THE FORMATION OF COMPANIES UNDER THE ENGLISH COMPANY LAW: A COMPARISON WITH AMERICAN LEGISLATION.

The Provisions of the English Companies Act (1908).

By the common law of England a corporation could be formed only in one way, by special charter granted by the crown. The legislature might, it is true, by a special act create a corporation, but it was not a common law corporation, for this act of the legislature was a statutory change in the law. Though it was always possible to form a corporaion by royal charter, this method was not frequently resorted to, the crown being very reluctant to grant charters of incorporation. Necessarily, therefore, applications to Parliament for special acts of incorporation increased with the development of industrial conditions.

The formation of what may be called "the Common Law Companies," that is, unincorporated associations or large partnerships trading upon a joint stock with transferable shares, originated in a desire for a simpler form of business organization which would secure, as far as practicable, by mere mutual agreement among the members, the benefits of incorporation. At the beginning of the 18th Century a mania for speculation caused these companies to multiply rapidly; some being formed for a useful, but the majority for the most chimerical, purposes. The Bubble Act (1719) was an attempt "to check these dangerous and mischievous projects." It is said, however, that the South Sea Company, itself the greatest speculator, was the instigator of this act, in order to stifle competition. It eventually proved a dead letter, and was repealed in 1825.[1]

It was inevitable that the passage of a special act for the incorporation and regulation of each company, whenever incorporation was desired, should become burdensome to Parliament. Necessarily the special acts repeated the same provisions as to all corporations of the same class, resulting in general similarity

[1] Encyclopædia of Laws of England, Vol. 3, page 255.

throughout this legislation. The natural step in advance was a general act, and in 1844 the first general incorporation act [2] was passed enabling all projected companies, with few exceptions, to obtain a certificate of incorporation without applying for a charter or a special act. In 1845, Parliament passed an act called "The Companies Clauses Consolidation Act." [3] The provisions of this act were to be taken as embodied in all subsequent special acts, except in so far as expressly excluded. The act did not deal with the formation of companies, but merely provided a method of regulating companies formed under special acts.

This was the beginning. From that time to this, with the increase in corporations, especially corporations for profit, commonly known as "business corporations" many enabling or regulating acts were passed. The most radical step, however, came in 1855, when the legislature for the first time sanctioned the principle of limited liability.[4] With the passage of this act, the potentialities of joint stock association became apparent. Since 1855 many amendatory or repealing acts have been passed with a view to the better regulation of these companies.

With co-operation and limited liability as an incentive, company enterprise in England has increased remarkably. In 1907 fully 40,000 companies were carrying on business under the Companies Act.[5] In 1908, all the previous Companies Acts were repealed, and "The Companies (Consolidation) Act of 1908" [6] was passed, retaining, however, most of the provisions of the Act of 1862. This act aims to embody all the provisions of previous acts that have been found necessary and practicable after years of legislation and litigation.

The first section of the act makes it obligatory on the part of a partnership of more than twenty persons to register and to go through the same steps as a company seeking incorporation.

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[2] 7 & 8, Vict. c. 110.
[3] 8 & 9, Vict. c. 16.
[4] 18 & 19 Vict. c. 133.
[5] Encyclopædia of Laws of England, Vol. 3, p. 255.
[6] 8 Edw. VII, c. 69. An act to consolidate the Companies Act, 1862 and the Acts amending it.

The second section is permissive, and gives to any partnership consisting of seven or more persons (any two or more persons where the company to be formed will be a private company within the meaning of this act)[7] associated for any lawful purpose, the right to form an incorporation. In order to accomplish this, these "seven or more persons" must subscribe their names to a memorandum of association.[8] The company may be incorporated with the liability of its members (1) limited, or (2) unlimited, or (3) limited by guarantee; that is to say, each member agrees to contribute to the assets of the company a certain sum not exceeding a stated amount in the event of the company being wound up. Any of these companies may or may not have its capital divided into shares.

The memorandum to which these seven incorporators subscribe, must state which one of the three kinds of liability is selected, and by what name the company is to be called. If the liability is limited by shares or guarantee, the word "Limited" must be appended to the company name. The memorandum must also state whether, and how much of, the capital stock is to be divided into shares, and each subscriber must write opposite his name the number of shares he takes. No subscriber may take less than one share. The objects of the company must also be set out.[9]

No company will be permitted to register by a name identical with or so similar to the name by which a company in existence is already registered, as to be calculated to deceive.[10] Any company may, with the approval of the Board of Trade, change its name.[11]

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[7] See the discussion of the private company in another part of this article (*infra*).

[8] Sec. 2 of the Act.

[9] Secs. 2, 3, 4, 5.

[10] Sec. 8.

[11] Sec. 8, c. 3. This Board of Trade is entirely different in its functions from our Board of Trade. Its origin dates back to 1782 and the Act of 22 George III, c. 82, may be taken as the ultimate foundation upon which the Board rests. Since its creation it has changed by degrees from a consultative to an administrative or regulative body. "The Board of Trade, although apparently an ordinary Government office directed by a single minister of State with the aid of a permanent staff, is strictly speaking a committee of the Privy Council, the president of which in theory has no

The memorandum must be delivered to the Registrar of Companies in the place where the registered office of the company is to be situate.[12] (The office of Registrar of Companies is the office in which all documents requiring registration must be filed.)

Annexed to the act are a number of provisions for the regulation and management of a company limited by shares, called "Table A." Under section 10 of the act, a company limited by shares *may* register, with its memorandum, articles of association signed by the subscribers and prescribing regulations for the company. But the company limited by guarantee or unlimited *must* file articles of association with its memorandum.[13] The articles *may* adopt any or all of the regulations contained in Table A. In the case of a company limited by shares, if no articles are registered, or if articles are registered, in so far as the articles do not exclude or modify the regulations in Table A, those regulations shall, so far as applicable, be the regulations of the company in the same manner and to the same extent as if contained in duly registered articles.[14] Though it is not necessary for any company to adopt Table A as its regulations, yet the courts have held that it may be looked on as showing the views of the legislature with regard to the matter therein contained.[15] It has also been held that in view of sections 10 and 11, any act done under an article which is in substance identical with a regulation found in Table A, cannot be *ultra vires*.[16]

The memorandum and articles when registered are binding upon the company and upon all the members to the same extent

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greater administrative powers than his colleagues have." The Board has the duty of settling and approving the by-laws of railway companies, and duties in connection with the inspection of passenger steamers. It is now divided into departments each dealing with a separate subject matter, and consisting of the Statistical, Railway, Marine, Harbour, Finance, Fisheries and Bankruptcy Departments. Encyclopædia of Laws of England, Vol. 2, pages 312-325. See page 314 to 318 for a discussion of the "Growth of the Functions of the Board of Trade."

[12] Sec. 15.

[13] Sec. 10.

[14] Sec. 11.

[15] Pyle Works, 44 Ch. Div. 534, 571; Barnard Banking Co., 3 Ch. 105, 113, 114.

[16] Lock v. Queenland Investment Co., 1896, 1 Ch. 397, 406; 1896, A. C. 461, 465.

as if they respectively had been signed and sealed by each member, and contained covenants on the part of himself, his heirs, executors and administrators, to observe all the provisions of the memorandum and of the articles, subject to the provisions of the act.[17]

Upon the registration of the memorandum and articles, the registrar certifies under his hand that the company is incorporated, and in the case of a limited company that it is limited. From the date mentioned in this certificate, "the subscribers of the memorandum together with such other persons as may from time to time become members of the company, are a body corporate by the name contained in the memorandum, capable forthwith of exercising all the functions of an incorporated company, and having perpetual succession and a common seal, with power to hold lands; but with such liability on the part of the members to contribute to the assets of the company in the event of its being wound up as is mentioned in this act."[18] This certificate of incorporation is conclusive evidence of compliance with all the requirements of the act in respect to registration and all matters precedent and incidental thereto.[19]

Having received the certificate of incorporation the members are now an incorporated body. This, however, does not mean that it may carry on the business for which the corporation was formed.[20] It may, however, proceed to sell its shares to the public. To do this, a "Prospectus" is issued as an advertisement soliciting subscriptions. The act, however, provides that certain statements for the protection of the public must be made in this prospectus. The requirements are very numerous and practically amount, when carried out, to a full disclosure of the affairs of the company up to the time this invitation to subscribe is issued to the public. In general, it is required to contain the names of the directors or proposed directors, a copy of the memorandum and the number of deferred shares and the nature and extent of the interest (if any) of the holders in the property of the com-

[17] Sec. 14.
[18] Sec. 16, c. 2.
[19] Sec. 17.
[20] Sec. 87.

pany, the number of shares necessary to qualify a director (fixed by the articles), the minimum subscription upon which the directors may proceed to an allotment, and the amount payable on application and allotment on each share (fixed by the articles, but never less than five per cent.), the amount paid or intended to be paid to any promoter and the consideration therefor, the nature and extent of the interest of any director in the promotion of, or in the property proposed to be acquired by the company, the dates and parties to every material contract and a reasonable time at which they can be inspected. This requirement, however, does not apply to any contract entered into in the ordinary course of business carried on, or intended to be carried on, by the company. If there are shares of more than one class, the respective rights of voting conferred by the several classes of shares must be stated. In case the company has acquired, purchased, or proposed to purchase, any property which is to be paid for wholly or partly out of the proceeds of the issue offered for subscription by the prospectus, or in shares of the company, the prospectus must state the name or names of the vendors, a description of the property and the consideration therefor, and the interest in the company (if any) of any one or more of the vendors of the property.[21] If good will is included in the above consideration, the estimated value of good will must be set out.[22] And, finally, any condition requiring or binding the applicant for shares to waive compliance with these requirements, or purporting to effect him with notice of contracts, etc., to be set forth, is void.[23]

This prospectus must then be dated and a copy thereof, signed by the proposed directors, filed in the proper office of the Registrar of Companies.

The prospectus having been issued and shares subscribed for, the directors may then proceed to allotment. But no allotment may be made until, *first,* subscriptions have been received to the amount, if any, fixed by the memorandum or articles and set

[21] These provisions are not applicable to a private company, which does not issue a prospectus. See Sec. 82.

[22] Sec. 81 (g).

[23] Sec. 81, c. 4.

out in the prospectus, as the minimum subscription upon which the directors may proceed to allotment (or if no amount has been so fixed, then unless the whole amount of the capital offered has been subscribed for), and, *second,* the sum fixed as payable on application has been received by the company. An allotment made by the company to an applicant in contravention of the above provisions of the act is voidable at the instance of the applicant within one month after the holding of the statutory meeting [24] of the company and not later, and shall be so voidable notwithstanding that the company is in the course of being wound up.[25]

No company is entitled to commence business or exercise borrowing powers until a declaration has been filed with the registrar stating that shares have been allotted to an amount not less than the minimum subscription, and that every director has paid in cash to the company on each of the shares taken or contracted to be taken by him, a proportion equal to that payable on application and allotment on the shares offered for public subscription. Upon filing this declaration sworn to by the secretary, the registrar certifies that the company is entitled to commence business, and this certificate is conclusive evidence that the company is so entitled.[26] Any contract made by a company before such certificate has been issued is provisional only and is not binding on the company until that time, when it does become binding.[27]

Within not less than one nor more than two months after the issue of the certificate entitling the company to commence business, every limited company must hold a general meeting of its members, called the "statutory meeting."[28] Seven days prior to the date set for the meeting, the company (except a private company) must send to all its members a report called the "statutory report," certified by not less than two of the directors. The

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[24] *Infra,* page 425, for explanation of statutory meeting.
[25] Sec. 85, clauses 1, 2 and 3.
[26] Sec. 87 (a), (b), (c) and (d) and clause 2.
[27] Sec. 87, clause 3.
[28] Sec. 65.

report must contain, in general, a full statement of the condition of the company up to the time of making the report, and a statement of the disposition of the funds received. It must show the total number of shares allotted and how they have been paid for, the expenditure and income under distinct headings, the names and addresses of the directors, secretary and auditors (if any), and the particulars of any contract, the modification of which is to be submitted to the meeting for its approval, and the particulars of the modifications. A copy of this report must be filed with the registrar immediately after it has been sent out to the members.

During the meeting the directors shall cause a list of members and their addresses to remain open and accessible to the members. Any matter arising out of the report or relating to the formation of the company may be discussed at the meeting; and if proper notice has been given, a resolution relating thereto may be made. If proper notice has not been given, the resolution may be brought up at the adjourned meeting in order to permit of such notice, it being proper under the act to adjourn the first statutory meeting from time to time, each succeeding meeting having the same power as the previous meeting. An application for winding up the company may be based on the failure to hold the statutory meeting or to file the statutory report as required by the act, but the court may in its discretion order the meeting to be held or the report filed, or grant the petition.[29]

It is, therefore, apparent that the members at the meeting may take up the details of the issue of stock for property, and if they find any over-valuation, propose upon proper notice, a resolution with reference to the issue. The effect of this section, in conjunction with the sections dealing with the form and contents of the prospectus, is to give to the members an opportunity to protect themselves from the evil effects of the over-valuation of property paid for with stock of the company.

Comparison with American Legislation.

The idea of compulsory incorporation in the first section of the Companies (Consolidation) Act of 1908, is entirely foreign to

[29] Sec. 65, clauses 6, 7 and 8.

our law, except in so far as such requirement has been applied to a particular class of business in which the public are said to have an interest because of its extra hazardous nature, as, for instance, the insurance business. It may be argued that many non-incorporated associations are required, in most states, to register with a particular state officer, and that the English Act does not amount to more than this because of the fact that partnerships, even though registered under the English Act, may have, if they so desire, unlimited liability of their members, and, if registered as a private company (under the definition given in the act),[30] non-transferable shares. But this is not so. The act requires more than mere registration. Given an association of more than the specific number of partners, that association must register. Once there is an association which must register, it must go through the same steps as a company seeking incorporation. When an association has complied with all the requirements of the act relating to registration, a *certificate of incorporation* is issued,[31] and the association becomes subject to all the regulations applicable to an incorporated body under the act. It is apparent, therefore, that mere registration is not sufficient.

It will also be noted that the second section of the act permits *any* seven or more persons to form an incorporated company, without regard to their citizenship. In this country many of the states make citizenship requirements, some requiring that at least one,[32] others that a majority,[33] of the incorporators shall be citizens of the state in which the incorporation is sought. The Missouri statute provides that at least three of the *directors* of the corporation must be citizens of the state. Many states are content with the provision that one or more of the *incorporators* shall be *residents* of these states.[34] New Jersey has no requirement of citizenship; any persons by otherwise complying with the provisions of the statute may form a corporation. Pennsylvania requires at least one incorporator within its juris-

[30] Sec. 121.
[31] Sec. 16.
[32] Maryland, Pennsylvania.
[33] Ohio.
[34] California, Idaho, New York, Wisconsin.

diction to whom it can turn in the event of evasions or fraud, etc. It is submitted that these provisions do not accomplish the purpose for which they were framed. In practice there is nothing to prevent the real incorporators from setting up a "dummy" incorporator to meet the requirements of the Pennsylvania statute, or three "dummy" directors in Missouri. Have either one of these states accomplished more than the State of New Jersey? Is it wise to burden an act with provisions which accomplish nothing of value?

Under section two of the English Act, in order to form a corporation in the ordinary case, there must be at least *seven* incorporators. But if the corporation "to be formed will be a private company within the meaning of this act," there need be only *two* incorporators.[35] In this country the distinction between a private and a public corporation seems to be that the latter "are such only as are founded by the government for public purposes, the whole interests belonging to the government."[36]

This, however, is not the distinction comprehended by the English Companies Act. A private company is defined in the Act as a company which by its articles:

(*a*) restricts the right to transfer its shares; and

(*b*) limits the number of its members (exclusive of persons in employment of the company) to fifty; and

(*c*) prohibits any invitation to the public to subscribe for any shares or debentures of the company.[37]

This private company is similar to what business men in this country call a "close corporation." It is resorted to in small partnerships where the partners desire to obtain the benefits of incorporation and the general public are not invited to buy stock. The stock is held by the partners in proportion to their interests in the business previous to incorporation. Under our statutes, however, there is nothing to prevent one partner from transferring his shares to a third person, and it is this risk which the members in the "close corporation" would like to avoid

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[35] Sec. 2.

[36] Mr. Justice Story in Dartmouth College v. Woodward, 4 Wheaton, 668.

[37] Sec. 121.

under such incorporation. The "private company," as defined in the English Act, would prevent such action by any member since the right to transfer the shares in such company is restricted. In addition to this, a private company is exempt from the restrictions placed by the act on the appointment of directors,[38] and on the commencement of business.[39] It is also exempt from the provisions requiring balance sheets to be furnished to debenture holders,[40] or annual statements of its financial condition,[41] or the statement in lieu of prospectus to the registrar.[42] It is a well-known fact that the number of corporations in this country, at least of the smaller class, is decreasing; many corporations have gone to the extent of giving up their charters in order to avoid the necessity of throwing open to the public, facts relating to their business, in which the public has, as a matter of fact, no interest. Business associations of the smaller class desire "corporate" existence to avoid many inconveniences of the common law partnership, as, for instance, those resulting from the death of one partner. Under our system business men, if they avoid the inconveniences of the common law partnership by incorporation, find themselves saddled with other inconveniences the burden of which, in the end, often forces the surrender of the corporate privilege. If, however, we adopt the idea of the private company as defined in the English Act, we give to the small business man the advantages of incorporation without the necessity of filing annual reports, balance sheets, reports to the state and to the Federal Government, and many other minor details, requirements of no advantage to the public in the case of a company which does not offer its shares for public subscription, and extremely inconvenient and distasteful to the small business man.

It has been pointed out that three classes of companies were contemplated by the English Act: (1) The company limited by shares; (2) the company limited by guarantee; and (3) the un-

[38] Sec. 72, c. 3.
[39] Sec. 87, c. 6.
[40] Sec. 114, c. 2.
[41] Sec. 26, c. 3.
[42] Sec. 82, c. 2.

limited company. The unlimited company is practically extinct. Of the three classes, the company limited by shares is the normal type of company. This privilege of incorporation with any one of three kinds of liability under one act is practically unknown to our law. In its working out, the privilege of a choice does not seem to have been valued, for the right to incorporate with unlimited liability is rarely exercised, and in the majority of corporations the liability of the members is *limited by shares.*

However, two features of the company limited by guarantee are worthy of note. The first is the guarantee contained in the memorandum of association, by which each member undertakes to contribute a certain amount to the assets of the company in the event of its being wound up. The act fixes no minimum amount for this guarantee. But, since the credit of the company may very well be dependent on the extent of the guarantee, as a practical matter, a substantial guarantee is imperative. The other feature is that the shares of the members or the proportions of their interest, have no nominal money value attached to them. Property can be held by the company without putting any particular value upon it or the shares of the members in it. It becomes the property of the members in fractional amounts represented by the shares. It is submitted that this method of issuing shares would tend to prevent representation of an inflated property value; which is largely responsible for public antipathy to corporations. The formation of such a corporation has never had legislative sanction in this country, though "An Act to Amend the Business Corporations Law so as to provide for a new class of corporations authorized to issue capital stock, without a nominal or par value," fostered by the New York State Bar Association,[43] was passed by the legislature but failed to receive the approval of Governor Hughes, because of technical defects.

Section 3 of the English Act provides that in the case of a company which proposes to be incorporated with limited liability, the memorandum shall state the name of the company with "Limited" as the last word in its name. It is,

[43] Report of New York State Bar Association 1910, pages 272 to 282.

therefore, possible to say from the name without recourse to any other source, whether the members of a given association are limitedly liable or not. With us this is not possible, without going to the public records. Some of our largest corporations conduct their business under the name of an individual who was at some previous time the owner of the business, and there is nothing in the name to distinguish the character of the association as at present constituted from its character as previously conducted. John Smith owns a small business in a growing city. He induces capital to invest in his business and increases it. John Smith now becomes John Smith & Co. The business grows; more capital is invested; John Smith & Company incorporate. In the majority[44] of our states there is nothing in the statutes which requires that John Smith & Company shall after corporation "ear mark" their name in some way that A or B dealing with them may know at once the nature of the association and the liability of its members. John Smith may himself trade as John Smith, or add "& Co." or merely "Co." to his name; or he may trade under a fancy name, and if he incorporates his business he may do likewise. Yet the addition of some such word as "incorporated" or "registered" or "limited" would be no burden on the members of the corporation, while, on the other hand, it would prevent deception and relieve those who desired to deal with the firm from the necessity of searching the public records to determine this fact.

Section 10 of the Act requires that with the memorandum of association there shall be registered the articles of association. These articles prescribe the regulation and government of the company, being, therefore, equivalent to the by-laws of a corporation in our country. With us the by-laws are not required to be registered. The adoption of section 10 in this country would mean that the "by-laws" as well as the "charter" of our corporations would become matters of public record; that persons dealing with the corporation would have notice of

[44] The statutes of the following states do require that the name shall contain the word "incorporated," "inc.," "corporation," "company," or some similar word: Kentucky, Virginia, Alabama, Colorado, Connecticut, Delaware, Kansas, Maryland, Minnesota, Missouri, Nevada, North Carolina, Ohio, Massachusetts and Rhode Island.

the authority of the directors and the rights of the members as to voting, etc.

It will also be noted that annexed to the English Act is a schedule of regulations which may be adopted by any corporation formed or registered under it. It is not obligatory on the part of companies forming or registering under the act to adopt any or all of these regulations. However, as has been said above, these represent the view of the legislature on the matters contained therein, and serve as a model to guide the members of a company in framing their by-laws, and tend, therefore, to procure a certain degree of uniformity in the by-laws of different companies, in itself a great advantage.

Section 16 provides that on registration of the memorandum and articles of association the registrar shall certify under his hand that the company is incorporated and "from the date mentioned in the certificate * * * the subscribers of the memorandum," and their successors "shall be a body corporate * * * with power to hold land," etc. This power is not restricted or limited in any way by this or any other section except with respect to associations not for profit. By section 19 such associations are not permitted without the consent of the Board of Trade, to hold more than two acres of land. In this country, as a general rule, the right to hold land is restricted to land necessary in the conduct of the business.

The certificate of incorporation issued by the registrar is *conclusive evidence* that all the requirements of the act in respect to registration and matters precedent and incidental thereto, have been complied with, and that the association is a company authorized to be registered and duly registered under the act.[45] It would seem, therefore, that with the adoption of this provision in our statutes, the necessity for the doctrine of *de facto* corporations would be practically obviated; for in order to invoke the doctrine, the general rule seems to be that there must be (1) a valid act under which the corporation could lawfully be incorporated, (2) a *bona fide,* colorable attempt to incorporate, and (3) an organization and exercise of corporate functions.[46]

[45] Sec. 17.

[46] Thompson on Corporations, 1 Vol., p. 244.

Upon the issue of the certificate of incorporation, even though the incorporators have failed to comply with some technical requirements, the corporation becomes a corporation *de jure,* because all these defects are cured by the certificate. Therefore, the only case in which the doctrine might be necessary is in the rare case of a compliance with all the requirements of the act, but a failure to receive the certificate of incorporation where such certificate is necessary.

Nevertheless, in only one of our states is the certificate of incorporation conclusive evidence that all the previous requirements have been complied with.[47] The provisions in the statutes of the remaining jurisdictions vary. Some make the *certificate* (1) evidence,[48] or (2) *prima facie* evidence,[49] or (3) presumptive evidence,[50] of incorporation; others make the *charter,*[51] or the *agreement to incorporate,*[52] or the *copy of the petition* for incorporation,[53] evidence of incorporation.

The most important and difficult problem in framing any corporation act is to provide against the serious evil of over capitalization. It grows out of the practice of forming a corporation to succeed an unincorporated company, the property of which is taken over by the incorporated company. In such cases it is usual for the incorporators (who, or a majority of them, are usually the owners of the succeeded business), to fix a value upon the property transferred to the corporation, and issue to themselves stock in payment therefor. In most cases the valuation is excessive. Thus the company is burdened at the outset with an inflated property value upon which to pay dividends. That this is an evil no one will deny.

Various remedies have been suggested and many have been adopted by the different states. Of these a number have proved more or less successful. The general thought, however, in all

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[47] Massachusetts.
[48] Colorado, Delaware, Missouri, New Jersey, Virginia.
[49] Arkansas, California, Connecticut, Maryland.
[50] New York, District of Columbia.
[51] Pennsylvania.
[52] Rhode Island.
[53] Georgia.

of the methods adopted seems to have been "publicity"; to make public what has been the disposition of the shares and the consideration therefor. For fraudulent misrepresentations of fact, the injured party has his common law right of action in deceit or some statutory rights—remedies whch by reason of the proficiency of "promoters" in the art of manipulation, have become wholly inadequate. The details of the methods to secure "publicity" widely differ. Some states [54] require a description of the property paid for by the shares of the company, to be set out in the *articles;* others [55] in a *certificate* to be filed after the issue. Still others[56] require it to be set out in the *subscription list,* or the fact of the issue of stock for property must be set out in the *charter,*[57] or in the *record books of the corporation.*[58] An appraisement by the officers of the company, or a provision that the property be taken "at the reasonable value thereof," or a similar provision, is all that is required in some jurisdictions.[59]

The effect of these provisions is to give a remedy for a wrong rather than to prevent the commission thereof. It is submitted that beneficial results may be attained only by provisions which tend to *prevent* over-valuation and not by those which merely give a remedy, in one form or another, to the injured creditor or stockholder.

Without suggesting the adoption of the provisions contained therein, or maintaining that any one will successfully prevent the evil of over-capitalization, the following methods of dealing with the subject are set out for comparison. It is suggested that this be made with the view of ascertaining which of these methods will, with the greatest certainty, *prevent* rather than *punish,* over-capitalization, which our statutes have failed to do.

The German Commercial Code provides that "when shareholders in getting capital together, bring in capital otherwise

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[54] Florida, Massachusetts, Michigan.
[55] Iowa, Maryland, Virginia.
[56] Alabama, South Carolina.
[57] Pennsylvania.
[58] Connecticut, West Virginia.
[59] Illinois, Kentucky, Tennessee, Wisconsin.

than in cash," the articles of association shall specify what is thus brought in, the person from whom the company acquires such property and the number of shares to be given in exchange.[60] Every agreement relating to the acquisition of property for shares, if not inserted in the articles, is of no effect so far as the company is concerned.[61] The company may then ask for subscriptions to its shares. Those who subscribe for shares sign two copies of certificates of subscription (one for the company itself and one for the court when the company is registered), which must set out the same facts as those which are required by other articles of the code to be set out in the articles of association.[62] When the shares have been subscribed for either by the founders, or by the general public, or by both, then a "council of supervision" must be appointed.[63] A "founder," according to the Code, is "a shareholder who has drawn up the articles of association and who brings in as capital anything other than cash."[64] If, therefore, the founders subscribe for all the shares, they themselves must appoint, at the formation of the company (which takes place when all the shares have been subscribed),[65] the council of supervision.[66] If, however, the founders do not subscribe for all the shares, they must, after all the capital has been subscribed, call a general meeting for the purpose of electing a council of supervision.[67] After the first payment called for in the subscription has been made, a preliminary meeting is called by the court,[68] at which the council of supervision express themselves upon the results of their investigation of the founders' estimation of the value of the property brought into the company, required by another section of the code[69] to be stated in writing. The report of the directors or

[60] Article 186, par. 2, German Commercial Code.
[61] Article 186, par. 4.
[62] Article 189, par. 3.
[63] Article 190.
[64] Article 187.
[65] Articles 188 and 189.
[66] Article 190, par. 1.
[67] Article 190, par. 2.
[68] Article 196, par. 1.
[69] Article 191.

governing body, also required by the code, upon the manner in which the company has been formed, must be investigated by the council and reported on at this meeting. If any one of the directorate or governing body is also one of the founders, then an inspection of the matters to be reported on by the directors must be made by specially appointed persons, chosen by that organ which officially represents trade, or by the court of the district where the company carries on business.[70] At this meeting the formation of the company must be approved by a vote of the majority of shareholders, which must include at least one-fourth of the shareholders on the list, who do not represent any shares paid for in property.[71] Thus the approval or disapproval of the formation is in the hands of the subscribers who vote on the question after a report by a committee of investigation, composed of unbiased persons.

The present Commercial Code of Japan is based upon and practically adopts the German system; but the committee of inspection under the Japanese Code in addition to making its report showing how the company has been formed, must state whether or not the amount of shares issued in consideration of the property contributed to the capital of the company, is reasonable. At the meeting the members may not agree with the committee, and if they (the members) are of the opinion that the sum paid in shares is unreasonable, it may be altered; but the contribution may in such case be made in money if the meeting decides to decrease the number of shares given in exchange for the property.[72]

The Company Law of England, at least the later acts, follows the German System with slight changes. Under the Companies Act of 1908 as has been shown, the memorandum of association is a mere recital of the nature and extent of the operation of the proposed company, with no reference to its organization. In this particular it differs from the German Code, under which the fact of a contribution to the capital stock otherwise than

[70] Article 192, par. 3.
[71] Article 196, par. 5.
[72] Article 135 of the Commercial Code of Japan, translated by Yang Yin Hang.

in cash must be set out in the articles of association, which are analogous to the memorandum of association under the English Act.

Under the present Companies Act as has been shown[73] the fact of such contribution to the capital stock in all public companies must appear in the prospectus. At the statutory meeting referred to in the early part of this article, the matter of the formation of the company is open for investigation and discussion, each of the members having been previously supplied with a report of the progress of the company from its inception to the date of the calling of the statutory meeting.[74] At this meeting the value of the property contributed in exchange for shares in the company is open to discussion, and any member may propose a resolution with reference to it. The German Code, has, however, this advantage over the English Act: by the German Code in the vote on the approval or disapproval of the formation of the company and the contributions to the capital otherwise than in cash, the contributors who hold shares for that contribution have no vote *qua* those shares, while under the English Act the contributors of property might prevail by reason of their voting the very shares, their title to which is being questioned by that vote.

While these provisions undoubtedly are a distinct advance in legislation tending to prevent over-capitalization, it appears from a careful study that the cloak of protection is only thrown around the stockholders, and that the creditor of the corporation is left to take care of himself. It is true that it may be easier for him to do this because of the resultant publicity and the better facilities for procuring information. If he learns of facts which lead him to believe that there has been an overvaluation of property contributed, he cannot say he dealt blindly with the corporation. But the provisions do not seem to be successful in preventing over-capitalization in so far as creditors are concerned, for it is evident that if the stockholders were the organizers of the corporation, and subscribed for all the stock,

[73] *Supra*, p. 423.

[74] *Supra*, pp. 425-426. (Sec. 65 of the English Act.)

the consideration for which was property or business to be taken over by the corporation, it would be an easy matter for "the stockholders" at the preliminary meeting, to approve of the formation of the company even though the property was grossly overvalued. As a result, the creditors are still left to run the risk of the success of the company in spite of the inflated property value, or else refuse to deal with the company. To prevent this some means of investigation of these vital matters, distinct from the action of the promotors, stockholders, or other interested persons, is necessary, so that *once and for all* the real value of the property may be determined and settled. What appears necessary, is an investigation of the value of the property by an impartial and responsible person. The state is the only person answering both these requirements.

With the exception of one of our states,[75] there is not, in this country, any system under which a state investigation of the value of the property contributed is made. What seems, however, to be the greatest advance toward the prevention of over-capitalization by means of a state investigation is the proposed Federal Incorporation Act, understood to have been drafted by the present Attorney-General, Mr. Wickersham, introduced by Mr. Parker in the House of Representatives in the second session of the Sixty-first Congress.[76] It is entitled "A Bill to Provide for the Formation of Corporations to Engage in Interstate and International Trade and Commerce," and applies only to corporations whose capital stock is not less than $100,000.

By Section 3 of the proposed Act, it is the duty of the "Commissioner of Corporations" to examine the "Articles of Association," which must be transmitted to him, and if, "in his opinion, they conform to the requirements of this Act * * * he shall * * * file the said articles in his office and record the same in a book to be kept by him for that purpose, and, upon proof satisfactory to him that the amount of capital with which the corporation is to commence business has been paid in cash

[75] Iowa.

[76] House of Representatives Bill Number 20142.

to the treasurer named in the articles, he shall thereupon issue a copy of said articles so filed, together with a certificate, under his hand and seal of office, that the incorporators have complied with all the provisions of the law required to be complied with and have become and are a national corporation * * * ." And by Section 17 the corporation is given the right to purchase "any property necessary for its business and issue stock in payment therefor, which shall be full paid and the holder thereof shall not be liable in any event for any further payment with respect thereof to the use or for the benefit of the corporation or its creditors: *Provided,* however, that *before* any such stock is issued there shall be filed in the Bureau of Corporations a statement in writing signed and sworn to by a majority of the directors giving a full description of the property, and the number of shares to be issued in payment and the par value thereof, or if they have no par value then the number of shares to be so issued; the names and addresses of the vendors of the property and whether or not any of them are officers or directors of the company or owners of shares in the company, and if so, how many of such shares; the terms of any agreement for the transfer of such property to the corporation," etc. If the stock to be issued has a par value then there must be filed with such statement in the Bureau of Corporations an appraisement of the value of such property made by two disinterested appraisers, *approved in writing by the Commissioner of Corporations;" and the Commissioner may in his discretion, appoint* one or more other appraisers to make valuations of such property * * * *and no stock having a par value shall be issued in payment of property* * * * *to an amount* of such par value *in excess* of the value of said property as approved by the Commissioner of Corporations after such appraisement." Subsection (G) of this section (17) deals with the case of a corporation formed for the purpose of taking over "the property and business of any existing corporation formed under the laws of any State or Territory of the United States and engaged in interstate commerce of the character proposed to be carried on by the corporation formed hereunder." By the provisions of this section the Commissioner of Corporations is given the same

rights of investigation as in the previous case, and the plan of reorganization must be submitted to and approved by him, as to the method, the value of the property and amount of shares given in exchange.

It is submitted that this represents a complete system of state investigation which will, with honest officials, make the valuation of the property conform as nearly as possible to its *actual* value, and persons interested either as stockholders or creditors may look with comparative safety to the valuation approved by the Commissioner of Corporations. We may, however, go farther and say that it is unnecessary to look to the *value* of the property, for after all it is not the value of property to which the creditor looks; he deals with a corporation which, for instance, holds itself out as having a ten million dollar capital, of which a large part is composed of property contributed for shares. The real question in such case is not what is the stated value of the property, but has the property, whatever its stated value, been over-valued? If the company has received its certificate of incorporation under the proposed act, and if the affairs of the bureau are managed with a reasonable degree of ability, we could safely rest assured that it has not. It is probably with that idea in mind that the framers of the act have concluded section 17 with the provision that "the approval of the value of the said property or business given pursuant to any of the provisions of this section, shall be conclusive as against the corporation and its stockholders and creditors." The section also provides that if "any statement required by this section shall be false in any material aspect the directors uniting" in such statement shall be jointly and severally liable to all subscribers or purchasers of such stock, as well as to future creditors, for any damage sustained by them by reason of the issue of such stock or purchase thereof, or extension of credit to the corporation in reliance upon the truth of such statement. The burden of proving that the plaintiff in such case did not rely on the statements is placed by the same section upon the defendant; the presumption being that the plaintiff did rely upon them.

The provision making the approval of the Commissioner of Corporations conclusive gives to the creditor and stockholder

comparative security in acting on the assumption that the property of the corporation has not been over-valued; it gives to the honest director assurance, should the venture prove a failure, that he will not be harassed by creditors, on the ground of an over-valuation of the property, when in fact the value of the property, as fixed at the time it was taken by the corporation was entirely reasonable and proper.

To return to the English Act: By section 16 the registrar must, upon filing of the memorandum and articles, certify that the company is incorporated, and this certificate is made conclusive evidence of the fact that all the requirements of the act previous to incorporation have been complied with. As has been shown[77] this does not in itself entitle the company to begin the business for which it was formed. Certain other requirements already set out must be complied with, after which the registrar issues another certificate stating that the company is entitled to commence business. This second certificate is also conclusive evidence of compliance with all requirements preliminary to the commencement of business.[78] There is thus a *double certificate* system: one which enables the company to secure subscriptions from the public and organize; the other to transact the business for which it was incorporated.

In this country the issue of a certificate of incorporation is made dependent upon the performance of a condition, the nature of which varies greatly. In some states *before incorporation is complete,* there must be at least from ten per cent.[79] to fifty per cent.[80] of the capital stock paid in; in others between ten per cent.[81] and twenty-five per cent.[82] *before the corporation is entitled to commence business;* and others require that before the company is entitled to transact any business a certain proportion of the capital stock ranging from ten per cent.[83] to all[84] must be *subscribed.* The advantage of the double certificate

[77] *Supra,* p. 423.
[78] Sec. 87, c. 2, of the English Act.
[79] District of Columbia, Pennsylvania.
[80] Texas, Illinois.
[81] Florida, Georgia.
[82] Kansas, Vermont.
[83] Nebraska, Ohio, Oregon (50%).
[84] Washington.

seems to lie in the fact that it does not in any way interfere with or delay "organization" of the corporation. Under this system the issue of the certificate creates a corporation which is entitled to sell its shares and do other acts necessary to the complete organization of the company.

In England, upon filing a statement by the company, that the shares have been allotted and several minor details have been performed, the registrar issues the second certificate stating that the company is entitled to carry on the business for which it was incorporated. Only two states in our country have this system of double certification.[81] It is submitted that it is better to divide the process by which the right to do business under corporate existence is acquired, into two stages: *first,* the formation of the corporation, and *second,* the organization thereof. Whatever restrictions are deemed necessary for the protection of the public should be placed upon the "organization," and not upon the "formation" of the company. This would facilitate the compliance with those provisions and at the same time be just as protective to the general public.

The conclusive certification by the proper officer that the company is entitled to commence business, if recorded in a place accessible to the general public, gives a more certain status to the corporation, together with security to the general public. To make restrictive provisions without giving the public an easy means of ascertaining whether or not those provisions have been complied with, is to create uncertainty in the minds of those persons who might deal with the corporation.

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