

Fall 9-1-1978

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Recommended Citation

Robert M. Campbell, *A Concise Textbook On Legal Capital. By Bayless Manning*, 35 Wash. & Lee L. Rev. 1101 (1978), <https://scholarlycommons.law.wlu.edu/wlulr/vol35/iss4/11>

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BOOK REVIEW

A CONCISE TEXTBOOK ON LEGAL CAPITAL. By Bayless Manning, Mineola, New York: The Foundation Press, Inc., 1977.

As its subtitle indicates, this volume¹ is "a general exposition . . . of corporation law regulating corporate capital accounts, par and no par stocks, distributions to shareholders, equitable contribution, promoters' liability and related mysteries." Indeed, the subtitle more clearly indicates the breadth and scope of this small volume² than does the formal title "*A Concise Textbook on Legal Capital*." In addition, neither the formal title nor the subtitle reveals that approximately one-third of *Legal Capital* consists of a discussion of twenty-three transactions which cover the growth of a small corporation, starting with its first year of operations and continuing through a ten-year period with successively more complicated transactions. *Legal Capital* also deals in some detail with accounting principles involved in these transactions and contains balance sheet entries with notes discussing the accounting problems and the legal capital restraints involved in the various transactions. Another valuable portion of the work deals with creditor protections (other than secured transactions) outside the legal capital statutes, and discusses the protective covenants contained in a typical bond indenture.³ In short, Dean Manning has set himself a most formidable task—to deal succinctly and clearly with a broad range of difficult subjects in a small volume.⁴

At first glance, it might appear that the effort is doomed to failure, but Dean Manning is careful to point out that this volume is *not* a treatise—it is "a textbook to be read by law students . . . without the aid of an instructor."⁵ The author's intent is clear: *Legal Capital* "should emancipate teachers of corporation law from the futile task of trying to deal in the classroom with regulation of capital structures and should release valuable classroom time for attention to matters of more substance."⁶

The instinctive reaction of some teachers of corporation law to this pedagogical approach may be negative. They may question how students can absorb complicated subjects without classroom discussion of cases illustrating legal principles. The usual method of casebook and classroom discussion over a considerable number of hours undoubtedly would result

¹ D. MANNING, A CONCISE TEXTBOOK ON LEGAL CAPITAL (1977) [hereinafter cited as MANNING].

² *A Concise Textbook on Legal Capital (Legal Capital)* is 167 pages in length. Part II of *Legal Capital* is 54 pages in length and is devoted to an analysis of various capital transactions. See text accompanying notes 8-10 *infra*.

³ MANNING, *supra* note 1, at 91-107.

⁴ See note 2 *supra*. Professor Cary's text, CORPORATIONS, which may consider the most comprehensive casebook in the corporate law field devotes approximately twice as many pages to the subjects covered in *Legal Capital*. See CARY, CORPORATIONS, ch. VIII § 1, 2, 3, ch. IX § 1, 2 & ch. X § 1(j) (4th ed. 1969).

⁵ MANNING, *supra* note 1, at vii.

⁶ *Id.* at ix.

in a better student understanding of the subjects covered in this textbook than they would obtain by even a careful and thoughtful reading of *Legal Capital*. In the curricula of a number of law schools, however, there is simply not a sufficient number of hours devoted to the field of corporation law. Thus, there is considerable time pressure to cover those aspects of corporate law which are of basic importance, are in the forefront of modern corporate law, and can be effectively taught only through the case method. If Dean Manning's work is successful, *Legal Capital* "should release valuable classroom time for attention to matters of more substance"⁷ than the rules of capital structures.

Furthermore, *Legal Capital* should be of considerable help in familiarizing students with the basic accounting principles involved in capital transactions. In order to analyze properly a scholarly opinion in the corporate field, it is often necessary to construct a balance sheet or profit and loss statement in order to present more clearly a complicated factual situation. Part II of *Legal Capital* facilitates analysis of corporate financial affairs by discussing various corporate transactions and by setting out the basic accounting entries involved therein and by explaining alternative accounting treatments which may be available in some situations.⁸ For teachers in law schools which do not offer an accounting course, this portion of the book will be of particular value.

Legal Capital rightly emphasizes that the lawyer, of necessity, is involved vitally in many corporate transactions. An unqualified certificate from the independent accounting firm is surely of great importance, but as Dean Manning points out, many, if not most, of the transactions in this area will involve a favorable opinion from counsel as to the legality of the proposed transaction as a sine qua non for proceeding with the transaction.⁹ In discussing the interplay of the corporate counsel and the accountant and the important role performed by each in dealing with corporate financial problems, Dean Manning emphasizes that the views of counsel and accountant are not always compatible. Dean Manning demonstrates the possible conflict between counsel and accountant in his discussion of a hypothetical write-down of corporate assets.¹⁰ In this problem Dean Manning assumes that the corporation has a profit from operations of \$6,000.00 during a particular year and that the corporation's accountants insist that the valuation of a secret process carried on the corporation's book at \$5,000.00 be written down to \$1.00. The proposed write-down would result in a charge against earned surplus, the only surplus account of the corporation. Dean Manning states that in some states which permit payments of dividends out of earned surplus, the law is not clear whether the write-down is a loss which must be deducted in computing the amount available for distribution. When state law does not require the writedown to be so

⁷ *Id.*

⁸ *Id.* at 109-63.

⁹ *Id.* at 35.

¹⁰ *Id.* at 117-18.

charged, the amount available for distribution will be \$4,999.00 greater than the amount shown as earned surplus on the certified balance sheet. Such a situation leaves a concealed bear trap for the unwary corporate counsel.

More detailed comments on some aspects of *Legal Capital* follow:

In *Legal Capital's* preface, Dean Manning observes that "the book is not reverent in its attitude for the law in this area."¹¹ This may well be considered a substantial understatement. The book is replete with evidences of this "irreverence."¹² To be sure, Dean Manning does advise the reader that "one must not demand too much clarity or coherence from the record of the past in this field. . . . Nineteenth century judicial opinions dealing with par values, stock issues, capital and stock subscriptions, are nearly always analytically incoherent. But to harp on that point is unseemly; it is to shoot fish in a barrel."¹³ The remainder of the book, however, does indeed contain many caustic comments on nineteenth and twentieth century opinions. The constant sharpness of approach may harm the book in two ways. First, it may give students the impression that the courts of earlier years were completely incompetent in this field (which they were not) and it may so distract other readers that the overall effectiveness of the book is lessened. On the other hand, for some readers, this sharpness may make *Legal Capital* more readable and interesting than would a cautious, measured tone.

Dean Manning's pointed style should not detract, however, from the fact that *Legal Capital* analyzes coherently and logically the various legal and accounting issues involved in legal capital transactions, and interprets the applicable statutes. Dean Manning's discussion begins with an explanation of the fundamental problems that are posed by the conflicting interests of the creditors of the business corporation and its shareholders and by the concept of legal capital.¹⁴ *Legal Capital* proceeds with a detailed analysis of the regulation of the shareholder's contribution. Dean Manning points out that most state corporation laws have only minimum pay-in requirements, amounting in the laws of many states to an aggregate requirement of \$1,000.00, and that even this modest requirement has been eliminated in a number of states.¹⁵ *Legal Capital* uses the early federal case

¹¹ *Id.* at viii.

¹² For example, Dean Manning states: "But the *Heppenheimer* case [See v. *Heppenheimer*, 69 N.J. 36, 61 A. 843 (Ch. 1905)] serves as a reminder and illustration of the literal-minded, antique flavor that besets much of the law of legal capital. . . ." MANNING, *supra* note 1, at 42. "To argue that [the issue of a stock dividend] is permissible under the statutes because the 'surplus' is 'property', and to say that the accounting entry is a 'pay-in', is ridiculous on so many levels that it betrays the truth that the concern of modern legal capital law is frequently no more than formal in character." *Id.* at 43.

¹³ *Id.* at 16.

¹⁴ *Id.* at 1-39.

¹⁵ The Japanese commercial code is much stricter and more precise in its requirements regarding minimum pay-in requirements than are our states' laws. The Japanese commercial code requires that when the Japanese equivalent of our corporation is being formed, at least one-quarter of the authorized shares must be issued at the time of incorporation, Article

of *Wood v. Dummer*¹⁶ as the starting point of its discussion of the regulation of distribution to shareholders. *Legal Capital* also analyzes in some detail the different results obtained under the various statutes which regulate distribution. The statutes regulating distribution to shareholders are divided into five general groups: balance sheet surplus statutes; earned surplus statutes; surplus or net profits statutes; current earnings statutes; and insolvency statutes.¹⁷

In his discussion of the insolvency statutes, Dean Manning refers to the Uniform Fraudulent Conveyance Act (the Act),¹⁸ but only addresses that portion of the Act which deals with "conveyance without a fair consideration by a person who is rendered insolvent thereby. . . ."¹⁹ In fact, the Act deals not only with conveyances by persons who are thereby rendered insolvent, but also more broadly with conveyances without fair consideration when the person making the conveyance is engaged in a business "for which the property remaining in his hands after the conveyance is a unreasonably small capital."²⁰ Furthermore, the substance of these provisions of

166, that these shares must be paid for in full before the organizational meeting of the corporation can be held, Article 177, and that the payment of the shares referred to above be deposited with a Japanese bank or trust company which is to conduct the business of receiving payment. Article 175, ¶ 2 (10).

¹⁶ 30 Fed. Cas. 435 (No. 17,944) (C.C.D. Me. 1824). In this case, the shareholders who received a distribution of capital in liquidation were ordered by Mr. Justice Story to pay damages to creditors whose claims were not paid by the liquidated corporation, a Massachusetts bank. The bank became insolvent within a year after the liquidating distribution, and the holders of the claims against the bank sued some of the former shareholders. The defendants (who owned 16% of the stock of the insolvent company) were ordered to pay the plaintiffs an amount equal to 16% of their claims. Dean Manning commends Justice Story's opinion in the case and comments upon his use of the word "stock" in its early meaning as the "root of something growing." The plaintiff stockholders were successful in the federal courts only after two earlier suits in the Massachusetts state court failed to obtain relief. For a detailed discussion of this case and a critique of Dean Manning's summarization of the facts, see the review of *Legal Capital* by C. Robert Morris, Jr., 61 MINN. L. REV. 1035, 1036-43 (1977).

¹⁷ MANNING, *supra* note 1, at 59-83.

¹⁸ *Id.* at 59, citing UNIFORM FRAUDULENT CONVEYANCE ACT § 4.

¹⁹ MANNING, *supra* note 1, at 59.

²⁰ One court has held that this broader wording applies to dividends. See *United States v. 58th Street Plaza Theatre, Inc.*, 287 F. Supp. 475 (S.D.N.Y. 1968). In *58th Street Plaza Theatre* the United States brought an action against the corporation and certain stockholders to recover corporate income taxes. The corporation declared dividends to its stockholders at various times after the corporate income tax claims were asserted. The court found that the management of the corporation and the stockholders knew that the corporation would be unable to pay the income tax claims if the claims were upheld. The court stated that certain dividends paid to the corporation's stockholders, as well as various other payments made by them, were fraudulent as to present and future creditors, even if the transferor was solvent at the time of the transfer if the transferor was left with "unreasonably small capital." *Id.* at 498, citing N.Y. DEBT. & CRED. LAW §§ 274-75 (McKinney 1945). The court further held that the transferees were liable to the government for the amount received. Section 274 of the New York Debtor and Creditor Law is based on § 4 of the Uniform Fraudulent Conveyance Act and reads in pertinent part:

Every conveyance made without fair consideration when the person making it is

the Act has been incorporated into the Bankruptcy Act at sections 67(d) and 70(e).²¹

Legal Capital also discusses in some detail the effect of an impairment of capital on the ability of a corporation to pay dividends under the various types of state statutes regulating distribution to shareholders and points out that the impairment of capital would prevent distribution in balance sheet surplus statutes.²² The text goes on to discuss the effect of a reduction of capital either by means of a reduction in the par value of shares or by a reduction in the number of shares and indicates that a reduction in capital achieved by a reduction in par value does not in itself harm the creditors of the corporation.²³ A reduction in par value does create, however, a potentiality for harm in jurisdictions where the surplus resulting from the reduction in par value would be available for distribution to shareholders. This example illustrates, of course, the ease of circumventing the purpose and function of the *Legal Capital* statutes in many jurisdictions.

Dean Manning concludes his evaluation of legal capital statutes in Part I with the observation that the legal capital machinery makes only a marginal effort to protect groups or classes of shareholders from each other despite their often conflicting interests and that as to creditors, the legal capital statutes "are inherently doomed to a low level of effectiveness. . . ."²⁴ Certainly, one would have to agree with this conclusion at least as to corporations incorporated in states with highly flexible legal capital statutes. One might argue, perhaps, that even in these states, counsel for many corporations (including in particular counsel for small

engaged . . . in a business . . . for which the property remaining in his hands after the conveyance is an unreasonably small capital, is fraudulent as to the creditors . . . without regard as to his actual intent.

N.Y. DEBT. & CRED. LAW § 274 (1945).

²¹ 11 U.S.C. § 107(d) & 110(e) (1976). The Bankruptcy Reform Act of 1978 was signed into law by President Carter on November 6, 1978 but its provisions will not take effect until October 1, 1979. The substance of the provisions of the old law is continued in effect by section 54B(a) of the new law.

²² MANNING, *supra* note 1, at 60-66.

²³ Dean Manning discusses the effect of a reduction in the par value of stock in Transaction 20(3) in Part II of *Legal Capital*. *Id.* at 143-44. In transaction 20(3) the management of the corporation in question desires to sell additional shares of \$40.00 par common stock, but the prospective purchasers will pay only \$25.00 a share. The text observes that this difficulty could be eliminated by reducing the par value of the stock. Would one expect past or future creditors to object to the lowering of the par value so that additional shares can be sold? One would certainly think that creditors (current or future) would welcome this transaction. New assets are brought into the corporation and the claims of the shareholders will be junior to all creditors.

An interesting comparison can be made with the provisions of Italian corporation law. In Italy, if a corporation's capital has been reduced below the statutory minimum (i.e., one million lira, which is slightly more than \$1,000.00), the company must be dissolved unless the restoration to the legal minimum has been arranged. C.C. §§ 2327, 2448 (1), 2464 & 2497 (1). Furthermore, if a company incurs losses which exceed one-third of the amount of the corporation's issued capital, a reduction of capital must be effected. *See* P. VERRUCOLI, *ITALIAN COMPANY LAW* 50 (1977).

²⁴ MANNING, *supra* note 1, at 84.

corporations) would hesitate to recommend the various courses of action which may be available, such as reduction in par value, partly for fear of creditor reaction and partly because the declaration of a dividend out of surplus so achieved would seem to have highly undesirable federal tax consequences for shareholders. Thus, the legal capital machinery may have a somewhat greater practical effect than a reading of the statutes and cases would lead one to expect.

In Part II of *Legal Capital*²⁵ which presents the various transactions, Dean Manning begins by cautioning the reader that the law regarding legal capital varies from state to state and that more than one accounting method is often available. Accordingly, Dean Manning's entries reflecting the transactions are intended as illustrative only. Such a caveat is surely appropriate in regard to a book of 167 pages which attempts to deal with such a variety of complicated subjects in a colorful and straightforward manner. Indeed, despite this caveat, a book of this nature is almost sure to be subject to possible criticism in a number of areas.²⁶

In conclusion, however, it must be stressed that the book offers a highly useful tool to corporate law teachers sorely pressed for time and for practicing lawyers who would like a general survey and refresher in this important

²⁵ *Id.* at 109.

²⁶ Issue might be taken, for example, with Dean Manning's analysis in Transaction 8, which discusses the accounting treatment of stock dividends. Dean Manning states the general rule that in order to reflect a stock dividend, stated capital should be increased by the fair market value of the shares issued, so long as the fair market value is not less than par value. It is believed, however, that the more customary practice is to increase stated capital by the fair market value of the shares issued only when the stock dividend is a fairly "small" one—not more than one additional share issued for each four or five shares held, and that for larger stock dividends, stated capital is increased only by the aggregate par value of the new shares issued. See A.I.C.P.A. RESTATEMENT—REVISIONS OF ACCOUNTING BULLETINS, Bulletin 43 (1953).

Dean Manning's analysis and Transaction 9 is open to question. Dean Manning states:

On the whole, lawyers and accountants tend to use the term "stock dividend" where the change in the number of outstanding shares is relatively small and "stock split" when it is relatively large. If par stock is involved and if the transaction has denominated a "split" the lawyer assumes that a reduction of par will be made, since otherwise stated capital will be sharply increased and the company's freedom to declare dividends correspondingly reduced.

MANNING, *supra* note 1, at 122.

Customarily, however, the term "stock split" is used where additional shares are issued with no change in the stated capital of the aggregate shares outstanding, whether the change in the number of shares is relatively small or large. The term "stock dividend" is used when the new issue of shares results in an increase in the stated capital of the aggregate shares outstanding.

Legal Capital contains numerous helpful pointers as to specific action by counsel in various situations. Since the "legal capital" statutes vary so substantially from state to state, it would have been helpful if Dean Manning had suggested that in recommending the state under whose laws a new corporation should be organized, counsel should be influenced to some extent by the applicable state law provisions as to legal capital.

For additional comments on Dean Manning's analysis, see the review of *Legal Capital* by C. Robert Morris, at 61 U. MINN. L. REV. 1035, 1048-50 (1977).

and technical field. *Legal Capital* will be a boon to law students generally, and particularly to those whose accounting background is limited. The subjects are presented, discussed and illustrated in a lively, easily readable style.

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