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Statutory Protection of Creditors in Reduction of Capital Stock

CHARLES C. CALLAHAN*

The sharp process of deflation which business has undergone during recent years has vested statutes relating to the reduction of corporate capital with an importance little appreciated when most of such statutes were enacted. Since 1929 an abrupt reversal of the previous tendency to increase corporate capitalizations has taken place. Enormous sums of money and the interests of many people have been subjected to the procedures for reduction of capital prescribed by the various corporation acts. With a few exceptions the protection which these acts afford to the creditors of the corporation involved is entirely inadequate, a situation which may be ascribed largely to a failure to comprehend the position of the creditor and the accounting problems involved in the reduction situation.

It is not the purpose of this article to attempt to clear up any confusion which may exist as to the meaning of such terms

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1 For an account of the extent of the reductions during the first years of the depression see Cartinhour and Dewey, Capitalization Changes as a Result of the Depression (April, 1932) Corp. Prac. Rev. 26. See also Hornberger, Accounting for No-Par Stocks During the Depression (1933) 8 Accounting Rev. 58, 59; Marple, The Sources of Capital Surplus (1934) 9 Accounting Rev. 75, 79; Comment (1934) 47 Harv. L. Rev. 693. The process is not yet complete. During the first four months of 1936 twenty-seven major companies announced the approval of capital reductions and fifteen others announced proposed reductions. Poore's Daily Reports (Industrials).

2 "There is unspeakable confusion among lawyers and accountants over the law relating to 'capital,' greatly increased by that most deceptive and variable term 'capital stock.' In these financial matters it is with the utmost difficulty that the legal and accounting professions can get together and understand the concepts and policies of the other." Ballantine, Problems in Drafting a Modern Corporation Law (1931) 17 A.B. A. Jour. 579. "The subject of reduction of capital stock, as it is often called, is involved in rather hopeless confusion in the statutes of most states." Ballantine, A Critical Survey of the Illinois Business Corporation Act (1934) 1 Univ. of Chi. L. Rev. 357.
as "capital" and "capital stock," but a few fundamental distinctions are necessary for the discussion to follow. The assets upon which a corporation operates are derived from two primary sources, its creditors and its stockholders. In the balance sheet of the company this source distinction is made on one side only, that showing liabilities and net worth. There is not, and of course cannot be, any such separation of the assets. In the most elementary manner the net-worth section may be described as made up of, first, the amount of the contribution made by the stockholders and dedicated to the business, this being the "Capital Stock" account, and, second, the so-called "Surplus" account which reflects the fortunes of the business and may, at any given time, show either a surplus or a deficit as the result of past operations. It is to this net-worth section that the creditor of the corporation looks for protection. In theory it represents the amount by which the asset values of the company may shrink before he becomes the loser.\(^3\) Obviously, so long as the asset values actually are present within the corporation it is of no concern to the creditor whether the balancing entries appear under "Capital Stock" or "Surplus"; and if the reduction of Capital Stock were really confined to that, and consisted merely of a bookkeeping entry shifting an amount from the Capital Stock to the Surplus account, it would not endanger him. The creditor's interest in this shuffling of values arises from the fact that, while the Capital Stock account may be a closet from which funds can pass only to Surplus, yet the latter has several openings which lead directly to the pockets of the shareholders and involve a withdrawal of assets from the corporation. Considerable confusion may be avoided, then, by remembering that, while "Reduction of Capital Stock" may refer only to the bookkeeping process by which funds are transferred from the Capital Stock account to the Surplus account, any effect which is detrimental to creditors must arise because of the subsequent disposition of the funds thus transferred.

\(^3\) Krauss, Maintenance of a Corporation's Capital (1931) 9 Tenn. L. Rev. 215, 218.
It must, of course, be recognized that there are conditions under which a reduction of the Capital Stock account, and even a subsequent distribution of the surplus thus created to the shareholders, may be quite desirable for the corporation and of no detriment to its creditors. Obviously if the capital is larger than the needs of the business demand and such capital may be employed more profitably elsewhere it is proper to withdraw the excess from the capital stock account and distribute to the shareholders an equivalent amount in assets. But by far the more common condition is that which calls for a reduction in order to absorb a deficit. Such a deficit may be the result of operating losses and be reflected in the surplus account, or it may have arisen from a shrinkage in value of the assets of the corporation which impairs the real capital although perhaps not yet apparent in the accounts. By absorbing the deficit through reduction, current earnings, which otherwise would be charged against the deficit, are made legally available for dividends. That the usefulness of this procedure is recognized generally is evidenced by the fact that corporation acts uniformly allow capital to be reduced. Such statutory

5 Kester, supra note 4. The large number of reductions during the depression were made, of course, as a means of absorbing deficits, Cartinhour and Dewey, supra note 1. When such is the case no assets are withdrawn from the corporation and the creditors have no cause for complaint.
authority is necessary for reduction and the procedure followed must conform to the formalities prescribed by the statute. Typically, statutes require a vote of two-thirds of the outstanding shares to authorize a reduction. Once authorized, the reduction may be effected in a variety of ways, concerning which the statutory provisions are not always clear. In general the methods falls within the following classes: (1) Reducing the par value of outstanding shares, or reducing the stated capital where the shares are without par value, (2) Retiring shares which have been surrendered by the shareholders, either pro-rata or by lot, (3) Purchasing shares for retirement pro-rata, in the open market or at private sale, (4) Exchanging par value for no-par value stock or no-par for par. Regardless of

(Remington, 1932, Supp., 1935) § 3803-40; Wis. Stat. (1933) § 180.07. The statutes are typical of those prevailing in the remainder of the states. In Georgia and Iowa the power to reduce depends upon a general power to amend the articles. Ga. Code (1933) § 22-308, 309; Iowa Code (1931) § 8360.


In some states a majority of the outstanding shares or of each class is sufficient. See the California, Delaware and Massachusetts statutes cited supra note 6.

Nine methods are enumerated in the Ohio and Delaware statutes. Ohio Gen. Code (Page, Supp., 1934) 8623-39; Del. Rev. Code (1915) § 1942, as amend., L. 1933, c. 91, § 5. It has been said that much of the confusion of the statutes is due to a failure to distinguish between such different operations as reducing stated capital, retiring shares, adjusting par value of outstanding shares to conform to stated capital as reduced, etc. Ballantine, A Critical Survey of the Illinois Business Corporation Act, supra, note 2.

the manner in which the reduction is effected the result is a credit entry to surplus. Corporation acts generally provide that the amount thus credited may be distributed to the shareholders, under varying restrictions, in the form of cash or other assets.12 And it has been held that such a distribution may be made on "general principles" irrespective of statutory authority.12

On the problem of the protection of creditors against a distribution following reduction the cases offer little or nothing. It is said that the statutory regulation of the subject is primarily for the creditors' protection.13 And courts have shown some willingness, when confronted with a reduction situation, to go beyond the books of the corporation and inquire as to its actual condition.14 But there is a surprising paucity of cases in which creditors' rights actually are adjudicated.15

To protect creditors adequately and, at the same time, secure flexibility in corporate capitalization is a nice problem for the legislator.16 Where this problem has been faced squarely admirable statutes have resulted; but the great majority of corporation acts offer the creditor little security in the reduction situation. Uniformly, and perhaps necessarily, the statutes

11 See infra, notes 18-21.
13 State ex rel. v. Benson, 32 Del. 576 (1924); Coleman v. Hagey, 252 Mo. 102, 145 (1913). These cases, however, did not involve creditors' rights.
14 Benas v. Title Guaranty Trust Co., 216 Mo. App. 53 (1924); Strong v. Brooklyn Cross-Town R. R. Co., infra note 12. In the latter case the court said: "The surplus, if any, which a corporation, reducing its capital, under the Act of 1878, is at liberty to pay to its shareholders, must, in every case, be ascertained, and depends upon the result of an examination into its affairs, and not upon the difference between the original amount of capital and the reduced amount." It should be noted that these cases also involved shareholders, not creditors.
15 See note 47 Harv. L. Rev. 693, 697. Creditors have been allowed recovery against stockholders who have withdrawn capital subsequent to the debt. Crandall v. Lincoln, 52 Conn. 73 (1884).
make reduction dependent upon a vote of the shareholders, the
very group against which creditors require protection.16a It is
most obvious, then, that some restriction should be placed upon
the extent to which a corporation may be allowed to distribute
the reduction surplus and thus effect a partial dissolution which
may turn out to have been done at the expense of the creditors.
Yet, strangely enough, the corporation acts of twelve states
contain no restrictions regarding such a distribution.17 In New
Jersey, one of the states, the court has made general statements
to the effect that the distribution must not affect the rights of
creditors or impair the capital of the corporation. This state-
ment, that creditors' rights must not be affected, is embodied in
the statutes of Nebraska and Virginia.18 Such provisions, of
course, go no further than merely to state the problem. A
larger group of statutes make "solvency" the limit beyond
which a distribution of reduction surplus shall not extend.19 In

16a See note 6 supra.
17 Alabama, Arizona, Kansas, Kentucky, Michigan, Mississippi, New
Jersey, New Mexico, North Carolina, Oregon, Pennsylvania, and Vermont.
These states have statutes prescribing formalities for reduction; Ala. Code
104; Miss. Code Ann. (1930) § 4133; N. J. Comp. Stat. (1911) p. 1616,
§ 29, as amend., L. 1931, c. 18; N. M. Stat. Ann. (Courtright, 1929) § 32-
§ 5795.
(Vernon, 1925) Art. 1332.
19 The following statutes prescribe "solvency" or a one-to-one ratio of
assets to liabilities and capital as reduced: Ark. L. 1931, c. 225, § 24; Conn.
Gen. Stat. (1930) § 3420, as amend. L. 1935, c. 53, § 1 (in case the dis-
tribution renders the corporation insolvent the directors and shareholders are
made jointly and severally liable); Fla. Comp. Gen. Laws Ann. (1927)
23, § 32, as amend., L. 1931, c. 480; Mass. Gen. Laws (1932) c. 156,
§ 45; Minn. Stat. (Mason, Supp., 1936) § 7492-38; Nev. Comp. Laws (Hill-
some of this latter group the provision is merely that the distribution shall not render the corporation insolvent; in the others, that the assets remaining after the distribution shall at least equal liabilities plus the capital stock of the corporation as reduced. A few statutes require that the assets remaining must be "sufficient to pay any debts, the payment of which has not been otherwise provided for." 20 Still another group includes the acts of the District of Columbia and a few western states which require that the capital stock, as reduced, must exceed existing liabilities, or, in other words, that the ratio of total assets to liabilities must be at least two-to-one. 21 Some of the more recent acts, notably that of California, indicate a much better grasp of the problem and will be examined in more detail.

Conceding that some restrictions must be placed upon the disposition of the surplus arising from a reduction of capital, the following are suggested as points which should be taken into account if a statute is to be designed for the proper protection of creditors.


(i) The credit balance resulting from reduction of the Capital Stock account must not be confused with Earned Surplus. Any restriction upon a distribution of capital as such is nullified if the same thing may be done by submerging the amount of the reduction in a general surplus reservoir from which regular dividends subsequently are paid. The courts have shown little tendency to ferret out the sources of the "surplus" which gives rise to dividends and have tended to confuse the matter somewhat by applying the term, dividends, to distributions of capital in the reduction situation. Accountants have long recognized that the only surplus rightly available for regular dividends is that arising through the actual operation of the business, that is, surplus representing realized profits. In order to accomplish this the general Surplus account must be divided into at least two components—Earned and Capital Surplus. The surplus arising from reduction quite obviously belongs in the latter class and there it should be listed if the temptation to withdraw it in defraud of creditors is to be minimized.

Only a few of the corporation acts refer to this distinction in dealing with reduction surplus. The acts of Illinois and Ohio designate the surplus so arising as "paid-in" surplus, although they do not expressly require that it be so shown on the balance

22 See Benson v. Title Guaranty Trust Co., 216 Mo. App. 53 (1924); Dominguez Land Corp. v. Daugherty, 196 Cal. 453; Comment (1934) 19 Corn. L. Quart. 470, 474.

23 Herskowitz, Archaic Laws and Dividend Policies, 4 Corp. Prac. Rev. (March, 1932) 47; Dewing, Financial Policy of Corporations (3rd. ed., 1934) 604; 1 Kester, Accounting Theory and Practice (3rd ed., 1930) 426 et seq. "So long as the law fails to take account of the sources of surplus, the opportunities for financial manipulation are many. Dividends may be paid out of the creation of legal surplus which includes (among other things) reduction in stated capital value of stock." Herskowitz, loc. cit. p. 48.

24 See recommendations of the Committee on Stock List of the New York Stock Exchange (Jan. 12, 1932), Herskowitz, supra, note 23, p. 48; Kester, supra, note 23.
The California Act is somewhat more specific in the requirement that the amount by which the capital is reduced shall be transferred to a "Reduction Surplus Account." The Michigan reduction statute recently has been amended to require that a division of the surplus between surplus arising from earnings and surplus arising from other sources be maintained on the books of the corporation. Although the procedures stipulated by these acts, other than that of California, are not particularly descriptive of the exact source of the surplus, they are satisfactory from the creditors' standpoint. The name of the account is of small importance so long as it is not classed as earned.

(2) There must be a differentiation between current and fixed assets in determining the limits beyond which a distribution of reduction surplus shall not extend. In this respect the great majority of the state acts have failed to take into account the true position of the creditor. Any struggle arising between creditors and shareholders in a reduction situation must center around the current asset group. If a distribution is contemplated it will be made, except in the most unusual cases, from

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25 "The surplus, if any, created by or arising out of the reduction of stated capital shall be deemed to be paid-in surplus...." Ill. Rev. Stat. Ann. (Smith-Hurd, 1934) c. 32, §157.60. "Such excess of assets shall be passed to and added to the surplus of the corporation and thereafter shall be subject to the disposition of the directors in all respects as surplus paid in by shareholders." Ohio Gen. Code (Page Supp., 1934) § 8623-40. cf the Nevada statute: "... such excess may be transferred to surplus and be treated as such for all purposes." Nev. Comp. Laws (Hillyer, 1929) § 1624, as amend., L. 1931, c. 224, § 7; to same effect. R. I. Gen. Laws (1923) § 53, as amend., L. 1932, c. 1941, § 3.

26 Cal. Civ. Code (Deering, 1931) § 348b, as amend., L. 1933, c. 533, § 51.

27 "A corporation shall at all times keep its books in such manner as to indicate clearly the division of the surplus accounts between surplus arising from earnings and surplus arising from other sources and it shall likewise indicate clearly such items in its annual reports to the state and its annual reports to its shareholders." Mich. P. A. 1935, No. 194. The statute is further interesting in the provision that no reduction of stated capital by more than fifty per cent shall be effective until all known unsecured creditors have been notified by mail.
the current assets.\textsuperscript{28} And it is to this group that the unsecured creditor must look for payment of his claim. The creditor is concerned primarily with the liquidity of the corporation’s assets; their total amount usually is of little importance to him. The statutes, then, which purport to protect the creditors’ interest by a provision that no distribution shall be made which renders the corporation insolvent, or by setting up any ratio to be maintained between total assets and liabilities, or total assets and liabilities plus capital stock, fail in their purpose since, under them, the asset values which remain after the distribution may be entirely non-liquid, although greatly exceeding the statutory requirement as to amount.\textsuperscript{29} Some recognition of the liquidity problem appears in the statutes of California and Ohio. Under the California Act the surplus resulting from reduction may not be distributed unless the directors determine that such a distribution will not render the corporation unable to meet its liabilities when they become due and that the remaining assets, at fair present value, will at least equal one and one-quarter times its debts and liabilities.\textsuperscript{29a} Here, although the ratio of one and one-quarter to one refers to the assets as a whole, the question of liquidity is implicit in the required determination that the corporation will be able to meet its obligations as they fall due. Ohio offers a similar general safeguard in the provi-

\textsuperscript{28} The corporation is not required to distribute cash. Specific property may be turned over to the shareholders where it is more feasible to do so. Continental Securities Company v. Northern Securities Company, 66 N. J. Eq. 274 (1904). Some statutes contain this provision. Cal. Civ. Code (Deering, 1931) § 348b, as amend., L. 1933, c. 533, § 52; Ill. Rev. Stat. Ann. (Smith-Hurd, 1934) c. 32, § 157.60. Even if property, rather than cash, is distributed it is quite likely to be from the current asset group.

\textsuperscript{29} Most of the statutes fall in this class, \textit{supra}, notes 19-21. Cal. Civ. Code, \textit{supra}, note 28. “It seemed to the California Committee, both in connection with dividends and distribution of assets and also in connection with purchases by the corporation of its own shares, that the \textit{liquidity} of the corporation as well as its \textit{solvency} should be considered, since even earned surplus may be represented merely by the book value of fixed and unmarchetable assets.” Ballantine, A Critical Survey of the Illinois Business Corporation Act, \textit{supra}, note 2, p. 379.

sion that there shall be no such distribution if there is reasonable ground to believe that the corporation is, or will thereby be rendered, unable to satisfy its obligations. The restriction contained in statutes of the Delaware type, that the remaining assets must be sufficient to pay debts the payment of which has not been otherwise provided for, may perhaps be interpreted to require that the remaining assets must be sufficient in nature as well as in amount but the point certainly is none too clear.

No state has attempted to set up any specific requirement as to the degree of liquidity to be maintained; and it is quite likely that any such requirement will prove difficult to apply. Yet it would seem that something approaching a definite standard must be prescribed by statute if any real protection for creditors is to result. Such provisions as those of the California and Ohio statutes are commendable in their recognition of the liquidity problem but offer little in the way of an effective answer. The California Act is satisfied if the directors determine that the proposed distribution will not render the corporation unable to meet its debts as they fall due. This suggests little more than another bit of formality to be enacted by the directors and included in a certificate to be filed with the secretary of state. Except in the most flagrant cases, the possibility of recovery against the directors would be small, if only because of the general nature of the proposition which they are required to determine. The Ohio statute does not require even the formality but leaves the matter to a "reasonable belief" to be entertained by some undetermined person or body.


"No such reduction, however, shall be made in the capital of the corporation unless the assets of the corporation remaining after such reduction are sufficient to pay any debts the payment of which shall not have been otherwise provided for and said certificate shall so state." Del. Rev. Code (1915) § 1942, as amend. L. 1933, c. 91, § 5. The other statutes, supra, note 21, are to the same effect with minor variations in wording.

The statute contains the further provision that no director shall be liable to the corporation, a creditor, or a shareholder if he acted in good faith and with reasonable care, supra, note 28.

If a specific standard of liquidity is to be set up it must involve a ratio between the liquid, or "current," assets of the corporation and the amount of unsecured claims against it. A perfect agreement among accountants as to what is to be included within the current asset group is scarcely to be expected; but it is believed that the term has sufficient meaning to be useful in this connection. Clearly it includes cash, receivable items and other property which may be expected to be turned into cash within a short time, although the particular accounts included may vary from business to business.\(^3\) Because of this variation it would seem unwise to attempt to enumerate by statute the items to be included within the current asset group. Also because of such variations the selection of a ratio between current assets and unsecured liabilities, beyond which a distribution to shareholders shall not extend, must be somewhat arbitrary. A ratio of two-to-one has been regarded traditionally as the ideal one from the standpoint of the extension of credit, on the theory that the shrinkage of asset values because of a liquidation will not exceed one-half. It is recognized that a business may operate on a ratio substantially smaller than this and still be in a sound position, in many cases, and that there is considerable unfairness in applying such a rule of thumb method in considering an extension of credit.\(^4\) But the error of the method seems to lie on the side of safety for the creditors; and if the application of the two-to-one ratio to the reduction situation seems unduly stringent it should be remembered that we are not concerned with anything so vital to the business

\(^3\) Three to six months has been given as the time within which assets should be expected to be turned into cash if they are to be regarded as current. I Kester, Accounting Theory and Practice (3rd ed. 1930) 28-29. See also, Wall and Duning, Analyzing Financial Statements (1930) p. 110 et seq.; Hatfield, Accounting (1928) p. 13.

\(^4\) "The banker merely wishes to have his loans paid when due and he seeks other criteria upon which to base his judgment than any arbitrary ratio between current capital and current debts." Dewing, Financial Policy of Corporations (3rd ed., 1934) pp. 485-488. See also Wall and Duning, supra, note 33, p. 243.
as the extension of credit. The ratio is not offered as a check on reduction but as a safeguard when it is proposed to distribute to the shareholders the surplus arising from such reduction. If the reduction is made in order to absorb losses, and this usually is the case, no distribution is made and no inconvenience to the corporation can result from the requirement. If the purpose of the reduction is to enable the shareholders to withdraw capital from the corporation, the personal interest of the shareholders alone is involved and no reason is seen why they should not be required to leave the creditors of the corporation in an ideal position after the distribution.

(3) **There should be some recognition of the extent to which the problem is affected by the valuation of assets.** The question of the true basis upon which asset values should be determined has long been a cause for despair among accountants and there is little agreement as to its answer.\(^{35}\) The principal contenders for recognition are (1) original cost less depletion and depreciation, (2) reproduction cost and (3) liquidation value; and perhaps different bases of valuation should be applied to different classes of assets.\(^ {36}\) It is argued that the liquidation value is the one which is of primary significance for the creditor and that this is the proper basis from which to value current assets.\(^ {37}\)

At any rate it is clear that the assets of the corporation must

\(^{35}\) Hatfield, Accounting (1928) p. 73. Kester lists fourteen kinds of value which have become established, including cost, market, reproduction, salvage, present, fair and taxable, II Accounting Theory and Practice (2d ed. 1925) p. 113.


\(^{37}\) "It is to the current assets that creditors must look as the source of the payment of debts. Cash is the only universally accepted medium of payment of debts. The content of the current asset section of the balance sheet should, therefore, be stated on a cash basis. . . . The general principle of valuation, therefore, for the current assets may be stated as a valuation on the basis of cash realizable values." Cost less depreciation is the proper basis for valuing fixed assets. II Kester, *supra*, p. 124.
be valued within the bounds of reasonable accuracy if any protection is to be afforded to creditors in the situation under discussion. In suggesting checks on the distribution of reduction surplus it has been assumed that the balance sheet of the corporation presented an accurate picture of the state of the business. Distortion of the picture may very easily nullify any effort to protect creditors. Thus it has been pointed out that if the assets of a corporation have been grossly overvalued, a reduction of the capital account, followed by a distribution to the shareholders of the apparent surplus created by the reduction, will result in destroying the protecting equity of the creditors, both secured and unsecured.38 Since, because of the overvaluation, the shareholders have furnished tangible value up to only a fraction of the amount of their stock, they are entitled to a distribution only of a corresponding fraction of the bookkeeping surplus created by the reduction. Actually they may receive it all; and, of the money distributed, a large percentage will have been furnished by the creditors.

The creditors may be defeated also where there has been a sizable undervaluation of the assets. If the book value of the corporate property is reduced to a figure below its actual value and the deficit thus created is written off against a surplus resulting from a reduction of the capital account, subsequent profits will be overstated by reason of the reduced charges to depreciation.39 These profits appear as earned and are subject to regular dividends; but, to the extent that they are overstated,

38 If, before reduction, a corporation presents the following balance sheet:

\[
\begin{array}{ll}
\text{Assets} & \text{Liabilities} \\
\text{Actual value} & \text{Debts} \\
$6,000 & $5,000 \\
\text{Overvaluation} & \text{Stock} \\
$9,000 & 10,000 \\
\hline
$15,000 & $15,000
\end{array}
\]

and the stock is then reduced by $1,000 it is improper to turn over an equivalent amount of assets to the shareholders. The proper procedure would be to distribute to the shareholders an amount representing the ratio of their investment to their stockholdings, which is one-tenth of $100, and apply the remainder to amortizing the overvaluation of assets. Reiter, Profits, Dividends, and the Law (1926) p. 236.

39 See comment, 44 Yale L. J. 1025, 1029.
they represent surplus which, in fact, arose not from operation of the business but from the reduction of capital. Put in another way, expenses are paid out of capital, ostensible profits are thereby increased and the net effect is that a reduction surplus is distributed in the form of ordinary dividends.

Undervaluation is not uncommon during a period of general writing down of asset values and it is the more dangerous because usually disguised as “conservative practice.”40 Obviously the answer to the problem is not to be found in regulation of the distribution of reduction surplus as such, since it is a distribution by ordinary dividend which is in question and in that situation the usual distribution statutes have no opportunity to operate. Rather, restrictions should be placed upon the extent to which a reduction surplus may be used to absorb asset devaluations. The limit should be set, and this of course can be done only roughly, at the point at which the write-down ceases to reflect present value and begins to anticipate future depreciation.

Of the state statutes only five expressly recognize the valuation problem in connection with reduction and distribution. The statutes of Idaho and Washington require that the effect of the reduction must not be to reduce the fair value of the assets of the corporation to an amount less than the total of its debts and liabilities plus capital stock as reduced.41 In Minnesota no part of the reduction surplus may be distributed to the shareholders unless the fair value of the remaining assets equals liabilities plus stated capital as reduced.42 The California Act requires, in computing the one and one-quarter to one ratio,
that the assets be valued at *fair present value*. New York provides that there shall be no reduction if the effect of such *reduction or of any distribution* made pursuant thereto would be to reduce the *actual value* of the assets below the one-to-one ratio. Although differing in terminology these statutes appear to have the same essential meaning. Those of Minnesota and California, referring only to distribution, clearly do not cover the practice of undervaluation mentioned above. And the statutes which tie *fair value* and *reduction* together seem just as inapplicable. They prohibit only the reduction of the assets, taken at their fair value, below the solvency point. They can hardly be construed to require that a reduction surplus shall not be used to write down assets to a point below their fair value. Be that as it may, such provisions, of course, do little more than recognize that the problem of valuation is present. But, in the case of a direct distribution of the reduction surplus, they do afford grounds upon which to check any injustice to creditors due to flagrant mis-valuation of the corporate assets. Since the valuation of assets is at best an estimate, and since accountants are not in agreement as to the manner in which the

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42. See note 29, *supra*.
43. N. Y. Cons. Laws (Cahill, 1930) c. 60, § 38.
44. There may be some protection against detriment to the creditors through undervaluation of assets in the restrictions which the particular state places upon the payment of dividends generally. The usual restriction is that dividends may be paid only out of surplus or, in a few states, out of earned surplus. In some states there is added a general insolvency limitation. Ballantine and Hills, *Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws* (1935) 23 Cal. L. Rev. 229, 239; Weiner and Bonbright, *Anglo-American Dividend Law* (1930) 30 Col. L. Rev. 330; Comment (1935) 10 Wis. L. Rev. 269. Since, where the assets are undervalued, the questionable amount appears as earned surplus on the books, only the latter type of statute offers any possibility of restriction; and then only when “insolvency” is interpreted to mean the inability of a corporation to meet its debts, rather than the technical excess of liabilities over assets. See Ballantine and Hills, *supra loc. cit.*; Rett, *When is a Corporation Insolvent?* (1932) 30 Mich. L. Rev. 1040. The former definition is expressed in the acts of California and Ohio. Cal. Civ. Code (Deering, 1931) § 346, as amend. L. 1933, c. 533, § 49; Ohio Gen. Code (Page Supp., 1934) § 8623-38.
estimate is to be made, it is likely that any attempt to be more specific than the requirement that the assets be taken at "fair present value" would be ill-advised.

Assuming that the various corporation acts properly restrict reduction and distribution of the resulting surplus, what remedies has the creditor where the statutory provisions have been violated, or where violation threatens? He may resort to the statutes which allow recovery against directors or shareholders for the wrongful payment of dividends; these statutes usually expressly apply to other distributions.\textsuperscript{45} The statutes and the decisions construing them vary as to the necessity for dissolution or insolvency in order to give rise to the liability and as to the extent to which good faith will excuse the director or shareholder.\textsuperscript{46} At best they merely provide a method, and a dubious one, whereby one creditor may recover his losses. The only enforcement provisions of a preventive nature, in this country, appear in the statutes of Texas, which provide that no reduction shall prejudice the rights of creditors and that the secretary of state may require, as a condition precedent to filing the certificate of reduction, that the debts of the corporation be paid or reduced.\textsuperscript{47} The matter appears to be entirely discretionary with him and of doubtful value to the creditor.

The suggestion has been made that we should adopt the


\textsuperscript{46} See Notes (1928) 55 A.L.R. 73, 98; (1932) 76 A.L.R. 892, 893.

\textsuperscript{47} Tex. Ann. Civ. Stat. (Vernon, 1925) Art. 1332. Some of the state statutes require notice of the proposed reduction to be published for a prescribed period. It has been suggested that these may possibly be interpreted as giving an injunctive remedy. Comment, 44 Yale L. J. 1025, 1042. In Schoenfeld v. American Can Co., 55 Atl. 1044 (New Jersey, 1903) the plaintiff attempted to enjoin the payment of a dividend on the ground that it did not arise from earned profits. The court held that the statutory liability of directors for illegal payment was an adequate remedy and the injunction was denied.
English practice in the reduction situation, sacrificing flexibility in order to secure a maximum of protection for creditors.\textsuperscript{48} By the Companies Act of 1929 reductions of capital are placed under the control of the court.\textsuperscript{49} After a corporation passes a resolution to reduce capital it applies to the court for an order of confirmation. If the reduction involves a distribution to shareholders, or a cancelling of liability for unpaid stock, a list of the creditors must be settled and the consent of such creditors to the reduction must be obtained. The reduction can proceed over the objection of a creditor only if the company secures the payment of his claim in full, or in an amount fixed by the court if the claim is disputed. Upon confirming the reduction the court may require the publication of the reasons for it and may order the company to add the words, "and reduced," to its name for a specified period. To conceal the name of any creditor or to misrepresent the nature of his claim is a misdemeanor; and any creditor whose name is omitted from the list, and who was prevented from appearing through ignorance of the proceedings, may recover against the members of the company. Undoubtedly the British are more solicitous about the creditors' position than any American legislature has shown itself. If a creditor comes out the loser under the English Act it is quite likely his own fault. At the same time, the advantages of flexibility in the corporate capital structure should not be discarded lightly, especially in cases where the creditors are not jeopardized; and, in view of the competition for corporate business existing among the states, it is probable that the respective legislatures would be loath to discard such advantages. Further, the large number of capital reductions which continue to be effected in this country would lay a considerable additional burden upon already overcrowded court dockets.

The more workable procedure then would seem to be one which would require court intervention on behalf of the creditor only when he can show, after receiving proper notice of the

\textsuperscript{48} Comments (1934) 47 Harv. L. Rev. 693; 44 Yale L. J. 1025, 1051.
\textsuperscript{49} 19 and 20 Geo. 5, c. 23, §§ 55-60.
proposal, that the statutory regulations are being violated to his detriment. If such violation appears, the creditor should be allowed to enjoin any distribution to the shareholders which exceeds the statutory limit. If no creditor complains the reduction will go through with as much facility as under present statutes.

Following the points set out above, an attempt has been made to draft a statute from the standpoint of the protection of creditors. Problems relating to the respective rights of shareholders, such as the mechanics by which the actual reduction of the capital stock account is to be effected and the manner in which any distribution of assets, once determined as allowable, is to be made, have not been considered. Further, when considering the statute in connection with any one state, the more general provisions of the particular corporation act, such as those regarding valuation of the corporate property and the liability of directors and shareholders may require notice.

1. If the capital stock of a corporation is reduced in any manner provided by law the amount of such reduction shall be carried at once to a reduction surplus account and shall remain a part of such account and appear as such in all reports made by the corporation until disposed of in accordance with the terms of this section.

No disposition of the amount appearing in such reduction surplus account shall be made except when authorized by a resolution of the board of directors and approved by the vote or written consent of the holders of a majority/two-thirds of the outstanding shares.

The amount of such reduction surplus may be written off against any deficit arising through operation of the business of the corporation or through a bonafide revaluation of the assets of the corporation, provided that no part of the corporate property shall be shown on the books of the corporation at less than its fair present value following such write-off.

Assets of the corporation may be distributed to its share-
holders up to the amount of such reduction surplus, provided that the assets remaining after such distribution and taken at their fair present value shall at least equal its debts and liabilities plus its capital stock as reduced, and provided further that the current assets of the corporation remaining after such distribution and taken at their fair present value shall equal at least twice the amount of the unsecured debts and liabilities of the corporation.\(^5\)

No distribution of assets of the corporation shall be made to its shareholders, either as a distribution of reduction surplus or in the form of regular dividends, within thirty days after the approval by the shareholders of a reduction of capital stock.

2. Whenever a reduction of the capital stock of a corporation has been approved by the shareholders the president of the corporation shall, within ten days after such approval, notify by mail all known creditors of the corporation whose claims are unsecured. Such notification shall state the amount of the reduction and the manner in which it is to be effected and shall state in detail the proposed distribution of the resulting reduction surplus. Any creditors of such corporation, upon petition to a court of competent jurisdiction and upon a showing that the provisions of this act have been violated or are about to be violated, shall be entitled to an injunction restraining such violation.

Nothing in this section shall be construed to abrogate or limit any liability placed upon any director, officer and/or shareholder of any corporation by any of the provisions of this act.

The above suggested statute differs from any existing act chiefly in the requirement that a liquidity ratio be maintained and in the provision allowing affirmative relief to the creditors. In securing this latter end facility of procedure must be sacri-

\(^5\) It will be noted that, in addition to the current ratio, the one-to-one, or "solvency," ratio has been retained. Although it probably means very little it may offer some protection for the long term creditors to whom present liquidity is not of primary concern.
ficed to an extent consistent with adequate notice to the creditors. Although this entails some little delay to the corporation, it is believed that the statute secures adequate protection for the creditors without being too unwieldy from the standpoint of management.