lead to prolongation of an already thoroughly confused treatment of the problem of who shall bear the burden of a federally imposed estate tax.

THE CORPORATE CREDITOR AND LEGISLATIVE RESTRICTIONS ON THE DISTRIBUTION OF CAPITAL

An ever-present policy conflict is involved in the enactment of statutes restricting the dissipation of corporate capital since an attempt must be made to compromise the interest of creditors in the complete satisfaction of their claims and the interest of corporations in managerial freedom. Comparatively recent state legislation limiting the reduction of capital[1] and the disposition of the resulting surplus,[2] not only has achieved greater protection for the creditor[3] of a corporation, but has also made provision for the need of the corporation for a flexible capital amount.[4]

The corporate creditor has available all of the safeguards provided by law for creditors of individuals.[5] The creditor is thus protected

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1. The term, "capital," in this note, does not refer to "capital" as defined by economists, (assets used to acquire additional wealth); nor does the term refer to the proprietorship account used by the accountant. See HATFIELD, SURPLUS AND DIVIDENDS 3 (1948).

Capital is used in the sense of "legal capital" and means that ". . . amount which measures the margin of net assets or value which is to be retained in the business as against withdrawals in favor of the shareholders." BALLANTINE, CORPORATIONS § 206 (Rev. Ed. 1946). See also Bailey, *Safeguarding the Claims of Creditors,* 4 BAYLOR L. REV. 470, 473-474 (1952).

"Capital," when used in the phrase "distribution of capital," refers to a distribution of assets.

For other definitions of capital, stated capital, legal capital, and capital stock, and discussions of the legal capital concept, see BALLANTINE, CORPORATIONS §§ 206, 207, 227, and 266 (Rev. Ed. 1946); BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 162-163 (1948); 11 FLETCHER, CYCLOPEDIA ON THE LAW OF PRIVATE CORPORATIONS §§ 5079, 5080 (Perm. Ed. 1943); Bailey, *supra* at 473; Bonbright, *The Dangers of Shares Without Par Value,* 24 COL. L. REV. 449, 450 (1924); Hills, *Model Corporation Act,* 48 HARV. L. REV. 1334, 1359 (1935).

2. A reduction surplus will arise when the impairment of capital, if any, at the time of the reduction of capital, is less than the amount by which the capital is reduced.

3. The creditor considered in this note is the general, unsecured, trade creditor. Consideration of creditor protection involves the ability of the corporation to satisfy his claim out of income, the satisfaction that the creditor may receive from a sale of the assets on liquidation, and the benefits accruing to the creditor from a reorganization of the corporation.

4. For comprehensive summaries of the methods by which capital may be reduced, see 1 TEX. L. & LEGIS. 276, 280 (1947); Note, 44 A.L.R. 11, 20 (1926).

It should be noted that three distinct steps are involved in each reduction procedure: (1) determination by the directors and shareholders of the amount of capital as reduced, (2) the actual reduction of the capital stock, and (3) the distribution of assets to shareholders. BALLANTINE, CORPORATIONS § 266 (Rev. Ed. 1946).

5. Warren, *Safeguarding the Creditors of Corporations,* 36 HARV. L. REV. 509 (1923).

against fraudulent conveyances of reduction surplus.[6] Unless the corporation is insolvent, however, a distribution of a reduction surplus to stockholders is not considered a fraudulent conveyance, and the protection of the creditor lies—implied or expressed—in the general corporate statute.[7] The limited liability of stockholders, a concept developed in the eighteenth century, created a need for more adequate protection of the corporate creditor's interests and resulted in development of the parallel concept of permanent corporate capital.[8] It is upon this permanent capital which the law not only permits the creditor to rely for his protection but assumes that he does so rely.[9]

The care with which this permanent capital was guarded in the past century is attributed to the fact that the corporation was then feared as a social evil.[10] Today, through the statutes permitting the reduction of capital, there is a recognition of the corporation as an integral part of modern society, no longer plagued by the stigma attached to the corporate form as a result of the nineteenth century "fly-by-night" enterprises.[11] The various decisions under the trust fund doctrine reflect this change in social prestige of the corporation and indicate a revised attitude toward the large corporation and toward the relationships between creditor and shareholder.[12]

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6. For an interesting and clear distinction between a fraudulent conveyance and a distribution of capital to the corporate shareholder see II GLENN, FRAUDULENT CONVEYANCES AND PREFERENCES § 604 (Rev. Ed. 1940).

7. Powers v. Heggie, 268 Mass. 233, 167 N.E. 314 (1929); Scriggins v. Dalby Co., 290 Mass. 414, 195 N.E. 749 (1935). These Massachusetts decisions were decided under the Uniform Fraudulent Conveyance Act § 4, 9A U.L.A. 73 (1951); MASS. ANN. LAWS c. 109A, § 4 (1954).

8. For a discussion of the growth of the permanent capital concept see KEHL, CORPORATE DIVIDENDS c. 1 (1941).

9. HATFIELD, SURPLUS AND DIVIDENDS 3-4 (1948); Bonbright, *supra* note 1, at 450; see 5 THOMPSON, CORPORATIONS § 3685 (3rd Ed. 1927); Callahan, *Statutory Protection of Creditors in Reduction of Capital Stock*, 2 OHIO ST. L.J. 220, 221 (1936).

10. See KEHL, CORPORATE DIVIDENDS 17 (1941).

11. *Ibid.*

12. The growth of the size of corporations during the latter part of the nineteenth century changed the corporate shareholders from a small group of individuals, intimately acquainted with the operations of the concern, to a large group of far-flung investors who have little or less familiarity with the operations of the enterprise than have the creditors. See McDonald v. Willliams, 174 U.S. 397 (1899). This case recognizes the position of the large group of shareholders who are not involved in corporate affairs. See generally, STEVENS, CORPORATIONS § 102 (1936); BALLANTINE, CORPORATIONS § 255 (Rev. Ed. 1946).

Compare the results in light of the facts in Chicago, M. & St. P. Ry. v. Third National Bank, 134 U.S. 276 (1889); Scammon v. Kimball, 92 U.S. 362 (1875); Crandall v. Lincoln, 52 Conn. 73, 52 Am. Rep. 560 (1884); and Hastings v. Drew, 76 N.Y. 9 (1879) *with* the results and facts of Koch v. U.S., 138 F.2d 850 (10th Cir. 1943); and Beatty v. Patterson-Garfield-Lodi Bus Co., 126 N.J. Eq. 472, 9 A.2d 686 (Ch. 1939). A good discussion of and exhaustive collection of cases under the trust fund doctrine is found in 15A FLETCHER, *op. cit. supra* note 1, §§ 7369-7389. For other discussion of the trust fund

Not only is the creditor presently denied recovery of the capital distributed by a solvent corporation to stockholders who receive it in good faith, he is also denied an injunction prohibiting a planned distribution of capital.[13] A result of this rejection of equitable relief[14] is possible distribution of capital to a good faith stockholder while the creditor is endeavoring to establish his claim, thus placing the capital beyond his

doctrine illustrating the restrictions upon the rights of the creditor see Deinzer, *Capital Stock and Surplus: Legal and Accounting Relations,* 10 ACC. REV. 333 (1935); Notes, 8 COL. L. REV. 303 (1908); 25 GEO. L.J. (1937). Important decisions laying the foundation for the restriction of the trust fund doctrine of McDonald v. Williams were Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371 (1893), restricting the operation of the trust fund doctrine to the administration of the assets by the court of equity; and Hospes v. Northwestern Mfg. & Car Co., 48 Minn. 174, 50 N.W. 1117 (1892), expressly repudiating the trust fund doctrine in that jurisdiction. See I COOK, CORPORATIONS § 289 (8th Ed. 1923). See generally 12 FLETCHER, *op. cit. supra* note 1, § 5423.

13. The creditor may not interfere with the cancellation of the corporation's shares where the corporation is solvent and the debt of tne creditor is not mature. Rice v. Thomas, 184 Ky. 168, 211 S.W. 428 (1919); *cf.* Adler v. Fenton, 24 How. 407 (1861); see TAYLOR, PRIVATE CORPORATIONS § 664 (2nd Ed. 1888).

See Mobile & O. R.R. v. Tennessee, 153 U.S. 486, 496 (1893) stating that "[c]orporations are liable to be enjoined by shareholders or *creditors* from making a distribution in dividends of capital." (Emphasis added). The Court then cites TAYLOR, PRIVATE CORPORATIONS § 565 (2nd Ed. 1888) where the following language is found: ". . . the distribution in dividends of the capital of the corporation may be enjoined by a shareholder." Taylor makes no reference to an injunction by a creditor.

See 11 FLETCHER, *op. cit. supra* note 1, § 5150, where, in stating that a creditor can enjoin a corporation which attempts to purchase its own shares to reduce capital stock and distribute assets against existing creditors, the author cites in support Crandall v. Lincoln, 52 Conn. 73, 52 Am. Rep. 560 (1884). This case did not involve a prayer for an injunction but is rather an action by creditors for the *recovery* of assets distributed in the purchase by a corporation of its own stock. The same treatise later states that "[i]t has also been held that such a suit [referring to a prayer for an injunction to prevent the payment of a dividend when there are no profits from which the dividend may be lawfully paid] may be maintained by a creditor of the corporation." 12 FLETCHER, *op. cit. supra* note 1, § 5419. The case cited in direct support is Reid v. Eatonton Mfg. Co., 40 Ga. 98, 2 Am. Rep. 563 (1869). This case is an action for the recovery of dividends paid while a corporation was solvent but which later became insolvent. Reference of the author is probably to this statement by the court: "But we will not say that in a proper case, where the corporation is *insolvent,* and the capital stock upon the faith of which the credit was given, has become insufficient for the payment of the debts of the company, a case might not be made where a Court of Equity would enjoin the payment of future dividends to the stockholders, till the debts are paid." (Emphasis added). Reid v. Eatonton Mfg. Co., *supra* at 104, 2 Am. Rep. at 566. Since the court here limits the action for the injunction to the case of the insolvent corporation, the anticipated distribution is controlled by the law of fraudulent conveyances. See notes 6 & 7 *supra.*

Another writer states that "[b]oth shareholders and directors should be permitted to enjoin the payment of dividends out of capital—shareholders, on the ground that the return of capital is in violation of the membership contract, as well as the statutory scheme; and creditors, on the ground that for their protection the policy of the law is against the return of capital to shareholders while there are or may be creditors." However, no authority is cited to support this statement. STEVENS, CORPORATIONS § 102 (1936).

14. An exception to this general rule is found in Hoyt v. E. I. duPont de Nemours Powder Co., 88 N.J. Eq. 196, 102 Atl. 666 (Ch. 1917) where bondholders, secured by a lien in all present and future corporate assets were granted an injunction preventing the distribution of capital.

reach.[15] Real legislative regard for the interest of the creditor might lie in granting him statutory injunctive relief when the assets of a corporation fall below a certain minimum ratio to liabilities.[16]

The primary remedy of the creditor for the unlawful reduction and distribution of capital upon which he has relied in extending credit lies, however, not in an action against a distant stockholder, who, if found, will probably be protected as a good faith recipient of the payment, but rather, under state corporation laws, against the directors who assented to the unlawful distribution of capital.[17] Liability is thus placed on those directly responsible for the distribution. A point of interest, however, is that although the statutes of forty-five states impose liability on directors for unlawful distributions of capital or dividends, twelve of the same jurisdictions also place liability upon shareholders for the receipt of such a distribution or dividend.[18] In absence of this latter statutory liability on the shareholder, it seems that, as a general rule, such an unlawful distribution or dividend may be recovered from the shareholder as long as he has not received it in a good faith belief that the distribution was lawful.[19] The Model Business Corporation Act resolves the matter by

15. See I GLENN, *op. cit. supra* note 6, § 84.

16. It has been suggested that the creditor be given specific rights whenever the assets fall below the capital as it stood when the creditors made the loan. Littleton, *The Dividend Base*, 9 ACC. REV. 140 (1934).

17. See note 12 *supra*.

18. The two states which do not by statute directly place liability on the director are Georgia and South Carolina. Alabama indirectly makes the director liable by adopting the trust fund doctrine in the corporation laws and making the directors trustees of the trust fund for five years after dissolution. ALA. CODE tit. 10, §§ 103, 110 (1940).

The 12 jurisdictions placing liability on the shareholder in addition to liability on the director are: KY. REV. STAT. ANN. § 271.275 (1953); LA. REV. STAT. ANN. § 12:27 (1951); MASS. ANN. LAWS c. 156, § 156:45 (Cum. Supp. 1953); MICH. COMP. LAWS § 450.48 (1948); MINN. STAT. ANN. § 301.23 (West 1945); MISS. CODE ANN. § 5328 (1942); N.H. REV. LAWS c. 274, § 103 (1942); OKLA. STAT. tit. 18, § 1.148 (1951); VT. REV. STAT. § 5825 (1947); W. VA. CODE ANN. § 3025 (1949); WASH. REV. CODE § 23.16.080 (1952); WIS. STAT. § 180.40 (1953). It should be noted that the Vermont statute only places liability on the shareholder where the unlawful dividend or distribution is received by him with knowledge that the payment was unlawful.

19. Bartlett v. Smith, 162 Md. 478, 160 Atl. 440 (1932); *cf.* American Steel & Wire Co. v. Eddy, 130 Mich. 266, 89 N.W. 952 (1902). But see the discussion by Fuld, *Recovery of Illegal and Partial Liquidating Dividends from Stockholders*, 28 VA. L. REV. 50, 55 (1941).

However, the shareholder may protect himself by enjoining the unlawful distribution of capital. 12 FLETCHER, *op. cit. supra* note 1, § 5419; TAYLOR, PRIVATE CORPORATIONS § 565 (2nd Ed. 1888). Further, a suit by a preferred shareholder where distribution of a reduction surplus is contemplated, though not for the purpose of protecting shareholders from liability to creditors, will have that effect. See Page v. Whittenton Mfg. Co., 211 Mass. 424, 97 N.E. 1006 (1912); Seignouret v. Home Ins. Co., 24 Fed. 332 (C.C.S.D.La. 1885). For general discussions of the interests of the preferred shareholder in the distribution of a reduction surplus, see SEC, REPORT ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL, AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, pt. VII, 483-493 (1938); Luce, *Trends in Modern*

placing primary liability on the director and secondary liability on the shareholder.[20]

A creditor might possibly contend that the remedy afforded by the statutes does not abrogate the common law rule permitting recovery from the shareholder but rather imposes a minimum standard.[21] The lone case supporting this view can be distinguished on its facts,[22] and it would seem that any assumption of the courts of concurrent jurisdiction with the legislature for the regulation of corporations is unwarranted.[23] The creditor must look to the various statutory restrictions on the distribution of reduction surplus for his remedy.[24]

It is not reduction of capital in itself but rather the distribution of the surplus resulting from the reduction which causes injury to the creditor.[25] This fact is particularly important in the case of a declining industry where the stockholders will be anxious to withdraw their funds and reinvest in more profitable enterprises.[26] The reduction of capital is

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Corporation Legislation, 50 MICH. L. REV. 1291 (1952); 39 COL. L. REV. 1037 (1939); Notes, 31 COL. L. REV. 844 (1931); 65 HARV. L. REV. 1203 (1952).

20. The Model Business Corporation Act provides that the shareholder shall be liable "(a) when no director is liable to the corporation . . ., or (b) to the extent that the corporation is unable to obtain satisfaction after judgments recovered against directors. . . ." Model Business Corporation Act § 25, 9 U.L.A. 104 (1951). See Note, 1953 WIS. L. REV. 380, 383 (1953).

21. See Fuld, *supra* note 19, at 60.

22. See Kimbrough v. Davies, 104 Miss. 722, 61 So. 697 (1913). In this case liability under the statute arose when a distribution of capital was made which rendered the corporation insolvent. MISS. CODE § 923 (1906). The statute imposes joint and several liability on the directors and stockholders. The appellant (defendant below) rested his case on contentions that the corporation was not insolvent, that the statute required joinder of all stockholders in the action, and that it was not shown that the amount claimed was part of capital stock. The court avoids the question of insolvency and instead accepts the argument of appellee that the capital stock is a trust fund. The court goes on to say that the statute does not limit liability under the trust fund doctrine. This step was unnecessary. Since from the fact that the corporation had distributed its capital without making adequate provision for the contingencies and expenses, the distribution of the capital did in fact render the corporation insolvent in both the equitable and bankruptcy senses. Therefore, it was not necessary to determine that there was liability beyond the statute in order to permit recovery from the appellee.

23. See Warren, *supra* note 5, at 547.

24. The exact manner in which a limit on the distribution of a reduction surplus will operate to protect creditors is discussed *infra* at p. 249.

25. See Hills, *supra* note 1 at 1341; Note, 21 VA. L. REV. 562 (1935). See the discussion of the desirability of permitting a reduction of capital *infra* at pp. 249-251.

26. In order to have the surplus from a reduction of capital distributed, it seems that provision should be made for the distribution when the shareholders vote on the reduction. It was once held that a shareholder could compel the distribution of a reduction surplus. Seely v. N. Y. National Exchange Bank, 8 Daly (N.Y.) 400, 4 Abb. N. Cas. 61, *aff'd* 78 N.Y. 608 (1879). However, this rule has been repudiated in effect in New York by Jay Ronald Co. v. Marshall Mortgage Corp., 291 N.Y. 227, 52 N.E.2d 108 (1943). *Cf.* McCann v. First National Bank of Jeffersonville, 112 Ind. 354, 14 N.E. 251 (1887); Wools v. First National Bank of Jeffersonville, 112 Ind. 600, 14 N.E. 255 (1887). See BALLANTINE, CORPORATIONS § 271 (Rev. Ed. 1946); 11 FLETCHER, CYCLO-

a fundamental power which cannot be exercised in absence of statutory authority;[27] nor does an expressed power to increase create an implied power to reduce capital.[28] Where authority to reduce capital is granted, strict compliance with the statutory procedures is required.[29] Failure to conform strictly, however, will not always be fatal in an action between shareholders where the vote on reduction was in good faith since such a defect is one of form only.[30]

Thirty-five jurisdictions presently provide direct limitations upon the reduction of capital[31] while only nineteen provide for a direct limitation on the distribution of a reduction surplus.[32] However, the twenty-nine jurisdictions which do not provide for direct limitation on distribu-

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PEDIA ON THE LAW OF PRIVATE CORPORATIONS § 5150, n.9 (Perm. Ed. Cum. Supp. 1954); 5 THOMPSON, CORPORATIONS § 3695 (3rd Ed. 1927); Note, 44 A.L.R. 11, 40 (1926). *But cf.* Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919). An interesting policy parallel is found in North Carolina where a preferred shareholder is permitted to institute a suit for the dissolution of a corporation not paying dividends at a rate set by statute. Kistler v. Caldwell Cotton Mills Co., 205 N.C. 809, 172 S.E. 373 (1933). See Golding, *Corporate Receivership in North Carolina,* 32 N.C.L. REV. 149, 155 (1954).

27. Mannington v. Hocking Valley Ry., 9 Ohio N.P.N.S. 641 (1910); Sutherland v. Olcott, 95 N.Y. 93 (1884). *But cf.* Allen v. Francisco Sugar Co., 193 Fed. 825 (3rd Cir. 1912).

28. Re Financial Corp., L.R. 2 Ch. 714 (1867); *see* Moses v. Ocoee Bank, 1 Lea 398, 408 (Tenn. 1878); see Note, 44 A.L.R. 11, 17 (1926).

29. Butler v. New Keystone Copper Co., 10 Del. Ch. 371, 93 Atl. 380 (Ch. 1915); Star Publishing Co. v. Ball, 192 Ind. 158, 134 N.E. 285 (1922); Uffelman v. Boillin, 19 Tenn. App. 1, 82 S.W.2d 545 (1935). *See* Barnard Mfg. Co. v. Ralston Milling Co., 71 Wash. 659, 662, 129 Pac. 389, 391 (1913).

30. Gade v. Forest Glen Brick Co., 165 Ill. 367, 46 N.E. 286 (1897); Meisenheimer v. Alexander, 162 N.C. 226, 78 S.E. 161 (1913).

31. D.C. CODE ANN. § 29-230 (1951); FLA. STAT. § 608.18 (1953); IDAHO CODE ANN. § 30-149 (1948); ILL. ANN. STAT. § 32.042 (Cum. Supp. 1949); IND. ANN. STAT. § 25-229 (Cum. Supp. 1954); IOWA CODE ANN. § 491.41 (1949); KAN. GEN. STAT. § 17-322.3 (1949); KY. REV. STAT. ANN. § 271.460 (1953); LA. REV. STAT. ANN. § 12.45 (1951); ME. REV. STAT. c. 49, §§ 38, 39 (1944); MASS. ANN. LAWS c. 156, § 156.45 (Cum. Supp. 1953); MICH. COMP. LAWS § 450.20 (1948); MINN. STAT. ANN. § 301.39 (West Cum. Supp. 1954); MISS. CODE ANN. § 5328 (1942); MO. ANN. STAT. § 351.195 (Vernon 1952); MONT. REV. CODES ANN. § 15-212 (1947); NEB. REV. STAT. § 21-159 (1954); NEV. COMP. LAWS § 1624 (Supp. 1941); N.H. REV. LAWS c. 274, § 274-48 (1942); N.M. STAT. ANN. § 54-317 (1941); N.Y. STOCK CORPORATION LAW § 58-27; N.D. REV. CODE § 10-0330 (1943); OHIO REV. CODE ANN. § 1701.44 (Page 1954); OKLA. STAT. tit. 18, § 1.142 (1951); ORE. REV. STAT. § 57.406 (1953); PA. STAT. ANN. tit. 15, § 2851-705 (Purdon 1938); S.C. CODE § 12-276 (1952); S.D. CODE § 11.0205 (Supp. 1952); TENN. CODE ANN. § 3736 (Williams 1942); TEX. STAT., REV. CIV. art. 1332 (1948); UTAH CODE ANN. § 16-2-45 (1953); VA. CODE §§ 13-35, 93, 206 (1950); WASH. REV. CODE § 23.16.120 (1951); W. VA. CODE ANN. § 3025 (1949); WIS. STAT. § 180.60 (1953).

32. ARK. STAT. ANN. § 64-604 (1947); CAL. CORP. CODE ANN. § 1907 (1953); COLO. STAT. ANN. c. 41, § 51 (1935); FLA. STAT. § 608.18 (1953); ILL. ANN. STAT. § 32.041 (Cum. Supp. 1949); MD. ANN. CODE GEN. LAWS art. 23, § 23:32 (1951); MINN. STAT. ANN. § 301.39 (West Cum. Supp. 1954); MO. ANN. STAT. § 351.195 (1952); NEV. COMP. LAWS § 1624 (Supp. 1949); N.H. REV. LAWS c. 274, § 274-100 (1942); N.Y. STOCK CORP. LAW § 58-38; OHIO REV. CODE ANN. §§ 1701.43, 45 (Page 1954); OKLA. STAT. tit. 18, § 1.145 (1951); ORE. REV. STAT. § 57.221 (1953); R.I. GEN. LAWS c. 116, § 53 (1938); S.C. CODE § 12-277 (1952); UTAH CODE ANN. § 16-2-15 (1953); W. VA. CODE ANN. § 3025 (1949); WIS. STAT. § 180.39 (1953).

tion of reduction surplus do place limits upon the distribution of dividends and redemption of shares from stockholders or acquisition of a corporation's own shares as treasury holdings. These regulations may operate indirectly to limit a distribution of capital.[33]

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33. See generally KEHL, CORPORATE DIVIDENDS c. 2 (1941); Bonbright and Weiner, *Theory of Anglo-American Dividend Law: Surplus and Profits,* 30 COL. L. REV. 330 (1930).

A corporation may, without express statutory authority, repurchase its own shares in order to settle management differences. San Antonio Hdwe. Co. v. Sanger, —— Tex. ——, 151 S.W. 1104 (1912). Without statutory authority, however, a corporation cannot reacquire its own shares merely to establish treasury holdings. See 18 C.J.S. Corp., § 212 (1939). Though a few jurisdictions limit the acquisition of treasury holdings, nearly half of the states permit, by statute, the redemption of shares out of capital. Such redemption, whether permitted explicitly by a statute, or made possible through the interaction of several other provisions, is prejudicial to the creditor.

For a discussion of the loopholes which permit the distribution of all a corporation's capital through the stock redemption device see BALLANTINE, CORPORATIONS § 268 (Rev. Ed. 1946); Bailey, *Safeguarding the Claims of Creditors,* 4 BAYLOR L. REV. 470, 483 (1952). To prevent this the reacquired share should be considered as a restriction on earned surplus until sold or retired through a satisfactory statutory reduction procedure. See BALLANTINE, CORPORATIONS § 227 (Rev. Ed. 1946); Comment, 24 ROCKY MT. L. REV. 89 (1951).

There are generally three types of statutory restrictions on the payment of dividends. Two of these, the capital impairment test and the insolvency test, are subject to the same criticisms as when applied to the distribution of reduction surplus. *Infra,* p. 247. See KEHL, CORPORATE DIVIDENDS 25 *et seq.* (1941). Both of these tests are measures of a balance sheet surplus. The third, the net profits tests, is probably the best; but in some jurisdictions it has been used with a balance sheet surplus test, and this often results in a double standard for the computation of the fund available for dividends. The double standard arises when the net profits test expressly or by interpretation permits the payment of dividends out of current earnings while capital is impaired. See Kehl, *The Origin and Early Development of American Dividend Law,* 53 HARV. L. REV. 36 (1939); HATFIELD, SURPLUS AND DIVIDENDS 26 *et seq.* (1948). Some writers feel that the two tests when found together are merely explanatory of each other and do not actually provide a double standard. See Ballantine and Hills, *Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws,* 23 CALIF. L. REV. 229, 241 (1935).

One writer feels that the only test for the validity of a dividend should be the net profits test. Littleton, *The Dividend Base,* 9 ACC. REV. 140 (1934). A better phrasing of the net profits test would limit dividends to "unreserved and unrestricted earned surplus." See Seward, *Sources of Distribution to Stockholders,* 5 BAYLOR L. REV. 242 (1953).

The payment of dividends out of capital surplus is another undesirable result of some corporation acts. See PATON, ADVANCED ACCOUNTING 567 (1941); Werntz, *Progress in Accounting,* 72 J. ACCOUNTANCY 315, 316 (1941); Note, 19 CORN. L.Q. 470 (1934).

Even a statute restricting dividends to earned surplus arising out of the business will not necessarily prevent the distribution of capital through the dividend channel if the statute does not also prohibit unsound accounting practices such as: (1) paying dividends out of a surplus from revaluation of assets, (2) writing down assets below actual market value against capital stock thereby reducing depreciation charges too far and consequently overstating net earnings, or (3) charging operating losses against a capital surplus or capital stock account and distributing a carry-over earned surplus balance in dividends. *Compare* Berks Broadcasting Co. v. Craumer, 356 Pa. 620, 52 A.2d 571 (1940), limiting the use of a surplus from unrealized appreciation of asset value to stock dividends, *with* Randall v. Bailey, 23 N.Y.S.2d 173 (1940), *aff'd* 262 App. Div. 844, 29 N.Y.S. 2d 512 (1941), 288 N.Y. 280, 43 N.E.2d 43 (1942) holding valid a dividend paid from a revaluation surplus. See also Floyd, *Depreciation of Fixed Assets: A Proposal for Re-*

Before considering the protection afforded the creditor under the various statutory restrictions on the distribution of reduction surplus, it should be noted that the safeguards available in different jurisdictions may differ, even though providing the same type of limitation, where definitions of capital vary. Eleven of the twenty-one states limiting the distribution of reduction surplus provide a statutory definition of capital.[34]

At first glance, the provisions apparently offering the greatest amount of protection for creditors are those prohibiting the distribution of a reduction surplus when there are unpaid debts.[35] In enacting this type of provision, however, the legislatures certainly did not intend to include all debts—secured or unsecured—not mature at the time of the distribution. The intention seems to have been to secure payment of only those debts which have matured at the time of the distribution; and, consequently, little protection is afforded creditors holding unsecured and unmatured claims.[36]

A requirement that directors give notice to the stockholder of the source of the payment shifts liability, where the mandate is obeyed, from the director to the shareholder under the rule of *McDonald v. Williams*.[37]

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form, 31 TAXES 825, 827 (1953); Comments, 4 ARK. L. REV. 208 (1950); 35 MICH. L. REV. 286 (1936); 44 YALE L.J. 1025 (1935); Note, 2 DRAKE L. REV. 14 (1952). Directors may attempt a justification of these accounting manipulations which permit a perhaps not actually, but technically unlawful distribution of capital on the premise that a formal reduction of capital may adversely affect the goodwill of the concern. See II BONBRIGHT, THE VALUATION OF PROPERTY 914 (1937).

For a general summary of what an accountant feels should be considered in computing the fund available for dividends, see Briggs, *Asset Valuation in Dividend Decisions,* 9 ACC. REV. 220, 236 (1934).

All three dividend tests are inadequate when the economists' definition of income is considered. To an economist net income is the amount of goods and services that a firm can dispose of during a given period and still remain as well off in terms of real capital at the end of the period as at the beginning. See Bell, *Fixed Assets and Current Costs,* 28 ACC. REV. 44 (1953).

34. ARK. STAT. ANN. § 64-601 (1947); CAL. CORP. CODE ANN. § 1900 (1953); FLA. STAT. § 608.17 (1953); ILL. ANN. STAT. § 32.002 (Cum. Supp. 1949); MINN. STAT. ANN. § 301.02 (Cum. Supp. 1954); MO. ANN. STAT. § 351.015 (1952); NEV. COMP. LAWS § 1623 (1929); OHIO REV. CODE ANN. § 1701.42 (Page 1954); OKLA. STAT. tit. 18, § 1.79 (1951); ORE. REV. STAT. § 57.004 (1953); WIS. STAT. § 180.02 (1953).

35. S.C. CODE § 12-277 (1952); UTAH CODE ANN. § 16-2-15 (1953).

36. Broad construction of this provision would require the liquidation of the firm which certainly is not the legislative intent.

37. 174 U.S. 397 (1899). Notice to the shareholder receiving a dividend out of capital while the corporation is solvent defeats the shareholders' defense of good faith belief that the dividend was from profits. This permits the unsatisfied judgment creditor to reach the corporate assets placed in the hands of the shareholders. The following states require notice: ILL. ANN. STAT. § 32.041 (Cum. Supp. 1949); OHIO REV. CODE ANN. §§ 1701.43, 45 (Page 1954); OKLA. STAT. tit. 18, § 1.145 (1951); ORE. REV. STAT. § 57.221 (1938); W. VA. CODE ANN. § 3025 (1949); WIS. STAT. § 180.39 (1953). See also BALLANTINE, CORPORATIONS § 272 (Rev. Ed. 1946); HATFIELD, SURPLUS AND DIVIDENDS 44 (1948); Warren, *supra* note 4, at 537-538; Broad, *Some Comments on Surplus Account,* 66 J. ACCOUNTANCY 215, 223 (1938); Farr, *Give the Stockholder the Truth,* 93 SCRIBNER'S 228 (1933).

This notice provision, however, does not stand alone in any statute as the sole limit on the distribution of a reduction surplus, but is coupled with other restrictions. It would seem, therefore, that the notice provisions are intended to supply the stockholders with information on the financial activities of the enterprise rather than to afford security to creditors.

Laws prohibiting the distribution of a reduction surplus when the corporation is or will, as a result, be rendered insolvent in the bankruptcy sense[38] provides a remedy additional to those offered by the law of fraudulent conveyances.[39] No cushion of assets is required retained in the possession of the corporation, however, and the creditor is not, therefore, provided any greater opportunity to obtain satisfaction in an action against the corporation. Those provisions prohibiting the distribution of a reduction surplus when the capital is or will, as a result, be impaired are actually no more than bankruptcy insolvency rules disguised.[40] Capital can be reduced to little or nothing as long as the distribution of the resulting surplus does not impair the remaining capital.[41] Under both the bankruptcy insolvency and the capital impairment tests, the protection afforded the creditor will be determined to some extent by the standard of valuation used by the court in determining insolvency or impairment.[42] Provisions which require that assets remaining after distribution be equal to all liabilities, the payment of which is not otherwise provided for, are subject to the same criticisms as the two standards just discussed.[43]

Those acts requiring that no distribution of reduction surplus be made where there are unpaid dividends due on cumulative preferred stock are a protection, not for the creditor, but for the preferred stockholder.[44] A similar purpose seems to prevail in provisions requiring that the net assets remaining must equal the liquidation preferences on out-

38. OKLA. STAT. tit. 18, § 1.145 (1951). See Bonbright & Pickett, *Valuation to Determine Solvency under the Bankruptcy Act*, 29 COL. L. REV. 585 (1929).

39. See discussion at pp. 239-240 *supra*.

40. The following statutes provide the capital impairment test: ARK. STAT. ANN. § 64-604 (1947); FLA. STAT. § 608.18 (1953); ILL. ANN. STAT. § 32.041 (Cum. Supp. 1949); MINN. STAT. ANN. § 301.39 (West Cum. Supp. 1954); N.Y. STOCK CORP. LAW § 58-38; OKLA. STAT. tit. 18, § 1.145 (1951); R.I. GEN. LAWS c. 116, § 53 (1938).

41. See Note, 47 HARV. L. REV. 693, 696 (1934). Arkansas prohibits distribution of a reduction surplus which will reduce capital below $300. ARK. STAT. ANN. § 64-604 (1947).

42. See Bonbright & Pickett, *Valuation to Determine Solvency Under the Bankruptcy Act*, 29 COL. L. REV. 582 (1929).

43. COLO. STAT. ANN. c. 41, § 51 (1935); MO. ANN. STAT. § 351.195 (1952); NEV. COMP. LAWS § 1624 (Supp. 1949). Precisely at what point a distribution becomes unlawful under this law is uncertain. Under the most strict interpretation this would seem to be the bankruptcy insolvency test; it would seem that the legislatures had a less restrictive standard in mind.

44. OKLA. STAT. tit. 18, § 1.145 (1951); ORE. REV. STAT. § 57.221 (1953); WIS. STAT. § 180.39 (1953).

standing shares to be preferred on liquidation.[45] Any protection for the creditor in these limitations is only incidental to that provided preferred shareholders. It should be noted, however, that these limitations do not stand as the sole restriction on the distribution of a reduction surplus but are almost always coupled with other limitations aimed directly at creditor protection.[46]

Restrictions presenting extreme difficulty in application are those which place liability on the director for the distribution of a reduction surplus where the corporation is or will, as a result, be rendered insolvent in the equity sense.[47] It is almost impossible in many instances to determine whether a given distribution actually rendered the corporation unable to meet obligations maturing at some later time, assuming that the provision is to be so broadly interpreted.[48] By limiting the interpretation of the provision to include only those obligations currently mature, it is possible that the assets will not equal the total amount of liabilities, leaving the corporation insolvent in the bankruptcy sense.

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45. MD. ANN. CODE GEN. LAWS art. 23, § 23:32 (1951); OKLA. STAT. tit. 18, § 1.145 (1951); ORE. REV. STAT. § 57.221 (1953); WIS. STAT. § 180.39 (1953). The Oklahoma restriction includes a provision that the remaining net assets must be equal to the sum of liquidation preferences plus one-half of the remaining outstanding capital stock not so preferred in liquidation.

46. An exception is found in Maryland where the only direct limitation is that net assets must equal liquidation preferences after distribution. MD. ANN. CODE GEN. LAWS art. 23, § 23:32 (1951). Two jurisdictions combine the capital impairment test with the equitable insolvency test, one adding the requirement that the shareholder be given notice of the source of the distribution. R.I. GEN. LAWS c. 116, § 53 (1938); (notice) ILL. ANN. STAT. § 32.041 (Cum. Supp. 1949). See for a discussion of these laws Ballantine, *A Critical Survey of the Illinois Business Corporation Act,* 1 U. OF CHI. L. REV. 357 (1936); Dodd, *Statutory Development in Business Corporation Law, 1886-1936,* 50 HARV. L. REV. 27, 48 (1936).

Two states combine equitable insolvency, liquidation preference, unpaid cumulative dividends, and notice of the source of payment tests. ORE. REV. STAT. § 57.221 (1953); WIS. STAT. § 180.39 (1953). One state combines the equitable insolvency and "remaining assets to equal liabilities, payment of which is not otherwise provided for" tests. NEV. COMP. LAWS § 1624 (Supp. 1949). Ohio adds the notice requirement to the equitable insolvency test. OHIO REV. CODE ANN. §§ 1701.43, 45 (Page 1954). Arkansas adds a $300 minimum to the capital impairment test. ARK. STAT. ANN. § 64-604 (1947). The most comprehensive statute includes the capital impairment and both insolvency tests, together with four other provisions benefiting creditors and preferred shareholders. OKLA. STAT. tit. 18, § 1.145 (1951). Another good combination is that of the equitable insolvency test and the restriction that net assets at their fair, present value must be equal to one-fourth of liabilities. CAL. CORP. CODE ANN. § 1907 (1953). See Hills, *Model Corporation Act,* 48 HARV. L. REV. 1334, 1377 (1935).

It should be observed that restrictions on the reduction of capital as opposed to the restrictions on the distribution of a reduction surplus may operate to further limit the distribution of capital. See *infra* at p. 249 as to policies for allowing reduction of capital.

47. CAL. CORP. CODE ANN. § 1907 (1953); ILL. ANN. STAT. § 32.041 (Cum. Supp. 1949); NEV. COMP. LAWS § 1624 (Supp. 1949); OHIO REV. CODE ANN. §§ 1701.43, 45 (Page 1954); OKLA. STAT. tit. 18, § 1.145 (1951); ORE. REV. STAT. § 57.221 (1953); R.I. GEN. LAWS c. 116, § 53 (1938); WIS. STAT. § 180.39 (1953).

48. See the significant discussion by Fuld, *supra* note 19, at 60-62.

The more recent statutes permit the distribution of a surplus arising from the reduction of capital but impose liability on the directors where a certain minimum amount of assets is not retained in the corporation. Most of these statutes give some recognition to the valuation problem in providing that the aggregate of the assets shall be computed at "fair, present values".[49] The best single restriction in the present statutes is that providing that the *net* assets at their fair, present value must after the distribution be equal to at least one-fourth of debts and liabilities.[50]

It is essential to observe how this restriction provides protection for the creditor. In the first place liability is placed on the director, thus encouraging caution in determining whether the reduction surplus may be distributed. The directors are therefore prone to insist on the maintenance of the requisite "one-fourth" cushion, thus keeping the corporation from the border of insolvency.

Further, where the cause of action arises in an unsatisfied judgment creditor, in the trustee in bankruptcy, or in the receiver, and the recovery is statutorily limited to the amount of the unlawful distribution, the "one-fourth" provision can be an aid to the creditor. Manipulations possible under the bankruptcy insolvency test to minimize the liability of the directors are not possible where liability is determined by the "one-fourth" rule.[51] Assuming that full satisfaction is obtained in the suit against the directors, jointly or severally, the amount recovered because of the "one-fourth" rule will help significantly to offset the loss usually resulting from the sale of assets in liquidation. Even further protection is afforded where a cause of action against the director lies also in the corporation, and the extent of the liability of the director is determined by the amount of the loss to the creditors rather than being limited to the amount of the unlawful distribution.[52]

Though complete protection of the creditor could probably be achieved through statutory prohibition of the distribution of a reduction surplus together with a statutory requirement of periodic appraisal of the assets to determine the absence or presence of a capital impairment,

49. See for example the phrasing in CAL. CORP. CODE ANN. § 1907 (1953); MINN. STAT. ANN. § 301.39 (West Cum. Supp. 1954); NEV. COMP. LAWS § 1624 (Supp. 1949); OKLA. STAT. tit. 18, § 1.145 (1951). Though Washington does not include a restriction on the distribution of a reduction surplus, a reduction of capital is limited and a comprehensive valuation standard is included. WASH. REV. CODE § 23.24.020 (1952).

50. CAL. CORP. CODE ANN. § 1907 (1953); OKLA. STAT. tit. 18, § 1.145 (1951). See note 46 *supra*.

51. By reducing and distributing capital in several steps, the distribution which actually renders the corporation insolvent could be a very small one, thus keeping the liability of the directors at a minimum.

52. See for example CAL. CORP. CODE ANN. § 825 (1953); MO. ANN. STAT. § 351.345 (1952); N.Y. STOCK CORP. LAW § 58-58; OKLA. STAT. tit. 18, § 1.145 (1951).

the fact that such a law has not been enacted implicitly recognizes the interests of corporations in flexible capital. Even stronger reasons exist for permitting the reduction of capital. First and foremost, reduction is permitted in order to provide a means of writing off operating deficits, thereby freeing current earnings for dividends necessary to attract new capital.[53] Such losses are not necessarily attributable to poor management and related internal factors but are often solely the result of external factors beyond the control of corporate management.[54] During a prolonged period of falling prices, it may be advisable for a corporation to write down the book values of assets to correspond with present market values.[55] The recognition of operating and business-cycle losses[56] through writing down assets against earned surplus, capital surplus, and capital stock does not injure the position of the creditor and is sound accounting practice.[57] A further reason for allowing reduction exists in those jurisdictions which impose the same tax on no-par stocks as on par value stocks

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53. See KESTER, ADVANCED ACCOUNTING 542 (3rd Ed. 1933) ; Ballantine and Hills, *Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws*, 23 CALIF. L. REV. 229, 247 (1935) ; Hills, *Model Corporation Act*, 48 HARV. L. REV. 1334, 1376, n. 85 (1935) ; Callahan, *Statutory Protection of Creditors in Reduction of Capital Stock*, 2 OHIO ST. L.J. 220, 222 (1936) ; Note, 47 HARV. L. REV. 693 (1934).

See GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 639-644 (1940) for examples of how corporations have used the reduction surplus instrument to write off losses.

54. A general summary and discussion of these external factors contributing to losses is found in *id.* at 651 *et seq.* The general classes of external factors causing losses are: excessive competition, changes in public demand, the business cycle, excessive taxation, hostile regulation, adverse tariff policies, foreign factors (such as a severe depression on the Continent), and accidents of nature (fire, wind, etc.).

55. A fine analytical approach to the problem of value loss during a period of declining prices is used by one writer who suggests that capital should be viewed as a res, rather than a quantum. Such an approach calls for capitalization of asset value increment and reduction of capital when asset values fall due to fluctuations in the purchasing power of the dollar. Isaacs, *Principal—Quantum or Res*, 46 HARV. L. REV. 776 (1933). See discussion *infra* at pp. 252-253, 257. See generally MARPLE, CAPITAL SURPLUS AND CORPORATE NET WORTH 95 (1936) ; KESTER, ADVANCED ACCOUNTING 540-541 (3rd Ed. 1933).

56. By "business-cycle losses" reference is made to those decreases in asset value which are caused by the increase in the purchasing power of the dollar.

57. Sound accounting practice dictates that any loss should be written off first against earned surplus, then if the earned surplus balance has been completely absorbed, against capital surplus, and finally, if the loss has not been thereby offset, it should be written off against the capital stock account. HATFIELD, SURPLUS AND DIVIDENDS 21 (1948) ; BALLANTINE, CORPORATIONS § 227 (Rev. Ed. 1946).

The reduction of capital to facilitate writing off a loss is of no danger to the creditor in itself since it merely recognizes a loss that has already occurred. Writing down fixed assets on a falling market is all the protection that is needed by a creditor since the depreciated value may better reflect the lower cost of replacement on the depreciated market. This, however, is a valid contention only when considering long-term creditors. Those with claims currently due are interested in the satisfaction they can obtain now; they are not concerned with the ability of the corporation to continue profitable operation. See discussion of the going concern *infra* at pp. 260-261. See Comment, 44 YALE L.J. 1025, 1031 (1935).

of one hundred dollar par value. This has forced some corporations to reduce capital stock and change to par value shares of nominal amounts in order to avoid such discriminatory franchise taxes.[58] Finally, where a reorganization of the corporation is needed, the statutory reduction of capital permits the corporation to avoid the expensive and cumbersome court proceedings for formal reorganization.[59]

One of the reasons for allowing a distribution of reduction surplus is that it is sometimes desirable or necessary that the scope of the corporate activities, geographical or otherwise, be contracted.[60] Such a distribution permits the shareholder to reinvest his unproductive capital in a more profitable enterprise. Further, distribution of reduction surplus may benefit the stockholders since, under the income tax laws, ordinary dividends are subject to taxation as income, while distributions of capital are taxable only at capital gain rates, if taxable at all.[61] No injury to the creditor is present when this is accomplished by transferring portions of earned surplus to capital stock, reducing capital, and distributing the reduction surplus.

The legislatures are thus confronted with the problem of resolving the conflict between these interests of the corporation and those of the creditor seeking adequate security against operating and business-cycle losses and possible prejudicial actions of corporations. The legislatures are also interested in encouraging incorporation under the laws of their respective states in order to increase revenue directly through franchise taxes and indirectly through other revenue measures should the corporation choose to operate within the state.[62]

The result of an attempted resolution of the interests involved is that today probably no statute provides sufficient restrictions on the reduction

58. See MARPLE, CAPITAL SURPLUS AND CORPORATE NET WORTH 87 (1936); Hornberger, *Accounting for No-Par Stocks During the Depression*, 8 ACC. REV. 58 (1933).

59. This practical matter is recognized by accountants. NEWLOVE, SMITH, & WHITE, INTERMEDIATE ACCOUNTING 326-328 (Rev. Ed. 1948).

60. This is the most easily justified reason for distributing capital. Bailey, *Safeguarding the Claims of Creditors*, 4 BAYLOR L. REV. 470, 487 (1952); Note, 47 HARV. L. REV. 693 (1934).

61. Distributed reduction surplus is a distribution of capital and not taxable as income. Flint v. Commissioner of Corporations & Taxation, 312 Mass. 204, 43 N.E.2d 789 (1942); Commissioner of Corporations & Taxation v. Filoon, 310 Mass. 374, 38 N.E.2d 693 (1941). A stock dividend is not income for tax purposes. Eisner v. Macomber, 252 U.S. 189 (1919); Union and New Haven Trust Co. v. Taintor, 85 Conn. 452, 83 Atl. 697 (1912). A stock dividend is considered part of a trust res accruing to the remainderman rather than the life tenant. Bryan v. Aikin, 10 Del. Ch. 1, 82 Atl. 817 (1912).

See Adams, *Some Tax Aspects of the Complete and Partial Liquidation of Corporations*, 28 N.C. L. REV. 36 (1949); Comment, 17 U. OF CHI. L. REV. 338 (1950).

62. Statistics indicative of this fact have been presented. See Comment, 49 YALE L.J. 492, 496 (1940).

and distribution of capital.[63] If the law is to recognize fully the priority of the rights of creditors in the assets over the rights of shareholders, then further limitations on the distribution of capital seem in order. As indicated earlier, the statutory restriction providing the most adequate protection is that requiring that the fair, present value of net assets after distribution be equal to not less than one-fourth of the liabilities.[64] The true limitations are in the required ratio of net assets to liabilities and in the valuation requirement, *i.e.,* "fair, present value."

An attempt to increase the protection allowed creditors by increasing the ratio of net assets to liabilities may not only prove too restrictive in some situations, but would also fail to recognize the fact that the unsecured creditor is the one especially in need of protection.[65] The secured creditors are protected by their liens upon certain assets, the sale of which on liquidation will generally leave little or nothing for the general creditor. The unsecured creditor's real interest is in the maintenance of an adequate amount of current assets.[66] Though a two-to-one ratio of current assets to current liabilities would provide protection against loss on sale of those assets classified as current but permitted to lose their liquidity, application of such a standard in a seasonal industry would be unduly harsh. The application of a lower ratio would offer creditors little protection in a situation where it is necessary to reduce capital since it is quite probable that the current assets have lost a great deal of their liquidity.[67]

Any discussion of "fair, present value" and its determination must recognize that the value of any given asset may change in two different respects, aside from such usually recognized changes as depreciation, de-

63. A statement to this effect has been made by a noted writer. See BALLANTINE, CORPORATIONS § 270 (Rev. Ed. 1946).

64. See *supra* at p. 249.

65. Industries where heavy debt financing is the order of the day would certainly find a statutory ratio of assets to liabilities of two-to-one a most oppressive restriction. The most prominent examples of such industries are the utililties and the railroads.

66. Since the secured creditor generally looks to the fixed assets for his protection, the general creditor must look to the current assets. See II DEWING, FINANCIAL POLICY OF CORPORATIONS 733-734 (4th Ed. 1941); Callahan, *supra* note 53 at 229-231.

67. In some businesses the current ratio should exceed the two-to-one standard while in others such a ratio requirement would prove to be an unduly harsh restriction. See II DEWING, FINANCIAL POLICY OF CORPORATIONS 733-734 (4th Ed. 1941). A reasonable limitation might well be that current assets shall after a distribution of a reduction surplus exceed current liabilities by at least one-fourth. See Hills, *Model Corporation Act,* 48 HARV. L. REV. 1334, 1344 (1935).

To require a seasonal industry to maintain a two-to-one ratio would mean that in the inactive seasons the corporation would probably be forced to maintain an idle cash balance either by retaining earnings or through short-term financing. Current liabilities during the inactive season would tend to consist of incidental, overhead expenses.

The relative amount of protection afforded the creditor by any given ratio will vary between jurisdictions depending upon when the liability of the director or shareholder arises and in whom the cause of action is vested. See the discussion *supra* at p. 249.

pletion, and normal obsolescence.[68] Value of an asset may change first in the number of dollars which will be given for the asset by a willing buyer to a willing seller at different points of time in the business cycle. Secondly, the value of an asset as between two points of time in the business cycle will change with changes in the ratio of the number of dollars given for that specific asset to the number of dollars given for all other commodities.[69]

It also must be recognized that the method used to determine the value of a concern or its assets is always directly related to the purpose for which the valuation is made, the valuation for each purpose producing a different net result.[70] Assuming that "fair, present value" has been defined, that the place and time of the valuation has been noted, and that the nature and extent of the property to be valued has been determined, the remaining problem lies with selection of the method by which the valuation is to be made.[71]

Most statutes do not provide a method of valuation other than through reference to "fair, present value" which is often coupled with a provision saving the directors from liability where they have relied in good faith on the books or statements of the corporation as represented to them to be correct by the president, the officer in charge of the books, or by an independent public accountant.[72] Since this type of provision is

68. The term "asset" as used in this discussion is a shorthand term for all commodities, services, and combinations of commodities, services, or both.

No definition of "fair, present value" has been found. However, the use of this phrase in the statutes indicates that a closely analogous definition would be found in the cases interpreting "fair valuation" and "present fair salable value" under the Bankruptcy Act. "Fair valuation," 11 U.S.C.A. § 1 (19) (Cum. Supp. 1953); "present fair salable value," 11c U.S.C.A. § 107 (d) (1) (d) (1953). See cases interpreting and defining these phrases collected in 16 W. & P. 93 (Perm. Ed. 1940). These definitions are for the purpose of determining insolvency. Compare these definitions with the cases defining "fair market value" collected at 16 W. & P. 81-84 (Perm. Ed. 1940). See discussions of "fair market value" in I BONBRIGHT, THE VALUATION OF PROPERTY 54-64 (1937); PATON & PATON, ASSET ACCOUNTING 361 (1952).

69. See GRAHAM & KATZ, ACCOUNTING IN LAW PRACTICE 198-199 (2nd Ed. 1938). A particular asset may change greatly in value while the purchasing power of the dollar may remain constant. A tract of land may be greatly enhanced in value through the development of surrounding areas. PATON & PATON, ASSET ACCOUNTING 322 *et seq.* (1952).

70. There can be no intelligent valuation of property without reference to the purpose for which the valuation is made. This fact is reflected in the varying interpretations and methods of determining value found in the decisions of the courts. I BONBRIGHT, THE VALUATION OF PROPERTY 3 *et seq.* (1937).

71. I BONBRIGHT, THE VALUATION OF PROPERTY 10 (1937). The "fair, present value" of an asset or the aggregate of the assets seems to mean that price at which the corporation could sell the assets within a limited period of time. See note 68, *supra* and discussion *infra* at pp. 254-256.

72. Examples of statutes containing both a valuation standard and a provision protecting the directors from liability when relying in good faith on the corporate statements or books are: CAL. CORP. CODE ANN. §§ 829, 1907 (1953); MINN. STAT. ANN.

found in nearly one-third of the states,[73] it would seem that the legislatures recognize the book value of assets as determined "in conformity with generally accepted accounting principles"[74] to be representative of "fair, present value."[75]

Frequent criticism of the accountants' treatment of assets, however, creates doubt of the validity of the book value of assets as a measure of "fair, present value."[76] It has been suggested that when assets are carried at cost, neither of the two above described changes in value are reflected, making it impossible to achieve the true purpose of accounting, that is, to show the actual earning power of the concern.[77] Neither, it is maintained,

§§ 301.23, 301.39 (1947); NEV. COMP. LAWS §§ 1624, 1625 (Supp. 1949); OKLA. STAT. tit. 18 §§ 1.135, 1.145, 1.146 (1951).

73. ARK. STAT. ANN. § 64-605 (1947); CAL. CORP. CODE ANN. § 829 (1953); DEL. CODE ANN. tit. 8, § 141 (f) (1953); KAN. GEN. STAT. § 17-3507 (1949); KY. REV. STAT. ANN. § 271.275 (1953); MD. ANN. CODE GEN. LAWS art. 23, § 23:58 (1951); MINN. STAT. ANN. § 301.23 (1947); MO. ANN. STAT. § 351.345 (Vernon 1952); MONT. REV. CODES ANN. § 15.407 (1947); NEB. REV. STAT. § 21-178 (1954); NEV. COMP. LAWS §§ 1624, 1625 (Supp. 1949); OKLA. STAT. tit. 18, §§ 1.135, 1.146 (1951); TENN. CODE ANN. § 3759 (Williams 1942); WIS. STAT. § 180.40 (1953). One case is found, however, which holds that the director is not protected in reliance on a report of the corporation's treasurer. Cornell v. Seddinger, 237 Pa. 389, 85 Atl. 446 (1912).

74. This phrase is contained in the American Institute of Accountants approved short form of the accountant's certificate as quoted in PATON, ACCOUNTANTS' HANDBOOK 32 (3rd Ed. 1947). This certificate is affixed to the corporate statements if the independent accountant auditing the records of the firm finds that the records are actually maintained in accordance with the accepted practices.

However, if the principles by which the accountant measures the accuracy of the corporate records are faulty, then the certificate of the accountant becames nothing more than a misleading statement. SEC HOLDING COMPANY ACT, RELEASE No. 2282 (1940); PATON & PATON, ASSET ACCOUNTING 334 (1952).

75. An argument may be made that if the director were not permitted to rely on the corporate records in determining the availability of funds for distribution, it would be difficult to persuade individuals to accept the position of director.

76. It is suggested that the reflection of value changes is essential and should be attempted so that the corporate records will indicate only the true economic income of a concern. This is important in order to correct the current tendency to indirectly distribute capital. See Dean, *The Relationships of Law and Economics to the Measurement of Income*, 28 ACC. REV. 328 (1953).

The failure to show adequately the true present liquidation position of a concern in the corporate records when current accounting practices are followed may arise from the fundamental presupposition of accountancy that all economic values can be expressed in terms of a common monetary unit. This results in showing the changes in the aggregate money values of a business over a period of operation as measured by a quantum of money units but not necessarily the change as measured in present money values. See I DEWING, FINANCIAL POLICY OF CORPORATIONS 536 *et seq.* (4th Ed. 1941); PATON & PATON, ASSET ACCOUNTING 313 *et seq.* (1952); GRAHAM & KATZ, ACCOUNTING IN LAW PRACTICE 198-199 (2nd Ed. 1938).

77. Dean, *supra* note 46. The accountant has a tendency to overlook the fact that the word "cost" is not merely a figure placed on a piece of paper but is an economic quantum. See PATON & PATON, ASSET ACCOUNTING 316 (1952). The reluctance of the accountant to accept revaluations of assets in order to reflect changes in the purchasing power of the dollar can be attributed to the difficulty of incorporating such data into a system where no provision is made for handling the value changes. See PATON, ADVANCED ACCOUNTING 338 (1949).

is the true financial position of the corporation reflected.[78]

The use of an index for purchasing power of the dollar as a basis for converting the cost-of-acquisition book values of the assets to "fair, present value" presents serious problems.[79] A general price index will probably not be valid for any particular industry and a price index for a particular industry will not reflect local variations from the general industry price level.[80] Assuming the development of a valid index, the current price level should be used as the base for adjustment since the public thinks in terms of the current purchasing power of the dollar.[81] An alternate method of value adjustment would be the use of a ratio comparison to the price of a staple commodity as of the time of purchase of the asset and the time of the valuation.[82] Neither the index nor ratio adjustment will compensate for those changes in value not related to the change in the purchasing power of the dollar.

If unadjusted or adjusted book values of assets are an unreliable basis for the determination of "fair, present value," then it reasonably follows that the statutes should anticipate an appraisal of the assets, independent of the corporate records, before distribution of a reduction surplus. But in making such an appraisal if the directors rely on the

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78. ". . . the data resulting from accounting procedures based on the assumption of a fixed measuring unit are subject to inherent limitations as expressions of either financial position or earning performance." PATON & PATON, ASSET ACCOUNTING 313 (1952). See Callahan, *supra* note 53, at 232-233.

The courts have recognized that the amount available for distribution of a reduction of capital is not to be measured by the difference between capital before and after reduction but rather by the excess of the actual value of the net assets over capital as reduced. Kassler v. Kyle, 28 Colo. 374, 65 Pac. 34 (1901); Strong v. Brooklyn Crosstown R.R., 93 N.Y. 426 (1883); Cannon v. Wiscassett Mills Co., 195 N.C. 119, 141 S.E. 344 (1928); *cf.* Knoxville v. Knoxville Water Co., 212 U.S. 1 (1909); Jerome v. Cogswell, 204 U.S. 1 (1907); Shaw v. Ansaldi Co., 178 App. Div. 589, 165 N.Y. Supp. 872 (1917). See 14 C.J. Corp. § 741 (1919); BALLANTINE, CORPORATIONS § 271 (Rev. Ed. 1946); I COOK, CORPORATIONS § 289 (8th Ed. 1923); 11 FLETCHER, *op. cit. supra* note 1 § 5150; 13 AM. JUR. Corp. § 664 (1938); Notes, 44 A.L.R. 11, 40 (1926); 3 BROOKLYN L. REV. 91, 96 (1933). In determining the amount of this excess, the courts are permitted to look behind the books of the corporation. Benas v. Title Guaranty & Trust Co., 216 Mo. App. 53, 267 S.W. 28 (1924). See 13 AM. JUR. Corp. § 198 (1938). However, there seems to be a tendency on the part of the courts to overvalue assets and under-allow depreciation. On this see the discussion in II BONBRIGHT, THE VALUATION OF PROPERTY 1182 (1937).

79. See the discussion by PATON & PATON, ASSET ACCOUNTING 317-326 (1952).

80. *Ibid.* Such a general price index would be the U. S. Bureau of Labor Statistics' "Consumer's price Index."

81. *Ibid.* The task of changing all asset values or costs into terms of the purchasing power of the dollar at a fixed time could probably not be mastered with present accounting tools. To require that the base period be the current price level changes a faintly possible method of book readjustment into a maze of hopeless confusion.

82. See I BONBRIGHT, THE VALUATION OF PROPERTY 57-59, 64-65 (1937). A simple example is illustrative. A bushel of wheat is sold for $10 in 1965 and for $20 in 1966. A certain type chair is purchased in 1965 for $25. Using the bushel of wheat as the staple, base commodity, the value of the chair in 1966 is $50 (before depreciation).

current market value, they will not necessarily be declaring a lawful dividend since the courts will, at times, determine a fair market value different from the actual market price.[83] If the director is permitted to follow the "willing buyer and willing seller" standard,[84] overvaluation would naturally result since directors will be tempted to determine the corporation's willingness to sell the assets in terms of their present value to the concern.[85] A better standard would be the price at which the corporation *could*, rather than *would*, sell the asset within a limited time.[86]

Revaluation procedures seem to have some merit in showing the true financial position and earning power of the concern. Where the concern actually follows accepted current accounting practices, however, "fair, present value" can generally be approximated as accurately by deducting from the book-depreciated asset totals such items as intangibles, pre-paid expenses, and any unrealized losses.[87] Inventory valuation procedures

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83. See the discussion in I BONBRIGHT, THE VALUATION OF PROPERTY 56 (1937). However, it should be noted that probably a majority of the courts do not permit the use of market value as a measure of the assets in determining the presence of watered stock and in computing annual corporate income. 2 *id.* at 54. See note 68 *supra*. "Market value" as used by the courts takes a number of meanings. I BONBRIGHT, THE VALUATION OF PROPERTY 65 (1937).

84. The courts have generally preferred a liquidation value test of "fair valuation" in determining solvency under the Bankruptcy Act. This value, however, is one determined at a hypothetical market where willing buyers and willing sellers will exchange at fair, market values. Such a standard prohibits consideration of a forced sale. Bonbright & Pickett, *Valuation to Determine Solvency under the Bankruptcy Act*, 29 COL. L. REV. 582, 620 (1929).

85. See the discussion in I BONBRIGHT, THE VALUATION OF PROPERTY 415 (1937). Certainly, the value to the concern, as measured by the loss the concern would suffer if the asset were removed, should never be considered. This is particularly true if the loss of income through interrupted operations would be considered. 2 *id.* at 79.

86. In finding the "fair valuation" of merchandise in order to determine insolvency under the Bankruptcy Act, one court has said that "[f]air valuation . . . excludes, on the one hand, the sacrifice price that would result from an execution or foreclosure sale, and, on the other hand, the retail price that could be realized in the slow process of trade. This latter value should be excluded because it could only be gained by large expense and the many risks of a mercantile venture. 'Fair valuation' means such a price as a capable and diligent business man could presently obtain for the property after conferring with those accustomed to buy such property." Stern v. Paper, 183 Fed. 228, 230 (N. Dak. 1910), *aff'd* Paper v. Stern, 198 Fed. 642 (8th Cir. 1912). See I BONBRIGHT, THE VALUATION OF PROPERTY 44 (1937).

The use of replacement cost as a valuation base is limited to the establishment of a maximum value limit by one writer. I *id.* at 151 *et seq.* Other writers seem to favor the use of replacement cost. Tietjen, *Original Cost Basis Gives Railroads Unrealistic Valuation and Depreciation*, 86 J. ACCOUNTANCY 123 (1948). The writer just cited refers to the problems of valuation in a merger or reorganization. Another writer feels that replacement cost is a better way of adjusting book values to current price levels than the use of a price-index method. Paton, *Aspects of Asset Accounting*, 9 ACC. REV. 122 (1934). See note 82 *supra*.

87. See the provisions in OKLA. STAT. tit. 18, § 1.135 (1951). The accountant in separately listing intangibles, pre-paid expenses, and similar assets on the balance sheet gives silent recognition to the view of the law that for certain purposes only those assets can be considered in a valuation which can be used to satisfy debts directly through a

combining the "lower of cost or market" standard with either the "last-in, first-out" standard during a period of rising prices or "first-in, first-out" during a period of declining prices generally prevent the distribution of capital through overstated net earnings, or through the reduction process by keeping the inventory account at a low figure.[88] Business practice tends to keep the inventory figure in line with the current market through a constant effort to achieve a higher rate of inventory turnover.

Changes in value have their most significant effect on fixed assets. Protection for the creditor of the corporation is not likely to be lessened to any appreciable degree by an indirect distribution of capital through misstated earnings as affected by unadjusted depreciation charges. However, the position of the creditor could be materially weakened where capital is reduced and the surplus distributed in a period of declining prices, and the directors, in determining the available surplus, are permitted to rely on the unadjusted, cost-basis corporate records.[89] Here again, if the accepted current accounting practice of recognizing unrealized losses is followed, the reliance of the directors on the corporate statements as prepared by independent accountants is justified.[90]

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conversion into cash by sale. See I DEWING, FINANCIAL POLICY OF CORPORATIONS 534 (4th Ed. 1941).

In the same light, it might be advanced that the balance sheet should disclose, at least through a footnote, corporate obligations such as those arising periodically under a long-term lease.

88. The mentioned use of LIFO and FIFO not only keeps the balance sheet inventory figure at a lower amount, but it also operates to reflect a conservative income figure. A low closing inventory will increase the cost of goods sold amount and thereby lower the gross profit on sales. See I *id.* at 547, note "v" criticising the use of the "lower of cost or market" standard. The criticism there advanced is ably met by another writer. PATON & PATON, ASSET ACCOUNTING 85 (1952).

89. One writer suggests that since most mercantile and manufacturing concerns will have only a relatively small portion of their expenses represented by depreciation charges, the danger of distribution of capital through inadequate depreciation provisions is slight in those industries. In those corporations where depreciation is a significant figure, fixed charges measured by the same dollar purchasing power as measures the depreciation figure are found. Hylton, *Should Financial Statements Show "Monetary" or "Economic" Income?*, 26 ACC. REV. 503, 504 (1951). Those corporations which have a large portion of capital or fixed assets are the utilities (including the railroads), which are regulated by the SEC and the ICC respectively. Through the rate regulation of those agencies the problem of asset replacement at inflated dollar levels is probably adequately adjusted.

90. Though book recognition of unrealized losses due to the increased purchasing power of the dollar is an accepted accounting practice, one writer considers this to be the most illogical of the accepted practices. See GILMAN, ACCOUNTING CONCEPTS OF PROFIT 129 (1939).

Several important reasons have been advanced for carrying fixed assets at cost. The money measure of net income based on cost is in harmony with the understanding of the public of profit. This money measure of net income is necessary to measure the management's success or failure in buying and selling in order to obtain the most favorable price relationships. Thus the cost basis becomes a gauge of the ability of management. The cost basis of depreciation is required for tax returns and for other reports to the Federal Government. The stock exchanges also require the use of the cost basis.

To require that corporate accounts be continuously adjusted to reflect the current purchasing power of the dollar is to ask that which is a practical impossibility.[91] Though apparently valid arguments are advanced in favor of readjusting records to prevent distribution of capital, the same practical effect may be achieved through the use of footnoted, cost-basis balance sheets and statements of earnings together with restrictions on earned surplus.[92] Separate statements on a readjusted value basis should be used by directors and management in determining necessary restrictions to be placed on earned surplus before declaring dividends and the amount of reduction surplus available for distribution.[93] The protection for the creditor lies internally in a minor tightening of accounting practice which will reflect in the scrutiny given the corporate records by the public accountant in his audit.

See PATON & PATON, ASSET ACCOUNTING 330-331 (1952); Bell, *Fixed Assets and Current Costs,* 28 ACC. REV. 44 (1953).

91. Accounting is certainly not a simple art under the current principles. To upset the basic assumption that cost gives value and to attempt to pattern the accounting system as a scale of economic values would create chaos. Under the present cost assumption accuracy of accounting is only relative since many figures used are estimates. To take into consideration the purchasing power of the dollar would convert the entire structure of accounts into a collection of guesses.

92. By footnoting the balance sheet and statement of earnings, the reader can be told that the assets are carried at cost as of a certain date and that the present market value of these assets is probably greater (or less) than the depreciated book value by a certain amount. The future creditor and the shareholder then can estimate with greater accuracy their relative positions.

Restriction of earned surplus is an accepted practice. "When there are gross discrepancies between the cost and current values of productive facilities, the committee believes that it is entirely proper for management to make annual appropriations of net income or surplus in contemplation of replacement of such facilities at higher price levels." *Depreciation and High Costs,* ACCOUNTING RESEARCH BULLETIN No. 33, COMMITTEE ON ACCOUNTING PROCEDURE, AMERICAN INSTITUTE OF ACCOUNTANTS, (Dec. 1947).

It is noteworthy that twenty of the twenty-one members of the Committee assented to this statement. One member assented with qualification. Another member, Mr. Paton, did not vote. *Ibid.* Ten months after RESEARCH BULLETIN No. 33 was issued, the Committee, with four dissents, including that of Mr. Paton, reaffirmed the position taken there. (COMMUNICATION FROM THE COMMITTEE ON ACCOUNTING PROCEDURE TO THE MEMBERS OF THE AMERICAN INSTITUTE OF ACCOUNTANTS, October 14, 1948). See generally Carroll, *Some Challenges to Accounting,* 26 ACC. REV. 9 (1951).

93. Rather than attempt a compromise on the balance sheet between a reflection of the going concern values and the present liquidation values, it is better to admit that there are two distinct balance sheets, each reflecting a separate and independent picture of the concern at any given point of time. It is suggested that independent and different balance sheets could be used for creditors, investors, tax collectors, and customers. I DEWING, FINANCIAL POLICY OF CORPORATIONS 542-549 (4th Ed. 1941). See BONBRIGHT, THE VALUATION OF PROPERTY 252-253 (1937); Bell, *supra* note 90, at 53.

See also Paton, *Aspects of Asset Accounting,* 9 ACC. REV. 122, 127 (1934). Mr. Paton's recent views have apparently changed somewhat from his position in 1934 when he advocated no change in actual asset accounts on the balance sheet in order to reflect price changes. He then preferred reflecting value changes through footnotes to the balance sheet. There is then actually no inconsistency between his position then and now since he probably foresaw recovery from depression after 1934.

The "fair, present value" standard coupled with a one-fourth ratio of net assets so valued to liabilities should afford adequate protection if it could be assumed that a corporation would, when necessary, sell assets in order to meet maturing obligations. However, even where the statutes have greatly reduced the common law requirement as to the necessary consent of stockholders for an anticipated sale of assets by a solvent corporation, it is doubtful that, except in the case of the closely held corporation, a meeting of the stockholders could be arranged, the necessary consent obtained, the assets sold, and the creditor satisfied before the creditor could file suit.[94]

Though the "fair, present value" might have been realized on a voluntary sale, a forced sale even under the best conditions will prove disappointing to the creditor and corporation alike.[95] During a period of even a minor recession of the level of business activity, the creditor will realize on a forced sale only an inadequate return when compared to the "fair, present value". A forced sale during a major decline will afford the creditor little if any satisfaction. Therefore, since the protection to the creditor under the restrictions on the distribution of a reduction surplus is determined by the present liquidation position of the corporation, it would seem to follow that the statutes anticipate liquidation as the ultimate means of satisfying the creditor; and, consequently, the tendency is to destroy rather than preserve productive asset values.[96]

It was previously indicated that the law assumes reliance by the creditor on the amount of capital which a corporation represents itself as maintaining. This is only partially true. The relative amount of reliance will vary with the type of credit being extended, the nature of the industry engaged in by the prospective debtor corporation, general business conditions, the reputation of the prospective debtor for prompt payment and discounting, the relative stability of the concern, and the

94. The common law majority rule was that a solvent, going concern on the vote of the directors and with the consent of all the stockholders could liquidate its assets and distribute the proceeds to the stockholders. A strong minority held that the directors and a majority of the stockholders of a solvent, going concern could effect the dissolution. However, when the corporation is insolvent or in a failing condition, the directors can on their own authority sell the assets in order to pay debts and avoid a sacrifice price in a forced sale.

The statutes of over 40 states now permit a prosperous and going concern on the vote of the directors and a stipulated percentage of the shareholders (usually two-thirds) to sell the assets and liquidate. BALLANTINE, CORPORATIONS §§ 281, 282 (Rev. Ed. 1946). See Levy & Levy, *Liquidation of Corporate Assets other Than in the Ordinary Course of Business or by Judicial or Statutory Proceedings,* 58 COMMERCIAL L.J. 85, 86 (1953).

95. See II DEWING, FINANCIAL POLICY OF CORPORATIONS 1444 (4th Ed. 1941).

96. See Blum, *The "New Directions" for Priority Rights in Bankruptcy Reorganizations,* 67 HARV. L. REV. 1367, 1371, 1374 (1954); GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 654 (1940); Comment, 49 YALE L.J. 492, 502 (1940).

dynamic capacity of the concern as reflected in the energy and effectiveness of the active management in development of the concern and the securement of profits.[97] Primary emphasis is and should be placed on the ability of a concern to earn profits.[98]

The "going concern" theory of corporate accounting is the currently accepted standard and portrays the earning potential of a corporation.[99] The balance sheet under the "going concern" concept does not attempt to reflect market values but rather is a summary of the storehouse of work units which will be consumed in the income-producing activities of subsequent periods.[100] In this capacity the balance sheet is now viewed as of lesser importance than the statement of profit and loss.[101] This "going concern" value assigned to the assets on the balance sheet may, if preserved, afford the creditor real protection by facilitating the procurement of future revenue from which the creditor may be paid. An attempted sale of such an asset which may have become obsolete through new technological developments would produce only scrap value.[102] A second

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97. See WALL, ANALYTICAL CREDITS 92 *et seq.* (1921), which classifies business risks as static, dynamic, and general conditions of the times. The static risk is determined by a balance sheet analysis of the amount of capital as an asset shrinkage cushion. *Ibid.*

The various sources of credit information are certainly evidence of the fact that the trade creditor does not rely alone on capital in extending credit. Trade check lists, banks, mercantile agencies, the press, acquaintances, and the subject himself are all potential sources of credit information. *Id.* at 15 *et seq.;* see BECKMAN & BARTELS, CREDITS AND COLLECTIONS IN THEORY AND PRACTICE 96 (1949).

The creditor who is engaged in an industry with a rapid inventory turnover and a small profit margin per sale is interested in payment without resort to legal procedures. The expense of litigation in many cases would not only consume the profits on the sale, but be equal to or greater than the entire amount that could be recovered.

98. A creditor may be compared to a farmer, who does not feed hay to a horse in order to increase its weight and realize the invested cost of the hay when the horse dies and is sold to a fertilizer establishment, but rather to give the horse energy and realize the value of the invested hay through the work the horse will do in pulling his plow. A similar adaptation of the working horse analogy has been used. I DEWING, FINANCIAL POLICY OF CORPORATIONS 541, note "n" (1941).

99. "The going business, the combination of permanent property, of current capital and of . . . intangibles . . . is not an aggregate of producer's goods, but an organized instrument for bringing wealth into existence." I *id.* at 296.

100. The concept of the going concern supports the practice and theory prevalent in accounting today of reflecting on the balance sheet costs that are assignable to future activities rather than values which would be realized on the sale of those assets in a liquidation. KARRENBROCK & SIMONS, INTERMEDIATE ACCOUNTING 42 (1953). See REITER, PROFITS, DIVIDENDS AND THE LAW 242 (1926). See the discussion in LaBelle Iron Works v. United States, 256 U.S. 377, 393 (1921).

101. The purpose of a business is to produce income. Therefore, the statement showing the extent to which it has reached its goal is of prime importance. I DEWING, FINANCIAL POLICY OF CORPORATIONS 539 (1941).

102. *E.g.,* X manufacturer of shoes is using style A stitching machine which has been obsolete for several years because of new modifications. All other manufacturers of shoes have installed the machines with the new modifications. However, through generally efficient production, X is able to produce the same shoes at the same price and profit as his competitors. Later due to external factors X becomes insolvent and must

important result of the "going concern" concept is the recognition of organization values which only exist as an inseparable part of the going concern.[103] The actual computation of organization values generally occurs only in a situation of merger, consolidation, reorganization, or sale of a controlling interest.[104]

It must be emphasized that these "going concern" values will exist only as long as the life of the concern is preserved. The corporation in financial difficulty should therefore be reorganized rather than liquidated to protect the creditor.[105] Reduction of capital is, in effect, a reorganization of a corporation, though accomplished informally and outside of the courts.[106] That the legislatures favor such informal reorganization, thereby relieving the burden on the courts, seems evident in that all states either expressly or by implication permit the reduction of capital.[107]

Where the reduction is necessitated by losses caused by increase in the purchasing power of the dollar, however, an apparent injustice results

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either liquidate or reorganize. The sale of the stitching machine would bring the creditor only scrap value since no other manufacturer could use it. However, by reorganizing the corporation and permitting production to continue, the essential stitching machine will facilitate the production of more shoes which can be sold to satisfy the creditors. See I *id.* at 289-290.

103. Organization values fall into three classifications: (1) internal management techniques, liaison, and relations, (2) business relations with those outside of the enterprise, and (3) files and records, experience, formulae and methods of operation, patents, trade names, etc. I *id.* at 291.

104. See PATON, ACCOUNTANTS' HANDBOOK 868 (3rd Ed. 1947).

105. See GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 654-656 (1940); Blum, *supra* note 96. The natural process to follow especially when a large corporation is in financial difficulty is to reorganize rather than to liquidate. Littleton, *The Dividend Base,* 9 ACC. REV. 140, 145 (1934).

106. The SEC has defined "quasi reorganization" to be that procedure in which corporations ". . . without the creation of a new corporate entity and without the intervention of formal court proceedings, is enabled to eliminate a deficit whether resulting from operations or the recognition of other losses or both and to establish a new earned surplus account for the accumulation of earnings subsequent to the date selected as the effective date of the quasi-reorganization." SEC, ACCOUNTING SERIES RELEASE No. 25 (May 29, 1941). Suggested principles to be followed by the accountant in a quasi-reorganization are listed and discussed by Werntz, *Some Current Problems in Accounting,* 14 ACC. REV. 117 (1939).

Accountants agree that where a quasi-reorganization has occurred, the new earned surplus account should be dated as of the date of the reorganization. This dating will stand as notice to creditors and investors that a new earned surplus account has been started and that probably a quasi-reorganization has occurred. See BALLANTINE, CORPORATIONS § 272 (Rev. Ed. 1946); NEWLOVE, SMITH & WHITE, INTERMEDIATE ACCOUNTING 326-328 (Rev. Ed. 1948); *Quasi-Reorganization or Corporate Readjustment—Amplification of Institute Rule No. 2 of 1934,* ACCOUNTING RESEARCH BULLETIN No. 3, COMMITTEE ON ACCOUNTING PROCEDURE, AMERICAN INSTITUTE OF ACCOUNTANTS (Sept. 1939).

107. The statutes of those 35 states expressly providing for the reduction of capital are cited at note 31 *supra.* The rest of the states permit amendments of the corporate charter to change par value of shares and to decrease the amount of capital stock which in effect are grants of statutory permission to reduce capital. *E.g.,* see ALA. CODE tit. 10, § 18 (Cum. Supp. 1953).

in causing the stockholder to bear the entire burden of such losses. The creditor in real terms is enriched while the stockholder suffers real loss. This injustice is recognized in reorganizations under Chapter X of the Bankruptcy Act where, though the "absolute priority" theory of valuation is the stated rule, in application the exceptions and modifications seem to achieve some sort of compromise between the "absolute" and "relative" priority theories.[108] The rulings of the courts under Chapter X proceedings seem to justify a suggestion that creditors need no longer, in light of the current tendency to reorganize rather than liquidate, be distinguished so sharply from stockholders since both are actually contributors of assets to which both look, under different contract terms, for the return of the investment.[109]

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108. The absolute and relative theories of priority rights in corporate reorganizations were first given their names in 1928. Bonbright & Bergerman, *Two Rival Theories of Priority Rights of Security Holders in a Corporate Reorganization*, 28 COL. L. REV. 127 (1928). The absolute theory calls for priority of principal, giving the senior security holders complete satisfaction before the junior holders may participate. The measure of complete satisfaction in a reorganization, since there can be no distribution, is the fair value of the new securities issued in exchange for the old. The relative theory calls for an exchange of securities with approximately the same income claims and which have priority over any securities issued to the junior security holders allowed to participate. Under the first theory, junior security holders probably will not be able to participate in most reorganizations while under the second they may. An exception to the second theory arises when new capital is contributed by a group. Since the new capital benefits all concerned, the securities given in exchange for that new capital may be granted priority even over those securities issued to the former holders of first mortgage bonds.

Both theories have certain shortcomings and therefore it is believed that some compromise of the two should be adopted. *Ibid.* In practice the reorganizations seem to be a compromise between the two theories. II BONBRIGHT, THE VALUATION OF PROPERTY 867-870 (1937).

The Supreme Court has expressly held that the absolute theory is to be followed in reorganizations. Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939); Northern P. Ry. v. Boyd, 228 U.S. 482 (1912). The Court does recognize that the new securities issued need not be of the same quality (having liens in the same assets or an absolute, contractual right to interest) as long as the holders of the old securities are compensated for their loss in quality with an issue of an increased reorganization dollar quantity of securities. Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510 (1941). See Blum, *The Law and Language of Corporate Reorganization*, 17 U. OF CHI. L. REV. 565, 593 (1950) for a discussion of "reorganization currency." One writer, however, in discussing the absolute priority theory in connection with the *Consolidated Rock* case, feels that this decision limits the absolute theory to no more than an ideal. This view is based on the holding of the Court that the question of the fairness and feasibility of a reorganization plan lies in the informed discretion of the district court. II DEWING, FINANCIAL POLICY OF CORPORATIONS 1362 (4th Ed. 1941).

See the following for an interesting treatment of the two theories: Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization: New Directions*, 67 HARV. L. REV. 553 (1954); Blum, *The "New Directions" for Priority Rights in Bankruptcy Reorganizations*, 67 HARV. L. REV. 1367 (1954); Billyou, *"New Directions": A Further Comment*, 67 HARV. L. REV. 1379 (1954).

109. It has been suggested that creditors and stockholders alike be considered suppliers of capital and that their interests be referred to as capital supply contracts. This would facilitate reorganization of corporations through mutual agreement of the parties

To include all reductions of capital under the Bankruptcy Act, requiring regnlation of such reductions by the courts, would be to recognize the reduction of capital as, in effect, a reorganization. Since regulation by the courts would place a tremendous burden on them, it might be better, however, to provide for regulation by an administrative body. This has already proven successful in the public utility field.[110] Whether constitutional power could be found, in this area, to allow for regulation of all corporations under a federal act is doubtful.

A more satisfactory solution would be administrative regulation by the states, a modified form of which is already found in the Texas corporation statute.[111] Full review by a state administrative body of the application by a corporation for permission to reduce capital or distribute a reduction surplus would accomplish the same goals as the English courts in their supervision of the reduction of capital.[112] Not only would the creditor be permitted to present his case before the reduction actually occurred, but the real gains and losses of creditors and shareholders resulting from the fluctuations in the value of the dollar could be adjusted.

One basic reason why administrative regulation of the reduction and distribution of capital probably has not been attempted may well lie in the fact that such regnlation would actually permit adjustment of real economic gains and losses between the stockholders and the creditors in the reduction situation. It may seem proper that the law permit one to realize in profits only his actual contribution to the increment in value of a commodity as measured by the conversion of the values of all component parts of the commodity into values determined by the purchasing power of the dollar at the time the commodity is sold in the market. However, it must be recognized that, carried to its logical extreme, the result

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under state supervision. Littleton, *The Dividend Base,* 9 Acc. Rev. 140 (1934).

110. For insight into possible operation of administrative regulation of corporations in this area see Public Utilities Commission of District of Columbia v. Capital Transit Co., 214 F.2d 242 (D.C. Cir. 1954) in which the Public Utility Commission of the District of Columbia attempted to enjoin the possible distribution of the capital of a utility.

See also Luce, *Trends in Modern Corporation Legislation,* 50 Mich. L. Rev. 1291, 1312 (1952).

111. This statute permits the Secretary of State to require the payment of certain creditors before reduction may be accomplished. Tex. Stat., Rev. Civ. art. 1332 (1948). See Bailey, *Safeguarding the Claims of Creditors,* 4 Baylor L. Rev. 470, 479-482 (1952); Seward, *Sources of Distributions to Stockholders,* 5 Baylor L. Rev. 242 (1953); Comment, 44 Yale L.J. 1025, 1042 (1935).

112. Before an English corporation may reduce its capital, a court order confirming the resolution of the corporation to reduce capital must be obtained. The court publishes a list of creditors when the corporation applies for the order. This list may be amended to admit the names of creditors not there listed. The creditor is permitted to enter court and object to the reduction. The court may order payment of claims or that security be provided for payment before it will permit the reduction. 11 & 12 Geo. 6, Ch. 38, §§ 66-71 (1948). See Comment, 44 Yale L.J. 1025, 1049-1053 (1935); Notes, 47 Harv. L. Rev. 693, 698 (1934); 21 Va. L. Rev. 562, 564 (1935).

of such adjustment in all transactions would be to place all individuals in a society on the same economic plane.

Existing laws and legal institutions do not generally attempt to make adjustments for the changes in the purchasing power of the dollar between the time a debt is contracted and the time of payment.[113] Accounting practice recognizes the relative ability of management to secure in profits more than the actual contribution of a firm to the increment in value of a commodity. The relative economic position of an individual or a firm in the American society today is, therefore, more likely a measure of the relative contribution of individual ability and effort. Appreciation of this postulate has undoubtedly operated to deter the enactment of legislation permitting administrative or judicial supervision of all corporate reductions and distributions of capital. The social and political implications of the problem are self-evident and will undoubtedly be the primary factors in the initiation of any major change in legislative policy in this area.

Another limitation on the use of such administrative control over corporate reductions of capital lies in the difficulty of applying such principles to the small corporation where organization values are negligible if they exist at all. The creditor of the small corporation finds little protection in anticipated earnings of the corporation and actually bases his reliance on the represented capital and the personal integrity of the individual operating the firm.

It then seems that any immediate legislative action is limited to efforts to secure uniform state laws. In the interest of the creditor, revisions of the statutes should include the provision that no distribution of a surplus arising from the reduction of capital shall be permitted unless the fair, present value of the net assets remaining after distribution shall be at least equal to one-fourth of the liabilities. The uniform adoption of this limit on distribution of a reduction surplus, though not providing absolute protection for the general creditor, does provide a definite, determinable cushion against losses in asset value. The necessity for managerial freedom presently outweighs the need for any additional safeguards for creditors.[114] Management is given a better opportunity to provide for interests of the many small stockholders who probably need

113. See PATON & PATON, ASSET ACCOUNTING 317 (1952).

114. See KEHL, CORPORATE DIVIDENDS 17 (1941); Berle, *Investors and the Revised Delaware Corporation Act*, 29 COL. L. REV. 563, 564-565 (1929). It may be advisable to include a provision imposing liability on directors when a distribution is made while current assets are or which reduces current assets below a limit of one and one-fourth times current liabilities. See Hills, *Model Corporation Act*, 48 HARV. L. REV. 1334, 1343-1344 (1935).

as much protection today as creditors.[115] Until present economic, social, and political sentiments so change as to cause a general shift in the legislative policy governing the regulation of corporations, it seems that "quasi" or "accounting" reorganization must be preserved unregulated except for the deterrent liability on directors and stockholders when a distribution of reduction surplus violates applicable statutory restrictions.

LOCAL-STATE RELATIONS IN INDIANA: PROPOSED CHARTER MAKING POWERS FOR MUNICIPALITIES

The extent to which cities and towns[1] in Indiana should be permitted to govern themselves has been a subject of constant controversy.[2] To the many individuals who inhabit these political subdivisions[3] the question of home rule[4] is more than academic. The manner of government under which they live affects materially the amount of taxes they

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115. See Dodd, *Statutory Developments in Business Corporation Law, 1886-1936,* 50 HARV. L. REV. 27, 58 (1936).

1. Indiana cities are divided into five population groupings by statute. IND. ANN. STAT. §§ 48-1201, 48-1202 (Burns 1950). Towns are incorporated places of 1500 persons or less. However, some of those having more than 1500 population are still classified as towns since they have not held the necessary elections to become cities.

2. For a while the Indiana Supreme Court followed the inherent right doctrine enunciated by Judge Cooley in Michigan. People *ex rel.* Le Roy v. Hurlbut, 24 Mich. 44, 9 Am. Rep. 103 (1871). The gist of the doctrine is that, in the absence of any express provision in state constitutions, cities and towns have certain inherent rights of self-government which cannot be interfered with by the legislature. Evansville v. State, *ex rel.* Blend, 118 Ind. 426 (1889); State *ex rel.* Holt v. Denny, 118 Ind. 449 (1889); State *ex rel.* Geake v. Fox, 158 Ind. 126, 63 N.E. 19 (1902). The Indiana cases have never been expressly overruled but have since been interpreted as holding that the inherent powers are identical with those commonly designated as implied or incidental powers essential to enable municipal corporations to accomplish the purposes for which they are created. Logansport v. Public Service Commission, 202 Ind. 523, 529, 177 N.E. 249, 251 (1931). The inherent right doctrine has also been regarded as an exception to the general rule that the legislative power of the state is limited only by the express provisions in the constitution. State *ex rel.* Schroeder v. Morris, 199 Ind. 78, 88, 155 N.E. 198, 202 (1927).

For a detailed critical analysis of the inherent right doctrine see McBain, *The Doctrine of an Inherent Right of Local Self-Government,* 16 COL. L. REV. 190-216, 299-322 (1916).

3. According to the 1950 United States Census, 2,217,468 persons, or nearly sixty percent of the total population of Indiana, reside in cities and towns. INDIANA STATE CHAMBER OF COMMERCE, STATISTICAL ABSTRACT OF INDIANA COUNTIES 7 (1954).

4. The term "home rule" has several connotations. In the sense that cities and towns may choose their own officers to administer local government they have always had home rule. However, as referred to here, it involves not only the right of cities and towns to choose their own officers but also the authority to determine for themselves their form of government and to make policy decisions in municipal matters without first securing the assent of the legislature. MOTT, HOME RULE FOR AMERICA'S CITIES 6 (1949).