
Richard O. Kummert
University of Washington School of Law

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THE FINANCIAL PROVISIONS OF THE NEW WASHINGTON BUSINESS CORPORATION ACT

Part III

RICHARD O. KUMMERT

B. Regulation of Asset Distributions

2. Distributions of Assets From Stated Capital.

a. Nimble Dividends. One of the most important innovations in the New Act is the provision permitting payments of cash or property 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 principal effect of this provision is to permit distributions of assets when a deficit in earned surplus exists.


Under the old act, cash or property dividends could be paid only from a corporation's surplus, i.e., excess of assets over liabilities and capital stock. See Kummert, The Financial Provisions of The New Washington Business Corporation Act part II, 42 WASH. L. REV. 119-28 (1966) [hereinafter cited as part II, 42 WASH. L. REV. at —]. Hence, if a corporation had a deficit in earned surplus and no paid-in surplus, earnings in any period would be applied to reduction of the deficit rather than be available for distribution.


The New Act does not, as other nimble dividend statutes do, (see, e.g., CALIF. CORP. CODE § 1500(b) (West 1955)) cover the point explicitly. See, however, the Comment appearing in 1 Model Act Ann. § 40(a) ¶ 1. One interpretation problem that the New Act seems to avoid concerns the case where the corporation begins the relevant period with a deficit and then earns a little bit more than the deficit. If the current earnings statute is triggered by a lack of earned surplus, then it may not apply in the case posed, with the result that the distribution is limited to the excess of the earnings over the deficit. Under the New Act, however, it seems clear that the full amount of the earnings will be available.

If the Act contained only the language stated above, it could be argued that net earnings should be interpreted to permit dividends only when no deficit in earned surplus exists. See McDowell, The Theory of Capital in Virginia: An Historical
Such distributions, called nimble dividends\(^{579}\) because of the speed with which directors must act to prevent application of the earnings to the deficit,\(^{580}\) are in essence distributions out of stated capital. In partial recognition of this fact, the New Act proscribes such distributions when the corporation is or would be rendered unable to meet its obligations in the usual course of its business or when the resultant net assets of the corporation would be less than the voluntary liquidation preference of shares having preferential rights to assets in the event of liquidation.\(^{581}\)

The wisdom of nimble dividend statutes, which are currently in effect in only a distinct minority of states,\(^{582}\) has long been debated.\(^{583}\)
Such a statute can be best evaluated through an analysis of the interests of the various participants in a corporate enterprise—creditors, preferred shareholders, common shareholders, corporate management, and society generally—as they relate to distributions from earnings despite a deficit. Creditors would obviously prefer that the stated capital "cushion" be restored before any distributions are made. But the strength of their claim for restoration in a particular situation presumably would depend upon, *inter alia*, whether (1) the fair value of the corporation's assets remaining after the distribution was greater than its liabilities; (2) the corporation would be rendered incapable of meeting its obligations in the foreseeable future; (3) the deficit resulted from improper distribu-

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124, 140-43 (1943) (holding *contra* on the Michigan statute). All of these cases, with the exception of *Mangham*, involved the undistributed profits tax rather than questions of corporation law. For discussion of the cases, see McCormick, *supra* note 580, at 198-201 and McDowell, *supra* note 578.


Accounting opinion seems quite firmly against declaration of dividends in the face of a deficit in earned surplus. See, e.g., R. *Wixox*, *Accountants' Handbook* 23.30-31 (4th ed. 1956); *H. Hatfield*, *Surplus and Dividends* 26 (1943). The reasons offered for this position are that the corporation has not yet earned anything distributable to shareholders (see *H. Hatfield, supra*) and that it views the capital impairment test with an improper definition of capital (i.e., capital at the beginning of the period) in mind.


For nimble dividend statutes imposing such a limitation, see *Ark. Stat. Ann.* § 64-402-II (B) (2) (1966); *Cal. Corp. Code* § 1501 (West 1955); *N.C. Gen. Stat.* § 55-50 (c) (1) (1963); *Okla. Stat. Ann.* tit. 18, § 1.133 (2) (1953); *Wyo. Stat. Ann.* § 17.36.39 § 1 (1957); and *Hills, supra* note 580, at 1365. Hills' Act also required that the corporation's current assets after payment of the dividend be at least one and one-quarter times the amount of the corporation's current liabilities. *Id.*
tions\textsuperscript{388} or from extraordinary non-recurring losses;\textsuperscript{389} (4) the deficit approaches the amount of stated capital;\textsuperscript{500} (5) management intends to distribute all of the current earnings;\textsuperscript{501} and (6) the earnings are of such a nature as may reasonably be expected to continue.\textsuperscript{502}

Some interests of preferred shareholders are advanced by the existence of a nimble dividend statute because such a statute may enable preferred dividends to be continued without reduction of stated capital, which step, requiring as it does approval of common shareholders, usually can be obtained only at the cost of concessions by preferred shareholders.\textsuperscript{503} However, the preferred obviously desire

\textsuperscript{388}No statute currently makes this distinction. For the suggestion, see Solether & Jennings, The Minnesota Business Corporation Act, 12 Wis. L. Rev. 419, 435 (1937); H. BALLANTINE, CORPORATIONS 582 (rev. ed. 1946). Solether & Jennings supra explain the limitation in terms of the foreseeable risks to the stated capital, of which improper distributions is not one.

A related problem concerns payment of nimble dividends when the deficit arose from the issuance of watered stock (see part II, 42 WASH. L. Rev. at 168-69 as to the probability under the New Act that a reduction in earned surplus results from watered assets). If the arguments previously advanced (part II, 42 WASH. L. Rev. at 170-71) as to why earned surplus should not bear the charge for a reduction of watered assets are approved, then the existence of a nimble dividend provision should likewise be approved. If, however, it is desired that the water be eliminated by earnings before dividends of any sort can be declared, then obviously the nimble dividend provision should be limited depending on the source of the deficit. In the latter connection, it should be noted that a bankruptcy solvency test and protection of preferred liquidation preferences may operate to eliminate much of the problem.

\textsuperscript{389}Ballantine & Hills, supra note 583, at 247 offer the following example as a partial justification for nimble dividend statutes:

Suppose a corporation owns ten houses or ten motor buses, each worth $10,000 and each earning $1,000 per year. If one is destroyed without insurance, the current earnings would still be $9,000 per year. If there is a capital deficit of $10,000, more than a year of profitable operation will be needed to obtain a surplus. Must the income of the shareholders be entirely cut off and all the earnings applied to wipe out the deficit unless the legal capital be reduced? May not the restoration of the deficit be spread over several years, continuing dividends in the meantime at a reduced rate or upon the preferred shares only?

\textsuperscript{388}See also H. BALLANTINE, supra note 588, at 580-81.

\textsuperscript{389}OKLA. STAT. ANN. tit. 18 § 1.132 (a) (3) (1953) and Hills, supra note 580, at 1364 and 1367 n.51 raise this issue by requiring that in a one-class case, no dividends be paid until the fair value of net assets equal one-half of the stated capital.

\textsuperscript{390}Only Hills, supra note 580, at 1364 (only two-thirds of the earnings could be distributed) and OKLA. STAT. ANN. tit. 18, § 1.132(3)(1953) (only one-half of the earnings can be distributed) impose such a limitation.

\textsuperscript{391}A frequent objection to nimble dividend statutes is that they permit a corporation with alternating periods of prosperity and depression to declare dividends despite the gradual erosion of stated capital. See H. HATFIELD, supra note 585, at 26; Berle, supra note 583, at 575-76.

\textsuperscript{392}Hills, supra note 580, at 1366 n.51 seems to recognize this interest with his suggestion that it might be desirable to establish a standard of prudence and due care applicable to dividends within legal bounds.

\textsuperscript{393}See Ballantine & Hills, supra note 583, at 247-48; Baker & Cary at 1231-32 (quoting the commentary accompanying the North Carolina nimble dividend provisions). N.C. GEN. STAT. § 55-50(b) (1965), in recognition of this interest, further provides that any charter clause attempting to make nimble dividends unavailable
to prevent distributions to common shareholders from current earnings at least until the net assets exceed the preferred shares' liquidation preference and possibly until the deficit is eliminated. The preferred shareholders may find some conflict in their own interests when the net assets as a result of a deficit are less than their liquidation preference and the corporation has current earnings. In such a situation, some preferred shareholders may favor retention of assets in the corporation until the liquidation preference is covered so as to protect their earnings claim. Other preferred shareholders may desire that the dividend payments be kept as current as possible despite the shortage in liquidation preference coverage.

Common shareholders generally would prefer that distribution from current earnings be made to the extent that the distribution would not impede the corporation's earning capacity. However, some may feel that since the distribution is in essence a return of their investment, notice should be given to the shareholders stating the extra-

for the payment of preferential dividends will be null and void. Such a provision would seem to be a worthwhile limitation on the power to make article provisions under Wash. Rev. Code § 23A.08.420 § 1 (1965).

All of the statutes listed in note 582 supra and Hills, supra note 580, at 1364 provide protection to the liquidation preference of the preferred. They vary as to whether the preferred shares should receive distributions when net assets are less than the amount of the preference. See note 596 infra.

Only Okla. Stat. Ann. tit. 18, § 1.132(a)(3) (1953) and Hills, supra note 580, at 1364 provide that corporations with preference shares outstanding will be able to distribute nimble dividends only to those shares.


This interest is suggested by the example posed by Ballantine & Hills, supra note 583. See also H. Ballantine, supra note 588, at 582 where the suggestion is made that in a one-class case, net assets equal to one-half of the stated capital should be retained. This seems to be an attempt to define by formula means the interest stated in text. For a statute currently imposing such a test, see Okla. Stat. Ann. tit. 18, § 1.132(a)(3) (1953).

Support for the common shareholders' position is offered by statutes permitting easy reduction of stated capital, since virtually the same results may be achieved under a reduction as under the nimble dividend privilege. See Lattv, Uncertainties In Permissive Sources of Dividends Under Present G.S. 55-116, 34 N.C.L. Rev. 261, 288-69 (1956). Most proponents of the nimble dividend privilege recognize the efficacy of a reduction of capital as an alternative but favor nimble dividends because of the omission of shareholder approval. See 25 Minn. L. Rev. 744, 771 (1941); Ballantine & Hills, supra note 583, at 248; Baker & Cary at 1229.
ordinary character of the distribution and the circumstances thereof.\textsuperscript{598}

Corporate management presumably would prefer maximum latitude in making distributions to shareholders simply because of the favorable implications that distributions have for shareholders as to the operation of the corporation. Additionally, management would prefer a legal standard that is relatively clear in application so as to minimize potential liability. Society’s interest is probably best served by a healthy continuing corporation.

A fair accommodation of these competing interests is possible by modifying slightly the New Act nimble dividend provision and by construing its terms in full view of the interests concerned. The creditor’s solvency interest would be met if, as previously suggested,\textsuperscript{599} the solvency limitation stated in the Act is extended to include the bankruptcy test of solvency in addition to the equity test. Further protection of that interest arises from the liquidation preference limitation found in the Act. Inclusion of the latter limitation should not generally prove adverse to preferred shareholders in the long run and would be fairer to common shareholders.\textsuperscript{600} The preferred shareholders’ interest should be strengthened with respect to distributions on the common shares by requiring that only one-half of any earnings available after the preferred liquidation preference is met and all accrued preferred dividends are paid be distributable.\textsuperscript{601} In one-class cases, the basic conflict between creditors and shareholders with respect to the possibility of non-recurring or seasonal earnings is partly resolved by the New Act requirement that earnings be computed for a two-year period.\textsuperscript{602} But it


\textsuperscript{599}See part II, 42 Wash. L. Rev. at 131-32.

\textsuperscript{600}See Hills, \textit{supra} note 580, at 1366 n.51.

\textsuperscript{601}Even with these protections, preferred shareholders may desire to add further refinements on the corporation’s power to pay dividends in their preferred stock agreement. See Buxbaum, \textit{Preferred Stock—Law and Draftsmanship}, 42 Calif. L. Rev. 243, 255-57 (1954); Note, \textit{Consideration of “Nimble Dividend” Statutes in Drafting Preferred Share Contracts}, 44 Calif. L. Rev. 584, 588-89 (1956).

There is a general analogy between distributions from current earnings and from paid-in surplus. See Buttimer, \textit{Dividends and the Law}, 36 Accounting Rev. 434, 436-37 (1961) who suggests that regulations of each type of distribution ought to be consistent with each other; Hills, \textit{supra} note 580, at 1365 n.50. It is hoped that the amendments proposed to New Act regulations governing capital surplus distributions (see part II, 42 Wash. L. Rev. at 136-41) and nimble dividends are consistent.

\textsuperscript{602}The two-year computation base found in the New Act and its Model Act prototype is unique. Cal. Corp. Code 1500 (b) (West 1955); Okla. Stat. Ann. tit. 18, § 1.132(a)(3) (1953); and Wyo. Stat. § 17.36.39(a) (1965) allow dividends out of net profits earned during the preceding accounting period, which can not be less than six months or more than one year in duration. Ark. Stat. Ann. § 64-402-II(A)(3)
would seem that creditors and shareholders should both share in the benefits of improved earnings, rather than have all the benefits accrue to the shareholders, as under the New Act. Therefore, there should be added to the New Act a limitation that only one-half of any earnings be distributable until the deficit is eliminated. And it would be desirable to add a requirement to the Act that shareholders be notified that a distribution is being made from current earnings despite a deficit.

If no changes are made in the New Act provision, a number of construction problems will arise regarding its terms. A prime example is the term "net earnings" which is not defined by the Act.

The term has heavy accounting overtones and a relatively clear


Two-year provisions seem much preferable to one-year provisions since the former help to screen short-term earnings increases from valid long-term earnings improvement. Of the two-year formulations, that chosen by the New (Model) Act seems superior to the remaining such provisions because it makes clear that the operations of the years concerned must be blended to determine the amount eligible for dividend. The other provisions are capable of the construction that if the corporation in the preceding year has a loss, that year is ignored. See D. Kehr, Corporate Dividends 65 (1941).

This view rejects the notion that there should be available to the creditors a safety factor at least equal to perhaps one-half of the stated capital. The two-year computation approach alleviates some of the need for such a provision. In addition, the most important factor for creditors who have been creditors during a period of substantial losses and who have not made special arrangements limiting distributions would appear to be that the corporation's operations have improved and will continue to improve in the future. If the latter conditions are met, there will be no immediate need to apply earnings to the deficit to any specific level.

The suggestions in text also reject the notion that a limitation on nimble dividends should be placed where the deficit arises from illegal distributions. This type of limitation appears to be an attempt to reinforce the director liability provisions as an extra sanction against illegal distributions. There is no guarantee under the provision that the guilty parties will bear the onus of the extra sanction. Moreover, it is hard to see why the creditors' position is any different from a case where the deficit arose from operations; indeed, the corporation may be better able to produce earnings in the future. Hence, it would appear better to impose a more severe sanction, if necessary, than to add this particular indirect sanction.

The only cases involving nimble dividend statutes to come before the courts have not posed significant questions of interpretation. See Weinberg v. Baltimore Birch Co., 34 Del. Ch. 586, 108 A.2d 81, aff'd, 114 A.2d 812 (Ch. 1954), aff'd, 114 A.2d 812 (Sup. Ct. 1955) (involving determination of whether certain charter clauses represented a restriction on the power to pay nimble dividends under the Delaware statute); Morris v. Standard Gas & Electric Co., 31 Del. Ch. 20, 63 A.2d 577 (1949) (involving valuation of assets in connection with the liquidation preference protection clause in the Delaware statute).
relationship to earned surplus,\(^{605}\) which the draftsmen defined by means of an early accounting definition.\(^{606}\) Hence, it would seem that, following the analysis previously presented,\(^{607}\) a court faced with an interpretation question should determine the content of the term under generally accepted accounting principles and then determine whether the accounting result should be qualified so as to provide a better accommodation of the interests of the groups involved.

The reference to accounting principles leaves us with many of the problems considered earlier in connection with computing earned surplus\(^{608}\) and with one major new problem: net earnings to

\[^{605}\text{It seems reasonably clear that net earnings become part of earned surplus (defined by Wash. Rev. Code \$ 23A.04.010(12) (1965) as the balance of a corporation's net profits, income, gains and losses from date of incorporation). Cf. P. Grady, Inventory of Generally Accepted Accounting Principles, Accounting Research Study No. 7, 202-203 (1964). It does seem unfortunate that the draftsmen chose "net earnings" over "net profits" since the latter would not have increased the number of undefined terms in the statute.}\]

\[^{606}\text{See part II, 42 Wash. L. Rev. at 126 n.364.}\]

\[^{607}\text{See part II, 42 Wash. L. Rev. at 125-28. The advocates of the "current values" approach to dividend fund determinations, see part II, 42 Wash. L. Rev. at 171-73, presumably would argue in favor of determining earnings by comparing the current value of the corporation's net assets at the end of the fiscal years concerned. It should be noted that this approach not only involves problems of unrealized appreciation, see part II, 42 Wash. L. Rev. at 148-53, but also potentially involves use of an all-inclusive income statement approach to defining earnings. See Baker & Cary at 1230 and text discussion infra beginning note 609.}\]

\[^{608}\text{The following problems considered in connection with the determination of earned surplus will also be problems in computing net earnings:}\]

\[\text{1. Effect of unrealized appreciation on net earnings. The Accounting Principles Board of the American Institute of Certified Public Accountants in 1965 approved an earlier Institute rule to the effect that "unrealized profit should not be credited to income account of the corporation either directly or indirectly ...." See Accounting Principles Board, Status of Accounting Research Bulletins, Opinion No. 6, at \$ 11 (1965) which does not disapprove the rule quoted that appears in AICPA Research Bull. No. 43, at 11 (1961). Although the rule has generally been interpreted as applying to appreciation on inventory goods, see part II, 42 Wash. L. Rev. 119, 150 n.463, it is clear that appreciation on fixed assets is subject to the same restrictions. See Accounting Principles Board, Status of Accounting Research Bulletins, Opinion No. 6 \$ 17 (1965); Hackney, Accounting Principles in Corporation Law, 30 Law & Contemp. Prob. 791, 807 (1965); R. Wixon, supra note 585, at 5,7; and L. Rappaport, SEC Accounting Practice and Procedure 16.20 (2d ed. 1963). It would seem that a similar result should obtain in determining net earnings for purposes of a nimble dividend statute. See analysis in part II, 42 Wash. L. Rev. at 152-53. Indeed, one can argue that even if unrealized appreciation is recognized as a source of earned surplus for purposes of regular dividends, it should not be recognized as a source of net earnings for nimble dividend purposes simply because of the less stable condition of a corporation proposing to pay a nimble dividend.}\]

\[\text{2. Effect of unrealized diminution in assets upon net earnings. As previously noted, part II, 42 Wash. L. Rev. at 154-55, accounting recognition of unrealized diminution in value depends upon the type of asset involved and the permanence of the decline involved. A secondary problem has to do with classification of the loss as one deductible from current operating earnings or as one deductible from accumulated earnings. The accountants' rules carefully applied (see part II, 42 Wash. L. Rev. at 156-57) will generally produce appropriate results in determining whether unrealized losses ought to be recognized in the general accounting process}\]
be computed inclusive or exclusive of extraordinary transactions and 
accounting adjustments occurring during the period which relate 
to prior periods? After many years of debate, the Accounting 
Principles Board of the American Institute of Certified Public Ac-
countants recently opined that net income should reflect all items of 
profit or loss recognized during the period except prior period adjust-

for the period concerned. Then a secondary decision must be made as to whether 
such losses ought to be considered as affecting net earnings for the purposes of 
nimble dividend declarations. See text infra beginning note 609.

3. Effect of rising price levels and replacement costs upon net earnings. See dis-
scussions of each subject in part II, 42 Wash. L. Rev. at 157-61, 173, to the effect 
that price-level adjustments should be made in determining net earnings but that 
lack of objective techniques for determination of replacement costs precludes a 
legal standard requiring deduction of depreciation and other expenses determined 
on such costs.

4. Effect of a subsidiary's earnings upon a parent corporation's net earnings. Refer-
ence should be made to part II, 42 Wash. L. Rev. at 161-63, relating to the 
various accounting procedures that may be used in reporting parent-subsidiary 
operations. Although the language in Wash. Rev Code § 23A.08.420(1) (1965) 
regarding earned surplus dividends ("only out of the unreserved and unrestricted 
earned surplus of the corporation") can be interpreted to prohibit use of consoli-
dated data, the statute's language on nimble dividends is curiously ambiguous ("or 
out of the unreserved and unrestricted net earnings of the current fiscal year and 
the next preceding fiscal year ... "). Presumably the word "corporation"s is to 
be implied following the word "the" in the latter clause since whatever decision 
is reached on the effect of a subsidiary's earnings upon the parent's earned surplus 
ought to carry over to the determination of net earnings.

As noted earlier, see part II, 42 Wash. L. Rev. at 167, even though con-
solidated data may not be used in determining the dividend fund, a court 
could reach the same result by interpreting the language of the act to permit the 
economic-basis of reporting. In the event that the problem is to be solved by 
statute, as suggested in the portion cited above, all that need be added to the 
Pennsylvania statute is a clause permitting a dividend from the special type of 
capital surplus even though the parent has a deficit in earned surplus.

Another significant question posed by the reference concerns the need for 
consistency in reporting of transactions between the various periods concerned. See Baker & Cary at 1229. Accounting principles currently rely upon a high 
degree of consistency as a means of making interperiod comparisons meaningful. 
See, e.g., P. Grady, supra note 605, at 31-32. A similar degree of consistency should 
be required in determining net earnings for nimble dividend purposes. The latter 
does not mean that a corporation should not be permitted to adopt a new method of 
reporting on a new operation or some other change supported by good business 
reasons. But it should not be permitted to shift, for example, from the LIFO to the 
FIFO method of inventory pricing simply to enlarge its net earnings for dividend 
purposes.

An analogous problem exists with respect to the propriety of the charges giving 
rise to the earned surplus deficit. These charges must be carefully examined to see 
that during the periods giving rise to the deficit extra expenses were not recognized 
solely for the purposes of enhancing net earnings of later nimble dividend periods. 
Cf. the problem noted by Callahan, Statutory Protection of Creditors in Reduction 
of Capital Stock, 2 Ohio St. L.J. 220, 233-34 (1936); Comment, Writing Down 
Fixed Assets and Stated Capital, 44 Yale L.J. 1025, 1035 (1935) in connection with 
reductions of capital. See text beginning note 674 infra.

The history of the debate, involving the members of AICPA, inter se, and the 
SEC, is chronicled in R. Amory & C. Harbee, Materials on Accounting 56-62 
(3d ed. D. Herwitz & D. Trautman 1959); and AICPA Research Bull. No. 43, 
ch. 8 (1961).
Prior period adjustments, defined to be those material adjustments which can be specifically identified with and directly related to business activities of particular prior periods, are not attributable to economic events occurring subsequent to the date of financial statements for the prior period, depend primarily on determinations by persons other than management, and were not susceptible to reasonable estimation prior to the period of recording, are made directly to earned surplus. Treatment of the accounting net income as the "net earnings" for purposes of a nimble dividend declaration will not produce a satisfactory accommodation of the various interests involved. The accounting interpretation would permit gains from unusual sales of assets not acquired for resale to swell the net earnings available for distribution. But there are strong overtones in the nimble dividend privilege that the level of net earnings involved can be expected to continue. Moreover, inclusion of extraordinary gains may lead managers to make unnecessary sales simply for the purpose of inflating the fund available. Hence, it might seem that net earnings ought to be computed on a regular operating basis for the period concerned. But this view also goes too far since net earnings would then ignore losses from extraordinary transactions or transactions requiring prior period adjustments occurring during the period. The creditors' interest would appear to require that the overall deficit become no worse as a result of transactions occurring during the years concerned and the declaration of a nimble dividend. Hence net earnings should take into

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611 Accounting Principles Board, Reporting the Results of Operations, Opinion No. 9 ¶ 3 (1967).
612 Id. at ¶ 23.
613 Id. at ¶ 18. It is contemplated that such adjustments will be rare. See id. at ¶ 23. Examples include material, nonrecurring adjustments or settlements of income taxes, of renegotiation proceedings or of utility revenue under rate processes and settlements of significant amounts resulting from litigation. Id.

Extraordinary transactions, defined as events and transactions of material effect which would not be expected to recur frequently and which would not be considered as recurring factors in any evaluation of the ordinary operating processes of the business, see id. at ¶ 21, are shown under a special caption, following income before extraordinary items and before net income, on the income statement. Id. at ¶ 20. Examples include material gains and losses from sale or abandonment of a plant or a significant segment of the business, the sale of an investment not acquired for resale, the writeoff of goodwill due to unusual events during the period, the condemnation or expropriation of properties and a major devaluation of a foreign currency. Id. at ¶ 21.

614 It is assumed that the sale is not likely to recur frequently and that the gain is material. See note 613 supra.
615 See D. Keil, Corporate Dividends 152-53 (1941).
616 See H. Ballantine, supra note 588, at 582; 25 Minn. L. Rev. 744, 773 (1941); but see D. Keil, supra note 615, at 65 interpreting the Delaware statute contra.
account extraordinary and prior period losses to the extent they exceed extraordinary and prior period gains during the period, and, apart from such offsetting value, extraordinary and prior period gains should be excluded. 617

Several other problems of construction arise under the New Act provision. The first concerns the term "current fiscal year." It seems generally assumed that fiscal year has reference to the corporation's regular annual accounting cycle. 618 But even if this is true, is it possible to combine the earnings of only a part of the current fiscal year with the earnings of the next preceding fiscal year? The answer would appear to be that the current year must be completed before the calculation can be made in order to minimize management manipulation. 619

Another difficult problem concerns the operation of the two-year computation period where a number of years are involved. Assume, for example, that a corporation in the first three years of its existence loses $100,000. In year 4, it loses $15,000. In year 5, it has net earnings of $25,000 and its managers declare the maximum permissible nimble dividend, $10,000. Suppose in year 6 the corporation has net earnings of $25,000. What is the maximum permissible nimble dividend—$50,000? $40,000? or $25,000? The statute read literally would permit $50,000, the sum of the net earnings for years 5 and 6. But it would seem that the very process of combining two years ought to mean that the $15,000 of year 5 earnings applied to the year 4 loss is thereafter unavailable for the dividend. Moreover, it would also appear that the amount of net earnings paid as a dividend should not be available in a later year. Hence, the answer would appear to be $25,000. Further, suppose instead that no dividend was declared in year 5 and that at the end of year 6 (the net earnings in each year being the same as assumed above), the directors declare as a nimble dividend $15,000. Assume that in year 7 the corporation has net earnings of $25,000. How much is

617 Under Accounting Principles Board Opinion No. 9, supra note 611, at ¶ 20, 26, extraordinary transactions and prior period adjustments are shown on financial statements net of the federal income tax effect. It would appear that similar treatment ought to be afforded to the items when included or excluded as indicated in text.

618 See Baker & Cary at 1230.

619 Solether & Jennings, supra note 588, at 436 suggest that similar language should be interpreted to mean that the "current" fiscal year refers to the year for which rather than during which the dividends are declared. The result would be that current earnings would not become payable until they have been definitely ascertained as of the close of the year.
the maximum permissible nimble dividend - $50,000? or $35,000? Here it would seem that the dividend in year 6 should be charged to the earnings of the current year and that the net earnings yet available for distribution should only be the original net earnings less the dividend. Hence the answer would appear to be $35,000.

A final question that may be raised in connection with a nimble dividend provision is what types of distributions should be allowed from such earnings. If current earnings can be used to support a distribution of cash or property, should they also be usable to support purchases of the corporation's shares? As a source for stock dividends? These questions can be better answered in connection with the discussion of each of these subjects below.⁶２⁹

b. Dividends By Wasting Asset Corporations. Both Acts contain the common provision⁶²¹ permitting corporations engaged in the business of exploiting natural resources or property having a limited life⁶²² to declare cash dividends out of depletion reserves.⁶²³ In partial recognition of the fact that such dividends may represent a return

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⁶²⁹ See text infra beginning at notes 805 and 852.
⁶²¹ 1 Model Act Ann. § 40(b) ¶ 2.03 indicates that only 15 states (Arizona, Florida, Hawaii, Illinois, Kentucky, Massachusetts, Missouri, New Hampshire, New Jersey, New Mexico, Rhode Island, South Dakota, Tennessee, Vermont, and Wisconsin) do not have a dividend fund provision relating to dividends by wasting asset corporations. South Dakota should be deleted from this list. See S.D. Laws ch. 22 § 42(2) (Business Corp. Act (1965)).
⁶²² Both Acts give as examples of assets with limited lives a lease for a term of years or a patent. See Wash. Rev. Code §§ 23.01.250(7) (1958); 23A.08.420(2) (1965).
⁶²³ See Wash. Rev. Code §§ 23.01.250(7) (1958), 23A.08.420(2) (1965). The language used in text is taken from the New Act. The language in the old act varies from that in the New Act in the following respects: (1) the corporations eligible under the old act are those owning wasting assets intended for sale in the ordinary course of business such as mines, or oil or gas wells, or timber; (2) the effect of a corporation's eligibility under the old act is that it need not deduct the depletion of such assets by sale or lapse of time in the computation of the fund available for dividends and such a corporation may pay dividends from the net profits arising from its business without deduction of such depletion; and (3) the old act permitted depletion dividends to be paid in cash or property. Compare Wash. Rev. Code § 23.01.250(7) (1958) with Wash. Rev. Code § 23A.08.420(2) (1965). The old act's approach in providing examples of the assets involved is superior to the New Act formulation simply in terms of natural resources. Presumably the latter must be interpreted to include activities in which under generally accepted accounting principles depletion (rather than some other form of amortization) is taken. But the accounting guidelines as to which assets are subject to depletion are not particularly clear. Compare H. Finney & H. Miller, Principles of Accounting-Intermediate 323 (6th ed. 1965) (limiting depletion to wasting assets such as mines, timber, or oil wells) with W. Paton & W. Paton, Jr., Asset Accounting 438 (1952) (stocks of game, fisheries, orchards and agricultural land may be included). As to the preferable technique for stating the exception, see note 645 infra. The rationale for the New Act's limitation of depletion dividends to cash is not stated. Possibly the thought was to limit such dividends to funds generated by exploiting the resource. See note 630 infra.
of stated capital, the New Act adds the requirements that the corporation be solvent in the equitable sense before and after the distribution and that dividends be identified as a distribution from depletion reserves. Rather surprisingly, however, the New Act fails to offer even the rather vague protection afforded by the old provision to preferred shareholders in wasting asset corporations.

The genesis of the wasting assets exception was an early assertion

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624 Neither Act makes clear whether traditional dividend sources—i.e., earned surplus or current earnings under the New Act and surplus computed with a deduction for depletion under the old act—must be exhausted before distributions can be paid "out of" depletion reserves. This issue, which is analogous to the question raised in connection with distributions from capital surplus (see part II, 42 Wash. L. Rev. at 138 & nn.414-15), is fairly important because of the fact that under the New Act depletion reserves can only be used as a source of cash dividends and not as a source of property dividends, share dividends, or share repurchases. Accounting authorities are clearly against the practice of paying dividends out of depletion reserves (see, e.g., R. Montgomery, Auditing 409 (8th ed. N. Lenhart & P. Deflese 1957); H. Hatfield, supra note 585, at 45) and hence take the position that traditional sources must be exhausted before depletion reserves be used. See, e.g., M. Moonitz & L. Jordan, Accounting, An Analysis of Its Problems 418 (rev. ed. 1965). No aspect of dividend policy contradicts this result.

A related question concerns how the corporation is to account for a dividend paid out of depletion reserves. Some companies apparently simply omit depletion allowances in financial statements (see Montgomery, supra at 408; P. Grady, supra note 605, at 153), which practice would further confuse shareholders receiving the distribution. To eliminate this practice, the New Act should be amended to include the provision in Tex. Bus. Corp. Act art. 2.39(5) (1956) requiring that any such dividend be carried in the corporation's accounting records in a separate account which is appropriately titled and shown on all financial statements as a deduction from the reserve accounts on the basis of which the dividend was paid. See also H. Finney & H. Miller, supra note 623, at 327.

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626 Wash. Rev. Code § 23A.08.420(2) (1965). In addition, the amount per share paid from such reserves must be disclosed to the recipient shareholders concurrently with the distribution. This notice is essential to shareholders in order that they may give the distribution appropriate treatment for federal income tax purposes. See generally Int. Rev. Code of 1954, §§ 301, 316. But to be useful the notice must indicate to the shareholder how the depletion reserve was computed and the status of the corporation's earnings and profits account. See Treas. Reg. § 1.316-2(e) (1955).

627 Wash. Rev. Code §§ 23.01.250(7) (1958) stated that distributions made from surplus computed without deduction of depletion were "subject...to the rights of the shareholders of different classes." The Commissioners' Note in 9 U.L.A. 171 (1957) indicates that this requirement would be satisfied only if "a sufficient amount of the net profits [is]...retained to insure the repayment of principal to the holders of the preferred shares." Presumably this language is intended to refer only to those cases where the corporation has net profits because of the failure to take depletion. So interpreted, the language would produce protection of the preferred shareholders' interest similar (but not identical) to that afforded by the New Act to such shareholders on most types of distributions. See part II, 42 Wash. L. Rev. at 132 et seq. On appropriate protections for preferred shareholders, see note 646 infra.

628 Shortly after Morawetz wrote, the Court of Appeal in England decided Lee v. Neuchatel Asphalte Co., 41 Ch. D. 1 (1889). There a common shareholder sought to enjoin the distribution of a dividend to preferred shareholders from "profits" computed without deduction of depletion on the ground that the limited-period mineral concession held by the company was a wasting asset and hence declaration of a dividend without depletion deductions would represent a return of capital. The company's articles of association provided that depletion need not be deducted in determining net profits available for dividends. The preferred shares were
by Morawetz that depletion need not be taken by a corporation with one class of shareholders where its sole purpose was to invest in a specific wasting asset. The tenor of his argument was that if such a corporation was not permitted to distribute cash as the asset was exploited, it would become virtually an investment company with respect to the dollars that would build up as a result of the deduction of depletion from revenues. Shareholders in such cor-

entitled to a seven per cent annual dividend and participated rateably after the common shares had received a like dividend. In the event of liquidation, all shares participated rateably. Evidence offered at the trial court indicated that the concession was of greater value at the time of trial (because of renegotiation) than at the time the corporation was formed. Three judges, relying in varying degrees upon the notion of fixed and circulating capital, refused to enjoin the dividend. For discussion, see Gold, Fixed and Circulating Capital In The English Law of Distributions, 6 TORONTO L.J. 14 (1945). Despite the numerous possibilities for confining the case, it was promptly introduced into American cases (see Excelsior Water & Mining Co. v. Pierce, 90 Cal. 131, 27 P. 44 (1891) (also citing Morawetz)) and was soon cited as adopting a “wasting assets” exception to statutes barring distributions resulting in capital impairment. See, e.g., 1 W. COOK, STOCK AND STOCKHOLDERS AND GENERAL CORPORATION LAW 724 (3d ed. 1894); W. CLARK, CORPORATIONS 346 (1st ed. 1897). For discussion of later American cases, see Wittenberg v. Federal Min. & Smelting Co., 15 Del. Ch. 147, 133 A. 48 (Ch. 1926), aff’d, 15 Del. Ch. 411, 138 A. 347 (1926) (suggesting restriction on Lee where preferred shares with a liquidation preference are present); Williams, Dividends From Wasting Assets Corporations, 43 W. VA. L.Q. 53, 58-59 (1936); W. FLETCHER, PRIVATE CORPORATIONS § 5347 (1958 rev. vol.).

The first American statute on the subject, DEL. CODE ANN. tit. 8, § 170(a)(2) (1953), was adopted in response to the decisions in Wittenberg v. Federal Min. & Smelting Co., at 1289. 1 V. MORAWETZ, PRIVATE CORPORATIONS 415-16 (2d ed. 1886). Morawetz went on to say that a mining company could not expand its ability to pay dividends by selling (presumably without profit) a portion of its property. (To the same effect is Excelsior Min. Co. v. Pierce, 40 Cal. 131, 27 P. 44 (1891),) Precisely how such a sale can be distinguished from periodic sales of the mined product is not made clear. Possibly the property sale can be distinguished from periodic sales on the grounds of creditor expectations, i.e., on the ground that creditors of mining companies expect distributions as the product is mined in ordinary course of business but do not anticipate extraordinary sales of the mining property. See V. MORAWETZ supra, at 416; see also WASH. REV. CODE § 23.01.250(7) (1958) limiting the depletion excuse to corporations owning wasting assets intended for sale in the ordinary course of business (query: how often do corporations hold mines for sale in the ordinary course?). But Morawetz seems to undermine this distinction with his further statement that “no dividend can be declared without considering the rights of creditors, and providing for future liabilities.” Id. In any event, the New Act formulation would seem to preclude distributions in the event of realization by sale because such sales will not increase the amount in the depletion reserve. Indeed, it would seem that a sale of the property would deprive the corporation of all rights to distribute “out of” the depletion reserve since the depletion reserve will disappear in connection with the sale. Compare the treatment afforded by N.Y. BUS. CORP. LAW § 510(b) (McKinney 1963) which permits a corporation to declare dividends in excess of surplus, computed after deduction for depletion, to the extent that the cost of the wasting asset has been recovered by depletion reserves, amortization or sale.

If it can be assumed that revenues are received in cash, a wasting-asset corporation will experience a greater increase in cash during the year than the amount of its net profits simply because depletion represents an allocation of a previously incurred cost rather than a current cash outlay. For illustrations of the
corporations were said to prefer to invest the funds produced rather than to let the corporation's directors undertake this task. Also, creditors and shareholders were said to possess the common knowledge that mining companies distributed funds out of capital and could protect themselves by agreement against this risk if they desired.

In evaluating Morawetz' argument, it should first be noted that generally accepted accounting principles now, in contrast to when Morawetz wrote, require that appropriate charges for depletion be made. Hence, it is doubtful that creditors and shareholders are generally aware that depletion may be ignored in determining the dividend fund. Moreover, depreciation has the same potential cash build up effect where a corporation does not replace its equipment; yet no suggestion has recently been made that depreciation can be ignored in determining a corporation's dividend capacity. Perhaps more mining companies than manufacturing companies operate with

dollar build up that may occur (both dealing with depreciation), see R. Amory & C. Hardee, supra note 610, at 273-75; de Capriles, Modern Financial Accounting (Part II), 38 N.Y.U.L. Rev. 1, 10-13 (1963).

A secondary factor undoubtedly leading to early expansion of the depletion avoidance exception was the difficulty in computing depletion. See Greenough & Ayer, Funds Available For Corporate Dividends in Washington, 9 Wash. L. Rev. 123, 140 (1934); 25 Minn. L. Rev. 744, 769 (1940). Such computation requires determination of the cost of the depletable asset, which may be difficult to determine where capital stock is issued, (for various techniques, see, e.g., R. Wixon, supra note 585, at 15.2-6; Fernald, Peloubet & Norton, Accounting for Nonferrous Metal Mining Properties and Their Depletion, 68 J. Accountancy 105-108 (1939) ) and the amount of the resource available on a commercial basis. The latter on occasion may be largely guess work. R. Wixon, supra, at 15.14.


See 1 V. Morawetz, supra note 629, at 416; Comment, Corporations: Liquidating Dividends By Wasting Asset Corporations in California, 34 Calif. L. Rev. 204, 210 (1946).

See, e.g., P. Grady, supra note 605, at 148-49; W. Paton & W. Paton, Jr., Asset Accounting 443 (1952); and R. Montgomery, supra note 624, at 280. A number of companies, however, omit depletion charges, relying in part upon state statutes permitting dividends "out of" depletion reserves. See id., at 279 ; P. Grady, supra, at 153; Seitelman, The Depletion Problem, 28 Accounting Rev. 102, 106 (1953). See also AICPA Accounting Trends and Techniques 194 (12th ed. 1966) indicating that among large corporations few engaged in resource exploitation did not take depletion charges.


Indeed, the inclusion of the notice provision in the New Act seems to be at least in part responsive to this fact.

See examples cited in note 630 supra.

It should be noted that Morawetz in a paragraph preceding his discussion of depletion allowances recommends that depreciation be taken into account in determining a corporation's dividend capacity. 1 V. Morawetz, supra note 629, at 414-15. For a review of the authorities, see Baker & Cary at 1271-85. A slight qualification of the text statement appears in Idaho Code Ann. § 30-130(7) (1948) which allows wasting asset corporations to disregard depreciation of plant and equipment in determining the size of the dividend fund.
a view to liquidation when present assets are exhausted but a fairer exception would concern itself with all corporations operating with a view to liquidating rather than singling out the predominant group. Finally, why should it make a difference in a resource-depleting corporation whether the resource is acquired for an annual payment rather than a bulk payment at the outset? Despite the similarity in economic effect, Morawetz’ argument would provide no exception in the lease case. These factors suggest that as a matter of good dividend policy, the depletion deduction exception ought to be abolished.

Even if the case for a wasting assets exception is found persuasive, several changes should be made in the New provision so as to confine the benefits of the exception to the intended recipients. Clearly, some limitation should be inserted in the Act preventing a resource-depleting corporation that intends to reinvest funds received in other resources from qualifying for the exception. Corporations desiring

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638 Seitelman, supra note 633, at 106 surveyed 24 corporations engaged in non-ferrous metal mining (the sample drawn from corporations listed in Moody’s Industrial Record) and concluded that not one of the corporations was operating with a view to liquidating.

639 See H. Ballantine, supra note 588, at 587. Cf. the statutes listed in note 642 infra which deal with corporations organized to liquidate specific assets.

640 See Ballantine & Hills, supra note 583, at 251 where the authors compare the case of a leasehold acquired for a bulk payment with a leasehold subject to an annual obligation to pay rent.

641 H. Ballantine, supra note 588, at 587 states:

The statutory exception in dividend statutes derived from erroneous English decisions, excusing deduction for depletion of wasting assets, is based on no sufficient reason or need. Such lax provisions for liquidating dividends should be repealed. No corporation should be authorized to make gradual returns of their investment to shareholders without statutory proceedings to reduce capital.

It may be argued that if the wasting assets exception is abolished, a one-shot mining corporation will have no recourse but to let depletion funds accumulate. But available solutions include at least repurchase of redeemable preferred shares if the corporation has such or reduction of capital. See text discussions on each topic infra, beginning notes 653 and 715, respectively.


A preliminary question is whether the required relationship between the corporation’s total operations and that part devoted to resource exploitation is made sufficiently clear in the New Act. Wash. Rev. Code §23A.08.420(2) (1965) requires that the corporation be engaged in the business of exploiting natural resources or
to qualify should be required to have article provisions authorizing such distributions,\(^4\) to file appropriate notification with the secretary of state, and to denominate themselves as resource liquidating corporations.\(^4\) The depletion exception should be restated in terms that would prohibit the payment of dividends when there was a deficit in earned surplus greater than the amount in the depletion owning property having a limited life. This suggests (albeit not too clearly) that resource exploitation must be quite a substantial portion of the corporation's activities. For clearer resolutions of the problem, see, e.g., *Calif. Corp. Code* § 1503 (West 1955) ("engaged solely or substantially in the exploitation of mines..."); and *Minn. Stat. Ann.* § 301.22(5) (1947) ("engaged principally..."). Note that the New Act so interpreted is a good deal narrower than the old provision ("a corporation which owns wasting assets..."). *Wash. Rev. Code* § 23.01.250(7) (1958). See in this connection *Baker & Cary* at 1291 where the authors ask whether a corporation with a mine representing 40% of its activity should be denied the privilege while a 90% mining corporation receives it.

The Washington draftsmen, in order to make the new provision parallel to the old, added the language concerning corporations owning property having a limited life to the Model Act predecessor section, Model Act § 40(b). The Note, *Dividends From Contributed Capital and Protection of Preferred Shareholders*, 65 *Harv. L. Rev.* 1203, 1206 (1952) prefers the narrower Model Act formulation as affording more protection to the preferred. However, if the business is read broadly, a liquidation-view is required and Mr. Weiner's suggestion for protecting preferred shares is adopted, see note 646 infra, the extension would not appear to be required.\(^6\)

Neither the old nor the New Act requires that the corporation's articles of incorporation authorize directors to make such distributions. *Compare Wash. Rev. Code* § 23.01.250(7) (1958) *with Wash. Rev. Code* § 23A.08.420(2) (1965). In order to achieve this result, the Washington draftsmen had to amend the Model Act predecessor to the New Act provision, Model Act § 40(b), to delete such a requirement.

There is a general analogy between depletion dividends, distributions from capital surplus (see Buttimer, *Dividends and The Law*, 36 *Accounting Rev.* 434 (1961)), and distributions from surplus arising from reductions of capital. The requirements for distributions of capital surplus and reduction surplus both suggest the desirability of requiring a shareholder approval of depletion dividends. *See* part II, 42 *Wash. L. Rev.* at 136-41 and text beginning at note 676 infra. But if depletion dividends required a shareholder vote, then there would be no substantive difference between reducing stated capital and depletion dividends. On the theory that depletion dividends, if they can be supported at all, are meant to be less rigorous than a reduction of capital and to avoid the burden otherwise imposed because of frequent distribution of depletion dividends, such requirement seems unnecessary. *See* *Baker & Cary* at 1292.

The purpose of this requirement is obviously to notify creditors and outside investors that the corporation intends to declare depletion dividends.

*Tex. Bus. Corp. Act* art. 1.02(17) (1956) requires that the phrase "a consuming assets corporation" must be used as part of a corporation's official corporate name if it desires to avoid depletion for dividend purposes. The corporation must give the phrase equal prominence with the rest of the corporate name on its financial statements and certificates representing shares. All certificates representing shares in such corporations must further state "This corporation is permitted by law to pay dividends out of reserves which may impair its stated capital." It is assumed that such statutes have been amended pursuant to the suggestion made in part II, 42 *Wash. L. Rev.* 131-32 (1966) that the bankruptcy insolvency test be added to the equitable insolvency test for dividends. For statutory language dealing with this precise problem, see *Tex. Bus. Corp. Act* art. 2.39(1) (1956).

*Ind. Ann. Stat.* § 25-211 (Additional Supp. 1967) qualifies a provision generally similar to *Wash. Rev. Code* § 23.01.250(7) (1958) by making distributions from depletion "subject to the rights of creditors." Precisely what power is granted to corpora-
reserve and no current earnings available for distribution. Finally, provisions protecting the liquidation preference, common capital cushion and current earnings claim of preferred shares should be inserted.

645 The phenomenon described in text may occur because the New Act defines a corporation's dividend capacity in terms of the depletion reserve rather than in terms of earned surplus or current earnings computed without deduction for depletion. For better formulations of the dividend limitation, see N. C. GEN. STAT. § 55-50(d) (1963); N.Y. BUS. CORP. LAW § 510(b) (McKinney 1963). Both formulations also avoid the misleading implications that arise from language permitting payment of cash dividends out of depletion reserves. See part II, 42 WASH. L. REV. at 119 n.317; M. Moenitz & L. Jordan, Accounting, An Analysis of Its Problems 418 (rev. ed. 1963).

Hackney, The Financial Provisions of The Model Business Corporation Act, 70 HARV. L. REV. 1357, 1385 n.130 (1957) points out another difficulty with the New Act formulation: use of depletion reserves as a source may cause confusion in view of the directors' power under WASH. REV. CODE § 23A.16.130 (1965) to abolish reserves created out of earned surplus. Fortunately, the draftsmen's comment to Model Act § 40(b) (1960) clearly indicates depletion reserves are not to be included. See 1 MODEL ACT ANN. § 40(b) ¶ 4 (1960).

The New York provision highlights another difficulty with the New Act formulation with its limitation of depletion dividends "to the extent that the cost of the wasting asset...has been recovered by depletion reserves." As pointed out earlier, see note 630 supra, determination of the asset's cost (and hence the maximum potential depletion) is exceedingly difficult. Indeed, it may be determined on the basis of appraised value, e.g., R. Wixon, Accountants' Handbook 15.3-15.6 (4th ed. 1956), in which the only limits on value would be the par value of stock issued (if any), the extent of discretion afforded to directors under WASH. REV. CODE § 23A.08.160 (1965) (see part I, 41 WASH. L. REV. at 248-49 (1966), and conceivably S.E.C. regulation. See L. Rappaport, SEC Accounting Practice and Procedure 3.6-3.9; 3.11-3.13 (2d rev. ed. 1966). Allowing dividends from depletion reserves can only accentuate the desirability of high valuations. Removing the emphasis on the depletion reserve as a source, as suggested above, will aid on the problem. In addition, it would seem that a concept approaching cost for federal income tax purposes (see Treas. Reg. § 1.316-2(e) (1955)) should be adopted as the appropriate cost in the New York formulation above.

646 On the basis of the discussion appearing in part II, 42 WASH. L. REV. at 132-36, it may seem that all that need be done is to add a liquidation preference protection clause to WASH. REV. CODE § 23A.08.420(2) (1965) similar to that appearing in WASH. REV. CODE § 23A.08.420(1) (1965). As Weiner, Theory of Anglo-American Dividend Law: American Statutes and Cases, 29 COLUM. L. REV. 461, 482 (1929) points out, however, the result of such a clause in a depletion deduction exception situation is to redeem the common stock while permitting it to retain all other rights in the company, or a conversion of the common shares to shares with the true preference. He suggests that any such distributions be made first to the preferred shares in partial redemption, and, only after the preferred shares are eliminated, then to common shareholders. (For an analogous provision, see CALIF. CORP. CODE § 1500(c) (West 1955).) See also N. Lattin & R. Jennings, Cases and Materials on Corporations 1164 n.1 (3d ed. 1958) suggesting in the alternative pro rata distribution between the classes. The most protective statute, Tex. BUS. CORP. ACT. art. 2.39 (2), (3) (1956), requires only that all cumulative preferred dividends be paid first and that net assets equal the voluntary liquidation preference after the distribution. Note that this statute offers inadequate protection to preferred...
c. Distribution of Assets Following Reduction of Capital. The old act provided that the capital stock of a corporation could be reduced if the holders of two-thirds of the voting power of all shareholders approved, articles of reduction were filed with and certified by the secretary of state, and the reduction did 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 so reduced. Several ambiguities were present in these provisions. A reduction of capital in and of itself involves no distribution of assets shares with no liquidation preference. Other statutes range from no provision at all (a clear majority) to requirements of adequate provision for liquidation preferences (see, e.g., CAL. CORP. CODE § 1503 (West 1955)) and protection of rights of shareholders of different classes (see, e.g., OKLA. STAT. ANN. tit. 18, § 1.132(b) (1953); WASH. REV. CODE § 23.01.250(4) (1958)) to standard liquidation preference protection clauses. (See, e.g., N.Y. BUS. CORP. LAW § 510(b) (McKinney Supp. 1967.).) As to how the "adequate provision" and "protection of rights" clauses might be interpreted by a court, see Note, Dividends From Contributed Capital and Protection of Preferred Shareholders, 65 HARV. L. REV. 1203, 1207 (1952) and note 627, supra.

One alternative that might be considered to the suggestions presented by Mr. Weiner and Professors Lattin and Jennings is the requirement of a favorable vote by two-thirds of the preferred shares as a class before any distribution could be made. See BAKER & CARY at 1292. The earlier suggestions, however, seem more tenable since common shareholders have a comparative advantage over preferred shareholders because of superior organization and management connections. See 65 HARV. L. REV. at 1213.

It may be argued that a court would protect preferred shareholders in the event of a proposed dividend to common shareholders under the New provision despite the absence of a specific clause protecting preferred shareholders. Cf. Wittenberg v. Federal Min. & Smelting Co., 15 Del. Ch. 147, 133 A. 48, 51 (Ch. 1926), aff'd, 25 Del. Ch. 409, 138 A. 347 (1927), bill dismissed on change of statute, 15 Del. Ch. 351, 138 A. 352 (Ch. 1927). But cf. Mellon v. Mississippi Wine Glass Co., 129 La. 406, 56 So. 343 (1911) (rejecting a preferred shareholder's action to compel creation of a sinking fund for the benefit of preferred shareholders). Even if the court were favorably disposed, it is hard to see how it could avoid the relatively clear negative legislative intent manifested in clear inclusion of a liquidation preference clause where one was desired in the New Act.

On protection of preferred shareholders' interest generally, see D. KEHL, CORPORATE DIVIDENDS 225-34 (1941); 75 U. PA. L. REV. 350 (1926).

WASH. REV. CODE § 23.01.010(10) (1958) defines "capital stock" as (a) "the aggregate amount of par value of all allotted shares having a par value, including such shares allotted as stock dividends, and (b) the aggregate of cash, and the value of any consideration other than cash...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."

WASH. REV. CODE § 23.01.430 (1958). The articles of reduction must state 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 so reduced. WASH. REV. CODE § 23.01.430(2) (1958). WASH. REV. CODE § 23.01.430(3) (1958) then conditions validity of the reduction upon a requirement that the reduction would not reduce the actual value of corporate assets to an extent prohibited by subsection (2). No explanation of the difference in terminology appears in the Commissioners' Notes (see 9 U.L.A. 197-98 (1957)). Commentators treat the two terms as synonymous, see e.g., Gose, Legal Significance of 'Capital Stock', 32 WASH. L. REV. 1, 22 (1957), as appears appropriate in view of the interrelation between subsections (2) and (3).
and hence it was not entirely clear what the last limitation meant.\textsuperscript{449} Where the reduction was to occur by means of a reduction of the par value of outstanding shares, it was not clear whether an amendment of the articles of incorporation was required in addition to preparation of articles of reduction.\textsuperscript{450} Where the reduction was for the purpose of removing an amount voluntarily transferred to capital stock by the directors, it was not clear what procedure was required.\textsuperscript{451} Finally, some doubt existed as to whether cancellations of shares acquired out of surplus or by donation required reduction procedure.\textsuperscript{452}

Under the New Act, the procedure for and limitations upon reductions of stated capital\textsuperscript{453} depend on how the reduction is to be ac-

\textsuperscript{449} Gose, \textit{supra} note 648, at 22 argues that the statute must be interpreted to require that no distribution of assets can be made in connection with a capital stock reduction which would leave less assets than specified by the statute. \textit{See also} Greenough & Ayer, \textit{Funds Available for Corporate Dividends} in \textit{Washington}, 9 \textit{WASH. L. REV.} 63, 71-72 (1934). Even this construction, however, does not completely resolve problems with the asset restriction. If the restriction were omitted, a corporation's dividend capacity would be determined by virtue of the regulations in \textit{WASH. REV. CODE} \textsection{23.01.250} (1958) under the terms of which unrealized appreciation could not be recognized but unrealized losses were recognized. \textit{See part II, 42 \textit{WASH. L. REV.}} at 148, 154. Thus, in determining a corporation's dividend capacity, assets were valued in essence at cost or market, whichever was lower. The language in the asset restriction, as interpreted by Gose, seems to permit all assets to be valued at their current value even where that valuation would produce unrealized appreciation on balance. It seems unlikely that this result was intended by draftsmen so careful to include a special prohibition against dividends from unrealized appreciation. About the best one can do with the asset restriction language is to assume it was designed to reinforce the dividend provisions by requiring that in the event of a reduction of capital stock, all unrealized losses would be taken into account before any asset distributions could be made. This construction would then accord with accounting notions as to correct reduction procedure. \textit{See authorities discussed infra} at note 681. \textit{Cf. WASH. REV. CODE} \textsection{23.01.420(3)} (1959) governing recapitalizations. Hay v. The Big Bend Land Co., 37 Wn. 2d 877, 209 P.2d 35 (1950) presented the court with a case where the asset restriction might have been in issue but the question was not raised.

\textsuperscript{450} \textit{See} Commissioners' Note, 9 U.L.A. 197 (1957) which is ambivalent; Gose \textit{supra} note 648 at 25.

\textsuperscript{451} Voluntary transfers to capital stock were not part of "capital stock" as defined by statute (\textit{see WASH. REV. CODE} \textsection{23.01.010(10)} (1958) quoted in note 647 \textit{supra}) and hence it was argued that removing such amounts did not reduce capital stock. It seems likely, however, that courts would stretch the capital stock category to cover such transfers, particularly if there had been any creditor reliance thereon.

\textsuperscript{452} \textit{WASH. REV. CODE} \textsection{23.01.430(1)} (1959) makes no exceptions for share cancellations. \textit{Cf. D. HERWITZ, BUSINESS PLANNING} 351-52 (1966). However, Gose, \textit{supra} note 648 at 25-26 can be read as stating that no filing is required on cancellation of shares donated pro rata by the shareholders. \textit{See} Palmer, \textit{Choosing the Share Structure of a Washington Business Corporation}, 37 \textit{WASH. L. REV.} 557, 564 n.32 (1962).

\textsuperscript{453} "Stated capital" is defined in \textit{WASH. REV. CODE} \textsection{23A.04.010(10)} (1965) as: the sum of (a) the par value of all shares of the corporation having a par value that have been issued, (b) the amount of the consideration received by the corporation for all shares of the corporation without par value that have been issued, except such part of the consideration therefor as may have been allocated to capital surplus in a manner permitted by law, and (c) such amounts not included in clauses (a) and (b) of this paragraph as have been transferred to stated capital of the corporation, whether upon the issue of shares as a share
Redeemable shares are cancelled when purchased or redeemed by the corporation. Other shares reacquired by a corporation may be cancelled by resolution of its board of directors. In either case, stated capital is deemed reduced by that part of the stated capital which was represented by the shares cancelled upon filing with the secretary of state a statement of cancellation. Where stated capital is to be reduced by reducing the aggregate par value of shares having par value or the aggregate of stated capital allocated to shares issued without par value, the New Act requires that the procedure for amending the corporation's articles of incorporation (i.e., director resolution, notice to shareholders, approval by holders of two-thirds of appropriate share classes) be followed. After filing the amendment...
with the secretary of state and upon his issuance of a certificate of amendment, the amendment becomes effective and stated capital is reduced to the extent indicated in the amendment. Finally, amounts transferred voluntarily to stated capital may be reduced upon adoption of a resolution by directors to that effect, approval by holders of a majority of shares entitled to vote on the issue, and filing with the secretary of state of a statement of reduction.

The only limitation imposed by the New Act upon the size of a reduction of stated capital appears in the section setting forth the procedures for reducing amounts voluntarily transferred to stated capital. That section provides that no such reduction may be made which would reduce the amount of aggregate stated capital of the corporation to an amount equal to or less than the aggregate preferential amounts payable upon all issued shares having a preferential right in the assets of the corporation in the event of an involuntary liquidation, plus the aggregate par value of all issued shares having a par value but no preferential right in the assets of the corporation in the event of involuntary liquidation. The New Act does, however, set limits upon distributions of assets from surplus created by any type of reduction of capital by providing that such surplus is capital surplus. It will be recalled that asset distributions from capital surplus are generally permitted under the New Act only when authorized by

As to when a class of shares is entitled to vote as a class on a proposed amendment (in which event there must be approval by holders of two-thirds of the shares in such class and of the total shares entitled to vote on the question), see Wash. Rev. Code § 23A.16.030 (1965). On the specific question of whether preferred shareholders are entitled to vote as a class, see note 702 infra. See Wash. Rev. Code §§ 23A.16.060, .040(7) (1965).


Wash. Rev. Code § 23A.16.120(5) (1965). Assuming that this means of protecting the preferred's interest in total stated capital is adopted, see text infra beginning at note 700, it is unclear why a reduction should not be permitted where the result is total stated capital equal to the liquidation preference plus par value of shares without liquidation preference.


Under Wash. Rev. Code § 23A.08.430 ¶ 2 (1967), the directors through their own action may distribute cash dividends out of capital surplus to holders of shares having a cumulative preferential right to receive dividends in discharge of their cumulative dividend rights if the corporation has no earned surplus and the corporation's solvency is not in question. Also, under Wash. Rev. Code § 23A.08.430 (2) (1967), regulated investment companies can make distributions of cash out of capital surplus without an authorizing article provision or shareholder approval.

As to the corporation's right to purchase its own shares from capital surplus, see text infra beginning at note 727.
the articles of incorporation or a majority of all shares outstanding, all cumulative dividends accrued have been paid, the corporation is not insolvent before such payment and will not be rendered insolvent by the payment, shareholders are notified of the source of the distribution, and the remaining net assets will exceed the aggregate preferential amount payable in the event of voluntary liquidation to shareholders of preference shares.666 It should also be recalled that capital surplus may be applied by the directors to the reduction or elimination of any deficit arising from losses, however incurred, after earned surplus is exhausted.667 Apparently it is not required that a corporation with an earned surplus deficit undergoing a reduction of capital must apply capital surplus created by the reduction to the elimination of the deficit before any asset distribution can be made from such capital surplus.668

Evaluation of these provisions can best proceed from an analysis of

668 It is unclear why the earned surplus deficit which can be cancelled is limited to one arising from losses. Does this provision mean that an earned surplus deficit resulting from an illegal distribution cannot be eliminated by reducing stated capital? See id. at 1386-87 n.137. See also potential problems in eliminating water in assets. See part II, 42 Wash. L. Rev. at 169 n.548. It would appear that Wash. Rev. Code § 23A.16.130 ¶ 2 (1965) should be broadened to cover elimination of earned surplus deficits generally.
669 The second full paragraph of Wash. Rev. Code § 23A.08.430 (1967) contains the only reference in that section to a required relationship between the earned surplus and capital surplus accounts that must exist before capital surplus may be distributed. That provision would appear to permit capital surplus arising from a reduction of capital to be used to pay cumulative dividends despite a deficit in earned surplus. A fortiori it would appear that a corporation could generally make asset distributions from reduction surplus despite an earned surplus deficit under the remaining provisions in Wash. Rev. Code § 23A.08.430 (1967). See part II, 42 Wash. L. Rev. 138 at n.414. It may be argued, however, that the general incorporation of the accountants' definition of earned surplus, including therein specific reference to elimination of an earned surplus deficit by application of capital surplus, has resulted in the incorporation of the accountants' principles regarding reductions of capital. See D. Herwitz, Business Planning 362 (1966). Under their procedures, it seems reasonably clear that the earned surplus deficit must be eliminated before any asset distribution can be made. See, e.g., Miller, Quasi-Reorganizations in Reverse, 23 Accounting Rev. 154, 155 (1948). While this construction certainly would be in line with the interests of the various groups concerned, see text infra beginning note 669, it is difficult to square with the provisions of Wash. Rev. Code § 23A.08.430 (1967) and those in Wash. Rev. Code §§ 23A.16.130 ¶ 3 (1965). The latter, dealing with the application of capital surplus to earned surplus deficits, contains no hint that elimination of such deficits is a prerequisite to asset distributions from capital surplus arising from a reduction of capital.
the effects of a reduction of capital upon the interests of the creditors, preferred shareholders, and common shareholders of the corporation involved. Creditors are less concerned with the reduction itself than with what is to be done with the surplus arising out of the reduction. If it is proposed that the surplus be used to support a distribution of assets, creditors will obviously argue for minimization of the amount distributable since any such distribution results in a diminution of assets upon which at least pre-reduction creditors are presumed to have relied in extending credit to the corporation. At a minimum, the creditors' interest here requires that the amount of surplus available for distribution be reduced by any deficit in earned surplus and by the amount of any losses not yet recognized that are foreseeable. Full satisfaction of their interest under the classic theory of stated capital would obviously require that no asset distributions be made. Where the surplus arising out of the reduction is not to be distributed but is to be applied to the elimination of an earned surplus deficit, the creditors' general interest is similar to their interest in connection with "nimble" dividends: apart from the operation of either privilege, future earnings of the corporation would be frozen until the deficit was cured with a corresponding increase in the assets available for creditors' claims. Here, as there, a danger exists that assets

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610 See, e.g., D. Herwitz, Business Planning 358 (1966); Baker & Cary at 1308-09. Because of what may be done with surplus arising from a reduction of capital, creditors are interested in being notified of a proposed reduction. See note 694 infra.

611 See Baker & Cary at 1309.

612 As to the possibility that the former requirement can be read into the New Act, see note 668 supra. As to the possibility that the latter requirement may be read into the Act, see D. Herwitz, Business Planning 359 (1966).


Note that if a decline in replacement cost of equipment or general price level is present, the creditors' interest is complicated in ways previously discussed. See part II, 42 Wash. L. Rev. at 157-61, 173; Comment, Writing Down Fixed Assets and Stated Capital, 44 Yale L.J. 1025, 1031-34 (1935). It is assumed in this section that price level changes have either been taken into account or are not present and that replacement value changes are currently ignored in determining stated capital protection.


615 See note 609 supra.
will be written down below their present value with the effect of inflating earnings available for distribution.

Preferred shareholders' interests in connection with a reduction of capital are generally similar to those of creditors: to the extent that surplus arising from the reduction is used to support increased current or future asset distributions, assets otherwise available to produce earnings and to insure their liquidation preference are lost. In addition to this interest in the total amount of stated capital, preferred shareholders also on occasion have an interest in the type of stated capital being reduced. Finally, with respect to potential distributions of assets from the surplus arising from a reduction of capital, preferred shareholders have basically the same interests as indicated in the previous discussion of distributions of capital contributions in excess of legal minima.

While common shareholders generally may not be concerned over the amount of stated capital attributed to their shares, possible intra-class conflict concerning the wisdom of elimination of an earned surplus deficit or distribution of assets would seem to indicate that their acquiescence in a reduction of their capital is necessary. In addition, they have strong interests in preventing use of the reduction surplus in a way that gives misleading inferences as to the profitability of the corporation. Thus, fair asset valuations after the reduction are essential if the corporation's future earnings and profitmaking ability are not to be overstated. Similarly, common shareholders need to be informed that reduction surplus has been applied to an operating deficit and to be reminded of that fact for some reasonable period in order to allow accurate assessment of the corporation's total performance.

Finally, shareholders need to be informed when distribu-

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See D. Herwitz, Business Planning 364-65 (1966). Some courts have taken the position that all common capital must be extinguished before preferred capital can be reduced. See Page v. Whittenton Mfg. Co., 211 Mass. 424, 97 N.E. 1006 (1912). As Herwitz points out, however, the critical issue in most reductions is the total amount of stated capital as the preferred's liquidation preference is untouched by a reduction. See id. at 364. Thus, the fact that preferred stated capital is subject to reduction is relevant only on issues of class voting and in cases where the common may be able to reduce common stated capital later without preferred shareholders' consent.

On this subject, see part II, 42 Wash. L. Rev. at 136-41.

See id. at 138.


These interests are suggested by the accounting procedure for a quasi-reorganization (the accounting title for a reduction of capital) as described in
tions are made from surplus arising from the reduction so that they will not be misled as to the corporation's past earnings.\textsuperscript{682}

The least adequately protected interest under either statute is the creditors' interest in limiting asset distributions from surplus arising from a reduction of capital.\textsuperscript{683} The asset restriction imposed by the old act was illusory.\textsuperscript{684} The protection afforded this interest under the New Act\textsuperscript{685} seems to come down to the equitable insolvency test,\textsuperscript{686} management's general reluctance to approach shareholders with a reduction proposal,\textsuperscript{687} and the accountants' general reluctance to approve reductions where there is any prospect that the corporation will generate profits in the foreseeable future.\textsuperscript{688} Other statutes over the years have tried a variety of techniques for protecting this aspect of the creditors' interest including requiring publication of notice of the reduction,\textsuperscript{689} payment of all debts as a condition to reduction,\textsuperscript{690} and AICPA, \textit{Accounting Research Bull.} No. 43, ch. 7A (1953). To the same effect are the SEC requirements. \textit{See} L. Rappaport, SEC \textit{Accounting Practice and Procedure} 3.28-3.31 (2d ed. 1966).

\textsuperscript{682} See part II, 42 Wash. L. Rev. at 138.\textsuperscript{683} This is not to say that the creditors' interest in connection with the use of reduction surplus to eliminate deficits does not need further protection than that afforded by the New Act. Thus, creditors should receive adequate notice of the proposed reduction before it takes place so that they can take whatever steps are necessary to protect their interests in view of the possibility of future distributions. \textit{See} note 694 infra. Moreover, assets must be valued fairly in connection with such a procedure if future earnings are not to be overstated. \textit{See} text infra at note 697. But application of the reduction surplus to elimination of a deficit causes no immediate distribution of assets and seems supportable by the same general policy considerations discussed in connection with nimble dividends. \textit{See} text supra beginning at note 584. \textit{See also} note 696 infra as to whether the assets test suggested ought to require accumulation of assets up to the prescribed level in connection with a deficit elimination type of reduction.

\textsuperscript{684} The asset restriction, however interpreted (see note 649 supra), sets no limit on the extent to which stated capital can be reduced and, hence does not prevent withdrawal of assets down to equality with liabilities. \textit{See} Gose, \textit{Legal Significance of "Capital Stock"}, 32 Wash. L. Rev. 1, 22 (1957); Note, \textit{The Current Law Regarding Reduction of Capital: Its Methodology, Purposes and Dangers}, 110 U. Pa. L. Rev. 723, 732 (1962).

\textsuperscript{685} Creditors may also be protected by provisions of the Uniform Fraudulent Conveyances Act (see part II, 42 Wash. L. Rev. at 129). Section 5 of the Act, relating to conveyances without fair consideration leaving the transferor with unreasonably small capital, appears particularly relevant here. \textit{See} Wash. Rev. Code § 19.40.050 (1958).

\textsuperscript{686} See Wash. Rev. Code § 23A.08.430(1) (1967). Even if the bankruptcy test of insolvency is added to the Act, see part II, 42 Wash. L. Rev. at 131-32, this protection is no greater than that afforded under the old act. \textit{See} note 684 supra.

\textsuperscript{687} See 25 Minn. L. Rev. 744, 782 (1941). An additional factor affording protection is management's desire to maintain the creditors' goodwill. \textit{See} Comment, \textit{Writing Down Fixed Assets and Stated Capital}, 44 Yale L. J. 1025, 1031 (1935).


\textsuperscript{689} See, e.g., Del. Code Ann. tit. 8, § 244(e) (1967) (notice of the reduction of capital must be published at least once in a newspaper published in the county in which the corporation has its registered office within fifteen days after filing the
judicial or administrative regulation of the proceedings, or maintenance by the corporation of specified ratio of assets to liabilities after any such distribution. Of these approaches, the last, supplemented by adequate notice to creditors and an opportunity to enjoinder.

certificate of reduction); N.J. STAT. ANN. § 14:11-5 (1937) (a certificate stating the fact of reduction of capital and the manner of effecting the same and terms and conditions thereof shall be published for three weeks successively, at least once each week, in a newspaper published in the county in which the principal office of the corporation is located); HAWAII REV. LAWS § 172-52(e) (Supp. 1965) (similar to New Jersey except that four weekly insertions in a newspaper of general circulation are required).

See § 28 of the Delaware Corporation Law discussed in State ex rel. Radio Corp. of America v. Benson, 32 Del. 576, 128 A. 107 (1924); Cf., Note, Capital Stock Reduction As Affecting the Rights of Creditors, 47 HARV. L. REV. 693, 698 (1934).

This approach, suggested by the Note, Capital Stock Reduction as Affecting the Rights of Creditors, 47 HARV. L. REV. 693, 697-98 (1934) and by the Comment, Writing Down Fixed Assets and Stated Capital, 44 YALE L. J. 1025, 1051 (1935), does not appear to have been adopted in the United States. The origin of the suggestion was the provisions in the English Companies Act requiring court sanction of reductions of capital where the rights of creditors are affected. For a thorough exposition of English practice and authorities, see Rice, Capital Reduction and Its Effects on Class Rights, 23 CONN. (N.S.) 244 (1959). Generally, consent of creditors must be obtained to any reduction of capital which will result in a return of capital. Creditors who do not consent must be paid off or provision made for their debts. See PALMER, COMPANY LAW 84-86 (18th ed. 1948).

See, e.g., HAWAII REV. LAWS § 172-52(e) (Supp. 1965). Under that statute, if the reduction involves the retirement or reduction in the par value of any shares which are issued, or the release or cancellation of any stock subscription, publication of the reduction must be made (see note 689 supra). If no protests or objections are made to the state's director of regulatory agencies within thirty days after the first publication of notice, the director shall approve the reduction. Otherwise, the director shall proceed to consider any objections made, and if the director is thereupon satisfied that the required vote or "other determination has been obtained," he will enter the reduction. The other determination apparently refers to satisfaction of the 2-for-1 assets-liabilities and net asset equivalence with par tests imposed by Hawaii. HAWAII REV. LAWS §§ 172-52(a) (Supp. 1965). A similar procedure was at one time in effect in Texas (see TEX. ANN. CIV. STAT. art. 1332 (1925)) described in the Comment, Writing Down Fixed Assets and Stated Capital, 44 YALE L. J. 1025, 1042 (1935) but was abandoned in favor of provisions generally on the pattern of the Model Act. See TEX. BUS. CORP. ACT. art. 4.10-13, 2.40 (1956).

The Note, The Current Law Regarding Reduction of Capital: Its Methodology, Purposes and Dangers, 110 U. PA. L. REV. 723, 741 (1962) recommends that reductions be regulated by means of a required standard of business exigency the presence of which a state official would determine. Precisely when a reduction should be permitted was not made clear. Cf. N.C. GEN. STAT. § 55-50(e) (1) (1965) requiring a determination by directors that the assets of the corporation are in excess of the needs of the business. In view of the obvious difficulties in defining such a standard and in administering it, an assets test appears to be a more feasible solution.

See, e.g., CALIF. CORP. CODE §§ 1907, 1908 (West 1955) (5-to-4 fair value asset-to-liability ratio); HAWAII REV. LAWS §§ 172-52(g) (Supp. 1965) (2-to-1 asset-to-liability ratio and equality of assets (net?) to total par value of remaining capital stock of the corporation); N.C. GEN. STAT. § 55-50(e) (3) (1965) (2-to-1 fair value assets-to-liability ratio); MONT. REV. CODE § 15-212 (1947) (capital stock must at least equal the corporation's indebtedness, or 2-to-1 asset-to-liability ratio); S.D. CODE § 11.0205 (Supp. 1960) (same); Hills, Model Corporation Act, 48 HARV. L. REV. 1334, 1364-65 (1935) (5-to-4 fair value current asset-to-current liability ratio); Callahan, Statutory Protection of Creditors in Reduction of Capital Stock, 2 OHIO St. L.J. 220, 231 (1936) (2-to-1 current assets-to-unsecured liabilities).

Washington at one time required that the assets remaining after a reduction must be twice as large as the corporation's debts. See REM. REV. STAT. § 3830 (1932) in
proposed distributions,\(^6\) seems to be the most feasible.\(^6\) Among the various ratios possible, the requirement imposed by California on distributions of reduction surplus—that the assets after the distribution taken at their fair present value shall at least equal one and one-quarter times the corporation's debts and liabilities—seems reasonable\(^6\) and

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\(^6\) Notice to creditors and an opportunity to object before distributions are made from reduction surplus appear fundamental to adequate protection of the creditors' interest. See Callahan, supra note 674, at 237-38. As earlier noted, see note 683, creditors should receive notice of a proposed reduction even where the surplus is to be used to eliminate a deficit. Publication of the fact of reduction in a local newspaper appears inadequate as a means of communicating with creditors; many creditors may be out-of-state or may not follow newspaper notices. Hence, it would appear that each creditor should receive timely personal notice of every proposed reduction of capital of significance. See Mich. Stat. Ann. §§ 21.20, .43 (1963) (requiring personal notice to unsecured creditors where reduction of capital is in excess of 50 percent of capital). Such notice should describe the technique for reducing stated capital, present financial information necessary to evaluate the fairness of asset statement, and where a distribution of reduction surplus is contemplated, present data with which to determine whether the assets test would be met.

Distributions from reduction surplus should be prohibited for a period of at least two weeks following delivery of notice to the creditors (see Callahan, supra note 674, at 239 recommending thirty day interim; Cal. Corp. Code § 1908 (West 1955) (two weeks)) in order to give creditors the opportunity to examine the statement and to commence action to prevent the distribution if illegal.

Creditors obviously would be better protected if payment were required as a condition of the reduction. But payment would cause an asset drain at a time that most corporations seeking reduction could not afford one and would not be necessary if the corporation were merely seeking to eliminate a deficit. Even if a distribution of assets were currently contemplated, the question of whether creditors should be paid before such a distribution ultimately should turn on the relative size of net assets (or stated capital) as compared to the amount of the liabilities. Hence, the best approach seems to be to focus directly on the net assets factor.

As to whether the type of assets present ought to be a factor, see note 696 infra.

\(^6\) CAL. CORP. CODE § 1907 (West 1955). Choice of an appropriate ratio raises issues similar to those raised in determining what is an appropriate ratio of debt to equity before the debt will be recognized as debt for federal income tax purposes, and the amount of equity necessary before the corporate entity will be recognized. On those subjects, see D. Herwitz, Business Planning 69-76, 135-47 (1966). The present issue is determination of a general minimum standard capital structure below which the creditors' interest is unduly threatened. Requiring assets to be twice the amount of liabilities (a 1-to-1 ratio of debt to equity) appears unrealistic as a minimum standard. The test proposed in text, on the other hand, which permits a 4-to-1 ratio of debt to equity, seems more in accord with minimum capital structure notions.

A secondary issue under the assets test is whether unrealized appreciation ought to be taken into account in measuring assets for purposes of the test. The fact that unrealized appreciation apparently may be recognized as capital surplus (see part II, 42 Wash. L. Rev. at 153) suggests that most corporations involved in reductions of capital will either have no unrealized appreciation or appreciation matched or exceeded by unrealized depreciation. Accounting authorities, to the extent they have considered the issue, are not unfavorable. See H. Finney & H. Miller, Principles of Accounting, Intermediate 499 (5th ed. 1963); Werntz, Some Current Problems in Accounting, 14 Accounting Rev. 117, 118-23 (1939). (California authorities have not considered the question. See 1 Ballantine & Sterling, California Corporation Laws 345-46 (4th ed. 1966).) It would appear that since a liberal ratio has been adopted, the creditors' interest should be further strengthened by disregarding unrealized appreciation for purposes of the test.
A third issue that arises under the assets test is whether the test ought to be concerned solely with current assets as against current liabilities. Callahan, supra note 693, at 231 argues that no distribution should be made from reduction surplus unless one-and-one-quarter times the corporation's liabilities ratio exists. See also Hills, Model Corporation Act, 48 HARV. L. REV. 1334, 1364-65 (1935). Liquidity is a factor with any distribution of assets from a corporation. This factor has been recognized by the New Act by means of the equitable insolvency test which appears to cover the creditor interest concerned in connection with a distribution of reduction surplus. The unprotected creditor interest under the New Act appears to be that of intermediate-term creditors, which interest seems protected under the California assets test.

A fourth issue that may be raised about the assets test is whether the test ought to operate in such a way that distributions to shareholders after a reduction could not be made unless assets exceeded one and one-quarter times the corporation's liabilities. Cf. the suggestion in Note, Capital Stock Reduction as Affecting the Rights of Creditors, 47 HARV. L. REV. 693, 698 (1934) that all surplus arising from the reduction be impounded until all existing unsecured claims have been discharged. So stated the test would operate primarily where the corporation had used reduction surplus to write off an earned surplus deficit and proposed to make a distribution from later earnings. Such application of the test would be supported by the analysis set forth in connection with the nimble-dividend requirement that only part of the earnings be currently distributable. See text supra beginning note 602. But it is difficult to support such a limitation unless there generally exists a limitation on the distribution of assets, whether or not from earned surplus, of a similar type. Hills, supra, required current assets to be one and one-quarter times the corporation's liabilities after any dividend distribution. Limitations of this sort have not generally been accepted presumably because of the uneven way they hit corporations with varying asset-liability requirements. For an excellent summary of the weaknesses in a current ratio test, see Blough, Accounting and Auditing Problems, 108 J. ACCOUNTANCY (Aug. 1959) 76-77. It therefore would appear unwise to prescribe generally such a requirement or to prescribe it in connection with distributions out of test surplus after a reduction of capital.

Finally, it may be argued that use of a fair present value standard involves the corporation in the difficult matter of determining current values. See part II, 42 WASH. L. REV. at 171-72. Reductions of capital, however, should be relatively rare events, and in any event, accountants here generally attempt to determine such values in this context. See, e.g., AICPA, ACCOUNTING RESEARCH BULL. No. 43, ch. 7A (1953). Hence, the requirement does not seem unreasonable.

Segregation of the surplus arising from reductions of capital is necessary because an assets test is not imposed on distributions of capital surplus. A number of statutes impose such a test on distributions of capital surplus (and hence simply label surplus arising from reductions of capital as capital surplus) presumably in recognition of the strong resemblance between surplus arising from a contribution of a shareholder not placed in stated capital and surplus arising from a reduction of amounts attributed to stated capital. See, e.g., N.C. GEN. STAT. §§ 55-50(c)(3) (1965); Hills, Model Corporation Act 48 HARV. L. REV. 1334, 1364-65 (1935). While equation of capital surplus with stated capital would be a useful simplification in the New Act, short of such complete assimilation of capital surplus into stated capital it would seem that capital surplus ought to be more readily available than stated capital. Application of the assets test to surplus arising from reductions of capital but not to capital surplus generally achieves this result. More fundamentally, more stringent standards appear warranted on distributions from stated capital since creditor expectations concerning the maintenance of that level of assets in the corporation are much stronger than they are for maintenance of amounts of capital surplus.

If the surplus arising from capital reductions is labelled reduction surplus, then additional amendments will be necessary to indicate what uses are permissible.
assets be written down to fair present value in connection with any reduction of capital and requiring that any deficit in earned surplus be eliminated before any asset distribution is made from reduction surplus.

The assets test should be supplemented by provisions prohibiting asset distributions from reduction surplus when the net assets remaining after the distribution do not exceed the liquidation preference of any preferred shares outstanding. The preferred shareholders' interest in the total amount of stated capital could be protected either by provisions prohibiting reduction of stated capital below their liquidation preference or by provisions authorizing a class vote for even non-voting shares in connection with reductions of capital other than those involving cancellation of shares acquired by the corporation out of surplus or stated capital. The latter approach seems preferable.

Thus, directors should be authorized (and in some cases required, see text at note 699) to apply reduction surplus to the elimination of earned surplus deficits, see Cal. Corp. § 1910 (West 1955), and to distribute assets to shareholders subject to limitations discussed in text. Whether corporations should be authorized to reacquire their own shares is a matter of debate. Compare Cal. Corp. Code § 1906 (West 1955) limiting share acquisitions to preferred shares with N. C. Gen. Stat. §§ 55-52, -50 (1965) apparently permitting acquisition of shares from reduction surplus without application of the assets test. Subject to the equitable rules suggested in text infra beginning note 807 no reasons appear why corporations should not be able to acquire their own shares from reduction surplus so long as the assets test is met.

This requirement is basically modelled on the procedures that accountants follow under quasi-reorganizations. See AICPA, Accounting Research Bull. No. 43, ch. 7A, ¶ 4 (1953). It appears necessary to give creditors information regarding application of the assets test in the event a distribution is planned and to give shareholders the information they require regarding the corporation's profitability.

This requirement is imposed not so much for the creditors' benefit (their interest in this connection is adequately protected by the assets test) as for the benefit of shareholders who must interpret future financial statements. In short, it is simply an attempt to incorporate the accountants' requirement that earned surplus should emerge from a quasi-reorganization with a zero balance. See Miller, Quasi-Reorganizations in Reverse, 23 Accounting Rev. 154, 155 (1948).

These provisions would parallel those already in existence governing distributions of capital surplus. See Wash. Rev. Code § 23A.08.430(4) (1967) prohibiting asset distributions from capital surplus unless the liquidation preference of preferred shares is protected. See part II, 42 Wash. L. Rev. at 133.


Hills, Model Corporation Act, 48 Harv. L. Rev. 1334, 1376 (1935) would require both protection of the liquidation preference and a class vote whether or not the class otherwise votes. In view of the preferred shareholders' interest in stated capital (see text beginning note 676 and following note 702), the liquidation preference protection appears unnecessary.

Under the New Act, where a reduction occurs by means of a cancellation of
since it will permit preferred shareholders to agree to total stated capital less than their preference rather than perhaps forcing a reduction of the liquidation preference. And, of course, the class vote approach will permit preferred shareholders to protect their interest in the amount of their own stated capital. Finally, the interest of preferred shareholders in possible distributions of reduction surplus should be protected by provisions of the sort previously discussed in connection with distributions of capital contributions in excess of legal minima.

Protection of the common shareholders' interest would be better afforded if the corporation were required to disclose to its shareholders that reduction surplus had been applied by the directors to an earned surplus deficit, and to indicate to shareholders on financial state-

shares acquired by the corporation, the preferred shareholders have no say in the reduction procedure. See Wash. Rev. Code § 23A.16.110 (1965). Where the reduction occurs by means of an article amendment, the interest of the preferred (typically non-voting) is protected only to the extent that Wash. Rev. Code § 23A.16.030 (1965) authorizes the preferred to vote and to vote as a class on the amendment. That authorization is clear in the event that the preferred's par-value or liquidation preference is involved but is unclear where its own stated capital or the stated capital of common shares is involved. The latter issues depend on whether such amendment changes the "preferences, limitations or relative rights of the shares of such class." Wash. Rev. Code § 23A.16.030(5) (1965). Cf. Brill v. Blakely, 308 N.Y. 951, 127 N.E.2d 96 (1955) (holding that a reduction of preferred stated capital entitled preferred shareholders to receive the appraised value of their shares because it altered a "preferential right" of the shares); In Matter of Kinney, 279 N.Y. 423, 18 N.E.2d 645 (1939) (holding that a reduction of common stated capital gave preferred shareholders same right). S.E.C. authorities under the Public Utility Holding Company Act provision using similar language appear in BAYE & CARY at 1319 n.17. See also id. at 1320 & n.18 for arguments that preferred shares, if not entitled to a class vote in these circumstances, should be protected by a freeze on dividends to the common. For possible equitable limitations on capital reductions to prevent unfairness to preferred shares, see H. BALLANTINE, CORPORATIONS 631-40 (rev. ed. 1946). As to possible equitable protection of common shareholders in connection with a reduction, see Hay v. Big Bend Land Co., 32 Wn. 2d 887, 204 P.2d 488 (1949).

No valid reason appears as to why different standards should be applied to reductions of capital based on the way that the reduction occurs. But see N.Y. Bus. Corp. Law § 516 (McKinney 1963) which permits directors, subject to a liquidation preference protection clause, to reduce stated capital arising from amounts voluntarily transferred to stated capital or from no par shares. Disclosure must be made to the shareholders.

See discussion in part II, 42 Wash. L. Rev. at 139-40.

Cf. Cal. Corp. Code § 1910 (West 1955); Mich. Stat. Ann. § 21.43 (1963), N.Y. Bus. Corp. Act. § 517(4) (McKinney 1963) requires that shareholders must approve the application of capital surplus to the elimination of any deficit in the earned surplus account. Such approval seems unnecessary as to an application of reduction surplus to a deficit in view of the need for shareholder approval to create the reduction surplus and the requirement of notice to shareholders of the application. Application of capital surplus to a deficit should require the vote of shareholders by classes (whether or not entitled to vote by the articles) to protect the interest of preferred shareholders in such surplus (see part II, 42 Wash. L. Rev. at 139-40) and to dramatize the application of the surplus to a deficit in a one-class corporation.
ments that reduction surplus had been applied to the deficit for a period of ten years.\textsuperscript{706}

One last matter that may be raised in connection with reduction of capital is Professor Miller’s\textsuperscript{707} suggestion that the requirements and limitations imposed upon a reduction of capital be imposed upon the recognition of and distributions from unrealized appreciation. The principal effects of the adoption of that proposal in the present context would be that a shareholder vote would be required before the appreciation would be recognized and creditors would be informed of the recognition and the valuation process before any distributions are made. While this procedure would not eliminate the problems in computing current values or in maintaining liquidity previously noted,\textsuperscript{708} the attendant publicity should curb excess valuations without depriving corporations of the possibility of recognizing unrealized appreciation in appropriate cases.\textsuperscript{709} Consideration should be given to this means of dealing with the problem of unrealized appreciation.

\textsuperscript{706}See PA. STAT. ANN. tit. 15 § 1704(c) (1967); OHIO REV. CODE ANN. § 1701.32(G) (1964) (5 years). AICPA, ACCOUNTING RESEARCH BULL. NO. 46 (1956) appears to limit the required period for “dating” earned surplus to ten years, barring exceptional circumstances. The S.E.C. apparently agrees generally with this view, although it reserves the right to discontinue dating earned surplus at an earlier date in the light of special circumstances. See RAPPAPORT, supra note 681, at 3.30. Since no harm should arise from a prolonged “dating” period, ten years is suggested as a statutory standard.

\textsuperscript{707}See Miller, Quasi-Reorganizations in Reverse, 23 ACCOUNTING REV. 154, 156-57 (1948). See also Erickson, Quasi-Reorganizations and Related Tax Effects, 6 ARTHUR ANDERSEN CHRONICLE 173 (July 1946) ; and W. PATON & W. PATON, JR. ASSET ACCOUNTING 345-49 (1952).

Miller would require, consistent with the requirements in a quasi-reorganization, that any earned surplus in existence at the date of reorganization be capitalized and that earned surplus be dated as of the date of reorganization. On the basis of previous analysis, it would appear that earned surplus ought to be exhausted before unrealized appreciation is utilized. See part II, 42 WASH. L. REV. at 136-41; 148-53. PATON & PATON, supra, at 346-48, consistent with the reduction of capital analogy, would credit unrealized appreciation to shareholders' equity.

\textsuperscript{708}See part II, 42 WASH. L. REV. at 152-53, 171-73.

\textsuperscript{709}In view of the extensive list of problems arising in connection with the use of unrealized appreciation as a source for asset distributions, see part II, 42 WASH. L. REV. at 151-53, 171-73, some justification must be offered for recognizing any use of appreciation. A ready example is a closely-held corporation whose asset appreciation has caused the value of its shares to be far greater than its stated capital and surplus. If that corporation under a restriction on transfers of shares agreement must repurchase the shares, even on an installment purchase (see text infra beginning note 799), there are substantial possibilities that it will be unable to complete the purchase if the unrealized appreciation is not recognized. (See the two most recent cases involving recognition of unrealized appreciation, Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737 (4th Cir. 1960), and Baxter v. Lancer, Inc., 213 F. Supp. 92 (E.D.N.Y. 1963).) In short, just as there may be cases where corporations with earned surplus should not as a matter of good financial policy declare dividends, there are also cases where application of existing general rules would permit no dividend where good financial judgment would permit a distribution. But since managements may be too eager to classify their corporation as one in the second category, some check upon their discretion, whether by the

Under the old act, a corporation could redeem its preferred shares only if the fair value of the corporation's assets after the redemption was at least equal to the total amount of its debts and liabilities plus the amount of its capital stock as so reduced. In contrast, corporations were permitted to purchase their own shares only so long as the purchase would not cause any impairment of the capital stock of the corporation. The Washington Supreme procedures regulating capital surplus distributions as previously discussed (see part II, 42 WASH. L. REV. at 153) or, better yet, by reduction of capital proceedings appears warranted.

The corporation must file a certificate with the secretary of state and the office of the auditor for the county in which the corporation has its registered office showing compliance with share provisions governing redemption, the corporation's financial condition, and the effect of the redemption on the corporation's financial structure. Redeemed shares are cancelled. The recording of the certificate hence has the effect of reducing the corporation's stated capital by the amount thereof applicable to the redeemed shares.

This provision, which does not appear in the UNIFORM BUSINESS CORPORATION ACT, was added to the old act in 1939. See Wash. Sess. Laws of 1939, ch. 143 § 15. It bears obvious resemblance to a provision that had been the law prior to adoption of the Uniform Act. See Wash. Sess. Laws of 1919, ch. 172 § 1.

The Washington Supreme Court held that corporations were not empowered to traffic in their own shares and that the trust fund doctrine prohibited share reacquisitions unless undertaken in connection with reductions of capital. See, e.g., Barto v. Nix, 15 Wash. 563, 568, 46 P. 1033, 1034 (1896) (dictum); Tait v. Pigott, 32 Wash. 344, 347, 73 P. 364, 365 (1903); Kom v. Cody Detective Agency, 76 Wash. 540, 543, 136 P. 1155, 1156 (1913); State ex rel. Howland v. Olympia Veneer Co., 138 Wash. 144, 150, 244 P. 261, 263 (1926). But see Yeaton v. Eagle Oil & Refining Co., 4 Wash. 183, 29 P. 1051 (1892). The court in these cases was helped in reaching its conclusion by statutory language prohibiting withdrawal, division, or payment of a corporation's capital stock unless by means of reduction of capital (see, e.g., Kom v. Cody Detective Agency, supra). The Uniform Act contained no such language (nor any other relating to the problem) but the court read WASH. REV. CODE §§ 23.01.250, .260 (1958) as having the same effect as the old statutes. See Whittaker v. Weller, 8 Wn. 2d 18, 21, 111 P.2d 218, 220 (1941). The only exceptions to the rule that the court recognized were for stock received from shareholders in cancellation of indebtedness (see Barto v. Nix, 15 Wash. 563, 569, 46 P. 1033, 1034 (1896) (subscription indebtedness); Mitchell v. Blue Star Mining Co., 98 Wash. 191, 167 P. 130 (1917) (stock assessments); and Child v. Idaho Hewer Mines, 155 Wash. 280,
Court appears to have interpreted "impairment of capital stock" to mean that purchases can be made only out of surplus.\textsuperscript{113} Thus, assuming a constant price level,\textsuperscript{114} a corporation under the old act could redeem preferred shares out of stated capital but could purchase shares—redeemable or not—only out of surplus.

Redeemable shares that had been called in were cancelled and retired and the corporation's stated capital reduced accordingly.\textsuperscript{115} The status of purchased shares was not clear under the old act.\textsuperscript{716} All states now permit corporations to acquire their own shares. See 1 Model Act Ann. § 5 ff (1960).

The court in Jackson v. Colagrossi, 50 Wn. 2d 572, 574, 575, 313 P.2d 697, 699 (1947) interpreting the clause made the following inconsistent statements:

However, by the 1947 amendment, a corporation was permitted to repurchase its own shares provided there was an earned surplus with which to pay therefor. . . . The legislature in authorizing a corporation to purchase its own stock, copied the Delaware statute almost verbatim. . . . The Delaware statute was construed in In re International Radiator Co., 10 Del. Ch. 358, 92 Atl. 255, to mean that such repurchase could only occur when it would not diminish the corporation's ability to pay its debts or lessen the security of its creditors by reducing the amount of the assets of the company below the amount represented by the aggregate outstanding shares of the capital stock of the company.

Presumably the court meant to say net assets in the last clause quoted. It also seems that the court intended the latter interpretation of the statute as none of the cases it cites uses an earned surplus test. See In re International Radiator Co., supra; Ashman v. Miller, 101 F.2d 85 (6th Cir. 1939). Both cases use a surplus test interchangeably with the impairment of capital test, as do H. Ballantine, Corporations 611-12 (rev. ed. 1946) and Note, 23 Wash. L. Rev. 149, 150 (1948), also cited by the court. Thus, it seems reasonable to conclude that the court intended to impose a surplus test. See also Burk v. Cooperative Finance Corp., 62 Wn. 2d 740, 751, 384 P.2d 618, 625 (1963) where the court at one point seems to equate the impairment of capital stock test with a surplus test.

The court in In re West Waterway Lumber Co., 59 Wn. 2d 310, 318, 367 P. 2d 807, 812 (1962) held that Wash. Rev. Code §23.01.120 (1958) applied to all Washington corporations, rather than to only those formed after the statute was adopted. No mention of the vested rights doctrine was made. See part I, 41 Wash. L. Rev. at 208-12 and note 940 infra.

If the value of a corporation's assets has appreciated over their original cost, the corporation's capacity to redeem preferred shares would be increased. The effect of such a change in the corporation's capacity to reacquire shares depends on how the court interprets the impairment of capital stock or surplus test. Delaware courts appear to read the surplus test to preclude dividends (and presumably share purchases) from unrealized appreciation. See Kingston v. Home Life Ins. Co., 11 Del. Ch. 258, 272, 101 A. 898, 904 Ch. 1917, aff'd without note of the point, 11 Del. Ch. 428, 104 A. 25 (Sup. Ct. 1918). Moreover, this result is strongly suggested by the dividend provisions in the old act. See Wash. Rev. Code §23.01.250(4) (a) (1958); part II, 42 Wash. L. Rev. at 148. But see Mountain State Steel Foundries, Inc. v. Commissioner, 284 F.2d 737, 741 (4th Cir. 1960) interpreting a West Virginia impairment of capital statute regulating share repurchases to permit conservative use of unrealized appreciation; and Baxter v. Lancer Indus., Inc., 213 F. Supp. 92, 96 (E.D.N.Y. 1963) interpreting Florida surplus statute to permit same result.

If the value of a corporation's assets declines it would appear that both capacities are decreased. See part II, 42 Wash. L. Rev. at 154-57.

\textsuperscript{715} WASH. REV. CODE §23.01.440(1958).

\textsuperscript{716} None of the post 1947 cases has offered any hints on the subject. The limited number of Washington cases prior to 1947 permitting reacquisition of the corporation's own shares suggest only that the shares could be resold free of the general
nor were the consequences of the sale of such shares stated.\textsuperscript{717} Apparently cancellation of such shares could occur only with the formality of a reduction of stated capital\textsuperscript{718} and dividends of such shares had to meet the requirements for dividends of unissued shares.\textsuperscript{719}

Share redemptions and purchases under the New Act are subject to the general requirement that the corporation must be able to pay its debts as they arise in the ordinary course of business both before and after the redemption or purchase.\textsuperscript{720}

Share purchases under the New Act are further regulated by two sets of provisions that appear to overlap. The first set of provisions appears in the definitions section of the Act. "Treasury shares" are defined as shares of a corporation which have been issued, have been subsequently acquired by the corporation, and have not, by reason of the acquisition or other action, been cancelled or restored to the status of authorized but unissued shares.\textsuperscript{721} The Act then defines "net assets" as the amount by which the total assets of a corporation, excluding treasury shares, exceed the total debts of the corporation.\textsuperscript{722} Surplus is next defined as the excess of the net assets of a corporation over its stated capital.\textsuperscript{723} Finally, stated capital is defined in terms of shares that have been issued.\textsuperscript{724} These definitions are identical to provisions in the 1950 version of the Model Act\textsuperscript{725} which were construed by the draftsmen to cause a reduction in surplus in connection with the acquisition by a corporation of its own shares.\textsuperscript{726}
The second set of provisions in the New Act generally duplicate the financial regulations added to the Model Act in 1957 as an amendment to its provision empowering corporations to purchase their own shares. Solvent corporations can purchase their own shares only to the extent of their unreserved and unrestricted earned surplus, or, if (1) the articles permit, (2) the corporation is a regulated investment company, or (3) a majority of shares entitled to the reacquired shares. Since treasury shares remain "issued," stated capital must remain constant; thus, surplus, either earned or capital, must be reduced.

Section 5 of that Act permitted corporations to acquire their own shares "out of" earned surplus primarily and capital surplus secondarily. "Out of" as used in this connection usually means that the named surplus account is reduced. (See, e.g., Wash. Rev. Code § 23A.08.420(1) (1965).) Despite the presence of § 5 in the Act, the draftsmen indicated that the definition sections in the Act had the effect of making surplus unavailable for purchases of shares and for payment of dividends as long as the shares purchased were held as treasury shares. Hence, they seemed to have interpreted the definition provisions to give rise to a reduction of surplus on acquisition of treasury shares. As to the commonness of this construction, see Hackney, The Financial Provisions of the Model Business Corporation Act, 70 Harv. L. Rev. 1357, 1392 n.166 (1957).

The definition provisions have been interpreted by most commentators on the Act to give rise to a reduction of surplus on acquisition of treasury shares. See Hackney, id. at 1393; D. Herwitz, Business Planning 423 (1966) (endorsing Hackney's position); Sprouse, Accounting for Treasury Stock Transactions: Prevailing Practices and New Statutory Provisions, 59 Colum. L. Rev. 882, 888-90 (1959); and Kessler, Share Repurchases Under Modern Corporation Laws, 28 Fordham L. Rev. 637, 641 n.15 (1960).


Wash. Rev. Code § 23A.08.030 § 1 (1967) states that purchases of a corporation's own shares, whether direct or indirect, shall be made only to the extent stated in the text immediately following. This language would prevent purchase of the corporation's shares by any arrangement with an individual or corporation to purchase the shares for its account, absent compliance with the surplus limitations. However, the application of the language to a parent-subsidiary situation is far from clear. Does the language mean that a subsidiary cannot purchase the parent's shares if the parent has no surplus but the subsidiary does? See Clarke, The New Colorado Corporation Act, 35 Dicta 317, 329 (1958). Are the two corporations to be taken on a consolidated basis? Or may subsidiaries purchase the parent's shares to the extent of their own surplus? The appropriate answer seems to be purchases of the parent's shares can be made only to the extent of consolidated earned surplus, as there seems to be little justification for permitting a subsidiary with surplus to purchase shares of a parent with a deficit larger than the subsidiary's surplus. If the suggestions earlier made are accepted, see part II, 42 Wash. L. Rev. at 166-68, the share purchase provision should be amended to make clear that neither the parent nor any subsidiary would be permitted to purchase either the parent's or outstanding subsidiary shares when the consolidated group has no earned surplus. Absent those changes, the New Act provision should be amended to clarify which corporation's surplus is relevant. See, e.g., Cal. Corp. Code § 1705 (West 1955).

This provision was added to the previously adopted Model Act provision by Wash. Sess. Laws of 1967, ch. 190 § 8. Special provisions for regulated investment companies appear warranted by the common knowledge that mutual funds' shares may be subject to shareholder redemption options and by the special type of creditor such corporations would have. The most interesting aspect of the Washington addition is that it did not authorize such purchases out of stated capital. For statutes so providing, see Md. Ann. Code art. 23, § 32 (b) (2) (1957); N.C. Gen. Stat. § 55-52 (b) (5) (1965); and Ohio Rev. Code Ann. § 1701-35 (5) (Page 1962).

Wash. Sess. Laws of 1967, ch. 190 § 8 changed the required shareholder vote from two-thirds, as it was in Model Act § 5, to a majority, apparently with a view
vote thereon approve, then to the extent of its unreserved and unrestricted capital surplus. The surplus used as a measure of the corporation's right to acquire its own shares is restricted so long as the shares are held as treasury shares; the restriction is removed pro tanto upon disposition or cancellation of any such shares.\textsuperscript{730}

The combined effect of both sets of New Act provisions appears to be that generally the purchase by a corporation of its own shares causes both a reduction of surplus (presumably earned if available)\textsuperscript{731} and a restriction of an equal amount of a specified type of surplus.\textsuperscript{732}

However, Professor Rudolph has suggested that the two sets of provisions can be reconciled by interpreting the first set as incorporating into the statute the cost method of accounting for treasury shares\textsuperscript{733} whereby the amount expended for treasury shares is treated as a floating negative net worth item which effectuates the surplus to being consistent with the provisions governing distributions from capital surplus. See Wash. Rev. Code § 23A.08.430(2) (1967). One critical difference between the two provisions remains: under Wash. Rev. Code § 23A.08.430(2) (1967), the required vote is a majority of the outstanding shares of each class whether or not entitled to vote thereon by the provisions of the articles of incorporation of the corporation whereas under Wash. Rev. Code § 23A.08.030 (1967) the required vote is simply a majority of all shares entitled to vote thereon. Thus, non-voting shares are enfranchised and vote as a class on distributions of capital surplus but do not vote at all on purchases of shares from capital surplus. For better provisions, see note 761 infra.

One other omission from Wash. Rev. Code § 23A.08.030 (1967) that should be noted is the lack of a provision specifically recognizing limitations upon a corporation's ability to purchase its own shares in its articles of incorporation. Such a provision qualifies a corporation's right to pay dividends (see Wash. Rev. Code § 23A.08.420(1) (1965)) and no reason is apparent why a similar provision should not be recognized in connection with treasury share purchases.

\textsuperscript{730} This language presumably means that if half of the treasury shares are sold or cancelled, half of the restriction is removed. But see Hackney, \textit{The Financial Provisions of the Model Business Corporation Act}, 70 Harv. L. Rev. 1357, 1394 (1957) who suggests it may also be construed to mean that "if 100 shares are bought for $100 and 50 are resold for $80, 4/10 of the restriction is lifted." This would seem to say that if part or all of the shares are cancelled, none of the restriction is lifted—a result contrary to statutory language.

\textsuperscript{731} Sprouse, \textit{Accounting for Treasury Stock Transactions: Prevailing Practices and New Statutory Provisions}, 59 Colum. L. Rev. 882, 889 (1959) concludes that the appropriate surplus account to be reduced first is capital surplus on the ground that capital surplus is the "residual amount" under the Model Act. The draftsmen's comment to Model Act § 5 (1950 rev.) clearly states that the effect of the surplus reduction is to make \textit{earned} surplus unavailable. Moreover, the general structure of the Act clearly suggests that unspecified charges will be made to earned rather than capital surplus. See part II, 42 Wash. L. Rev. at 169; Hackney, supra note 730, at 1390. Rudolph, \textit{Accounting for Treasury Shares Under the Model Business Corporation Act}, 73 Harv. L. Rev. 323, 324 (1959) also reaches this conclusion.

\textsuperscript{732} This is the conclusion of most of the commentators on the Model Act predecessor provisions. See Hackney, supra note 730, at 1393; D. Herwitz, \textit{Business Planning} 423 (1966); Sprouse, supra note 726, at 888-90, and Kessler, \textit{Share Purchases Under Modern Corporation Laws}, 28 Fordham L. Rev. 637, 641, n.15 (1960).

restriction required by the second set of provisions.\textsuperscript{734} It would appear hazardous to rely on this construction of the Act pending court interpretation. The Act gives no hint of recognizing a negative net worth item.\textsuperscript{735} Moreover, in connection with possible distribution of treasury shares as a share dividend, the Act uses language indicating that the acquisition of shares gives rise to a reduction of surplus rather than a restriction.\textsuperscript{736} Finally, as the material following will indicate, a system involving a double surplus effect is feasible and may resolve some of the problems that would arise with only a restriction approach.\textsuperscript{737}

The second set of New Act provisions goes on to provide that "notwithstanding the foregoing limitation", solvent corporations may acquire their own shares for the purpose of eliminating fractional shares, collecting or compromising indebtedness to the corporation, paying dissenting shareholders entitled to payment for their shares under the provisions of the Act, effecting, subject to the other provisions of the Act, the retirement of its redeemable shares by redemption or by purchase at a price not to exceed redemption price.\textsuperscript{738} The other provisions regulating redemption or purchase of redeemable shares prohibits such action when the result would be to reduce the corporation's

\textsuperscript{734}Rudolph, supra note 731, at 324-26. This construction was endorsed by Ray Garrett, a member of the ABA Committee on Corporate Laws, in Garrett, Treasury Shares Under the Model Business Corporation Act, 15 Bus. Law. 916, 918 (1960). Hackney, supra note 730, at 1393 n.167, offers and rejects one other means of reconciling the two sets of provisions:
The only way in which the reduction of surplus arising from the definition of net assets in § 2 (i) and the restriction on surplus imposed by § 5(b) can be reconciled is to require a reduction in every case and to say that the reduction effectuates the restriction and so a further restriction is unnecessary. The restriction language in §5(b) then would become completely superfluous, and the status of the surplus which would arise upon disposition of the shares is again put in doubt. This was obviously not the intention of the 1953 amendments to the Model Act.

\textsuperscript{735}See Rudolph, supra note 731, at 326; see also Garrett, Capital and Surplus Under the New Corporation Statutes, 23 Law & Contemp. Prob. 239, 242 (1958) ("The Model Act proposes that the interests of shareholders be identified in three categories: stated capital, capital surplus, and earned surplus."")

\textsuperscript{736}WASH. REV. CODE § 23A.08.420(3) (1965) and its Model Act predecessor, § 40 (c), refer to shares acquired "out of surplus of the corporation."

\textsuperscript{737}See text beginning note 745 infra and notes thereto.

A number of the states that have otherwise adopted the Model Act have amended the provisions to eliminate the problem outlined by Hackney and Sprouse. See WIS. STAT. § 180.02 (1961) (providing that treasury shares, while not net assets, are to be treated as such in computing capital surplus); S.C. Bus. Corp. Act §§ 12-11.2(0), 12-15.17 (1962) (restating test as out of earned surplus; redefining net assets) (see Folk, The Model Act and The South Carolina Corporation Law, 15 S.C. L. Rev. 275, 342 n.228 (1963)); ARK. STAT. ANN. § 64-105 (1965) (restating test to out of earned surplus); and Wyo. Bus. Corp. Act § 5 (1961) (restating test as out of earned surplus) (Professor Rudolph was Reporter for the Wyoming Revision Committee).

\textsuperscript{738}WASH. REV. CODE § 23A.08.030 ¶ 3 (1965).
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.\(^7\)

It is difficult to determine precisely what the limitation in the second set of provisions is.\(^4\) The most sensible construction seems to be that the surplus limitation and restriction appearing in the second set of provisions can be ignored in making special purchases of the types listed.\(^7\) This construction would mean that purchases for such purposes would be permitted as long as sufficient surplus was available to be reduced under the first set of provisions. Redeemable shares would be excepted from even the latter requirement as

\(^7\) WASH. REV. CODE § 23A.16.090 (1965).

It is unclear from any of the provisions here concerned what type of share is "redeemable". As earlier noted, the share authorization provisions in the New Act seem to allow redeemable common shares. See part I, 41 WASH. L. REV. at 227 n.111, 229. If this interpretation were used in connection with the purchase and redemption provisions, solvent corporations with only redeemable common shares outstanding could redeem all their outstanding stated capital from stated capital. While this power might be useful in closely-held corporations, see note 780 infra, it appears to undercut the thrust of the regulations regarding treasury shares. Id. Hence, redeemable shares for this purpose should be interpreted as any shares callable by a corporation which has a non-callable class of shares outstanding.

It seems reasonably clear that provisions restricting transferability and giving the corporation an option to purchase the shares do not create redeemable shares. See, e.g., In the Matter of West Waterway Lumber Co., 59 Wn. 2d 310, 367 P.2d 807 (1962); Dodd, Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law, 89 U. PA. L. REV. 697, 723 (1941).

This result can be reached by determining that the only real "limitation" in the second set of provisions is the limitation of purchases to surplus and by treating the restriction merely as a device to effectuate the limitation. Two states that have adopted the Model Act provision generally have amended it so as to qualify the surplus limitation specifically rather than the foregoing provisions generally. See CONN. GEN. STAT. REV. § 33-358(d) (1960); WIS. STAT. ANN. § 180-385 (2) (1957).

Construction problems with the "notwithstanding" clause abound even if the restriction provisions in the New Act are found to be the only regulations of share purchases. If a corporation has no surplus and purchases its own shares under one of the exceptions, what source is reduced in connection with the transaction? Stated capital? Or, as Hackney supra note 732 at 1398 suggests, is a surplus deficit created? If stated capital is to be charged, as would seem to be intended, is the effect of the notwithstanding clause to make stated capital available for such transactions even though surplus is available? The answer here would appear to be no in view of the general protection of stated capital built into the Act. See part II, 42 WASH. L. REV. at 138 n.414. Assuming the provision is limited to cases where surplus is unavailable, precisely when is it unavailable? Suppose the directors decide to reserve all of the corporation's earned and capital surplus. May exceptional purchases now be made from stated capital? Suppose the corporation has no earned surplus and its shareholders will not permit its capital surplus to be used to purchase its shares. May the exceptional purchases be made? Some of these questions can be resolved in connection with clarification of the statute as to the effects of various treasury share transactions upon the corporation's accounts. See text following note 779 infra. But the remainder can be finally resolved only by the addition of clauses requiring surplus to be exhausted before stated capital can serve as a source. Cf. part II, 42 WASH. L. REV. at 137-38 and note 782 infra.
they are cancelled on acquisition and hence stated capital, rather than surplus, would be reduced on their acquisition. Thus, redeemable shares can be redeemed or purchased at a price not to exceed their redemption price even in the absence of surplus.

Acquired shares that are not redeemable—treasury shares—are deemed by the New Act to be "issued" but not "outstanding" shares. Because they are not "outstanding", treasury shares are not entitled to vote, are not counted in determining the required vote under the various provisions of the Act that specify a required vote, and are not eligible to receive any type of dividends. Treasury shares are not covered by the New Act preemptive right provision and may be sold by directors for such consideration as they deem appropriate. In the event of sale of the shares, the surplus restriction, if one was imposed in connection with the acquisition of the shares, is removed pro tanto. The secondary effects of treasury share sales upon surplus are not clear under the New Act. If the proceeds equal the cost of the shares, then apparently the surplus reduced in connection with the acquisition of the shares is restored. If the

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742 See WASH. REV. CODE § 23A.16.100 (1), (4) (1965). The difficult question not answered by the Act is what account is charged for any difference between the redemption price of shares (or their purchase price) and the amount of stated capital attributable to the shares. Hills, Model Corporation Act, 48 HARV. L. REV. 1334, 1335, 1360 (1935) solved the problem by requiring that stated capital for redeemable shares not be less than the redemption price. Such a provision appears overly restrictive. For other statutory solutions to the problem, see note 797 infra.


744 See WASH. REV. CODE § 23A.08.300 (1965).


Hackney, supra note 730, at 1399-1400 argues that the act should be amended to permit treasury shares to receive share dividends. Otherwise corporations would suffer where the treasury shares were being held as a hedge against an intervening price rise in fulfillment of future obligations to sell or deliver shares when the obligation is subject to anti-dilution provisions. See also Jones, Should Treasury Stock Participate in a Stock Dividend?, 15 ARTHUR ANDERSEN CHRONICLE 37 (1954); Blough, Current Accounting & Auditing Problems, 96 J. ACCOUNTANCY 478 (1953) for evidence that corporations do desire to declare share dividends for such purpose. While there appears to be little harm that might come from such an authorization, the corporation's need for a share dividend in the circumstances, as against simply reserving authorized shares to cover the future obligations, does not seem strong enough to warrant changing the New Act provision.

746 See WASH. REV. CODE § 23A.08.220 (1965). It therefore seems unlikely that such shares will be subject to the right. See part I, 41 WASH. L. REV. at 224.

747 See WASH. REV. CODE § 23A.08.150 (1965) and part I, 41 WASH. L. REV. at 243.

748 See WASH. REV. CODE § 23A.08.030 ¶ 2 (1967).

749 The draftsmen's comment to Model Act § 5 (1950 rev.) indicates that on cancellation the surplus reduced would be restored. If such is the case, then a break-even sale should certainly have the same effect. Qualification is necessary, however, as the resulting entries—a debit to cash and a credit to earned surplus—are not likely to leave accountants comfortable absent clear statutory direction. See, e.g., AICPA, ACCOUNTING RESEARCH BULL. No. 43, ch. 1 § B (1953); SEC, ACCOUNTING RELEASE No. 6 (May 10, 1938); and AMERICAN ACCOUNTING ASSOCIATION, ACCOUNTING AND REPORTING STANDARDS FOR CORPORATE FINANCIAL STATEMENTS 7
proceeds are less than the cost of the shares, apparently the surplus first reduced remains permanently reduced by the difference.\textsuperscript{760} In the event the proceeds are greater than the cost of the shares, apparently the surplus first reduced is restored and some type of surplus—unspecified by the Act, but presumably capital surplus—is increased by the amount of the excess.\textsuperscript{761}

Treasury shares may be cancelled by a resolution of the board of directors.\textsuperscript{762} The effects of cancellation are that the surplus restriction, if one was imposed, is removed pro tanto,\textsuperscript{763} stated capital is reduced by that part of the stated capital which was represented by the cancelled shares, the shares so cancelled are restored to the status of authorized but unissued shares,\textsuperscript{764} and the surplus arising out of the reduction of stated capital apparently is capital surplus.\textsuperscript{765}
Finally, treasury shares may be distributed as share dividends. The apparent consequences of such a distribution are that the surplus restriction, if one was imposed, is removed pro tanto, and the shares are shifted to the category of outstanding, issued shares.

The financial effects of a share acquisition on a corporation can be determined only after some later event occurs. If the shares are cancelled, distributed as a share dividend, or resold at a loss, the effects are largely those of a cash dividend: the corporation's assets have been diminished with nothing to replace them. If, however, the shares are resold for an amount at least equal to their cost, the effect is similar to a sale from the selling shareholder to the ultimate
to purchase all of a corporation's stock. The difficulty with this assertion is the direction in Wash. Rev. Code § 23A.16.130 ¶ 1 (1965) (and Model Act § 63) that surplus created by or arising out of a reduction of stated capital shall be capital surplus. Reasonably interpreted, the latter provision should override the draftsmen's comment at least insofar as any surplus finally arising from the reduction of stated capital. D. Herwitz, *Business Planning* 426 (1966) reaches this result by treating the cancellation as a type of resale-for-less-than-cost-case, and by viewing the cancellation as a disposition of the shares for zero consideration. To the same effect is Sprouse, supra note 731, at 892-93.

The language in Wash. Rev. Code § 23A.08.420(3) (1965) indicates quite clearly ("Dividends may be... paid in its own shares out of any treasury shares that have been required out of surplus of the corporation") that surplus is not effected by the distribution of treasury shares as a share dividend. Surplus is reduced when the shares were acquired and this supports the share distribution. In final effect, then, the combination of transactions is indistinguishable from a dividend.
buyer with the corporation as an intermediary.\textsuperscript{760} The substantial possibility of dividend effect, particularly when the corporation’s fortunes wane, has led to the common requirement that such purchases be made only to the extent, and in the circumstances, that the corporation could freely pay the funds to be expended as a dividend.\textsuperscript{761} In view of this framework, the double surplus requirement apparently imposed by the New Act cannot be supported on financial grounds\textsuperscript{762} and hence should be eliminated.

The next facet of the New Act that should be re-examined is its determination that shares reacquired by a corporation are “issued” but not “outstanding”.\textsuperscript{763} It is difficult to understand how a corporation can own part of itself.\textsuperscript{764} Indeed, this conception of reacquired...
shares does much to foster the discredited analysis of the shares as assets.\textsuperscript{765} It would seem far sounder to view such shares, as Ballantine\textsuperscript{766} and most accountants do,\textsuperscript{767} as reverting to the status of authorized, unissued shares. Such a change would mean that directors could no longer issue "treasury shares" free of the general consideration requirements.\textsuperscript{768} However, that exception has been subject to considerable abuse in the past and most of its beneficial

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for a valuable consideration if its charter law permits—but that is a mere incident of incorporation which is applicable to unissued as well as issued shares. Treasury shares are not a corporate "asset" and cannot be considered as an asset in computing net assets or surplus available for dividends or share purchases. They have no more value to the corporation than ordinary unissued shares, which is nil. They are not a property, interest or claim and not a form of self-ownership.


\textsuperscript{765} Treasury shares were once commonly shown on the corporation's balance sheet as an asset. See Hills, Statement of Legal Concepts of Accounting, 30 IOWA L. REV. 214-15 (1951); R. AMORY & C. HARDER, MATERIALS ON ACCOUNTING 324 (3d ed. D. Herwitz & D. Trautman 1958). (On the role of this concept in the historical development of treasury share regulations, see Nussbaum, Acquisition By A Corporation of Its Own Stock, 25 COLUM. L. REV. 971, 978 (1935).) Generally accepted accounting principles still permit display of treasury shares as an asset "in some circumstances" (e.g., when acquired for the specific purpose of resale to employees). See AICPA, ACCOUNTING RES. BULL. No. 43 ch. I B (4) (1953); STATUS OF ACCOUNTING RESEARCH BULLETINS, OPINION OF THE ACCOUNTING PRINCIPLES BOARD, OPINION No. 6 § 12 (b) (1965); L. RAPPAPORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 14.18 (2d ed. 1966). However, "the vast majority of accounting authorities do not recognize any legal basis for showing treasury shares as an asset." R. Wixon, ACCOUNTANT'S HANDBOOK 21.33 (4th ed. 1956). See also W. PATON & W. PATON, JR., CORPORATION ACCOUNTS AND STATEMENTS 189 (1955) (analogizing acquisition of treasury shares to retirement of a seasonal bank loan).

The statement in WASH. REV. CODE § 23A.04.010(9) (1965) that "net assets means the amount by which the total assets of a corporation, excluding treasury shares, exceed the total debts of the corporation" (and its Model Act predecessor, § 2 (i)) apparently was intended in part to end the controversy. See G. HILLS, THE LAW OF ACCOUNTING AND FINANCIAL STATEMENTS 143 n.17 (1957) and sources cited therein. However, the approach adopted heavily implies that for purposes other than the computation of net assets, treasury shares are assets. But see Hackney, supra note 730 at 1394 n.169 where the author reads the Model Act provisions as preventing display of treasury shares as assets.

If the contraction of capital approach to reacquired shares is adopted, there can be no argument that reacquired shares are assets. The approach would prevent reacquired shares from being displayed as assets even in the exceptional circumstances now approved but Wixon's statement supra indicates that this deprivation would scarcely be significant enough to block adopting the approach.


\textsuperscript{768} See WASH. REV. CODE § 23A.08.150 § 3 (1965).
aspects could be achieved by relaxation of the requirement that par value shares must always be sold for par, as previously suggested.\textsuperscript{769} Another effect of the change would be that reacquired shares would be subject to the preemptive right.\textsuperscript{770} This extension would aid closely-held corporations and would not be onerous to publicly-held corporations in view of the numerous exceptions thereto and the statutory power to abolish the right.\textsuperscript{771}

The major difficulty with the "contraction of capital" approach to share reacquisitions becomes apparent when the operation of its supporting financial provisions is analyzed.\textsuperscript{772} Presumably such a statute would provide that share acquisitions could only be made to the extent of earned surplus. On reacquisitions stated capital applicable to the shares would be reduced immediately with the difference between the purchase price and stated capital charged to earned surplus, if positive, or capital surplus, if negative. A surplus restriction would be imposed to the extent of the reduction in stated capital (or purchase price if less than stated capital reduction) in recognition of potential dividend effects. On resale of the shares at a price equal to or greater than the amount of the restriction, the

\footnotesize{\textsuperscript{769}See Ballantine, The Curious Fiction of Treasury Shares, 34 Calif. L. Rev. 536, 538-39 (1946); Baker & Cary at 849; and part I, 41 Wash. L. Rev. at 243, 247.}

\footnotesize{\textsuperscript{770}See Wash. Rev. Code § 23A.08.220 (1965).}

\footnotesize{\textsuperscript{771}See part I, 41 Wash. L. Rev. at 221-24.}

\footnotesize{\textsuperscript{772}The text following models its entries basically upon the accounting technique devised to follow the contraction of capital theory. That technique, called the par value method of reporting reacquired shares, differs in one major respect from the entries set forth in text: on reacquisition, a treasury shares account is opened with a value equal to the stated capital value of the shares, rather than a direct reduction of stated capital. Accountants would make the latter entry but for the legal restrictions upon reducing stated capital. See, e.g., American Accounting Association, Accounting and Reporting Standards for Corporate Financial Statements 7 (1957). On the mechanics of the par value method, see R. Amory & W. Hardee, Materials on Accounting 327-30 (3d ed. D. Herwitzi & D. Traunman 1958); H. Finney & H. Miller, Principles of Accounting, Intermediate 130-31 (6th ed. 1965); J. Mauriello, Intermediate Accounting 493-97 (1950). For other views as to how to record the contraction of capital, see W. Paton & W. Paton, Jr., Corporation Accounts & Statements 190-204 (1955) (including the authors' controversial proposal to revalue the corporation's assets in connection with the contraction).}

Only Ohio currently uses the contraction of capital theory but its statutes differ in two significant respects from those described in text: (1) the only limitation imposed upon acquiring shares is that the fair value of the corporation's assets not be less than its liabilities and stated capital immediately after the acquisition (see Ohio Rev. Code Ann. § 1701.31 (c) (Page 1964)); (2) despite immediate reduction of stated capital (see Ohio Rev. Code Ann. § 1701.31 (A) (Page 1964)), the shares acquired are treated as issued but not outstanding (see Ohio Rev. Code Ann. §§ 1701.1 (K), (L) (Page 1964) and 1701.36 (O) (Page 1964)). The effects of "profits" and "losses" from transactions in the corporation's own shares upon the corporation's surplus are specified (see Ohio Rev. Code Ann. § 1701.32 (a) (Page 1964)) but it is unclear from the statute whether gains are measured on acquisition or resale. See Sprouse, supra note 731, at 897. On the operation of the Ohio act provisions generally, see Note, Accounting For Treasury Shares, 29 U. Cin. L. Rev. 235, 243-44 (1960).}
restriction would be lifted. Note, however, that the resale is treated as a sale of new shares, which means that any excess of the resale price over the amount of stated capital attributable to the shares would be capital surplus. Hence, even on a break-even sale at prices above the stated capital per share, earned surplus will be reduced and capital surplus increased in the amount of the excess of the purchase price over stated capital.\textsuperscript{773} But this defect, if indeed it is a defect,\textsuperscript{774} can be overcome by providing that on resale any excess of the price over stated capital may be used to restore earned surplus previously reduced.\textsuperscript{775}

If the "contraction of capital" theory is rejected, it then becomes relevant to choose either the surplus reduction or the surplus restriction technique as the means of effectuating the New Act's general limitation on purchases of treasury shares to surplus. The restriction technique is generally favored by accountants\textsuperscript{776} and apparently the Model Act draftsmen because of the ease with which earned surplus

\textsuperscript{773} Even where the resale price is less than the purchase price but above the stated capital value, the contraction approach causes a greater reduction in earned surplus than would occur under the reduction method. See R. Amory & W. Hardee, \textit{Materials on Accounting} 331 (3d ed. D. Herwitz & D. Trautman 1958).

\textsuperscript{774} Cf. Cal. Corp. Code §§ 1707, 1711, and 1714 (West 1955) providing that earned surplus is reduced in acquisition of treasury shares but that paid-in surplus is increased by the amount of any proceeds "insofar as an excess of net assets over the amount of stated capital results therefrom." \textit{Id.} (As to the operation of the quoted clause, see Buttmer, \textit{Statutory Influence on Treasury Stock Accounting}, 35 Accounting Rev. 476, 478 (1961).) Ballantine, \textit{The Curious Fiction of Treasury Shares}, 34 Calif. L. Rev. 536, 541 (1946) states: "The proceeds do not represent profits, but a new investment by the purchaser." 1 H. Ballantine & G. Sterling, \textit{California Corporation Laws} 309 (4th ed. 1966) states that the purpose of the California scheme is to limit and discourage speculation by a corporation in its own shares.

\textsuperscript{775} This provision may provoke a reaction from accountants who argue as Ballantine does in the preceding footnote that a new investment in a corporation cannot give rise to earned surplus. See, e.g., American Accounting Association, \textit{Accounting and Reporting Standards for Corporate Financial Statements} 7 (1957); W. Paton & W. Paton, Jr., \textit{Corporation Accounts & Statements} 206 (1955); Katz, \textit{Accounting Problems in Corporate Distributions}, 89 U. Pa. L. Rev. 764, 784 (1941); Hackney, \textit{supra} note 730, at 1393 n.166. However, it is difficult to distinguish a statute of the sort suggested and the provision in Wash. Rev. Code § 23A.08.170 ¶ 3 (1965) permitting directors on a merger or acquisition of substantially all the assets of another corporation for shares to allocate what would otherwise be capital surplus on the issuance of shares to earned surplus. On this general subject, see part II, 42 Wash. L. Rev. at 141-47.

\textsuperscript{776} See de Capriles, \textit{Modern Financial Accounting (Part II)}, 38 N.Y.U. Rev. 1, 30 (1963); Katz, \textit{supra} note 775, at 788. But see W. Paton & W. Paton, Jr., \textit{Corporation Accounts & Statements} 212 (1955). AICPA, \textit{Accounting Trends and Techniques} 263 (20th ed. 1966) indicates that over two-thirds of the companies surveyed owning treasury shares purchased for retirement carried them at cost, a part of the restriction technique. To this same effect is the table, \textit{id.}, at 156. Few companies deducted the cost of treasury shares from surplus. Yet, a majority of states' statutes, including those of New York, Delaware and California, call for a reduction of surplus on acquisition.
can be freed in the event of break-even resale of the shares.\textsuperscript{777} However, if the New Act were amended to spell out carefully the effect upon surplus of each type of treasury share transaction, as would seem necessary to provide planning certainty, the statute would be inordinately complex.\textsuperscript{778} A far simpler approach\textsuperscript{779} would reduce earned surplus (or capital surplus, if shareholders approve) at the time of acquisition, label surplus from cancellation of reacquired shares as capital surplus,\textsuperscript{780} make no surplus entry in the event of


\textsuperscript{779} These provisions, as do those previously discussed in connection with the contraction of capital theory, have the added benefit of prescribing the accounting technique for treasury shares, to which presumably accountants will adhere. See, e.g., Accounting Principles Board, Status of Accounting Research Bulletins, Opinions of the Accounting Principles Board, Opinion No. 6 ¶ 13 (1965). Considerable evidence exists that accountants in the past have not shown surplus restrictions on financial statements. See Rabel, Financial Statements Should Show Corporate Surplus Restrictions from Treasury Stock Purchases, 95 J. Accountancy 572 (1953); data noted in note 776 supra. But see Hackney, supra note 730, at 1392-93 n.166 who prefers the restriction technique in part because the method of accounting would then be left to the accountants. Note that the reduction of surplus technique will also answer problems regarding status of the shares as assets. See note 765 supra. Finally, the reduction technique seems to provide a neater solution to cases involving constructive retirement of the shares. Cf. Accounting Principles Board, Status of Accounting Research Bulletins, Opinions of Accounting Principles Board, Opinion No. 6 ¶ 12 (1965).

\textsuperscript{780} This provision would prevent the revolving cancellation and reacquisition possibility that Hackney and Rudolph see if the New (Model) Act restriction is viewed as the sole financial regulation of share acquisitions. See note 755 supra; Rudolph, supra note 731, at 326-31. The revolving cancellation and reacquisition possible in New York because of use of surplus generally for repurchases is defended by de Capriles and McAniff, supra note 778, at 1270, as a useful method in a close corporation for corporate acquisition of a deceased or retiring partner's shares without need of amending the articles of incorporation. They state that the dangers in the device are exaggerated in view of the solvency test protection for creditors. (See also, Katz, supra note 775, at 787). While the device may be of value in closely-held corporations, it would appear quite easy to get shareholder approval for distributions of capital surplus in such corporations. In any event, the privilege afforded under a revolving cancellation and reacquisition statute is in no way confined to closely-held corporations. The effect of a general grant of a revolving cancellation and reacquisition approaches abolishing stated capital protections in favor of a test based on equitable insolvency. Since the rest of the Act has not adopted this view, there seems to be no reason to do so with share repurchases.

Rudolph, supra note 731, at 331 suggests as an alternative approach, which would permit revolving cancellation and reacquisition, requiring the same procedure for cancellation of treasury shares as for other reductions of capital. (Cf. Pa. Stat.
distribution of the shares as a share dividend, and permit earned surplus restoration in the event of sale of shares purchased out of earned surplus up to the amount of the original purchase price.

An immediate question with such a statutory formulation is whether some types of share acquisitions should be permitted even in the absence of surplus. It is assumed that any such acquisitions from stated capital will be subject to both the equity and the bankruptcy tests of insolvency as previously suggested. Of the four exceptions to the second set of provisions in the New Act, the easiest to support is the one almost universally granted to purchases made in

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**Footnotes:**

781 Ballantine argues that surplus must be capitalized in connection with a share dividend of treasury shares, even though surplus was reduced in connection with the acquisition of the shares. See Ballantine, The Curious Fiction of Treasury Shares, 34 Calif. L. Rev. 536, 541 (1946); H. Ballantine & G. Sterling, California Corporation Laws 277 (4th ed. 1966). He relies on footnote dictum in Bass v. Commissioner, 129 F.2d 300, 305 n.3 (1st Cir. 1942) to the effect that such a distribution of treasury shares would not be a stock dividend for federal tax purposes as there had been no reduction of the corporation's earnings and profits. That case seems unpersuasive on the corporate point because the court assumed that state law will not require capitalization of surplus as the premise for its conclusion. It would seem that the appropriate entries on the transactions in question can best be determined by integrating the acquisition of the shares and their later distribution. Thus, the effect of the transactions would be similar to a dividend distribution in which each of the recipient shareholders took the cash received and purchased his pro rata share of the selling shareholders' shares. Under this scheme, treasury shares purchased out of surplus could then be issued as a share dividend without further surplus effects. This result would be produced under the contraction of capital theory if the amount of earned surplus capitalized is simply the par value of the shares concerned. (See text discussion infra beginning at note 825 concerning this point.) And such result would obtain under a restriction scheme. See Hackney supra note 730, at 1397. N.Y. Bus. Corp. Law § 511(d) (McKinney 1963) and S.C. Bus. Corp. Law § 12-15.15(2) (1962) so provide specifically. As to other protections that might be provided shareholders in connection with such dividends, see note 843 infra.

782 Both Wyo. Bus. Corp. Act § 5 (1961) and S.C. Bus. Corp. Act § 12-15.17 (1962) (essentially) retain the Model Act "notwithstanding" clause. To avoid questions as to whether purchases for the purpose noted can be made from stated capital even if surplus is available, the Act should be amended to provide purchases can be made from stated capital only in the absence of available surplus. For statutory form, see Hills, Model Corporation Act, 48 Harv. L. Rev. 1334, 1364 (1935). It would appear that capital surplus should be available for the exceptional purchases without shareholder vote since otherwise stated capital might be reduced but capital surplus would remain intact. Following the scheme earlier discussed, capital surplus attributable to junior classes should be exhausted first. See part II, 42 Wash. L. Rev. at 140.

Model Act § 5 (1953 rev.) permitted share purchases for the four purposes listed in Wash. Rev. Code § 23A.08.030 ¶ 3 (1967) notwithstanding possible insolvency as a result of the acquisitions. As the text following indicates, the advantages to the corporation and its shareholder groups from such purchases do not outweigh the creditors' interest when insolvency is imminent. Thus, the current New Act provision making such purchases subject to the insolvency test should be retained.

783 See note 761 supra and citations therein.

good faith compromise of a debt owing to the corporation.\textsuperscript{785} Neither the creditors of the corporation nor its various shareholder groups will be injured by such a transaction where it results in the corporation maximizing its return on the debts in question.\textsuperscript{786} The exception for purchases made to eliminate fractional shares, which is also common,\textsuperscript{787} seems acceptable in view of the de minimis effect that such transactions are likely to have on the corporation's assets and the record-keeping convenience resulting from the shares' elimination.\textsuperscript{788} The exception for purchases or redemptions of redeemable shares at a price not to exceed the redemption price, also common, has been forcefully supported on the grounds that redeemable shares are viewed by investors and creditors as a type of long-term loan that may be paid off at any time, and that management, usually representing common shareholders, would not undertake the transactions unless the common shareholders' interest would be stronger for the action.\textsuperscript{789} While these arguments support the general excep-

\textsuperscript{785} See Wash. Rev. Code § 23A.08.030(2) (1967). This exception was permitted even to the prohibition against acquisition of treasury shares extant in Washington prior to 1947. See, e.g., Barto v. Nix, 15 Wash. 563, 46 P. 1033 (1896), and cases cited in note 712. As to the generality of the exception, see 6A W. Fletcher, Corporations § 2857 (rev. ed. 1950); R. Stevens, Corporations 277 (2d ed. 1949); Levy, Purchase By A Corporation of Its Own Stock, 15 Minn. L. Rev. 1, 15-16 (1930).

Neither Wash. Rev. Code § 23A.08.030 (2) (1967) nor its Model Act predecessor, § 5(b), require that the compromise be made in good faith. Even though it seems clear that courts would imply such requirement, Texas amended the Model Act provisions to require good faith by directors. See TEx. Bus. Corp. Act, art. 2.03 (B) (1955). As a precaution, such language should be added to the New Act.

\textsuperscript{786} See, e.g., R. Stevens, Corporations 278 (2d ed. 1949). Past uses of the exception appear to have been primarily in connection with subscription or assessment defaults on stock in insolvent corporations (see, e.g., cases cited in note 712 supra) in which the corporation is in essence writing off a bad debt. Here the creditors' interest is not effected adversely because no real asset decrease takes place. However, where the debtor is solvent or where the corporation's stock can be resold by the debtor, the corporation's acquisition of the stock does effect a decrease in the creditors' cushion of assets. This decrease seems generally acceptable because it is likely to be small and chances for abuse are not great. Also, the corporation's liquid assets are not decreased as a result of the transaction, except possibly to the extent required to equalize an even number of shares with the amount of the debt. See Kessler, supra note 732, at 657. Despite these points, Hills, Model Corporation Act, 48 Harv. L. Rev. 1334, 1370-71 n. 63 (1935) would permit acquisition of only redeemable shares for this purpose out of stated capital. See also Hackney's qualified endorsement, Hackney, supra note 730, at 1399.

\textsuperscript{787} See Wash. Rev. Code § 23A.08.030 (1) (1967). The statutes of 31 states provide exceptions to general share acquisition rules for fractional shares.

\textsuperscript{788} See, e.g., Hills, Model Corporation Act, 48 Harv. L. Rev. 1334, 1371-72 n. 64 (1935).

\textsuperscript{789} Dodd, Purchase and Redemption By A Corporation of Its Own Shares: The
tion, the size of the potential stated capital invasions here seems significant enough to warrant application to such redemptions of the assets test previously suggested in connection with distributions of assets from reduction of surplus.

The final New Act exception for share acquisitions from shareholders dissenting to organic changes authorized by the Act presumably reflects the notion that the ordinary acquisition rules should not be allowed to block the acquisition of the corporation's assets by merger or by purchase. Hackney argues that to protect creditors, dissenters' rights should only be paid out of surplus. But the creditors' position in most of the transactions concerned can be determined only by examining the financial position of the acquiring or surviving corporation, which position is quite unrelated to the amount of the acquired corporation's surplus. It would thus appear that problems of creditor protection in connection with such transactions can be better dealt with by specific regulation of the sale or merger rather than through repurchase limitations; thus, the current exception should be retained.


But see Kessler, supra note 732, at 654, who argues: "Even if a redeemable shareholder [sic] be regarded as a species of a corporate creditor, is there any justification for favoring him in preference to the other, and the only legally recognized, creditors, which is the real effect of such a grant of power?" Kessler nowhere discredits Dodd's analysis; indeed, he seems to agree that redeemable shares are commonly viewed as a type of debt. Id. at 645. On the general resemblance of redeemable shares to debt, see Jones, Redeemable Corporate Securities, 5 S. Cal. L. Rev. 63, 87-88 (1931).

See text supra beginning at note 683. Cf. Wash. Rev. Code § 23.01.440 (1958); N.Y. Bus. Corp. Law § 513(e) (McKinney 1963) and Ohio Rev. Code Ann. tit. 8 § 1.137(2) (Page 1954). This test is suggested by Dodd's statement that the corporation will scarcely redeem shares unless it has a substantial margin of assets over liabilities after paying the redemption price, see Dodd, supra note 789, at 725, and serves as a check on the second assertion.

Note that the test proposed is a substantial change from the test in the New Act which requires only that net assets after a redemption of a class of shares exceed the liquidation preference of shares having prior or equal rights to the assets of the corporation. See Wash. Rev. Code § 23A.16.090 (1965).


See, e.g., Hills, Model Corporation Act, 48 Harv. L. Rev. 1334, 1372 n. 65 (1935); Kessler, supra note 732, at 658.

Hackney, supra note 730, at 1399 states: "It might seem better not to allow the merger or sale to go through where there are dissenters sufficient to demand withdrawals of capital."

In a merger or consolidation, the surviving corporation is liable for all of the obligations of the disappearing corporations. Wash. Rev. Code § 23A.20.060 (5) (1965). According to Darrell, The Use of Reorganization Techniques in Corporate Acquisitions, 70 Harv. L. Rev. 1183, 1202 (1957), most asset acquisitions are accompanied by an express assumption of at least some of the transferor's liabilities.

A number of corporation statutes go on to provide an exception for situations where the corporation has either an option to repurchase shares or a binding obligation to repurchase shares. See, e.g., N. C. Gen. Stat. § 55-52 (b) (4) (1965),
Three questions concerning the financial aspects of the New Act provisions remain. The first is whether the acquisition of shares by a corporation pursuant to either the exercise of a conversion privilege contained in its articles of incorporation or a recapitalization exchange constitutes a "purchase" under either set of New Act regulations. From the standpoint of the corporation's creditors and various shareholder groups, it would appear that the initial acquisition should be integrated with the issuance of new shares with the critical issue being whether the newly issued shares have sufficient consideration backing their issuance. It is not clear, however, that such result obtains under the New Act; hence, the New Act should and CAL. CORP. CODE § 1706 (e) (West 1955), relating to shares issued to employees; OHIo REV. CODE ANN. § 1701.35 (5) and (7) (Page 1964) relating to repurchase contracts; and finally, OHIo shareholder repurchase rights granted in articles of incorporation. It would appear that these provisions are designed primarily to assist closely-held corporations in affording compensation to employees and in retaining ownership in a closely-knit group. Serious consideration should be given to an exception for shares issued to employees other than officers and directors subject to either an option to repurchase or a binding obligation to repurchase. Such a provision would give corporations freedom to use shares as a compensation device but would avoid the possibility of controlling shareholders being able to resell their shares to the corporation in the absence of surplus. See generally Dodd, supra note 739, at 715-16.

3 Other problems of lesser importance concern how purchases out of stated capital are to be recorded in the corporation's accounts and how shares so acquired are treated. Consider the purchase or redemption of redeemable shares at their redemption price, which includes a premium over the shares' par value. Under WASH. REV. CODE § 23A.16.100 (1965), if a statement of cancellation is filed, stated capital is reduced by the acquisition of redeemable shares to the extent of the part of stated capital which is represented by the shares. But what happens to the excess? If the corporation has no surplus available, stated capital is reduced (or least would be under the amendment proposed supra note 782); but which stated capital account is reduced? The stated capital attributable to the redeemable shares? To junior shares? It would appear appropriate to charge all such excesses over the stated capital attributable to the shares repurchased to the stated capital of junior classes until exhausted. Redeemable shares are cancelled on acquisition and are restored to the status of authorized but unissued shares unless the articles provide that on acquisition such shares should be removed from the authorized category. WASH. REV. CODE § 23A.16.100 (8) (1965). Other reacquired shares become treasury shares on acquisition, even if acquired out of stated capital. See WASH. REV. CODE §§ 23A.04.010 (1965), 23A.16.110 (1965). But if this classification is to be adhered to, the following changes should be made in the New Act: (1) consideration received from the sale of such treasury shares must be transferred to stated capital up to the amount paid for the shares; (2) such shares must be treated as unissued shares for purposes of share dividends; and (3) on cancellation of such shares, no further reduction of stated capital is made. See Hills, Model Corporation Act, 48 HARV. L. REV. 1334, 1374 n.74 (1935). At the cost of not completely restoring stated capital on resale, it would appear simpler to deem such shares as authorized unissued shares. See id. at 1373.

Several contrary indications can be found in the Act. If the shares acquired are not redeemable, they apparently are treasury shares under WASH. REV. CODE § 23A.04.010 (8) (1965). This suggests a surplus reduction on their acquisition under the first set of New Act provisions. But this step and the provisions regulating the type of surplus arising on cancellation (WASH. REV. CODE §§ 23A.16.110 (1965) and 23A.16.130 (1965)) do not mesh with the provisions in
be amended to clarify treatment of these transactions.\textsuperscript{790}

The second question is how the various provisions in the New Act will be (and should be) applied to an installment acquisition by the corporation of its own shares. The insolvency limitation appearing in the second set of New Act provisions states that "[N]o purchase

\textit{WASH. REV. CODE \S\S 23A.08.150 \S 5 (1965) which provide that consideration for shares issued in exchange for other shares shall be deemed to be the stated capital then represented by the shares exchanged or converted and that part of the surplus, if any, transferred to stated capital upon the issuance of shares for the shares so exchanged or converted. This language and the language in \textit{WASH. REV. CODE \S\S 23A.16.010 (5) (1965), and 23A.16.030 (4) (1965), stating that share exchanges can occur by article amendment suggest that the acquisition of shares is not a purchase. Hackney, supra note 730, at 1399 assumes that shares received on both types of exchange are purchased. Kessler, supra note 732, at 656 n.58, feels that acquisition of shares in connection with a conversion is not a purchase but argues that recapitalization exchanges should be purchases to help avoid problems in determining fairness in recapitalizations. In Kessler's favor is the fact that those state statutes considering the problem appear to stop with exchanges pursuant to conversion privileges. \textit{See CAL. CORP. CODE \S 1707 (West 1955); GA. CODE ANN. \S 22-1828 (b) (1966); KAN. GEN. STAT. ANN. \S 17-3004 (Supp. 1961); MONT. REV. CODE ANN. \S 15-801 (9) (1967); OKLA. STAT. ANN. tit. 18, \S 1.136 (1953). It is difficult to distinguish recapitalization exchanges from conversion of shares, however, insofar as ultimate effect on the corporation's dividend capacity is concerned. One problem with special treatment for recapitalization exchanges is determining precisely which transactions are recapitalizations. For this purpose, it would appear that the exceptions ought to be limited to the part of a transaction which involves an exchange of shares. If debt or cash is exchanged in addition to shares, then only the portion of the transaction equal to the ratio of the value of shares exchanged to the value of total consideration exchanged should be considered not a purchase. The acquisition of the remaining shares would be subject to the surplus rules.\textsuperscript{790} Hackney, supra note 730, at 1399, suggests that an exception should be added to the New (Model) Act exceptions to permit conversions and recapitalization exchanges out of stated capital. \textit{GA. CODE ANN. \S 22-1828 (b) (1966); KAN. GEN. STAT. ANN. \S 17-3004 (Supp. 1961) and MONT. REV. CODE ANN. \S 15-801 (9) (1967) so provide on conversion exchanges. This approach, however, only avoids one of the problems resulting from characterization of the transaction as a purchase. If the transactions are purchases, the "price" paid for the shares acquired appears to be the value of newly issued shares and correspondingly the initial surplus or stated capital reduction will equal to that amount. A portion of this reduction can be retrieved by cancelling the acquired shares. But the price would also apparently govern the issuance of new shares with the effect that any excess of value over the par value of the newly-issued shares will be capital surplus. This problem can be avoided by considering the price of the acquired shares as the par value of the acquired shares, or if none, then the stated capital represented by the shares exchanged. Though this appears to be a rather odd method of determining the purchase price of shares received, this alternative would reduce the accounting for the transaction to only that required by \textit{WASH. REV. CODE \S 23A.08.150 \S 5 (1965), as is suggested in text. Assuming that this is what Hackney meant by his suggestion, his approach would permit stated capital to be applied to stated capital deficits between shares acquired and those issued without shareholder vote. It is unclear which class of stated capital he would reduce, but in any event free shifting of stated capital appears to be far in excess of the corporations' need for capital structure flexibility. (Note that if previous suggestions, see part I, 41 \textit{WASH. L. REV.} at 231, are followed, convertible shares would not be a problem here.) Thus, it would appear better to provide that conversion and recapitalization exchanges are not purchases for purposes of the Act. \textit{Cf. CAL. CORP. CODE \S 1707 (West 1955); OKLA. STAT. ANN. tit. 18, \S 1.136 (1953); Hills, Model Corporation Act, 48 \textit{HARV. L. REV.} 1334, 1370 (1935).}
of or payment for its own shares shall be made at a time when the corporation is insolvent or when such purchase or payment would make it insolvent.\(^{800}\) The words "payment for" were added to the Act's Model Act predecessor section in 1957;\(^{801}\) hence, it seems reasonable to conclude that the insolvency limitation is to be applied both at the time of purchase (presumably the date of contract for the shares) and when each installment payment is made on the contract.\(^{802}\) This view is in accord with the clear majority of court decisions on the question and appears to be the best resolution of the interests involved.\(^{803}\) It appears that both the surplus reduction occurring in the first set of provisions and the surplus restriction appearing in the second set of provisions are applied only at the time of purchase.\(^{804}\) As Herwitz has carefully demonstrated, this application of the two financial limitations avoids many difficult problems inherent in installment by installment application of the surplus test with no major disadvantages.\(^{805}\) Hence, if the Act's surplus tests are amended, all that need be done on this issue is to make clear that the amended surplus test is to be applied to installment purchases at the outset.

The third and final financial issue that can be raised about the New Act provisions is whether share repurchases should be permitted from extraordinary dividend sources, i.e., current earnings or...
depletion reserves (if retained as a source). There would appear to be no valid financial reason why such repurchases should not be permitted.806

The last issue arising under the New provisions is whether those provisions should have gone beyond financial controls in an attempt to protect against such other possible abuses807 as use of the power to purchase shares to insure or acquire voting control,808 to benefit the insolvency limitation. Maximum protection for creditors would be afforded by dual application of the surplus test. But had the entire amount been paid to the departing shareholder, and the corporation's fortunes declined for unforeseeable reasons, creditors would receive no such protection. The departing shareholders' agreeing to accept an installment obligation from a corporation with sufficient surplus in essence permits the corporation to keep the assets for the creditors' protection during the period of the obligation. It seems harsh to penalize the departing shareholder for having done so. (One need not pursue this argument much further, however, to conclude that the insolvency limitation ought to be applied only at the outset.) See Wolf v. Heidritter Lumber Co., 12 N.J. Eq. 34, 163 A. 140 (Ch. 1932). As between the outset test and an installment by installment test, creditors will receive greater protection generally under the former. Note, however, that such application will prevent some companies from making repurchases that might well have made them under an installment by installment test. See Herwitz supra at 320 for planning suggestions.

806 Such is the logical result of permitting share repurchases to the extent of a corporation's dividend capacity. See text supra beginning note 759. One deterrent to adoption of such a change is the resulting statutory complexity. However, while the list of sources might be extended by such action, it would appear that the only addition required to the portion of the statute tracing consequences of later treasury share transactions would be language permitting restoration of the purchase source in the event of a break-even or better sale.

If the corporation has no surplus, it may be argued that to permit it to use extraordinary sources to repurchase its own shares will tempt management to bail out favored shareholders from a shaky situation. But if the requirements discussed in the text paragraph following are imposed, the possibility is substantially eliminated.

807 The possibility of equitable remedies for the abuses listed is beyond the scope of this paper. For difficulties with such remedies, see, e.g., Comment, Buying Out Insurgent Shareholders With Corporate Funds, 70 YALE L. J. 308 (1960); Note, Is There A Fiduciary Duty Between Majority and Minority Shareholders, 36 CALIF. L. REV. 325 (1948). Additional remedies for the abuses may be available under rule 10b-5. See Note, Rule 10b-5 and Purchase By A Corporation Of Its Own Shares, 61 NW. U. L. REV. 307, 322-24 (1966); Israels, Corporate Purchases of Its Own Shares—are There New Overtones, 50 CORNELL L. Q. 620 (1965).

808 Hendricks v. Mill Engineering & Supply Co., 68 Wn. 2d 463, 413 P.2d 811 (1966) appears to be as clear a case of this abuse as could be presented. Hendricks in a two year campaign to acquire control of the corporation acquired 26½% shares of common stock in the corporation and 25 shares of voting redeemable preferred stock. The majority directors group owned 28½% shares of common stock. Before Hendricks could vote his majority position for new directors, the old board redeemed his preferred shares. The court, relying on Kors v. Carey, 39 Del. Ch. 47, 158 A.2d 136 (1960), concluded that the directors had "in the exercise of their honest business judgment adopted a valid method of eliminating what appeared to them a clear threat to the future of the corporation." Id. at 493. The ease with which the court reached its decision is surprising in view of the extensive criticism of the Kors doctrine. See, e.g., Comment, Buying Out Insurgent Shareholders With Corporate Funds, 70 YALE L. J. 308 (1960); Israels, Corporate Purchase of Its Own Shares—are There New Overtones, 50 CORNELL L. Q. 620, 624 (1965). Even if the Kors line of cases is accepted, that line could have been easily distinguished on the ground that the sellers in both cases receiving the Delaware court's approval (Kors and Cheff v. Mathes, 41 Del. Ch. 494, 199 A.2d 548 (Del. 1964)) were willing insurgent sellers. In Hendricks, by virtue of the fact that the shares con-
majority shareholders financially, to silence insurgents, and to manipulate the price of the corporation's stock. While all potential abuses cannot be eliminated by simple statutory amendments, many would be alleviated through adoption of the controls present in

concerned were redeemable, the seller was not a willing seller. (It is interesting that the court chose not to deal with the various authorities concerned with abuse of the redemption procedure. See, e.g., State ex rel. Waldman v. Miller-Wohl Co., Inc., 42 Del. 73, 28 A.2d 148 (1942); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Specht v. Eastwood-Nealley Corp., 25 N. J. Super. 69, 95 A.2d 485 (App. Div. 1953)). Moreover, the result of the purchases in the Kors and Cheff cases merely eliminated potential insurgents and avoided a potential proxy fight whereas the result of the acquisition in Hendricks was a shift of control from Hendricks to the directors presently in office. In short, in Hendricks the court itself, and not the shareholders, decided who should run the corporation. From all that appears in the case, the majority directors had an equal opportunity throughout the period that Hendricks was acquiring shares to acquire sufficient shares to give themselves majority ownership of the corporation's shares. If they did not have such an opportunity, part of the connection with the redeemable shares, then the court might have ordered that the shares be put up for public auction as a solution to the disharmony present. See Andrews, The Stockholders Right to Equal Opportunity In the Sale of Shares, 78 Harv. L. Rev. 505, 562-63 (1965).

The Hendricks case also demonstrates how far the Kors doctrine has taken the courts away from an inquiry into whether maintenance of control was the dominant motive for the directors' action in acquiring the shares. It is difficult not to conclude that any acquisition of swing shares from an unwilling seller is not undertaken primarily to maintain the directors' control of the corporation. Yet the court was able to uphold the transaction without any determination that the directors' "honest" belief that Hendrick's acquisition of control would harm the corporation outweighed their obvious desire to maintain their offices. See, e.g., H. Ballentine, Corporations 609 (rev. ed. 1946).

In this connection, the recent financial literature concerning the use of share repurchases as a means of increasing the corporation's earning per share (and presumably share price) and improving the capital structure "mix" is of interest. See articles cited supra note 759 and Bierman & West, The Acquisition of Common Stock By The Corporate Issuer, 21 J. Finance 687 (1966) (arguing that the same financial results can be achieved by a dividend payment and a reverse stock split and that favorable tax results for shareholders involved is the real factor leading to increased purchases of shares by corporations). A number of financial commentators feel that full disclosures should be made of corporations' repurchase plans so that selling shareholders can make informed decisions as to the potential value of their shares. See Stevenson, Corporate Stock Reacquisitions, 41 Accounting Rev. 312 (1966); Bierman & West, supra at 696; A. Roncsek & S. Myers, Optimal Financing Decisions 133 (1965). Stevenson, supra at 313, determined that relatively few corporations actively acquiring their own stock ever reported that fact in the Wall Street Journal. For discussions of possible duty to disclose under rule 10b-5, see L. Loss, 3 Securities Regulation 1453-54 (2d ed. 1961); Zilber, Corporate Tender Offers for Their Own Stock: Some Legal and Financial Considerations, 33 U. Cin. L. Rev. 315, 336-38 (1964); Note, Rule 10b-5 and Purchase By A Corporation of Its Own Shares, 61 Nw. U. L. Rev. 307, 320-22 (1966); and Comment, The Regulation of Corporate Tender Offers Under Federal Securities Law: A New Challenge for Rule 10b-5, 33 U. Chi. L. Rev. 359, 361-72 (1966).

Other abuses are listed in Nemmers, The Power Of A Corporation To Purchase Its Own Stock, 1942 Wis. L. Rev. 161, 163-67; Dodd, supra note 739, at 706; Levy, Purchase By A Corporation Of Its Own Stock, 15 Minn. L. Rev. 1, 22-25 (1930); Nussbaum, Acquisition By A Corporation Of Its Own Stock, 35 Colum. L. Rev. 971 (1935).

As to the efficacy of provisions involving a shareholder vote in resolving

...
the original version of the recent North Carolina act: purchases must either be made after a pro rata offer to all of the corporation's shareholders or all of a class of shareholders, or be approved by a majority of shareholders of the class to be repurchased after full disclosure of any plan to purchase shares. These provisions, subject to an exception for purchases pursuant to restrictions upon the transfer of the corporation's shares, would be a valuable addition to the Act.

C. Share Dividends.

The old act provided that a corporation could pay a dividend of its own shares only from surplus, which for this purpose included unrealized appreciation. It required that surplus be transferred to such abuses, see Zilber, Corporate Tender Offers For Their Own Stock: Some Legal and Financial Considerations, 33 U. CHI. L. REV. 315, 330-32 (1964); Kessler, supra note 732, at 660-74; Comment, Buying Out Insurgent Shareholders With Corporate Funds, 70 YALE L.J. 308, 318-20 (1960); and Kennedy, Transactions By A Corporation In Its Own Shares, 19 BUS. LAW. 319, 331 (1964).

N. C. GEN. STAT. § 55-52 (c) (2) (1965), requires pro rata purchases from the shareholders involved. However, as Kessler, supra note 732, at 672 points out, this appears impractical since the refusal of any shareholder in the class to participate would defeat the purchase plan. A pro rata offer to shareholders of the class would appear sufficient.

See N. C. GEN. STAT. § 55-52 (c) (2) and (3) (1965). Purchases of the type discussed in text immediately preceding are generally free of these requirements. It would appear, however, that redeemable shares should be chosen for redemption by lot or pro rata (cf. New York Stock Exchange Company Manual § 1 (9), at A 24) and that purchases of redeemable shares should be made only after adequate notice to shareholders of the class. See N. C. GEN. STAT. § 55-52 (1) (1965) (requiring such notice in the event of default in payment of accrued dividends). It has been argued that corporations should not be able to purchase preferred shares without favorable vote of that class. See Comment, Purchase By A Corporation Of Its Own Preferred Shares With Dividends in Arrears, 14 U. CHI. L. REV. 66, 74 (1946). However, as Dodd, supra note 732, at 726 notes, the real difficulty is not with the corporation's power to purchase shares in such a situation but rather with the strength of the preferred's interest in the event of default.

In 1963, the North Carolina statute was amended to allow free purchase (subject to financial regulations) from any shareholder of shares listed on any securities exchange regulated by the S.E.C. or other regulatory authority of the U.S. Government. See N.C. GEN. STAT. § 55-52 (6) (1965).

See N.C. GEN. STAT. § 55-52 (c) (4) (1965). N.C. GEN. STAT. § 55-52 (c) (5) (1965) makes a further exception for shares acquired in connection with stabilizing operations authorized by the S.E.C.

Kessler, supra note 732, at 687-88, offers a more stringent set of regulations. Under his scheme, a corporation could purchase shares from earned surplus only with two-thirds approval of holders of each class of shares (whether or not voting) immediately prior to the reaching of the offer by the corporation and by lot selection or pro rata offer, as shareholders choose after full disclosure. He would permit the latter purchase methods to be avoided with respect to purchases of up to 5% of its outstanding shares if two-thirds of shareholders of each class, voting or not, authorize the corporation to do so at least one year after incorporation.

Other statutes requiring a shareholder vote at least in certain circumstances are listed in Comment, Buying Out Insurgent Shareholders With Corporate Funds, 70 YALE L.J. 308, 319 n.54 (1960).

See WASH. REV. CODE § 23.01.250(4) (b) and (a) (1958). On the general sub-
capital stock equal to the aggregate par value of shares issued, if any, or in the event no par shares were issued, apparently the value attributed to the shares by the directors. The act prohibited payment of a dividend in shares of any class to shareholders of another class unless the articles so provided or such payment was authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made. The New Act provisions regarding share dividends differ only in the following substantive respects: (1) share dividends may not be declared when the corporation is insolvent; (2) dividends of treasury shares reacquired out of surplus of the corporation may be declared without further capitalization of surplus; (3) the amount of surplus transferred to stated capital in the event par value shares are distributed must be at least equal to the aggregate par value; (4) the amount...
The primary inquiry that may be raised about these provisions is whether they should have incorporated the views of the American Institute of Certified Public Accountants,826 the New York Stock Exchange827 and the Securities and Exchange Commission828 regarding requirements for any distribution of shares to be designated a "stock dividend." Generally, these authorities define a stock dividend in terms of the intent of the corporation to give shareholders "some ostensibly separate evidence of a part of their respective interests in accumulated corporate earnings without distribution of cash or other property."829 Despite the fact that they characterize the receipt

824 WASH. REV. CODE § 23A.08.420(4)(b) (1965). It is clear under this provision that some amount of surplus must be capitalized in connection with a dividend of no par shares. However, this requirement can be avoided under the New Act by the simple expedient of labelling the distribution as a stock split. See WASH. REV. CODE § 23A.08.420 ¶ 2 (1963); D. HERWITZ, BUSINESS PLANNING 344 n.11 (1966).

825 WASH. REV. CODE § 23A.08.420 ¶ 2 (1965). Even if the proposals later presented are not adopted, this provision should be amended to expand the concept of a split-up beyond transactions in which stated capital does not change. See Manne, Accounting For Share Issues Under Modern Corporation Laws, 54 NW. U. L. REV. 285, 319 (1959).

826 See AICPA, ACCOUNTING RESEARCH BULL. No. 43, Ch. 7B (1953).


828 See L. RAPPAORT, SEC ACCOUNTING PRACTICE AND PROCEDURE 16.32 (2d ed. 1966) indicating that the SEC agrees with the pronouncements of the AICPA on the matter of accounting for stock dividends.

829 AICPA, ACCOUNTING RESEARCH BULL. No. 43, Ch. 7B ¶ 1 (1953). A "split-up" may be identified by the desire of the corporation to increase the number of outstanding shares for the purpose of effecting a reduction in their unit market price and, thereby, of obtaining a wider distribution and improved marketability of the shares. Id. at ¶ 2. Distributions of shares of another class are not covered by this bulletin. Id. at ¶ 3.

Although the New York Stock Exchange Company Manual makes reference to AICPA ACCOUNTING RESEARCH BULL. No. 43, Ch. 7B in its discussion of stock dividends, it goes on to define as a stock dividend all share distributions representing less than 25% of the number of shares outstanding prior to the distribution. (Classification of the distribution as a stock dividend means that earned surplus equal to the fair value of the shares distributed must be transferred to the corporation's permanent capitalization.) Distributions of 100% or more of the number of shares outstanding prior to the distribution are split-ups. Distributions of more than 25%, but less than 100%, may be classified by the Exchange as stock dividends if "such distributions assume the character of stock dividends through repetition under circumstances not consistent with the true intent and purpose of stock split-ups." See N.Y. STOCK EXCH. CO. MANUAL § A13 at 235 (1966); Id. at § A14 (1964-67).

Compare with these definitions the typical legal definition of a stock dividend as any share distribution accompanied by a capitalization of earnings and of a
of a stock dividend as not giving rise to income; \textsuperscript{830} they state: \textsuperscript{831}

... [A] stock dividend does not, in fact, give rise to any change whatsoever in either the corporation's assets or its respective shareholders' proportionate interests therein. However, it cannot fail to be recognized that, merely as a consequence of the expressed purpose of the transaction and its characterization as a dividend in related notices to shareholders and the public at large, many recipients of stock dividends look upon them as distributions of corporate earnings and usually in an amount equivalent to the fair value of the additional shares received. Furthermore, it is presumed that such views of recipients are materially strengthened in those instances, which are by far the most numerous, where the issuances are so small in comparison with the shares previously outstanding that they do not have any apparent effect upon the share market price and, consequently, the market value of the shares previously held remains unchanged. The committee therefore believes that where these circumstances exist the corporation should in the public interest account for the transaction by transferring from earned surplus to the category of permanent capitalization (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of the additional shares issued. Unless this is done, the amount of earnings which the shareholder may believe to have been distributed to him will be left, except to the extent otherwise dictated by legal requirements, in earned surplus subject to possible further similar stock issuances or cash distributions.

Shareholders of closely-held corporations are presumed to have such intimate knowledge of the corporation's affairs as to preclude the incorrect implications noted; thus, in connection with distributions

\textsuperscript{830} AICPA, \textit{Accounting Research Bull.} No. 43, Ch. 7B, § 6 (1953).


Two recent statutes dealing with allocation of trust receipts to principal and income, N.Y. \textit{ESTATES, POWERS & TRUSTS LAW} § 11-2.1(e)(2) (McKinney 1967) and PA. \textit{STAT. ANN. tit. 20, § 3470.5} (1964), both take the unfortunate view that small share distributions (6\% or less) are income. While this approach will simplify the trustee's problems in connection with such distributions (see, e.g., Flickinger, \textit{A Trustee's Nightmare: Allocation of Stock Dividends Between Income and Principal}, 43 B.U.L. \textit{REV.} 199 (1963); Dunham, \textit{A Trustee's Dilemma As to Principal and Income}, 26 U. \textit{CHI. L. REV.} 405 (1959)), it does so at the cost of propounding the confusion surrounding share distributions. The trustee's problem is as effectively solved by the Massachusetts and Uniform Principal and Income Act rules that all share distributions are principal and the beneficiaries' interests could have been protected equally through careful application of the trustee's duty to advance the interests of both income and principal beneficiaries. \textit{See}, e.g., Barclay, \textit{Stock Dividends Belong to Principal}, 103 \textit{TRUSTS AND ESTATES} 482, 484 (1964).

In connection with split-ups, the absence of circumstances that might mislead shareholders means that earned surplus need not be capitalized in excess of the amount required by the consideration requirements. The bulletin goes on to
by such corporations there is no need to capitalize earned surplus other than to the extent required by the basic legal consideration requirements. As a guide to when the relative size of the share distribution is large enough to influence the unit price of the stock materially, the authorities state that few share distributions of less than 20 or 25% of the number of shares previously outstanding will not have the effect indicated.

The New Act's general approach of enabling rather than requiring, corporations to meet these accounting requirements appears recommend that every effort be made to avoid the use of the word "dividend" in related corporate resolutions, notices and announcements. It is unclear whether the accounting requirements apply to distributions of treasury shares. See Sprouse, Accounting Principles and Corporation Statutes, 35 Accounting Rev. 246, 255 (1960).

According to the AICPA's justifications stated in text, several other explanations of the market value capitalization approach have been offered. Thus, W. Karrenbrock & H. Simons, Intermediate Accounting (Comprehensive) 699 (3d ed. 1958) argue that a stock dividend is in essence two transactions: (1) the payment by the corporation of a cash dividend; and (2) the return of such payment to the corporation in exchange for shares of stock. As Herwitz points out, however, both parts of this transaction have independent legal and tax consequences making it difficult to accept such a constructive view of a share dividend. See D. Herwitz, Business Planning 347 (1966); see also Manne, supra note 825, at 322-23. R. Milroy & R. Walzen, Accounting Theory and Practice—Intermediate 534 (1960) believe that a better construction of the transaction is that capitalization of market value recognizes the opportunity cost to the issuer of issuing additional shares without consideration. The difficulty with this view of a share dividend is that it is not clear why the same analysis does not apply to a share split-up. Moreover, it is unclear that the corporation has lost any opportunity to issue shares simply by increasing the number of shares outstanding.

The Model Act predecessor of WASH. REV. CODE § 23A.08.420 (1965), § 40, as originally adopted provided simply that on the issuance of par value shares surplus equal to the par value should be transferred to stated capital. See 1 Model Act § 40(d) (1) (1950 rev.). The language "at least" was inserted after the word "surplus" in the 1955 Addendum to the Act, 1 Model Act Ann. § 40(c) to (e) ¶ 1, for the purpose of enabling corporations to meet the accounting requirements. Id. at ¶ 4. It should be noted, however, that the New (Model) Act language does not fully capture the accounting technique for the language suggests that surplus in excess of par value may be transferred to stated capital. As the quotation in text in note 831 indicates, accountants would permit any excess over par value to be transferred to capital surplus.

TENN. CODE ANN. §§ 48-211, 48-708 (1964) are the only provisions in the United States requiring that surplus equal to the fair value of the shares distributed as a share dividend be transferred to stated capital in connection with the dividend. Note that this statute is both more liberal and more conservative than the accountants' requirements. The accountants require that only earned surplus be used to support a share dividend whereas the Tennessee statute will permit any kind of surplus to be used. But the accountants do not require, as the Tennessee statute does, that all the surplus be transferred to stated capital.
to be the best current solution.\textsuperscript{838} Considerable doubt has been raised about their propriety as accounting requirements.\textsuperscript{837} Thus, it is not clear why a corporation should treat a share dividend as a distribution of current earnings simply because some shareholders may incorrectly think of it that way.\textsuperscript{838} And it is also unclear why the market effect of a share dividend should be taken into account where a similar effect, arising from basically the same causes, is ignored in


If the accounting requirements were to be required by statute, it would appear necessary to promulgate a definition of a closely-held corporation which would be excluded from the requirements, to define with precision what types of distributions constitute a stock dividend, and to determine the accounting requirements regarding a distribution of treasury shares. The Tennessee provisions referred to above undertake none of these tasks.


In addition to the citations in the following footnotes, see L. Rappaport, SEC Accounting Practice and Procedure 16.33 (2d ed. 1966) where the author indicates that many foreign accountants are strongly opposed to the position espoused by Accounting Research Bull. No. 43 and "are at a complete loss to understand the reasoning on which it is based." See also Barker, Are Accounting Requirements for Stock Dividends Obsolete?, 14 Analysis Journal 69 (Nov. 1958) who argues that use of market value as the amount to be capitalized subjects managements to great uncertainty in connection with planning a consistent stock dividend policy. It is not clear why this problem is not now easily avoided by split-ups.

\textsuperscript{835}See dissent by Calkins and Mason, AICPA, Accounting Research Bull. No. 43, Ch. 7B (1953); Wilcox, Accounting for Stock Dividends: A Dissent from Current Practice, 96 J. Accountancy 176, 179-80 (1953); Horngren, Stock Dividends and the Entity Theory, 32 Accounting Rev. 379, 383 (1957); D. Herwitz, Business Planning 346 (1966). See also Vatter, Corporate Stock Equities in, Handbook of Modern Accounting Theory 392 (M. Backer ed. 1955) who argues that it does not make sense to say that capitalization of earned surplus reduces the shareholder's expectation of cash dividends:

The ability of a firm to pay dividends does not depend upon past earnings, but upon future income and its management. The additional shares merely change the arithmetic of such distributions as may be made.

Id. at 392 n.5.

In addition to the fact that accountants generally treat stock dividends as not giving rise to income, share distribution generally does not constitute income to the shareholder for federal income tax purposes. See Int. Rev. Code of 1954, § 305a, See D. Herwitz, Business Planning 344-46 (1966).
connection with share split-ups. Even if the requirements can be justified from an accounting standpoint, it is hard to rationalize the requirements in terms of the relevant legal interests in the size of the corporation's dividend fund. Viewed from the latter context, share dividends and split-ups both appear to be types of recapitalizations accomplished by director action. Hence, it would appear that generally the amount and type of surplus to be capitalized should be left up to the board of directors except to the extent of minimum legal consideration requirements.


Barker, Evaluation of Stock Dividends, HARV. BUS. REV. 90 (July-August 1958), concluded from a study of all stock dividends of 5 percent or more by companies listed on the New York Stock Exchange during the years 1951 to 1954 that stock dividends, in themselves, had no lasting influence on market price. He asserted that lasting price increases associated with stock dividends were the result of simultaneous increases in cash dividend payments. He reached similar conclusions in studies of the effect of stock splits upon the overall value of a corporation's shares. See Barker, Effective Stock Splits, HARV. BUS. REV. 101 (Jan.-Feb. 1956), and Barker, Stock Splits in a Bull Market, HARV. BUS. REV. 72 (May-June 1957). M. SUSSMAN, THE STOCK DIVIDEND 61-72 (1962) examined all stock dividends paid by corporations listed on the New York Stock Exchange during 1958. Using techniques slightly different from those used by Barker, he concluded that there appears to be a slight tendency for stock dividends, particularly those of relatively small size, to enhance the market value of their respective stocks. Id. at 69. Other studies, less helpful for lack of isolation of cash dividend increases as a factor, include Myers & Heath, The Periodic Stock Dividend--Boom or Sop!, COM. & FIN. CHRON., Feb. 13, 1958 at 731; Bothwell, Periodic Stock Dividends, HARV. BUS. REV. 89 (Jan.-Feb. 1950); Sheehan, The Big Pay-Out, FORTUNE, Nov., 1956, at 147; Livermore, The Value of Stock Dividends, 20 AM. ECON. REV. 687 (1930); and Siegel, Stock Dividends, HARV. BUS. REV. 76, 87 (Oct. 1932).

The fact that the corporation distributes no assets in connection with a stock dividend (or for that matter, a stock split) makes it exceedingly difficult to integrate the accounting analysis with traditional interest analysis of the dividend fund. Even assuming that such integration could be made, it is hard to justify the results that would obtain under the New Act's provisions. Under the Act, earned surplus but not more than the amount of the aggregate amount of the shares issued may be transferred to capital surplus. (See WASH. REV. CODE § 23A.08.170 (1965).) Thus, unless the New Act's provisions regarding possible distribution of capital surplus are amended, that portion of the earned surplus transfer may be readily available for dividends by the corporation. See WASH. REV. CODE § 23A.08-.430 (1967); and part II, 42 WASH. L. REV. at 136-139.

See the excellent analysis in Vatter, Corporate Stock Equities, in HANDBOOK OF MODERN ACCOUNTING THEORY 391-93 (M. Backer ed. 1955); Eiteman, Are There Two Kinds of Stock Dividends? NAA BULL. (Oct. 1963) 53, 57; Manne, supra note 825, at 317-27 (1959); Hills, Model Corporation Act, 48 HARV. L. REV. 1334, 1339 (1935); and cf. W. PATON & W. PATON, JR., CORPORATION ACCOUNTS AND STATEMENTS 123-25 (1955); HORNGREN, STOCK DIVIDENDS AND THE ENTITY THEORY, 32 ACCOUNTING REv. 379 (1957); D. HERWITZ, BUSINESS PLANNING 343-44 (1966). As Vatter states, “A stock dividend is really very much in the nature of recapitalization—a realigning of share equities to meet current financial patterns and demands, such as ‘greater cushions’ to protect creditors with the need to regard earnings as ‘frozen’ because of higher price levels and greater working capital requirements.” Id. at 392.

The statement in text assumes, of course, that sufficient authorized shares are available to cover the distribution.

On the basic legal consideration requirements, see WASH. REV. CODE § 23A-.08.150 (1965); and part I, 41 WASH. L. REV. at 242-49. An exception to the basic rules would be necessary so as to require that surplus equal to the redemption price
The basic problem which the accounting requirements attempt to solve is shareholder misconception as to the nature of a share "dividend." It would appear that the best way to solve this problem is an educational campaign by the stock exchanges, financial press, analysts and declaring corporations to bring home to shareholders the basic diluting effect of all types of share distributions and the fact that such distributions do not represent divisions of current earnings. The following amendments in the New Act's general

of any redeemable shares distributed must be transferred to stated capital. Otherwise a corporation could in effect make a cash dividend out of stated capital by means of a share distribution of redeemable shares backed by little surplus which shares it then redeemed out of stated capital. See D. Herwitz, BUSINESS PLANNING 348-49 (1966). If the shares distributed have a liquidation preference, strong arguments can be made that surplus equal to the liquidation preference ought to be capitalized. See id. at 349; Manne, supra note 825, at 326-27 (1957); and part I, 41 WASH. L. Rev. at 245 n.225. But if the relative rights of outstanding classes are protected, (see text following note 848), and if dividends from earned surplus are prohibited (as they are under the New Act by WASH. REV. CODE § 23A.08.420(1) (1965)) until the liquidation preference is protected, there seems to be no need to capitalize surplus equal to the liquidation preference.

With respect to the type of surplus that can be capitalized in connection with a share distribution, once share distributions are recognized as recapitalizations involving capitalization of surplus, capital surplus would appear as eligible for capitalization as earned surplus. See D. Herwitz, BUSINESS PLANNING 348 (1966); Wilcox, supra note 832, at 181; Horngren, supra note 841, at 380; see also AICPA, ACCOUNTING TRENDS & TECHNIQUES 234 (20th ed. 1966) (indicating two-thirds of stock splits recorded charged capital surplus). But see W. Paton & W. Paton, JR., CORPORATION ACCOUNTS AND STATEMENTS 124 (1955) labelling the use of capital surplus as a "weird performance." However, difficulties arise where the shares distributed are redeemable, and hence potentially a cash dividend substitute, or where the corporation has two classes of shares already outstanding with varying contributions to capital surplus. The latter problem could be dealt with by means of an adverse effect statute (see text beginning note 848). But to avoid construction problems under such a test, and to impose the appropriate limits on distributions of redeemable shares, it appears best to impose the limitations previously described for cash distributions upon use of capital surplus for these types of share distributions. See part II, 42 WASH. L. Rev. at 138-40.

It should be noted that it is by no means clear that anything need be capitalized in the event of a distribution of par value shares. Thus, Hill, Model Corporation Act, 48 HARV. L. Rev. 1334, 1339 (1935) treated all share distributions as a readjustment of shares similar to an amendment of the articles. In conformity with this view, surplus was not required to be capitalized on a single class dividend which was authorized by consent of the shareholders. Id. at 1368-69. Stated capital was defined to exclude such dividends. Id. at 1360, 1363 n.46. See also Manne, supra note 825, at 322. Hill's scheme was not recommended above because of the effect of the proposal on long-held notions of stated capital (see Mulford, Corporate Distributions to Shareholders and Other Amendments to the Pennsylvania Business Corporation Law, 106 U. PA. L. Rev. 536, 549 (1958)) and because the requirement of a shareholder vote on each share distribution seemed overly burdensome in view of possible benefits to shareholders from the requirement.


In this connection, managements might well reexamine their companies' policies concerning the use of share distributions. M. Sussman, The Stock Dividend 97 (1962) concludes from a survey of companies to determine the reasons for share distributions that the primary reason why corporate managements issue stock dividends is for purposes of public relations. See also Myers & Health,
scheme would help in this campaign: (1) the provisions regulating share distributions should be removed from the section regulating dividends and placed in a separate section labelled “share distributions;” and (2) provisions should be added requiring (a) that every distribution of shares be accompanied by a written notice denoting the distribution as a “share distribution,” and (b) that such notice inform the recipient of the effects of the distribution on the corporation's stated capital, capital surplus and earned surplus and the effect upon his proportionate interest in the corporation if he sells the shares received.

A second area of inquiry concerning the New Act provisions relates to the sufficiency of its controls over potential abuses of share distributions possible where the distribution is of shares of a different class than those owned by the recipients or is of the same class.

The Periodic Stock Dividend—Boom or Sop?, 187 Com. & Fin. Chron. 731, 757 (Feb. 13, 1958) who point out that despite the expense of small share distributions:

From the corporate standpoint, stock dividends offer nothing except that they please the stockholder. Broadening the base by increasing the number of shares can be done more economically by an occasional large stock dividend or split than by many small ones. Fractions can be avoided and the many issuing expenses on a single distribution can hardly be determined by the number of shares to be issued to a given number of stockholders.

It seems generally agreed that the label “stock dividend” is a misnomer (see, e.g., H. Ballantine, Corporations 481 (rev. ed. 1946); Vatter supra note 841, at 391; Burke, Stock Dividends—Suggestions for Clarification, 37 Accounting Rev. 283 (1962)) but few statutes attempt to remove this source of confusion. See Mulford, supra note 842, at 550-51 discussing Pa. Stat. Ann. tit. 15, § 1702.1 (1967); N.Y. Bus. Corp. Law § 511(e) (McKinney 1963).

As part of this change, the amended provisions could omit, as do those cited immediately above, all reference to insolvency. See note 821 supra.

It seems generally agreed that the label “stock dividend” is a misnomer (see, e.g., H. Ballantine, Corporations 481 (rev. ed. 1946); Vatter supra note 841, at 391; Burke, Stock Dividends—Suggestions for Clarification, 37 Accounting Rev. 283 (1962)) but few statutes attempt to remove this source of confusion. See Mulford, supra note 842, at 550-51 discussing Pa. Stat. Ann. tit. 15, § 1702.1 (1967); N.Y. Bus. Corp. Law § 511(e) (McKinney 1963).

Following the New York pattern, there probably should be a provision clearly authorizing additional transfers from earned surplus to stated capital or capital surplus in connection with a share distribution (N.Y. Bus. Corp. Law § 511(e) (McKinney 1963)) and provision stating that a split-up or division of issued shares into a greater number of shares represented by the same stated capital does not require a transfer to stated capital. N.Y. Bus. Corp. Law § 511(e) (McKinney 1963).

but the corporation has more than one class of shares outstanding. Under the New Act, it appears that the directors, without shareholder approval, could distribute shares of a class not previously outstanding despite the significant effects possible on the relative rights of the outstanding class or classes. Similarly, the directors apparently by their own action can distribute voting common shares to common shareholders even though this has the effect of reducing the relative voting power of other classes. To avoid these problems, the New Act should be amended to require that share distributions of any class of shares not previously outstanding must be authorized by the vote of a majority of shares of each class outstanding voting as a class and that other share distributions be specifically authorized by the majority vote of each class that might be adversely affected by the distribution.

A final inquiry concerns the propriety of the New Act's limitation of the source for share distributions to surplus. This statement of the limitation will permit share distributions from unrealized appreciation generally to the same extent that cash dividends may be paid from that source, which seems appropriate. But the statement also has the effect of prohibiting share distributions from the two extraordinary dividend sources previously discussed, current earnings

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850 Cf. N.C. Gen. Stat. § 55-51(b) (1965); and Ohio Rev. Code Ann. § 1701.33(c) (Page 1964). So that the shareholders of a corporation with two classes of shares outstanding can determine the effects of a proposed distribution on their rights, the shareholders' notice should spell out the capitalization procedure including sources of surplus to be capitalized, amounts to be capitalized and effects of the transaction on book values. Cf. Vatter, supra note 841, at 394-95.

851 A number of states follow the old act's approach of permitting unrealized appreciation to be used as a source of share distributions but prohibiting cash dividends from that source. See, e.g., Ill. Rev. Stat. Ch. 32, § 157.41(c) (1954). This approach puts heavy burdens upon supervision of reductions of capital since some screening must be done to determine if the surplus resulting and available for distribution arose from unrealized appreciation. See Gose, Legal Significance of "Capital Stock," 32 Wash. L. Rev. 1, 19 (1957). Hence, if unrealized appreciation is not to be used as a source for cash dividends, then share dividends should also be prohibited from that source.

On the other hand, if unrealized appreciation is available as a source of cash dividends or share reacquisitions, no dividend policy dictates that a different treatment ought to be afforded to the appreciation for purposes of a share dividend. In connection with possible use of unrealized appreciation as a source of share dividends and the earlier suggestion regarding recognition of such appreciation by reduction of capital procedure, see Chambers, Asset Revaluations and Stock Dividends, 106 J. Accountancy 55 (Aug. 1958) discussing widespread Australian practice of using share distributions in connection with recognition of higher asset values.
and depletion reserves. The omission of the latter is explicable on the ground that share distributions are antithetical to the basic rationale of the depletion reserve privilege. But there would seem to be little reason why a share distribution from current earnings should not be permitted.

D. Director and Shareholder Liability for Illegal Distributions

Under the old act, directors who knowingly, or without making reasonable inquiry, voted in favor of payment of a dividend in violation of Wash. Rev. Code § 23.01.250 or any other unlawful distribution of assets to shareholders were jointly and severally liable to the corporation for the amount of the dividend or distribution so made. Shareholders receiving unlawful payments were liable to the corporation for amounts so received in two situations: (1) when no director was liable to the corporation in connection with the payment; and (2) when, and to the extent that, the corporation was unable to obtain satisfaction on judgments recovered against directors for unlawful payments. Actions against directors had to be brought within two years of the date on which the distribution was made. Actions against shareholders had to be brought within two years from the date on which final judgment against the directors was entered. The right of directors held liable for illegal payments to contribution from co-directors or reimbursement from shareholders was left to the uncertainty of the common law.

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832 See text supra beginning at note 628.
833 This section is limited to a discussion of liability imposed on directors and shareholders for illegal corporate distributions by provisions typically found in corporation codes. For a brief discussion of other types of potential shareholder liability for corporate distributions, see part II, 42 WASH. L. REV. at 129 n.372.
835 WASH. REV. CODE § 23.01.260(2) (1958). Note that this provision would impose liability in connection with illegal stock dividends, in addition to illegal cash and property dividends. Compare the situation under the New Act regarding stock dividends, noted in note 859 infra.
837 American decisions on the common law right of a director held liable for illegal dividends to seek contribution from co-directors are not consistent. Sharp v. Call, 69 Neb. 72, 95 N.W. 16, 96 N.W. 1004 (1903), the only holding on the issue, denied a director contribution in connection with a judgment rendered against him for making a distribution from an insolvent corporation knowing of a pending action against the corporation. Cf. Rogers v. Bonnett, 2 Okla. 553, 37 P. 1078 (1894). However, the Sharp court in dictum recognized the possibility of contribution if the original action had been in good faith and with the defendant's participation. 95 N.W. at 17. Other dicta to the same effect appear in Hodde v. Nobbe, 204 Mo. App. 109, 221 S.W. 130, 133 (1920); Wiles v. Snidom, 64 N.Y. 173, 177 (1876); cf. Wallach v. Billings, 195 Ill. App. 605, 617-18 (1915), aff'd without discussion of the point, 277 Ill. 218, 115 N.E. 382 (1917), cert. denied, 244 U.S. 659 (1917). The adverse reactions to contribution in the circumstances appear to be based on the gen-
The New Act provides that directors who vote for or assent to the declaration of any dividend or other distribution of assets of a corporation to its shareholders contrary to the provisions of the Act or any restrictions in the articles of incorporation will be jointly and individually liable for the amount of such dividend which is paid... or the value of such assets which are distributed...." (Compare Wash. Rev. Code § 23A.08.450(1) (1958) making directors, who clearly are liable for illegal stock dividends, see note supra, liable for the amount of the dividend so paid.) Moreover, there is an obvious parallelism between the dividend and distribution language in Wash. Rev. Code §§ 23A.08.450(1) (1965) and the provisions in Wash. Rev. Code §§ 23A.08.420 (1965) and 25A.08.430 (1967). Dividend as used in § 23A.08.420 ¶ 1 (1965) includes share dividends.

The draftsmen's comments offer no assistance on the question. See 2 Model Act Ann. § 43 ¶ 4.

severally liable to the corporation for the amount of such dividend which is paid or the value of such assets which are distributed in excess of the amount of such dividend or distribution that could have been lawfully paid. Directors who vote for or assent to the purchase by a corporation of its own shares contrary to the provisions of the Act will be jointly and severally liable to the corporation for the amount of consideration paid for such shares which is in excess of the amount that could have been lawfully expended for such shares. These liabilities, according to the prefatory clause to the director

§ 7-3-28 (1957); and Tenn. Code Ann. § 48-212 (1964) make directors liable for illegal share dividends in provisions covering director liability for illegal dividends or distributions of assets.

The arguments against making directors liable for illegal share dividends presumably center on the fact that no assets are distributed and that it is difficult to find any injury to existing creditors from an illegal share dividend (except possibly in the case of a distribution of redeemable shares, where the problem may be dealt with in the event of redemption.) Cf. Whitlock v. Alexander, 160 N.C. 465, 76 S.E. 538 (1912). However, the possibility of injury to future creditors is generally as clear here as in the watered stock cases. Moreover, since illegal share dividends will involve surplus, and hence asset, overstatement, present creditors may have been injured by the directors' past failure to take such overstatements into account. To encourage directors to eliminate overstatements and hopefully to avoid unfair shareholder liability, the New Act provisions should be amended to make directors liable for illegal share dividends. It is later argued that the directors' liability for illegal asset distributions ought to be limited to claims arising from injuries to creditors and shareholders at the time of distribution. See text infra beginning note 915. In the case of illegal share dividends, the remedy ought to benefit future creditors as well as present; hence, a separate director liability provision ought to be enacted on the subject modelled on Wash. Rev. Code § 23A.08.450(1) (1965), which gives the benefit of recovery to future creditors.

Both statutes thus make the corporation the beneficiary of any recovery of illegal dividends. This formulation seems preferable to one permitting creditors or shareholders to sue individually as often such statutes do not cover all interested groups. See H. Ballantine, Corporations 596 (rev. ed. 1946); Steadman, Liabilities of Directors Under the Model Business Corporation Act, 7 Bus. Law, July 1952, 9, 14.

By stating the amount of the liability in this way, the Act precludes the possibility of holding directors liable for a distribution simply because of a failure to give notice to shareholders. See Wash. Rev. Code § 23A.08.430(5) (1967). While it is clear that directors should not be liable for the full amount of a distribution simply because of a ministerial omission, it also seems clear that some liability should arise from failure to give notice where shareholders are injured as a result of the omission. N.Y. Bus. Corp. Law § 520 (McKinney 1963) seems a suitable solution to the problem. It makes the corporation liable for any damage suffered by a shareholder as a result of a failure to give required notice. If the corporation suffers such liability as a result of director misconduct, it can then seek recovery from the responsible directors. See deCapriles & McAniff, The Financial Provisions of the New (1961) New York Business Corporation Law, 36 N.Y.U. L. Rev. 1239, 1271-72 (1961).

As previously noted, see note 729 supra, Wash. Rev. Code § 23A.08.030 (1967) does not specifically mention restrictions in the articles of incorporation as a limitation on treasury share acquisitions. Wash. Rev. Code § 23A.08.450(2) (1965) also omits this term. It would appear that the clause ought to be added to both provisions.

liability section, are imposed "in addition to any other liabilities imposed by law upon directors of a corporation."\(^{864}\)

Any director present at the meeting of the board of directors at which an illegal dividend or distribution of assets is declared, or an illegal purchase of shares is approved, is presumed to have assented to such action unless (1) his dissent is entered in the minutes of the meeting, (2) his written dissent is filed with the secretary of the meeting before adjournment thereof, or (3) his written dissent is forwarded to the secretary of the corporation by registered mail immediately after the adjournment of the meeting. These techniques for registering dissent are not available to directors voting in favor of the action.\(^{865}\)

A director will not be liable in connection with illegal dividends, distributions of assets or purchases of treasury shares if he relied and acted in good faith upon financial statements of the corporation (1) represented to him to be correct by the president or the officer of the corporation having charge of its books of account, or (2) stated in a written report by an independent public or certified public accountant or firm of such accountants fairly to reflect the financial condition of such corporation.\(^{866}\) Moreover, a director will not be liable in connection with an illegal dividend, distribution of assets or purchase of

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\(^{864}\) WASH. REV. CODE § 23A.08.450 ¶ 1 (1965).

\(^{865}\) See WASH. REV. CODE § 23A.08.450 ¶ 2 (1965) which applies the presumption stated in text to all questions of which directors assented to particular corporate action.

Steadman, *Liabilities of Directors Under the Model Business Corporation Act*, 7 BUS. LAW, July 1952, 9, 14 states that the Model Act scheme "eliminates all controversy as to whether a particular director is responsible for a particular act." Consider, however, the director who is absent from the directors' meeting at which an illegal distribution is declared and who acquiesces in the decision when learning of it. The presumption does not apply to such a director, and since the presumption is not written to preclude proof of assent by other means, it would appear that plaintiffs could argue that such conduct by the absent director constituted assent. Cf. Aiken v. Insull, 122 F.2d 746 (7th Cir. 1941), cert. denied, 315 U.S. 806 (1942). See also 3 W. FLETCHER, *PRIVATE CORPORATIONS* § 1237 at 894 (repl. vol. by M. Wolf 1965). Controversies of this sort could be eliminated by amending the New Act to impose liability upon directors under whose administration an illegal distribution is made except for those who cause their dissent to be recorded in the minutes of the meeting at which such action was authorized, or who being absent at the time promptly file their written objection to the action with the secretary of the corporation upon learning of the action. See PA. STAT. ANN. tit. 15, § 1707 (1967).

Under either the Pennsylvania form of statute or the New Act provision, counsel must warn directors that simply voting against a proposed action will not prevent them from being held liable for its consequences. Query whether a vote against an illegal distribution is sufficient to constitute recorded dissent under either provision where the dissenting director is identified in the minutes.\(^{867}\) WASH. REV. CODE § 23A.08.450 ¶ 3 (1965). The first clause of this paragraph makes the defense also applicable in connection with distributions in liquidation which violate WASH. REV. CODE § 23A.08.450(3) (1965).
treasury shares if in determining the amount available for any such dividend or distribution, he, in good faith, considers the assets to be of their book value.\textsuperscript{667}

Any director held liable for an illegal dividend or other distribution of assets is entitled to contribution from shareholders who accepted or received the dividend or assets knowing that the dividend or distribution had been made in violation of the Act, in proportion to the amounts received by them respectively.\textsuperscript{668} Any director against whom a claim is asserted for unlawful dividends, distributions of assets or purchases of treasury shares is entitled to contribution from other directors who voted for or assented to the action upon which the claim is asserted.\textsuperscript{669}

1. Directors' Liability. One obvious result of the adoption of the New Act provisions is that plaintiffs will no longer have to prove fault on the part of directors in actions involving illegal distributions.\textsuperscript{670} This change seems sound in view of the severe practical problems that plaintiffs would otherwise face in proving that directors had negligently or intentionally made an illegal distribution.\textsuperscript{671} However, since

\textsuperscript{667}There is a conflict in language in the last clause of WASH. REV. CODE § 23A.08.450 ¶ 3 (1965), as noted in text. That clause reads:

nor shall he be so liable [under subsections 1 (illegal dividends and other distributions of assets), 2 (illegal treasury share purchases) and 3 (illegal liquidation distributions) of this section] if in good faith in determining the amount available for any such dividend or distribution he considers the assets to be of their book value.

Treasury share purchases can be encompassed in the italicized language only with difficulty. It would appear, however, that the omission was inadvertent.

\textsuperscript{668}WASH. REV. CODE § 23A.08.450 ¶ 4 (1965). Note that a director held liable in connection with an illegal treasury share purchase is not entitled to contribution from even a shareholder recipient who knew of the illegality. The same result also apparently obtains for a director held liable in connection with an illegal distribution in liquidation, Compare WASH. REV. CODE § 23A.08.450 ¶ 3 (1965) with WASH. REV. CODE § 23A.08.450 ¶ 4 (1965).

\textsuperscript{669}WASH. REV. CODE § 23A.08.450 ¶ 5 (1965). This provision extends to all other matters for which directors may be held liable under WASH. REV. CODE § 23A.08.450 (1965).

\textsuperscript{670}See Steadman, Liabilities of Directors Under the Model Business Corporation Act, 7 BUS. LAW, July 1952, 9, 13. Compare WASH. REV. CODE § 23.01.260(1) (1958) ("The directors who knowingly, or without making reasonable inquiry, voted in favor"...[of the illegal distribution shall be liable]) with WASH. REV. CODE § 23A.08.450(1) (1965) ("Directors of a corporation who vote for or assent to"...[any illegal distribution shall be liable].) Thus, under the old act plaintiffs had to prove that directors had intentionally or negligently violated the substantive provisions regulating dividend declarations. See Commissioner's Note, 9 U.L.A. 172 (1957).

\textsuperscript{671}See R. STEVENS, CORPORATIONS 465 (1949). Cf. the report of the Federal Trade Commission, with reference to the dividend provisions of the Delaware Act: "There is such a thing as an illegal dividend in that state, rendering the directors liable in that amount, but the directors are so hedged in with safeguards as to render problematical the value of such a cause of action against them." S. Doc. No. 92, pt. 69-A, 70th Cong., 1st Sess. 284 (1934).
removal of this burden from plaintiffs, without further changes, would have resulted in the imposition of absolute liability on directors for illegal distributions, the New Act goes on to give directors the above noted defenses of good faith reliance on financial statements and on book value. Numerous construction problems are raised by these provisions which must be resolved before the efficacy of the statutory scheme can be appraised.

The first such problem is presented by the term "good faith", which is not defined in the Act. The following comment of the Model Act draftsmen gives some hint as to its meaning:

"Net assets" are not necessarily equivalent to net book value. For example, if the actual value of assets has fallen so far below book value that the directors cannot be shown to have relied in good faith on the book value...current value may be the governing standard.

Thus, it seems that the existence of good faith on the part of directors in connection with any distribution depends on whether they were aware of information contrary to that appearing on the statements rather than on whether they exercised reasonable diligence in determining that the financial data appearing on the statements were accurate and reliable. It also seems clear that directors for this purpose will be charged not only with those discrepancies between the actual facts relevant to the question and the data appearing on the statement of which they were aware, but also with the discrepancies of which they should have been aware in view of facts and circumstances known to them.

It may seem that the relative distribution of the burden of proof as between directors and plaintiffs resulting from the New Act provisions unduly favors the plaintiffs. It should be noted, however, that plaintiffs must still demonstrate that a distribution was made illegally, a task not without difficulty. See Note, Actions Against Stockholders to Recover Illegal Dividends, 33 COLUM. L. REV. 481, 482-83 (1933).

This omission possibly reflects confidence of the type stated in Adkins & Janis, Some Observations on Liabilities of Corporate Directors, 20 BUS. LAW, 817, 829 (1965): "An explanation of what is meant by "good faith" seems hardly necessary and should be perfectly clear to anyone who feels confident enough to shoulder the responsibilities of a corporate directorship."


D. KEHL, CORPORATE DIVIDENDS 247 (1941); and H. BALLANTINE, CORPORATIONS 594-95 (rev. ed. 1946) reach this conclusion on such good faith provisions generally.

An example of the latter appears in Cabaniss v. State, 68 S.E. 849 (Ga. Ct. App. 1910). The court was willing to imply a good faith defense to a criminal action for illegal distributions by a banking corporation. The bank was hopelessly insolvent, but its financial statement did not so indicate as numerous worthless accounts were still carried as assets. The court held that the director
The "financial statements" mentioned in the defenses appear to be defined by the reference to statements "[S]tated in a written report by [a]... certified public accountant ... fairly to reflect the financial condition of [the]... corporation...."876 Under generally accepted auditing standards, such statements will include the corporation's balance sheet and income and earned surplus statement(s), and notes thereto, and such other supporting statements as the auditor includes within his opinion.877

The remaining terms in the defense section are more troublesome. Directors are not liable if they rely and act in good faith upon financial statements. But precisely what type of reliance is here comprehended? Does the section mean that directors desiring to ascertain legal dividend determinants, say the corporation's earned and capital surplus, will be safe if they simply accept the figures shown as balanced, who was president of the bank and spent long hours there, could not claim good faith in making the distributions: "[I]t is hardly conceivable that he could have failed to know that the bank was carrying as live assets this large amount of paper which was long since hopelessly dead." Id. at 854. Compare the treatment of an inactive, frequently absent director under the Delaware good faith statute as interpreted in Stratton v. Anderson, 278 Mich. 499, 270 N.W. 764 (1936). The dividend there was possible only because the corporation's executive committee voted to allocate 10 percent of the price paid for a bulk inventory purchase to a Franchise Rights account. No record of this action appeared in the directors' minutes and there was no evidence that prior to suit defendant "ever had any knowledge of this action of the executive committee." Held: defendant acted in good faith when he relied on the corporation's financial statements and the president's statements that sufficient surplus was present.

See also Seward, Earned Surplus—Its Meaning and Use in the Model Business Corporation Act, 38 VA. L. REV. 435, 440 (1952): "The book values may be relied on unless there is good reason to believe them to be incorrect." To the same effect is N. LATTIN, CORPORATIONS 490 (1959); and Mulford, Corporate Distributions to Shareholders and Other Amendments to the Pennsylvania Business Corporation Law, 106 U. PA. L. REV. 536, 559-60 (1958).

876 Wash. Rev. Code § 23A.08.450 § 3 (1965). The language in WASH. REV. CODE § 23A.08.450 § 3 (1965) regarding written reports stating that financial statements fairly reflect the financial condition of the corporation appears to be a paraphrase of the first clause in a typical auditor's opinion: "In our opinion, the accompanying balance sheet and statement(s) of income and retained earnings present fairly the financial position of X Company at..., and the results of its operations for the year there ended..." See AICPA, Auditing Standards and Procedures, Statements on Auditing Procedure, No. 33, 57 (1963). (Query, however, whether "financial condition" in the statute was meant to restrict the statements to the balance sheet and supplementary statements. It does not appear likely since the definition of earned surplus has reference to the income statement, see part II, 42 WASH. L. REV. at 125 n.361, as does the concept of current net earnings. See text supra beginning note 604.) Other statements may be covered by the auditor's report, in which case the report will state that in the auditor's opinion, the supplementary statements are fairly stated in all material respects in relation to the basic financial statements taken as a whole. See AICPA, Auditing Standards and Procedures, supra at 84-85.

WASH. REV. CODE § 23A.08.450 § 3 (1965) is substantively identical with Model Act § 43 § 3, which was taken from ILL. REV. STAT. ch. 32, § 157.42-10 (1954). The latter uses the words "balance sheet and profit and loss statement" in place of the former's financial statements.
ances in those accounts in the financial statements? Or does it mean, instead, that directors can rely on the accounting balances only as accurate starting points from which to make the adjustments necessary to reach the financial data relevant to resolving the legal issues present? Most of the commentators and the few cases available seem to accept the first construction. Two points should be noted about this conclusion. First, even if it is accepted, directors may not find it a complete defense as certain legal determinants, e.g., the corporation's solvency and restrictions in the articles of incorporation, may not appear on the financial statements. Second, the first construction means that the effective valuation standard in the statute is the standard governing the preparation of the financial statements concerned. In the case of financial statements stated by certified public accountants to reflect the financial condition of the corporation fairly, such statements must have been presented in conformity with generally accepted principles of accounting applied on a basis consistent with that of preceding years in order to merit such certification. But what standard is implicit in a representation by the corporation's accounting officer that the financial statements are "correct"? And by what standard must the "book value" of assets be

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It would seem, on the one hand, that every book entry made by a corporate officer cannot be taken blindly without further investigation by the board in determining the funds available for dividends. Many entries in the accounts involving an exercise of judgment and discretion, such as charges for maintenance and repairs (expensing v. capitalizing), or for building up a proper reserve for uncollectibles, are matters of such importance that the financial position reflected by the books may be completely reversed as a result of the decision made; and it would seem that the board of directors must assume the responsibility of at least reviewing and examining the action of the corporate officers in these areas.


878 See, e.g., deCapriles & McAniff, supra note 879, at 1271 & n.234 and sources cited therein.

879 Article restrictions on corporate distributions should be presented in the financial statements and notes thereto under generally accepted auditing procedures. See AICPA, Auditing Standards and Procedures, Statements on Auditing Procedure, No. 33, 54 (1963). However, as previously noted, see note 779 supra, accountants on occasion have omitted mention of such restrictions.


881 One wonders whether directors will ever be able to get a corporate accountant to represent that financial statements are "correct" since that word has such heavy connotations that the resulting statements present items in the only
determined? The structure of the Act strongly suggests that the standard to be applied in both cases is the same as that applied in connection with certified statements.\(^8\)

With the aid of these assumed definitions, the combined operation of the New Act's provisions on director liability and defenses against such liability can now be examined. It is clear under these provisions that if directors make a distribution without referring to the corporation's accounting data, they will be absolutely liable if the distribution proves to be illegal. In some cases this result can be justified on the ground that the directors have failed to make even the most rudimentary investigation of the effect of the distribution on the corporation.\(^8\) But suppose the directors were acting in good faith on opinion of counsel that the valuation standard used in the Act was current value\(^8\) and hence relied upon qualified appraisers' reports as to the value of the assets? The responsible directors would still be absolutely liable if any part of the distribution was found to be illegal, even though they had used due care throughout the proceedings.\(^8\) This seems to be harsh treatment of the directors.

The fact that analysis of financial statements is generally accepted as the first step in determining the amount available for any dividend offers strong general support for the New Act defenses. But numerous problems arise under those defenses when the directors consult the corporation's accounting data because of the way the statutory scheme is set forth. Suppose, for example, that the directors involved were negligent in selecting key accounting personnel or in supervising the corporation's operating procedures which control the accuracy and defensible way that the underlying transactions could be shown. Barring greater uniformity in accounting reporting standards than now exists, see generally the symposium on this subject in 30 Law & Contemp. Prob. 621-931 (1965), conscientious accountants are far more likely to represent that the financial statements have been prepared in conformity with generally accepted accounting principles applied on a consistent basis and that all reasonable steps have been taken within the corporation to safeguard its assets, check the accuracy and reliability of its accounting data, and encourage adherence to prescribed managerial policies.\(^8\) It seems reasonable to assume that the acceptable valuation standard here should conform to the valuation standard imposed in the Act as closely as is possible without denigrating its use as a defense. For arguments to the effect that valuations resulting from application of generally accepted accounting principles are the standard imposed by the Act, see part II, 42 Wash. L. Rev. at 125-28.


\(^8\) See Gibson, supra note 885, at 489.
reliability of its accounting data.\textsuperscript{887} It would appear that so long as the directors’ negligence was not so gross as to preclude good faith reliance on the financial data concerned, the defenses would still be available; hence, the directors would not be liable under the director liability provisions even if the distribution was determined to be illegal. However, a recent Illinois case\textsuperscript{888} interpreting the statutory scheme on which the New Act provisions are based\textsuperscript{889} can be read as imposing liability on directors in this situation for breach of the general duty of due care under the prefatory clause to the director liability section which states that statutory liability is “in addition to any other liabilities imposed by law upon directors.”\textsuperscript{880} Courts interpreting the New Act will have difficulty reaching this result because of the specificity of the director liability provisions\textsuperscript{881} and the drafts-

\textsuperscript{887} This example is suggested by Dodd, \textit{Purchase and Redemption By a Corporation of Its Own Shares: The Substantive Law}, 89 U. Pa. L. Rev. 697, 712 (1941).

\textsuperscript{888} Precision Extrusions, Inc. v. Stewart, 36 Ill. App. 2d 30, 183 N.E.2d 547 (1962) involved an action against directors for voting in favor of an illegal purchase of treasury shares. The Illinois Act does not contain a provision equivalent to Wash. Rev. Code §23A.08.450 (2) (1965) making directors specifically liable for illegal purchases of treasury shares. As one ground for upholding the complaint against a motion to dismiss, the court stated:

In the present case had the directors authorized the repurchase by the corporation of its own stock under the same circumstances, they could have been held liable at common law. Section 6 of the statute formulates rules with regard to an authorization of the repurchase of its own stock by a corporation, which places a definite duty on the directors. When the directors violate that duty it is not necessary that the statute specifically provide that they can be held responsible. At common law an action against them by the corporation or creditors would lie, since the result of such repurchase would be to illegally withdraw and pay to a stockholder a part of the assets of the corporation. When liability is imposed upon a director of a corporation by statute, his common law liability for misfeasance and negligence in the performance of his duty is not thereby excluded. (Emphasis added.)

\textsuperscript{880} III. Rev. Stat. ch. 32, § 157.42 (1954) (which is the source for Model Act §43, the predecessor of Wash. Rev. Code §23A.08.450 (1965).)

\textsuperscript{881} In Precision Extrusions, Inc. v. Stewart, 36 Ill. App. 2d 30, 183 N.E.2d 547 (1962), the court was filling a gap in the Illinois statute where share purchases in certain circumstances were proscribed but no liability was attached to that proscription. In the situation posed in text, the directors have specifically been made liable in connection with illegal distributions but given a defense that may be too broad. Here, in short, the legislature has spoken.
men's clear intention to avoid problems with a negligence standard. Hence, it would appear that a statutory amendment is necessary if this type of negligence is to be clearly proscribed.

Consider, as a second situation, the plight of directors of a corporation for which a financial statement has not been prepared. The Act provides that they will not be liable even if the distribution is in fact illegal as long as they in good faith considered the assets to be of their book value in determining the amount available for distribution. Apparently all of the other factors necessary in the determination of the size of the fund available for distribution, i.e., the total amount of surplus available (and hence the amount of the corporation's debts and stated capital), the type of surplus present, and the corporation's solvency must be determined in accordance with the legal rules extant. If a distribution is illegally made because of an error in one of these determinations, be it an error in compiling data or in determining the appropriate standard for compilation, the assenting directors will apparently be liable even though the mistake did not arise from their negligence. Assuming that the appropriate standard for determining the assets' book value is generally accepted accounting principles, it is hard to understand why, if the remaining accounts are also kept in accord therewith, directors are entitled to rely on such account balances if they appear on a financial statement but are not so entitled when they merely appear in the corporation's books.

An even more troublesome case arises where the directors have a certified financial statement prepared to be used as a basis for the distribution, and then in a step most careful directors presumably

694 It is interesting to note that Ballantine, A Critical Survey of the Illinois Business Corporation Act, 1 U. Chi. L. Rev. 357, 372 (1934) called attention to this problem shortly after the Illinois act was adopted.
695 A number of cases dealing with statutes imposing liability upon directors who "assented to" illegal distributions have avoided absolute liability for directors by interpreting the assent required to be with knowledge or reason to know that the dividend was illegal. See, e.g., Chick v. Fuller, 114 F. 22, 24, 28-29 (7th Cir. 1902) (involving an early Illinois statute), and cases cited in D. Kehl, Corporate Dividends 243 n.37 (1941). The Illinois Act was thereafter amended to provide that a director present at the meeting considering the illegal distribution was conclusively presumed to have assented to the distribution, apparently in part to overcome the Chick line of cases. See Ill. Rev. Stat. ch. 32, § 157.42-9 (1954). The provisions in the Model and New Acts regarding assent are modelled on those in the Illinois Act but both omit the word "conclusively." See Model Act § 43 ¶ 3; Wash. Rev. Code § 23A.08.450 ¶ 3 (1965). It would appear, however, that even this less powerful assent clause is sufficient to block arguments based on the Chick cases.
would take, consult counsel regarding the legality of a questionable
distribution. To be more specific, assume that the corporation ac-
cording to its financial statements has no earned surplus, capital sur-
plus or current earnings and that the corporation’s solvency would not
be adversely affected by the proposed distribution. The corporation’s
assets have substantially appreciated in value, but in accord with
generally accepted accounting principles, that appreciation has not
been recorded on the corporation’s books or financial statements.
Also assume that the corporation’s counsel is of the opinion that un-
realized appreciation is recognizable as earned surplus under the New
Act. There are two possibilities for error here, both of which could
make the distribution, or a part of it, illegal. First, it may be deter-
mined that counsel’s opinion was correct but that the value placed on
the assets was excessive. Here the directors would be absolutely liable
for the amount of the illegal distribution even if the error were clerical
in nature or even if the directors relied for their valuation of the assets
upon reliable appraisers. The second possibility for error is that
counsel’s opinion is determined not to be the law. Again the directors
would be absolutely liable for the illegal distribution. The full di-
mensions of this second possibility become clearer when the attorney’s
advice concerns matters which appear on the financial statements but
which in his opinion should be treated differently under the statute.

See e.g., Status of Accounting Research Bulletins, Opinions of the Ac-
counting Principles Board, Opinion No. 6, ¶ 17 (1965).

See, for support, Seward, Earned Surplus—Its Meaning and Use In The

The appraisers may have used approved techniques in determining the
value, but could well err on the appropriate valuation standard. As to the latter
difficulties, see Hackney, Accounting Principles In Corporation Law, 30 Law

This result seems to have been recognized by Gibson, Surplus, So What?,

A frequent problem under the Act calling for attorney’s advice is the makeup
of the corporation’s capital surplus account. An attorney might well advise his
client that there is a fair probability that the corporation’s capital surplus account
as computed under generally accepted accounting principles is less (and the
corporation’s earned surplus account is more) than it should be for purposes
of the statute. Examples of such overstatements: (1) The accountant may have
charged amounts against capital surplus which under the Act should have been
charged against earned surplus. (E.g., compare the charges arising from a re-
tirement of purchased treasury shares under generally accepted accounting prin-
ciples, see Status of Accounting Research Bulletins, Opinions of Accounting
Principles Board, Opinion No. 6, ¶ 12 (1965), and under the statute. See text
supra, beginning note 752.) (2) The accountant may have increased earned surplus
with amounts that under the statute are capital surplus. (E.g., the accountant may
have used the economic method of reporting an investment in a subsidiary and
credited earned surplus for the increase in the parent’s equity in the subsidiary.
See part II, 42 Wash. L. Rev. at 162. Under the statute, such increase apparently

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If counsel's advice causes directors to analyze the amounts shown as surplus on the financial statements, good faith reliance on the accounting balances is no longer possible; hence, directors will be absolutely liable if it is later determined that the distribution, or part of it, was illegal. Practical directors are likely to conclude that inclusion of lawyers in deliberations concerning distributions can only lead to trouble.

These problems suggest that a different statutory scheme should be adopted. But latent in the preceding analysis is the fact that such schemes require resolution of some of the most difficult policy issues in corporation law. The directors involved face huge potential liability in connection with transactions in which their own interests may be slight. The issues involved are so complex that directors in most cases are likely to rely heavily on the advice of the corporation's accountants and attorneys in making any distribution. Because these transactions are so recurrent, directors will desire a fairly certain standard by which their possible liability can be determined. But at the same time, directors generally would presumably not favor a certain standard that had the result of making them liable where they were not at fault. Creditors and shareholders would prefer that any liability standard adopted would encourage maximum compliance with the statutory protections afforded them by the Act. And, as previously noted, they obviously would desire that the scheme be so designed that suits on their behalf would not be a practical impossibility.

The draftsmen's weighing of these factors obviously ranked cer-
tainty primary, with the deleterious effects on the other interests already noted. Most of the problems noted would be avoided if in place of the present defenses directors were required to demonstrate that they had acted in good faith and with due care in connection with the illegal distribution. This standard has not received general acceptance presumably because of the fear that simple reliance on financial statements might not constitute due care. Provisions in the recently enacted New York act and in two other acts appear to have overcome this problem. The New York statute provides that assenting directors will not be liable for an illegal distribution if, in the circumstances, they have discharged their duty to the corporation. The director's duty to the corporation is discharged (a) when he acts in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions and (b) when he in good faith relies upon financial statements of the corporation represented to be correct by the president or the officer of the corporation having charge of its books of account, or stated in a written report by an independent or

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909 No United States corporation statute currently uses this precise formulation. However, Tex. Bus. Corp. Act, art. 2.41 (c) and (d) (1955), which inserts the words "in the exercise of ordinary care" before the Model Act good faith defenses and adds a similarly conditioned good faith reliance on counsel's opinion clause, seems to reach the same result in most cases. Also, a number of states still require that plaintiffs prove that defendants intentionally or negligently declared the illegal distribution. See, e.g., La. Rev. Stat. Ann. § 12.27 (1950); Mich. Stat. Ann. § 21.48 (1963); N. J. Stat. Ann. § 14:8-19 (1937). And such was the rule at common law. See D. Keihl, Corporate Dividends 237 & n.12 (1914).
910 See, e.g., Cornell v. Seddinger, 237 Pa. 389, 85 A. 446 (1912). But see Ballantine & Hills, Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws, 23 Calif. L. Rev. 229, 263 (1935), who seem to be of the view that due care may not even require examination of the financial statements. It is hard to believe that a modern court would reach that conclusion.

Ballantine and Hills also raise the issue of whether directors may be liable for violation of the duty of due care if they declare a dividend which is permissible under the statute but which no reasonable and prudent man in the exercise of due care would have made in the circumstances. Id. at 260. The loose language in Precision Extrusions, Inc. v. Stewart, 36 Ill. App. 2d 30, 183 N.E.2d 547 (1962), quoted supra note 888, could be interpreted as authorizing such an action. But the addition of the equitable solvency test to the Act should do much to eliminate problems of the sort mentioned by Ballantine and Hills. Moreover, that type of liability seems to undercut the whole notion of having statutes regulating the distribution of assets from corporations since the thesis of such statutes must be that directors need fairly clear rules by which to determine the propriety of distributions.

certified public accountant to reflect fairly the financial condition of the corporation.\(^9\) This provision permits directors whose diligent inquiries about the relevant financial data would otherwise disqualify them from asserting the good faith defenses to defend themselves from liability on illegal distributions by demonstrating that the distributions were made with due care. It seems to produce a fair accommodation of the interests discussed above and a resolution of the problems raised by the New Act provisions.\(^9\) The provision thus would be a valuable addition to the New Act.\(^9\)

A second issue raised by the New Act provisions on director liability concerns the propriety of holding assenting directors liable for the amount of the illegal distribution in every case.\(^9\) This provision,

\(^9\) N.Y. BUS. CORP. LAW § 717 (McKinney 1963).

It should be noted that the New York provision contains no reference to good faith reliance on book values. If the corporation's accounting records are kept in accordance with generally accepted accounting principles, there seems to be no reason why good faith reliance on such account balances should not be permitted. To avoid the asset limitation in the New Act, see text supra beginning note 866, the words “corporation's accounts or” could be inserted before the words “financial statements” where the latter first appear in WASH. REV. CODE § 23A.08.450 ff (1965). Cf. DEL. CODE ANN. tit. 8, § 172 (1953); ALA. CODE tit. 10, § 21 (31) (Supp. 1965).) (The words “financial statements” would have to be added before “stated in a written report...” to complete the section.) The good faith reliance on book value provision could then be deleted. Deletion of the book value clause might be viewed with dismay by those espousing the use of current values as the valuation standard in the Act (see Seward, supra note 875, at 440). But it was doubtful that that clause had that effect in any event. See part II, 42 WASH. L. REV. at 125-27 & n.364.

\(^9\) It is not crystal clear that the statute deals with the problem of director negligence other than by a provision similar to the prefatory clause to the New Act director liability section providing that the New York director liability provision shall not affect any liability otherwise imposed by law upon directors. See N.Y. BUS. CORP. LAW § 719(f) (McKinney 1963). However, the overall tone of N.Y. BUS. CORP. LAW § 717 (McKinney 1963) certainly suggests that directors will not have discharged their duties if they are negligent in supervising the accounting operations of the corporation.

\(^9\) Alternatives to the New York approach, attempting to resolve some or all of the problems noted in text, appear in TEX. BUS. CORP. ACT art. 2.41(c) and (d) (1955) discussed supra note 909, and ALA. CODE tit. 10, § 21 (31) (Supp. 1965) (adding reports made by an appraiser selected with reasonable care to good faith reliance defenses). Of these provisions, TEX. BUS. CORP. ACT art. 2.41 (c) and (d) (1955) is the closest to the New York provisions, with deviations that are both more restrictive and more liberal. Under the Texas provision, directors must act with “ordinary” care in using the financial statement. This may mean that directors may not be able to use the statements without the advice of counsel. The New York statute does not impose this requirement. The Texas provision specifically authorizes reliance on advice of counsel, which presumably would be recognized under the New York provision by means of the due care portion of the statute with about the same end result. But there is no room in the Texas statute for the use of appraisers, which would also be permitted under the New York due care provision.

As the Alabama provision illustrates, some of the problems mentioned in text could be solved by expanding the good faith reliance items. But this approach would not resolve the absolute liability questions.

taken from the Model Act, has been amended by some of the legislatures adopting that Act. These amendments provide that directors will be liable for illegal distributions only to the extent of (a) the claims of creditors as of the date the distribution was voted who obtain judgment against the corporation on which execution is returned unsatisfied and (b) the claims of any shareholder who is injured by the distribution, subject to an overall limitation to the amount of the illegal distribution. These provisions are superior to those in the New Act because they recognize that creditors whose claims arise after a distribution is voted could not have relied on the assets distributed. They also recognize that there is no reason for director liability on an illegal distribution where no injury results to either predistribution creditors or shareholders. Thus, such provisions should be considered as an amendment to the New Act.

A third question regarding the new director liability provisions concerns the propriety of leaving to the common law the determination of an appropriate statute of limitations for actions against directors for illegal distributions. Prior cases on the subject have not produced consistent results. Thus, one line of authority takes the position that because directors are trustees, no statute of limitations is applicable to such actions. And in the line of cases holding that limitations are applicable, there is considerable disagreement as to which of the more general statutes of limitation should be applied to such causes of action. Finally, there is considerable disagreement in the latter

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97 See CONN. GEN. STAT. ANN. § 33-321(b) (1958); N.C. GEN. STAT. § 55-32(c) (1965); cf. N.Y. BUS. CORP. LAW § 719(a) (McKinney 1963); HAWAII REV. LAWS § 172-110 (Supp. 1965); OHIO REV. CODE ANN. § 1701.95(A) (Page 1964); OKLA. STAT. ANN. tit. 18, § 1.146(b) (1953).
99 To allow the corporation to recover in such circumstances would allow the funds recovered to inure to the benefit of shareholders who were not injured in connection with the distribution. Some courts have not permitted such recoveries even though the statutes authorized them. See Spiegel v. Beacon Participations, 297 Mass. 398, 8 N.E.2d 895 (1935).
100 WASH. REV. CODE § 23A.08.450 (1965) contains no statute of limitations on such actions.
102 In the cases involving dividends paid in violation of statute, a number of courts have held that the appropriate statute of limitations is that governing actions based on liabilities created by the statute. See Purcell v. Baker, 270 Ky. 772, 110 S.W.2d 1079 (1937); McGill's Adm'r[s] v. Phillips, 49 S.W.2d 1025 (Ky. 1932); Gallagher v. New York Dry Dock Co., 19 N.Y.S. 2d 789, aff'd, 32 N.Y.S. 2d 348 (1942). In jurisdictions like Washington which do not have statutes of limitations on statutory liabilities, the cases split between analyzing the basic cause of action as a tort (see Smalley v. Bernstein, 115 So. 347 (La. 1927)), a viola-
group of cases as to when the cause of action can be said to arise. It would have been helpful had the draftsmen followed the old act’s example and included a specific limitation in the Act to resolve these unnecessary controversies.

Finally, the New Act section enabling directors held liable for an illegal distribution to seek reimbursement from shareholder-recipients appears to have omitted inadvertently a provision enabling directors to seek reimbursement from a shareholder whose shares were illegally purchased.

2. Shareholders’ Liability. The New Act omits the old act’s provisions regarding the circumstances in which shareholders receiving illegal distributions would be liable on suit by the corporation or its creditors. The effect of this omission seems to be that questions of direct shareholder liability are to be determined under the line of decisions involving shareholder liability in the absence of statute.


See Note, The Statute of Limitations in Stockholders’ Derivative Suits Against Directors, 39 Colum. L. Rev. 842, 851-52 (1939); W. Fletcher, supra note 921, at § 1306.

Wash. Rev. Code § 23.01.260(3)(a) (1958) (limiting actions to two years from date of payment).

Other statutes dealing specifically with the question include: N.C. Gen. Stat. § 55-32 (m) (1965); Conn. Gen. Stat. Ann. § 33-321(b) (1960) (both providing limitation of three years from the time when the cause of action was discovered or ought to have been discovered); Del. Code Ann. tit. 8 § 174 (1953) (six years after payment). Of these two forms, the date of payment appears the most certain starting point. Compensation can be made for problems in discovery by a longer limitation period of the type used in the Delaware statute.

There appears no logical basis on which to distinguish illegal dividends or asset distributions from illegal treasury share acquisitions on the right of directors to contribution. Indeed, if one pursues Dodd’s notion that shareholders whose shares are purchased illegally ought to be liable to the corporation in every case, see Dodd, Purchase and Redemption By a Corporation Of Its Own Shares: The Substantive Law, 89 U. Pa. L. Rev. 697, 710-11 (1941), director contribution rights in such cases should be even greater. The omission may have resulted from the fact that the Model Act draftsmen added the subsection imposing liability on directors for illegal share repurchases to the Illinois Act which the draftsmen used as a model (see Ill. Rev. Stat. § 157.42 (1954); Precision Extrusions, Inc. v. Stewart, 36 Ill. App. 2d 30, 183 N.E.2d 547 (1962)) without considering the effect of that change on the contribution section.


It may be argued that the draftsmen intended that shareholders should be liable only to directors for possible contribution (see Ballantine, supra note 916, at 373) and hence that liability to creditors or the corporation could arise only by virtue of a creditor’s bill upon the directors’ statutory right of contribution from knowing shareholders. See Sussex Trust Co. v. Bacon, 11 Del. Ch. 380, 102 A. 785 (1917). However, the Illinois court recently interpreted the predecessor provisions to the Model (New) Act provisions on director liability as not foreclosing a common law action against shareholders for illegal distributions.
Those decisions indicate generally that (a) recipients with knowledge of the illegality of the distribution are likely to be liable for the amount received, and (b) innocent recipients will be liable if the corporation was insolvent at the time of distribution, may be liable if the corporation was solvent at the time of distribution but later became insolvent, and probably will not be liable if the corporation was solvent both before the distribution and thereafter. Apparently corporate recovery of the illegal distribution from the directors will exonerate the shareholders.

It is unfortunate that the New Act draftsmen chose not to deal with the subject because they could have eliminated much of the uncertainty concerning when shareholder-recipients will be liable and could have taken into account other factors that have not been focused upon in the cases decided thus far. If such an amendment is considered, it should begin with provisions of the sort found in the old act which make shareholders liable only in the event that no director is liable in connection with the illegal distribution or in the event that execution of judgments against the directors held liable produces insufficient returns. These provisions make it clear that directors are primarily responsible for illegal distributions and that there is no justification for double recovery by the corporation of amounts distributed illegally. Further qualifications upon shareholder liability and standards for determining which shareholders should be liable for illegal distributions should be made in accord with the provisions in the recent Pennsylvania statute. Addition of the Pennsylvania provisions to the New Act would mean that when shareholders were liable under

See Reilly v. Segert, 31 Ill. 2d 297, 201 N.E.2d 444 (1964). This result seems to be the majority rule on the subject. See, e.g., Ulness v. Dunnell, 61 N.D. 95, 237 N.W. 208 (1931); Briggs, Stockholders' Liability for Unlawful Dividends, 8 Temple L.Q. 145, 180 (1933).

The text immediately following is a paraphrase of the excellent review of the common law results in such cases presented by Fuld, Recovery of Illegal and Partial Liquidating Dividends from Stockholders, 28 Va. L. Rev. 50, 50-54 (1941). Other authorities dealing with the situation at common law include Briggs, supra note 928; D. Keel, Corporate Dividends 270-76 (1941).

The authorities listed above and cases cited therein deal primarily with illegal dividends. However, the courts seem to apply the same rules to illegal treasury share purchases. See, e.g., Reilly v. Segert, 31 Ill. 2d 297, 201 N.E.2d 444 (1964).

See Williams v. Boice, 38 N.J.Eq. 364 (Ch. 1884).


See R. Stevens, Corporations 464 (1949).

N. Lattin, Corporations 493 (1959) states the Washington statute has “more insight into the facts of corporate life” than provisions making the shareholder directly liable to the corporation even though some or all of the directors may be liable and able to satisfy the judgment. See also Williams v. Boice, 38 N.J.Eq. 364 (Ch. 1884).
the Act, all shareholders would be liable to the corporation for the amount of any illegal distribution received by them only when the corporation at the time of the distribution was insolvent or when its net assets were less than the liquidation preference of preferred shares at the time of distribution. In all other cases in which shareholders would be liable for illegal distributions, only shareholders who knew or should have known from facts within their knowledge at the time the distribution was received that the distribution was illegal would be liable.934 This provision favors the innocent shareholder over creditors in cases where the corporation was solvent at the time of distribution but later became insolvent.935 That resolution of the controversy previously alluded to seems appropriate since creditors, as compared to shareholders, can more easily take steps to protect their interest in this respect.936 The provision expands the common law notions by prescribing general shareholder liability where the preferred shareholders' interest may be affected by an illegal dividend. This extension is appropriate because generally there is no reason to prefer even an innocent common shareholder over a preferred shareholder in such a case.937 These changes, along with modifications of the directors' right of contribution938 and the addition of the old act's statute of limitations,939 would be valuable additions to the New Act.940

934 PA. STAT. ANN. tit. 15, § 1707(B) (1967). This provision includes as a distribution of assets the purchase of the corporation's own shares. Dodd, Purchase and Redemption By a Corporation of Its Own Shares: The Substantive Law, 89 U. PA. L. REV. 697, 710-11 (1941) would make shareholders whose shares are repurchased illegally liable to the corporation in virtually every case. It is hard to understand why such liabilities should result where the shareholder was not at fault and the interests of the creditors and preferred shareholders are protected. Hence, the Pennsylvania provision seems more appropriate.

935 Accord, McDonald v. Williams, 174 U.S. 397 (1899); Carlisle v. Ottley, 143 Ga. 797, 85 S.E. 1010 (1915).

936 See Fuld, supra note 929, at 52-53; Note, Actions Against Stockholders to Recover Illegal Dividends, 33 COLUM. L. REV. 481, 491 (1933).


938 This change is necessary to make the contribution provisions correlate with the provisions regarding shareholder liability.

939 WASH. REV. CODE § 23.01.260(3)b (1958) provides that the statute of limitations on actions against shareholders is two years from the date of final judgment against the directors. This seems to be an appropriate limitation under the liability scheme described above, as it affords some protection to the shareholders' reliance interest. See Note, Actions Against Stockholders to Recover Illegal Dividends, 33 COLUM. L. REV. 481, 492 (1933).

940 Statutory changes adopted in the 1967 session of the legislature require an addendum to the first subject in this paper: the effect of the adoption of the New Act provisions on the rights of shareholders in corporations organized before its effective date. See part I, 41 WASH. L. REV. at 209-13. It will be recalled
that the court in Swanson v. Perham, 30 Wn. 2d 368, 191 P.2d 689 (1948), relied, in addition to its constitutional ground, (as to the validity of its constitutional analysis, see Kummert, Limitations on Alteration of Shareholder Interests in Connection with the Adoption of a New Corporation Statute in A REVIEW OF THE EFFECT OF WASHINGTON BUSINESS CORPORATION ACT ON EXISTING CORPORATIONS (King County Bar Association ed. 1967)), upon the following language that appears in the savings clause (Laws of 1933, ch. 185, § 63, 814) of the Uniform Business Corporations Act: "This act shall not impair or affect any...right accruing, accrued or acquired...prior to the time this act takes effect...." The court used this language to conclude that the legislature in enacting the Uniform Act had intended that no right accruing, accrued or acquired prior to the effective date of the old act should be impaired or affected by the adoption of that act. Id. at 376. (Emphasis the court's.)

The savings clause in the old act is similar to the savings clause appearing in § 143 of the Model Act:

The repeal of a prior act by this Act shall not affect any right accrued or established, or any liability or penalty incurred, under the provisions of such act, prior to the repeal thereof.

In an apparent attempt to avoid the statutory ground in Swanson, the New Act as adopted in 1965 contained the following clause (WASH. REV. CODE § 23A.44.140 (1958)) in place of the Model Act savings clause:

Neither the enactment of this title nor the amendment or repeal thereof...shall take away or impair any liability of [or?] cause of action existing or accrued against any corporation, its shareholders, directors or officers.

The effects of this provision were qualified by the adoption by the 1967 Legislature of the following separate section:

The repeal of a prior act by ch. 53, Laws of 1965, shall not affect any right accrued, acquired or established, or of any liability or penalty incurred under the provisions of such act prior to the repeal thereof.


Precisely what the draftsmen had in mind in connection with their latest change is not clear. It is evident, however, that the latest provision varies from the substantive language in the Model Act provision only in the addition of the word "acquired" between the words "right accrued or established." One is tempted to say that all that was intended was to realign the Washington statute with the Model Act. Such desire would be consistent with the earlier apparent intent of avoiding any question regarding vested rights under Swanson as the draftsmen of the Model Act have made clear their intention not to preserve any broad class of shareholder rights. See Comment, 2 MODEL ACT ANN., § 142 ¶ 4; Gibson, How Fixed Are Class Shareholder Rights?, 23 LAw & Contemp. Prob. 283, 292-94 (1958). However, the addition of the word "acquired" may indicate a different purpose on the part of the draftsmen, for the word appears in the Uniform Act savings clause interpreted by the court in Swanson, supra, and indeed was the subject of a number of references by the court in the process of reaching a conclusion that certain shareholder rights cannot be affected by the adoption of a new statute. See 30 Wn. 2d at 376. Therefore, perhaps the intent was to add a savings clause substantively identical to that considered in Swanson with a view to preserving the rights preserved by the court in Swanson.

If the second interpretation prevails, the question then becomes whether the court, in accord with the holding noted above, meant to protect all shareholder rights or simply those shareholder rights that are "vested." It may seem that under the broader interpretation the difficult question of which shareholder rights are vested is avoided. But in its place a new question arises as to which rights are shareholder rights, or in other words, whether any of the New Act's provisions can be applied to an existing corporation because in some sense they may affect a shareholder's rights. Assuming that the court intended to protect only "vested" rights, one then encounters difficulty in trying to determine which rights are "vested," in large part because of the increasing dissatisfaction with the term. See, e.g., H. BALLANTINE, CORPORATIONS 649 (rev. ed. 1946); McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N.Y.S.2d 253 (S. Ct. 1945). About the best that one can do is to examine the cases and the commentators to see what rights (and in particular those rights that may be affected by differences between the
old and new acts) have at some point been labelled "vested." Using this standard, the following rights would be "vested":

1. The right to vote cumulatively (and presumably any amendment designed to make that right less effective [e.g., classification of directors]). See Swanson v. Perham, supra. But see Maddock v. Vorclone Corp., 17 Del. Ch. 40, 147 A. 255 (1929).

2. The right to arrears of accrued dividends on cumulative preferred shares. See, e.g., Keller v. Wilson, 21 Del. Ch. 391, 190 A. 115 (1936).


6. The right to have shares remain non-callable (i.e., not subject to redemption at the option of the corporation). See Breslav v. New York & Queen Elec. Light & Power Co., 273 N.Y. 593, 7 N.E.2d 708 (1937).


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