.
4. See the (British) Monopolies and Mergers Act of 1965. Britain is a new entrant in the field of anti-trust regulation of mergers and take-overs. See the (United States) Clayton Act, s. 7, as amended by the Celler-Kefauver Act; and the (Canadian) Combines Investigation Act, s. 33 read with s. 2 (e), (f). See also Rowley, Mergers and Public Policy in Great Britain, 11 J. LAW & ECON. 423 (1968); Maule, Antitrust and Takeover Activity of American Firms in Canada, 11 J. LAW & ECON. 423 (1968).

5. Nor are we concerned with the problems, political and economic, of international corporate activity. See generally REPORT OF THE TASK FORCE ON THE STRUCTURE OF CANADIAN INDUSTRY: FOREIGN OWNERSHIP AND THE STRUCTURE OF CANADIAN INDUSTRY (Ottawa, 1968). This Report is familiarly known as the WATKIN'S REPORT after the name of the head of the task force.

6. For American statistics of business failures see HUNT, WILLIAMS & DONALDSON, BASIC BUSINESS FINANCE, 610-11 (3d ed. 1966). In America business failures have been relatively insignificant in recent years.

7. Id. 612.

8. Fraudulent bankruptcies are of course the greatest menace which has to be eradicated. On fraudulent bankruptcies in Quebec, and the abuse of the corporate form for the purpose, see the REPORT OF THE COMMISSION OF INQUIRY CONCERNING BANKRUPTCIES, LIQUIDATIONS, PROPOSALS, VOLUNTARY ASSIGNMENTS, IN WHICH THE DEPARTMENT OF REVENUE IS INTERESTED (known as the MERCIER REPORT after the name of the Chairman of the Commission) (1965). A slightly edited version of the official English translation of the report is printed in 8 CAN. BANKRUPTCY REPORTS (N.S.) 1 (1966).

9. The information is gathered from the CANADA YEAR BOOK 1968, 934-46 (Dominion Bureau of Statistics) and from the Quarterly Bulletins of the Dominion Bureau of Statistics.

10. The statistical data are taken from STATISTICAL ABSTRACT OF THE UNITED STATES 1967, 500 (U.S. Dept. of Commerce, 88th Annual ed.) which in turn has obtained the information from Dun & Bradstreet, Inc., New York, N.Y., THE FAILURE RECORD THROUGH 1965, and unpublished data.
11. Nor do the statistics deal with corporations in Canada operating at a loss. According to the "Taxation Statistics, 1962" (for the taxation year 1960) released by the Taxation Division, Department of National Revenue, Ottawa, of the 97,549 active taxable corporations in Canada, over a third (33,449) reported a loss.
12. Dominion Bureau of Statistics Quarterly Release Volume 47, No. 3 (Catalogue No. 61-002).
13. BEVIS, CORPORATE FINANCIAL REPORTING IN A COMPETITIVE ECONOMY, 2-3 (1965).
14. Manuel F. Cohen's Foreword to EZRA WEISS, REGISTRATION AND REGULATION OF BROKERS AND DEALERS (1965).
15. BEVIS, op. cit. supra n. 13.
16. Ibid.
17. Ibid.
18. Manuel Cohen, op. cit. supra n. 14.
19. BEVIS, op. cit. supra n. 13.
20. Manuel Cohen, op. cit. supra n. 14.
21. The [American] Uniform Fraudulent Conveyance Act, § 1; the [United States] Bankruptcy Act of 1898, § 1 (1) [11 U.S.C. § 1].

22. Ashbury Rly. Co. v. Riche, L.R. 7 H.L. (E. & I. App.) 653 (H.L. 1875).

23. Cotman v. Brougham, [1918] A.C. 514 (H.L.).

24. In re Jon Beauforte (London), Ltd., [1953] Ch. 131.

25. Stevens, A Proposal as to the Codification and Restatement of the Ultra Vires Doctrine, 36 YALE L. J. 297 (1927).

26. AMORY & HARDEE, MATERIALS ON ACCOUNTING, 44 (1959).

27. Model, § 43.

28. 1 MOD. ACT ANN., § 41 ¶ 2.01 (2), § 41 last para. ¶ 2.02.

29. 9B UNIFORM LAWS ANN. 70.

30. See F.S. Bowen Electric Co. v. United States Fidelity and Guarantee Co., 256 F. 2d 46 (4th Cir. 1958).

31. Fair consideration is defined by section 3 of the Act.

32. The Bankruptcy Act of 1898, § 67 (11 U.S.C. § 107) dealing with liens and fraudulent transfers, as amended. Section 67d, as amended by the Chandler Act of 1938 and the Act of July 7, 1952, P.L. 456, 82d Cong. 2d Session, ss 21 (e), (f), (g), (h), (i), embodies the substance of the Uniform Fraudulent Conveyance Act.

33. "Debt" is defined, just as in the Uniform Fraudulent Conveyance Act, as "any legal liability, whether matured or unmatured, liquidated or unliquidated, absolute, fixed or contingent." "Creditor" is defined as "a person in whose favor a debt exists." The definition of "fair consideration" is also identical.

34. Four months in a case falling under section 67d (3).

35. Powers v. Heggie, 268 Mass. 233, 167 N.E. 314 (Mass. Sup. Jud. Ct. 1929) (payment of dividend by insolvent corporation, held: recoverable from the shareholders; where the insolvent corporation had gone into bankruptcy, the trustee in bankruptcy is the proper party to recover dividends paid to shareholders when the corporation was insolvent; the good faith of the shareholder receiving the dividend, e.g. his belief that the dividends were earned and paid out of profits, his ignorance that the corporation was insolvent at the time, or that the payment defrauded the existing creditors of the corporation, were immaterial and could not change the fact that the dividends received were mere gift, and therefore the shareholders were bound to refund the dividends to the corporation for the benefit of creditors on demand). Doehler v. Real Estate Board of New York, 270 N.Y.S. 386 (1934); Morrisville Trust Co. v. Moon, 21 F. 2d 716 (1927); Lyndhurst First Nat'l Bank v. Bianchi, 106 N.J. Eq. 333, 150 A. 774 (1930).

36. See Scriggins v. Thomas Dalby Co., 290 Mass. 414, 195 N.E. 749 (1935) (purchase by a corporation of its shares).

37. See In re Lane-Fox, [1900] 2 Q.B. 508 (Wright, J.).

38. Statute of Fraudulent Conveyances, 13 Eliz., c. 5 (1570), 6 Statutes at Large (Pickering) 268. See also 27 Eliz., c. 4, which protected bona fide purchasers. "The principle on which the statute of 13 Eliz., c. 5, proceeds is this, that persons must be just before they are generous, and that debts must be paid before gifts can be made." Per Lord Hatherley, L.C., in Freeman v. Pope, L.R. 5 Ch. App. 538 (C.A. 1870).

39. See 9B UNIFORM LAWS ANN. 71-72 (1966). Cf. the [Ontario] Fraudulent Conveyances Act, R.S.O. 1960, c. 154. Of course the British and Canadian courts have reached the same conclusion as the American Uniform Fraudulent Conveyance Act. See Freeman v. Pope, supra n. 38, where Lord Hatherley pointed out that the intention to defeat, hinder, or delay creditors had to be inferred from the necessary consequences of the transferor's act in the light of all the surrounding facts and not by "speculating as to what was passing in the mind of the [transferor], which can hardly ever be satisfactorily assigned." Sir Gifford, L.J., also observed that proof of actual and express intent was not necessary when a conveyance was without valuable consideration, and that the intent might be inferred in such cases. See also the Canadian cases: Sun Life Assurance Co. of Canada v. Elliot, 31 S.C.R. 91 (Sup. Ct. Can. 1900); Atlantic Acceptance Corp., Ltd. v. Distillers Acceptance Corp., Ltd., 38 D.L.R. (2d) 307 (Ont. 1963). See generally McGUIGAN, CASES AND MATERIALS ON CREDITORS' RIGHTS (2d ed. 1967).

40. KENNEDY, CORPORATE TRUST ADMINISTRATION, 25 (1961) (hereinafter cited as KENNEDY). Nor is the indenture "trustee" chosen by the security holders. Under the United States Trust Indenture Act of 1939, all trust indentures (with some exceptions) should be submitted to the S.E.C. for "qualification" along with the issuer's registration statement required under the Securities Act of 1933. The S.E.C. will ensure (i) that there is no conflict-

ing interest between the trustee and the corporation or its underwriters, (ii) that the indenture does not contain broad exculpatory provisions relieving trustees of liability for breach of duty, (iii) that the indenture contains due provisions for the accountability and responsibility of trustees, etc. (id. 34, 37-57).

41. These are taken from KENNEDY, op. cit. supra.

42. KENNEDY, 88-101.

42a. Ibid.

43. Id. 125.

43a. Ibid.

44. Id. 126. Trust Indenture Act, § 314 (a).

45. Id. 127.

46. Ibid.

47. Id. 132-33.

48. Id. 133-34.

49. Id. 135-36.

50. Id. 136-37.

51. Id. 137.

52. Id. 138-39.

53. Id. at 137.

54. See the LAWRENCE COMMITTEE REPORT, 1967, Chapter XI (pp. 99-104); Ontario Bill (No. 125/1968), ss. 56-61.

55. Cohen, Manuel F., Federal Corporation Law, 20 J. OF LEGAL EDUCATION 529 (1968).

56. Ibid.

57. See generally Katz, The Philosophy of Midcentury Corporation Statutes, 23 LAW & CONTEMP. PROBLEMS 177 (1958); Latty, Why are Business Corporation Laws Largely Enabling, 50 CORNELL L.Q. 599 (1965); Folk III, Corporation Statutes : 1959-1966, [1966] DUKE L.J. 875; Folk III, Recent Developments in Corporation Statutes, 20 J. OF LEGAL EDUCATION 511 (1968).

58. Id. at 530.

59. PALMER'S COMPANY LAW, 293 (21st ed. 1968).

60. Coulson v. Austin Motor Co., 43 Times L. Rep. 493 (1927).

61. 1 DEWING, 145 and fnn. 85 & 86 on that page.

62. 280 U.S. 197 (1930), reversing 30 F. 2d 260 (2d Cir. 1929) (hereinafter referred to as the Wabash case).

63. Holmes, J., agreed with the dissenting opinion of Learned Hand, J., in the Second Circuit. It must be noted that in the Wabash case "It [was] not denied that the . . . expenditures [on additions and improvements] were proper and made in good faith, or that the money could not have been applied to dividends consistent with the duties of the [railroad company]." (280 U.S. at 202).

64. In Dent v. London Tramways Co., 16 Ch. D. 344 (1880), the company incorporated in 1870 under the Acts of 1862 and 1867 had preference shares entitled to 6% dividend out of "the profits of the particular year only." The company declared a dividend for the half year ending 31 Dec. 1878, but did not declare any dividend for the following two half years. In all the three half years it had income adequate to pay the preferential dividend. The plaintiff, a

preference shareholder, sued to recover payment of the dividend. The company contended that though it had income during the half years, yet it had wrongfully paid dividends for eight preceding years without setting apart out of its earnings a reserve fund for maintenance, etc., as required by the by-laws and that until this was rectified and the reserve fund made up, no dividend could be paid to the preference shareholders. Holding that "profits for the year" meant "the surplus in receipts, after paying expenses and restoring the capital it was in on the 1st of January in that year," Jessel, M.R., held that the company had profits to pay the dividends in the three half years. The Master of the Rolls would appear to have proceeded on the basis that the preference shareholders were entitled to dividend if there were profits for the year sufficient to pay them, whether or not a dividend was declared.

Earlier, in an action by a common shareholder for an injunction to restrain the company from paying the dividend declared for the half year ending 31 Dec. 1878, Jessel, M.R., granted the injunction: Davison v. Gillies, 16 Ch. D. 347n. (1879). In Dent v. London Tramways Co. the Master of the Rolls observed that "it has been assumed that I . . . decided [in Davison v. Gillies] a great deal more than I did really decide."

65. In re Bridgewater Navigation Co., [1891] 2 Ch. 317 (C.A.).

66. In re Crichton's Oil Co., [1902] 2 Ch. 86 (C.A.); In re Roberts & Cooper, Ltd., [1929] 2 Ch. 383; In re Wood, Skinner & Co. Ltd., [1944] Ch. 323. See GOWER, 340-41.

67. GOWER, loc. cit. In re F. de Jong & Co., Ltd., [1946] Ch. 211 (C.A.); In re Walter Symons, Ltd., [1934] Ch. 308; In re E.W. Savory, Ltd., [1951] 2 All E.R. 1036; In re Wharfedale Brewery Co., [1952] 2 Ch. 913.

68. GOWER, 341.

69. GOWER, loc. cit. In re W.J. Hall & Co., Ltd., [1909] 1 Ch. 521. Contra In re Wharfedale Brewery Co., supra n. 67; In re Springbok Agricultural Estates, Ltd. [1920] 1 Ch. 563; In re New Chinese Antimony Co., Ltd., [1916] 2 Ch. 115.

70. GOWER, 339 fn. 1.

71. 1 DEWING, 156-57.

72. 1 DEWING, 157.

73. Model, § 41.

74. Model, § 5.

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