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A CONCISE TEXTBOOK ON LEGAL CAPITAL

SECOND EDITION

. . . Being a General Exposition and Critique, for Law Students and Others, of Corporation Law Regulating Corporate Capital Accounts, Par and No Par Stock, Stated Capital, Distributions to Shareholders, Equitable Contribution by Shareholders, Promoters' Liability and Related Mysteries

By

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A CONCISE TEXTBOOK ON LEGAL CAPITAL

Part One

THE LEGAL CAPITAL STATUTES—ANALYSIS

Part One of this book is an analysis of the central concepts of modern legal capital statutes and doctrine. Part Two surveys a sequence of typical corporate financial transactions to illustrate the legal capital statutes at work. Neither of these Parts is likely to be well understood without the other.

Part Three provides an updating of some recent developments in the field, and presupposes a grasp of the first two Parts.

Chapter I

THE PROBLEM—CORPORATE CREDITOR AND CORPORATE SHAREHOLDER

The interests of creditors of a corporation and the interests of shareholders of a corporation are likely to conflict whenever assets of shareholders are to be committed to the corporation's treasury and whenever assets are to be distributed to shareholders from the corporate treasury. The legal apparatus built by common law and statute around the concept of "legal capital" is fundamentally aimed at striking a partial accommodation of that conflict of interests.

A. THE CREDITOR'S PERSPECTIVE

1. Creditors—General

The legal term "creditor" implies a single basic proposition. Except in extraordinary circumstances (as when, for example, a

debtor has received a bankruptcy discharge or holds a homestead exemption) a creditor has, subject to the special terms of the credit, a higher and prior claim to the assets of his debtor than the debtor has himself. When a loan or other class of creditor's claim has become due and payable, the creditor may, in normal course, enlist the engines of the law to compel his debtor to pay the debt, regardless of the consequent diminution of the assets that "belong" to the debtor. Though the term "priority" is usually reserved in the law to describe relationships among claimants other than the debtor, in a basic sense it may be said that the creditor's claim against the assets of his debtor is "prior" to the debtor's own claim to "his" assets. "Prior" in this sense has no relationship to the concept of time; it relates to hierarchy of claim. If the debtor has just enough assets to pay the creditor's claim, the creditor gets them all, i. e. his claim is "prior," and the debtor gets nothing.

General creditors are those creditors who are not secured creditors. A secured creditor is a creditor who, in addition to his creditor's claim, has a mortgage or other lien interest in particular assets of the debtor. Since all claims of all creditors to the assets of the debtor have priority over the debtor's claim, the secured creditor does not by force of his security interest in particular assets of the debtor gain in priority vis-a-vis his debtor. The purpose and effect of the mortgage or other lien interest obtained by the secured creditor is to achieve a preferred position as against, not the debtor, but other creditors. If, at the critical time for payment, the debtor has enough assets to pay all creditors, the secured creditor's security is irrelevant since he will be paid in any case. But if the debtor's assets are not sufficient to pay all the creditors' claims outstanding against him, some creditors will come out short. The creditor who has in some manner obtained a lien on particular assets of the debtor has, in effect, the opportunity to claim those assets for the full and complete payment of the debt owing to him, even if they are the only assets so that the dedication of the lien assets to his debt means that other creditors will receive nothing at all. Until paid, the secured creditor is "prior" to general creditors to the extent of the value of the assets that are subject to the secured creditor's lien.[1] The general creditors have no claim against the assets under the secured creditor's lien except to the extent that the value of the assets exceeds the secured creditor's claim.

1. The creditor, or class of creditors, may be persuaded, of course, to agree that its claim against the debtor's assets will rank below that of other creditors, or other particular classes of creditors, though still ahead of the debtor's claim to the assets. Such a creditor is said to be a "subordinated creditor," and his claim is called "subordinated debt."

Speaking generally, therefore, from the perspective of any single general creditor:

- he is more likely to be paid and is thus better off the more assets the debtor has on the payment date;
- he is adversely affected by an increase in the aggregate of outstanding claims of general creditors against the debtor since in any ultimate showdown, all the general creditors will share equally in the limited assets of the debtor; and
- he is more adversely affected still by the creation or existence of secured creditors, for in the showdown, the secured creditors will, to the extent of their security, be able to assert a claim prior to all general creditors.

2. The Creditor of the Individual Proprietorship or Partnership

When a creditor lends money to an individual, or allows him otherwise to become indebted to the creditor, the assets to which the creditor may generally look for payment of his claim are made up of the aggregate of the debtor's assets that have not earlier been placed under lien to some secured creditor. The creditor, may, of course, insist as a condition of his loan that he be empowered to pursue assets in addition to those owned by his debtor; he may, for example, require some device like a third party guaranty, a third party endorsement, or a third party pledge agreement. Occasionally, too, the law will step in to help a creditor reach assets beyond those of his debtor; thus a creditor may in some circumstances be able to reach the assets of a father for an indebtedness incurred by a child, or those of a husband for indebtedness incurred by a wife. But except for such special situations, (i) the creditor's *only* resort is the pool of unencumbered (unmortgaged) assets belonging to the debtor and (ii) *all* of the unencumbered assets of the debtor are at jeopardy for payment of the creditor's claim.

The second of these two propositions is more significant and less inevitable than may appear. Suppose B, a wealthy man, holds net unencumbered assets worth $1,000,000 made up of $950,000 in real property and a $50,000 sole proprietorship interest in a small suburban barber shop. Suppose, further, that the barber shop needs $20,000 worth of new furnishings and that, for whatever reason, B decides to borrow the money to pay for them. L, the lender, fully understanding that the money is to be used for the barber shop fixtures, and having satisfied himself that the profit potentials of the barber shop are such as to give promise that the loan can be paid off out of the proceeds of the barber shop business, thereupon lends B the $20,000.

In these circumstances, it might be argued that, when the time for payment comes, L should have no resort to B's assets beyond his property interest in the barber shop. But the law is to the contrary, and *all* of B's unencumbered assets—his "personal" as well as his "business" assets—will be held equally answerable to pay off L. L's claim is not limited to the assets of the enterprise for the use of which the loan was made. All of B's assets are at jeopardy. B is said to have "unlimited liability". The term is not a particularly apt one; B's liability is in fact limited in two ways—first by the size of the creditor's claim and second by the aggregate unencumbered assets that B has. But no matter. L, in considering whether to make the loan for purposes of the barber shop business, may assume that whatever unencumbered assets B may have when the loan becomes due (or, indeed, acquires thereafter) will be available to him (and other general creditors) for payment of his claim.

In substance, the same situation obtains, and the same results follow, if the borrower is a business enterprise conducting its affairs in the form of a partnership having partners P, Q, and R. Even though the loan be exclusively for the partnership enterprise, the law of partnership treats the loan as though each partner had been an individual borrower of the full amount of the loan. The lender may therefore, on the day of reckoning, look for his payment not only to the assets held in common in the business enterprise but to all unencumbered assets owned by each of the partners.[2] Again, the liability of each of the partners is said to be "unlimited".

In the case of a loan by L to B who has an individual proprietorship interest in an enterprise, or a loan by L to a partnership enterprise, L has an obvious and vital interest in seeing to it that the assets of the individual or of the partners are not dissipated before he is paid off. L will therefore not only investigate the asset condition of the individual, and of the partners, before he makes the loan, but he may seek to obtain a security interest in B's assets and/or seek to limit in some way his borrower's power to put assets beyond L's reach. L can do little or nothing to insure that B's investment portfolio will retain its market value, or that his other holdings will retain their value; but he may have at least a chance, by contract, to prevent B from engaging in certain transactions that could have the effect of leaving the creditor high and dry at the critical moment. L would like, for example, to prevent B from transferring all of his assets to his wife or children; and L will be very unhappy if B is left free to borrow more money from another lender or, worse, to pledge or mortgage his assets to another lender as security for another loan. Finally, L might like to try to keep B from living too high on the hog pending payment of the debt; enough yachts, trips around the world, and visits to casinos, and B's assets will have likely shrunk to nothing by the time L pounds on the door to collect his debt.

2. Of course, the lender who gave credit for the uses of the partnership enterprise may well, on maturity date, find himself locked in a struggle with personal creditors of the partners, where the sum of the partnership assets and the partners' assets is insufficient to meet both kinds of claims. Out of this situation arises the equitable procedure of marshalling assets and the principle that partnership creditors have prior claim to partnership assets, and personal creditors of the partners have prior claim to personal assets—embryonic recognition of the enterprise as an independent entity. See Uniform Partnership Act § 40(h), codifying the rule of *Rodgers v. Meranda*, 7 Ohio St. 180 (1857); see generally, Crane & Bromberg, Law of Partnership §§ 91 and 91A (1968).

To generalize, there is a particular pot of assets to which the creditor L knows that he must look for payment. From his perspective, it is critically important that the assets in that pool be substantial when the loan is made and that, so long as the loan is outstanding, B's uses of the assets be limited in a way that will prevent their being dissipated, leaving L holding an empty bag. A prudent creditor will seek to protect himself by close investigation before the loan is made and by extracting from B some restrictions on B's power of disposition of his assets during the period of the loan. L cannot, and will not try to, protect himself against all the risks to which he subjected himself by making the loan; he accepts as inevitable what may be called the business risks inherent in the situation—the risk that the barber shop will go broke as young men around the world suddenly decide to let their hair grow long, like their ancestors, or the risk that the bottom will fall out of the real estate and other markets as people conclude that it is more pleasant to live in the sea, like their ancestors.

3. The Creditor of the Corporation

Much is usually made of the proposition that the hallmark of the corporate form of business enterprise is "limited liability." The statement is not untrue, but it deserves somewhat closer attention than is usually given to it.

As a matter of history, it is at least worth noting that the feature of limited liability to which so much importance appears to be attached today, played little or no part in the development of modern corporation law. The law of corporations grew up not out of law of commerce but as an offshoot from the public law area of municipal government. The device of the corporate

charter, and of the implied separate corporate entity, found its appeal as a device for (i) providing a continuity of enterprise and of property ownership that would legally survive the death of individual participants in the enterprise, (ii) providing a semi-political vehicle for the grant of monopolies, such as the tobacco trade in a particular area, or a toll bridge, and (iii) providing a functional administrative structure that could simultaneously mobilize capital investments from many individual investors while offering a machinery for centralized decision making. Even when the corporate form had advanced so far as to be embodied in general corporation laws in the middle of the 19th century, limited liability for shareholders was not uniformly provided for in the general corporation laws in this country, and in England the Companies Act did not provide for generalized limited liability for corporate shareholders until 1862.

History aside, it is important to understand that modern corporation law does not "provide for" limited liability; what it does is provide that in the case of creditor claims against an enterprise in corporate form, *the corporation is the debtor* rather than those who hold claim to the proprietorship capital in the enterprise. Once that step is taken, the creditor law of the corporation exactly parallels the law of individual indebtedness and of creditors of individuals. As in the case of any debtor, the creditors of the corporation have a claim to the assets of the corporation that is prior to the corporation's own claim as "owner". The creditors' claim to the corporate assets is also axiomatically prior to the claim of the proprietorship investors—the shareholders. And the creditors' claim extends to *all* the assets of the debtor corporation. If necessary, the entire assets of the corporation must be devoted to payment of creditors of the corporation, even though nothing is left for the corporation and its proprietorship owners. Furthermore, as in the case of almost all debtors the creditors of the corporation must, in usual course, find their payment from the pool of assets that belong to the debtor corporation. If the assets of the corporation are insufficient to pay the claims, in the absence of some special guaranty a creditor can no more expect to pursue assets beyond the debtor corporation's assets than a creditor of an individual can expect that payment of a debt owed by that individual can be extracted from some other individual.

Thus, the creditor of a corporation has the same kind of economic interest as the creditor of a human individual and is subject to the same kinds of risks as the creditor of the individual. Similarly, the corporate creditor tries to resort to many of

the same devices to enhance the likelihood that his corporate debtor will have sufficient funds in hand to pay off the debt when maturity comes. As a part of the bargain negotiated when the corporation incurs the indebtedness, the creditor may, of course, succeed in extracting from a shareholder (or someone else who wants to see the loan go through) an outside pledge agreement, guaranty, endorsement, or the like that will have the effect of subjecting non-corporate assets to the creditor's claim against the corporation. Such protective arrangements are common when the corporation is closely held and not well funded. But in the general conduct of corporate enterprises, the creditor cannot exact such extra protection. In the usual case, therefore, it will be a matter of major concern to the creditor of the corporation to seek four objectives—precisely as in the case of the lender to an individual debtor.

(1) The creditor will be happier if his corporate debtor has substantial assets in the corporate till at the time he extends credit and thereafter;

(2) The creditor will want to prevent the corporation from incurring debts to other general creditors with whom he may have to share the corporation's limited assets;

(3) The creditor will want the corporate assets to remain free and unencumbered of any lien interests by a prior (secured) creditor; and

(4) The creditor will want to preserve a cushion of protective assets, and will want to see to it that no claimants who rank junior to him (usually shareholders, but sometimes subordinated debt holders) make off with assets of the corporation while the creditor's claim is still outstanding and unpaid.

Note again that even if the creditor should happen to be so fortunate as to achieve all four of these protections—which he seldom does—still he has, by making the loan, put his funds at risk of the basic *commercial* vicissitudes of the debtor enterprise. If the market for the enterprise's product disappears, or the market value of the assets it holds drops through the floor, the creditor is apt to be left to whistle for his claim. Absent some special arrangement for recourse to assets lying outside the corporate enterprise, as through a shareholder's personal guaranty, the creditor has no protection against such commercial risks except his own skill in predicting whether an enterprise will or will not make enough return to pay out the loan with interest. In the long pull, there is no security for enterprise creditors (or any other investors) other than the profitability

of the enterprise. This uncontrollable inherent commercial risk of the enterprise stands in marked contrast to the creditor's other risks—the risk that the corporate debtor might incur additional debt, or might distribute assets to the junior proprietorship investors, the shareholders. Those managers who control the business affairs of the corporate enterprise cannot determine what will happen to the general market, but they can determine whether indebtedness or distributions occur. Since the occurrence or non-occurrence of these events *are* amenable to managerial decision, they can be proscribed or limited by contract or by general law. And they often are.

To summarize the perspective of the lender to the corporation —he is willing to make the loan on the terms negotiated and assume the commercial risks that are inherent in it. But if he could have things all his way: the pool of corporate assets would be large; there would be no other creditors; the only other claimants to the pool would be the shareholders, whose claim is junior to his; the corporation would be forbidden from incurring later indebtedness, and especially secured indebtedness; and no assets of any kind would be permitted to be distributed out of the corporate pool to shareholder investors until the creditor had been paid off in full.

The legal doctrines revolving around the concept of "legal capital" developed as a partial response to, and was mainly attributable to, this perspective of the creditors of corporations. Before the accommodation reached by the legal capital system can be appreciated, however, it is necessary to take a look at the shareholder's perspective of the matter.

B. THE SHAREHOLDER'S PERSPECTIVE

1. Payouts to Shareholders

The ideal world as conceived by the creditor of the corporation is a world that is normally wholly unacceptable to the shareholder. The investor who buys shares of stock in the incorporated enterprise and the investor who lends money to the incorporated enterprise, are, as a matter of economics, engaged in the same kind of activity and are motivated by the same basic objectives. They are both making a capital investment; they both expect or hope to get their money back in the long run, either by liquidating pay-out or by sale of the security; and they both expect and hope to receive income from their investment in the interim before their capital is returned to them in full. In the stereotypic model transaction, the investor who chose to take a shareholder's position rather than a creditor's

position in a particular transaction, simply made a calculated economic judgment that he could make more money by relinquishing to creditor investors a "prior" claim for interest and a fixed principal payment on maturity, and, by opting for uncertain "dividends" and the residual claim to the assets of the enterprise that would remain after all creditors, with their fixed claims, had been paid off.[3] The shareholder's willingness to admit the "priority" of the creditor's interest claim and claim for principal payment on maturity, does *not* imply, however, that the shareholder is willing to stand by chronologically until such time as the creditors have been paid in full. The shareholder will insist, in general, that if, as he hopes, the enterprise makes money (and perhaps even if it does not), the shareholders will receive some return on (or of) their investment from time to time, regardless of the fact that there are creditor claims outstanding. Such periodic payments to shareholders are characterized as "dividends"; and, in the usual and normal case of the healthy incorporated enterprise, it is assumed that some assets will be regularly paid out from the corporate treasury to the shareholder investors in dividend form.

3. This stereotypic model, like the other illustrative models used here, is grossly oversimplified.

In the first place, it groups together as a unitary interest all those characterized as "shareholders". Even as creditors may be arrayed along a spectrum of claim from secured to subordinated, shareholders are often divided among themselves into subclassifications of hierarchical claim by the creation of different classes of stock, each class having a differentiated claim to dividends, liquidation payments, voting rights, etc. In usual parlance these classes are spoken of as either "preferred" or "common", but the usage is misleading, since the various classes (or series) may be almost infinitely varied in their terms and still remain "stock" so long as their claim to liquidation payment falls hierarchically below the lowest ranking creditor's claim in liquidation. As a result, clashes of interest *among* shareholder classes may in some circumstances be as intense as, or even more intense than, the more generalized clash of interest between shareholders as a whole and creditors as a whole.

Second, the investor's choice as between the debt or equity position will be influenced as well by his tax position, marginal preferences as to growth potential versus current income, concern with voting power, estimates about inflationary or deflationary trends, equity-debt leverage, and many other considerations. Moreover, in the hands of sophisticated financial lawyers, the equity-debt difference itself blends into a grey continuum in the cases of convertible debt, debt with warrants, income debentures, etc.

Finally there is no necessary correlation in any case between the lawyer's characterization of the security and the economic deal that underlies it; for example, the "common stock" of the Carolina & Clinchfield RR Co. each year pays a dividend of $5 per share and the corporate structure is designed so that exactly $5 per share will be paid, no more and no less.

Simple as this observation may be, its implications are far-reaching. If all creditors had to be paid off before *any* payment could be made to shareholder investors, and if shareholders received nothing until ultimate liquidation of the enterprise when they would divide the residuum left after payment of all creditors—if, in other words, the terms "prior" and "before" were chronological as well as hierarchical—the creditor would not have to worry about assets being drained away into the hands of junior claimants and he would sleep better at night. But once it is conceded that *during the life* of the creditor's claim, assets may be passed out to an investing group that hierarchically ranks below the creditors, the question becomes unavoidable: How much of the assets in the treasury of the incorporated enterprise may be distributed to shareholders, when, and under what circumstances?

While "dividends" are the most common form in which distributions are made to shareholders out of corporate assets, the distributive process is potentially Protean. If it is decided that an incorporated enterprise should be broken up, or that some of its assets or separable operations should be sold for cash, extraordinary cash distributions may be made to shareholders; these will be referred to as liquidating distributions, or distributions in partial liquidation. Similarly, the decision-makers in a going economic enterprise may conclude that the company has more cash or other liquid assets on hand than it needs, that no interesting investment opportunities are visible, and that the best thing to do is to distribute the excess assets to the shareholders; such a transaction may be referred to as a partial return of capital. Substantially the same transaction may occur where, for one reason or another, it seems desirable to those who are making the decisions to transfer a major nonliquid asset (such as a parcel of land) to the shareholders, either by transferring to each shareholder a proportionate undivided interest in the asset, or by putting the asset into a subsidiary and distributing the subsidiary's shares to the parent's shareholders. Or those in control of an incorporated enterprise may decide to "buy in" some of the outstanding stock of the corporation—a transaction that pays assets out of the corporate treasury to shareholders but brings in to the corporation nothing but pieces of paper in the hands of the corporation. If, for example, a corporation has three shareholders, each of whom owns twenty shares of stock, and the corporation "buys in" ten shares from each of them at $1,000 per share, the consequence will be that each shareholder will continue to own and control ⅓ of the enterprise, but there is $30,000 less in the corporate treasury to meet the claims of creditors. Whether the stock bought in is

said in lawyer's talk to be cancelled, or retired, or held as treasury shares, the result is identical as seen from the creditor's standpoint: $30,000 has been funneled off to the junior claimants, the shareholders.

These instances do not exhaust the numbers of ways in which assets can be transferred out of a corporate treasury into the hands of shareholders. Distributions of corporate assets to a shareholder may be denominated as "salary payments" though in excess of a compensation level that would be reasonable for the services performed for the corporation by the shareholder. Corporate assets can be sold to shareholders for less than their market value. Corporate assets can be loaned to shareholders, or leased to shareholders, on terms that in effect reduce the aggregate resources of the corporate treasury. If the corporation guarantees the debt of a shareholder to a third party, the corporation's credit is put in jeopardy to the benefit of the shareholder. Corporate assets can be pledged or mortgaged to shareholders through arrangements under which, upon nonpayment of the loan by the corporation (at the decision of the board), the assets will be forfeited to the shareholders.[4] These same transactions, with the same consequences, can be carried out through dealings between the shareholders of the corporation and subsidiaries of the corporation. In all these instances, and others, the problem of the creditor of the corporation is the same. Assets have left the corporate pot, have gone beyond his reach, and, worst of all, have been paid out to that group of investors whose claim to the assets of the corporation is junior to his.

Finally, it must be observed, there are two other factors that contribute to the creditor's unease. It is not just that there are many ways by which corporate assets *can* be channeled out of the corporate pot and into the shareholders' pockets. More worrisome is the shareholders' keen desire and incentive to do just that. The shareholder knows that so long as his money is at stake in the enterprise he will be the last one paid—or will not be paid at all—if the weather gets stormy. His instinct is to limit that risk by arranging for some kind of payout of at least his initial investment as soon as possible.

A closely related consideration is the dynamic known as "leverage". The creditor wants a thick equity cushion under him;

4. In addition, of course, one who is a shareholder can legitimately lend money to the corporation and thus become both a creditor and an equity owner. In that case, however, a payment made by the corporation on the loan is not, as an analytic matter, a distribution to shareholders, but a payment to creditors.

the equity investors tend to prefer a thick debt slice in the company's capitalization, up to the capacity of the enterprise to meet the carrying charges of the debt. The shareholder sees an obvious advantage in a funding plan under which he puts in $1 and the lender puts in $2, the lender agreeing to a fixed return of 5¢ for each dollar loaned; if the enterprise earns 10¢ on each of the three dollars invested, the end result is that the creditor's $2 investment yields him 10¢ while the shareholder's $1 investment yields him 20¢. Shareholders greatly relish such leveraged arangements under which the entrepreneurial harvest, if any, will come to them while the risk of capital loss is largely that of lenders.[5]

The second thought that disturbs the sweet slumber of the creditor is the knowledge that virtually all responsibility and power for the conduct of the enterprise is in the hands of the board of directors who are elected by and mainly interested in the shareholders, and of corporate officers selected by the board. As the creditor sees it, hungry goats have been set to watch the cabbages.

Out of the conflict between the creditor's desire to keep corporate assets from being distributed to shareholders, and the shareholder's insistence upon receiving asset distributions despite the existence of outstanding creditors' claims, arises the major problem to which the par and stated capital provisions—the legal capital provisions—of state corporation codes are directed.

2. Equitable Contribution Among Shareholders—A Separate Problem

Taken as a class, the shareholders of a corporation have in common a conflicting interest with that of creditors of the corporation. But within the class of those denominated "shareholders" clashes of economic interest also exist.

5. Again the real world proves more complex than the stripped down model. The desires of particular classes of investors will not always conform to the generalizations. Some creditors may, for example, have a view toward leverage that parallels that of the shareholder. A general creditor, though normally fearful that the corporate debtor might create senior debt ranking ahead of him, may see an advantage in the corporation's incurring new senior debt if the new money can be brought in at low cost so that the profits generated by the new capital will be greater than the cost of the new capital, the excess redounding to the advantage and payment of the junior creditor's claim. Moreover, if the enterprise is in sufficiently dire straits, the junior creditor may be happy to see senior debt created, regardless of the terms, where the new money may keep the enterprise going and where the only prospect for the enterprise in the absence of new investment would be bankruptcy.

Even in the simplest case of a corporation having a single class of stock, contention can arise between shareholder S1 and shareholder S2 as to whether each one made a fair and proportionate contribution of assets into the corporate pot in exchange for the share interest he received. Other things being equal, S1 will be very unhappy if he put up ⅔ of the total assets invested by shareholders into the corporate till and received only ⅓ of the total stock issued, while S2, who invested only ⅓ of the total equity input, received ⅔ of the stock issued.

It is easy enough to recite in black letter hornbook style: "The general principle is clear; shareholders should contribute equitably in proportion to their shareholdings." But this abstract principle is of little utility in dealing with any real situation. What is an equitable amount? What are equitable amounts when S2 buys his shares from the corporation at a different time from S1? What is an equitable amount for S2 to pay if he buys from the corporation an issue of shares of a class, or series, different from that held by S1? These, and many other related questions, constitute the problem of equitable contribution. Some of them are referred to in a later chapter and a number of illustrations are given in Part Two. For the present, it is enough to note the existence of the topic and to observe that one strand in the development of the law of par and stated capital has been an effort by the courts (often only dimly perceived or even unconscious) to develop a working solution to the problem of equitable contribution among shareholders.

C. THE CREDITOR'S AND SHAREHOLDER'S PERSPECTIVES COMBINED

It will now be seen that a corporate financial "model" has begun to appear. That model will be substantially elaborated in later pages. It is well to pause here, however, to emphasize again the point made in passing in two earlier footnotes—that the analytic corporate financial model discussed here is just that. The model does not purport to be fully descriptive of reality—of the actual way in which corporate creditors and shareholders go about their business of making investment decisions, and protecting their positions. Reality is much more complex, featuring detailed factors that are often determinative.

Moreover,—and this point deserves special underscoring—the whole model we are using here presents a fundamentally skewed picture because of its emphasis upon the creditor's concern about the *ultimate* payment of his claim out of his debtor's assets

in liquidation or bankruptcy. Creditors *are* concerned about that of course. And debtors *do* sometimes wind up in liquidation proceedings that set all the claimants against one another in a Donnybrook over who gets what from the insufficient carcass. But such events are not normalcy in the conduct of business. They bear the same relationship to daily business as a train wreck bears to a train trip. It *could* happen; one may do well to carry some travel insurance against it, perhaps even sit in the middle of the car; but if one knows, or seriously suspects, that a train may wreck, he does not usually take extra protective precautions—he stays off the train. In the usual case, creditors expect to be paid, and are actually paid, on an ongoing basis out of the profitability of the enterprise—out of *earnings*. The depression of the 1930's and the repeated wipe-out of gold-plated "fully secured" bond issues of blue chip railroads drove the point home at last; enterprise debt is not ultimately paid out of balance sheet assets but rather out of operating profits. Security liens, liquidation preferences and the like, are disaster remedies —like emergency exits. When an enterprise asks to borrow money, the prospective lender's primary interest will be in the profit prospects of the enterprise—the *dynamics* of the enterprise—quality of management, markets for the product, competition, assembly of production components, labor relations, adequacy of financing, technological leads—to name but some. The model outlined here of creditors' concerns is thus distorted in its pervasive implication that balance sheet assets are foremost in the creditor's mind, and in the essentially static character of the model.

In defense of the use of the model employed here, one can say two things:

(i) To a degree the creditor *does* look at static assets and consider the possibility of an ultimate liquidation Armageddon; to that degree the model is substantially accurate.

(ii) We have no choice but to develop and understand this model if we are to understand the corporate code provisions on stated capital, for whatever its deficiencies, it is the model on which the statutes are based.

Accepting the model as given, how should corporation law, statutory or judge made, regulate the activities of businessmen and lawyers so as to deal with the combination of the corporate creditor's perspective and the shareholder's perspective—namely:

(1) The creditor of the corporation desires that the enterprise have large quantities of assets against which the

only other claimants are those who rank junior to him, i. e. the shareholders. Shareholders, by contrast, would like to have as little as possible of their own assets tied up in the enterprise and exposed to the jeopardy of creditors' claims.

(2) The creditor does not ordinarily welcome the creation of additional creditors' claims against the limited assets of the enterprise. The shareholder investor will often (not always) be willing for the incorporated enterprise to incur further debt in order to benefit from leverage, especially when his own equity investment position is small.

(3) The creditor would prefer that the junior investment claimant, the shareholder, receive nothing as a return on his investment for so long a time as the creditor's claim has not been paid. The shareholder, on the other hand, insists upon a concurrent return paid out to him as the enterprise earns profits.

(4) The creditor wants protection against all manner of asset distributions to shareholders. The shareholder wants maximum freedom to receive such distributions.

(5) Each shareholder wants assurance that each other shareholder has contributed to the corporate pot a proprietorship investment proportionate to his shareholdings.

The provisions of state corporation codes dealing with legal capital are addressed to resolving, or at least accommodating, these conflicts.

Chapter II

LEGAL CAPITAL—DEVELOPMENT OF THE KEY CONCEPT

This chapter is devoted to tracing the development of the concept of legal capital—the key concept that our corporation codes have evolved to deal with the problems outlined in Chapter I. The ways in which the concept is used by the statutes, and the consequences of that use, are reserved for discussion in later chapters.

The legal capital scheme contained in our modern corporation codes is the direct product of nineteenth century legal history. Legal capital provisions are comprehensible (to the extent they are comprehensible at all) only in the context of that history.

At the same time, one must not demand too much clarity or coherence from the record of the past in this field. During the latter half of the nineteenth century, when industrial capitalism was maturing in the United States and finance capitalism was beginning to emerge, the profession of accounting was in its infancy. Accounting concepts that seem both elemental and indispensable today had not yet been perceived or crystallized; terminology had not yet been settled upon; and, outside a very small group of emerging professionals, double entry bookkeeping had not penetrated the consciousness of the public, the bench, or the bar. Nineteenth century judicial opinions dealing with par values, stock issues, capital, and stock subscriptions, are nearly always analytically incoherent. But to harp on that point is unseemly; it is to shoot fish in a barrel. The field of corporate finance was too embryonic to have assumed shape, and the courts and advocates were not yet equipped with the conceptual tools required to deal with it. In large degree, therefore, it is an error to attempt a precise reconstruction of the way in which the nineteenth century looked at such matters. The truth is that there simply was no coherent view of these matters in the nineteenth century. And while each generation must write its own history of the past, we should not try to attribute to nineteenth century courts an integrated set of analytic theorems that they would have been incapable of understanding, much less inventing.

A. THE STANDARD OF EQUITY INVESTMENT—WHAT AMOUNT OF WHAT ASSETS MUST SHAREHOLDERS PUT INTO THE CORPORATE POT?

1. Minimum Pay-in Requirements

As noted in Chapter I, a corporate creditor will be happiest if the corporation to which he extends credit has a substantial quantity of assets that are free of the claims of other creditors —assets whose only claimants are of the lowest priority rank, the shareholders.

The question of what amount of assets must be paid-in to an enterprise by its shareholders before it will be permitted to enter the market place has never been candidly addressed in American corporation law. For a governmental agency to prescribe minimum capital standards for particular enterprises or economic sectors has been considered wholly impractical as well as antithetical to the way in which we go about our economic process. There are exceptions to this statement, and they are significant ones; banks, insurance companies, and corporate trustees offer instances of enterprises where, as we have learned painfully, undercapitalization can be a public menace and in those instances a combination of statutes and regulations compels a minimum pay-in of equity assets. But the only fields of endeavor in which our law seriously undertakes to set minimum standards of capitalization are those we view as industries affected with a special public interest, and which we regulate in a number of other ways as well. Until very recently state corporation acts genuflected to the desirability of requiring a minimum amount of assets to be paid into a new enterprise as a prerequisite to achieving corporate status, or at least before commencing business. But these provisions were always *pro forma* only, typically requiring a *de minimis* pay-in on the order of $1,000 or less, and with no provision precluding an immediate return of this amount to the shareholders. In the last few years, however, most state statutes have eliminated even these *pro forma* requirements for initial pay-in by shareholders.[1] In general, therefore, the creditor has received little or no direct protection through legislative or regulatory prescription requiring an incorporated enterprise to have a minimum amount of assets at its inception.[2]

1. See 2 Model Business Corporation Act Annotated, § 54, Annot. ¶ 3.03(7) (2d ed. 1971).

2. Here and there a legal commentator or a judge will be found to say that shareholders may not enjoy the corporate shield of limited liability where the corporation is "grossly undercapitalized." And intuitively one wonders particularly about the situation of the tort vic-

2. The Prototypical Model and Par

Nonetheless, the corporate creditor's desire to have a well funded debtor has played a part in the development of the legal capital scheme contained in our corporation codes. To see the connection, it is necessary to reformulate the statement of the creditor's interest. To do so, it is necessary to run the statement through two transformations and, as a prototypical model, to consider a very simple business situation.

Consider a newly formed corporate enterprise at the stage of its initial financing by the issue of shares; the only assets in the corporate treasury are those which the shareholders have just put in for their stock, and the enterprise has done no business. If, at that time, a prospective lender asks the question, "How much assets does the corporation have free and clear after claims of creditors" the answer will be the same as the answer to the question, "How much did the shareholders put in?" Similarly, if a loan is then made to the corporation, the question, "How much assets did the corporation have at the time of the loan" has the same answer as the question, "How much assets have the shareholders put in over *all* time?" On this simplistic model, the statutory stated capital scheme is based. The scheme assumes that the key to protection of the creditor lies in the answer to these two questions which, taken together, become, "How much assets have shareholders put into the corporate treasury since the formation of the corporation?" Whether or not that question is one that really interests a creditor, it is the elemental question to which the statutory legal capital scheme is addressed.

The nineteenth century pattern of corporate financing provided a ready suggestion to judges and statutory draftsmen for a way to gauge the quantity of assets that shareholders had, at some time or another, put into the corporate treasury. According to that pattern of corporate practice, an entrepreneurial organizer, the "promoter" who had conceived of an idea for a new business would make the rounds of people who had money to invest ("capitalists" all, whether little grey widows or sturdy yeomen), and seek to persuade them to invest in stock of the proposed enterprise. If the idea had appeal, and if the promoter

tim of outrageous corporate negligence: would it really be possible to build a downtown culture center for bacterial warfare experiments and to immunize the equity investors from liability through formation of a corporation with an initial capitalization of $1,000? But, the concept of "gross undercapitalization" is too ill-defined a concept to afford creditors any predictable protection from the default of corporate enterprises capitalized on a shoestring, and actual judicial holdings on the point are, at most, scant.

was persuasive, he would succeed in obtaining commitments from them to buy stock. Such commitments called subscription agreements, had a number of features about them that were jarring to nineteenth century concepts of contract law and their assimilation into contractual jurisprudence proved very awkward. But its essence was simple enough: the subscriber agreed that if enough other subscribers were found, and if a corporation was formed for the purposes of the enterprise envisioned by the promoter, he, the subscriber, would, on call of the future board of directors of the corporation when organized, put in a set amount of money, or other assets, and would receive a set number of shares of the newly formed corporation. Given this practice, it was to be expected, and was perhaps inevitable, that in drawing up the subscription agreements for any single enterprise, a fixed mathematical relationship would be set between the amount of dollars to be invested by a subscriber and the number of shares he would receive: so many dollars to be put in for each share to be issued. That relationship produced the concept of the "par value" of the stock to be issued. In the normal situation, no equity investor could expect to obtain a share of stock for less than the par value of it, since presumably all other purchasers were paying that amount. Similarly, no share subscriber could be persuaded to agree to pay more than the par value for a share since other investors were receiving a similar share by paying in the par value.

If the promoter was successful in obtaining subscription commitments in an amount that appeared sufficient to provide the basic equity financing for the enterprise, he would then see to it that papers were prepared for obtaining a corporate charter under the local state law, often naming the subscribers (or a few of them) as the "incorporators".[3] The incorporators-subscribers were then brought together for an initial meeting, directors of the corporation were elected, by-laws were adopted, the board of directors made a call upon subscribers to ante up all, or a part of, the amount to which they had committed themselves under the subscription agreements, a corresponding amount of assets were paid into the corporate treasury by the subscribers, and stock certificates for an appropriate number of shares were delivered to the subscribers—now become shareholders. The stock certificates were formal and elaborate, and, in analogy to paper currency or banknotes, bore upon their face as the most dominant feature, the share's "par value" stated as

3. Sometimes the charter would have already been obtained, with only the earliest subscribers, or associates of the promoter, named as "incorporators."

a fixed number of dollars, typically $100. This number represented the amount the shareholders had agreed to pay for each share according to the subscription agreements. In time, by statute, the par value of the stock was required to be stated as a provision in the corporate charter.

The essentially arbitrary character of this number must be understood. If, for example, each of three investors agreed to invest $10,000 in stock of a new company, the number of shares to be issued, N, and the par value, $P, could be anything—could be any numbers that the promoters might set so long as N x $P = $30,000. Further, so far as the shareholders in this case were concerned, it was immaterial what "par" was so long as each one received the same number of shares for his $10,000 investment.

Against this familiar background of practice, however, it was easy for the courts—and legislatures—to take a next assumption, and it early became a matter of common understanding, that the "par value" was what the shareholder *ought* to have paid for his stock. Stock which was issued without a corresponding pay-in of assets valued at an amount equal to par was called "watered stock"—stock issued not against assets but against water. (The term also echoed an ancient sharp practice in another field, the aquatizing of livestock before weighing them in for sale.) The term "bonus shares" was reserved to describe shares that were issued to someone who had paid in nothing for them. Bonus shares and watered stock obviously gave the recipient shareholder a free, or cut-rate, ride, to the disadvantage of the other shareholders who had put more assets per share into the corporate pot.

It must be emphasized that concepts of watered stock and bonus stock, and the doctrines that came to surround them, were and are limited in application to the *issue* of stock, that is, sales by the *corporation* of its own stock. The doctrines do not in any way inhibit the *shareholder's* freedom to sell his stock at any price he can get, or to give it away if he wishes. Similarly, a corporation holding shares of another corporation may, like any other shareholder, dispose of them at any price it wishes or can get.[4]

3. "Par," "Capital" and the Creditor

It will be clear to the reader that the development of the "par" concept just described arose as a response to the problems of

4. See infra, as to resale of treasury shares.

assuring equitable contribution among shareholders. But development of the shareholders' par payment obligation served, in a somewhat fortuitous and naive way, to further the corporate creditor's interest in seeing shareholder assets committed to the enterprise. One can spin at least a hypothetical argument as to why this should be and how it came to be.

If a creditor extends credit immediately after the incorporation of the new enterprise and if he has been informed that the par value of the shares is $P and the number of shares that have been issued is N, it is not unreasonable for him to assume that the shareholders have collectively contributed into the corporate treasury an amount of dollars equal to the par value of the shares issued multiplied by the number of shares that were issued, or $PN. In a kind of rough and ready way, assuming that there have been no other transactions, the creditor might infer that the number $PN is an approximation of the total assets of the corporation, and on that basis might conclude that he could safely lend a certain amount of funds to the enterprise.

Did any rational creditor ever in fact act that way or extend credit on such a naive basis? The answer has to be "no." But two things did occur.

First, the number $PN came in time to be called in legal discourse the corporation's "capital."

Second, if the enterprise ultimately went broke, and the creditor did not get paid, and he found out at that later time that some shareholder had *not* in fact paid into the corporate treasury an amount of assets equal to the par value of the shares he had received, the creditor's lawyer would certainly *argue* in a suit against the shareholder that: (i) Everyone knows that shareholders should pay into the corporate treasury assets equal to the par value of the shares issued to them; (ii) the defendant shareholder did not pay in that amount; (iii) the corporation is insolvent, creditors are unpaid, and the shareholders are not liable for the corporation's debts; (iv) therefore the court should require the defendant shareholder to pay over to this energetic suing creditor, to the extent of his claim against the corporation, the amount by which the defendant shareholder failed to pay into the corporation assets equal to the aggregate par value of the stock he received; and (v) if (iv) does not appeal to the court as the appropriate remedy, then the defendant shareholder should be required to pay into *the corporate treasury* now for the benefit of all corporate creditors, the full amount by which he failed

earlier to pay into the corporate treasury assets of a value equal to the aggregate par value of the shares he received.

As will appear later, a number of serious analytic problems flaw this argument, as they do other approaches that litigants and courts tried in efforts to assert shareholder liability to contribute capital to the incorporated enterprise. And all sorts of remedial and procedural questions arose, as is discussed in Chapter III. But in time, this much became clear:

(i) The courts came to recognize that shareholders have some obligation to invest in the corporate enterprise;

(ii) It came to be understood (perhaps "assumed" is a better word) that the measure of the shareholder's liability was the number of shares issued to him times the par value of the shares; and

(iii) It came to be recognized that at least some creditors could in at least some circumstances enforce this obligation of the shareholder in some way.

Statements may be occasionally found to the effect that the *reason* why shareholders were held to pay in the par value of their shares is that that was the price exacted by the law for the corporate advantage of limited liability. While some such idea may have occurred to some nineteenth century court or legislative draftsman, the history of the matter will not bear out this theory. Limited liability arose in American corporation law as an almost incidental by-product of corporateness, and did so independently of the development of the par and stated capital scheme in the statutes.

4. The Going Enterprise: A Change in the Model

On the whole, the concept of par as a standard for shareholder investment did not work badly in the prototypical model of the corporate enterprise since par was nearly always the subscription price and since everyone agreed that a subscriber-shareholder should as a matter of contract be held to do what he had agreed to do. The system may not have helped the creditor very much, but at least it had a plausibility to it and could be made to work. But as the enterprise moved from the stage of initial financing to that of an ongoing enterprise, the system lost both plausibility and workability.

If an incorporated enterprise had navigated in the stream of commerce for ten years after its initial incorporation, and had undergone ten years of economic vicissitude, why would a prospective creditor in the company's 11th year consider it relevant to his credit decision to enquire whether subscriber-shareholders

had, ten years before, paid fully for their stock? Perhaps the shareholders had invested heavily but the company had lost all its assets; perhaps they had paid nothing but the company had prospered. The passage of time destroyed the prototypical proposition that the assets in the corporation were the assets that had been put there by the subscriber-shareholders. Plausibility for that proposition had departed.

The problem of workability arose a little differently. Suppose that the original promotor, ten long years before, had set the par of the shares at $100 and the original subscriber-shareholders had paid in that amount per share. It is now the eleventh year, and the board of directors decides that it would be desirable—perhaps necessary—for the company to sell additional shares of stock in order to increase working capital and make it possible for the company to obtain additional lines of credit. Assume finally that the current market value of the stock is $52. What is to be done? The statute says that a purchaser of a newly issued share of stock with a par value of $100 must pay at least $100 for it; under that principle, any person who buys a share of the new stock from the issuing corporation for its fair market value of $52 may someday be held liable for an extra $48, an untempting prospect for a new investor. Something must give way in the face of economic reality. Of course, it turns out to be the principle of par payment.

In *Handley v. Stutz* [5] a company that was on the verge of bankruptcy managed to bail itself out for a while by attracting new money through the sale of bonds; to make the bonds saleable, the company gave a certain number of free shares of newly issued stock to each purchaser. Action was brought by a judgment creditor of the corporation to hold the new shareholders liable for payment of the par value of the shares they had received. With no support of any kind in the statute, the Supreme Court came out with the common sense answer fitted to the circumstances before it. It held that if a company is in a state of economic emergency it may, without generating risk of liability to new stock purchasers, issue stock at the best price it can get, whether or not below par. A legal prophet at the time would have predicted that because courts are by and large sensible, they would gradually expand the *Handley* concept of "economic emergency" to cover any situation where the going market value of the stock was below the par value. But in fact that proposition never fully developed, for other ways were found to deal with the problem.

5. 139 U.S. 417, 11 S.Ct. 530 (1891).

It will be recalled that though the par value of a share of stock appears upon the stock certificate its roots lie in the corporate charter. In the example given above, would it not be possible through the normal avenues of shareholder meeting and vote to amend the charter so as to reduce the $100 par of the company's stock to a figure below $52 and thereby make it feasible to issue shares on the current market and to do so compatibly with the requirement that the sale price must at least be equal to par? The answer was "Yes," and thus was opened another way by which the problem was—and is—handled under the corporation acts.

By this point, however, it is clear that concern about the economic worries of the creditor has moved to the edges of the universe and is receding at an ever-increasing speed. With par alterable by charter amendment, the switches, levers, and throttles are all in the hands of the very group whose interests conflict squarely with those of the creditors—the shareholders and corporate management.

5. Low Par Stock

In the nineteenth century pattern of corporate financing, it was simply assumed that good companies—respectable companies—solid investments—would have stock with a high par value. It is a tribute, indeed, to the power of mythology and folklore, that the buying market, the investment bankers who feed it, corporate managements, and their legal counsel all continue today to feel considerably more comfortable with a $50 par stock and cannot say "penny stock" without a sneer. And it remains true today that most "preferred" stocks continue to carry a high par value.[6] Nonetheless, eventually the practical argument prevailed and the invariable practice of using high par value common stock gradually gave way to the use of low par common stock as it came to be perceived that if the stock has a low par from the beginning, it might never be necessary to amend it or rely upon the vague license of *Handley v. Stutz.*

With this shift made, a typical transaction might see a promoter (i. e., his lawyer) set a par of $10 per share and a *higher* subscription agreement, say, $50 per share. What difference does it make to any shareholder that the par is lower than the

6. As Britain moved to the decimal currency system, a major question was whether to retain the pound as the basic unit or to adopt as the basic unit the shilling, a currency unit of a conveniently commensurate order of magnitude with the Swiss franc, the French franc, the German mark, the Dutch guilder, the Danish crown, etc. The decision, of course, was made in favor of the pound. Despite the awkwardness of its size, it had a more prestigious "par".

purchase price, so long as each initial equity investor pays in the same amount per share? With this development, however, the prototype corporate model outlined earlier is reduced to splinters. If the subscription agreement calls for $50 per share for the $10 par stock, but the subscriber-shareholder pays in only $5 per share, should a subsequent unpaid corporate creditor be able at a later time to force an additional payment of $5 —to bring the shareholder's contribution up to the par value of $10—or should he be able to enforce a liability of $45—the balance the shareholder had agreed to pay under the subscription agreement? At this point it becomes conceptually critical whether the creditor is suing on a theory of statutory obligation of the shareholder to pay par, or on a contractual theory of enforcement of the shareholder's obligation to pay the corporation in accordance with the terms of the subscription. More important for present analytic purposes, the separation of par and purchase price has the effect of opening a chasm between the lawyer's perspective and the economist's concept of the entrepreneur's capital investment. If there are ten subscribers in a newly incorporated enterprise each of whom buys 10 shares of stock at a price of $50 per share, the economist, or the businessman, would say that the company's beginning "capital" is $5,000. But the lawyer (and later the accountant) will tell the economist or the businessman that the "capital" is determined by par, and in this case is the number of issued shares, 100, multiplied by the par value of each share, $10, for a total of $1,000; the other $4,000 is something else, about which we will hear more later. With the evolution of low par stock, came the evolution of that strange lawyer's convention, "legal capital"—the $1,000 in the example just given.

6. No Par Stock

If a corporation may have stock with a par value of 1¢, why not abandon the par concept entirely and permit the issuance of stock with no dollar amount printed on the share certificate? Why not have no par stock?

It was not until 1912 that analysis of the matter had reached a sufficiently wide circle to produce statutory authorization of no par stock. The advent of no par stock did not, however, have the effect of eliminating the concept of legal capital. It was, and still is, statutorily necessary to designate some dollar number on the corporate balance sheet as "capital". Since, with no-par stock, it is no longer possible to calculate what the "capital" is by multiplying the number of shares issued times the par value, a "capital" number can be arrived at for this purpose only by fiat—by declaration—by stating it. The responsibility

for making that statement, and the power to make it, is placed by corporation statutes with the board of directors, and the dollar number declared by them made in the customary form of a board resolution, is the "stated capital" of the corporation. It remains so until such time as it is changed to something else by means set forth in the corporation act. The accountants accept this designation of "stated capital" and it appears on the lower right hand side of the corporate balance sheet as the corporate "capital".

Although no-par stock is common in the world of contemporary corporate finance, it is interesting that it has not preempted the field, and par stock continues to be in majority use. This is true for several reasons. For a long time, the computational method of the federal stamp tax on stock issuance favored par as against no par stock and some state franchise tax provisions still do. Additionally, for a careful lawyer concerned about such things, it is appealing that a low par value on a share of stock sets the outer limit of liability of a subscriber-shareholder as against a creditor's claim, whereas in the case of no par stock the subscriber's liability would appear inevitably—for want of any other criterion—to be measured by the full amount that he agreed to pay for each share of the stock.[7] More important than either of these factors, however, are the two points referred to in the discussion of par stock. To the market's ear, no par stock does not quite have the same ring of virtue as par stock (though it sounds better than "penny stock"). At the same time, the use of lower par values, and the ease of shareholder amendment to reduce par in situations where the par proved not to have been low enough, combined to make par stock a usable tool in the hands of the experienced corporate practitioner.

7. Legal Capital

The discussion so far dealing with pay-in requirements for shareholders has yielded the rudiments of the concept of "legal capital" or "stated capital", as it is more often called today. For further refinement of the concept, we turn to the other side of the coin, corporate pay-outs to shareholders.

7. Interestingly, the 1967 Delaware corporation law obliterated this longstanding distinction between par and no par stock, so that the subscriber to par stock is now also liable for the subscription price rather than the par. See Del.Gen. Corp.Law § 162(a).

B. DISTRIBUTING CORPORATE ASSETS TO THE SHAREHOLDERS

1. Wood v. Dummer—The Classic Case

What does the law do to prevent shareholders of a distressed company from pulling assets out of the corporate treasury just when the creditor needs them? The problem is not hypothetical. Indeed, from an historical point of view, the entire range of subjects to which this book is addressed may be seen to emerge from a single 1824 opinion of Justice Story, *Wood v. Dummer*.[8] The case could not be more elegant in its purity. The corporation was a bank that went broke. Just before the bank went under, the board of directors distributed most of its bank's liquid assets to the shareholders. Certain of the creditors of the bank sued some of the shareholders, claiming that in the circumstances the distribution of assets was illegal and that the shareholders should be made to pay the claims of the creditors. In an opinion that is simple, clear and wholly adequate for the particular problem with which he was confronted, Justice Story ordered the defendant shareholders to pay to the plaintiff creditors a proportionate share of the debt owed by the bank to the plaintiffs.[9]

8. 30 Fed.Cas. 435 (no. 17,944) (C.C. D.Me.1824).

9. Other aspects of this early bank case are interesting, foreshadowing the bank regulations of a later era. Not only did the directors pay out most of the current assets to the shareholders, thus precipitating insolvency, but it also appeared that at least some of the share subscription money had never been paid in by the shareholders and that the bank had used much of the money it had borrowed through its bank notes (from plaintiffs and others) to lend to the bank's own directors —who were at the time of the lawsuit also bankrupt.

As a pardonable digression, the reader may also wish to share the author's delight in the following passages from the learned justice's opinion in the *Wood* case, on which he sat while riding circuit in Maine; from these paragraphs, much can be gleaned about jurisprudence in action, about lawyering and about Justice Story, as an intellect and as a person.

"Bill in equity brought by the plaintiffs . . . , as holders of the bank notes of the . . . Bank, against the defendants, as stockholders . . . for payment of the same notes upon the asserted fraudulent division of the capital stock by the shareholders.

. . .

"The case is full of difficulties. The bill is drawn in a very loose and inartificial manner. It proceeds principally upon the grounds of a gross over issue of bank notes, and other violations of the charter, and of a fraudulent dividend by the stockholders with a knowledge of their insolvency; grounds, which are denied by the answers, and are not in the slightest degree established in the proofs. It does not directly proceed upon the ground, that the defendants hold a trust fund applicable to the payment of the debts of the corporation; but leaves this to be picked up in frag-

The eminent scholar-jurist's innovative legal theory underlying his decision—the so-called "trust fund" theory—and its subsequent fate are discussed in later pages. But a point of terminology in the court's opinion in *Wood v. Dummer* invites special attention. Throughout the opinion, the Justice talks of "the capital stock" of the corporation. It is evident that in his usage "capital stock" means the *assets* that had been put

ments by a minute analysis of the bill.

. . .

"The next consideration is, whether the bill makes out a case, which upon the facts proved or admitted, entitles the plaintiffs to relief. I have already adverted to the loose structure of the bill. It primarily charges the case, as a case of fraud; that is now abandoned. If it can stand at all, it must be simply on the fact, that the defendants have the funds in their possession. That alone could not entitle the parties to relief, without allegations of insolvency on the part of the corporation or of the non-existence of other funds. Now the bill does not allege, that the corporation is insolvent, nor that it is dissolved, nor that there is no other corporate property, out of which the debts can be paid. These are extraordinary omissions; and if there had been a demurrer to the bill, it would be difficult for the court to have strained hard enough to support it. But these defects are in some degree helped by the answers, which admit the insolvency of the corporation, and show, that in fact no sufficient funds for payment of its debts are in existence, independent of the capital stock. Then again the bill (notwithstanding the intimations thrown out by the court on a former hearing of the cause) does not charge, that the capital stock is a trust fund, appropriated by law and the charter to the payment of the debts, and that the surplus only, after such payment, belongs to the stockholders. Such an allegation was most fit to have been made upon the grounds, on which ultimately the plaintiffs concluded to rest their case at the hearing. The court is therefore compelled to thread it out by inference and intendment and exposition of the charter, as made part of the charges the new Hallowell and Augusta Bank to be possessed of large funds of the old bank, which ought to be applied to the payment of the debts of the latter; and without attempting to bring the new bank to a hearing, the bill has, by the plaintiffs, been dismissed as against the new bank, leaving all the inferences, deducible from the charge in the bill, in full force against the plaintiffs. This ought to have been cured by an amendment of the bill.

"I advert to these defects, not in the spirit of censure, (for I am well aware, that an apology is found in the fact, that chancery proceedings have, hitherto, but in a slight degree engaged the attention of the bar in this district), but in a spirit of regret, because they have been most embarrassing to the court in every step of its progress, and distressed it by creating a perpetual struggle between the desire to do justice to the parties after so prolonged and expensive a controversy, and the difficulty of overcoming technical principles.

"The exception as to parties ranges itself under this head. There is no allegation in the bill, that the old corporation is defunct, so as to dispense with its being made a party. The answers do not deny, that it yet has a legal existence, and therefore afford no help to cure the defect. Now, if in existence, nothing can be more clear, than that it ought to have been made a party to the bill. It is the original debtor; its funds are to be applied in payment of debts, and it would be wrong to touch those funds without the most plenary proofs, that the debts were due, and the corporation had no defence." *Id.* at 435–6, passim.

One wonders how the lawyers for both parties explained these comments of the judge to their respec-

into the company by the stockholders, the "capital stock" that he held should not be withdrawn and returned to the proprietary investors until all creditors of the bank were paid.[10] Moreover, while the word "stock" in this phrase rings oddly to the modern ear, Story's use is the original etymological meaning of stock—the root of something growing, or a basic central supply. This meaning of "stock" continues today in many terms, such as "soup stock", "stockroom", "stock in trade", "gunstock" and "root and stock". But our concept of corporate stock has moved so far away from its original meaning that we are startled to hear Justice Story use "stock" as a synonym for the assets put in by the shareholders, and to hear him describe the events in *Wood v. Dummer* as an illegal return of the "stock" to the shareholders.[11] As perceived then by our most learned of judges in 1824, the terms "capital" and "stock" pointed to the upper left hand side of the balance sheet, close to the modern businessman's concept of current assets. But, as will appear in more detail subsequently, in the eyes of the law, both "capital" and "stock" were soon to slide over to the lower right hand side of the balance sheet.

Whatever the ultimate validity of Justice Story's theory in *Wood v. Dummer*, his decision on the facts in the case was unimpeachable. But it was certain to lead to a series of next questions that were much less susceptible to simple, or even sensible, answers. In *Wood v. Dummer*, the corporation was insolvent. It was easy to say that in such a case no assets should have been returned to the shareholders. But the *Wood* opinion gave only a general suggestion as to what limits there might be on distributions to shareholders if the bank had been a healthy ongoing enterprise.

2. The Key Proposition—"Legal Capital" as a Measuring Rod

As pointed out in Chapter I, there would be little or no problem about distributions to shareholders if corporate enterprises were periodically liquidated, creditors paid off, and only then the residuum or "velvet" returned to the equity investors. The problem of limiting distributions arises fundamentally out of the

10. E. g., "is the principal point argued in the cause, whether the capital stock in the hands of the stockholders is liable to the payment of the debts of the bank." Id. at p. 436.

11. Notice the similar usage in the 1784 newspaper announcement that led to the establishment of The Bank of New York:

"It appearing to be the disposition of the Gentlemen in this City, to establish a BANK on liberal principles, *the stock to consist of specie only*; they are therefore hereby invited to meet Tomorrow Evening at six o'clock, at the Merchant's Coffee-House, where a plan will be submitted to their consideration."

fm: New York Packet February 23, 1784

(Emphasis added)

economic pressure to make some regular and ongoing distributions to shareholders while at the same time leaving creditor claims outstanding and unpaid. The condition is one that arises from the reality of the ongoing enterprise operating over time. The transaction in *Wood v. Dummer*, seen as a model, was a pathological case of an incorporated insolvent enterprise at the moment of dismemberment by its creditors. Similarly, the prototypical model transaction on which the nineteenth century conception of par value was predicated was also a static instant-of-time concept—the instant when the equity money was first put in and the stock certificates first issued. Nonetheless, probably inevitably, the courts and legislatures drew upon these static models as they sought to develop a standard by which to judge the legal propriety or impropriety of distributions of assets to shareholders by an ongoing enterprise.

Inevitably or not, the courts and the statutes did in fact combine the principle of *Wood v. Dummer* and the par value concept to produce an answer to their problems. Two basic propositions slowly emerged: (1) The measuring rod for judging the propriety or impropriety of distributions to equity holders is the corporation's "capital"; and (2) "capital" refers not to assets but to that abstract number that is obtained by multiplying the number of shares of stock oustanding by the par value assigned to each share. Following the emergence of low par and no par stock, the next step was, of course, to expand the second of these propositions to read that "capital" means "stated capital", or "legal capital".

3. The Classic Example: High Par

The most instructive way to see these propositions at work is to consider a simplified balance sheet of a hypothetical corporation with high par stock at three stages in its corporate life—immediately following its organization and funding; at the end of its first year of operations; and at the end of a second year of operations.

The general concept of the legal capital scheme is that no distribution may be made to shareholders unless there is a "surplus"—that is, sufficient assets in the corporation to pay off the creditors *plus* an additional amount of assets greater than the "stated capital". If the accounting entries representing the enterprise's assets do not total to a figure equal to the indebtedness of the enterprise plus the "capital", the capital is said to be "impaired" and the stock is said to be "under water". In such a condition (if one assumes that the figures on the assets side of the corporation's balance sheet are equal to their sell-off value), if all the

assets were to be sold off for cash, and if all the creditors were to be paid off, the money that would be left for the equity investors, the shareholders, would be less than the "capital" they put into the enterprise in the first place. Where that is the condition, the statutory scheme forbids the distribution of assets to shareholders by dividend or otherwise.[12]

Assume that the shareholders of a new enterprise, Laminated Thumbscrew, Inc., pay in $50,000 in cash and take back 500 shares of $100 par common stock. The company's assets are $50,000 in cash; the corresponding entry on the right hand side of its balance sheet is the company's "legal capital", or "stated capital", the number of outstanding shares times the par value, $50,000. The balance sheet would read:

Balance Sheet of Laminated Thumbscrew, Inc.,
Immediately Following Organization and Funding

ASSETS		LIABILITIES	
Cash	$50,000		-0-
		SHAREHOLDERS' EQUITY	
		Capital: $100 par common, 500 sh.	$50,000
		Surplus	-0-
	$50,000		$50,000

In the circumstances of this balance sheet, there is no "surplus" and a distribution of assets to shareholders would be illegal.[13]

Now consider the same company's balance sheet at the end of a year of active business operations and a variety of transactions.

Balance Sheet of Laminated Thumbscrew, Inc.
Year End After One Year of Operations

ASSETS		LIABILITIES	
Cash	$20,000	Bank loan	$10,000
Accounts receivable	6,000	Accounts payable	2,000
		Liabilities	$12,000
Inventory	10,000	SHAREHOLDERS' EQUITY	
Land	5,000	Capital: $100 par common, 500 sh.	50,000
Patents	1,001	Surplus (Deficit)	(19,999)
		Shareholders' equity	$30,001
	$42,001		$42,001

12. This oversimplified introductory description assumes a so-called "balance sheet surplus test" statute. Other statutory variations are reviewed in Chapter IV and at length in the series of transactions in Part Two.

13. Deferred to Chapter III are all questions of who might be liable to whom for how much where an "illegal" distribution is made to shareholders.

This balance sheet shows that during its first year the corporation has incurred debt, that the accounting figures reflecting its assets have gone down and the enterprise suffered a loss during the year. The balance sheet in this condition shows—to use a common anomalous term—a "negative surplus". It will be observed that the corporation has far more than enough assets to pay off the $12,000 owed to its creditors and, indeed, the enterprise is in a position to pay them all off at once in cash. Nonetheless, distribution of any corporate assets to shareholders would be illegal where the legal capital figure of $50,000 is set as the bench mark of legality of the distribution.[14]

Suppose now the following balance sheet at the end of the company's second year of operations.

Balance Sheet of Laminated Thumbscrew, Inc.,
Year End After Two Years of Operations

ASSETS		LIABILITIES	
Cash	$16,000	Accounts payable	$ 3,000
Accounts receivable	8,000	Liabilities	$ 3,000
Securities	54,000	SHAREHOLDERS' EQUITY	
Inventory	15,000	Capital: $100 par common, 500 sh.	50,000
Land	5,000		
Patents	1,001	Surplus	46,001
		Shareholders' equity	$96,001
	$99,001		$99,001

As a result of the second year's operations, according to this accounting record, the company has acquired additional assets (most likely as a result of profitable operations during the year), has paid off the bank debt, overcoming the deficit it had at the end of the preceding year, and has generated a balance sheet surplus of $46,001 above its "capital" and debt. Under the general statutory scheme of the corporation codes, the company may now legally distribute to shareholders assets having a value of $46,001 or less (as valued how, and by whom?). Thus if the company should distribute all its cash ($16,000) to its shareholders, there would still be a surplus of $30,001, and the distribution would be in conformity with the statutory scheme. If the company sought to distribute to shareholders all its securities, however, the accounting effect would be to remove a $54,000 asset, wiping out the surplus, and generating a capital deficit of $7,999; distribution of all the securities would thus "impair" the capital, drive the stock under water again, and violate the statutory scheme.

14. While we speak of the inhibition as lying within the balance sheet, even the reader least familiar with accounting will be aware that the directors are not free to solve the problem by simply adding zeroes to the numbers representing assets, or removing zeroes from the figures representing debt. Accounting entries are made in accordance with so-called "generally accepted accounting principles" considered respectable and proper by the accounting profession and, in some respects, public agencies. These "principles" are often vague or conflicting or ambiguous, and the institutional sources of their legitimation are not yet fully identified. But the "principles" are sufficiently crystallized, sufficiently accepted as norms of behavior, and sufficiently recognized as a basis for fraud liability, that the accountant is not free to accept just any numbers the directors may wish. Application of the legal capital scheme inevitably entails a host of accounting problems, some of which are discussed later and especially in Part Two.

4. Legal Capital as a Bench Mark—Some General Observations

Even at this preliminary stage of introduction to the legal capital scheme, several of its basic features have become visible and are worth underscoring.

1. As an analytical matter, the scheme is utterly dependent upon the way in which the assets of the enterprise carried on the books of the company are valued. Accounting decisions on write ups and write downs, on depreciation, on amortization, on cost or market valuation, and the like, will determine the total figure assigned to the asset side of the balance sheet, and in consequence the size of the balancing entry on the right hand side, and, in consequence the legality of the shareholder distribution. Inherently, the efficiency of the system can rise no higher than the level of consistency, objectivity, unanimity, enforceability, and (in some sense) verity that can be achieved within the accounting profession on questions of asset value accounting in particular, and "generally accepted accounting principles" in general.

2. One result of the perspective adopted by the legal capital scheme is that lawyers and judges often speak of making a distribution "out of surplus", or of "paying out the surplus" to shareholders. There is no special harm in this manner of speaking so long as the speaker and all their listeners are fully conscious that the statement is hash. "Surplus" and "deficit" are concepts invented by lawyers and accountants. They refer to an arithmetic balancing entry on a balance sheet, to the number that is the resultant of all the other numbers on the balance sheet and that is dictated by the basic mandate of the double entry bookkeeping convention—that the left side and the right side must at all times balance. Distributions are never paid "out of surplus", they are paid out of assets; surplus cannot be distribut-

ed—assets are distributed. No one ever received a package of surplus for Christmas. A distribution of assets will produce accounting entries that reduce assets and also reduce something on the right hand side of the balance sheet—often surplus—but that is quite another statement.

The enterprise that wishes to make a distribution to its shareholders must use assets to do it. It will usually find that only a small fraction of its total assets are in a form suitable for the purpose. Dividends are typically paid in cash. Occasionally, distributions are made in kind, as by parceling out security holdings or, to recall a famous World War II instance, through the distribution of warehouse receipts for whiskey.[15] In special circumstances, a distribution may sometimes be made by distributing fractional undivided interests in a major asset, such as an oil well working agreement. But, to take the example of Laminated Thumbscrew, the directors would find it difficult as a practical matter to distribute the patents, the land, the inventory or the accounts receivable; only in unusual circumstances would it wish to distribute the securities; and it cannot distribute all the company's cash since it needs cash for running its operations. The practical choices that will face the Laminated board of directors are, therefore, to make no distribution, or to make a small cash distribution, or to sell off some of the securities to generate cash for distribution, or to borrow cash for the purpose of distributing it to shareholders, the last being a transaction that usually has little appeal for either lender or borrower. Except for an enterprise that is unusually cash heavy, or an enterprise that is in liquidation, the form and character of the assets (plus, of course, the need of the enterprise for working cash) will usually be much more of an inhibition on shareholder distributions (assuming that the management *wants* to make such distributions)[16] than the arithmetic statement on the right hand side of the balance sheet called "surplus".

3. It is obvious that "legal capital", or "capital" as used by the law, has little or no relationship to the word "capital" as the economist, or even the businessman, knows it. Nor is it the block of assets that Justice Story had in mind.

15. See *In the Matter of Ira Haupt & Company*, 23 S.E.C. 589 (1946).

16. Retained earnings are today the largest source of new capital investment for American business enterprise. Dividend payments tend to be held to about ⅓ of net profits after taxes, the other ⅔ being committed by management to growth and research. Institutional Investor, Study Report of the Securities and Exchange Commission, Vol. 1, Ch. III at pp. 72, 80 (Table III–5) (1971); Standard & Poor's Trade and Securities Statistics, Security Price Index Record at p. [illegible]

The following statements may now be made about "legal capital".

a. Legal capital is a number expressed in dollars.

b. That number is initially the product of par value—itself an arbitrary dollar amount printed on the stock certificate and recited in the certificate of incorporation—multiplied by the number of shares "outstanding".[17]

c. Legal capital is a number that appears on the *right-hand*, or claimant's side of the balance sheet, *not* on the left hand asset side. "Legal capital" is *not* an asset, a fund, or a collection of assets. And it does not refer to an asset, a fund, or a collection of assets. (The same is true of "surplus.")

d. Legal capital is a number that can at best be read to convey a message by implication—a message about an historical event. It can be read to imply that a valuation of at least that amount was placed upon some indeterminate assets that were transferred to the corporation at some indeterminate past time in exchange for shares then issued.

Legal capital is entirely a legal invention, highly particularized in its meaning, historical in reference, *and not relatable in any way to the ongoing economic condition of the enterprise.* For most purposes, it is best thought of simply as a dollar number—a number having certain consequences and derived by specified statutory procedures, but just a number.

4. The law makes use of the concept of "legal capital" in two ways:

a. It is the maximum number of dollars up to which someone might in certain circumstances be able sometime to hold some shareholders liable if the implied statement in 3d above could be proved to be false.

b. It is a datum line, or water table, or bench mark, or nock on a measuring stick laid alongside the total number on the asset side of the balance sheet, on the basis of which lawyers will—or will not—sign an opinion that a proposed distribution of corporate assets to shareholders is valid, legal, and generates no liabilities either

17. Legal capital where no par stock is involved is discussed later, as are situations in which the stated capital may be higher than the product of par times shares outstanding.

for the board of directors that declares it or the shareholders who receive it.

And here is the real bite. In the world of corporate finance, transactions are utterly dependent upon opinions of legal counsel. If the financial lawyers are unwilling to opine favorably upon the legality of a corporate transaction, or a subcomponent of it, the transaction will usually not go through. Whenever a corporate financial transaction requires the lawyers to inquire into a company's legal capital position, the impact of the statutory schemes of legal capital is enormously magnified by the Go/No-go function performed by opinions of counsel. The lawyers, in turn, are compelled to develop an understanding of the statutory scheme and of its application. From that state of affairs "legal capital" draws its vitality, and this small book draws its functional relevance.

5. The Classic Example Modified: Low Par

As described earlier, in the typical corporation financing of the nineteenth century, the stock had a high par value, such as $100, and the subscribers did not agree to pay in more per share than the par value printed on the certificate. As promoters and investors became more sophisticated, however, low par stock came into use with the end in view of lowering the liability exposure of shareholder investors and of simplifying later issuance. If Laminated Thumbscrew was to receive $50,000, and was to issue 500 shares, as in the earlier examples, but the stock was to have a par value of $10 rather than $100, how then would its legal capital structure operate and with what consequences?

Balance Sheet of Laminated Thumbscrew, Inc.
Immediately Following Organization and Funding

ASSETS		LIABILITIES	
Cash	$50,000		$ –0–
		SHAREHOLDERS' EQUITY	
		Capital: $10 par common, 500 sh.	5,000
		Paid-in surplus	45,000
	$50,000		$50,000

Since on this balance sheet the "capital" is only $5,000, there is, in some sense of the term, a "surplus" of $45,000. If the only limitation on distributions to shareholders is the aggregate of debt plus legal capital, it is apparent that this company could lawfully distribute to its shareholders up to $45,000 of the cash that has just been put into the enterprise treasury. If, for some

reason it is thought desirable that the statutory scheme prohibit such a distribution, the statute can do so only by going beyond the concept of capital as a restriction and by differentiating between one group of surpluses that may be properly charged when shareholder distributions are made and another group of surpluses that may not. The more modern accountant would characterize the particular surplus here as "paid-in surplus" or "contributions in excess of capital" or "amount paid in in excess of par"; older terminology, and most statutory provisions on legal capital, would call it "capital surplus". The status of such paid-in surplus, or capital surplus, under various alternative statutory schemes is discussed later.

The possible significance and impact of the use of low par stock and the creation of paid-in surplus may be seen by returning again to the Laminated Thumbscrew balance sheet at the end of its first year of operations, but with $10 par rather than the $100 par stock assumed earlier. Making that one change, the balance sheet at the end of the first year would look like this:

Balance Sheet of Laminated Thumbscrew, Inc.
Year End After One Year of Operations

ASSETS		LIABILITIES	
Cash	$20,000	Bank loan	$10,000
Accounts receivable	6,000	Accounts payable	2,000
		Liabilities	$12,000
Inventory	10,000	**SHAREHOLDERS' EQUITY**	
Land	5,000	Capital: $10 par common, 500 sh.	5,000
Patents	1,001	Paid-in surplus	25,001
		Shareholders' equity	$30,001
	$42,001		$42,001

The difference in the par, the capital accounting and the statement of the legal capital has changed a $19,999 negative surplus to a $25,001 surplus. If a paid-in surplus account is legally chargeable for equity distributions under the law of the state of the company's incorporation,[18] Laminated Thumbscrew, which with $100 par could pay no dividends, may, with $10 par, pay up to $25,001.

18. All matters of legal capital, shareholders' distributions and the like are governed by the law of the corporation's state of incorporation.

As Laminated Thumbscrew begins to make money in its second year of operations to an extent that would permit it lawfully to pay dividends with $100 par stock, a number of accounting options are legally available to deal with the paid-in surplus account that was generated by the issuance of the $10 par stock at a price of $50 per share. Those options need not be explored here, but the principle should be clear; the paid-in surplus may, depending upon the applicable statute, provide the company greater latitude of choice and a greater capability for making distributions to equity holders than it would have had if it had used $100 par stock.

6. The Classic Example Further Modified: No Par Stock

Statutory provisions authorizing the use of no par stock, and a corresponding sophistication of the money market making no par stock acceptable, pulled one of the pintles out of the statutory scheme for controlling corporate capital and equity distributions. If "capital" was supposed to be the par value of the shares multiplied by the number of shares outstanding, what was capital to be if there was no par to multiply by? The only available answer was to say that the "capital" was whatever the board of directors "stated" it to be. The removal of the "par" printed on the stock certificate brought to visibility the arbitrary character of the process by which the number called "capital" was arrived at.

No other changes in the operation of the statutory machinery were required by the advent of no par stock, and no analytic problems were solved by it. If the capital account of Laminated Thumbscrew was to be made up of 500 shares of no par stock, the board of directors at the time of the issue would simply assert by resolution that $X of the $50,000 entry on the right hand side of the balance sheet should be allocated as "capital" and $50,000 minus $X as capital surplus. From there on, the matter would be handled as in the case of low par stock.

7. Changes in Capital Structure of the Ongoing Corporation

The simplified models examined so far have assumed that Laminated Thumbscrew has a static capital structure that was set once and for all at the time the company was organized and funded. In fact, of course, the capital structure of a corporation is altered from time to time to conform to the evolving needs of the enterprise in response to the business conditions in which it finds itself. Additional stock may be issued; stock may be bought in by purchases out of the corporate treasury, after which it may be cancelled, or retired to the status of authorized but

unissued stock, or, as is said, "held in the treasury"; so-called stock dividends may be paid out, or the stock outstanding may be split; reverse splits are not unknown through which, for example, each two outstanding shares are converted into one; stock options may be granted and subsequently exercised; new stock subscription agreements may come into being; stock or debt instruments with convertible privileges may be turned into newly issued shares; new classes of stock may be created; by amendment of the certificate of incorporation, the par value of one or more classes of stock may be altered; the board of directors may wish in a particular circumstance to increase the stated capital or reduce it without altering the par of the outstanding class; or a merger may eliminate, or radically alter any existing capital structure.

Every one of these transactions, and others, can have the effect of altering the stated capital figure on the company's balance sheet. The effects of these changes, and the corporate procedures required to bring them about, are considered in more detail later, especially in Part Two. For the present it is enough to note three points. First, changes in the capital structure of a company are commonplace and may be frequent. Second, the procedures required for particular changes are usually specified in detail in the applicable corporation code. Third, almost any change affecting the number of shares "outstanding", or altering their particular characteristics of par, will require an adjustment in the stated capital account and will, therefore, have direct repercussions upon the legality, in accordance with the applicable corporation code, of distributions to its shareholders.

C. LEGAL CAPITAL AS A CONCEPT: CONCLUSION

The purpose of this chapter has been to develop a general understanding of the concepts of par value and legal capital. With the general concepts in hand, the next two chapters consider the way in which these concepts are used by the law to regulate shareholder investment and corporate pay-outs to shareholders.