THE MINNESOTA BUSINESS CORPORATION ACT

P. L. SOLETHER AND EDWARD G. JENNINGS

PART I

P. L. SOLETHER

The Business Corporation Act of 1933 was the first general revision of Minnesota's corporation laws since the General Statutes of 1866. The meager provisions of that early act relating to corporations were altered by succeeding legislatures for sixty-seven years, to meet special problems, without any serious effort to construct a comprehensive, co-ordinated chapter on corporations.[1] Consequently our statutory provisions became "crude, inconsistent and in conflict with each other".[2] Since 1872, Minnesota also suffered from a constitutional provision making shareholders personally liable for the debts of corporations to the amount of the stock owned by them.[3] Under our constitution and statutes, many attorneys practicing in Minnesota prior to 1933 felt compelled to use the laws of other states for purposes of incorporation.

Believing it was the duty of the state to furnish its citizens with suitable laws for the conduct of their business affairs, the Minnesota State Bar Association, in 1929, determined to take the initiative to correct this undesirable situation. It was first necessary to eliminate the shareholders' constitutional "double" liability. In 1930 the Association procured the submission of a suitable amendment to the electorate. The organized Bar led and financed a state-wide campaign in favor of the amendment which resulted in its adoption.[4]

Encouraged by this success, the Bar Association next undertook the more difficult work of revising the statutes relating to corpora-

[1] The General Revision of 1905 was a "rearrangement and restatement of the previously existing general statutory law of the state, with such amendments as the commission and legislature deemed advisable". See Minn. Rev. Stat. (1905) foreword, iii. The new matter relating to corporations was comparatively small.

[2] National New Haven Bank v. Northwestern Guaranty Loan Co., 61 Minn. 375, 386, 63 N. W. 1079, 1082 (1895).

[3] Minn. Const. art. X, §3; see also Dunnell's Minn. Dig. §2080. Corporations organized exclusively for "the purpose of carrying on any kind of manufacturing or mechanical business" were excepted from the constitutional shareholders' "double liability", so called. See Note, *What is a Manufacturing Corporation?* (1928) 12 Minn. L. Rev. 657.

[4] In 1928 a similar effort had been made by the state Bar, but the proposed amendment failed on that occasion to receive the required vote. The association had passed resolutions relating to the subject nearly every year since 1915.

tions. In 1931 a committee was formed to draft such an act. The committee consisted of a drafting division of seven lawyers, residing in the Twin Cities, and an advisory division of thirty lawyers, residing in other parts of the state.[5] Care was exercised by the president to select men of proved ability to work harmoniously with each other and with others. Two members of the drafting division were specialists in corporation law, three were general practitioners, one an assistant attorney general, and one a member of the faculty of the State University Law School. The chairman was a general practitioner, who had been chairman of the committee which had secured the adoption of the constitutional amendment. The drafting division, thus composed, could not be accused of representing any special interest group. The University connection increased the confidence of the Bar and of the public in the committee.

The advisory division was composed of general practitioners of recognized ability and leadership in their communities, men who had shown interest in bar association activities. It included several influential members of the legislature. The support of a proposed law by this division, it was believed, would carry weight throughout the state and in the law-making body.[6]

Thus constituted, the committee began its work early in 1932. A joint meeting of the two divisions was held. The then professor of corporation law at the University, Harvey L. Hoshour, not a member of the committee however, was asked to recommend a plan of procedure. He suggested the use of the Uniform Corporation Act for a working basis and that a draftsman be obtained to submit preliminary drafts with parallel statements of the Uniform Act, the Minnesota statutes and the recent acts of Delaware, Ohio and California. This plan was approved and Mr. Hoshour was prevailed upon to act as draftsman.

The members of the drafting division were supplied with copies of the Uniform Act and the recent revisions of Delaware, Ohio and California in convenient pamphlet form. Each report of the draftsman covered two or three sections of the proposed act with notes and references to the statutes of other states being used for comparison.[7] After studying his proposals the drafting division considered them at regular meetings held weekly, without interruption, for eight

[5] The members of the drafting division were chosen from a restricted area to facilitate frequent meetings.

[6] It was necessary to avoid the antagonism of certain political groups to corporations as such.

[7] The statutes of states other than those named were frequently referred to.

consecutive months. The draftsman frequently asked for instructions as to matters of policy. Although his work was scholarly and of the highest merit, the views of the committee members did not always coincide with his, and their opinions were not always unanimous. With only a few exceptions, however, final decisions were withheld until the unanimous approval of the committee and the draftsman could be given. Most sections of the act contained several subdivisions each of which involved matters of policy, wording, punctuation and arrangement. The draftsman's duties became so heavy that matters of rewording and rearrangement were usually referred to one or more members for submission at a later meeting. After a few weeks the meetings were well occupied with the consideration of questions of policy to be covered by later sections, reports of the draftsman, reports of subcommittees, and with efforts to arrive at final agreements.[8]

When about one-fourth of a tentative draft was completed, it was submitted to the advisory division, in mimeographed form, for study and criticism. A meeting of that division was called, at which the reasons for each proposal were explained. This gave the drafting division members experience in presenting the subject to others. New ideas were developed and weak places in the draft were discovered. The advisory division became convinced that the drafting division members were trying to do thorough, conscientious work, which enabled the two divisions to go on in a spirit of mutual trust and confidence.

This process was repeated several times until the first draft was completed. It was then printed and mailed to all the lawyers in the state for study. Meetings of district bar associations were next held, each of which was attended by one or more members of the drafting division. These meetings developed principles which were embodied in the first draft; but more important, at that stage, was the contact with the rank and file of attorneys and the gaining of their confidence. The proposed act was so extensive and at the same time so compact that few lawyers could be expected to devote the time required to understand the significance of every part. Their support necessarily rested largely upon confidence in the committee.

A second tentative draft was then prepared. The sections were rearranged and some new material added. This was submitted to the advisory division by mail and, after their approval, to the members

[8] Mr. Hoshour moved to New York City after the work was about half done. The members of the committee served as draftsmen of the remaining sections.

of the state Bar preceding a meeting in general convention. Here the final draft was examined again. The Association gave its unanimous recommendation that the proposed act be adopted by the legislature. At the convention some opposition was threatened by a few members who had been too busy to study the first proposals or to report their ideas to the committee. The confidence created at the district meetings and the support of the advisory members carried the day. The advisory members were able to report the evolutionary process through which their minds had gone. They urged that absolute perfection in the eyes of each member was not to be expected and that the committee merited their support. At this stage every lawyer who had any interest in the subject had been given ample opportunity to make his suggestions and criticisms directly to the committee. This prevented many ill-advised criticisms before the convention where the limited time made adequate explanations difficult, and where the critics naturally clung more tenaciously to their points of view than would have been the case were they arguing before a smaller group. In work of this kind there comes a time when that which is proposed must be accepted in full or rejected entirely.

In the legislature, practically no opposition was made. Final consideration of the bill was delayed until near the end of the session by certain members who suspected either that special interests were trying to secure special powers or that the bill was too drastic. Here again the support of the advisory division and the favorable publicity resulting from the district and state Association meetings were invaluable. Those having doubts accepted the judgment of the advisory members where they would not have accepted the conclusions of the drafting division. The lay members naturally deferred to the attorneys in the legislature, the majority of whom were already convinced of the need for a general revision and that the work of the State Bar Association merited their support. The bill was passed with only a few dissenting votes.

PART II

EDWARD G. JENNINGS

As shown by Mr. Solether, the work that had commenced with the removal, by the amendment in 1930, of the double liability obstacle to domestic incorporation theretofore imposed by the Minnesota constitution upon the shares of non-banking[9] business corpora-

[9] The double liability separately imposed upon the shares of banking corporations by the Minnesota Constitution, article IX, §13, remained unaffected by the 1930 amendment.

tions, thus happily eventuated in the enactment of a comprehensive corporations act[10] frankly designed to attract the local incorporation of legitimate local business.[11] Minnesota has no desire to become a chartermongering state. The Act permits incorporation by "Three or more natural persons of full age . . . for any lawful business purposes", excepting those as to which other statutes prescribe a special incorporating procedure.[12] By a conclusive presumption of acceptance, the Act has now become applicable to those corporations previously organized that failed to signify, within the time allowed their election, not to be bound by its provisions.[13]

Under the Act it is now possible in Minnesota to charter a corporation of indefinite duration.[14] Restrictively, the state reserves for the first time the power to alter, amend, or repeal.[15] The enumeration of powers common to corporations extends or at least liberally interprets the previously existing law in two respects: (1) by providing that "failure to affix the corporate seal, if any, shall not affect the validity of any instrument";[16] and (2) by including within the implied powers of a corporation all those *"expedient* for the attainment of the purposes stated in its articles".[17] (Italics supplied). The required filing of the corporate articles[18] "is for the purpose of afford-

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[10] Minn. Laws 1933, c. 300; as amended by Minn. Laws 1935, cc. 117, 212.

[11] See Hoshour, *The Minnesota Business Corporation Act* (1933) 17 Minn. L. Rev. 689, 690, 18 Minn. L. Rev. 1.

[12] §2.

[13] Section 61 (I) of the original Act allowed such corporations one year within which to elect not to be bound by its provisions. As to corporations that had neither accepted nor rejected the Act, nor amended their articles after April 18, 1934, so as to extend the corporate existence, the time limit of one year was extended to May 1, 1935, by Minn. Laws 1935, c. 44; and it was further extended to March 1, 1936, by Minn. Spec. Sess. Laws 1935, c. 53. The application of the time limit as extended, to bring a non-assenting corporation within the provisions of the Act has been upheld in a case before the District Court for Hennepin County. Subsequent legislation permitting the retroactive renewal of corporate charters that have expired has been made conditional upon the renewal constituting an election to come under the general Act; see Minn. Laws 1935, c. 272, §1; Minn. Spec. Sess. Laws 1935, c. 59, §1.

[14] §3 (I) (b).

[15] §60.

[16] §8(c). Under the previous Minnesota law, it was assumed that a corporate deed had to be under seal to convey legal title; Minn. Stat. (Mason, 1927) §6933. See Note (1933) 17 Minn. L. Rev. 543.

[17] §8 (f). Under the previous Minnesota law the existence of double liability was no doubt a factor in inducing judicial restriction of implied powers to those reasonably *necessary*, rather than merely *expedient*, for the attainment of the corporate purposes. See Nicollet Nat. Bank v. Frisk-Turner Co., 71 Minn. 413, 74 N. W. 160 (1898).

[18] §§5 and 6.

ing means of acquiring knowledge of the contents thereof, but shall not constitute constructive notice of such contents".[19]

For the purpose of avoiding ambiguity, the Act adopts the phrase "stated capital" to designate the "capital liability" of the corporation for legal purposes.[20] "Stated capital" is defined to include: (1) the aggregate par value of all allotted par shares, and the aggregate portion of the consideration received for no-par shares that has not been allocated by the board of directors to paid-in surplus;[21] and (2) the amounts of all transfers from surplus to stated capital upon the declaration of share dividends[22] or by other action of the directors or shareholders.[23] Separate provision is made for the reduction of stated

[19] §10. Under the previous Minnesota law, while it was said to be "a settled rule that a person who deals with a corporation must take notice of its charter or articles of association", see Marin v. Calmenson, 158 Minn. 282, 285, 197 N. W. 262, 263 (1924), about the only use that was actually made of this rule was "to limit the application of the now abolished constitutional double liability of shareholders"; see Hoshour, *The Minnesota Business Corporation Act* (1933) 17 Minn. L. Rev. 689, 696-697.

[20] §1 (X). That the conception of "capital liability" for legal purposes is fundamentally different from the accountant's conception of the total originally contributed proprietorship interest, see Marple, Capital Surplus and Corporate Net Worth (1936) 4, 6-9.

[21] §1 (X) (a) (1) and (2). Under §20 (III) the directors or shareholders, as the case may be, whose duty it is under §14 (II) to value the consideration received for shares, are required to designate at the time of allotting no-par shares the portion of the consideration received therefor to be allocated to stated capital, which portion, unless the subscription contract expressly provides otherwise, may not be less than the amount of the preference in liquidation, if any, carried by such shares; and if no such allocation is made, then under §20 (I) the whole amount of the consideration received for such no-par shares, valued as required by §14 (II) and (III), becomes automatically allocated to stated capital. For purposes of determining the minimum amount of stated capital as required by law, fixed by §3 (I) (f) at $1,000, and of determining the amount of incorporation fees, but for no other purposes, no-par shares must have a minimum stated capital value of $10 each; see Minn. Stat. (Mason, 1927) §§7470-4 and 7475-2 (a), as amended by Minn. Laws 1935, c. 230, §§1 and 2. These provisions are left applicable to corporations within the general Act by virtue of §62 thereof, as amended by Minn. Laws 1935, c. 117, §12.

Shares once allotted are required to be retained as stated capital whether still outstanding or not, until the procedure required by §38 for reducing stated capital has been complied with. For the proper accounting practice in such a situation, see Marple, Capital Surplus and Corporate Net Worth (1936) 52-76. The reacquisition by a corporation of its own shares is thus not a proper method of reducing stated capital. *Cf.* Germann v. Farmers' Tobacco Warehouse Co., 260 Ky. 249, 84 S. W. (2d) 82 (1935); and Cal. Civ. Code 1933, §342 (7).

[22] §1 (X) (a) (3). By §21 (III) (c) share dividends are required to be capitalized at (a) par; or (b) the involuntary liquidation preference, if any, of no-par shares; or (c) the "fair value" as estimated by the board of directors of no-par shares without preference in involuntary liquidations. See the discussion at pp. 437-8 of the text.

[23] §1 (X) (a) (4). It has been suggested that the capitalization of surplus without a share dividend may make possible the circumvention of the provision of §21 (I) of the Act against the payment of dividends out of unrealized appreciation—by capitalizing such unrealized appreciation and thereafter reducing

capital,[24] which, to the extent that stated capital has not already become impaired in the amount of the reduction, may result in a transfer to paid-in surplus.[25] No restrictions are placed upon the number of classes or series of shares or share-rights, so long as the incidents of each class or series are adequately set forth in the corporate articles.[26] Provision therefor must be made in the articles if the board of directors is to have power to alter the number of shares in any class or series in respect of unallotted shares, or to alter the dividend rate or liquidation or redemption price in respect of such shares, or to deny or limit preemptive rights that would otherwise exist.[27]

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stated capital under the provisions of §38 of the Act, thus transferring to paid-in surplus, out of which dividends may be paid in the manner permitted by §21 (II) (b) and §21 (III) (b), the amount of the previously capitalized unrealized appreciation. See Ballantine, *A Critical Survey of the Illinois Business Corporation Act* (1934) 1 U. of Chi. L. Rev. 357, 371. It is believed not unlikely, however, that a court would hold such a procedure to be in violation of the purpose of the restrictions on dividends, and therefore improper.

[24] §38. The stated capital may not be reduced below the aggregate par value of all outstanding par shares; or so as to impair the liquidation preference in stated capital of outstanding preference shares, without the prior affirmative vote of the majority in interest of each class of preference shareholders so affected; §38 (I). The resolution of reduction becomes in effect an amendment of the corporate articles, requiring filing in the same manner as an amendment; §38 (II) and (IV).

[25] §1 (X) (b). By the language of §38 (III) paid-in surplus so created may not be "distributed to the shareholders in any form" if to do so would impair the stated capital as reduced. But if the corporate assets have been properly valued it is difficult to see how in such a case there would be a paid-in surplus resulting from a reduction of stated capital, if distributions from it could result in an impairment of the stated capital as reduced. In the light of the restrictions imposed upon distribution by §21, §38 (III) would seem to be entirely redundant; see the discussion at pp. 431-4 of the text.

[26] §3 (I) (e). But by §13 (VI) options to subscribe for shares may not be granted except in connection with the issuance of shares or other securities or to existing shareholders "ratably in proportion to the number of shares held". That this limitation of the Minnesota Act may "prevent certain abuses" is the opinion of Professor Ballantine, see Ballantine, *A Critical Survey of the Illinois Business Corporation Act* (1934) 1 U. of Chi. L. Rev. 357, 363.

[27] §3 (I) (e) and (i). The Minnesota Act thus makes it possible for the directors to vary the dividend rate or the redemption or liquidation price of newly-issued shares "according to what the financial condition of the corporation and the state of the investment market may seem to require if the securities are to be readily sold". See Dodd, *Statutory Developments in Business Corporation Law, 1886-1936* (1936) 50 Harv. L. Rev. 27, 47, comparing the provisions of the Delaware and Illinois acts in this respect and pointing out the desirability of protecting "existing stockholders against a reckless use of this power by the provision [of the Illinois act] that the directors may not give the holders of such new series priority over the holders of existing series within the same class". A careful reading of §3 (I) (e) of the Minnesota Act should make it clear that in no event may the directors be given power thereunder to create new priorities over an existing series within the same class. For an otherwise "reckless" use of the power conferred by §3 (I) (e), the directors may become liable under §15 (II); see the discussion at pp. 447-8 of the text.

By §21 (III) (d) of the Minnesota Act provision therefor in the articles, or else the affirmative consent of two-thirds in interest of the class in which a

Since space limitations preclude complete analysis, the remaining discussion is devoted to a few selected problems as dealt with by the Act.

A. DE FACTO CORPORATE EXISTENCE UNDER THE MINNESOTA ACT

By Section 5 "the corporate existence shall begin" upon the issuance by the secretary of state of a "certificate of incorporation";[28] and the only requirements that can be construed as precedent to the issuance of the certificate are that the corporate articles "conform to law" and that all fees have been paid.[29] It is the opinion of an eminent authority that under such a statute there can be no de facto corporation;[30] since, if the certificate has been issued, there is at least a "de jure corporation subject to forfeiture",[31] whereas, if the certificate has not been issued, there is not sufficient "colorable compliance" and therefore at most a mere "corporation by estoppel".[32] Section 7 purports to make a certificate issued by the secretary of state, "in accordance with the provisions of Section 5, . . . conclusive evidence of the fact of incorporation". Read literally, Section 7 seems to add very little to Section 5; since, on the one hand, the "fact of incorporation" does not prevent forfeiture for sins either of commission or omission of sufficient materiality,[33] whereas, on the other hand, the reference back to the "provisions of Section 5" really begs the question, for purposes of direct and collateral attack alike.

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share dividend is declared, is essential to the participation of other classes in the share dividend.

[28] The "certificate", as distinguished from the "articles", is required to include only "the name of the corporation and the fact and date of incorporation".

[29] The required publication by the corporation of "a notice stating the name of the corporation, the date of its incorporation, the general nature of the business being, or about to be conducted by it, the address of its registered office, and the names and addresses of the incorporators and of the first board of directors", §5 (III), is probably not even a condition subsequent upon incorporation, since the statute specifically prescribes only a money penalty of $50 for the omission of this requirement. The duty of filing copies of the corporate articles in local offices is imposed by §6 upon the secretary of state rather than upon the incorporators, the secretary being authorized, however, to charge fees fixed by the Act for this service.

[30] Warren, Corporate Advantages Without Incorporation (1929) 794-795.

[31] Or, as called by Warren, a "de facto corporation of the first class", see Warren, *op. cit. supra* note 30, at 685-688, 701-718.

[32] Or, as called by Warren, a "de facto corporation of the third class", see Warren, *op. cit. supra note* 30, at 691-700, 796-839.

[33] By §56 (I) (a) and (c), fraud in procuring the certificate and failure of substantial compliance are specifically preserved as grounds of forfeiture by the state of the corporate charter, in a proceeding brought for that purpose; but by §56 (II) the corporation must first be given an opportunity to amend its articles if the act that has been done or omitted is one that may be corrected by amendment.

The answer to the problem should depend upon the extent to which Sections 5 and 7, read together, are construed as making the secretary of state a quasi judicial officer whose exercise of judgment in issuing the certificate has the effect of absorbing prior defects against collateral attack.[34] It should have that effect where there are merely some illegal provisions in the articles,[35] and perhaps where one or more of the incorporators are not qualified;[36] but if a certificate perchance be issued for wholly unlawful corporate purposes, it is possible that not even a "corporation by estoppel", at least as regards "estoppel to assert individual liability",[37] would be found.

Section 7 specifically disclaims any intent to "limit the existing rules of law" as to either de facto corporations or "corporations by estoppel". Situations in which a real de facto corporation might still be found are: (1) where there are two applications to incorporate approximately the same kind of business under similar names, and the secretary of state, intending to deny one, delivers a certificate intended for one set of incorporators to the other set instead, who take it and act thereunder in good faith;[38] and (2) where the charter period of a corporation of limited duration has expired without renewal.[39] Of course a certificate issued under the general act for banking purposes might raise a de facto corporation under the bank-

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[34] See Warren, *op. cit. supra* note 30, at 794; Westlake Park Inv. Co. v. Jordan, 198 Cal. 609, 616, 246 Pac. 807, 810 (1926).

[35] Westlake Park Inv. Co. v. Jordan, *supra* note 34.

[36] Under the previous Minnesota law it was held that a de facto corporation may result from a consolidation, although one of the consolidating units was not qualified under the statute authorizing consolidation; see Mabel First Lutheran Church v. Cadwallader, 172 Minn. 471, 213 N. W. 845 (1927), (1928) 12 Minn. L. Rev. 297; but *cf.* Evenson v. Ellingson, 67 Wis. 643, 31 N. W. 342 (1887). Since the main obstacle to the application of the de facto doctrine in such situations is the absence of a law by which a de jure incorporation of the constituent units is permitted—an obstacle that the Minnesota court has surmounted—, it would seem to follow that the same facts, under the present Minnesota law, would result in a de jure corporation subject to forfeiture. Section 56 (I) (b) of the Act specifically authorizes a proceeding *to terminate corporate existence* where "*The corporation* should not have been formed under this Act." (Italics supplied.)

[37] See Staver & Abbott Mfg. Co. v. Blake, 111 Mich. 282, 288, 69 N. W. 508, 510 (1896); Doyle v. Mizner, 42 Mich. 332, 337, 3 N. W. 968, 972 (1879).

[38] Such a situation is possible, considering the brevity of the certificate of incorporation; see note 28, *supra*. Would the courts say that the delivery of the certificate by mistake results in a voidable rather than a void incorporation, even though the certificate does not in terms apply to the ones to whom it is delivered? The receipt of such a certificate might well result in a de facto incorporation, considering the liberality of the Minnesota courts in applying the "colorable compliance" requirement: see Ebeling v. Independent Rural Telephone Co., 187 Minn. 604, 246 N. W. 373 (1933), (1933) 17 Minn. L. Rev. 813.

[39] Wilson v. Brown, 107 Misc. 167, 175 N. Y. S. 688 (1919); and see Note (1930) 14 Minn. L. Rev. 270.

ing laws.[40] And the requirement that the corporate name end in "Corporation", "Incorporated", "Inc.", "Company", or "Co.", provided that neither of the last two of such symbols be preceded by "and" or "&",[41] should facilitate the application of the "corporation by estoppel" doctrine.[42]

B. Ultra Vires

The Minnesota Act follows the general capacity theory and other modern acts by recognizing the distinction between authority and power, and therefore permits the assertion of ultra vires in (1) a proceeding by the state for forfeiture,[43] and in (2) an action for damages by or on behalf of the corporation against the directors and officers responsible for the ultra vires acts.[44] But the Minnesota Act further preserves the significance of ultra vires by (3) permitting it to be asserted by the corporation defensively against (a) a person with actual knowledge of the lack of authority, or (b) a director or officer;[45] and by (4) reserving the right of a shareholder as well as the state to enjoin "the doing or continuing" by the corporation of ultra vires acts, provided that "the court shall protect or make compensation for rights which may have been acquired by third parties".[46] As against all persons with or without knowledge the corporation is apparently intended to have full rights upon its ultra vires transactions, so long as neither a shareholder nor the state interferes to enjoin the corporation's own performance.

Obviously the Act was not intended to be creative of the defense of ultra vires by reviving it in situations wherein it had already

[40] Compare Jennings v. Dark, 175 Ind. 332, 92 N. E. 778 (1910).

[41] §4 (I).

[42] See Lowell-Woodward Hardware Co. v. Woods, 104 Kan. 729, 180 Pac. 734 (1919).

[43] Section 11 (III) (a) specifically recognizes only the right of the state as well as a shareholder to enjoin "the doing or continuing" by the corporation of ultra vires acts; but §56 (I) (d) permits forfeiture where the corporation "has abused or usurped corporate privileges or powers", provided the corporation first be given an opportunity to amend its articles, as required by §56 (II).

[44] §11 (III) (b). Aside from the general standard of "good faith" and "that diligence and care which ordinarily prudent men would exercise under similar circumstances in like positions", embodied in §30, the Act suggests no standard specially applicable for determining the liability of directors and officers whose ultra vires acts cause loss to the corporation. Apart from the Act the present Minnesota law appears to be that they are liable regardless of good faith where the acts are "clearly beyond the scope of their authority", Burns v. Essling, 163 Minn. 57, 61, 203 N. W. 605, 606 (1925) (dictum as to liability of directors and officers of private corporations), which probably means no more than that their liability, although involving a mistake of law, is based upon negligence rather than absolute. *Cf.* Hodges v. New England Screw Co., 1 R. I. 312 (1850).

[45] §11 (II).

[46] §11 (III) (a).

been judicially rejected in this state.[47] Hence the preservation to the corporation of the defense as against one with actual knowledge of the lack of authority ought not to be held to apply as against one with actual knowledge who has fully performed on his own part.[48] Likewise the reservation of the right of the state or a shareholder to enjoin the doing or continuing by the corporation of ultra vires acts was not intended to be creative; so that a court need not feel required by the Act to compel by injunction the breach by a corporation of an ultra vires obligation that would have been entirely valid before the Act was passed.[49] It would seem to be only to the extent that the Act extends the common law, by giving some legal effect to executory ultra vires transactions, that the reservation of the right to enjoin can have very much significance; and forcing the alternative of compensation upon the other party, where the corporation is willing to perform, should normally be permissible as regards only those rights acquired by virtue of the Act. Even so, it follows that the Act is to some extent an Indian giver, and that the rights under it of the

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[47] See Benson Lumber Co. v. Thornton, 185 Minn. 230, 237, 240 N. W. 651, 654 (1932) (dictum): "The present tendency is to restrict the defense of ultra vires in actions between private parties so far as possible, if not to deny it altogether, except in the case of contracts wholly executory".

[48] Under the previous Minnesota law such a person had full contractual rights upon the ultra vires transaction; see Marin v. Calmenson, 158 Minn. 282, 286, 197 N. W. 262, 264 (1924): "The innocence or ignorance of the creditor is not essential to his right to enforce the contract, because the principle of estoppel is not applied, but the fundamental principle that one who seeks equity must do equity and may not accept the benefits and repudiate the burdens of his contract". See also Ballantine, Manual of Corporation Law and Practice (1930) 257-263, 280-282. That a different rule may apply where the party who has fully performed has actively participated in or controlled the application of his performance to the ultra vires purpose, see Franklin Co. v. Lewiston Institution for Savings, 68 Me. 43, 28 Am. Rep. 9 (1877).

[49] While the state may properly assert by equitable proceedings, as well as by quo warranto, its visitorial powers over private corporations, Pound, *Visitorial Jurisdictions Over Corporations in Equity* (1936) 49 Harv. L. Rev. 369, it is believed that a court should feel reluctant to grant an injunction even at the suit of the state, against performance by a corporation of an ultra vires obligation that by hypothesis is valid as between the parties to it, unless a very strong public interest, over and above the general interest in keeping corporations within their charter powers, would be more seriously affected by performance than by the payment of damages for breach. The jurisdiction being equitable, the court is entitled to exercise its own discretion in the matter. And "ordinarily the rights of a stockholder to urge ultra vires is [sic] no greater than that of the corporation"; see 7 Fletcher, Cyclopedia of the Law of Private Corporations (1931) §3453, p. 601; 13 Fletcher, *ibid.*, §5823, p. 130. A shareholder who has participated or acquiesced in the incurring by the corporation of an ultra vires obligation should in no case be entitled to enjoin its performance; French v. Long, 42 F. (2d) 45, 47 (C. C. A. 4th, 1930); Jarett v. Adolph, 98 S. W. (2d) 304, 305 (Ky. 1936): "In a proper case a nonassenting stockholder may enjoin a threatened ultra vires act or contract of the corporation, but a stockholder cannot attack acts or contracts as ultra vires, where he has given his consent thereto or has participated in the ultra vires act".

other party to an executory ultra vires transaction with a corporation are not full contractual rights—at the most they represent an obligation of the corporation that it may be compelled to breach, although willing to perform. A comparison should be made with the clear-cut and thorough-going provision of the California act, whereunder the right of either the state or a shareholder to enjoin the doing or continuing of ultra vires acts is restricted to situations where no rights at all of other parties have intervened—in other words to situations where not even an executory contract has yet been consummated.[50] It was the purpose of the draftsmen of the Minnesota Act to avoid holding out too great an invitation to corporate directors and third parties to disregard entirely, or not inform themselves of, the scope of the corporate articles, and at the same time to leave a court free to protect acquired interests of third parties in the manner and by the measure of compensation that may seem to the court most equitable and just under the circumstances of each individual case before it, according due consideration to *all* the interests concerned.[51] It is believed that in application, the power as reserved by the Minnesota Act to a court at the suit of the state or a shareholder, to enjoin the doing or continuing of ultra vires acts, will be restricted in the main to situations where (1) not even an executory contract has yet been consummated; or (2) the other party is a director or officer or person with knowledge who would have acquired no enforceable rights as against the corporation either at common law or under the

[50] Cal. Civ. Code 1933, §345. With reference to §8 (a) of the Illinois act and §303 (1) of the Pennsylvania act, which are similar in effect to §11 (III) (a) of the Minnesota Act, Professor Ballantine has made the following criticism: "This creates a very anomalous situation indeed. Neither the corporation nor the third party may rescind the contract nor set up the defense of ultra vires as a defense even to an action for specific performance, but in a judicial proceeding at the instance of a shareholder against the corporation further performance may be enjoined and the contract may be rescinded. This perpetuates much of the old uncertainty and confusion as to the validity of legal transactions which have been some of the worst evils of the doctrine of ultra vires. Such vague, timorous and uncertain provisions are likely to confuse the courts, encourage litigation, unsettle contracts and accomplish no good purpose. Does it not seem an outrage upon the third party to make a contract authorized by the directors binding on him, but not on the corporation if the corporation can persuade some shareholder to bring a suit for an injunction and rescission? This enables the corporation to speculate at the expense of the third party and deprives a third party contracting with a corporation in good faith of the anticipated profits of his partly executed contract, while reserving a right to such profits to the corporation". See Ballantine, *A Critical Survey of the Illinois Business Corporation Act* (1934) 1 U. of Chi. L. Rev. 357, 382.

[51] See Hoshour, *The Minnesota Business Corporation Act* (1933) 17 Minn. L. Rev. 689, 696: "What is sacrificed in definiteness by these provisions is believed to be compensated for by fairness and justice to shareholders and third parties alike".

Act; or (3) it appears to the court that the public interest of the state or the financial interests of innocent shareholders (a) will be more adversely affected by the corporation's performance of its ultra vires obligation than by its payment of damages for breach, and (b) will also outweigh the interest of the other party in the corporation's being permitted to perform, provided further that (c) the interest of the other party is such as may be readily compensated by a measure of damages to be fixed by the court so as to do complete justice in the individual case.

Under the Minnesota Act corporate shareholding in another corporation can raise questions of ultra vires as distinguished from illegality only where such shareholding is neither (a) authorized by the articles, nor (b) "reasonably necessary or incidental to accomplish the purposes stated" therein;[52] and (c) does not violate the common law or any federal or state statutes in respect of monopoly or restraint of trade.[53] Any idea of an anti-monopoly policy extending to corporate shareholding as such is distinctly rejected.[54]

Purchase or redemption by a corporation of its own shares is permitted only out of earned or paid-in surplus, with the use of the latter for this purpose restricted to preferential shares where there are such.[55] Since the improper acquisition by a corporation of its

[52] §9. Corporate guaranty of the obligations of another corporation is linked with corporate shareholding in the second clause of §9, but not in the first; so that, if §9 be construed literally, corporate guaranty is permissible when reasonably necessary or incidental to accomplish the purposes stated in the articles, but not otherwise even though the power be expressly provided in the articles. It is doubtful if the provision will be given such an effect. To the extent, however, that corporate guaranty regularly engaged in may constitute an "insurance" business, it would not be governed by the Business Corporation Act at all, but by Minn. Stat. (Mason, 1927) c. 19. This was perhaps the thought of the draftsmen of the Act in failing to include corporate guaranty in the first clause of §9.

It is unlikely that §9 was intended to apply any different standard to corporate guaranty of the obligations of another corporation than to corporate guaranty of the obligations of an individual. In fact the case of M. Burg & Sons, Inc. v. Twin City Four Wheel Drive Co., 140 Minn. 101, 167 N. W. 300 (1918) which involved the guaranty by a corporation of tbe obligations of an employee, is cited in the notes of the draftsmen to §9.

It is also doubtful if §9 was intended to apply any stricter standard to either corporate shareholding or corporate guaranty than that of reasonable expediency already embodied in §8 (f). Section 9 apparently was intended as a statement of the present weight of judicial authority upon these questions, see Hoshour, ***The Minnesota Business Corporation Act*** (1933) 18 Minn. L. Rev. 1-2.

[53] §57.

[54] *Cf.* People ex rel. Moloney v. Pullman's Palace-Car Co., 175 Ill. 125, 153, 51 N. E. 664, 677 (1898). The present Illinois law, Ill. Rev. Stat. (Smith-Hurd, 1933) c. 32, §157.5 (8), is in accord with the provision of the Minnesota Act.

[55] §21 (VI) (a) and (b). It would seem that the reason for restricting to surplus tbe corporation's right to reacquire its own shares should apply also to the acquisition by a subsidiary corporation of the shares of its parent, to the extent that the value of the latter depends directly upon the acquiring subsidiary's assets.

own shares is really a form of illegality rather than ultra vires, and since in any event the shareholder party to such a transaction is in about the same position as that of a director or officer when the latter is a party to an ultra vires transaction with the corporation,[56] it necessarily follows that an executory contract for the purchase or redemption by the corporation of its own shares, although entirely valid when made, becomes unenforceable if, when, and so long as, at or after the time for performance, the stated capital has become and remains impaired or will be impaired by performance.[57] Analogizing this to the ultra vires problem is useful for the purpose of extending in this situation to other shareholders, who may be as much injured as creditors, the same right to an injunction against performance that is expressly reserved to them as regards ultra vires transactions.[58] And since the shareholder party to a share repurchase or redemption transaction is under an immediate liability to restore to the corporation the amount of any impairment of stated capital resulting from the corporation's performance[59]—a liability intended at least in the main for the better protection of creditors, who are entitled to rely upon the stated capital not being returned to the proprietors free of creditors' claims—it follows that a creditor

The Minnesota Act makes no express exceptions, as does the California act, Cal. Civ. Code (1933) §342. But under the Minnesota Act at least one exception to the restriction to surplus of the corporation's right to reacquire its own shares arises out of the requirement of payment in cash to dissenting shareholders, in the event of a consolidation, renewal, or amendment effecting a "substantial change" in the corporate purposes, of the appraised value of their shares; see §39 (I) (II) and (IV), as amended by Minn. Laws 1935, c. 212, §§1 and 2; and §43 (I). The only restriction there imposed is that the payment not render the corporation actually insolvent in a bankruptcy sense; §39 (III). Another exception may arise whenever a corporation without a surplus is held liable for the conversion of its own shares by its refusal to register one rightfully a shareholder.

Under the Illinois act paid-in surplus is no more available than stated capital for the reacquisition of the corporation's own shares; Ill. Rev. Stat. (Smith-Hurd, 1933) c. 32, §157.6. Under both the Illinois and Minnesota Acts unrealized appreciation may not be used for share reacquisition—under the Minnesota Act by virtue of its exclusion from the definition of surplus, except in the case of securities having a readily ascertainable market value; see §21 (I) of the Minnesota Act.

[56] §11 (II) (b).

[57] In re Fechheimer Fishel Co., 212 Fed. 357 (C. C. A. 2d, 1914). The previous Minnesota case of Vent v. Duluth Coffee & Spice Co., 64 Minn. 307, 309, 67 N. W. 70, 71 (1896) asserting the broad proposition that a repurchase provision contained in an original subscription contract "constituted a material and substantial part of the consideration and inducement for the purchase of the stock by plaintiffs, and, if the provision is void, it seems to us that it vitiates the whole contract, and is a sufficient reason for the rescission of that contract and the return of the purchase price", can hardly now be regarded, if it ever could, as permitting the repurchase agreement to be carried out, even by way of rescission of the original subscription, if to do as of the time for performance would impair stated capital.

[58] §11 (III) (a).

[59] §22 (I) (a).

who can show any likelihood of irreparable injury should be able under the Minnesota Act to enjoin performance of such a transaction to the extent that impairment of stated capital would otherwise result.[60]

C. Dividends

Cash dividends are payable from three sources, the first of which is earned surplus. In determining earned surplus, unrealized appreciation may not be included except in the case of securities having a readily ascertainable market value;[61] but losses "of every character whether or not realized",[62] and reasonable allowances for deprecia-

[60] In Loveland & Co. v. Doernbecher Co., 149 Ore. 58, 39 Pac. (2d) 668 (1934) it was held that a subsequent bond creditor of a corporation, with knowledge of a prior share repurchase agreement, and whose bonds were not yet due, could not enjoin performance by the corporation of the repurchase agreement where there was no showing that performance would render the corporation insolvent, although it was conceded that the stated capital was already impaired. Speaking practically, a creditor whose claims are not yet due is in a better position to enjoin an impairment of stated capital than is a creditor whose claims are past due, since the latter, so long as the corporation is not rendered actually insolvent, may immediately collect his claims in full without need of reliance on preservation of stated capital as future security. And under the Minnesota Act, since share reacquisition is not a permissible method of reducing stated capital, a subsequent creditor with knowledge is as much entitled as anyone else to rely on the corporation's not performing if to do so, as of the time fixed for performance, would impair stated capital. Such creditors should not be compelled to sit by and watch the wrongful distribution of corporate assets to possibly judgment-proof distributees. Under the facts of the Oregon case the Minnesota Act should require a different result than the one reached by the Oregon court. See Note, *Creditors' Rights Where Corporation Purchases Its Own Shares* (1936) 20 Minn. L. Rev. 422.

[61] §21 (I). Unrealized appreciation on treasury shares is specifically excluded from the exception in favor of securities having a readily ascertainable market value; but it would seem that treasury shares, even at their cost price, may not be treated as assets in determining the amount of surplus available for dividends. For, since treasury shares may be acquired only out of surplus, under §21 (VI), to hold otherwise would allow the same item of surplus to be used for both share reacquisition and dividend purposes, which was obviously not the intent of the framers of the Act. Good will and prepaid expense items would seem to be assets in this connection only in the sense of their likelihood of swelling the profits of future years, and should therefore be deemed unrealized. Considering the purpose of this restriction on dividends a court should be very careful not to "invert the normal trend of thought whereby outgo is believed to be the contrary of income and spending the opposite of thrift". Haebler v. Crawford, 258 N. Y. 130, 179 N. E. 319 (1932). Prepaid rent may well represent the cost price of an asset in the form of a term for years, for the length of time that the rent is prepaid. See Majestic Theatre Co. v. Orpheum Circuit, Inc., 21 F. (2d) 720 (C.C.A. 8th, 1927).

[62] §21 (I). Since this provision, as the corresponding one of the California act, was designed to require "sound accounting methods", Ballantine, California Corporation Laws (1932) 347, it may properly be held to require that current assets held for sale be inventoried at their market value when that is lower than their cost; but not to require deduction for a drop in the market value of fixed assets where an adequate depreciation reserve is being built up. See Weiner and Bonbright, *Theory of Anglo-American Dividend Law: Surplus and Profits* (1930) 30 Col. L. Rev. 330, 344, 975.

tion and depletion, with a wasting assets exception,[63] must be deducted. The wasting assets exception applies only to corporations "principally engaged" in exploiting such assets,[64] and permits payment of dividends without deduction for depletion provided (a) that notice to the shareholders that no such deduction has been taken accompanies payment, and (b) that "adequate provision" be made for meeting fixed liquidation preferences of outstanding preference shares. Where the wasting assets are not easily measurable, as in the case of a mine or oil well, the mandate for "adequate provision" may find no very adequate sanction, unless "adequate provision" acquires a varying legal content requiring under some circumstances the setting aside of the full amount of all liquidation preferences before dividends may be paid on junior shares. The Act is attempting in these respects to follow sound accounting practice, and the courts will no doubt so apply it. It does not, however, follow accounting practice to the extent of regarding unborrowed cash as the only form of earned surplus properly available for cash dividends.

A second source of cash dividends is paid-in surplus, provided (a) that notice of the source be given concurrently with payment, and (b) that only the dividends on shares preferential as to dividends may be so paid from paid-in surplus where there are such shares.[65] In permitting cash dividends to be paid at all from paid-in surplus, the Act does not purport to be following sound accounting practice; but it is not for the law to enforce good business policy upon a corporation so long as enough restrictions are imposed to prevent any legal wrong resulting to anyone from its not following it.[66] The Act apparently looks upon preferential dividends as fixed charges to the extent of setting up paid-in surplus, even when derived from the common shareholders, as a buffer for the preferential dividends against slack times. The restriction in favor of preferential shares does not in terms apply in favor of shares preferential in liquidation

[63] §21 (V).

[64] Compare the broader scope of the wasting assets exception as embodied in §24 (VII) of the Uniform Act.

[65] §21 (II) (b).

[66] Certainly the return of their capital to the shareholders is no wrong to them, so long as they are apprised of the fact. Nor is the return of paid-in surplus any wrong to creditors, unless the law should adopt an accountant's view that, to the extent of the total originally contributed proprietary investment, "Creditors, having no share in the profits, should not be expected to bear any of the risks or losses attendant on business operation"; see Marple, Capital Surplus and Corporate Net Worth (1936) 7. It is possible that the legality of cash dividends from paid-in surplus, by permitting a false picture of corporate prosperity to be presented to outsiders, helps facilitate promoters' frauds upon those subsequently becoming shareholders. See Marple, *ibid.* 6.

only and not as to dividends, as does the corresponding restriction in favor of preferential shares of the corporation's right to repurchase or redeem its own shares from paid-in surplus;[67] yet the reason for the broader scope of the restriction would seem to be equally present in both cases.[68] As to shares preferential in liquidation only, a court might very well hold under the Act that common dividends may not be paid from paid-in surplus to the extent that it has been contributed by the preferential shareholders.[69]

The third source of cash dividends is the net earnings of the corporation for the current or next preceding fiscal year, "whether or not it then has a paid-in or earned surplus", but provided (a) that the corporation not be actually insolvent in the bankruptcy sense, and (b) that, where there are outstanding shares preferential in liquidation, dividends may not be so paid from net earnings to other shareholders to the extent that the stated capital represented by such preferential shares has become impaired and would remain impaired following the payment of such dividends.[70] The apparent intent was to permit a corporation that has suffered an impairment of stated capital through business losses bona fide incurred and as to which creditors may reasonably be required to run the risk, to await better times without having to suspend dividends entirely until the stated capital has been restored. Consequently the Act need not necessarily be interpreted so as to permit the payment of dividends from current net earnings where there has been an impairment of stated capital caused by acts wrongful to creditors, as by the issuance of watered shares or the improper consummation of share repurchase or redemption transactions or the prior unlawful payment of dividends. It would seem fair to defer to the interests of creditors the rights even of innocent shareholders to dividends from current net earnings, where there has been an impairment of stated capital caused by wrongful acts on the part of the corporation that they at least might have prevented.[71]

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[67] §21 (VI) (b).

[68] As regards the interests of shareholders preferential in liquidation only and not as to dividends, the paid-in surplus, preserved for their benefit against impairment by reacquisition of common shares, might be just as quickly dissipated by the payment therefrom of common dividends.

[69] See Note, *Declaration of Dividends from Paid-In Surplus* (1931) 31 Col. L. Rev. 844, 849.

[70] §21 (II) (c).

[71] As conceded by Professor Ballantine, draftsman of the California act, "The wisdom of this relaxation of the surplus requirement is much debated and a majority of American jurisdictions do not permit it." See Ballantine and Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation*

The net earnings provision of the Minnesota Act has been criticized as permitting by implication the setting up within the current fiscal year of an arbitrary accounting period, during which the major items of annual corporate expenses do not fall due, with the result that dividends may be paid despite a net loss as of the entire year.[72] But the Minnesota Act may more reasonably bear the construction that the "current" year refers to the year *for* which rather than *during* which the dividends are declared, with the result that current net earnings do not become payable until it has been definitely ascertained, as of the close of the year, that there are such net earnings. If so, the Minnesota Act is stricter in this respect than the provision of the California act for a minimum accounting period of six months as of which net earnings may be determined.[73] The result would be that current net earnings may remain in a state of suspension for a maximum period of two years before operating automatically to restore stated capital.

Laws (1935) 23 Cal. L. Rev. 229, 245. The laws of California and Minnesota are criticized in this respect as "in effect permitting capital to be used for the payment of dividends". See Marple, Capital Surplus and Corporate Net Worth (1936) 80.

In determining the availability of dividends from current net earnings, a distinction might well be taken between the effect of a stated capital impairment owing to watered shares, and the effect of a stated capital impairment resulting from wrongful share reacquisition transactions or the prior unlawful payment of dividends. In the former case no liability to creditors for watered shares is imposed upon anyone until the corporation is in fact insolvent, and then only to the extent that there are subsequent creditors without knowledge who relied upon the apparent share capital and have been injured thereby, see §14 (IV) and (V); and consequently it is not likely under the Minnesota Act that corporations will ever be required to forego dividends out of current net earnings merely because of the existence of a stated capital impairment resulting from water in their shares. But on the other hand the shareholders receiving unlawful distributions resulting in an impairment of stated capital, and the directors or other shareholders negligently voting therefor, come under an immediate liability to the corporation in behalf of creditors to restore the same, see §22 (I) (a) and (b). To the creditors injured by such distributions, cash in the corporate treasury is worth more than the right to compel the corporation to take action against directors or shareholders whose solvency may be problematical. It would seem that the corporation ought not to be permitted to pay dividends from current net earnings at a time when it is under an immediate duty in favor of creditors to take action to restore stated capital.

[72] See Ballantine and Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws* (1935) 23 Cal. L. Rev. 229, 246.

[73] Cal. Civ. Code (1933) §346 (2). In the light of the incentive contained in the new federal accumulated profits tax, it is likely that the provision of the Minnesota Act will be interpreted to permit the payment of dividends out of the net earnings of the current year, on the basis of estimates, before the actual close of that year. But it would seem that the shareholders receiving such dividends, and to a lesser extent the directors voting them, will be required to run the risk of the liabilities imposed by §22 of the Act attaching, should the estimates, out of which dividends are paid during the current year, prove, as of the close of the year, to have been excessive.

Share dividends are payable from (1) earned surplus, or (2) paid-in surplus, provided such source be designated; but provided further, whichever the source, that such dividends be capitalized at (a) par, or (b) the involuntary liquidation preference, if any, of no-par shares, or (c) the "fair value" as estimated by the board of directors of no-par shares without preference in involuntary liquidation.[74] The basis provided for the capitalization of no-par shares without preference in involuntary liquidation is not altogether clear. The purpose of the Act was no doubt to prevent the painting of a deceptive picture of corporate prosperity by the declaration, during an artificially high share market, of a large no-par share dividend with only a very small stated capital value allocated from surplus to each share. But the provision of the Act is circuitous, in that it begins by directing that upon the declaration of a share dividend "the amount of surplus from which such dividend is declared shall be capitalized". Ascertainment of the proportionate stated capital value of each no-par share might thus become a matter simply of mathematics, and the purpose of the Act to avoid an excessive issue of no-par shares at an unduly low stated capital value not be accomplished. On the other hand the "fair value" of such shares is necessarily the same as that possessed, just after the share dividend has been declared, by shares of the same class, if any, previously issued; or, if there are no shares previously issued of the same class in which the share dividend is declared, the "fair value" of the new shares depends upon their incidents as related to the total corporate net assets. Read literally the Act may thus appear to require that no part of a no-par share dividend may represent uncapitalized book value attributable to the surplus remaining after the share dividend has been declared. Yet it can hardly be supposed that the purpose of the draftsmen was to accomplish a result whereby a no-par share dividend may be required to represent a higher stated capital value per share than shares of the same class, if any, previously issued. In such a case it should be sufficient if the stated capital represented by each dividend share is approximately the same as the stated capital represented by

[74] §21 (III) (c). As shown by the discussion in the text, the provision for the capitalization of no-par share dividends without preference in involuntary liquidation, at their estimated "fair value", will probably be construed to impose about the same requirement as the more aptly phrased provision of the Michigan act, to-wit: "No stock dividend from shares without par value shall be declared unless there shall be transferred to capital at least the equivalent in value per share of such dividend as equals the average original consideration amount per share of the shares without par value outstanding at the time of such declaration which is carried as capital". See Mich. Comp. Laws (Supp., 1933) §10135-22.

each share of the same class before the declaration of the share dividend; and it would follow that the figure fixed by the board of directors should not be interfered with unless so low as clearly to violate the purpose of the requirement. But "fair value" seems a somewhat unfortunate phrase in which to couch the requirement, since what was really intended was that the amount of the surplus capitalized should restrict the *number* of no-par shares to be created *therefrom*, rather than that the value of such shares should determine the amount of surplus to be capitalized. In corporate management the amount of the surplus to be capitalized is ordinarily the decision first made.

D. SHAREHOLDERS, DIRECTORS, AND OFFICERS

1. Subscriptions. Pre-incorporation subscriptions are made irrevocable until sixty days after incorporation provided incorporation has occurred within one year from the date of the first subscription.[75] The difficulties of spelling out such a contract among the subscribers as will give the corporation an irrevocable specifically enforceable option, within a reasonable time limit, are thus avoided.[76] Acceptance by the board of directors of pre-incorporation subscriptions, or the making of the contract in the case of post-incorporation subscriptions, constitute the "allotment".[77] By virtue of the further requirement that acceptance of post-incorporation subscriptions be made by the shareholders or by the board of directors when so authorized by the articles or by the shareholders themselves,[78] it must be assumed that the making of the contract, to constitute an "allotment", has been authorized by the same persons. Despite the provision for "allotment" by the mere consummation of the subscription contract, executory contracts to subscribe and conditional subscriptions are no doubt still possible, in part by virtue of the further provision that a subscription may be avoided "upon such grounds as exist at law or in equity for the avoidance of any contract".[79] Because of the concur-

[75] §16 (II) (a) and (b).

[76] It should also follow that otber subscribers have no right of action for damages for breach by one subscriber of his subscription agreement, as they were held to have in Eden v. Miller, 37 F. (2d) 8 (C.C.A. 2d, 1930), for their only injury would result from the corporation's failure to accept and specifically enforce the subscription agreement.

[77] §16 (IV). In this respect the Minnesota Act is unlike §6 (III) of the Uniform Act, which permits the mere fact of incorporation to constitute completion of the pre-incorporation subscription agreement, at least in so far as the rights of the corporation thereon are concerned.

[78] §16 (V).

[79] §16(III). It is doubtful, however, wbether Stern v. Mayer, 166 Minn. 346, 207 N. W. 737 (1926), upon its actual facts, is still law under the Act. One of the factors that induced the court in that case to find merely an executory con-

rent adoption of the Uniform Stock Transfer Act in Minnesota,[80] the Corporations Act properly requires that no certificate be issued for shares not fully paid for.[81] But the theory of an "allotment" occurring upon the consummation of an unconditional subscription contract may appear to be somewhat inconsistent with the further provision that a subscriber "shall be treated for all purposes as if he were a holder of a number of shares equal to that proportion of the total number of shares subscribed for by him which the portion of the subscription price paid bears to the total subscription price, unless the subscription agreement expressly restricts or negatives such rights".[82] It would seem that the final words "such rights" must be read as restricting the previous words "for all purposes", so that, despite this provision, the "allotment", occuring upon the consummation of a subscription contract construed as unconditional, creates the status of shareholder as to all the shares subscribed for, whether paid for at the subscription price or not, for purposes of the liabilities in behalf of creditors imposed by the Act upon such status.[83] The provision was undoubtedly intended only to protect shareholders who have fully paid for their shares, against dividend and voting participation by those without proportionate capital investment.[84]

2. *Powers and Rights.* Shareholders' meetings may be held within or without the state as provided in the by-laws or by the board of directors pursuant to the by-laws or the written consent of all shareholders entitled to vote.[85] The only sound reason that ever inhered in the rule denying corporate validity to shareholders' meetings held without the state, that of inconvenience to resident shareholders, is thus sufficiently adhered to. Any act that may be done by the shareholders in meeting may be done by them without a meeting "if authorized by a writing signed by all of the holders of shares who would be entitled to a notice of a meeting for such purpose".[86] Voting trusts are permitted for not to exceed fifteen years in duration or such longer period of corporate indebtedness as a voting trust in favor

tract to subscribe rather than a subscription, was the absence of a provision in the subscription agreement for call by the board of directors. Section 16 (VI) of the Act provides that where no time is fixed for payment "shares shall be paid for on the call of the board of directors".

[80] Minn. Laws 1933. c. 331.

[81] § 17 (I).

[82] §16 (VIII).

[83] §14 (IV) and (V).

[84] Compare the reasoning in Baltimore City Pass. Ry. Co. v. Hambleton, 77 Md. 341, 26 Atl. 279 (1893).

[85] §24 (I).

[86] §25 (XI).

of creditors is designed to secure, provided that unless otherwise specified therein the trust is terminable at will by the holders of a majority in proprietary interest.[87] Presumably such an unqualified authorization was not intended to preclude courts from invalidating voting trusts when furthering ends detrimental to the corporation's best interests, or from holding voting trustees to a somewhat higher fiduciary obligation both to the corporation and to shareholders outside the trust than has ever been imposed upon shareholders voting their own shares separately. Irrevocable proxies are permitted when "coupled with an interest".[88] The circumstances in which such proxies will be sustained are undoubtedly intended to be the same as those established by the common law. Irrevocable proxies or voting agreements may not serve purposes contrary to public policy or to the corporation's best interests, or purposes at too great variance from the duties owing by one shareholder to another.[89]

The Act changes previous Minnesota law by requiring that cumulative voting be permitted upon twenty-four hours' notice by any shareholder of an intention to cumulate his shares, except where cumulative voting is precluded by the articles.[90] Shareholders are entitled to inspect the corporate books "for any proper purpose".[91] The Act thus more nearly follows the common law than the construction placed by some courts upon statutory rights of inspection.[92] Creditors' rights to information as to dividends paid and shares reacquired by the corporation are sanctioned by granting them an election to declare their claims immediately due and payable if such information is refused.[93] Creditors are permitted such voting rights as may be provided by the articles.[94]

Matters calling for the exercise of shareholders' powers under the Act fall into eight main categories. (1) Acceptance of post-incorporation subscriptions has already been treated.[95] (2) The share-

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[87] §26 (I).

[88] §25 (IV).

[89] Cone v. Russell, 48 N. J. Eq. 208, 21 Atl. 847 (1891); *Cf.* Smith v. San Francisco & N. P. R. Co., 115 Cal. 584, 47 Pac. 582 (1897). See also Notes (1936) 21 Minn. L. Rev. 103; (1932) 17 Minn. L. Rev. 89; (1931) 79 U. of Pa. L. Rev. 1142. The Minnesota Act contains many detailed provisions governing the administration of shareholders' meetings, voting, and voting trusts and proxy voting, see §§24-26 incl.

[90] §25 (III). By the previous Minnesota law, Minn. Stat. (Mason, 1927) §7462, cumulative voting was permitted only when provided for in the articles.

[91] §33 (V).

[92] Compare State ex rel. Dempsey v. Werra Aluminum Foundry Co., 173 Wis. 651, 182 N. W. 354 (1921); Note (1932) 30 Mich. L. Rev. 769.

[93] §34 (II) and (IV).

[94] §25 (XII).

[95] §See above, p. 438 of text.

holders have the power to pass by-laws, not inconsistent with law or the articles, fixing or altering the number, qualifications, classifications, or terms of directors, or altering or repealing by-laws passed by the board of directors under authority of the articles; and they also have the more general power, shared by the board of directors when so provided in the articles, to pass by-laws, not inconsistent with law or the articles, for the governance of the corporation's affairs and the "management of its property and business".[96] Such a broad scope of the power to pass by-laws should not be construed so as to deprive a minority of the benefit of the discretion in matters of business management and policy vested by another section of the Act in the board of directors.[97] (3) The power is in the shareholders to elect directors, in the manner prescribed by the articles or by-laws, for terms of not more than five years,[98] and to remove them, with or without cause, by the vote of a majority in interest of the shareholders entitled to vote in the election of directors, but provided that, where cumulative voting is not precluded by the articles, a single director may not be removed if there are votes in his favor sufficient cumulatively to have elected him.[99] (4) The sale or other disposal of all the corporate assets, even in the absence of failing circumstances, may be authorized by the vote in shareholders' meeting or written consent of the holders of "two-thirds of the voting power on such proposal", or by such other proportion not less than a majority, or vote by classes, as the articles may require.[100] Conceivably the putting of a prosperous corporation out of the business stated in its articles, by the disposal of all its assets, ought to require the consent of at least a majority in interest of all shareholders, whether otherwise entitled to vote or not. Furthermore, in this connection the Minnesota Act makes no provision for the payment in cash to dissenting shareholders of the appraised value of their shares.[101] But possible doubts as to the constitutional validity of this provision of the Minnesota Act, as

[96] §23 (I) and (II).

[97] §27 (I).

[98] §§24 (II) and 27 (III). Despite the provision of §27 (III) permitting the "manner of election" of directors to be prescribed by the articles or by-laws, it would seem not to be permissible, under §24 (II), for the articles or by-laws to make the board of directors a self-perpetuating body. The "manner of election" must be by the shareholders.

[99] §28 (I).

[100] §35.

[101] Compare the provisions of the Illinois act for cash payment to dissenting shareholders. Ill. Rev. Stat. (Smith-Hurd, 1933) c. 32 §157.73.

applied to corporations previously organized,[102] would seem to be sufficiently dispelled by a dictum in a previous Minnesota case,[103] approving the minority view at common law, which was to the effect that if a majority of the voting shareholders may dispose of all the assets of a failing corporation "to prevent greater loss", they may likewise dispose of all the assets of a prosperous corporation "to make greater gains", so long as they do it in good faith and as a purely business proposition.[104] It would seem clear that no smaller majority than that of "two-thirds of the voting power of all shareholders", as required for voluntary dissolution,[105] should ever be permitted to force the directors against their own better judgment to dispose of all the assets of a corporation not in failing circumstances. Conversely, the requirement of a two-thirds majority, where the articles do not provide for less, ought never to be applied so as to prevent the directors, in their own business judgment and with the consent of an actual majority, from disposing of all the assets of a failing corporation for the purpose of avoiding greater losses.[106] (5) Amendments of the corporate articles require the affirmative vote in shareholders' meeting, called upon at least ten days' notice of the proposal to amend, or the written consent, of such proportion of the total voting power not less than a majority as the articles may require, or, if the articles make no provision, then either a two-thirds majority of the total voting power, or else a bare majority provided the minority against the proposed amendment is less than one-fourth.[107] But where the proposed amendment (a) would affect adversely any class or classes of shareholders, or (b) would affect all classes by making a "substantial change" in the corporate purposes, then its

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[102] Such possible doubts could exist only as to those corporations that, by failing either to accept or reject the act, have been brought within its provisions by the conclusive presumption of acceptance contained in §61 (I); see note 13 *supra*.

[103] Patterson v. Shattuck Arizona Copper Co., 186 Minn. 611, 624-627, 244 N. W. 281, 286-287 (1932); see also Hill v. Page & Hill Co., 268 N. W. 705 (Minn. 1936).

[104] Bowditch v. Jackson Co., 76 N. H. 351, 356, 82 Atl. 1014, 1017 (1912).

[105] §46 (I).

[106] A minority should not be enabled to "hold the majority to an unprofitable and hopeless enterprise"; see Ballantine, Manual of Corporation Law and Practice (1930) 209; see note 68. Under a Tennessee statute authorizing the disposal of all a corporation's assets by the directors with the consent of a majority of the shareholders, it has been held that a majority of the shareholders, in the particular circumstances numbering over three-fourths, may effect a sale of all the assets of a failing corporation without its having been authorized by the board of directors. Teller v. W. A. Griswold Co., 87 F. (2d) 603 (C. C. A. 6th, 1937).

[107] Section 36 (III) (a) (b) (1) and (2), as amended hy Minn. Laws 1935, c. 117, §6.

adoption requires the consent separately given of each class so affected, whether otherwise entitled to vote or not; the voting by classes to be by the same proportions in interest as set forth above, except that in the case of "substantial change" the articles may not permit of a smaller proportion than the law requires in the absence of provision in the articles.[108] If an amendment so adopted effects a "substantial change" in the corporate purposes, or prolongs the duration of a corporation not chartered for the maximum period allowed by the law under which it was organized, or results in a consolidation or merger with another corporation, then dissenting shareholders, by having severally made demand upon the corporation before adoption of the amendment, become entitled to payment in cash of the fair appraised value of their shares.[109] (6) Reduction of stated capital requires the affirmative vote of at least a majority in interest of all voting shareholders, and also, if the reduction will impair the liquidation preference in stated capital of outstanding preference shares, the further affirmative vote of a majority in interest of each class of preference shareholders so affected.[110] The powers and rights of shareholders in (7) consolidation or merger,[111] and in (8) voluntary dissolution,[112] require no further separate comment. A single shareholder may institute involuntary dissolution proceedings,[113] and internal dissension to the point of inability to conduct business advantageously is recognized as a sufficient ground therefor.[114] Powers and rights both of creditors and of shareholders in the adoption of re-

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[108] Section 36 (III) (c) (1) and (2), (d) (1) and (2), as amended by Minn. Laws 1935, c. 117, §§7 and 8.

[109] Section 39 (I) (II) (III) and IV), as amended by Minn. Laws 1935, c. 212, §§1 and 2; and §43 (I). By §39 (II) the corporation is required to pay the appraised value of the shares within thirty days from the date of the appraisal; but by §39 (III) such payment may not be made if to do so would render the corporation actually insolvent in a bankruptcy sense. Minn. Laws 1935, c. 272, §5, by which §39 of the general act was made applicable in behalf of shareholders not assenting to the renewal of corporations whose charters have already expired, attached as a condition that in actions to recover the appraised cash value of their shares "the court may in its discretion, in any order or judgment therefor, require that such amount be paid in one payment or in installments at stated intervals as to the court may seem just and proper, consistent with the best welfare of said non-assenting stockholder, and the ability of said corporation to make such payment or payments". It would seem that such a provision might well have been made an amendment to §39 (II) of the general act.

[110] §38 (I).

[111] §§40-44, incl.

[112] §§ 46-47, incl.

[113] §49 (I) (a).

[114] §48 (d).

organization plans follow out the same general principles that are embodied in the new federal bankruptcy procedure.[115]

"The business of a corporation shall be managed by a board of at least three directors, who need not be shareholders unless the articles of incorporation or by-laws so require."[116] The interrelation between the independent statutory position thus preserved to the board of directors in matters of business policy and management and the powers of the shareholders to pass by-laws affecting the management of the corporate "property and business",[117] will no doubt be developed in line with common law precedents. Directors' meetings may be held within or without the state, and the powers of the whole board during interims between meetings may be devolved by its unanimous consent upon an executive committee of two or more members, subject to the whole board's overriding power so long as vested rights have not accrued in others from action taken by the executive committee.[118] Powers of the whole board may be exercised without a meeting by all the members separately consenting in writing.[119] Since this was intended as a relaxation of the common law rule, it should not be construed as precluding a still more informal ratification of unauthorized action,[120] or as denying corporate effect to the entirely informal action of directors who are also the sole shareholders. Apart from the Act the present Minnesota law is that a conveyance of corporate property in his own name by a director and officer who is also substantially the sole shareholder is binding upon the corporation so long as the rights of innocent third parties are not prejudiced thereby;[121] the Act should in no way restrict the

[115] §54. See Hoshour, *The Minnesota Business Corporation Act* (1933) 18 Minn. L. Rev. 1, 12.

[116] §27 (1).

[117] §23 (I).

[118] §27 (IV) (h).

[119] §27 (IV) (g).

[120] See Fayette Lumber Co. v. Faught, 5 N. E. (2d) 132 (Ind. App. 1936); Hoisting Machinery Co. v. Goeller Iron Works, 84 N. J. L. 504, 87 Atl. 331 (1913); Jourdan v. Long Island R. R. Co., 115 N. Y. 380, 22 N. E. 153 (1889); Sherman v. Fitch, 98 Mass. 59 (1867).

[121] Prudential Ins. Co. v. Enkema Holding Co., 196 Minn. 154, 264 N. W. 576 (1936). The court did not refer to the earlier Minnesota case of Baldwin v. Canfield, 26 Minn. 43, 1 N. W. 261 (1879), where one King, the owner of substantially all the shares of a corporation, pledged the shares to Baldwin for money borrowed, and thereafter, by a deed signed by each director individually, conveyed all the corporate property to Canfield as consideration for bonds with which King thereupon absconded. The court there refused to give corporate effect to the deed to Canfield. Aside from the fact that the deed to Canfield, signed by all the directors individually, would now be in proper corporate form by virtue of §27 (IV) (g) of the Minnesota Act, the two Minnesota cases are entirely reconcilable and represent a distinction still valid as regards many situations that may arise under the Act.

application of such a rule. Nor does the Act in any way affect existing rules of law as to the scope of the apparent authority of particular corporate officers.[122]

3. Liabilities. (1) For (a) watered or bonus shares, or (b) shares issued for a consideration unfair to other shareholders. The Minnesota Act permits of no distinction for legal purposes between watered and bonus shares, or between insufficient cash and insufficient property consideration, and requires that all shares be paid for in cash, property, or services rendered or to be rendered, in an amount equal, by a fair valuation, to the stated capital attributed to such shares.[123] As regards creditors, the Act provides for a right of action in the corporation, on behalf of subsequent creditors without knowledge, against the holders of watered or bonus shares or their transferees with knowledge, to compel them to make up tbe stated capital deficit attributable to their shares, to the extent of such creditors' actual damages resulting from their reliance upon the apparent

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[122] See Pink v. Metropolitan Milk Co., 129 Minn. 353, 355, 152 N. W. 725, 726 (1915): "It is scarcely necessary to say that a corporation may hire a cashier and accountant without resolution or other direct act of the board of directors . . . The power to hire such an employee or to authorize an agent to do so is presumably incident to the position of general manager of a commercial corporation".

[123] §14 (I) (II) and (III). Apparently the Act adopts the "*fair* value" as contrasted with the "good faith" rule for determining the fact of overvaluation. See Ballantine, California Corporation Laws (1932) 118, so construing Cal. Civ. Code (1933) §300a, upon which the provisions of the Minnesota Act are based. Compare the previous Minnesota law as announced in Hastings Malting Co. v. Iron Range Brewing Co., 65 Minn. 28, 34, 67 N. W. 652, 654 (1896): ". . . the value of the property is to be determined, not from subsequent events, but as of the time of the transaction, and from the situation, nature, and condition of the property as they honestly appeared to the parties at the time. Although there was in fact an overvaluation of the property, it will not render the stockholders liable for the deficiency if it was the result of an honest mistake or error of judgment". Except where the property taken as consideration for shares has been turned in to the corporation by a promoter who has bought it for the purpose, see Note (1924) 8 Minn. L. Rev. 520, it should still be permissible in determining its "fair value" to take into account the extent to which its market value has been enhanced by its desirability for exploitation by the corporation. The liabilities of the directors or shareholders making the overvaluation, as distinguished from those of the persons receiving the shares, require either bad faith or failure to make a resonable investigation; see §14 (IV).

The reverse change from a "true value" to a "good faith" rule, as made by the recent Illinois act, Ill. Stat. (Smith-Hurd, 1933) c. 32, §157.18, has been held not to apply retroactively to a transaction consummated before the change was made; Strickland v. Washington Bldg. Corp., 4 N. E. (2d) 973, 978 (Ill. App. 1936): "Without question the 'Actual Value Rule' was in force in Illinois at the time of this transaction. . . . It may be true that the rule has been changed by a later statute, but this cannot operate retroactively". Conceivably a similar holding, that the change does not operate retroactively, may be made under the Minnesota Act.

share capital.[124] By including only subsequent creditors in the protection afforded, the Act thus follows the fraud or "holding out" theory of the well-known Minnesota case of *Hospes v. Northwestern Mfg. Co.*,[125] as the basis of the liability imposed; but at the same time it removes the "presumption" of reliance, embodied in the *Hospes* doctrine, by requiring each subsequent creditor to prove his actual reliance upon the apparent share capital and that his damages have resulted from such reliance.[126] To show that his damages have been caused by his reliance it will be necessary, of course, for him to show that the corporation has become unable through insolvency to pay him; but it should not be necessary for him to show that the corporation would not have become insolvent had it not been for the water in its shares. Normally the assets of an insolvent corporation with which to pay creditors' claims are less by virtue of the water in its shares than they would have been had such shares been paid for in full; and this should be sufficient to make out a prima facie case of damages resulting from actual reliance where that is shown. Under the Act it may be permissible for the defendant shareholders to show the extent to which payment in full for their shares, had it been made, would have been lost or depreciated in the corporate hands.

The criticisms that have been directed to the *Hospes* doctrine[127] are not entirely obviated by the provision of the Minnesota Act. It would seem that the law can never be entirely logical or free of criticism in this respect until it recognizes that in all such cases creditors really rely only upon the total net worth of the corporation as shown by the balance sheet, upon its appearance of prosperity, or upon the reputation for ability and integrity of its managers. Logically a share of stock should represent either one or the other of two things, but not something half-way between the two. Either it should represent only a fractional interest in the total net worth of the corporation, to which the claims of unsecured creditors have priority as they fall due but are otherwise unrelated; or else it should represent a capital contribution that is required in all cases, upon grounds of public policy and as one of the conditions of doing business with limited liability,

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[124] §14 (IV) and (V). Since the right of action is in the corporation, although as trustee for creditors, it should follow that the right of action passes by operation of law to the corporation's receiver or trustee in bankruptcy, thus reversing the result reached as to a Minnesota corporation in Courtney v. Georger, 228 Fed. 859 (C. C. A. 2d, 1915).

[125] 48 Minn. 174, 50 N. W. 1117 (1892).

[126] § 14 (IV) and (V).

[127] See Ballantine, *Stockholder's Liability in Minnesota* (1923) 7 Minn. L. Rev. 79, 91-92.

to be honestly commensurate with the dollar sign upon it. To the extent that the latter character is the motive, it is certainly arguable that any statutory imposition in behalf of creditors of a liability for watered or bonus shares should treat prior and subsequent creditors alike.[128]

The Minnesota Act also imposes in behalf of subsequently relying creditors a liability, commensurate with that imposed upon the holders of the watered or bonus shares, upon all directors or other shareholders who "wilfully or without reasonable investigation" voted in favor of the allotment of such shares.[129] Although the Act does not provide for rights of contribution as among those held liable, it would seem likely that such rights were intended.[130]

As regards other shareholders whose proprietary interests are diluted by the issuance of shares for a consideration less than the value of their own, the Act provides for a right of action in the corporation, on behalf of non-assenting shareholders whose interests are thus diluted, against the directors and shareholders, jointly and severally but with rights of contribution as among themselves, who "wilfully [or ?] without reasonable investigation" voted in favor of the allotment of the diluting shares or were present and entitled to vote and did not vote against it.[131] Such liability may be avoided by first offering preemptive rights in the new shares to existing shareholders for the same consideration at which the shares, if not taken by them, are later issued to others; in which case, in the absence of deliberate fraud, the consideration is "conclusively presumed to have been fair".[132] It would seem that an injured shareholder who has sold his shares for their value as diluted ought still to participate in

[128] It may be asked as a matter strictly of logic, if prior creditors have no right to compel payment in full of the stated capital attributed to subsequently issued shares, then why should they have any greater rights in case of the dissipation, through cash dividends or share reacquisition transactions, of the stated capital actually paid in as consideration for such subsequently issued shares? The real basis of the imposition of any liability at all in either case comes down to a feeling that a capital contribution honestly commensurate with stated capital is required by public policy as a condition of limited liability; and it follows that the public policy declared in subdivisions (I) (II) and (III) of §14 of the Minnesota Act is but very imperfectly sanctioned by subdivisions (IV) and (V).

[129] §14 (IV).

[130] As to the very similar liability imposed by §15 (II) for the benefit of injured shareholders, rights of contribution are provided by §15 (III), as amended by Minn. Laws 1935, c. 117, §5. The Act leaves open, for the courts to settle, any question of the order of liability as between the holders of watered or bonus shares and the directors or other shareholders "wilfully or without reasonable investigation" voting in favor of the allotment of such shares.

[131] Section 15 (II) and (III), as amended by Minn. Laws 1935, c. 117, §§3 and 5.

[132] Section 15 (II), as amended by Minn. Laws 1935, c. 117, §3.

the recovery. On the contrary, it is arguable that his vendee should be the one to participate if the latter has paid the undiluted value of the shares.[133]

It is interesting to consider the possible implications of these provisions of the Minnesota Act upon the problem of promoters' frauds. The Act imposes liability only for the dilution, by subsequent issues, of prior proprietary interests, which is the reverse of the most common promoters' fraud situation; nor does it purport to impose any liability at all upon the recipients of the diluting shares. While the Act thus leaves the courts free to work out the liabilities of the recipients of the diluting shares, where they are participants in actual fraud, in accordance with common law principles, it is believed that the two problems are nevertheless rather closely related. In the promoters' fraud situation the Supreme Court of Minnesota has followed the rule of *Davis v. Las Ovas Co.*,[134] and approved by dictum the rule of *Old Dominion Copper Mining & Smelting Co. v. Lewisohn.*[135] Under the Act it has an analogical basis upon which to continue to require the existence of innocent shareholding interests already in the picture at the time secret profits are taken, and to whom no disclosure is made, as essential to a corporate right of recovery against the promoters; but it would seem also to have an analogical basis upon which to limit recovery henceforth to the amount of the actual injury to such innocent shareholding interests, to be turned directly over to them rather than go into the corporate treasury.[136] It would have been a unique contribution had the framers of the Minnesota Act been able to work out an adequate provision covering the whole problem of the effect of the consideration paid for shares upon the interests both of prior and of subsequent shareholders—one offering a solution which, whether the best possible one or not, would at least

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[133] The limitation by §15 (II) of the corporate recovery to the amount that the "then shareholders" are damaged, need not necessarily require reduction of recovery pro tanto where a shareholder, who has originally been damaged, has passed the loss on to his vendee. Subrogation of the vendee may well be permitted.

[134] 227 U. S. 80, 33 Sup. Ct. 197, 47 L. Ed. 426 (1913), followed in American Barley Co. v. McCourtie, 150 Minn. 460, 185 N. W. 506 (1921).

[135] 210 U. S. 206, 28 Sup. Ct. 634, 52 L. Ed. 1025 (1910), approved in Hoffman Motor Truck Co. v. Erickson, 124 Minn. 279, 283, 144 N. W. 952, 953 (1914) (but the subsequent shareholders were here found to have had knowledge); see also Advance Realty Co. v. Nichols, 126 Minn. 267, 148 N. W. 65 (1914) (here there were other shareholders in the picture at the time the promoters' profits were taken but they were found to have had knowledge of the same).

[136] This was the measure of the recovery allowed in Hyde Park Terrace Co. v. Jackson Bros. Realty Co., 161 App. Div. 699, 146 N. Y. S. 1037 (1914), approved in Note (1934) 47 Harv. L. Rev. 1031.

be free of the unsound distinctions drawn in the application of the rules of the *Old Dominion Copper Mining & Smelting Co.* cases.[137]

(2) Other liabilities. (a) The articles of incorporation are required to set forth the amount of stated capital, not less than $1,000, with which the corporation is to begin business;[138] and if the corporation incurs debts, other than those incidental to organization or the

[137] If public policy actually does require capital contributions commensurate with stated capital as a condition of doing business with limited liability, then promoters' liability for secret profits might as well be imposed from the beginning, or from the moment that there are any innocent interests, either of creditors or of shareholders, capable of asserting it; and it may well follow, on this premise, that the measure of liability imposed by Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 159, 89 N. E. 193 (1909) is sound. But in its application there is no logical basis for drawing a distinction where the innocent shareholders receive their shares from the promoters rather than by direct subscription, as was done in Hays v. The Georgian, Inc., 280 Mass. 10, 181 N. E. 765 (1932); or for making the result turn upon the bringing in of innocent shareholders by direct subscription having been actually contemplated at the time the secret profits were taken by the promoters. Likewise nothing but confusion can result from purporting still to follow the rule of the Lewisohn case but at the same time applying the rule of the Bigelow case on the basis of creditors' interests alone, as was done by a majority of the United States Supreme Court in McCandless v. Furlaud, 296 U. S. 140, 56 Sup. Ct. 41, 80 L. Ed. 74 (1935); for Comments see (1936) 36 Col. L. Rev. 488, (1936) 49 Hav. L. Rev. 785, (1936) 20 Minn. L. Rev. 552, (1936) 84 U. of Pa. L. Rev. 409.

If, on the other hand, it is felt that public policy does not require capital contributions commensurate with stated capital, or with the contributions of other shareholders, except to the extent that creditors or other shareholders are actually injured by reliance on their being commensurate when in fact they are not, which seems to be the principle embodied in §18 (I) of the Minnesota Act, it must be admitted that the measure of corporate recovery allowed in the Bigelow case is illogical; but the rule of Davis v. Las Ovas Co., 227 U. S. 80, 33 Sup. Ct. 197, 57 L. Ed. 426 (1913), is just as illogical, especially as applied in Hughes v. Cadena Mining Co., 13 Ariz. 52, 108 Pac. 231 (1910), where the only innocent shareholder in the corporate picture at the time the secret profits were taken, and on account of whom the corporation was allowed to recover the full amount of such profits, had already sold his shares at the time of the corporate recovery. The measure of recovery allowed in Hyde Park Terrace Co. v. Jackson Bros. Realty Co., 161 App. Div. 699, 146 N. Y. S. 1037 (1914), is a sound alternative to the Bigelow doctrine, provided that in its application no requirement is made that it must have been actually contemplated at the time the secret profits were taken that subsequent shareholders were to be brought in by direct subscription. Since the recovery is by the corporation only to the extent that innocent shareholders are actually injured, as trustee for them, it should be entirely sufficient that at some time there are such shareholders, in whatsoever manner brought in.

The action of the Securities and Exchange Commission in In the Matter of Haddam Distillers Corporation, 1 S. E. C. 37 (1934), see MacChesney, *The Securities Act and the Promoter* (1936) 25 Cal. L. Rev. 66, 71-75, suggests the feasibility of the administrative method for the solution of this perplexing problem. Under §14 (I) of the Minnesota Act the pre-incorporation services of promoters might well be accepted to the extent of their reasonable value, often very great considering the risk taken, as payment for shares in the form of "services rendered". It would seem especially desirable to have an administrative tribunal available to determine the "reasonable value" of such services in advance of the allotment of shares.

[138] §3 (I) (f).

obtaining and collection of subscriptions to shares, before consideration "equal to the amount of stated capital with which it will begin business", as set forth in its articles, has been fully paid in, the directors or officers who participate in or authorize or ratify the incurring of such debts become personally liable, jointly and severally to the corporation on behalf of creditors, for the payment of the same.[139] Presumably their liability, although to the corporation as trustee for creditors, is intended to be secondary to that of the corporation itself. An interesting problem in the application of this provision would arise if only no-par shares are issued and the consideration paid in for such no-par shares, but not the stated capital attributed to them, equals the amount of stated capital with which the corporation is to begin business. It would seem that in such a situation personal liability ought to result to the extent that creditors are injured by the dissipation, in any way that it would be wrongful as to creditors to dissipate stated capital, of the difference between the amount of the consideration paid in *as stated capital* and the amount of stated capital with which the corporation was to have begun business.[140]

(b) Shareholders who receive unlawful distributions as dividends or for the reacquisition by the corporation from them of its own shares, or following a reduction of stated capital, become immediately liable to the corporation to restore the amounts so received by them.[141] Directors who "wilfully or negligently" voted in favor of such distributions, without reasonable reliance on a certified profit and loss statement, are also liable jointly and severally for their return, with rights of contribution as among themselves.[142] It is likely that their liability was intended to be secondary to that of the shareholders

[139] §12 (I) and (II).

[140] There would be the further question whether the corporation's charter should be subject to forfeiture for its having hegun business in violation of the requirement of §12. Perhaps for this purpose "It seems logical in case the entire consideration is recorded as capital and treated as a fixed capital fund, that this should meet the requirement"; see Marple, Capital Surplus and Corporate Net Worth (1936) 42.

[141] §22 (I) (a). Their liability is apparently intended to be absolute, regardless of good faith, and to run in favor of prior and subsequent creditors alike, as held in the previous Minnesota case of Mackall v. Pocock, 136 Minn. 8, 161 N. W. 228 (1917). Compare in this respect the more limited liability imposed upon shareholder distributees by Cal. Civ. Code 1933, §363. Conceivably the liability imposed by the Minnesota Act may be avoided, prior to the expiration of the three-year period of limitation provided by §22 (III), by a restoration from later earnings, or by a reduction under §38, of stated capital. See Green v. Boardman, (1932) 143 Misc. 2, 201, 256 N. Y. S. 340 (1932), aff'd. 240 App. Div. 741, 265 N. Y. S. 965 (1933).

[142] §22 (I) (b).

receiving the distributions, except possibly where the latter have so changed their positions in reliance upon the legality of the distributions that to hold them primarily liable for the benefit of wrongdoing directors would be inequitable. Since these liabilities to the corporation are imposed for the benefit of creditors and other shareholders, they should be able to compel the corporation to assert its right of action or to enjoin the distributions before they are made.[143]

(c) Directors and officers making or assenting to loans by the corporation to directors or officers, or to shareholders upon the security of their shares, become jointly and severally liable for the repayment thereof.[144] Presumably their liability is secondary to that of the borrower, although, since such loans are prohibited, the liability of all parties to repay would seem to be immediate, regardless of the due date of the loan. The Act apparently adopts the theory that a loan to a shareholder upon the security of the corporation's own shares, even when made as an investment of surplus, creates an asset as unreliable as treasury shares, the value of which will completely evaporate in the event of the corporation's own insolvency.[145] But it would seem that a corporation ought to be able to take its own shares as additional security for a loan or sale of goods on credit that it might otherwise make to a shareholder on the faith of his personal security. In any event, since the Act expressly permits a corporation to take a lien upon its own shares as security for an antecedent debt, the prohibition may easily be avoided by first making the loan, where that is intra vires, and thereafter taking the shares as security. The Act strikes primarily at a liberal policy of shareholder loans deriving their whole value as corporate assets from the quick-sand security of the corporation's own shares.

(d) The liabilities so far considered, excepting only the liabilities of directors or shareholders voting for the allotment of shares for a consideration unlawful as to creditors or other existing shareholders, or voting for unlawful distributions to shareholders of corporate assets, are absolute rather than qualified. As regards the liabilities of directors and officers to the corporation in matters of ordinary business management, the Act purports to follow the present majority view by imposing a standard of good faith and that degree of "diligence and care which ordinarily prudent men would

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[143] See above, p. 433, note 60.

[144] §31.

[145] See Nussbaum, *Acquisition by a Corporation of its Own Stock* (1935) 35 Col. L. Rev. 971, 993-994.

exercise under similar circumstances in like positions".[146] Presumably the objective character of such a standard includes a reasonable degree of business intelligence as well as diligence and care.[147] About the same standard will probably be held to govern the liability of directors and officers to the corporation for damages resulting to it from their ultra vires acts.[148] The present rule in Minnesota permitting the avoidance of intra vires transactions between the corporation and its own directors and officers only for actual unfairness[149] is left untouched by the new Act.

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[146] §30.

[147] Compare the language of Judge Learned Hand in Barnes v. Andrews, 298 Fed. 614, 618 (S. D. N. Y. 1924): "Directors are not specialists, like lawyers or doctors. They must have good sense, perhaps they must have acquaintance with affairs; but they need not—indeed, perhaps they should not—have any technical talent."

[148] See note 44, *supra.*

[149] Minnesota Loan & Trust Co. v. Peterler Car Co., (1916) 132 Minn. 277, 156 N. W. 255; Note (1928) 12 Minn. L. Rev. 536.