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Book Reviews: A Concise Textbook on Legal Capital

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A CONCISE TEXTBOOK ON LEGAL CAPITAL. By Bayless Manning.* Foundation Press, Mineola, New York. 1977. Pp. 163. Reviewed by Mark D. Coplin.†

Possibly no body of law is more taken for granted and less genuinely understood than that regulating the capital structure of business corporations. Myriad state statutes and court decisions attempt to fix standards for stock issuance and to place limits upon the distribution of corporate assets to shareholders in order to protect both stockholders and creditors of the corporation against inequitable dissipation of the corporate capital. However, in practical application, these rules often prove to be inadequate to accomplish their avowed purpose. This phenomenon is examined in scholarly fashion by Bayless Manning in his new textbook on "legal capital," which the author states is intended to be read by law students and other interested persons without the aid of an instructor.[1]

The reader is reminded that the special status of the capital of a corporation as a "trust fund" for its creditors was first established in United States law in 1824 by the classic decision of Justice Story in *Wood v. Dummer,*[2] wherein stockholders of a bank were required to return distributions of funds which had rendered it insolvent. This decision and much of the current law on the subject is protective of creditors, who want to be assured that the assets of their corporate debtors are retained in the business until the indebtedness has been paid. However, as the author notes, this view is in conflict with the desire of shareholders to receive dividends even though such distributions deplete the assets available for payment of corporate debts. Dean Manning deftly analyzes the practical and conceptual problems which are inherent in the law of "legal capital" (a term used by the author interchangeably with the more familiar term, "stated capital") and then proceeds to appraise the state statutes which have attempted to resolve these questions.

The concept of "par value" has become deeply ingrained in the law as the minimum standard for the consideration to be received by the corporation when its legal capital is created by the issuance of shares. Thus, most state statutes still declare that stock may not be issued for less than its par value. Dean Manning demonstrates that this standard is of little practical value because the statutes do not

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1. B. MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL at VII (1977). The subjects treated include stated capital, par and no par stock, reductions of capital, restrictions on distributions to shareholders, impairment of capital, equitable contribution, stock watering, and promoters' liability.

2. 30 F. Cas. 435 (C.C.D. Me. 1824) (No. 17,944).

attempt to require that the par value of capital thus created will be adequate for the enterprise, and the par value concept, itself, has generally been neutralized by other statutory provisions which permit stock to be issued for only a nominal par value, without par value, or even for an amount less than par. Moreover, the statutes generally permit stated capital, even if originally reflecting a substantial par or other stated value, to be reduced at the whim of the corporation and its stockholders, without any consultation with company creditors.

The state laws are shown to be equally erratic and ineffective in regulating corporate distributions.[3] Many states, including Maryland, still generally prohibit payments to shareholders if the stated capital is or will thereby be impaired. Some states apply only a test of corporate "solvency," which ignores the concept of legal capital; others look to the existence of balance sheet "surplus," which dispenses with the notion of capital in favor of accounting concepts. Whatever the efficacy of a particular statutory scheme, it is generally rendered inoperative by other provisions of law which permit the corporation and its stockholders to reduce the stated capital and thereby create capital surplus which can either be distributed to shareholders or applied to eliminate an existing deficit and thus permit distributions to be made to shareholders which would otherwise be barred. Dean Manning calls attention to at least two states, California and Delaware, which have departed from the traditional "trust fund" approach. California,[4] which has also abandoned the concept of par value in connection with the issuance of shares, ignores stated capital and surplus and permits distributions to shareholders so long as the book value of corporate assets is at least 125 percent of liabilities and current liabilities do not exceed current assets. Delaware, the most famous state of incorporation of them all, long ago formally rejected *Wood v. Dummer* by expressly permitting insolvent companies to pay "nimble" dividends to their

3. The legal capital provisions of Maryland law, not cited by Manning, are typical, as evidenced by the following sections of MD. CORP. & ASS'NS CODE ANN. (1975). Unless stock is without par value the charter must state the par value of authorized shares, § 2-104(a)(6)(iii). But even par value stock may be issued for less than par, § 2-203(e). Consideration for par value stock, up to the par value, constitutes stated capital; excess is capital surplus, § 2-303(a). Directors may allocate consideration for no par stock between stated capital and capital surplus, § 2-303(b)(2). Capital surplus, whether derived from reduction of stated capital or from original stock issuance, may be used to reduce existing deficit or to make distributions to stockholders, and if resulting from reduction of capital, may expressly be used to reduce liability of shareholders on unpaid stock subscriptions, §§ 2-304, 308. A corporation may not purchase its own stock, make a distribution in partial liquidation, or pay dividends if either the capital is or will be impaired, or the corporation is or would thereby be rendered insolvent, §§ 2-309(b), 311(c)-(d).

4. CAL. CORP. CODE §§ 202(c), (e), 500 (West).

shareholders if payment is made from earnings of the current or next preceding fiscal year.[5]

This reviewer has seen no evidence that California or Delaware corporations, despite their revisionist laws regulating corporate distributions, find it especially difficult to obtain credit. To the contrary, thinking businessmen could well feel that the California asset ratio standard provides more protection to creditors than the more customary legal capital tests, and despite Delaware's libertarian "anti-creditor" approach, that state remains a popular place of incorporation. Dean Manning correctly concludes that creditors (if not most judges and legislators) know that corporate debts are paid from earnings and real assets, rather than from formalized legal capital.

The author believes that under present law virtually any distribution to shareholders can be done legally by an experienced practitioner, provided that the company (unless formed in Delaware) is not insolvent, but he warns that the legal capital system can be a trap for inexperienced counsel and uninformed clients, either by creating an avoidable liability or by blocking a transaction which the parties could have accomplished if they had been more familiar with the law.

Is there any value in the legal capital system? Dean Manning points out that historically, bankers and other businessmen are suspicious of a "thin" stated capital and generally share the idea that distributions to shareholders should not be made from capital. However ineffective, the present statutory scheme reflects a general norm of behavior to which the business community subscribes, making it unlikely, in the author's view, that the legal capital statutes will be repealed or significantly amended. In an effort to validate present law, Dean Manning comments that prevailing legal capital legislation probably creates an atmosphere which psychologically inhibits corporate managers from making indiscriminate distributions to shareholders, and that medium-sized companies (those which are too large to ignore legal niceties and too small to employ loophole-wise counsel) are actually guided by the legal capital requirements. But in the end, the author is constrained to state that creditors do not gain much from the present system (he claims to have found no modern case where a creditor has successfully attempted to force shareholders to return a distribution), but that they actually rely on their own credit investigations, demands for security or guarantees, or protective restrictions contained in loan agreements.

The final one-third of the textbook is devoted to 23 hypothetical transactions which illustrate the effect of various types of legal capital legislation upon corporate balance sheet, capitalization, and

5. DEL. CODE ANN. tit. 8, § 170.

distribution problems. These case studies confirm that present laws are irrational and provide challenging exercises in balance sheet gymnastics which will delight the accounting-minded but shock the sensibilities of those who may not already have lost confidence in the legal capital system.

Practitioners and students alike will be grateful to Dean Manning for this revealing overview of the undisciplined law of legal capital. The volume should not only improve general understanding of the subject, but also speed the adoption of legislation in Maryland and elsewhere which will eliminate some of the aberrations which Dean Manning has so graphically described.[6]

6. This reviewer believes that any global resolution of the legal capital problem must also take into consideration certain related questions which are generally not covered by the statutes and which often plague practitioners and their clients. Whatever the statutory test, is the validity of a redemption distribution paid in a series of installments properly determined when the debt is created or as of the date of each installment? Under what circumstances will a shareholder's claim to receive proceeds of a stock redemption be subordinated to the claims of other creditors in the event of bankruptcy of the corporation? What is the rationale for preventing a corporation from validly guaranteeing its stockholder's debt?