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A CRITICAL SURVEY OF THE ILLINOIS BUSINESS CORPORATION ACT*

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THE new 1933 Illinois Business Corporation Act springs from the patient, unselfish labors of lawyers, legal scholars, accountants and officials who have given freely of their time and thought for several years toward its preparation and passage. No doubt the major burden of drafting has fallen most heavily on one or two men. The new act is part of a notable legislative movement, sponsored for the most part by bar association committees, which has been carried on in the last few years in Ohio, Indiana, California, Louisiana, Michigan, Minnesota, Washington, and Pennsylvania. This movement has been influenced to a greater or less extent by the Uniform Business Corporation Act and also by the Delaware General Corporation Law. The new Pennsylvania Business Corporation Law of 1933 is largely founded upon the Illinois draft of 1931, although also influenced by the California General Corporation Law of 1931.

As one who has devoted much time since 1928 as draftsman for the State Bar Committee to doctoring up the superannuated corporation laws of California, the writer has been invited to comment upon the new Illinois act. It is not necessary here to praise the good points of the new law or to point to the improvements made upon the Illinois General Corporation Act of 1919. Rather it seems advisable, with all deference to the Committee, to attempt a critical testing of the leading provisions of the new act in comparison with other modern acts, particularly the California General Corporation Law, with a view to calling attention to certain doubtful points that may possibly call for further study and revision. In California the work of revision has required the continuing efforts of the State Bar Committee and its draftsman prior to, and during, the last three legislative sessions.

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The article will consider in the first place provisions dealing with questions of corporation finance, such as stated capital; the issue of shares; the purchase, redemption, and retirement of shares; treasury shares; declaration of dividends; reduction of stated capital, and the liability of directors and shareholders. Then certain other important topics will be touched upon, such as de facto corporations; ultra vires contracts; sale of entire assets; inspection of records; reports and financial statements to shareholders; voting rights; election of directors and, finally, winding up and dissolution.

On many of these matters there is much room for difference of opinion and discussion as to the policies, restrictions, and liabilities that should be embodied in the law. A modern corporation act is an intricate mechanism which must have many delicate adjustments in balancing the claims of efficiency of management, the due limitations of official discretion, the simplification of formalities as to voting and certificates to be filed, and the protection of the rights of creditors and of share holders of different classes and factions. There is danger of abuse of remedies given to the minority as well as of the fraudulent abuse of power by the majority. The need of brevity in such a survey will perhaps excuse some reference to the writer's exposition of the provisions of the California General Corporation Law.²

STATED CAPITAL

The use of the term "capital stock" has wisely been avoided in the Illinois Act, as in several of the recent corporation acts.³ It is important to adopt some exact, clear-cut term for what may be called the "capital liability" of a corporation, which operates as a brake upon declarations of dividends and purchases of its own shares.⁴ The legal surplus cannot be ascertained without deducting the true amount of the stated capital from the value of the net assets. The right to declare dividends and purchase the corporation's own shares is in general made to depend upon the existence of an earned surplus. (§§ 6, 41.)

"Capital stock" is sometimes used to refer to shares of stock, sometimes to the aggregate amount of the par value shares authorized in the articles, sometimes to the assets received from the shareholders upon the issue of

² Ballantine, *California Corporation Laws* (1932), Supplement (1933).

³ Cal. Civ. Code (1931), Gen. Corp. Law, § 300b; Ohio Page's Ann. Code (1932; supp.) Gen. Corp. Act, § 8623-37; Minn. Laws of 1933, c. 300, §§ 1-10; Pa. Bus. Corp. Act, §§ 2, 614.

⁴ Delaware uses the term "capital" for this purpose. Del. Gen. Corp. Law, §§ 14, 19, 26, 27, 28, 34.

shares.⁵ The term "stated capital" came into use in connection with non-par shares and the permission to credit part of the consideration received to paid-in surplus and the balance to stated capital.

By the Illinois definition stated capital is measured by the amount of capital contributions of the shares "then issued" whether par or non-par. In two sections there is a reference to "any surplus arising from surrender to the corporation of any of its shares." It may seem to be implied that if shares are surrendered to the corporation they cease to be issued and that there is an automatic reduction of stated capital and the creation of a surplus without any other proceedings. (See §§ 6, 41.) But the Illinois act is evidently drafted upon the assumption that shares once issued remain issued until they are permanently retired and stated capital is reduced pursuant to statutory authority. (§§ 58, 59.)

By Section 19 certain limitations are placed upon the amount of the consideration for shares without par value which may be allocated to paid-in surplus in case such shares have a preference in event of involuntary liquidation. But if non-par shares have no liquidation preference the total consideration paid in excess of a nominal part may be allocated to paid-in surplus. Thus if \$1,000,000 is received as consideration for non-par common shares, \$999,000 of this amount may be allocated to paid-in surplus. The directors are given 60 days after issue to make the allocation if the shares are issued for services or property other than cash, as under Section 14 of the Delaware law. Perhaps the percentage of the consideration which may be allocated to paid-in surplus should be limited to say 50 per cent, and the allocation should be made in all cases upon the issue of the shares as a valuation of the consideration in monetary terms should be made prior to issue.⁶

The dangerous laxity of the Delaware law as to the creation and use of paid-in surplus is guarded against under the Illinois act by limitations imposed upon the corporation as to the use of paid-in surplus for dividends and for the purchase of shares. Under the Delaware law the net assets in excess of capital may be freely used either for dividends or the purchase of shares.⁷ Both in the Illinois and California corporation laws limitations are placed on the use of paid-in surplus for such purposes which make it truly a capital surplus.⁸

⁵ Fletcher, *Cyc. Corps.* (1932 ed.) § 5079; Ill. Gen. Corp. Act, 1919, §§ 6 (4), 33, 34, 39; *Armstrong v. Emmerson*, 300 Ill. 54, 132 N.E. 768, 18 A.L.R. 693 (1921).

⁶ See Cal. Civ. Code (1931), § 300a; Ballantine, *Questions of Policy*, 19 Cal. L. Rev. 465, 471 (1931).

⁷ Del. Gen. Corp. Law, §§ 19, 34.

⁸ Ill. Cahill's Rev. Stats. (1933), Bus. Corp. Act, c. 32, §§ 6, 41; Cal. Civ. Code (1931), §§ 342, 346.

ISSUE OF SHARES: CONSIDERATION AND PAYMENT

The new act, Section 17, requires that par value shares shall be issued for a consideration not less than the par value. There is no recognition of the common law exception established in most jurisdictions permitting issue at less than par in the case of a going concern.⁹ The basis of this exception is that no wrong is done either to creditors or existing shareholders by issuing shares for what they are actually worth. It seems impossible to set up in advance an arbitrary minimum for the issue price of shares for all time to come. The doctrine that an embarrassed corporation, or a corporation which has incurred losses, may issue its par shares at less than par is founded on sound reasons of practical policy. What is the sense of a hard and fast requirement that par value shares can never be issued for less than par, which inevitably drives the management to the good old plan of having the shares issued for property or services of dubious value and then donated back to the corporation to be sold as treasury shares at whatever discount may be desired?

Section 17 calls inflexibly for payment of the par value, but Section 18 provides a simple detour around the requirement by providing that while shares issued for cash must be fully paid up to the par value, shares may be issued for property tangible or intangible or for services, and the judgment of the board of directors, in the absence of actual fraud in the transaction, shall be conclusive as to the value of the consideration received.

The California law^{9a} provides that shares may be issued for less than par if the board of directors determine that the shares cannot be sold at par. Par value shares may thus be issued for a consideration less than par as fully paid up under a resolution of the board of directors determining that such shares cannot be sold at par and only the amount of the agreed consideration is credited to stated capital.¹⁰

It is a fiction to assert that creditors are in any way deceived by the issue of par value shares for less than their par value. Creditors do not in fact rely upon the valuations arrived at by the directors, but on their own estimates of the corporate assets and credit. Since the amount of the

⁹ *Clark v. Bever*, 139 U.S. 96, 11 Sup. Ct. 468, 35 L. Ed. 88 (1891); *Handley v. Stutz*, 139 U.S. 417, 11 Sup. Ct. 530, 35 L. Ed. 227 (1891); *Camden v. Stewart*, 144 U.S. 104, 116, 12 Sup. Ct. 585, 36 L. Ed. 363 (1892).

^{9a} Cal. Civ. Code (1931), § 299.

¹⁰ A provision for issue at less than par is contained in the Indiana Act and also in the Maryland Act. Ind. Burn's Ann. Stats. (1929 supp.) § 4827 (c); Md. Bagby's Ann. Code (1929 supp.) Art. 23, §§ 41 (8), 43, 44. See also Ohio Page's Ann. Code (1932 supp.), § 8623-16; 19 and 20 Geo. 5, c. 23, § 47 (1929), power to issue shares at a discount.

consideration can easily be varied by paying commissions or by issuing the shares for property or services of uncertain values, there seems to be no utility in forbidding the issue of par value shares at a discount, which is merely accepting in terms what the law has already conceded in practice.

Such a provision as that contained in Section 299 of the California law enables corporations to issue shares from time to time at varying prices within a fair range of discretion according to market conditions without danger of liability to creditors or technical objection by minority shareholders, and eliminates the subterfuge of issuing shares on the basis of fictitious valuations of patents, options, and good will, and the donation of such shares to the corporation's treasury for purposes of sale at a discount after the immunity bath. It gives par value shares much the same flexibility as to issue price possessed by non-par shares, and obviates an undue increase of the stated capital account by the process of stock watering. There can be no actual fraud, either on creditors or upon shareholders, committed in issuing shares for their true value though less than par.¹¹

The situation may be illustrated as follows. The X corporation is authorized to issue 100,000 shares of common stock at \$5 par value. It issues 50,000 shares at \$5 par value, giving it a stated capital of \$250,000. The first year's operations result in a loss of \$50,000. Additional capital is needed and there are buyers for the unissued shares willing to pay \$4 per share. Under the Illinois requirement the corporation must reduce the par value of its shares and its stated capital in order to be able to issue these shares for cash without subterfuge and circumvention. Reduction proceedings may mean delay, loss of market, and perhaps may frighten away the investors. The issue of the new shares at the current market price, though below par, would seem to be the obvious procedure for the benefit of the creditors and the existing shareholders.

Under Section 18 while neither promissory notes nor future services may constitute payment or part payment for shares of a corporation, there is nothing either in this section or Section 17 which would forbid the issue or creation of shares as partly paid shares for a small amount of executed consideration with the balance of the consideration evidenced by notes or contracts to give future services. A person may become an owner of shares and a shareholder of record with all the rights incident thereto except a certificate, although he has paid only a nominal executed consideration. (§§ 16, 23.) Under Section 21, however, no certificate for shares may be issued for any share until the balance of the consideration

¹¹ See Dodd, *Stock Watering* (1930), 235-241.

for the share is fully paid up or executed. It is not clear whether it is intended to forbid the acceptance of promissory notes of third parties or of the corporation or corporate debentures in payment for its shares.

PREINCORPORATION SUBSCRIPTIONS

In order to meet the constitutional requirement of election of directors by the shareholders, Section 16 of the Illinois act provides that the filing of articles of incorporation by the secretary of state shall ipso facto make subscribers for shares into shareholders of record, apparently without reference to payment or the conditions of the subscription contract. This is necessary to provide voting shareholders, for unless the subscribers become shareholders automatically there is no one with authority to accept subscriptions or issue shares for the corporation. The authority to obtain the necessary subscriptions to shares and to manage the corporate affairs prior to the election of directors is sometimes conferred on the incorporators.¹² Under the general law incorporation makes preincorporation subscriptions irrevocable contracts, but does not have the effect of making the subscribers shareholders without some act of acceptance on behalf of the corporation.¹³ Under Sections 17 and 18 some payment of executed consideration is required for the issue of shares, but it appears that under Section 16 shares may be issued for a wholly executory consideration although such shareholders would not be entitled to any certificate. (§ 21.) It would seem that any conditions precedent in preincorporation subscriptions are rendered inoperative and it is impliedly required that such subscriptions be absolute and unconditional.¹⁴

PREEMPTIVE RIGHTS

Section 24 of the act permits the preemptive right of a shareholder to acquire "additional shares of a corporation" to be limited or denied in the articles of incorporation. This section is a recognition that shareholders have certain "preemptive rights" but it does not attempt to define the extent of the right which may be so limited or denied or what is meant by "additional shares."¹⁵ Does it extend to shares originally authorized but unissued, or only to shares authorized by an amendment of the articles? Does it extend to preferred shares and preferred shareholders? To treasury shares? To non-voting shares? To the issue of shares for property? To convertible bonds? All of these questions are in a state of more or less uncertainty under the common law.

¹² Del. Gen. Corp. Law, § 8.

¹³ 61 A.L.R. 1463, 1522 note.

¹⁴ See *Pittsburgh & S. R. Co. v. Biggar*, 34 Pa. 455 (1859).

¹⁵ § 52 (o) as to amendments, refers to "additional shares . . . whether then or thereafter authorized."

It seemed best to the California Committee to abrogate the common law doctrine of preemptive rights for the reason that in a complex corporate structure the proper assignment of preemptive rights gives rise to insoluble difficulties. What we really have is an obligation on the part of the management to exercise the power of issuing shares in good faith in such a way as to protect the interests of the existing shareholders.

As has been pointed out,¹⁶ the doctrine of preemptive rights should never have hardened into a rigid rule of law, and it should revert to its original status as a remedy in equity against abuse of power. The trend is to eliminate this right altogether.¹⁷

The Illinois act contains no provision such as is found in the Delaware, California and Ohio acts as to the grant of options to purchase or subscribe for shares evidenced by stock purchase warrants in connection with the issue of shares and other securities.¹⁸ The new Minnesota Business Corporation Act¹⁹ has an interesting provision forbidding the granting of options to subscribe or purchase shares independently of the issue of shares or other securities except in case of options to shareholders to subscribe rateably in proportion to the number of shares held. This limitation might prevent certain abuses.²⁰

Employee stock purchase plans may be adopted under Section 24 by vote of the holders of two-thirds of the shares or by the board of directors pursuant to like approval of the shareholders. Such issue may be made to any employees of the corporation or of any "subsidiary corporation" for such consideration and upon such terms and conditions as may be so authorized without prior offer to the shareholders. The two-thirds vote of the shareholders does not seem an adequate protection against such abuses as were revealed in connection with the American Tobacco Company case where managerial officers obtained large blocks of cheap stock to the detriment of the shareholders.²¹

¹⁶ Berle & Means, *Modern Corporation and Private Property* (1932), 146, 176-179, 258, 259.

¹⁷ Cal. Civ. Code (1931), § 297; Ind. Burn's Ann. Stats. (1929 supp.) § 4827 (i); *Yoakum v. Providence Biltmore Hotel Co.*, 34 F. (2d) 533, 539 (1929); Ballantine, *California Corporation Laws* (1932), 98-101; *Drinker, The Preemptive Right of Shareholders to Subscribe New Shares*, 43 Harv. L. Rev. 586, 616 (1930); Ballantine, *Questions of Policy*, 19 Cal. L. Rev. 465, 469 (1931).

¹⁸ Del. Gen. Corp. Law, § 14; Cal. Civ. Code (1931), § 296; Ohio Page's Ann. Code, (1932 supp.), Gen. Corp. Act, § 8623-20.

¹⁹ Minn. Laws of 1933, c. 300, § 13 (VI).

²⁰ See Berle & Means, *Modern Corporation and Private Property* (1932), 180-184; Ballantine, *Questions of Policy*, 19 Cal. L. Rev. 465, 468 (1931).

²¹ *Rogers v. Guaranty Trust Co.*, 288 U.S. 123, 53 Sup. Ct. 295, 77 L. Ed. 382 (1933); 21 Cal. L. Rev. 358 (1933); 46 Harv. L. Rev. 828 (1933).

SHAREHOLDERS' LIABILITY FOR ISSUE PRICE

The liability of subscribers and shareholders to the corporation or its creditors is limited to "an obligation to pay to the corporation the full consideration for which said shares were issued or to be issued" (§ 23). This is somewhat ambiguous as to whether it limits the liability of the shareholder as under the New York law to the agreed issue price or whether it imposes liability for such amount as would make the shares fully paid under the statutory requirements. It would seem that if the subscriber or shareholder has fully complied with his contractual obligation to the corporation he is under no further liability. The "issue" of the shares is the agreement of the corporation and the subscriber to create a share. If shares are issued for less than par or as a bonus without consideration it is difficult to find superadded by this section any liability either to the corporation or to its creditors. If the directors have violated Section 17 the securities may be invalid, but the subscriber does not commit any wrong against the corporation or its creditors or make himself liable as upon a contract. His liability depends upon his contractual agreement.²²

Under the Delaware law, Section 20, the holder of par value shares is made liable for the benefit of creditors up to the par value and it is only in the case of shares without par value that his liability is limited to the unpaid balance of the consideration for which the shares were issued by the corporation. The Illinois provision would seem to do away with any question of liability of the shareholder upon watered stock, that is where shares are issued as full paid for less than par or for overvalued property, and the only liability would be that of the directors if any.²³

LIMITATIONS ON THE PURCHASE BY A CORPORATION
OF ITS OWN SHARES

One of the most stubbornly fought conflicts in corporation law is over the proper limitations to be placed upon the power of a corporation to purchase its own shares.²⁴ Some of the most flagrant abuses and frauds perpetrated by banks, public utility holding companies, investment trusts

²² *Christensen v. Eno*, 106 N.Y. 97, 12 N.E. 618 (1887); *Southworth v. Morgan*, 205 N.Y. 293, 98 N.E. 490 (1912).

²³ Compare the careful provisions as to liability of shareholders and directors for improper issues of shares in the Minn. Act, Minn. Laws of 1933, c. 300, §§ 14 (IV), 15 (II), 18.

²⁴ *Consolidated Music Co. v. Brinkerhoff Piano Co.*, 64 F. (2d) 884 (1933); *Levy, Purchase by a Corporation of its Own Stock*, 15 Minn. L. Rev. 1 (1930); *Berle & Means, Modern Corporation and Private Property* (1932), 174, 175; *Ballantine, Questions of Policy*, 19 Cal. L. Rev. 465, 479 (1931).

and corporations generally in recent years have been by market operations by the corporate management in shares issued by the corporation and by its affiliated corporations and by carrying their own shares as part of their assets.

The Illinois Act, like the California law, seeks to discourage speculation by a corporation in its own shares by restricting purchases in general to earned surplus. The Illinois draftsmen, however, have avoided the use of the term "earned surplus" on account of the difficulty of framing any statutory definition of this accounting term, and have deemed it best to back into the concept by a process of elimination. The Illinois Act limits as a general rule the purchase by a corporation of its own shares by prohibiting such purchase directly or indirectly unless it has assets over debts and liabilities of not only the amount of its stated capital but also the amount of its paid-in surplus, any surplus arising from unrealized appreciation in value or revaluation of its assets and "any surplus arising from surrender to the corporation of its own shares."²⁵ Under the Delaware General Corporation Law purchases of its shares may be made by a corporation from any surplus, that is, as long as no impairment of capital is caused.^{25a}

An Illinois corporation is not expressly limited in any way, even by solvency, in the purchase of its own shares for certain special purposes, namely (a) eliminating fractional shares; (b) settling or compromising or securing debts due the corporation previously incurred; (c) paying dissenting shareholders in case of merger, consolidation or sale of assets. In effecting the redemption of its preferred shares certain limitations are imposed under Section 58. While an Illinois corporation is legally limited in using its funds to buy and sell its own shares for any other purpose, except to the extent to which it may have an earned surplus, strangely enough no statutory liability is imposed either upon directors or shareholders for the violation of this limitation as there is under the California law.²⁶

Under Section 6 a corporation is forbidden to purchase its own shares in general either "directly or indirectly" except when it has an earned surplus. The word "indirectly" may be construed as intended to prohibit the common device of purchasing shares through a subsidiary or affiliated company as a method of evasion of the limitation of purchases from earned

²⁵ § 6. A surplus could arise from the surrender to the corporation of its own shares only if the stated capital could be reduced upon such surrender, as treasury shares may not be included in "net assets" for the purpose of determining the right of a corporation to declare dividends or to purchase its own shares. § 2 (m).

^{25a} Del. Gen. Corp. Law, § 19.

²⁶ See Cal. Civ. Code (1931), §§ 363, 365.

surplus. This prohibition however might well be made more explicit as to whether the earned surplus of the holding corporation or of the subsidiary is to be affected.²⁷

TREASURY SHARES

Under the Illinois act, if any of its shares are acquired by a corporation (except for redemption and cancellation under Section 58) they are treasury shares, that is, they continue to be regarded for some purposes as issued shares. Such acquisition does not reduce the legal stated capital. In case of purchase the effect is in general to reduce the earned surplus, since (except for special purposes under Section 6 (a), (b), (c) and (d)) shares may be purchased only by the use of what is equivalent to earned surplus and no asset is received to take the place of what is paid out, any more than in the case of a dividend. Earned surplus may not be reimbursed by carrying treasury shares as an asset.²⁸

The phrase "net assets" as relating to the determination of the right of a corporation to purchase its own shares or to declare and pay dividends, is defined by the Illinois act to exclude shares of its own stock "belonging to the corporation."²⁹

The definition of treasury shares in Section 2 (j) as shares of its own stock "belonging to a corporation," which are to be deemed issued shares but not outstanding shares, seems to be inaccurate and misleading. A corporation can never in any true sense be the owner of its own shares any more than the same individual can be both debtor and creditor. Treasury shares, if an asset for any purpose, are of a kind which will be found without value when it becomes important for creditors to realize upon them.³⁰

The Illinois act (§ 2 (f)) defines "shares" as units of interest "into which the shareholders' rights to participate in the control of the corporation, in its surplus or profits, or in the distribution of its assets, are divided." A corporation can of course have none of these rights against itself. When such a unit is once created in favor of a third party and is then surrendered to the corporation, it is only by a fiction of law that it can be regarded as still "issued" or "belonging to the corporation," and its reissue is in reality the creation of a new unit of interest, although made subject to certain exceptions as to the usual requirements with reference to original issue.

²⁷ See Cal. Civ. Code (1931), § 342; Ohio Page's Ann. Code (1932 supp.), Gen. Corp. Act, § 8623-41.

²⁸ See as to unfortunate practice sanctioned under Colorado law, *Colorado Loan, etc. Co. v. Clem*, 82 Colo. 399, 260 Pac. 1019 (1927).

²⁹ § 2 (m). See also Cal. Civ. Code (1931), § 342b.

³⁰ *Graham & Katz, Accounting in Law Practice* (1932), 154-156; *Borg v. International Silver Co.*, 11 F. (2d) 147, 150 (1925).

The normal rule would be that shares of stock automatically cease to be issued when they are acquired by the corporation, but here a difficulty arises. When a corporation has acquired its shares which it formerly issued, and which have made their contribution to stated capital, it should not be required upon reissue or sale to allocate to stated capital all or any part of the consideration received upon such reissue, except in cases where the stated capital has been reduced upon acquisition. The legal way of describing this situation is to say that the corporation has a right to hold the shares as "issued" and unextinguished, so that it may dispose of them without increasing the stated capital. Their subsequent reissue is treated by fiction as if it were a transfer of shares from the original holder to the new purchaser through the medium of the corporation.

The fiction of treasury shares is also used to facilitate the sale of par value shares at a discount and by an unfortunate accounting practice to enter treasury shares as an asset, create a fictitious surplus and facilitate the speculation by a corporation in its own shares.

If a corporation is permitted to reduce its stated capital in connection with the purchase or redemption of its shares, then such shares acquired "out of stated capital" may well be treated as restored to the status of authorized but unissued shares. Upon reissue they will make a contribution to stated capital to take the place of reduction upon their retirement.³¹

It is important that accountants and others should understand that in truth and reality treasury shares are not issued shares at all. They have no real existence, cannot be voted and are not counted for voting purposes, cannot receive dividends or distributions of assets and are not an asset of the corporation. They bring nothing to the corporation on liquidation. The effect of the purchase or acquisition of shares by the corporation is simply to increase the proportional right of participation of the remaining shareholders in the remaining assets. They represent merely a power to create or issue new shares if anyone wants them, which power is for certain technical reasons distinguished from the power to create shares upon original issue. The only reason for this distinction is that the corporation has already received a capital contribution creating a capital liability in respect of the shares so issued and acquired which was not removed upon acquisition of the shares.

There is no limitation in the Illinois act (see § 17) with reference to the sale of treasury shares, that when such shares are disposed of by the cor-

³¹ Ballantine, Cal. Corp. Laws (1932), 310-321; 1933 Supp., 127-133.

poration the consideration received shall not reimburse the earned surplus. Earned surplus thus may become a revolving fund which may be used over and over again for the purchase of shares. Provision is made, however, in the California law that the entire consideration received upon the sale of treasury shares shall be attributed to paid-in surplus except as needed to write off a deficit of net assets below stated capital.³² Such sale does not reimburse earned surplus. Any tendency of a corporation to speculate in its own shares will be discouraged by the requirement of attributing the proceeds to paid-in surplus which is not generally available for the further purchase of shares. The speculation by a corporation in its own shares is thus not so much restricted under the Illinois law as it is under the California law.

There is no provision of the Illinois act that when preferred par value shares are converted into common shares the stated capital shall not be increased. The surrender of the preferred shares to the corporation will leave such shares in the status of treasury shares and the par value of the common shares issued must be added to the stated capital. An amendment of the articles under Section 52 would be necessary to prevent an increase of stated capital upon such conversion. Under the California and Delaware law, however, no change in stated capital is made by the conversion of one class of shares into other shares,³³ and the shares surrendered have the status of authorized but unissued shares. Under the Illinois act there is no increase of stated capital upon the conversion of non-par preferred shares into other shares. (§§ 2 (k), 17.)

DECLARATION AND PAYMENT OF DIVIDENDS

Section 41 of the act imposes its limitations both upon the declaration and also upon the payment of dividends. Most corporation laws impose their limitations only upon the declaration of dividends and the debt which arises upon such declaration ranks with other debts so that the shareholder may compete with other creditors in case of supervening insolvency.³⁴ In the case of contracts for the purchase of shares, on the other hand, such contracts although valid when made, are generally held unenforceable unless the corporation has the requisite surplus at the time of performance. The seller of shares cannot compete with other creditors.³⁵

In general, cash or property dividends may be paid only out of earned

³² Cal. Civ. Code (1931), § 342b.

³³ Cal. Civ. Code (1931), § 342a.

³⁴ See *Ford v. Easthampton Rubber etc. Co.*, 158 Mass. 84, 32 N.E. 1036 (1893).

³⁵ *Cross v. Beguelin*, 252 N.Y. 262, 169 N.E. 378 (1929); 29 Col. L. Rev. 356 (1929); 18 Corn. L. Quar. 589 (1933).

surplus. Deduction must be made from net assets of the amount of the stated capital. Deductions must also be made of the amount of any paid-in surplus, "any surplus arising from the surrender to the corporation of any of its shares," and any surplus arising from unrealized appreciation in value, or revaluation, of assets, which also act as reserves or margins. The remainder after making these deductions would seem to be "earned surplus." Dividends may however be paid out of paid-in surplus or surplus arising from the surrender of shares upon shares having a preferential right to receive dividends.

The Illinois act does not permit the alternative which is allowed under the English law, the Delaware law, the California law and the laws of a number of states, of paying dividends out of net profits during a certain accounting period, such as the current or preceding fiscal year whether or not there is a surplus and in spite of impairment of stated capital,³⁶ if preferred shares are protected by net assets equal to the stated capital represented by them. It is said in the committee comments upon the 1931 draft of the Illinois Corporation Act, "Obviously no dividend should be declared at a time when the net assets of the corporation are less than the stated capital, or which will reduce the net assets below the stated capital." It has evidently been deemed a wise policy in a number of other states, however, that investors should not necessarily be required by law to forego dividends or income from their investment by reason of impairment of the value of net assets below the stated capital, if the corporation is solvent, on the up grade, and has made profits from operations during the current or the preceding year. Reasonable latitude is thus given the directors for the exercise of discretion as to how best to write off past losses without the formality of reducing the stated capital in cases where the corporation has a deficit or its assets have diminished in value. There is room for much difference of opinion on the subject of dividend limitations, which at the present time are of very dubious value.

The Illinois law is more strict than the Delaware and California law in not expressly excusing deduction for the depletion of wasting assets in the case of wasting asset corporations, even in the case where there is only one class of shares. Perhaps the courts might imply such an exception as they have done elsewhere.³⁷

³⁶ Weiner, *Anglo-Am. Dividend Law*, 29 *Col. L. Rev.* 461, 473, 477 (1929); Berle, *Revised Del. Corp. Act*, 29 *Col. Rev.* 563, 575 (1929); Weiner, *Amount Available for Dividends*, 29 *Col. L. Rev.* 906, 909 (1929); Ballantine, *Questions of Policy*, 19 *Cal. L. Rev.* 465, 478 (1931); *Minn. Laws of 1933*, § 21 (IIC).

³⁷ See *Del. Gen. Corp. Law*, § 34; *Cal. Civ. Code* (1931), § 346; 55 *A.L.R.* 8, 41, note; Weiner, *Anglo-Am. Dividend Law*, 29 *Col. L. Rev.* 461, 477, 482 (1929), 30 *Col. L. Rev.* 330, 355 (1930).

Strange to say share dividends are not allowed out of paid-in surplus except on preferred shares, but they are allowed under Section 41 (c) out of surplus arising from unrealized appreciation in value, or revaluation of assets. The California committee included a provision prohibiting share dividends on such a basis although permitting them out of paid-in surplus.³⁸ Share dividends are declared as a rule for stock market purposes and "cutting the melon" has contributed to the profits of many a pool. Stock dividends are frequently a method of deceiving the public and the statutes should not encourage the declaration of such dividends, especially out of unrealized earnings and revaluation of assets.³⁹

There is no provision in connection with the use of paid-in surplus permitting a corporation to declare share dividends against such surplus or to write off losses or a deficit in earned surplus by the application of paid-in surplus. Some accountants argue that a deficit in the account of earned surplus may not be written off by the application of capital surplus, and this point may well be settled by statute.⁴⁰

In connection with the declaration of a dividend payable in shares without par value, such shares may be issued at such value as shall be fixed by the board of directors. It might be deemed a wise policy to make some more strict requirement as to the amount of surplus which should be transferred to stated capital such as the liquidation price in case of preferred shares and the estimated fair value upon issue of common shares or an amount arrived at by multiplying the average stated capital represented by all shares of that class then issued by the number of shares issued as a dividend.⁴¹

Section 41 (a) prohibits payment of a dividend on shares having a preference as to dividends over the shares upon which the dividend is paid, unless expressly authorized in the articles. This is one restriction in the Illinois act which is not found in other corporation acts, although the danger of abuse has been pointed out in Berle & Means, *Modern Corporation and Private Property* (p. 197). Such dividends on preferred shares might be used as a device to give common shareholders a preferred claim on future earnings or distribute paid-in surplus to common shareholders.⁴²

³⁸ Cal. Civ. Code (1931), § 346a.

³⁹ See Berle & Means, *Modern Corporation and Private Property* (1932), 167; Weiner, *Anglo-Am. Dividend Law*, 29 Col. L. Rev. 981-983 (1929).

⁴⁰ Cal. Civ. Code (1931), § 346c.

⁴¹ Cal. Civ. Code (1931), § 346a.

⁴² Under the Minn. Act, Minn. Laws of 1933, § 21 (III d), no dividend payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote or written consent of the holders of $\frac{2}{3}$ of the shares of the class in which payment is to be made. See 28 Ill. L. Rev. 566 (1933).

A fairly easy method of evasion of the restriction of Section 41 (c) forbidding cash dividends out of surplus from unrealized appreciation may be found under Section 19 which permits the directors by resolution to order "that all or part of the surplus of the corporation be transferred to stated capital." The stated capital may then be reduced and the paid-in surplus thereby credited may be distributed in cash or in kind to the shareholders under Section 60. A similar method of evasion would seem to be open under the California law,⁴³ except that distribution of the "reduction surplus" is more strictly limited.

The general limitations upon dividends as upon purchases by the corporation of its shares are (1) earned surplus of net assets in excess of stated capital, and (2) solvency or an equivalence between the amount of its assets and liabilities. Earned surplus is a far better limitation than surplus generally, including all excess of net worth over stated capital; but even earned surplus of net assets may be based largely upon fixed, unmarketable and frozen assets, such as investment in plant and permanent improvements. Surplus has no relation to "current ratio" of liquid assets to current liabilities and so to the ability of the corporation to meet its debts and liabilities as they fall due and to keep sufficient "working capital" to continue the business. Great abuses are possible within the statutory limits as to surplus. The directors might well be made expressly responsible for the exercise of reasonable care in declaring dividends and making share purchases, with a view to maintaining a prudent margin to meet debts and liabilities as they mature and to continue the operation of the business for the benefit of creditors and shareholders. Such a general limitation, putting the responsibility upon directors, might be more practical than the complicated system of stated capital and surplus or the net profits limitation, all of which involve valuation and estimates of assets and liabilities, which are subject to accounting manipulation and which determine little as to the propriety or safety of dividends or share purchases.

LIABILITY OF DIRECTORS FOR IMPROPER DIVIDENDS, DISTRIBUTIONS OF ASSETS AND LOANS TO OFFICERS AND DIRECTORS

Liability to reimburse the corporation is imposed upon the directors who vote for or assent to the declaration of certain improper dividends or other distributions of assets to the shareholders, but only if the corporation is insolvent or its stated capital is impaired or if the declaration of the dividend or other distribution will render the corporation insolvent or reduce its net assets below its stated capital. No civil liability seems to be

⁴³ Cal. Civ. Code (1931), §§ 348c, 348b.

imposed upon the directors for violations of the dividend limitations of Section 41 as to paragraphs (b) to (h) inclusive, for example declaration or payment of dividends out of paid-in surplus or from unrealized appreciation in value or revaluation of assets, nor for declaration or payment of dividends contrary to restrictions in the articles, nor for improper share dividends. No liability is imposed upon the directors for authorizing the wrongful payment of a dividend as authorized by a valid declaration thereof if the corporation later incurs a deficit or becomes insolvent, unless this is included in the term "other distribution of the assets."⁴⁴

The measure of liability imposed by Section 42 (a) and (b) is the amount of dividends paid or the value of the assets distributed if the corporation be insolvent or its stated capital be impaired, or the extent to which it is rendered insolvent or its net assets are reduced below the amount of its stated capital. The civil liability to the corporation is no doubt for the benefit of the creditors and the shareholders prejudiced, but is not limited to the amount of existing debts nor to the amount of loss to the shareholders, so the directors may be held liable although the corporation has no debts and the shareholders have suffered no loss, as may well be the case if the capital is merely impaired. It seems a harsh and penal liability to impose on the directors the entire amount of the payment without reference to the question of wilfulness or negligence or the extent to which the debts and liabilities of the corporation are not paid or whether anyone has been injured by the unauthorized dividend or distribution. (Cf. § 42 (c).) Such an arbitrary, penal measure of damages is no longer imposed by the California law.⁴⁵

The liability of the directors is apparently made absolute except in so far as the declaration or distribution has been made in good faith in reliance upon a balance sheet and profit and loss statement duly represented to be correct or certified by a public accountant, or if in good faith directors take the assets at their book value. Nothing is stated as to how the amount of the liabilities, losses and other deductions shall be ascertained in the absence of a financial statement.

No express provision is made as to the liability of shareholders for improper dividends or other distribution of assets except to make proportional "contribution" (i.e., reimbursement) to directors when the shareholder knowingly has accepted or received any such dividend or assets. "Knowingly" probably means with knowledge of facts indicating that it was improper, as under the California law.⁴⁶

⁴⁴ As to remedies in event of a fraudulent share dividend, see *Pontiac Packing Co. v. Hancock*, 257 Mich. 45, 241 N.W. 268 (1931).

⁴⁵ Cal. Civ. Code (1931), § 363; Ballantine, Cal. Corp. Laws, 1933 Supp., 201-205.

⁴⁶ Cal. Civ. Code (1931), §§ 363, 364, 365.

The liability of the shareholder at the suit of the corporation, its trustee in bankruptcy, receiver or creditors to respond for illegal dividends and distributions innocently received is left in doubt and uncertainty.⁴⁷ The draftsmen may have intended that the primary liability should be placed squarely on the directors for illegal dividends and distributions, and that a shareholder should only be liable to return the amount received to any director who might be held liable, if the shareholder accepted the dividend with knowledge of the fact that it was improperly declared or paid. But the statutory liability of the directors does not exonerate the shareholders and both directors and shareholders may be sued concurrently.⁴⁸ Moreover the instances in which the directors are made liable do not cover all the situations where distributions may be made contrary to the restrictions of the act.

There is no provision as to the liability of the directors or shareholders in the event of improper purchase of shares by a corporation (§§ 6, 42) nor for improper redemption of shares contrary to Section 58 nor for violations of Section 60 (a) and (b) as to liquidating dividends. Perhaps the phrase "other distribution of assets" in Section 42 (a) and (b) is intended to cover purchases and redemption of shares as well as rateable distribution. If a statute prohibits a particular act but fails to make provision for either criminal punishment or civil liability for its violation, the transaction prohibited is presumably voidable and subject to rescission. There may also be civil liability on the part of the violators depending upon questions as to what are the classes of persons and what are the interests which are intended to be protected and whether violation of the act is negligence *per se* or mere evidence of negligence. (See § 8 (b).) An innocent shareholder might very possibly be held liable to return the purchase price received for his shares from the corporation contrary to Section 6 of the act.

The criminal liability imposed on directors under Section 42 (h) for improper declaration of dividends, other distributions of assets and loans to officers and directors is absolute, irrespective of good faith or reasonable care, and is not confined to wilful or negligent violations of the statute. Reliance upon a balance sheet or profit and loss statement or upon the book value of the assets is apparently no defense as to improper dividends or distributions. This penal liability did not have the approval of the committee which drafted the act.

The provision of Section 42 (c) making directors and officers personally liable for "loans" to an officer or director of the corporation might well be

⁴⁷ See note, 33 Col. L. Rev. 481 (1933); Minn. Laws of 1933, c. 300, §§ 22, 38.

⁴⁸ *Ulness v. Dunnell*, 61 N.D. 95, 237 N.W. 208 (1931).

extended to cover indorsements or guarantees of the obligations of such persons and also to the directors or officers of subsidiary corporations lending its funds to directors or officers of its holding corporation. Corporation statutes must take more express notice of the use of subsidiary corporations in such matters as loans, purchases of shares, inspection and financial statements.⁴⁹

REDEMPTION AND CANCELLATION OF SHARES

The Illinois Act is peculiar in failing to take cognizance of the possibility of retiring shares to the status of authorized, but unissued shares, particularly in connection with redemption and reduction of stated capital. This results in arbitrary limitations. Provision for the reduction of stated capital upon redemption of shares is made only in event that the article provide that the shares redeemed "shall be cancelled and shall not be reissued." No provision is apparently made for the purchase or redemption of redeemable shares out of stated capital, or even from paid-in surplus, unless the shares redeemed are required to be "cancelled" and the authorized number of shares is to be reduced by what amounts to an amendment to the articles of incorporation. Why does this section attribute so much importance to "cancellation" and a provision that the shares shall not be reissued in connection with redemption and reduction of stated capital, when the authorized number of unissued shares has no relation to the amount of stated capital?

The Delaware act^{49a} and the California law^{49b} permit the stated capital to be reduced either upon purchase or redemption of redeemable shares, and such shares become unissued shares in the absence of provision that they shall not be reissued. Under the California law if redeemable shares are purchased from earned or paid-in surplus they may be carried as treasury shares. If acquired out of stated capital, the shares are restored to the status of authorized, but unissued shares and the stated capital should be reduced.⁵⁰

If stated capital may be reduced upon the redemption of redeemable shares under the option reserved in the articles, why may it not also be reduced upon the *purchase* of such shares for retirement in the open market at a lower price? Provision is authorized for the creation of a sinking fund for the redemption or purchase of shares. (§ 15 (e).)

The power to exercise the option of redemption of shares is subject to a

⁴⁹ See Cal. Civ. Code (1931), §§ 278, 344, 366, 356, 357, 358.

^{49a} Del. Gen. Corp. Law, § 27.

^{49b} Cal. Civ. Code (1931), §§ 342, 342a.

⁵⁰ See Ohio Page's Ann. Code (1932 supp.), § 8623-39 (2), (7).

limitation similar to that in the California law⁵¹ that the remaining assets of the corporation shall not be reduced below an amount sufficient to pay all debts and known liabilities of the corporation as they mature, except such debts and liabilities as have been adequately provided for. It is difficult to see why similar limitations on the purchase of shares generally should not have been included in Section 6, as they are in the California law.⁵² Even if a corporation has an earned surplus this surplus may be represented by fixed assets and the use of funds to purchase shares might threaten the ability of the corporation to meet its debts and liabilities as they mature. A similar limitation also might well be included in Section 41 as to dividends as well as the general limitation of solvency and the existence of an earned surplus.

There are serious objections to compulsory redemption provisions, but there seems to be no restriction express or implied in the Illinois act against including a provision in the articles of incorporation for the compulsory redemption of preferred shares, that is for the purchase by a corporation of its own shares at a fixed price at a future date or at the option of the holder of the shares, subject to the restrictions of Section 58.⁵³ Such purchase may operate to cause an impairment of the net assets below the amount of the stated capital and exhaust the funds which are needed in the business at the time. The only limitation is the reservation of an amount sufficient to pay all debts and known liabilities of the corporation as they mature, except such as have been adequately provided for, and to cover the aggregate amount of liquidation preferences of shares with equal or prior rights. Such provisions for compulsory redemption have been severely criticized as tending to fraud both on shareholders and on creditors, and are expressly forbidden under the California law.⁵⁴ The right of redemption should be an option to be exercised only by the corporation in the discretion of the directors when it is deemed to be for the benefit of the corporation to retire the preferred shares. Provision may, however, be made for the accumulation of a sinking fund from net earnings which may be required to be applied to the purchase or redemption of redeemable shares.⁵⁵

The second paragraph of Section 58 speaks of "debts and liabilities adequately provided for." It might be well to define or explain this phrase as meaning that the assumption or guarantee in good faith by one or more

⁵¹ Cal. Civ. Code (1931), § 342.

⁵² *Ibid.*

⁵³ §§ 6 (d), 14 (a), 15 (e), 47 (g), (h), 58.

⁵⁴ Cal. Civ. Code (1931), § 294; *Koeppler v. Crocker Chair Co.*, 200 Wis. 476, 228 N.W. 130 (1930); *Ballantine, Cal. Corp. Laws* (1932), 357, 1933 Supp., 47.

⁵⁵ See Cal. Civ. Code (1931), § 294; Illinois Act, § 15 (c).

solvent individuals or corporations of such debts and liabilities would be deemed an adequate provision, if so determined in good faith and with reasonable care by the board of directors at the time.⁵⁶

REDUCTION OF STATED CAPITAL

It is a difficult legislative problem to fix the safeguards for the protection of creditors and preferred shareholders, under which a corporation should be allowed to reduce its stated capital for the purpose of relaxing the limitation on dividends and share purchases, or permitting the withdrawal and distribution of part of the funds invested. The subject of reduction of "capital stock," as it is often called, is involved in rather hopeless confusion in the statutes of most of the states.⁵⁷ This is due partly to confusion of concepts and terminology and partly to a failure to discriminate between the five different operations of (1) reducing the amount of stated capital by action of the shareholders; (2) retiring shares; (3) adjusting the par value of outstanding shares to conform to stated capital as reduced; (4) changing the share structure by amendment of the articles as to the authorized number of par value of shares; and (5) distributing assets to the shareholders out of surplus arising from reduction of stated capital.

Reduction of stated capital is left largely to the whim of the management and the shareholders, the very interests who are supposed to be restrained from improper withdrawals. The creditors, who are the ones supposed to be protected by stated capital, have in American legislation no voice in its reduction, although it is otherwise under the English Companies Act.⁵⁸

Under the Illinois act there are three methods by which reduction of the legal stated capital may be accomplished, namely:

First, by an exchange, reclassification, or cancellation of shares, or by a reduction of the number of authorized shares of any class below the number of issued shares of that class, by amendment of the articles under Section 52 (3), (f), (r) and (m). (See also § 55 (e) and (f).) Any such amendment will require a two-thirds vote of the shareholders and may also require a two-thirds vote of the class affected if the amendment falls under the provisions of Section 54.

Second, by the redemption of shares which under the provisions of the articles are to be cancelled and not reissued. This is provided for in Sec-

⁵⁶ See Cal. Civ. Code (1931), § 401a.

⁵⁷ But see Del. Gen. Corp. Law, § 28; Ohio Page's Ann. Code (1932 supp.), § 8623-39, 40.

⁵⁸ 19 and 20 Geo. 5, c. 23, §§ 55, 56, 57 (1929), Palmer, Company Law (14th ed.), 88-95.

tion 58. This of course applies only to redeemable preferred shares. It does not apply even to redeemable shares unless the articles provide that the shares when redeemed are to be cancelled and may not be reissued. It is hard to see what reducing the number of authorized shares has to do with the reduction of the amount of "stated capital." If redeemable preferred shares are "purchased" under Section 6 (unless they are purchased under paragraph (d) for the purpose of "effecting the redemption of its preferred shares" under Section 58), the purchase will not reduce the stated capital.

Third, by vote of shareholders and directors under Section 59 to reduce stated capital.

Section 59 provides for the reduction of the amount of stated capital by resolution of the board of directors and approval of the proposal by a majority vote of the shareholders. A surplus arising from a reduction of stated capital is required to be set up as paid-in surplus. (§ 60.) If a corporation desires to reduce the amount of its stated capital either to get rid of a deficit or to distribute part of its assets its stated capital may be reduced by proceedings under Section 59 without any amendment of the articles.

The only limitation upon reduction of stated capital under Section 60 is the aggregate of the involuntary liquidation preferences of the non-par preferred shares to remain outstanding. This limitation does not refer to the liquidation preferences of par value shares or of treasury shares. Such preferences are protected only against distributions under Section 60.

In case of a corporation issuing only common shares without par value or preferred non-par shares without liquidation preference or par value shares, there seems to be no limitation upon the amount of reduction of the stated capital. It may be reduced down to a nominal amount, leaving practically no prescribed margin of assets over liabilities as a limitation upon surplus available for liquidating dividends. It may distribute all its assets down to a bare equivalence between assets and liabilities, leaving the creditors to take all the chances on subsequent adversity.⁵⁹

In view of the definition of stated capital contained in Section 2 (k) it would seem that formal reductions of stated capital may be made under Sections 59 and 60 without any amendment reducing the par value or liquidation preferences of outstanding or issued shares with par value, so that the capital as reduced by formal reduction will be less than the aggregate par value or liquidation preferences of all the par value shares then

⁵⁹ The corporation must have a minimum paid in capital of \$1,000 before it may commence business. §§ 47 (i), 50.

issued. No limitation upon reduction to the aggregate par value of shares to remain outstanding after reduction is contained in Section 60 similar to that contained in the California law.⁶⁰

It would seem under Sections 6 and 41 (b) referring to "any surplus arising from surrender to the corporation of any of its shares," that a reduction of stated capital might be accomplished by the voluntary surrender by shareholders of their shares to the corporation and the retirement of those shares to the status of authorized but unissued shares without any amendment of the articles, unless the first paragraph of Section 59 limits these prior sections.

The amount of the stated capital is not fixed by the articles but by the issue of shares and other proceedings. It seems peculiar that it may be reduced as in the Illinois law by amendment of the articles operating on the par value of the issued shares and transferring stated capital to paid-in surplus. (§§ 54, 55.) Under the California law^{60a} and under the Delaware law^{60b} the mere amendment of the articles reducing the number or aggregate par value of the issued shares will not of itself automatically reduce the stated capital but direct proceedings must be taken with that end and purpose explicitly in view and with limitations for the protection of the parties concerned, although some incidental amendment of the articles adjusting the shares representing the stated capital may also be needed.⁶¹

LIQUIDATING DIVIDENDS

Surplus arising from reduction of the amount of stated capital is designated as "paid-in surplus," as in the Minnesota act.⁶² An interesting feature of the Illinois act is the provision for liquidating dividends which may be paid out of paid-in surplus whether created by reduction of stated capital or otherwise. (§ 60.) The limitations on distributions on the basis of paid-in surplus are first that the distribution shall not be made when the corporation is insolvent or when the distribution would render it insolvent or reduce its net assets below its stated capital. There are the further restrictions that no such distribution may be made unless all cumulative dividends accrued on preferred or special classes of shares entitled to preferential dividends have been paid or if the distribution would reduce the remaining net assets below the aggregate preferential amount payable in event of voluntary liquidation to holders of shares having

⁶⁰ Cal. Civ. Code (1931), § 34. See also Minn. Laws of 1933 c. 300, § 38.

^{60a} Cal. Civ. Code (1931), § 362.

^{60b} Del. Gen. Corp. Law, § 26.

⁶¹ See also Minn. Bus. Corp. Laws of 1933, c. 300, §§ 37, 38; State ex rel. Radio Corporation v. Benson, 32 Del. 576, 128 Atl. 107 (1924).

⁶² Minn. Laws of 1933, c. 300, § 20 (IV).

liquidation preferences. Such dividends out of paid-in surplus may be paid only upon the vote of two-thirds of the outstanding shares of each class, and the fact that it is a liquidating dividend must be disclosed to the shareholders.

This provision is a great improvement in the way of protection of the preferred shareholders over provisions to be found in the Delaware corporation law and in those of many other states as to distribution of paid-in surplus and reduction surplus. The question may be raised, however, whether even this provision for a two-thirds vote of each class of shareholders gives adequate protection to preferred shares. We have already seen that stated capital may in most cases be reduced down to a nominal amount and all of the net assets thus become subject to distribution except for liquidation preferences.

The California General Corporation Law⁶³ protects the preferred shares by requiring that a "reduction surplus" be applied first to the redemption or retirement of the preferred shares. It permits distributions of reduction surplus among the holders of common shares only in event that there are no other classes of shares. Preferred shares should not have their margin of security reduced down to a mere equivalence of net assets to the aggregate amount payable in event of voluntary liquidation.

The Illinois provision which may permit liquidating dividends up to the verge of insolvency may be criticised for failing to provide adequate protection for creditors. Under the California law⁶⁴ there has been included as a limitation upon the use or distribution of reduction surplus, not only a determination by the directors that the distribution will not render the corporation unable to meet its debts and liabilities when they fall due (a more adequate protection than the Illinois test of insolvency), but also a determination that the fair present value of its assets after such distribution will be at least one and one-quarter times the debts and liabilities of the corporation, thus preserving some margin or equity for their protection. It seemed to the California committee, both in connection with dividends and distributions of assets and also in connection with purchases by a corporation of its own shares, that the *liquidity* of the corporation as well as the *solvency* should be considered, since even earned surplus may be represented merely by the book value of fixed and unmarketable assets. The policy is recognized in the Illinois Act, Section 58, as to the redemption of shares, that the ability of the corporation to pay all its known debts and liabilities as they mature should be considered, but this does not seem to be expressly required in other analogous situations.

⁶³ Cal. Civ. Code (1931), § 348b.

⁶⁴ Cal. Civ. Code (1931), § 348b.

Neither the creditors nor the preferred shareholders should be forced to bear the risk of impairment of their security by slight business losses or reverses or any shrinkage in the value of the net assets. As Mr. Weiner says with reference to allowing what are liquidating dividends to be paid on the common shares so long as assets equal to the capital preference are retained, "the capital preference promised to the preferred stock by the contract is wholly illusory, and the common stock obtains in reality a preference as to capital."⁶⁵

DE FACTO CORPORATIONS AND PROOF OF CORPORATE EXISTENCE

Under Section 49 of the act the issue of a certificate of incorporation by the secretary of state, upon filing the articles of incorporation, is made conclusive evidence, except against the state, that all conditions precedent required to be performed by the incorporators have been complied with and that the corporation is duly incorporated under the act. A similar legal effect is given under the California General Corporation Law to the filing of the articles by the secretary of state without the requirement of the issue of any certificate of incorporation.⁶⁶

This provision by which the certificate of incorporation establishes corporate existence largely supersedes the necessity of resorting to the common law doctrines of de facto corporations and of corporations by estoppel where there is some defect or irregularity in the incorporation papers or proceedings leading up to the issue of the certificate. In the case of foreign corporations, however, and corporations which attempt to organize but fail to file the articles with the secretary of state or to obtain a certificate of incorporation, such doctrines may need to be invoked.⁶⁷

Section 150 of the Illinois act as to unauthorized assumption of corporate powers seems to be a rather blind and inadequate revision of a section of the former law.⁶⁸ This section purports to impose personal liability for debts and liabilities incurred by persons who assume to exercise corporate powers without authority to do so. It is not clear whether this liability extends only to agents and officers who act in the name of a pretended corporation, which is not a de facto corporation, or to all the members and shareholders. Literally it might seem to impose personal liability on all the agents and officers and possibly shareholders for ultra vires contracts of a de jure corporation or of a corporation whose term of existence has

⁶⁵ Anglo-Am. Dividend Law, 29 Col. L. Rev. 461, 482 (1929).

⁶⁶ Cal. Civ. Code (1931), §§ 292, 370, 370a.

⁶⁷ See *Hall v. Woods*, 325 Ill. 114, 156 N.E. 258, 269 (1927); notes in 22 A.L.R. 369, 37 A.L.R. 1319.

⁶⁸ Ill. Gen. Corp. Act, 1919, § 149.

expired or of a corporation which has filed a statement of intent to dissolve (§§ 42 (g), 78) or of a corporation which commences business before it has received the amount of consideration stated in its articles to be received for the shares to be issued before it commences business. (§§ 42 (e), 50.)

DEFENSE OF ULTRA VIRES

The Illinois act attempts to mitigate the evils of the ill-founded doctrine of ultra vires, but makes only a partial success. The defense of ultra vires has long been the subject of criticism by courts and writers.⁶⁹ Statutes have recently been adopted in California, Idaho, Indiana, Louisiana, Michigan, Minnesota, Ohio, and Pennsylvania intended to abrogate or at any rate cut down this defense. Some of these statutes have been based upon the proposal of the Uniform Business Corporation Act, which however seems hardly adequate.⁷⁰

California and Ohio have taken the lead in the abolition of this artificial defense, a defense which has been carried to unjust extremes in Illinois with results which served no useful purpose or policy and which were condemned by the courts which decreed them. The substance of the Illinois doctrine was that third persons dealing with a corporation were charged with notice of the express and implied limitations on the corporate powers and purposes contained in the articles and that ultra vires contracts were void and the courts would not give aid to either party in a suit upon such a contract. It was even held by the Illinois Supreme Court that a corporation could not realize on the security for an ultra vires loan and there was no estoppel to set up ultra vires by the party who had received the benefit of the contract. As Carter, J., dissenting, said, the effect was an unjust forfeiture.⁷¹

The general theory of the California provision,⁷² which has been followed to a large extent in Illinois, Michigan, Minnesota and Pennsylvania, is the abolition of the doctrine of ultra vires as invalidating transactions between the corporation and third parties. Limitations upon the purposes and powers *imposed by provisions of the articles* may not in general be asserted to invalidate legal transactions which have been authorized by the directors. Shareholders are sufficiently protected if allowed to enjoin

⁶⁹ Ballantine, *Private Corporations* (1927), 234-237; Ballantine, *Questions of Policy*, 19 Cal. L. Rev. 465, 473 (1931); Carpenter, *Doctrine of Ultra Vires*, 33 Yale L. Jour. 49 (1923).

⁷⁰ See Minn. Bus. Corp. Act (1933), § 11.

⁷¹ Calumet etc. Dock Co. v. Conkling, 273 Ill. 318, 112 N.E. 982, L.R.A. 1917B (1916), 814; see Ballantine, *Private Corporations* (1927), 258; *Mercantile Trust Co. v. Kastor*, 273 Ill. 332, 112 N.E. 988 (1916).

⁷² Cal. Civil Code (1931), § 345.

the corporation from engaging in future business outside of the purposes authorized in the articles and to hold directors liable for losses resulting from engaging in such unauthorized acts. The state may also raise questions of ultra vires in actions to dissolve the corporation or to enjoin the corporation from the transaction of unauthorized business.

A serious question must, however, be raised with reference to the policy and effect of paragraph (a) of Section 8 of the Illinois Act, and a similar provision in Section 303 (1) of the new 1933 Pennsylvania Business Corporation Law. Under this paragraph a shareholder may proceed against the corporation to enjoin the doing of unauthorized acts including the performance of an executory or even a partly executed contract, and the court may "if it deems the same to be equitable, set aside and enjoin the performance of such contract, and in so doing shall allow to the corporation or the other parties, as the case may be, compensation for the loss or damage sustained by either of them which may result from the action of the court in *setting aside* and enjoining the performance of such contract," but shall not award anticipated profits as damages.

This creates a very anomalous situation indeed. Neither the corporation nor the third party may rescind the contract nor set up the defense of ultra vires as a defense even to an action for specific performance, but in a judicial proceeding at the instance of a shareholder against the corporation further performance may be enjoined and the contract may be rescinded. This perpetuates much of the old uncertainty and confusion as to the validity of legal transactions which have been some of the worst evils of the doctrine of ultra vires. Such vague, timorous and uncertain provisions are likely to confuse the courts, encourage litigation, unsettle contracts and accomplish no good purpose. Does it not seem an outrage upon the third party to make a contract authorized by the directors binding on him, but not on the corporation if the corporation can persuade some shareholder to bring a suit for an injunction and rescission? This enables the corporation to speculate at the expense of the third party and deprives a third party contracting with a corporation in good faith of the anticipated profits of his partly executed contract, while reserving a right to such profits to the corporation.

In the second paragraph of Section 8 it is provided not only that "no limitation upon the business, purposes or powers of a corporation, express or implied in its *articles of incorporation*," shall be asserted to defeat any action at law or in equity between the corporation and a third person, but also that no limitation "*implied by law*" shall have such effect.⁷³ What are

⁷³ See also Pa. Bus. Corp. Law, § 303.

the limitations referred to which are "implied by law?" If a contract be forbidden by statutory prohibitions or limitations or contrary to the common law as against public policy, it is generally held illegal and void irrespective of the doctrine of ultra vires.⁷⁴ The abrogation of the defense of ultra vires based on limitations in the articles should not abrogate illegality as a ground of invalidity or rescission based on statutes or public policy. This clause raises a question as to the effect of all the limitations imposed upon corporations by statute such as that in Section 78 that a corporation shall cease to carry on business except in so far as necessary for its proper winding up after filing a statement of intent to dissolve, or that in Section 50 as to commencement of business.⁷⁵

The Illinois Corporation Law follows a wise policy in not making the abrogation of the defense of ultra vires dependent upon the question whether or not the person dealing with the corporation has actual knowledge of the limitations on the authority of its representatives, although this view is adopted in Ohio, Minnesota and Michigan.⁷⁶

INSPECTION AND FINANCIAL STATEMENTS

Shareholders are entitled to adequate information for their guidance and protection concerning their corporation, its management and financial condition.⁷⁷ Inspection of the records is only one means, and a rather poor one, of obtaining such information. Under the former Illinois law the right of inspection was absolute and evil motive was no defense. Under Section 45 of the new act the books and records of account, minutes and record of shareholders are open to inspection to shareholders of record (a) for six months, or (b) of 5 per cent of the outstanding shares. The exercise of such right of inspection is however now limited to "any proper purpose." Doubtless the shareholder must now show proper reasons for his demand of inspection, namely that it is for a purpose reasonably related to his interests as a shareholder.⁷⁸ If inspection is sought in bad faith or

⁷⁴ *Stevens v. Boyes Hot Springs*, 113 Cal. App. 479, 298 Pac. 508 (1931); *McWilliams, Ultra Vires Acts*, 6 Cal. L. Rev. 328 (1918); *Stevens, Ultra Vires Doctrine*, 36 Yale L. Jour. 297, 309 (1927).

⁷⁵ See *Ballantine, Cal. Corp. Laws* (1932), 331-334; *Ballantine, Revision of the Ultra Vires Doctrine*, 12 Corn. L. Quar. 453 (1927):

⁷⁶ *Ohio Page's Ann. Code* (1932 supp.), § 8623-8; *Minn. Laws of 1933*, c. 300, § 11; *Mich. Gen. Corp. Act*, § 11. See *Stevens, Ultra Vires*, 4 Univ. Cin. L. Rev. 419, 439 (1930).

⁷⁷ *Rogers v. American Tobacco Co.*, 143 Misc. Rep. 306, 257 N.Y. Supp. 321 (1931), and cases cited; *Ballantine, Cal. Corp. Laws* (1932), 386-395, 1933 Supp., 165-172.

⁷⁸ See with reference to the purposes for which inspection may be had, *State ex rel. Miller v. Loft, Inc.* 156 Atl. 170 (Del. 1931); *Notes*, 59 A.L.R. 1379; 80 A.L.R. 1503; 20 Cal. L. Rev. 449 (1932); *Ballantine, Cal. Corp. Laws* (1932), 387.

for ulterior purposes to the injury of the corporation and the other shareholders they may now be protected against abuse of the right.

The new act makes no provision as to any right of inspection by shareholders of the books and records of foreign corporations kept in the state although such a right of inspection is usually recognized in the absence of statute.⁷⁹ Convenience dictates that the books and records of foreign corporations should be subject to examination where they are located.⁸⁰

There should be no question as to the right of inspection of all books, records and documents of every kind, and also of the physical properties of the corporation by every director. The California law has added a section⁸¹ declaring the directors' right of inspection and extending it to foreign corporations, and to the books, records, documents and properties of subsidiary corporations.⁸² It seems very doubtful whether a shareholder has any right to inspect the property of a corporation and to check up its cash or securities with its books.⁸³

Some more adequate methods of investigation and of getting financial and other information should be made available to the shareholders than the very individualistic right of inspection. The California law makes provision for investigation of the corporate affairs and the remuneration of directors and officers by order of the court upon petition of ten per cent of the shareholders.⁸⁴ It also makes provision for an annual report to be sent to the shareholders in the absence of a by-law dispensing with such report.⁸⁵ It also provides for a compulsory financial statement upon demand of a certain percentage of the shareholders with balance sheet and profit and loss account showing essential items and the relations of the corporation with its subsidiary corporations.⁸⁶ The Illinois law gives no recognition to the necessity of setting forth the relations between holding corporations and their subsidiary corporations or to the making of any compulsory reports to the shareholders or for any judicial investigation of corporate affairs.

Shareholders, at least a certain percentage, should have the right to a

⁷⁹ See *Rogers v. American Tobacco Co.*, 143 Misc. 306, 257 N.Y. Supp. 321; 18 A.L.R. 1399 (1931).

⁸⁰ See Cal. Civ. Code (1931), § 355.

⁸¹ Cal. Civ. Code (1931), § 356.

⁸² See as to the right of officers to inspect books and records, Notes, 22 A.L.R. 59; 80 A.L.R. 1510; Ballantine, Cal. Corp. Laws (1932), 1933 Supp., 167.

⁸³ But see *Wm. Coale Dev. Co. v. Kennedy*, 121 Ohio St. 582, 170 N.E. 434 (1930).

⁸⁴ Cal. Civ. Code (1931), § 357.

⁸⁵ Cal. Civ. Code (1931), § 358.

⁸⁶ Cal. Civ. Code (1931), §§ 358, 359. See Minn. Laws of 1933, § 34; Ballantine, Cal. Corp. Laws, 1933 Supp., 171-183.

full disclosure by the directors of the financial conditions of the corporation and of matters affecting the compensation of the executive officers such as salaries, bonuses and stock purchase plans. There is a growing protest against the excessive compensation often diverted by the management from the corporate funds and there will probably develop an insistent demand for disclosure to the shareholders and to the public by the corporate management of all compensation received and of all transactions such as the issue and purchase of shares by which the management and the controlling shareholders obtain pecuniary benefits or advantages which are not enjoyed by all the shareholders alike.

VOTING RIGHTS AND MEETINGS

The Illinois Constitution, Article XI, Section 3, has been construed by the Supreme Court to mean that directors must be elected by the shareholders. In case of a vacancy occurring on the board the remaining members of the board cannot be authorized to fill the vacancy, as is customary under the corporation laws of other states.⁸⁷ Accordingly Section 36 of the Illinois act provides that vacancies in the board must be filled by the shareholders. It was also considered unsafe to provide that the articles of incorporation might designate the first board of directors, and accordingly Section 47 (j) provides that the articles shall specify the number of directors to be elected at the first meeting of the shareholders. The election of the first directors and adoption of by-laws is provided for at an organization meeting of shareholders. (§ 51.) Under the California law⁸⁸ the necessity of holding any such organization meeting of shareholders is avoided by the naming of directors in the articles and the corporation comes into existence with a board of directors able to adopt by-laws and to function without any meeting of shareholders.

The same provision of the Illinois Constitution also provides for cumulative voting, and Section 28 accordingly gives each shareholder the right to cumulate his votes and give one candidate as many votes as the number of directors (to be elected?) multiplied by the number of his shares shall equal, or to distribute his votes on the same principle among as many candidates as he shall think fit. In case the directors are classified with only one-half or one-third of nine directors elected annually, as is provided in Section 35, presumably the benefits of cumulative voting are cut down, since the larger the number of directors to be elected the greater the chance of minority holders to secure a representative on the board. In order to protect the right or advantage of cumulative voting, under the

⁸⁷ *People ex rel. Weber v. Cohn*, 339 Ill. 121, 171 N.E. 159 (1930).

⁸⁸ Cal. Civ. Code (1931), § 290.

California law, the number of directors cannot be reduced below five without the vote or consent of more than 80 per cent of the voting power.⁸⁹ Shareholders holding 20 per cent of the voting power may elect one out of five directors by cumulating their votes, but would lose this power if the number of directors is reduced below five. ✓

The Constitution only guarantees full voting rights in all elections of directors, but the statute does not authorize the limitation of voting rights even of preferred shareholders as to any other matters. The articles may not limit or deny the voting power of shares of any class (§ 14) and each outstanding share, regardless of class, is entitled to one vote on each matter submitted to vote at a meeting (§ 28). The privilege of greater voting rights, in event of non-payment of preferred dividends for certain periods, is thus forbidden to preferred shares.

Section 26 of the act commands that an annual meeting of the shareholders shall be held at such time and place as may be provided in the by-laws. Section 34 provides that at the first annual meeting of shareholders and at each annual meeting thereafter, shareholders shall elect directors to hold office until the next succeeding annual meeting, except as directors may be classified under Section 35 to hold until the second or third succeeding annual meeting. It is generally held that such a provision that there shall be an annual meeting for the election of directors confers a right on the individual shareholder, of which he should not be deprived by the officers or by collusion of a majority, to have an election held. It has been pointed out that the ultimate control of the management and policy of the corporation is in the shareholders, and this control cannot be exercised unless meetings of the shareholders are called as prescribed.⁹⁰ Holders of not less than one-fifth of the outstanding shares may demand the calling of a meeting for the election of directors.

Minority shareholders would be deprived of their right of cumulative voting and of their chance to elect a representative on the board if the majority were to defeat the holding of a meeting by voluntarily absenting themselves from a meeting duly called. In order to prevent evasion of meetings by lack of a quorum it is provided in the Delaware act^{90a} that at any election ordered to be held by the chancellor upon the application of any shareholder, the shares of stock represented at said meeting, either in person or by proxy, shall constitute a quorum for the purpose of such meeting, notwithstanding any provision of the by-laws of the corporation

⁸⁹ Cal. Civ. Code (1931), §§ 303, 362a. Cf. Ill. Bus. Corp. Act, § 34.

⁹⁰ *Bartlett v. Gates*, 118 Fed. 66 (1902); *Pennington v. Pennington Sons*, 170 Cal. 114, 148 Pac. 790 (1915); *Albert E. Touchet, Inc. v. Touchet*, 264 Mass. 499, 163 N.E. 184 (1928).

^{90a} Del. Gen. Corp. Law, § 31.

to the contrary. It was the rule of the common law that those who assemble at a shareholders' meeting, although a minority of the voting shares, constitute a quorum.⁹¹ It would seem that some provision should be made to prevent the majority from keeping directors representing the majority indefinitely in office without giving the minority a chance to exercise their right of cumulative voting.

The provision as to notice of shareholders' meetings (§ 27) fails to provide for giving any constructive notice if the address of the shareholder does not appear upon the records of the corporation. Failure to deliver notice either personally or by mail to each shareholder of record entitled to vote might invalidate the meeting and all transactions thereat.

The provision as to notice of directors' meetings (§ 40) leaves the method of notice to provision in the by-laws and does not provide for the giving of any notice in the absence of by-law provision. The California law has in general attempted to make the act sufficiently complete to permit a corporation to carry on its business in event that there should not be a code of by-laws or that it should be incomplete as to any detail, in such matters as the time of the annual meeting or the time and method of notice of meetings.⁹²

The Illinois act does not permit shareholders to act by majority written consent when shareholders' action is required, but action may be taken by the shareholders without a meeting only by unanimous consent. (§ 147.) It was evidently the view of the corporation committee that to permit such action by bare majority consent, or even by a two-thirds or three-fourths consent, would deprive minority dissenters of their fair opportunity to present their reasons against the proposed action in open meeting and to have the pros and cons fully discussed.

SALE OF ENTIRE ASSETS

Under Sections 71 and 72 the sale, lease, exchange or mortgage of all or substantially all the property and assets of a corporation may be made in the "usual and regular course of the business of the corporation" by the directors without any authorization or consent of the shareholders. But when not made "in the usual and regular course of its business," the terms and conditions and consideration of such sale must be authorized not only by resolution of the directors but also by vote of the holders of at least two-thirds of the outstanding shares.

It is difficult to see what is intended by the sale of the entire assets of a

⁹¹ *Morrill v. Little Falls Mfg. Co.*, 53 Minn. 371, 55 N.W. 547 (1903). See also *Lutz v. Webster*, 249 Pa. 226, 94 Atl. 834 (1915).

⁹² Cal. Civ. Code (1931), §§ 307a, 312.

corporation in the usual and regular course of its business. What classes of corporations regularly convert all of their assets into cash? This peculiar provision seems to be borrowed from the Indiana act.⁹³ The board of directors might reasonably be given authority to sell the entire property of a corporation without vote of the shareholders, (1) if the corporation is in a failing condition and the sale is required by the exigencies of the business and to meet its liabilities; or (2) if the sale is made to further rather than to terminate or dispose of the business for which the corporation is organized.⁹⁴ An investment trust, for example, formed for holding and trading in securities, might at certain times do well to convert all its securities into cash as part of the regular conduct of its business. A corporation formed to liquidate an estate would naturally be allowed to sell out its entire holdings without vote of the shareholders. A mortgage of the entire assets does not normally terminate the business. The California law does not require a vote of the shareholders to authorize the mortgage of the entire assets of a corporation, as, for example, in connection with a bond issue.⁹⁵ But a sale of a business used as a method of combination, reorganization or consolidation with another corporation may well require the shareholders' consent. The phrase "in the usual and regular course of its business" does not seem to be a happy one to indicate the distinctions intended.

REMEDIES OF DISSENTING SHAREHOLDERS

The remedies of dissenting shareholders in case of a sale of entire assets are covered in Section 73 and in case of consolidation or merger in Section 70. The reason for separate sections seems to be that in case of merger or consolidation the surviving or new corporation, which would be a domestic corporation in all cases, would be the proper corporation to pay the dissenting shareholder the amount due him. Under Section 73, however, the remedy is given against the selling corporation as the sale may be made to a foreign corporation and it would be a great hardship to require the dissenting shareholder to pursue his remedy against the acquiring corporation. Under the California law⁹⁶ compensation for dissenting shareholders is only given in the case of merger and consolidation and the remedy is to be sought against the constituent corporation rather than against the new or surviving corporation which, however, is liable for the debts of its constituents.⁹⁷

⁹³ Ind. Burn's Ann. Stats. (1929 supp.), §§ 4856.3, 4856.4.

⁹⁴ Thayer v. Valley Bank, 35 Ariz. 238, 276 Pac. 526 (1929); Unif. Bus. Corp. Act, § 37.

⁹⁵ Cal. Civ. Code (1931), §§ 343, 344.

⁹⁶ Cal. Civ. Code (1931), § 369.

⁹⁷ See Minn. Laws of 1933, c. 300, § 43.

In the case of merger or consolidation the Illinois act requires the dissenting shareholder to file with the corporation, prior to or at the meeting of shareholders at which the plan is voted on, a written objection to the plan of merger or consolidation. This is a very strict requirement as a condition precedent to further proceedings. (§ 70.) In case of a sale of entire assets "any shareholder who shall not have voted in favor thereof" may make written demand for the fair value of his shares within 20 days after the vote was taken (§ 73), which is a more reasonable provision.

Under both Sections 70 and 73 shareholders failing to pursue their remedy by way of petition for compensation are to be conclusively presumed to have approved and ratified the merger or consolidation or the sale or exchange, and are to be bound by the terms thereof. This would seem to make this remedy the exclusive remedy and there would be no right to litigate or contest such action on the ground of fraud or unfairness. More explicit provision to this effect is made in the California law.⁹⁸

These sections only extend to dissenting "shareholders" who by the definition of Section 2 (g) must be holders of record. A question may arise whether owners of shares, that is transferees who have not obtained record of the transfer on the books, would be affected either by the benefits or the limitations of these sections.

DISSOLUTION AND WINDING UP

In accordance with American tradition a limited term of existence may be stated in the articles. (§ 5 (a).) An option is given to make the period of duration of corporate life as stated in the articles perpetual. (§ 47 (c).) The writer is informed that there was blind, but vigorous, opposition in the legislature to permitting anything except a term of existence for a limited period of years.

Under California law prior to 1929 the term of corporate existence was limited to a maximum of fifty years, but under the statutes as revised since 1929 no option has been given to prescribe any fixed term of existence at the end of which the corporation will be automatically dissolved.⁹⁹ Such an arbitrary time of termination prescribed in advance may operate harshly upon innocent third persons dealing with the corporation, and also may easily be overlooked by the corporation, its creditors and shareholders, giving rise to much needless trouble, expense and confusion and the necessity of winding up and reincorporating. The shareholders should decide when the time has come for the corporate affairs to be wound up

⁹⁸ Cal. Civ. Code (1931), § 369.

⁹⁹ Cal. Civ. Code (1931), § 292.

and liquidated and should not be put on their guard to procure an extension of existence before it is too late.¹⁰⁰

By amendment of the articles the period of duration may be changed so as to bring about a speedy automatic dissolution without notice to creditors. (§ 52 (b).) Unfortunately there seems to be no provision for the winding up and liquidation of corporations upon dissolution by the expiration of the fixed period of duration. (§§ 79, 80, 81, 89, and 94.) It seems to be contemplated by the statute that the distribution of the assets will precede dissolution.

The Pennsylvania Business Corporation Law, which in general follows the Illinois act in these matters of dissolution and winding up among others, has made provision^{100a} (§ 1106) for the winding up of a corporation upon the expiration of its charter and for the continuance of its existence for the purpose of winding up its affairs by the board of directors.¹⁰¹

The Illinois act fails to provide for the continuation of corporate existence of dissolved corporations for winding up purposes, and it does not appear in the act what becomes of the title to corporate property upon dissolution. Modern laws should provide machinery by which the title to real estate and other assets will not become complicated or confused upon dissolution, but may be dealt with as corporate estate for shareholders and creditors.¹⁰² It would seem to be highly advisable to have a provision for the indefinite continuance of corporate existence in all cases of dissolution for winding up purposes rather than a provision for a mere survival of remedies after dissolution for a limited period, as under Section 94 of the Illinois act. The California law^{102a} continues the corporate existence indefinitely, no matter how a corporation may be dissolved, even by order of court, for purposes of winding up so far as needed. This provision was taken in substance from the New Jersey act.^{102b}

Under the Illinois act (§ 94) in cases of dissolution the rights and remedies of creditors and claimants against the corporation, its directors or shareholders, for any liability incurred prior to such dissolution, are preserved if suit thereon is brought and service had within two years after the date of dissolution. There seems to be no provision, however, for the

¹⁰⁰ § 52 (b); Ballantine, *Cal. Corp. Laws* (1932), 58, 473.

^{100a} Pa. Bus. Corp. Law, § 1106.

¹⁰¹ See also Cal. Civ. Code (1931), §§ 399, 400; Ballantine, *Questions of Policy*, 19 Cal. L. Rev. 465, 482 (1931).

¹⁰² 47 Am. L. Rep. 1288, 1425, 1545 n.

^{102a} Cal. Civ. Code, § 399.

^{102b} N.J. Gen. Corp. Act, § 53.

survival of rights and remedies upon claims in favor of the corporation. Suits may be prosecuted against and defended by the corporation in its corporate name so that the corporate existence is continued for this purpose.

It would seem that under this section creditors and claimants might be barred within two years after the date of dissolution even though dissolution took place by expiration of the term of existence without any notice to the creditors, and even though the claim was not yet due and the corporation was continuing in business in spite of its dissolution. This apparently opens up possibilities of great hardship upon creditors.

Under Section 74 provision is made for the dissolution of a corporation by its incorporators, but the statement must be made "that none of its shares have (has) been issued." Such a statement would seem to be impossible in any case, since under Section 16 the filing of the articles of incorporation constitutes acceptance by the corporation of all existing subscriptions to its shares and the subscribers become shareholders. Under Section 46 the incorporators must be subscribers to shares. Section 74 therefore was born dead and can never be utilized unless paragraph (3) can be interpreted with Section 16 to exclude necessary preincorporation subscriptions of the incorporators.

Section 76 provides for an election by the corporation to dissolve voluntarily and wind up its affairs, but there is no provision for the revocation of such election, as there is under Section 90 in case of involuntary liquidation proceedings commenced under Section 86 at the suit of a shareholder or creditor.

Section 79 provides in a very brief and general way for the winding up of the affairs of a corporation by the directors and officers who continue to function after filing of a statement of intent to dissolve, but if application is made by a corporation which has filed a statement of intent to dissolve to have liquidation continued under the supervision of the court, it seems that the winding up must be carried on by liquidating receivers. (§§ 86, 87.) No clear authority is given to the directors to invoke the aid and supervision of the court only to the extent needed or desired. Under the California law provision is made for the winding up by the board of directors even when carried out under supervision of the court in voluntary or involuntary proceedings, subject to the power of removal, without the necessity of the appointment of any receivers to carry on the liquidation, a method of administration which has usually proved expensive and even disastrous. The California corporation law avoids as far as possible any authorization for the appointment of receivers except as a last resort.¹⁰³

¹⁰³ Cal. Civ. Code (1931), §§ 401, 403, 403a, 403b; Cal. Civ. Proc. (1931), §§ 564, 565; Ballantine, Cal. Corp. Laws (1932), 460, 464, 484.

Section 91 provides for the making of a decree of involuntary dissolution when all debts, obligations and liabilities of the corporation have been paid and discharged and all property distributed to the shareholders, but it does not make provision for such decree in event that the payment of the debts, obligations and liabilities has been adequately provided for as in the case of voluntary dissolution. (§ 80 (c).) Suppose certain creditors cannot be found or certain claims are in litigation?¹⁰⁴

Section 93 provides for the deposit with the state treasurer of amounts due shareholders who are unknown or cannot be found or who are under disability, but no provision seems to be made for deposits on behalf of creditors who cannot be located or whose claims are in dispute.¹⁰⁵

The provisions of Section 86 as to involuntary dissolution at the suit of a shareholder extend not only to cases of deadlock in the management but also to cases where it is claimed "that the acts of the directors or those in control of the corporation are illegal, oppressive or fraudulent, or that the corporate assets are being misapplied or wasted." This confers a drastic remedy by way of involuntary dissolution in very vague and general terms which will make it easy for a single obstreperous shareholder or a small disgruntled minority to interfere with the management of the majority by creating a cash nuisance value.

The provisions of the California law on involuntary dissolution¹⁰⁶ as adopted in 1931, have been much limited after further discussion in the revision of 1933. The result of involuntary dissolution is a forfeiture of the corporate rights and a sacrifice or liquidation sale of all of its assets and business. This is so severe a remedy that the mere threat of institution of such proceedings may give minority shareholders an unfair advantage and may be used as a method of forcing majority interests to purchase their shares at an exorbitant figure.¹⁰⁷

Aside from involuntary dissolution there exist various equitable remedies such as the removal of dishonest directors from office, representative suits by the shareholders against the corporation and the directors for mismanagement or waste, the use of injunctions and other possible remedies. Relief by way of involuntary winding up or dissolution should be withheld unless there is no other method of relief or redress for the protection of the interests of the complaining shareholders which is adequate under the circumstances.

In event of deadlock in management the California law makes an interesting innovation, new in the corporation law of this country, as an

¹⁰⁴ Cf. Cal. Civ. Code (1931), § 403c.

¹⁰⁵ Cf. Cal. Civ. Code (1931), § 403d.

¹⁰⁶ Cal. Civ. Code (1931), § 404.

¹⁰⁷ Ballantine, Cal. Corp. Laws (1932), 1933 Supp., 256, 257.

alternative to receivership or to dissolution, namely the appointment by the court of a "provisional director" to sit with the board of directors and act as a member of the board until such time as the deadlock in the board is broken or until he be removed by order of the court or the vote of the shareholders. The court is given authority to appoint such provisional director in the case of a deadlock in the board even in an action for involuntary winding up or dissolution.¹⁰⁸

It seems very doubtful whether a creditor of the corporation should be empowered to enforce its involuntary dissolution on the ground that the corporation is unable to pay its debts and obligations in the regular course of business as they mature. (§ 86 (b).) A creditor is not interested in formal dissolution, but only in the application of the assets to the payment of his claim. It may or may not be for the best interests of the shareholders to have the corporation dissolved.

The Illinois act seems to make no provision for the liability of shareholders or owners of shares to the corporation and its creditors for amounts improperly distributed to them in the course of dissolution or winding up proceedings. This is a matter covered in the California corporation law¹⁰⁹ and provision is made under which those who satisfy any liability may obtain rateable contribution from other distributees and so adjust an erroneous distribution of assets.

SOME MISCELLANEOUS POINTS LACKING IN THE ILLINOIS ACT

Some matters, not referred to above, which are covered by provisions in the California General Corporation Law might well be considered in a further revision of the Illinois Business Corporation Act, as follows: (1) the removal of directors by the shareholders or by the court;¹¹⁰ (2) the effect of adverse interest of directors and of interlocking directors upon contracts and other transactions in which the directors participate or are counted to make up a quorum;¹¹¹ (3) appointment of inspectors of elections; (4) the validity of voting trusts;¹¹² (5) protection to the corporation as to its duty of recording transfers of shares upon its books in case of transfers by trustees, certificate holders with doubtful title, adverse claimants, foreign fiduciaries, minors, and incompetents;¹¹³ (6) the compulsory surrender and exchange of certificates for shares in event of amendment of the articles or cancellation of shares;¹¹⁴ (7) definition of holding and subsidiary corporations,¹¹⁵ and (8) proof of corporate proceedings, documents and seals.¹¹⁶

¹⁰⁸ Cal. Civ. Code (1931), § 404.

¹⁰⁹ *Ibid.* § 402.

¹¹⁰ *Ibid.* § 310.

¹¹¹ *Ibid.* § 311.

¹¹² *Ibid.* § 321A.

¹¹³ *Ibid.* §§ 328, 328a, 328b, 328d, 328e.

¹¹⁴ *Ibid.* § 326b.

¹¹⁵ *Ibid.* § 278.

¹¹⁶ *Ibid.* §§ 371, 372, 374.