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LEGAL SIGNIFICANCE OF "CAPITAL STOCK"

J. GORDON GOSE*

"The capital stock of banks," said the celebrated early American jurist, Judge Story, in a case decided in 1824, "is to be deemed a pledge or a trust fund for the payment of the debts contracted by the bank. The public, as well as the legislature, has always supposed this to be a fund appropriated for such purpose. The charter relieves [the shareholders] of personal responsibility and substitutes the capital stock in its stead. Credit is universally given to this fund by the public, as the only means of repayment. During the existence of the corporation it is the sole property of the corporation, and can be applied only according to its charter, that is as a fund for the payment of its debts . . ."¹

It is exceedingly doubtful that any portion of this classic statement was accurate in law or in fact when made, if taken literally. It is certain that this language does not accord with legal terminology or with corporate and business practices of the present time. The decision has, nevertheless, for more than 130 years had tremendous influence in confusing the meaning, in law and business, of the familiar expressions "capital" and "capital stock." Except for occasional statutory definitions these expressions have generally been defined either in terms of metaphor or in terms which themselves require definition.

Thus, the Washington corporation statute, as it stood for many years before the adoption of the present corporation act in 1933, contained numerous provisions in which the words "capital stock" appeared. Typical of these were requirements that the "amount of its capital stock" shall be stated in the corporation's articles of incorporation;² no corporation shall commence business "until the whole amount of

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¹ 3 Mason 308, Fed. Cas. No. 17, 944 (Cir. Ct., Dist Me. 1824).

² Rem. Rev. Stat. § 3805.

its capital stock has been subscribed";³ amendments may be made to the articles of incorporation by a "vote . . . of two-thirds of the capital stock";⁴ corporations have power to own "shares of the capital stock of any other corporation."⁵

In greater detail and under the more specific heading of "Capital Stock—How Reduced" the pre-1933 Washington statute stated:

It shall not be lawful for the trustees to make any dividend except from the net profits arising from the business of the corporation, nor divide, withdraw, or in any way pay to the stockholders, or any of them, any part of the capital stock of the company, nor to reduce the capital stock of the company unless in the manner prescribed in this chapter, or the articles of incorporation or by-laws; and in case of any violation of the provisions of this section, the trustees, under whose administration the same may have happened, except those who may have caused their dissent therefrom to be entered at large on the minutes of the board of trustees at the time, or were not present when the same did happen, shall, in their individual or private capacities, be jointly or severally liable to the corporation and the creditors thereof in the event of its dissolution, to the full amount so divided, or reduced, or paid out: Provided, that this section shall not be construed to prevent a division and distribution of the capital stock of the company which shall remain after the payment of all its debts upon the dissolution of the corporation or the expiration of its charter: Provided, further, that in the case of corporations whose stock is wholly or partly without any nominal or par value, the provisions of this section shall not apply to so much of the capital stock as is represented by such non-par-value stock, except in the amount of the designated "Initial Non-Par Capital." The rights of creditors shall not be limited by the provisions of this section.⁶

The former statute also dealt with "increase or decrease of capital stock" in these terms:

Any company incorporated under this chapter may, by complying with the provisions herein contained, increase or diminish its capital stock to any amount which may be deemed sufficient and proper for the purposes of the corporation; but before any corporation shall be entitled to diminish the amount of its capital stock, if the amount of its debts and liabilities shall exceed the sum to which the capital is proposed to be diminished, such amount shall be satisfied and reduced so as not to exceed the diminished amount of the capital . . .⁷

The foregoing statutory excerpts and the quotation of Judge Story's

³ Rem. Rev. Stat. § 3803.

⁴ Rem. Rev. Stat. § 3805.

⁵ Rem. Rev. Stat. § 3810.

⁶ Rem. Rev. Stat. § 3823.

⁷ Rem. Rev. Stat. § 3830.

remarks in *Wood v. Dummer* are representative of innumerable similar statements in statutes, court decisions and legal literature. Although these particular statutes have been superseded and the views advanced in *Wood v. Dummer* have been largely qualified or abandoned, the language of these statutes and that decision continue to color and cloud the meaning of "capital stock." On even casual examination, it will appear that the words "capital stock" have been used in different senses at different times and have often been used with no very clear meaning at all. On closer examination, it becomes evident that three possible meanings are involved in the usages most frequently employed. These regard "capital stock" as meaning (1) the "shares" held by the beneficial owners of the corporation; or (2) some or all of the property of the corporation; or (3) an "amount" stated in dollars and which initially bears some relation to the value of the consideration which the corporation has received or should under the law have received for its shares.

The purpose of this article is to clarify, if possible, these different meanings. In essence, it will be shown that the first meaning, that is, "capital stock" in the sense of "shares", while possibly technically inaccurate is practically unimportant; second, that the concept of "capital stock" as "property" or as a "trust fund" for creditors is, if given a literal meaning, most inaccurate, confusing and unnecessary; and third, that the concept of "capital stock" as an "amount", is the only usage which is useful and correct under the present Washington statute.

The ground to be covered has been plowed before but on the whole the wilderness has proved stronger than the plowman. Vague and conflicting usages have become so much a part of the language of both law and finance that it is doubtful that confusion will ever be entirely eradicated. This article is just another effort to clear away the weeds sown by the collective labors of courts, legislators and financiers.

"CAPITAL STOCK" IN THE SENSE OF "SHARES"

Quite obviously the words "capital stock" are surplusage when used in the common phrase "shares of capital stock." The ultimate owners of the corporate enterprise have *shares* in the entire venture. When it is said that a man owns ten shares of X corporation, the nature and extent of his holding have been just as completely described as if it had been said that the same man owned ten shares of the "capital stock" of the same corporation. Not only is the first statement shorter

than the second; it also more directly focuses attention on the essential fact, that is, that the man owns a part of the *whole* venture. If the addition of the words "capital stock" conveys any idea at all, it is likely to be the entirely inaccurate one that the shares are in some limited portion of the venture known as the "capital stock."

In recognition of these self-evident propositions, several of the more modern statutory revisions of corporation law consistently substitute the word "shareholder" for "stockholder" and studiously refrain from the use of the expression "shares of capital stock". The "Uniform Business Corporation Act", adopted in Washington in 1933, is typical of such acts in this regard.⁸ The definitions section of this statute carefully defines "shares"⁹ and "capital stock"¹⁰ in terms which make it entirely clear that the two are not to be used in juxtaposition in the sense of "shares of capital stock". Thus "shares" are defined as "the units into which are divided the shareholders' rights to participate in the control of the corporation, in its surplus or profits or in the distribution of corporate assets." A "shareholder" is defined as one "who owns one or more shares."¹¹ "Capital stock" is defined as an "amount" in the sense to be dealt with hereinafter and in no sense as defining the shares themselves.¹² Although this statute has been a part of the law of the state for nearly a quarter of a century, it is doubtful that the effort of the Uniform Law Commissioners in the direction of linguistic precision has made any real impression on the bench and bar. Certainly it made no impression on the sponsors and the legislators concerned with the 1947 amendment authorizing a corporation to purchase its own shares. That amendment simply copied the "shares of capital stock" language of the Delaware statute from which it was derived.¹³

The phrase "shares of capital stock" has probably become a permanent part of our financial and legal vernacular. While a case can

⁸ RCW, Title 23.

⁹ RCW 23.04.060.

¹⁰ RCW 23.04.100.

¹¹ RCW 23.04.070.

¹² The text of the statutory definition (RCW 23.04.100) is: "*Capital stock.*"

"The 'capital stock' of a corporation at any time is:

"(1) The aggregate amount of the par value of all allotted shares having a par value, including such shares allotted as stock dividends; and

"(2) The aggregate of the cash, and the value of any consideration other than cash, determined as provided in this title, agreed to be given or rendered as payment for all allotted shares having no par value, plus such amounts as may have been transferred from surplus upon the allotment of stock dividends in shares having no par value. [1933 c 185 § 1, part; RRS § 3803-1, part.]"

¹³ RCW 23.08.080. Cf. DELAWARE GENERAL CORPORATION LAW § 160.

certainly be made for dropping the words "capital stock" from the expression, no harm results if it is recognized that the extra words are of no real import in law.

CAPITAL STOCK IN THE SENSE OF "PROPERTY" OR A "TRUST FUND"

It is perhaps impossible at the present time to say exactly what Judge Story's entire concept of capital stock was at the time of the decision of *Wood v. Dummer*. His language certainly indicates that he thought that the "capital stock" constituted some identifiable part of the corporation's property and that this part was held by the corporation in trust for its creditors. Actually such a view has never accorded with the facts of corporate practice. The contributions of shareholders to the corporation in exchange for their shares are not held by the corporation in any separately identifiable fund. If such contributions are made in cash, the money is expended in payment for services, materials, equipment or other purposes necessary in the conduct of the business. Thus in place of such money the corporation acquires other assets which in turn are likely to be sold or changed in form. The result is that in the course of conducting its business operations the typical corporation acquires a variety of assets such as bank deposits, accounts receivable, tangible personal property and real estate. It may *happen* that some particular item of property such as land or a building or some specific item of personal property is held by the corporation in unchanged form for a long period of time. Such an item may be loosely referred to as a capital asset. Nevertheless, the fact that such an asset is held in its original condition is not due to any rule of law, nor is it, by reason or any rule of law, a part of the "capital stock." So far as the law is concerned, the corporation could at any time sell such an asset and reinvest the proceeds in such a way as to make them an unidentifiable part of the general assets of the corporation. The fact that some part of the assets originally contributed by shareholders may continue to be held in original form is a matter of coincidence and not of law. No portion of such assets is legally identifiable as the "capital stock."

It is equally manifest that no amount of property *equal in value* to the so-called "capital stock" is held in trust for creditors in any sense known to the law of trusts. The creditors of the corporation like the creditors of a living person have *all of the debtor's assets* available to satisfy their claims. The total assets are not held in trust by the corporation. The corporation has the right, so far as its creditors

are concerned, to sell or give any assets to third persons or distribute them to shareholders without violating any obligations known to the law of trusts.

Legal limitations on such dispositions of its property by the corporation are based not on rules of the law of trusts but on the law of fraudulent conveyances or upon the law of corporations.

Actually neither *Wood v. Dummer* nor innumerable decisions that have quoted all or some of its picturesque language have been concerned with specific property. On the contrary they have been concerned with the collection of amounts owing from shareholders to the corporation. The common characteristic of these cases is that instead of there being any "assets" or "fund" held by the corporation, the shareholder is sued because there is a shortage of assets. The courts have conventionally spoken as though a fund, in the sense of assets, existed when in fact the whole purpose of the proceeding was to obtain such assets.

The situation in *Wood v. Dummer* was remarkably simple. The corporation—a bank—was in the process of dissolution. The shareholders distributed some of the assets among themselves without first paying off the creditors. The action was brought to require them to repay enough to take care of the claims of the creditors. All that was necessary to support the action was a simple rule that on dissolution the assets of a corporation must first be devoted to the payment of the claims of the corporation's creditors and that only the amount remaining is available for distribution to shareholders. The common sense and justice of this rule are apparent and it requires no "capital stock" or "trust fund" theory to support it. Even if the corporation had an authorized capital stock of only \$1.00 but had acquired assets of \$100,000.00 and incurred debts of \$95,000.00, it could not on dissolution pay more than \$5,000.00 to its shareholders. The subordinated position of the shareholders in such a case would not be referable to the nominal "capital stock" of \$1.00, nor to any "trust fund" of that amount nor to any notion that "credit is universally given" to the "capital stock." Rather it would be referable to a perfectly sensible rule that the assets of a dissolving corporation are primarily to be devoted to the payment of its debts.

Judge Story's "trust fund" theory would have more nearly approached accuracy if he had stated that the "capital stock" consisted of all of the assets rather than a figure stated in the corporation's

charter. Actually he made it clear that by "capital stock" he meant only the latter. However, even if "capital stock" is taken to mean all of the assets which the corporation owns, it is clear that such assets are not held in "trust" for creditors except in the most general sense of that word. Actually the total assets are at the hazard of the entire business just as the assets of a living debtor are at the hazard of his business management. The so-called "trust" is intelligible only as a shorthand expression for a body of rules which require, under certain circumstances, that a shareholder make a specified minimum payment to the corporation and which forbid, under certain circumstances, the distribution of corporate assets to the shareholders. These rules are, on the whole, quite arbitrary and quite independent of trust principles. Today we properly identify them simply as rules of the law of corporations.

The first of these rules concerns the nature and extent of the obligation of a shareholder who obtains his shares from the corporation on original issue to pay for such shares. Stated otherwise it concerns the obligation to put assets into the corporation.¹⁴ Such an obligation, if it exists, rests either on contract in the form of a stock subscription or, alternatively, upon an arbitrary legal obligation to pay a minimum amount for the shares. Comparatively speaking the courts had little difficulty with the problem of enforcing stock subscriptions. These have been treated as contracts. Such problems as have arisen have been largely concerned with contract principles, such as offer and acceptance and consideration. Some peculiar rules dependent in part on the development of corporate law do exist, such as acceptance of pre-incorporation subscriptions by the promoters of a corporation as yet nonexistent¹⁵ and limitation of the subscribers' obligation, after insolvency of the corporation, to the pro-rata share necessary to meet the corporation's debts.¹⁶ Basically, however, valid stock subscriptions have constituted assets of the corporation like any other contractual obligation owing to it. One who subscribes for shares at a price of \$50 or \$100 or \$150 a share can be required to pay that amount without regard to the par value, if any, of the share. If, however, the promise is to pay less than the par value of a share, the stock is said to be "watered" to the extent of the difference between the amount promised

¹⁴ The second problem which concerns the limitations on the rights of shareholders to take assets out of the corporation will be considered in the latter part of this article.

¹⁵ BALLANTINE, CORPORATIONS, §§ 190, 190a (rev. ed. 1946).

¹⁶ FLETCHER, CYCLOPEDIA CORPORATIONS, § 1825 (1931).

and par value.^{16a} The question is then presented whether the shareholder is required to pay the deficiency to the corporation or its creditors.

At the present time this does not seem to be a difficult question, but for approximately a century following the decision of *Wood v. Dummer* it plagued and puzzled courts, legislatures and lawyers.¹⁷ Today there seem to be simple and reasonable arguments on both sides of the question with the choice of answer largely resting on policy considerations. Thus, on the one hand, it seems reasonable that as a condition to attaining the benefits of limited liability a shareholder should be required by law to pay some minimum amount for his shares, such minimum to be designated as par value.¹⁸ In opposition it can be plausibly maintained that no useful purpose is served by requiring any minimum amount per share and that the important thing is to focus attention of investors and shareholders alike on corporate assets rather than artificial standards like par value. This argument is developed by the assertion that "watered stock" liability is confused and complex and can well be supplanted by a simpler rule which requires an original shareholder to pay no more for his shares than the amount agreed upon by him and the corporation. These were in substance the arguments which led to the relatively modern introduction of non-par shares into the law of corporations.¹⁹ Although these opposing argu-

^{16a} For purposes of brevity the expression "watered shares" or "watered stock" has been used to designate any par value shares which have been originally issued for less than par value. In this context it includes "bonus shares" which are issued for no separate consideration along with some other purchased security, such as a preferred share or a bond; "discount shares" which are issued for an agreed money consideration less than par; and shares issued for property worth less than par value.

¹⁷ Perhaps the best known criticism of *Wood v. Dummer* is found in *Hospes v. Northwestern Mfg. & Car Co.*, 48 Minn. 174, 50 N.W. 1117, 15 L.R.A. 470 (1892). Judge Mitchell, the author of the opinion in that case, clearly demonstrated that there was no true "trust fund" arising out of shareholders' obligations to put assets into the corporation. For the "trust fund theory," he substituted a "fraud" or "holding out" theory under which only those creditors who relied, actually or presumptively, could assert claims against shareholders. While Judge Mitchell's criticism of *Wood v. Dummer* is largely valid, his own theory proceeds on the equally questionable premise that "The capital of a corporation is the basis of its credit." Further the confusion occasioned by distinguishing between creditors who have actually or presumptively relied seriously complicates the procedural aspects of shareholders' liability.

¹⁸ Early corporate charters and statutes do not usually contain the words "par value." The charters usually state a total amount, such as \$100,000.00 divided into shares of \$100.00 each. The current practice of calling the latter "par value" seems to have appeared in statutes and charters at a relatively late date.

¹⁹ Ballantine, *Non-Par Stock—Its Use and Abuse*, 57 AM. L. REV. (1923); Bonbright, *The Dangers of Shares Without Par Value*, 24 COLUM. L. REV. 449 (1924); Berle, *Problems of Non-Par Stock*, 25 COLUM. L. REV. 43 (1925); Morawetz, *Shares Without Nominal or Par Value*, 26 HARV. L. REV. 729 (1913); Wickersham, *The Progress of the Law on No Par Value Stock*, 37 HARV. L. REV. 464 (1924); Rice & Harno, *Shares With No Par Value*, 5 MINN. L. REV. 493 (1921); Israels, *Problems of*

ments seem quite obvious, neither courts nor legislatures evolved the law of watered stock in any such direct terms. Instead of determining a basic rule of policy in light of desirable practical objectives, the rules of "watered stock" liability were imperfectly tortured out of vague and misconceived notions of "capital stock" and "trust funds" and "holding out" and "fraud." The bald assertions of *Wood v. Dummer* that the "capital stock" is a "trust fund" to which "credit is universally given" by the creditors "as the only means of repayment" became the basis for holding shareholders obligated to pay at least the par value of their shares.

Had the problem been a simple one, the language of *Wood v. Dummer* would not perhaps have caused too much difficulty. Actually, however, any discussion of shareholders' obligations to make contributions to the corporation soon gets into a number of technical complications. These complications present difficulties even if the problem is clearly understood. When approached from the vague and unsound premises of *Wood v. Dummer*, the law of watered stock inevitably became largely unintelligible. Worse yet, the "trust fund" theory of *Wood v. Dummer* started a vicious circle. Just as that doctrine confused the law of "watered stock", conversely the "watered stock" cases by repeated quotation of Judge Story's remarks concerning "capital stock" confuse that expression to a point almost beyond repair.

It is not the purpose of the present article to explore the morass of the watered stock cases.²⁰ Suffice it to say that the "trust fund theory" of Mr. Justice Story has been followed, rejected, modified, qualified and criticized. The rule has been affected by statutes, themselves frequently vague or metaphorical. The primary "trust fund" doctrine has become entangled in procedural rules. It encountered complications arising from the valuation of property taken in payment for shares. It became lost in distinctions between creditors who gave credit knowing of the stock watering and creditors who had no such knowledge. It foundered on the shoal of *Handley v. Stutz*, in which the

Par and No-Par Shares: A Reappraisal, 47 COLUM. L. REV. 1279 (1947). A comparison of the last of these articles with the earlier ones will clearly show the changes which have developed in both theory and practice of corporate finance over the last half century. Some of the comments and predictions of the earlier writers seem naive at the present time.

²⁰ In addition to *Wood v. Dummer*, note 1, *supra*, and the *Hospes* case, note 17, *supra*, the following are typical: *Adamant Mfg. Co. v. Wallace*, 16 Wash. 614, 48 Pac. 415 (1897), the leading Washington case; *Lantz v. Moeller*, 76 Wash. 429, 136 Pac. 687 (1913); *Johns v. Clothier*, 78 Wash. 602, 139 Pac. 755 (1914); *Gordon v. Cummings*, 78 Wash. 515, 139 Pac. 489 (1914); *DuPont v. Ball*, 11 Del. Ch. 430, 106 Atl. 39, 7 A.L.R. 955 (1918); *Eastern National Bank v. American B. & T. Co.*, 70 N.J. Eq. 732, 64 Atl. 917 (1906); *Brockett v. Winkle Terra Cotta Co.*, 81 F.2d 949 (8th Cir., 1936).

Supreme Court permitted stock watering because the corporation could not, after a period of losses, sell its remaining unissued par value shares at par.²¹ We are not, however, concerned directly with this agonizing struggle but rather with demonstrating that "capital stock" is not, as the watered stock cases suggest, "property" or a "trust fund" or the basis of the corporation's credit.

It has already been pointed out that the assets of a corporation are not unchanging. It is also apparent that a creditor who extends credit on the basis of any intelligent investigation does not, except at the beginning of the corporation's life, rely on the original assets. No intelligent creditor would ever proceed upon the theory that the amount stated in the articles of incorporation as the total par value of all authorized shares, even if fully paid in when the corporation was formed, would thereafter indefinitely remain as assets of the corporation. It seems impossible that judges ever could have entertained the view that creditors actually relied upon a figure written into a corporate charter as indicative of the worth of the corporation. Nevertheless we find jurists of unquestioned competence accepting Judge Story's declaration of that proposition.

Thus Judge Dunbar, speaking in the leading Washington case of *Adamant Manufacturing Company v. Wallace*,²² said:

If it [the corporation] were allowed to hold itself out as having a capital stock of \$100,000.00, when in reality the capital stock, which is and must be, under the theory of law, assets in the hands of the corporation, is worth only one half of that amount, the corporation is to that extent doing business under false colors, and is obtaining credit upon the faith of an estate which is purely fictitious.

Similarly the categorical premise of a trust fund received appar-

²¹ 139 U.S. 417 (1890). In most of the early cases it was either required or assumed that the corporation would obtain subscriptions for all of its authorized shares before commencing business. Modern statutes usually do not contain such a requirement and authorized shares are in practice frequently reserved for issue at a later time or times. In the *Handley* case the original authorized shares were fully subscribed at par. Pursuant to authority contained in the charter, the number of authorized shares was increased. The additional shares were issued for less than par. The court felt that this was justified since buyers would not pay par because of the corporation's existing financial troubles. The modern corporate lawyer would simply amend the articles of incorporation to reduce par value or create non-par stock or create a new class of shares salable at par and thus avoid the stock watering problem. Apparently no such device was available at the time of the *Handley* case. It is apparent that the rule of that case undermines the reasoning behind both the "trust fund" and "fraud" theories, that is, that the "capital stock" is the basis of the corporation's credit since under the *Handley* rule there could be a substantial lawful watering of the "capital stock" upon which the creditors are said to rely.

²² Note 20, *supra*.

ently literal acceptance. Thus, in *Sanger v. Upton*,²³ the Supreme Court of the United States said:

The capital stock of an incorporated company is a fund set apart for the payment of its debts.

While the authors of these opinions did not point to any assets identifiable as "capital stock", their language suggests the possibility of doing so. Actually of course, the "capital stock" as used in a corporate charter can refer only to the *amount* of assets contributed or required by law to be contributed by the shareholders on original issue of their shares by the corporation. Such contributions are to the corporation what seed is to a farmer. Just as the latter's creditors will not realistically extend credit solely on the amount or quality of the farmer's seed, corporate creditors will not long give credit on the basis of shareholder contributions. Just as the seed will not remain in its original form but will sprout and bear increase or wither and vanish, so will the original contributions of shareholders change and increase or decline or disappear.

On any critical analysis it must be true that the real basis of a shareholder's obligation to pay a minimum amount for his shares must rest not on the reliance of the creditor on the perpetual existence of that amount in the coffers of the corporation, but on a more arbitrary requirement that the law imposes; that is, that to achieve limited liability he must put into the corporation the amount of "seed" which is equal in value to the par value of shares he has taken or promised to take. In other words, the cases holding a shareholder liable on "watered stock" rest on the premise that creditors, unless personally estopped from complaining, can call on the shareholders to put into a venture a minimum amount that the law requires if such payment is necessary to discharge the creditor's claim.

Wood v. Dummer and the many decisions which follow it in whole or in part have much greater faith in the original capitalization of the corporation than the facts warrant. Today, creditors probably rely primarily on two other factors, the assets and the debts of the corporation. From these factors plus the amount of the original agreed "capital stock", the conventional corporation balance sheet is constructed. This is critically examined by the careful creditor or the credit rating agency which he consults. The item "capital stock" appearing thereon does not indicate specific property. It indicates

²³ 91 U.S. 56 (1875).

rather an amount of money or property which is at least as great as the par value of issued par value shares and at least as great as some part of the value of consideration received by the corporation on the issue of non-par shares. This amount acts in a sense as a "brake" upon the distribution of corporation assets to shareholders. Its effectiveness in that regard will be examined in the next section of this article.

This "capital stock" amount connotes corporate assets only in that it indicates (1) that the corporation supposedly did receive from its shareholders for their shares at least that sum and (2) that if it did not receive such amount, it may be possible, depending on the refinements of the law of the corporation's domicile, to require the defaulting shareholders to pay the deficiency to the corporation or to its creditors. In the latter sense, the "capital stock" may be regarded as an asset, contingent upon a subsequent determination that the shareholders have not fully paid the par value of the shares held by them.

It is unfair to condemn without qualification the reasoning of the judges who developed the trust fund theory. Commencing with *Wood v. Dummer*, they were faced with the task of developing corporation law out of almost nothing. The whole area of commercial law is relatively modern and corporation law is particularly so. In *Wood v. Dummer*, Judge Story appears to have been working almost entirely from the terms of a corporate charter granted by the Massachusetts legislature. There was no general corporation statute in existence in Massachusetts at that time.²⁴ Likewise, there was very little common law of corporations. Charters granted by legislatures were frequently quite brief. The general practice was to specify a total amount of capital stock in dollars divided into shares of a specified dollar amount each. Such charters generally said nothing concerning the legal significance of these values. Consequently the rights and obligations of the corporation and its shareholders and the rights of creditors had to be worked out in conditions approaching a vacuum. Even when legislation of a general character developed, it generally was not complete and detailed.²⁵ Also, legislation was by no means uniform, thus adding to the confusion. It is, therefore, not surprising that judges attempted to reason from familiar principles of the common law and of equity. In applying such principles they appear to have been handicapped by lack of understanding of business and accounting practices,

²⁴ See BALLANTINE, CORPORATIONS § 9 (rev. ed. 1946).

²⁵ This statement is particularly true with respect to share structures and related problems such as "capital stock liability," "surplus," asset valuation and similar matters entering into the legal-accounting area.

the latter being largely undeveloped before the twentieth century. It is also probably true that judges have not been drawn generally from the commercial world or from the ranks of corporation lawyers. Faced with the phenomenon of a rapidly developing field of law, judges and lawyers sensed a necessity for some rules which would define shareholder responsibility and would protect corporate creditors. The confusion which developed from the efforts to work out these rules was perhaps unavoidable in light of the revolutionary changes in business which occurred during the nineteenth century.

CAPITAL STOCK IN THE SENSE OF AN AMOUNT

"Capital stock" as an "amount" generally suggests a figure appearing over withdrawal of corporate assets by shareholders. The fundamental idea was that only the excess of assets over the sum of the original much to focus attention on "capital stock liability" and to aid in understanding its significance. In a vague way, however, the law, both decisional and legislative, recognized and sought to give legal significance to this meaning at an early date. It simply remained for later judges and legislators to state these principles more completely and accurately, a process which is still incomplete.²⁶

The legal result sought from this "capital stock" concept was control over withdrawal of corporate assets by shareholders. The fundamental idea was that only the excess of assets over the sum of the original investment and claims of creditors should be distributable as dividends. This concept can be simply illustrated. Suppose a poker player buys \$20.00 in chips. Later he borrows \$10.00 in chips from another player. Assume a rule that he could never put any chips in his pocket unless, after doing so, he still had \$30.00 on the table. Translated into corporation law, the same principle permits shareholders to receive a dividend (or other form of distribution essentially equivalent to dividends) only to the extent that the assets exceed the amount of the original investment required to be made in shares plus the amount of the corporation's debts.²⁷ This rule is conventionally abbreviated in

²⁶ Some of the more modern corporation statutes recognize the existence of a variety of meanings for "capital stock" and accordingly use some different expression to denote the "amount" which appears on the balance sheet. Thus the Model Business Corporation Act prepared by the American Bar Association's Section of Corporation, Banking and Business Law employs the words "stated capital" in place of "capital stock." The California Corporations Code likewise uses "stated capital." The substitution seems desirable, but it may prove difficult to induce lawyers and judges to pay attention to statutory definitions. There is always a tendency to continue the use of familiar terminology.

²⁷ For purposes of brevity, the word "debts" as used in this article comprehends all liabilities of the corporation to third persons.

modern law to the statement that a corporation can lawfully pay dividends only "out of surplus."²⁸

It thus becomes apparent that there are three factors to be considered in determining the legality of a dividend—assets, debts and "capital stock." Although the rule as stated is simple if applied to facts as elementary as the poker example, the actual complications of corporation finance sometimes make it difficult in application. The valuation, in precise amount, of assets other than cash presents obvious difficulties. The amount of debts may to a considerable extent be quite certain but there are frequently unliquidated or contingent claims which will vary the result. It is not, however, the purpose of this article to explore the complexities of calculating a dollar value for assets and liabilities. Rather its purpose is to examine the "capital stock" factor in the equation. Three questions are presented: (1) how is the amount of "capital stock" originally calculated; (2) how can it be changed; and (3) what are its practical consequences?

In the simplest type of case, the calculation of "capital stock" is as simple as the poker game example. If, in the early period of corporation law, the corporation was organized with a "capital stock" of \$100,000.00 divided into shares of \$100.00 each, and all was subscribed and paid in,²⁹ the "capital stock" would be \$100,000.00. The same would have been true if subscribed and not paid in. On principle it might seem that the same should have been true if the entire 1,000 shares had been taken for \$40.00 a share with an understanding between the corporation that no more should be payable. The stock then would be "watered" to the extent of \$60,000.00 but its "amount" would still be \$100,000.00. However, a New Jersey case,³⁰ held in effect that the "capital stock" for purposes of determining legality of a dividend was limited to the amount actually paid in or subscribed. A somewhat similar problem would exist if the corporation took

²⁸ Since surplus is simply an amount and not any separately identifiable part of the corporation's assets, dividends are paid with the corporation's money resources. The payment reduces assets and by so doing automatically reduces the amount of surplus. The correct statement would be that dividends can lawfully be paid up to the amount of an existing surplus. However, the figurative statement that dividends can be paid only "out of surplus" is now deeply embedded in legal and financial language.

²⁹ Early corporation laws frequently required that all of the shares be subscribed for before the corporation could commence business. The pattern at the present time requires subscriptions in nominal amount only. For example, the Washington statute only requires that each incorporator subscribe for one share (RCW 23.12.020) and that, as a condition to commencing business, the corporation have paid in capital in such amount as may be fixed by its articles, which amount may be as low as \$500.00 (RCW 23.08.030).

³⁰ *Goodnow v. American Writing Paper Co.*, 73 N.J.Eq. 692, 69 Atl. 1014 (1908), affirming 72 N.J.Eq. 645, 66 Atl. 607 (1907).

\$40,000.00 in property for \$100,000.00 in par value stock. In that case the question would be complicated by a further one, that is, whether the valuation placed by the corporation on such property is conclusive.³¹

Modern statutes³² have quite generally simplified computation of "capital stock liability" on par value shares. The Washington statute is typical. It says: "The 'capital stock' of a corporation at any time is:

(1) The aggregate amount of the par value of all allotted shares having a par value, including such shares allotted as stock dividends; and

(2) The aggregate of the cash, and the value of any consideration other than cash, determined as provided in this title, agreed to be given or rendered as payment for all allotted shares having no par value, plus such amounts as may have been transferred from surplus upon the allotment of stock dividends in shares having no par values.³³

Parenthetically, it should be noted that this statutory definition does not include any suggestion of "capital stock" as consisting of "shares" or of being in any sense "assets" or a "trust fund." The Washington statute uses "capital stock" only with the meaning specifically given by this definition section, that is, as a dollar amount, except as one amendment to the statute uses it in the sense of "shares."³⁴

Reverting to the calculation under the statute, it will be seen that if shares have a par value of \$10.00 each, the number of "allotted shares" (that is, shares issued or subscribed for) times \$10.00 will arbitrarily give the "capital stock" even though the shareholder may have paid or agreed to pay exactly that amount or less or more per share. If in such a case, he agreed to pay only \$8.00 a share the stock would be watered to the amount of \$2.00 a share but capital stock would be calculated at \$10.00 a share. If he had paid \$12.00 a share, the only effect would be to create a paid in surplus calculated at \$2

³¹ Overvaluation of property received considerable attention in the watered stock cases, where the liability of the shareholder to the corporation was in issue. It has received little attention in connection with its effect on capital stock as an amount. But see the *Goodnow* case, note 30, *supra*. Overvaluation is irrelevant under many modern statutes such as those hereinafter discussed.

³² No attempt will be made to cite or analyze any number of such statutes. The discussion will center upon the Washington statute with comparative references to the Model Business Corporation Act, prepared by the Section of Corporation, Banking and Business Law of the American Bar Association and to the California Corporations Code.

³³ RCW 23.04.100.

³⁴ RCW 23.08.080. This is the 1947 amendment authorizing corporations to purchase their own shares under certain conditions. The pertinent portions of this statute are quoted and discussed at a later point herein.

for each such share. The statutory formula is tied entirely to par value and number of shares allotted.

The situation grows more complex when non-par shares are used. The statute starts with the plan of having "capital stock" equal the money value received on issuance of the non-par shares. It then recognizes that it may be or should be possible to have a paid in surplus on non-par shares. Since there is no ready-made formula, such as par value, for determining how allocation between "capital stock" and paid in surplus is to be made, that matter was specifically dealt with in another section of the statute, RCW 23.24.010, as follows:

If, upon the allotment of shares having no par value, any part of the consideration received by the corporation is to be treated as paid-in surplus rather than as payment upon such shares, the incorporators, shareholders or directors, as the case may be, who fix the amount of cash or determine the value of other considerations so received, shall at that time specify the proportion of such value that is to be considered as surplus and the proportion thereof that is to be considered payment for the shares.

Amounts of surplus paid in by shareholders shall be shown on the books of the corporation as a separate item designated 'paid-in surplus.

Another section, which must be read in connection with the foregoing, is RCW 23.16.030, which, insofar as here material, provides in substance that the issue price and the kind of consideration to be taken for non-par shares shall be fixed by the incorporators as to pre-incorporation subscriptions and by the shareholders or, if the articles of incorporation so provide, by the directors as to post-incorporation subscriptions.

It is of interest to note that non-par shares developed largely from a desire to avoid the "trust fund theory" which rested on a dollar value assigned to shares. The proponents of non-par shares originally seem to have assumed that no dollar value would be attached to the shares. Inevitably it became apparent that while watered stock problems could be avoided because no minimum amount need be paid for non-par shares, a "capital stock" valuation was necessary if the prevailing practice of limiting dividend distributions to the amount of surplus was to continue. Surplus, which is the difference between assets and the sum of debts and capital stock, can not be computed without assigning a "capital stock" value to the no-par shares. The simplest solution would have required that the entire value of the consideration

received for no-par shares should be the amount of the "capital stock." Such a simple rule would, however, have prevented the creation of paid-in surplus on the issue of non-par shares while permitting such surplus on the issue of par shares. Assuming 1,000 authorized shares of the par value of \$10 each and 1,000 shares of no-par stock, it would be possible for the corporation to sell 600 shares of each at the time of incorporation for \$10.00 each and the remaining 400 shares of each at a later time for \$15.00 a share. The "capital stock" would, in the absence of any permissible allocation as to the non-par shares between capital stock and surplus, be \$12,000.00 for the non-par as against \$10,000.00 for the par value shares. The difference of \$2,000.00 would appear as paid-in surplus on the issue of the par value shares. In order to permit a similar division between capital stock and paid-in surplus on non-par shares, the statute creates a power in the corporation's representatives to allocate the amount received as they see fit. Since, however, no minimum part of the consideration must go to "capital stock" as to non-par shares, the allocation possibilities are wider than in the case of par shares. In the assumed case it would have been possible to have allocated the price (\$6,000.00) of the original 600 non-par shares in the amounts of \$800.00 or \$2.00 a share to "capital stock" and \$5,200.00 or \$8.00 a share to paid-in surplus. Similarly an equally arbitrary allocation could be made of the \$15.00 a share received for the block of 400 shares later issued, as, for example, \$1.00 per share to "capital stock" and \$14.00 per share to paid-in capital. It has been urged that such a possibility is dangerous, especially as to non-par preferred shares. Such shares could be issued at \$100.00 per share, redeemable at and holding a liquidation preference of the same amount, and substantially all of such consideration could be allocated to paid-in surplus. If, as in Washington, dividends could lawfully be paid to the extent of paid-in surplus, it would be possible to use the greater part of the amount paid by the preferred shareholders for the payment of dividends upon common shares, thus draining off funds apparently obtained to enable the corporation to develop and carry on business. Although literal reading of the statutes might indicate possibilities of the character just mentioned, no such case has as yet been presented to the courts.³⁵ In all probability any allocation so

³⁵ Essentially the same scheme could be employed by using a very low par value for preferred shares. For example a \$1.00 par value preferred could be sold for \$100.00 a share and given a redemption price and liquidation preference of the latter amount. The only difference between this and the non-par share example is that the attention

manifestly designed to defraud or endanger the rights of the preferred shareholders and so dangerous to the welfare of the corporation would be effectively defeated by the courts. Special rules such as the fiduciary duties of controlling shareholders to the minority can be invoked to meet extreme cases.³⁶ In actual practice, allocations between capital stock and paid-in surplus have apparently been made in good faith and on some logical basis.

“Capital stock” as an “amount” becomes more complicated upon the declaration of a share dividend. Statutes vary somewhat, but in the main provide that as to par value shares, “capital stock” must be increased in the amount of the par value of the shares issued as a dividend. On a dividend payable in non-par shares, it also seems necessary to transfer something from surplus to distinguish the dividend from a stock split.^{36a} There must be a surplus against which the increased amount of capital stock is charged. This may be an earned surplus, a paid-in surplus or, in some states such as Washington, a revaluation surplus obtained by writing up the value of the assets of the corporation.³⁷ Laying aside for the moment, the possibility of using a revaluation surplus, it is apparent that the transfer of a part of paid-in or earned surplus to “capital stock” reduces the corporation’s ability to pay a cash dividend. When it is further considered that a dividend paid in common shares to common shareholders really does nothing for the shareholder except to divide his shares into smaller units, it follows, in principle, that the shareholder is worse off after a stock dividend than he was before. He owns the same percentage of shares as he did before and the corporation has reduced

of the purchaser is more likely to be directed to the large resulting paid-in surplus than in the case of non-par shares.

³⁶ See RCW 23.32.060.

^{36a} The only essential difference between a stock dividend and a stock split is that the former involves a transfer from surplus to capital stock while the latter leaves both these items unaffected. On a stock dividend the added shares are “paid for” by charging surplus. On a stock split of par shares, the existing shares are divided into a greater number of units and the par value is proportionally reduced. A stock split of non-par shares simply creates more units which in the aggregate are represented by the “capital stock” which arose on the original issuance of the non-par shares.

³⁷ The Washington dividend statute (RCW 23.24.030) does not distinguish between different types of surpluses except to forbid “cash or property” dividends on the basis of a revaluation surplus. By necessary inference “cash or property” dividends may be paid to the extent that any other type of surplus, such as paid-in, reduction or earned surplus, exists. Some statutes place restrictions on paid-in and reduction surplus, *e.g.* CALIFORNIA CORPORATIONS CODE § 1500. Inconsistently the same section of that statute, like the *Delaware General Corporation Law* § 170, permits “nimble dividends,” *i.e.* dividends payable from current earnings even though the corporation has a deficit rather than a surplus.

the amount available for payment of a cash dividend.³⁸ However, this theoretical consequence is seldom recognized in practice. Division of the shares into smaller units frequently results in a higher unit price, if the stock dividend is large enough to resemble a typical stock split as for example a dividend of one share for each one outstanding. If the dividend is a relatively small one, say one share for each twenty shares outstanding, and the corporation subsequently pays the same annual dividend on new and old shares, dilution of the outstanding shares and freezing of a part of surplus is likely to be ignored as a price factor with the result that each new and old share may have the same if not a higher market price than formerly.

The revaluation surplus possibility contrasts with the usual rules concerning cash dividends. While statutes are far from uniform, they tend, like the Washington statute, to conform to accounting practice by requiring conservative valuation of assets in calculation of a surplus for cash by requiring dividend purposes. Carrying of inventory and similar items at the lower of cost or market, elimination of unrealized appreciation in values, depreciation write-offs, write-downs for bad debts and contingencies are all designed to value the assets at the least optimistic figure. If the valuation assigned to assets is written up and the consequent increase in surplus is used to pay stock dividends, it can be argued that no harm is done since the increased values cannot be drawn off as cash dividends since they are now "frozen" into the capital stock account. To make that view wholly accurate, it would be necessary to forbid a subsequent corresponding reduction of capital stock and a declaration of a dividend from the resulting reduction surplus. Otherwise the total effect of four planned steps consisting of the upward revaluation of assets, a stock dividend charged to resulting revaluation surplus, reduction of capital stock and cash dividend charged to reduction surplus, would permit payment of a cash dividend initially unlawful. As will be seen when the statutes concerning reduction in capital stock are considered, that possibility along with others has not been considered in the Washington statute.

So much for the computation of "capital stock." In summary it consists of the number of issued or subscribed par shares multiplied by par value; the value of the consideration received for non-par shares less amounts allocated to paid-in surplus; and transfers from surplus, possibly including those from revaluation surplus, of the

³⁸ No such freezing of surplus into "capital stock" occurs on a share split. See note 36a, *supra*.

necessary par value of the dividend shares or whatever amount the directors may order on a dividend payable in non-par shares.³⁹

Along with these elaborate provisions for fixing the amount of "capital stock", statutes have also customarily provided for its reduction.

It would naturally be anticipated that having so carefully provided for a "capital stock" as a protection for creditors, strong safeguards would surround its reduction. Such has not always been the case. Probably the failure to give a greater amount of protection has been due more to a lack of understanding than to any deliberate disposition toward laxity.

The general pattern of corporation statutes has been to permit reduction of capital stock by vote of some substantial percentage of shareholders. Such statutes generally contain provisions intended to protect creditors. The earliest Washington statute⁴⁰ was enacted in 1866. This was a very highly developed statute for that early date. It forbade the reduction of the capital stock to an amount less than the amount of the outstanding debts unpaid when the reduction became effective. At this juncture it should be noted that *reduction* of the "capital stock" *alone* cannot possibly be of the slightest harm to anyone unless *reduction* is construed to include *an accompanying distribution* of corporate assets to shareholders. For example, if a corporation merely reduces par value of all outstanding par shares from \$100.00 to \$50.00 a share, the effect is to reduce "capital stock" to one-half of its former amount. If nothing more occurs, the creditors have just as many assets as before available to satisfy their claims and the shareholders have just as many assets as before working for them.^{40a} The real significance of the change is its effect of increasing surplus or reducing a deficit. In fact by this process an existing deficit may be wiped out and a surplus may appear in its place. Any increased or new surplus would then be available for dividend purposes. Similarly any

³⁹ Statutes often provide for the increase of "capital stock" by action which directs a transfer from surplus to capital stock without any corresponding issuance of shares. See CALIFORNIA CORPORATIONS CODE § 1900; MODEL BUSINESS CORPORATION ACT, note 32, *supra*, § 2j. The Washington statute contains no such express provision. Query whether an action so to capitalize surplus in Washington could be had over the objection of a shareholder?

⁴⁰ Laws of Washington, 1866, p. 55; (Volume 2, Pierce's Session Laws of Washington, p. 763, 768.) The text of the relevant section of the act (Sec. 20) is set forth herein above footnote 7, *supra*.

^{40a} The usual reason given for placing restraints on distributions of corporate assets is protection of creditors. Such restraints also carry out the implied compact between the shareholders that the corporation, if possible, will have a minimum amount of net assets available at all times in order to accomplish its purposes. See Berks Broadcasting Co. v. Cramer, 356 Pa. 620, 52 A.2d 571 (1947).

reduction in deficit would put the corporation that much closer to acquiring a surplus from subsequent operations. The real matter of concern to existing creditors lies in the newly created ability to declare dividends from the reduction surplus arising from the reduction of "capital stock". The practical significance of the 1866 statute therefore lay in the fact that it prevented the withdrawal of assets on a reduction of the capital stock unless the assets remaining after such reduction had a value twice as large as the debts.

The following example demonstrates the operation of the 1866 Washington statute. The restraining formula is that capital stock shall not be reduced to less than the amount of the debts. Suppose that assets are \$100,000.00, debts \$25,000.00 and capital stock \$75,000.00. As of that moment assets are in a ratio of 4 to 1 to debts, a most comfortable protection. Suppose the corporation reduces "capital stock" to \$26,000.00. A reduction surplus of \$49,000.00 at once appears. A dividend of \$49,000.00 is at once declared and paid. Assets of \$51,000.00 are now left to cover \$25,000.00 in debts. This is slightly more than a 2 to 1 ratio of assets to liabilities, the minimum possible under the statute. This might seem to be an ample margin of protection but it is quite possible that the dividend would have taken all the liquid assets leaving only those less suitable for the payment of debts.

The 1866 statute remained in effect until 1933. In that year the present corporation statute, then known as the Uniform Business Corporation Act, was adopted. As already noted, that act defined "capital stock" as an amount. The dividend sections employ this amount as a factor in the calculation of surplus available for dividends. On the whole these dividend sections reveal an awareness of the accounting, legal and practical problems involved in distributions to shareholders. As much cannot be said for the section authorizing reduction of capital stock. Whereas the dividend sections impose quite effective restraints on normal dividends, the reduction section is in some degree unintelligible and if literally followed can destroy the protection given by the dividend sections. The reduction section is as follows:

The capital stock of a corporation may be reduced by a resolution adopted by the vote of the holders of two-thirds of the voting power of all shareholders, cast in person or by proxy at a meeting of the shareholders duly called and held for that purpose, or by such vote as the articles of incorporation require.

Following the adoption of a resolution for the reduction of capital stock, articles of reduction of capital stock shall be prepared and filed in the manner required for the preparation and filing of articles of amendment. The articles of reduction shall also state the financial condition of the corporation *and that the proposed reduction will not reduce the fair value of the assets of the corporation to an amount less than the total amount of its debts and liabilities plus the amount of its capital stock as so reduced.*

No attempted reduction of capital stock shall be effective until the secretary of state has filed the articles of reduction and issued a certificate of reduction, and no such attempted reduction shall be valid, even if the secretary of state has filed the articles of reduction, and issued a certificate of reduction, and *no such attempted reduction shall be valid, even if the secretary of state has filed the articles of reduction, and issued a certificate of reduction, if such reduction would reduce the actual value of the corporate assets to an amount less than the total amount of its debts and liabilities plus the amount of capital stock as so reduced.*⁴¹ (emphasis added)

The practical effect of this language is to permit reduction of assets down to the point of equality with outstanding debts, that is to a 1 to 1 ratio. Actually it is necessary to do some violence to the statutory language to get even this favorable a result for creditors. "Reduction of the capital stock" standing by itself will never "reduce" the amount of assets. That will occur only when the reduction surplus is distributed. It can therefore be argued that the statute when read in light of the earlier statutory definition of capital stock,⁴² is meaningless since "reduction of the capital stock" will never reduce the assets to the extent forbidden by the statute or at all. It is unlikely, however, that a court would thus hold the statute meaningless. More probably it would be held, despite the resulting warping of the statutory definition, that the reduction section means that no distribution of assets can be made in connection with a capital stock reduction which would leave less assets than specified by the statute. If we accept this as the only possible construction of the statute (assuming it is to be given any effect at all), the possible practical operation of the statutory rule can be tested by the same hypothetical example used for the 1866 statute. Thus, again suppose the assets to be \$100,000.00, debts \$25,000.00 and capital stock \$75,000.00. There being no surplus, no dividends can be paid. Creditors have \$100,000.00 available for their claims, a ratio

⁴¹ RCW 23.16.120.

⁴² RCW 23.04.100.

of assets to liabilities of 4 to 1. The shareholders then reduce the capital stock to \$1,000.00, thereby creating a surplus of \$74,000. If this amount is distributed, an extremely small margin of assets over debts (\$26,000.00 to \$25,000.00) remains.^{42a} Thus the protection for creditors under the 1933 statute is materially less than under the statute in effect from 1866 to 1933.

Inasmuch as the dividend sections of the act carefully provide for the "capital stock" cushion—the amount of the capital stock as a minimum margin of assets over debts—it seems unlikely that the draftsmen of the act could have intended that the "reduction of capital stock" provisions would give so much freedom of action to the shareholders. Nevertheless, no more exacting standard can be spelled out of the section. If it be suggested that the statute does not expressly authorize *any* distribution of reduction surplus, the answer is that nothing in the entire act denies the right to distribute such a surplus and, further, that RCW 23.16.120 is unintelligible if reduction surplus is not distributable since a reduction of the amount of "capital stock" without an accompanying distribution of assets could not possibly *reduce* the assets. The wording of the statute is obviously defective, but that scarcely warrants the substitution of language which might be more desirable. That is a task for the legislature.

There has been considerable diversity of opinion as to what curbs should be placed on the reduction of "capital stock." It has long been an accepted view that some reduction should be permitted. The 1866 statute used a 2 to 1 ratio between assets and debts as the minimum limiting factor by providing that capital stock could not be reduced to a point below debts and liabilities.

There is much to be said in favor of such a ratio test, though opinions might differ as to the proper ratio. It has also been suggested that a ratio of assets to debts (or perhaps of current assets to debts) might be a more satisfactory control than the "capital stock" cushion for all dividends. In general, however, dividend statutes have been tied to the amount of the capital stock as selected by the corporation. The result of this is that the minimum permissible ratio between assets and liabilities has depended upon the capital structure of the particular corporation and not on any uniform fixed ratio. Thus a creditor who extends credit to a corporation having a "thin" capital stock cannot complain if

^{42a} The examples given in the text assume an existing surplus or, as in this last example, an exact equality between assets on the one hand and debts plus capital stock on the other. Obviously the statute also permits reduction to get rid of an existing deficit even to the extent of creating a surplus in its place.

the ratio of assets to liabilities is correspondingly small after the payment of dividends. If, on the other hand, there was a "thick" capital stock cushion when credit was given, there is certainly substantial reason for forbidding the reduction of the capital stock to a point where distribution of the amount of the reduction surplus may leave a dangerously low proportion of assets to debts.

As previously noted, distribution of a reduction surplus, if uncontrolled, may drain off liquid assets which are most important from the standpoint of creditors. This possibility also exists with respect to ordinary dividends but is potentially more serious when distributions of a reduction surplus are made because the latter may be so large, under a statute such as the 1933 Washington statute, as seriously to jeopardize the position of creditors.

The tenor of some of the more modern corporation statutes has been to include several restraints on the distribution of reduction surplus. For example, the Model Business Corporation Act,⁴³ prepared by the Committee on Business Corporations of the Corporation, Banking and Business Law Section of the American Bar Association, classifies a "reduction" surplus as a "capital surplus" and includes the following limitations on distributions of such a surplus "in partial liquidation": (1) no distribution permitted if the corporation is insolvent or will be made insolvent thereby; (2) no distributions permitted if dividends on preferred shares are in arrears except to pay such preferred dividends; (3) no distributions permitted if the effect would be to reduce the "net assets" (excess of assets over debts) to a point below the liquidation preferences on preferred shares.⁴⁴ The California statute⁴⁵ contains more elaborate provisions restraining distributions. If there is a class of preferred shares outstanding, reduction surplus may be distributed only in payment of dividends upon or for redemption or purchase of the preferred shares. If there are no such preferred shares, distributions may be made to the common shareholders. In either situation, however, there must be a ratio of assets to debts after payment in the proportion of $1\frac{1}{4}$ to 1.

As these modern statutes indicate, reduction of capital stock may be dangerous to preferred shareholders as well as to creditors. Accordingly protective provisions are included in them for such preferred shares. In each case, these statutes, in addition to the provisions

⁴³ Sections 40, 41, and 63.

⁴⁴ Note 43, *supra*.

⁴⁵ CALIF. CORP. CODE, §§ 1906, 1907. See also §§ 1500, 1501.

already mentioned, categorically forbid reduction of the "capital stock" to an amount less than the liquidation preferences of the preferred shares.

A survey of these and similar modern statutes indicates the propriety of including some statutory safeguards for the protection of creditors and preferred shareholders. The present Washington statute does not give such protection. However, it would no doubt be possible for a court to enjoin or recapture any distribution of corporate assets manifestly fraudulent as to creditors. The standards for such relief would, however, never be quite as definite as the statutory limitations of the Model Act or the California act, which are representative of the modern statutory trend.⁴⁶

The technique of accomplishing reduction of capital stock requires some consideration. Reduction may or may not involve amending the articles of incorporation. If, for example, reduction is sought to be accomplished by reducing the par value of the shares of the corporation, an amendment is seemingly necessary to effect the reduction. The corporation statute requires that the par value of the shares be stated in the articles.⁴⁷ Possibly it would be held that the articles of reduction are in effect articles of amendment but such a conclusion is at least debatable. A different situation exists if reduction is to be accomplished by reduction of the number of outstanding common par shares, that is, by having each shareholder surrender an equal proportion of his shares. In a legal sense, no harm would result to the shareholder since he has the same proportion of the common shares as he had prior to surrender. Also the articles of incorporation are in no way altered since the corporation is still authorized to issue the same number of par value shares as before. "Capital stock" would then be reduced solely by reducing the number of shares outstanding.

No amendment of the articles is necessary to reduce "capital stock" as to non-par shares. "Capital stock" referable to such shares does not depend on the articles of incorporation but on the amount received for such shares and upon any allocation thereof which may have been made between "capital stock" and paid-in surplus by action of the incorporators, shareholders or directors.⁴⁸ Consequently the simplest way in which "capital stock" arising from non-par shares can be reduced is by action aimed directly at the dollar amount determined

⁴⁶ Notes 43 and 45, *supra*.

⁴⁷ RCW 23.12.020(5).

⁴⁸ RCW 23.04.100; 23.16.030; and 23.24.010. It is necessary to read all three of these sections to understand the permissible allocation of the price of non-par shares.

from the issue price as modified by the allocation, if any. The appropriate procedure would be to adopt a resolution reciting the present amount of the "capital stock" and providing for its reduction from that figure to such lower figure as may be desired. In Washington no minimum figure is indicated so that the reduction could apparently be made down to a nominal sum.

While an amendment is not at all necessary as to non-par reductions, it would be possible to accomplish that result by amendment, as, for example, by changing 1,000 non-par shares having a current "capital stock" amount of \$100,000.00 to 1,000 shares having a par value of \$50.00 each, thus automatically reducing "capital stock" to \$50,000.00. A mere reduction of the issued number of non-par shares or the amendment of the articles reducing the number of authorized non-par shares and forcing a surrender of those outstanding in excess of the newly authorized number would not in and of itself reduce the "capital stock". Some direct action bearing on the dollar amount would be necessary in such a situation.

There remains to be considered the place of treasury shares in the computation of "capital stock". This subject has not been developed by judicial decision and, until recently, had been quite ignored by statute.

Treasury shares are those which have been once issued by the corporation and later reacquired by it. Reacquisition may be by gift, or in satisfaction of a debt owing from the corporation or by purchase. A sharp split of authority developed in American corporation law over the legality of a corporation's voluntary purchase of its own shares. In a line of cases,⁴⁹ Washington followed the strict English view that no such purchase could be made. These cases proceed on the theory that the purchase, or to be more precise, the payment of the purchase price effects a reduction of the capital stock and is illegal because not accomplished in accordance with the statutory procedure for capital stock reductions. The Washington rule forbade such purchases even though the purchase price was less than an existing surplus available for payment of dividends. The Washington cases considered collectively are excellent examples of the failure of courts to develop any

⁴⁹ *Kom v. Cody Detective Agency*, 76 Wash. 540, 136 Pac. 1155 (1913); *State ex rel. Howland v. Olympia Veneer Co.*, 138 Wash. 144, 244 Pac. 261 (1926); *Schwab v. Getty*, 145 Wash. 66, 258 Pac. 1035 (1927); *Duddy Robinson Co. v. Taylor*, 137 Wash. 304, 242 Pac. 21 (1926); *Big Bend Milling Co. v. Drake*, 149 Wash. 666, 272 Pac. 39 (1928); *First University Investment Corp. v. Roosevelt etc. Co.*, 170 Wash. 444, 16 P.2d 820 (1932); *Whittaker v. Weller*, 8 Wn.2d 18, 111 P.2d 218 (1941).

clear view of just what capital stock is. The court senses the fact that a distribution of assets to a shareholder may be dangerous but fails to note that no real harm is done if the capital stock cushion remains unimpaired. The court could have fully protected the creditors by holding in the purchase cases that such purchases would be valid if the corporation had a surplus in excess of the purchase price and if the "capital stock" in the sense of an amount would not be written down on reacquisition of the share. If the corporation does not have a surplus greater than the purchase price, the payment would be in the nature of an unlawful dividend; if the par value of the reacquired share or some dollar value referable to a repurchased non-par share is informally deducted from "capital stock," the assertion that "capital stock" is reduced contrary to the statutory procedure is correct. By requiring surplus as a condition precedent to and forbidding informal writing down of capital stock as a consequence of the purchase, objections to the purchase are removed.

In 1947 the Washington legislature amended the 1933 act to authorize a corporation to purchase its own shares. The statute is almost identical with that of Delaware and briefly deals with the problem in the following language:

(2) Every corporation organized hereunder shall have the power to purchase, hold, sell, and transfer shares of its own capital stock: *Provided*, That no such corporation shall use its funds or property for the purchase of its own shares of capital stock when such use would cause any impairment of the capital stock of the corporation.⁵⁰

An unfortunate aspect of this language is that it completely abandons the 1933 statutory definitions covering "capital stock" and restrains distributions of corporate assets in the vague old terminology of "impairment of capital" rather than in modern terms of surplus. It has, however, been held in Delaware that the prohibition against "impairment of capital" is the same as a limitation of payments to the amount of surplus. It can, therefore, be quite safely assumed that the statute authorizes corporations to purchase shares to the extent of any available surplus.⁵¹

The statute is, however, silent as to the effect of the purchase on "capital stock". It is obvious that if a corporation has a surplus of \$1,000.00 and, on the strength of this, buys ten of its own \$100.00 par shares for a total price of \$1,000.00 the surplus will at once be reduced

⁵⁰ RCW 23.08.080.

⁵¹ *In re* International Radiator Co., 10 Del. Ch. 358, 92 Atl. 255 (1914).

to zero. If, however, the sum of \$1,000.00 (the total par value of the ten shares) is immediately deducted from "capital stock" a surplus of \$1,000.00 at once reappears. Such a practice would permit a corporation to use a small surplus to purchase an unlimited amount of its shares. The process would be even more absurd if the purchase price paid were less than par value since surplus would be increased with every purchase. If the price paid were more than par, only a partial ultimate reduction of surplus would occur. Furthermore, the repeated subtraction of the par value of the repurchased shares from the "capital stock" would accomplish a "reduction of capital stock" without *any* of the safeguards usually required for such reduction. The only reasonable conclusion is that "capital stock" should not be reduced by repurchase but only by the method called for by the "reduction" sections of the law or some special statutory provisions designed to cope with the problem.^{51a}

In the present condition of the Washington statute, the argument for maintaining the same capital stock amount on a repurchase of shares gets involved in a statutory triangle. At one corner is the statutory definition of "capital stock" as an amount equal to the "allotted" (issued or subscribed for) shares times the par value per share.⁵² Treasury shares are certainly not "allotted" as that term is generally understood and in this light should not be reflected in capital stock. At the second corner of the triangle is the 1947 statute which permits purchases only if there is no resulting "impairment of capital stock", that is, only to the extent of a surplus.⁵³ Obviously this must mean a true surplus and not one which rises like the phoenix from its ashes upon a deduction of the purchase price from capital stock. Finally, at the third corner is the statute for the reduction of "capital stock" giving a rather detailed procedure for the making of such reduction.⁵⁴ This procedure would be frustrated by use of the purchase device for the same purpose. In this posture of affairs, the only reasonable course is to read into the "capital stock" definition a further requirement that the par value of repurchased shares remain a part of "capital stock" until reduced in the statutory manner. If non-par shares are repurchased the same philosophy should defeat any attempt to short-cut the reduction statute.⁵⁵

^{51a} The California statute specifically requires the regular proceedings for reduction of surplus before "stated capital" can be reduced with respect to treasury shares.

⁵² RCW 23.04.100.

⁵³ RCW 23.08.080.

⁵⁴ RCW 23.16.120.

⁵⁵ Since non-par shares have no assigned dollar value, the retirement or cancellation

It should also be noted that it is sometimes suggested that treasury shares should be treated as assets of the corporation. They are in a sense so treated so far as the watered stock problem is concerned. Having once been paid for, they have been held to be reissuable at less than par value.⁵⁶ Actually, however, their value to the corporation is no greater than authorized but unissued shares. To treat them as assets is entirely unsound and such a practice would compound the dangers discussed in the preceding paragraph.

CONCLUSION

Any exploration into the "capital stock" area can be continued almost endlessly. The field is at least as wide as the far ranging complexities of corporate financial structures extend. Such structures have in recent years become increasingly involved and will continue in that direction. Superimposed on the width of the problem, we have a further complicating factor of vague or misused and misquoted terminology. This terminology has come to us from business, accounting, finance, economics and law. Each group has no doubt played some part in shaping and confusing the familiar terms discussed herein.

No attempt has been made to examine all aspects of the problem. The problems of redemption of preferred shares have, for example, been passed over though they certainly affect "capital stock" in a significant way. The object of this article has been to direct attention to some of the significant fundamental concepts concerning shares of corporate stock, liabilities of shareholders to the corporation on original issue and the basic legal and accounting concepts of "capital stock" as a restraint on distribution of assets to shareholders. If the distinguishing fundamentals of these matters are clear and if it is understood that decisions and statutes are not always wholly accurate or exact in the use of "capital stock" and other legal-accounting terminology, solution of more specialized refinements of the basic problem are not too difficult.

thereof could in no event have any automatic effect on "capital stock."

⁵⁶ BALLANTINE, CORPORATIONS, § 202 (rev. ed. 1946).