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Lewis Tanner

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THE ILLINOIS BUSINESS CORPORATION ACT—
PURCHASE BY A CORPORATION OF ITS OWN SHARES—
ACCOUNTING AND LEGAL PROBLEMS

LEWIS TANNER

INTRODUCTION

The scarcity of case material on the Illinois Business Corporation Act necessitates much speculation in attempting to determine what "the law" is with respect to a corporation's power to purchase its own shares. The statute deals expressly with the power. However, many problems of statutory construction and interpretation may nevertheless arise. It is the purpose of this article to explore some of those problems and to suggest possible solutions.

The science of accounting definitely becomes associated with law in this field. Each has undoubtedly influenced the other in the past and will surely continue to do so in the future. More accountants have become interested in law, and more lawyers have turned to accountancy for aid. This is as it should be. Respect for the one can grow only through a thorough understanding of the other's problems. Each can contribute much needed wisdom to the solution of their common problems.

Although the science of accounting has made marked progress, it is still in a formative stage, and it were indeed a daring or foolhardy accountant who would attempt a categorical and dogmatic treatment of the subject. In accounting there is no person or academy whose pronouncement can be accepted as having unquestioned authority. Those who write on the
subject must, in general, express opinions and formulate arguments rather than render decisions.¹

Such modesty is commendable. The legal and accounting suggestions offered herein are made with the above thought in mind.

**THE SITUATION BEFORE THE PRESENT ACT**

Before approaching the present statutory provisions, it would, perhaps, be helpful to probe into the Illinois case history on this subject.

The cases may be classified on the basis of creditors having been absent from, or involved in, the lawsuit:

I. Where no creditors were involved:

An agreement by a corporation to repurchase some of its shares was first upheld by the Illinois Supreme Court in 1876² and, upon rehearing, was reaffirmed in a per curiam opinion.³ In the first opinion, the court thought that if the corporation's shares were a sufficient consideration when furnished by the corporation in exchange for another's bonds, then the same shares should be considered when furnished by the other to the corporation.⁴ Such a result on the surface seems to be based on fair play and mutuality. The second opinion reached the same result, relying on

¹ Hatfield, Accounting, Its Principles and Problems (1927) Preface viii.
² Chicago, Pekin & S.W. R. Co. v. Marseilles, 84 Ill. 145 (1876).
³ Ibid. 643 (1877).
⁴ The statute was silent on this question. The plaintiff alleged that it had issued $10,000 of its bonds for $10,000 of the defendant railroad company's stock with an agreement by the defendant to build a line from Pekin to Chicago which line was to pass through the plaintiff city. If it was not built as agreed, the railroad was to return the proceeds from the bonds for the stock. When the line was not built, plaintiff tendered the stock, but defendant refused to pay the money. One of defendant's pleas was that the contract was executed without good and valuable consideration. A demurrer to this plea was sustained. Plaintiff recovered a verdict after trial on other pleas. On appeal, this verdict was affirmed. In dealing with the demurrer, the Supreme Court said at pp. 149-150: "Nor does the averment at the close of the plea, that the company had no power to make the contract, in anywise render it a good plea. We entertain no doubt that a railroad may, for legitimate purposes, purchase shares of stock which have been issued to individuals. Such is believed to have been the general custom of such bodies, nor have we known the power to have been questioned. There is nothing in this plea to show that this purchase was not for legitimate purposes. If the shares issued to appellee were a consideration to support the contract for the delivery of the bonds to the company, and that they were cannot be questioned, then why was not the sale of the same shares by the village to the company a sufficient consideration to sustain this agreement? We are unable to perceive any reason."
cases from four other jurisdictions. The now familiar qual-

5 The court held that such an agreement to repurchase was within the corpora-
tion's power unless prohibited by its charter, and in the absence of proof to the con-
trary, that such an agreement would be presumed to have been made for legiti-
mate and authorized purposes (cases from other jurisdictions on releases of subscri-
biers from payments on subscriptions were held distinguishable and so not in point). Reliance was placed upon the following cases: "In the case of Taylor v. Miami Exportation Co., 6 Ohio (Hammond's R.) 83, it was held that a banking corporation might lawfully receive shares of its own stock from a solvent debtor in discharge of his indebtedness. The court went further, and held that, where a large number of shares had been issued to enable the holder to vote for certain persons for directors at an approaching election, and after the holder had thus voted, the money paid for the shares was returned to him, and he restores the shares to the bank, as there was no loss sustained by the transaction, and the result of the election was not changed, and whilst the court condemned the transaction it held that equity could afford no relief, as no one had been injured. It was also held in that case that, where the shares of the company were trans-
f erred to it in payment of such indebtedness, the corporation might hold and sell it as it did other property.

"In the case of the City Bank of Columbus v. Bruce, 17 N.Y. 507, it appeared that the board of directors passed a resolution that all stockholders indebted to the bank on stock notes, by a specified day, might pay such debts to the bank in its shares of stock, at a named per cent, and that not far from half of the stock of the bank was thus surrendered; and the court held, there was no ground for questioning the validity of the transaction; that no rule of common law or any provision of the charter forbade it; and the Ohio case is referred to and approved by the court. . . ."

"In the case of The State v. Smith, 48 Vt. R. 266, it was held, that where a railroad company had purchased 2350 shares of the stock of the company, the stock did not merge, and the legality of the purchase seems to be recognized by the court. And in further support of the rule, see Angell & Ames on Corp. sec. 280, where it is said it is one of the corporate powers that may be legally exer-
cised." 84 Ill. 644-6.

Apparently no distinction was thought worthwhile between a purchase of stock and a taking of it in payment of a debt (see § 6b of the present Act). The early case of Harridge v. Rockwell, R. M. Charl. 260 (Ga., 1828) was not cited by the court, although it reached a like result where a bank was involved. See Irving J. Levy, "Purchase by a Corporation of Its Own Stock," 15 Minn. L. Rev. 1 (1930), where the writer says at pp. 11-17 that courts have relied more on dicta of other courts than on the Georgia case. For other articles on this problem in general, usually cited, see the following: Leo G. Blackstock, "A Corporation's Power to Purchase Its Own Stock and Some Related Problems," 13 Tex. L. Rev. 442 (1935); Garrard Glenn, "Treasury Stock," 15 Va. L. Rev. 625 (1929); Artur Nuss-

In Chetlain v. Republic Life Ins. Co., 86 Ill. 220 (1877), X subscribed to some stock and paid 20% in cash and gave a note for the balance secured by a deed of trust on Blackacre. X died intestate, and the corporation filed a bill to foreclose the deed of trust and subject the trust property to a sale for the payment of the note. X's administrator set up as a defense that the corporation had mis-
appropriated its funds in several ways, one of which was reducing the amount of its capital stock without X's consent—the directors had issued paid up stock to some subscribers to the extent of the 20% paid in on subscriptions and cancelled the balance due. In rejecting the defense because of X's acquiescence, the court
ifications were added that there must be good faith and no fraud or injury to creditors or other stockholders.⁶

A corporation was held bound by its acceptance of overvalued property in full payment of stock, and a note given by the corporation in repurchasing that stock was held enforceable.⁷ Where a corporation sold stock with an agreement to repurchase it at the stockholder's option, such an option was said to be valid.⁸ However, if such an option were added by a corporation's special agent without authority and without disclosure to the corporation when it accepted the money, the corporation could retain the benefits of the sale and repudiate the option when the stockholder sought to exercise it.⁹ But a president who made contracts in the ordinary course of business was presumed to have

said there was no effort to reduce the capital stock by purchase of its own shares or otherwise, but even if a purchase had been intended, "there are numerous cases which hold that a corporation may do so and violate no duty to the stockholders, unless prohibited by its charter." (p. 225).

⁶ If any wrong were involved, the court said that relief lay in equity and not at law. "If it were shown that the purchase was made to promote the interests of the officers of the company alone, and not the stockholders generally, or if for the benefit of a portion of the stockholders and not all . . . or if it operated to the injury of creditors, or would defeat the end for which the body was created, or if it was done for any other fraudulent purpose, then chancery would interfere. . . . Whatever may be the rights of stockholders or creditors, if there are any, relief can only be had in equity, and by a stockholder or other cestui que trust." 84 Ill. at p. 646.

⁷ Kelly v. McCormick-Murray Mfg. Co., 201 Ill. App. 308 (1916). In Brown v. Fire Ins. Co. of Chicago, 265 Ill. App. 393 (1932), the appellate court held that the party relying on the contract to repurchase being invalid must plead its invalidity and cannot raise the question by a demurrer. A review of the Illinois cases is given with reasons supporting them as well as the view to the contrary. See also Brown Plastering Co. v. Gottschalk, 261 Ill. App. 147 (1931), where the guarantor of a corporation's repurchase agreement was not allowed to set up as a defense that the corporation was insolvent at the time it purchased its shares.

⁸ See Roush v. The Illinois Oil Co., 180 Ill. App. 346 (1913). The plaintiff was barred from exercising his option because of the statute of limitations and laches. No period was specified as to the length of time within which the option was to be exercised, so the court said it would be a reasonable time, and the period of the statute of limitations was used as a measurement. The court rejected the plaintiff's contention that the statute of limitations should not be held to run until after notice by the plaintiff and refusal by the corporation to perform.

⁹ Murray v. Standard Pecan Co., 309 Ill. 226, 140 N.E. 834 (1923), reversing 217 Ill. App. 587 (1920). The parties stipulated that the corporation's officers were not aware of the agreements to repurchase and repudiated it when notified, on the ground that the special agent had no authority to make such an agreement for a conditional sale or a contract to repurchase. The retention of the money was held not to be a ratification of the agent's unauthorized act.
authority to add such an option in a repurchase agreement. A corporation could validly retain an option to repurchase as well as give one. Thus where a corporation had an option to repurchase its shares from an employee when his employment ended, it was able to maintain a suit for specific performance.

II. Where creditors were involved:

The early cases reached favorable results for injured creditors where a corporation purported to release subscribers on unpaid stock or sought to make unpaid stock non-

10 Quigley v. W. N. MacQueen & Co., 321 Ill. 124, 151 N.E. 487 (1926); cf. Brown v. Fire Ins. Co. of Chicago, 274 Ill. App. 414 (1934), where the appellate court said there was such a presumption as to ordinary contracts but that where it involved a purchase of a company's own stock, a president had no such power in the absence of an authorization from the board of directors. Two judges concurred specially on the ground that the offer was by a "puffing" letter from the president to the plaintiff for the latter to show his bank so as to be able to maintain his credit. Apparently the plaintiff had no intention to sell when the letter was written and knew the president did not intend to make a real offer; note, 50 Yale L. J. 348.

11 Arentsen v. Sherman Towel Corp., 352 Ill. 327, 185 N.E. 822 (1933). The corporation had a 90 day option to buy at book value after he ceased to be in its employment as manager. The book value was to be determined by an auditor selected by the employee and/or the plaintiff corporation—goodwill and future profits were to be excluded. When the defendant ceased to work for the company, there was a deficit, so that the stock had no book value. The defendant attacked the accounting method of charging off various items to expense, but their value was less than the deficit, so that there would still have been no book value. The evidence did not show that certain charges made by an interested creditor were unreasonably high so as to boost the company's liabilities. In granting specific performance, the court pointed out that the defendant had been represented by an attorney when he made the contract, and that there was no evidence of fraud or unfair conduct. The court said at p. 339: "It is true that a court of equity will not grant specific performance of a contract that is inequitable, unconscionable or unjust. (Smith v. Smith, 340 Ill. 373.) It is also true, as a general rule, that inadequacy of consideration, exorbitance of price or improvidence of a contract, fairly and understandingly entered into by parties competent to contract, will not, in the absence of fraud, constitute a defense to a bill for specific performance. (Chicago Title and Trust Co. v. Merchants Trust Co. 329 Ill. 334.) It is the function of courts of equity to enforce rather than to sanction the evasion of contracts, and they are not concerned with the question of the wisdom or folly of contracts between parties competent to contract, where such contracts are made fairly, understandingly, for a consideration and without fraud. (Keogh v. Peck, 316 Ill. 318.) The contract between Arentsen and the corporation was fairly and understandingly made. Subsequent events proved that the contract was an improvident one on Arentsen's part, but there is no showing, viewed from the situation at the time the contract was made, that it is inequitable, unconscionable or unjust. Since the stock in the corporation was not on the market and the shares had no market value, the contract to sell such stock may be enforced by specific performance. Hills v. McMunn, 232 Ill. 498; Smurr v. Kamen, 301 id. 179." But cf. Topken, Loring & Schwartz, Inc. v. Schwartz, 249 N.Y. 206, 163 N.E. 735 (1928), noted in 29 Col. L. Rev. 358; 15 Corn.
assessable. Creditors were held not bound by such an arrangement. Nevertheless, since the corporation itself would be bound by the release, a receiver for the corporation was held to stand in no better position. A subscriber


12 Alling v. Wenzel, 133 Ill. 264, 24 N.E. 551 (1890). The shareholders involved had subscribed for stock and then surrendered it to the corporation. A bookkeeping entry was made designating it as treasury stock, and then the corporation sold the stock to them for less than par. § 8 of the statute then in force made a shareholder liable for the debts of a corporation to the extent of the amount unpaid on the stock he held. The plan was held to be an attempted evasion of the statute, and creditors were allowed to hold them for the unpaid amount. The question of a bona fide surrender and its effect as to subsequent creditors was left open. The court relied on Zirkel v. Joliet Opera House, 79 Ill. 334 (1875), and Melvin v. Lamar Ins. Co., 80 Ill. 446 (1875), in holding that creditors are not bound by an agreement between a corporation and its shareholders that the latter are to be released from liability for the balance of assessments due. The former case held that a plea by a shareholder as to such a release was not sufficient if it did not allege a valuable consideration had been given for the release and that there would be no injury to creditors. The latter case held that it would be a fraud on creditors and on shareholders for a corporation to release subscribers from the unpaid amount unless there was a valuable consideration.

The trust fund doctrine was mentioned for the first time by the Supreme Court of Illinois in the latter case, pp. 458-459. Another case relied upon in the principal case was Union Ins. Co. v. Frear Stone Mfg. Co., 97 Ill. 537 (1881) which held that an agreement by the corporation that unpaid stock was to be non-assessable was not binding on creditors. This case also talked about the trust fund doctrine at pp. 549-550. Alling v. Wenzel, supra, was followed in Coleman v. Howe, 154 Ill. 458, 39 N.E. 725 (1895), where creditors were allowed to reach a shareholder for the amount unpaid on his stock. The property that he had given the corporation for the stock was overvalued so much that it was obvious he had knowledge that the stock was not being paid for in full.

13 Republic Life Ins. Co. v. Swigert, 135 Ill. 150, 25 N.E. 680 (1890). The circuit court appointed a receiver under the 1874 act relating to dissolution of insurance companies. The receiver presented a petition to the court for an order to collect from some shareholders on unpaid subscriptions, based on the corporation having cancelled some certificates on which 20% had been paid and having issued new certificates for the number of shares paid. The circuit court entered such an order but the majority of the Supreme Court held that this was beyond the statute, because the receiver represented the corporation and not the creditors. The court said, at p. 162: "A corporation may, if it acts in good faith, buy and sell shares of its own stock. (Chicago, Pekin, and Southwestern Railroad Co. v. Marseilles, 84 Ill. 145; Same v. Same, id. 643; Chetlain v. Republic Life Ins. Co. 86 id. 220; Clapp v. Peterson, 104 id. 26.) The surrender by stockholders, to the company, of the certificates of stock upon which twenty per centum had been paid, and the issuance to such stockholders of certificates for paid up stock, was, in substance and legal effect, a purchase by the company of the unpaid stock at its par value. The transaction was not ultra vires. It was based upon resolutions adopted by the corporation at a stockholders' meeting. It does not appear that any stockholder has ever objected either to the resolutions or to the transfers of stock, which in conformity therewith, took place between the corporation and such of the stockholders as elected to avail themselves of the privilege given thereby. The contracts were valid as between the company and the stockholders who gave up their part paid stock, and received in lieu thereof
who surrendered some unpaid shares was held not liable to creditors when the shares had later been issued to another who had paid the corporation in full.\textsuperscript{14}

The stock-purchase cases went along similar lines with respect to existing creditors who were injured. Stockholders were held not liable to creditors when they sold some stock to the corporation while it was solvent and had an adequate surplus at the time, although it later became insolvent.\textsuperscript{15}

But where there was no surplus at the time of the sale, the seller who received realty for his shares was held not to be a bona fide purchaser, so that a creditor was allowed to reach the property.\textsuperscript{16} The court held that the surrender of full paid stock for one-fifth of the amount relinquished. The transaction was binding upon the company, and the stockholders who sold their stock should be protected against further payments upon their subscriptions, unless there were, at the time of such transaction, existing creditors in respect to whose rights it was fraudulent. It is to be noted, that thereafter, as between such stockholders and the company, there was no indebtedness to the company in regard to the subscriptions for stock."

The dissenting justice thought that the receiver represented the corporation and the creditors. Another justice did not participate because he said this was in effect a controversy between creditors and stockholders, and he had been attorney for one of the creditors in the court below. In Chicago, Pekin & S.W. R. Co. v. Marseilles, 84 Ill. 643 (1877), the court purportedly distinguished a release of subscriptions from the purchase of shares, while here it said they were alike in substance and in legal effect. The latter conclusion is undoubtedly sound.

See also Sangamon Coal Mining Co. v. Richardson, 33 Ill. App. 277 (1889), and Pullman v. Railway Equipment Co., 73 Ill. App. 313 (1897), where creditors seeking to reach the unpaid amount on subscriptions by garnishment were held to stand in the corporation's position.

\textsuperscript{14} First National Bank of Peoria v. The Peoria Watch Co., 191 Ill. 128, 60 N.E. 859 (1901), affirming 93 Ill. App. 502 (1900).

\textsuperscript{15} Fraser v. Ritchie, 8 Ill. App. 554 (1881). The appellate court discussed the trust fund doctrine and said that as a general proposition it was founded in reason and justice. The stockholders who sold the stock would be held liable to creditors if at the time of sale there was fraud in fact, or if the corporation was insolvent, or if the stock was surrendered for the purpose of winding up the corporation. But a distinction was drawn as to a corporation which was prosperous at the time of the purchase and able to meet all its obligations. The court said at p. 561: "Most of the cases which we have examined were, it is true, cases relating to financial or commercial corporations, but we are unable to see any valid grounds for holding that a corporation for manufacturing purposes may not, as between itself and its creditors, invest its surplus earnings in the purchase of shares of its stock, which would not apply with equal force to the former class."

\textsuperscript{16} Clapp v. Peterson, 104 Ill. 26 (1882). Plaintiff was defrauded by the corporation in selling some personal property to it. When she discovered the fraud, she immediately rescinded and recovered a decree, but execution was returned unsatisfied. X had sold some shares to the corporation for some land after the plaintiff was defrauded but before she had rescinded. The court allowed the plaintiff's bill seeking to subject the land held by X's estate to the payment of her decree. [Reference was made to the qualification as to creditors that
the shares was not an equivalent exchange as far as existing creditors were concerned, and that the sellers were charged with notice of the trust character\textsuperscript{17} of the capital stock fund.\textsuperscript{18} And any creditor was held eligible to object to a stockholder's attempt to hold an insolvent corporation liable for breach of a contract to repurchase its shares.\textsuperscript{19}

\textbf{Present Statutory Provisions}

The power of a corporation to purchase its own shares\textsuperscript{20} is recognized by the Act in Section 6, which provides that

17 This was the first time that the Illinois Supreme Court had relied upon the trust fund doctrine to let creditors reach property conveyed by the corporation. The doctrine had been mentioned before—see note 12, supra. For an explanation of the background and for a brief criticism of the theory of the doctrine, see Edward H. Warren, "Safeguarding the Creditors of Corporations," 36 Harv. L. Rev. 509, 544-546 (1923). For a concise review of Illinois cases, see Sveinbjorn Johnson, "Right of Creditors to Avoid Purchase of Its Own Stock by Corporation," 21 Ill. B.J. 27 (Oct., 1932). The author concludes at p. 30 that either existing or subsequent creditors should be able to object if the purchase was not made from surplus, regardless of good faith of the seller and regardless of when the company became insolvent.

18 For accounting terminology and distinction between funds and reserves, see Finney, Principles of Accounting (1934) I, 369.

19 Olmstead v. The Vance & Jones Co., 196 Ill. 236, 63 N.E. 634 (1902).

20 Defined in §§ 2 (f) and 2 (g).
the net assets\textsuperscript{21} must equal or exceed, both before and after
the purchase, the sum of the stated capital,\textsuperscript{22} paid-in sur-
plus,\textsuperscript{23} any surplus arising from unrealized appreciation or
revaluation of the assets, and any surplus arising from sur-
render to the corporation of its shares.\textsuperscript{24}

Thus stated capital and three types of surplus are men-
tioned. The two types of surplus last mentioned in Section 6
also appear in Section 41,\textsuperscript{25} which relates to dividends; but
they are not defined anywhere in the Act. The word “sur-
plus” is used in several sections,\textsuperscript{26} but in each case it proba-
bly has reference to any type of surplus possible.

It would have been simpler to base a corporation’s power
to purchase its own shares on the amount of earned surplus
it had accumulated, with a definition of that account. The
probable reason for the negative approach was the inability
of the drafters to agree on what does constitute earned
surplus.\textsuperscript{27}

Section 6 does not purport to exhaust all possible types
of surplus. If these other types are available on which to
predicate a corporation’s power to purchase under Section 6,
then that power will be extended every time an amount can
be credited to one of these other types rather than to one
of those mentioned in Section 6. Likewise, if an amount can
be charged to one of those mentioned in Section 6 instead

\textsuperscript{21} Defined in § 2 (m). A corporation’s own shares are excluded from its net
assets for specified purposes, and one of such purposes involves Section 6.

\textsuperscript{22} Defined in § 2 (k).

\textsuperscript{23} Defined in § 2 (l).

\textsuperscript{24} Four exceptions are provided in §§ 6 (a)-(d), which are as follows: (a)
eliminating fractional shares; (b) securing previously incurred debts to the cor-
poration, or collecting or compromising claims; (c) paying dissenting share-
holders entitled to be paid for their shares in case of merger or consolidation or
a sale or exchange of assets; (d) redemption of preferred shares as provided
in Section 58.

\textsuperscript{25} Surplus arising from the surrender to the corporation of any of its shares—
§ 41 (b); surplus arising from unrealized appreciation in value or revaluation of
assets—§ 41 (c). For an accounting treatment of appraisal surplus, see Finney,

\textsuperscript{26} §§ 17, 19 (d), 41 (e), 41 (f), and 55 (f). §§ 41 (e) and 41 (f) should also be
read with § 41 (c). The latter has reference to a share dividend which can be
based upon “surplus arising from unrealized appreciation in value or revaluation
of assets.”

\textsuperscript{27} The Illinois Business Corporation Act Annotated (Foundation Press, Chicago,
1934) 39-40.
of to one of the other types, then the power at least is to that extent preserved or not diminished.

To make this more specific, several illustrations will be considered. A chamber of commerce or a city may donate a lot and building to a corporation if it will open a factory there. Such a gift would not be a proper credit to earned surplus. The types of surplus mentioned in Section 6 would not be appropriate to receive this amount. An account such as "Donated Surplus" would probably be more appropriate.

A corporation may buy and sell its shares at a profit. Such a profit would not be required to go to any surplus account mentioned in Section 6. The Attorney-General has given an opinion that such a profit should go to earned surplus rather than to paid-in surplus. A separate account could be used to keep the profit out of earned surplus or paid-in surplus, such as "Surplus from Resale of the Corporation's Own Shares."

Even if earned surplus is to consist only of profits accumulated, there is no unanimity among accounting writers as to whether it should include both operating and non-operating profits. See Hatfield, Accounting, Its Principles and Problems (1927), 241-243 for a discussion of profits; Ibid. 296-298 for a discussion of surplus. See also Dodd & Baker, Cases on Business Associations (1940) I, 737 for a presentation of a profit and loss statement. If the "gift" were conditioned upon a specified payroll being met for a fixed period (or similar conditions) then the value might be considered as having been earned over the period involved.

It is neither appraisal surplus or surplus arising from surrender of shares to the corporation. Since it is a gift from outsiders, it clearly would not come within paid-in surplus as defined in Section 2 (l).

Since § 2 (l) refers to issuance and not reissuance of shares, and § 2 (j) considers a corporation's own shares acquired by it as being issued, the profit would not be required to be included in paid-in surplus. See Wilber G. Katz, "Accounting Problems in Corporate Distributions," 89 U. of Pa. L. Rev. 764, 787-788 (1941).

Attorney General's Opinion No. 526 (1933). Dodd & Baker, Cases on Business Associations (1940) I, 762 points out that no specific provision of the Act required this decision, and that there is no indication as to how to measure the profit—at selling price less cost or selling price less capital represented by the shares. However, § 2 (l) apparently does not require its inclusion in paid-in surplus.

In the SEC Accounting Series Release No. 6, May 10, 1938, the Chief Accountant states that such a profit should be treated as part of capital, because from an accounting standpoint, there is no substantial difference between the reacquisition and resale of a company's own stock and the reacquisition and retirement of such stock with a later issuance of stock of the same class.

Hatfield, Accounting, Its Principles and Problems (1927), 183 suggests that such a profit should go to an account clearly indicating the nature of the item, such as "Premium on Sale of Treasury Stock", and should not be put into current profit and loss or ordinary surplus; another view is pointed out which states that such a profit should be treated as income if it arose from a company's buying
Another type of surplus that may arise is some type of a reduction surplus under Sections 52(f), 58, 58a, and 60. Such a surplus is not mentioned in Section 6 and would probably be available just as the types mentioned in the preceding paragraphs.

The previous examples have been given to illustrate possibilities of extending a corporation's power under Section 6 by credits to some types of surplus not included there. An example will now be given to show how the power may be maintained instead of diminished by choosing a surplus account to receive a charge that is to be made.

A corporation may have a deficit on its books. If that amount could be charged to paid-in surplus with later earnings available to go to earned surplus, then the power under Section 6 would benefit. Section 60(a) purports to allow that by providing that "a corporation may, by resolution of its board of directors, apply any part or all of its paid-in surplus to the reduction or elimination of any deficit arising from operating or other losses or from diminution in value of its assets." A more difficult question arises where there

and selling its own stock, but if it was a sale of donated stock, that it should be considered as an increase in capital. Thus such an amount as the latter would go into surplus arising from surrender to the corporation of any of its shares under § 6. See note 60, infra.

The validity of Reg. 103, § 19.22 (a)-16, prescribing certain situations where such profit transactions are no longer considered as capital transactions, but are taxable, may be of some influence in the future. If such profits can legally be treated as earned income, then there should be legal grounds to consider those profits as part of earned surplus. However, many accountants would be reluctant to adopt such a view. At least part of their reasoning would be based upon the grounds that some non-deductible expenses for tax purposes are nevertheless charged to earned surplus (either directly or through the profit and loss account), so that the tax law is not of controlling or substantial influence. There should be less objection to the suggestion of using a separate account for such profits. See note 57, infra, for a brief treatment of losses on resale of a corporation's own shares.

32 § 52 (f) deals with amendment to articles of incorporation. See note 34, infra.

33 § 58 deals with redemption and cancellation of shares. See also § 6 (d).

34 § 58 (a) allows cancellation by resolution of the board of directors of shares owned by the corporation or a wholly owned subsidiary on July 13, 1933. As to shares acquired after that date (where § 58 does not apply), cancellation must be more formal, and is covered by § 52 (f) on amendment to the articles of incorporation.

35 Paid-in surplus may result by the provision in § 60.

36 Later earnings probably need not be used to replenish the amount of paid-in surplus used. See Charles G. Little, "The Illinois Business Corporation Law," 28 Ill. L. Rev. 997, 1012 n. 11 (1934).

See SEC, Accounting Series Releases Nos. 15 & 16, March 16, 1940 providing
is a sufficient balance in earned surplus as well as in paid-in surplus to offset a write-down in assets. Does Section 60(a) allow the charge to be made to paid-in surplus in such a case? What is meant by "deficit arising" as there used? If a deficit is merely a debit balance in the earned surplus account, then deficit and earned surplus would be mutually exclusive, i.e. a deficit would merely be earned surplus turned inside out.87

The Attorney General has written an opinion stating that such a write-down in fixed assets could probably be charged to paid-in surplus even though earned surplus was also sufficient to absorb the charge.88 He thought that this would violate the spirit of the Act as well as violate sound accounting principles.89 No analysis was made of "deficit."90 The Chief Accountant of the SEC has stated that as that disclosure should be made in the financial statements, and that notice should be given to the shareholders if the write-down was done by a resolution of the board of directors without a shareholder's vote.

87 See Wilber G. Katz, "Accounting Problems in Corporate Distributions," 89 U. of Pa. L. Rev. 764, 769 (1941), where deficit is called "earned surplus deficit." Accumulated earnings generally indicate a business is going forward, while a deficit tends to indicate the contrary. An analogy could be made to military terminology, where an "advance" and a "retreat" (or "an advance to the rear") are usually thought of as being mutually exclusive. "In accounting terminology, a deficit necessarily implies an absence of earned surplus"—Graham & Katz, Accounting in Law Practice (2d Ed. 1938) 152. See also the financial statements, Dodd & Baker, Cases on Business Associations (1940) I, 749 (iv). However, there is no inherent impossibility in the desire to have separate accounts for a deficit and earned surplus, especially where the deficit arises from different charges than the type of items credited to earned surplus. See Dodd & Baker, Cases on Business Associations (1940) I, 768, suggesting as a possibility an account called "Surplus (Deficit) from Reappraisal of Fixed Assets."


89 See Finney, Principles of Accounting (1934) I, 111-120 for a list and explanation of the following accounting principles:

(1) Distinguish between operating and extraneous profits.
(2) Take up income and expense in the proper period.
(3) Distinguish between profits and savings.
(4) Distinguish between capital and revenue expenditures.
(5) Value all assets as correctly as possible.
(6) Anticipate no profit and provide for all losses.
(7) Avoid unwarranted conservatism.

90 His conclusion is considered of doubtful soundness by Graham & Katz, Accounting in Law Practice (2nd Ed. 1938) 152 n. 13, but the impression there given is that the opinion relates to the use of paid-in surplus to absorb current losses when there is an earned surplus available. The opinion is also criticized by Wilber G. Katz, "The Illinois Business Corporation Act," 12 Wis. L. Rev. 473, 476-477 (1937).
a matter of sound accounting, a write-down of fixed assets should be charged off to earned surplus if available.\textsuperscript{41}

Probably a more minute analysis should be made. If the rate of depreciation for previous years had been too low, then profits would have been overstated, with a like result in earned surplus. A write-down necessitated because of such an inadequate depreciation rate should be charged to earned surplus.\textsuperscript{42}

If the write-down is a recognition that the property was overvalued when acquired, as when exchanged for shares, then it would appear more reasonable to charge it off to paid-in surplus, especially if paid-in surplus had been credited for such excess value at the time of acquisition. If depreciation previously charged was really too much due to the overvaluation, then an adjustment may also have to be made to earned surplus.\textsuperscript{43}

If the write-down is excessive in order to put a lesser depreciation burden on later periods, then it would be fairer to charge any available earned surplus, and make an adequate disclosure on the financial statements.\textsuperscript{44}

Current losses should be charged to earned surplus if current profits are credited to that account. However, if the Attorney General's opinion is sound as to a write-down of assets, then by analogy (although not a logical deduction), current losses could be charged to paid-in surplus although earned surplus were available, since Section 60(a) covers a deficit arising from operating losses as well as a deficit arising from diminution in the value of assets.

If a write-down is based on an unforeseen change in the

\textsuperscript{41} SEC Accounting Series Release No. 1, April 1, 1937. See Dodd & Baker, Cases on Business Associations (1940) I, 1152 n. 13 which points out that the opinion deals with special obsolescence. The basis of the Chief Accountant's reasoning was that the write-down was a later recognition of insufficient depreciation having been charged in prior years. See also Accounting Releases No. 4, April 25, 1938, No. 7, May 16, 1938, and No. 12, February 21, 1940.

\textsuperscript{42} It would be better to charge earned surplus and increase the reserve for depreciation in order to preserve cost figures for the fixed assets.

\textsuperscript{43} Perhaps the excess in reserve for depreciation could be credited to earned surplus, but probably it would be used to offset some of the write-down.

price level of fixed assets, then there would appear to be more justification in keeping such a charge separate from earned surplus.\textsuperscript{45} An analogy could be made to an appraisal upward. Such an appraisal surplus should be kept separate from earned surplus\textsuperscript{46} and indeed must be for purposes of Section 6.

Some aid might be obtained by seeking the purpose back of Section 60(a). The sum of stated capital and paid-in surplus is the basis for both license and franchise taxes.\textsuperscript{47} Therefore it has been suggested that the primary purpose of Section 60(a) was to enable the directors by resolution to reduce this basis without the requirement of shareholder approval.\textsuperscript{48} It would seem just to allow a reduction in the taxable basis where there is no earned surplus and a deficit exists, since there is an impairment in fact of the taxable basis. But where earned surplus is available for the charge, the opposite view should prevail.\textsuperscript{49}

\textsuperscript{45} The depreciation rate has not been necessarily wrong so that earned surplus is not overstated to that extent. No accounting rule would require such a write-down or require depreciation rates to be based on that valuation. To preserve cost figures, a separate reserve could be set up. Disclosure should be made on the financial statements.

\textsuperscript{46} See Finney, Principles of Accounting (1934) I, 287-297.

\textsuperscript{47} §§ 128-140 1/2; see also § 2 (k) (3).

\textsuperscript{48} The Illinois Business Corporation Act Annotated, Foundation Press, Chicago, (1934), 241. See also Attorney General's Opinion No. 179 (1933).

\textsuperscript{49} It would be plausible to expect the court to hold against a corporation in a franchise tax dispute involving such a case where earned surplus was available. The following cases on franchise taxes have pointed to just results. In Moline-Rock Island Mfg. Co. v. State of Illinois, 8 Court of Claims 678 (1935), the corporation saved on its franchise tax by reducing capital stock from $2,900,000 to $100,000 just before the present Act became effective. Under the latter, there would have been no saving since the amount reduced would have been paid-in surplus and part of the basis for the franchise tax. See §§ 59, 60, 131 and 132.

In Lake Shore Drive Bldg. Corp. v. Hughes, 369 Ill. 476, 17 N.E. (2d) 38 (1938), A corporation was organized in 1928 with power to acquire real estate, and to erect and manage apartment buildings. A's managers organized B corporation in 1929 with 14,500 no par shares. Ten shares were sold for $1000, while the balance were transferred to A in exchange for Blackacre which was purportedly worth $297,000 (A had paid $172,000 cash and had given a mortgage of $125,000). The next month, A and B made a contract whereby A was to lend B money to pay off the mortgage on Blackacre, and A was to erect a 28 story apartment building on Blackacre; in return, B was to pay A the $1000 received for the 10 shares sold and was to execute to A a 99 year lease of the occupiable parts of the apartment buildings. A was to pay as rent an annual sum of $1 plus "maintenance rent" to equal all expenses incurred by B in operating the building, plus a
A legal theory must often meet the pragmatic test: will it work? If the lawyer will tell the accountant what "the law" is, the latter can probably find accounts available to put that theory adequately into operation.

Several examples will be given. Corporation A has $4,000,000 assets, $1,000,000 debts, $1,000,000 stated capital (10,000 common shares at $100 par), $1,000,000 paid-in sur-

"special rent" to cover assessments on B's stock. A was given the power to assign portions of the lease to buyers of B's stock held by A.

A erected a building that cost $2,250,000 including a mortgage of $850,000; 11 of the 28 apartments had been transferred to tenants in proportion to the stock bought and the tenants were to have proportionate liability for "maintenance" and "special" rents.

The value of the completed building was required to be included under § 2 (1) of the Act as part of the consideration received by the corporation in exchange for its shares. In substance the whole plan was for A to transfer the building and Blackacre for practically all of B's stock and a 99 year lease on the building. The court rejected B's contention that the building was valueless to it because of the long lease which produced no income. The court pointed out that B's argument on valuation of the building was based on the capitalization of net earnings, while the facts showed that tenants of the building would all be shareholders of B and they could jointly sell the building at its approximate cost less depreciation.

Cf. Majestic Utilities Co. v. Stratton, 353 Ill. 86, 186 N.E. 522, 89 A. L. R. 852 (1933), which arose under the 1919 statute. A corporation had outstanding 500,000 no par shares, of which B corporation held 125,000 shares. A also owed B over $1,000,000. In March of 1931, B took over A's assets, assumed its liabilities, cancelled the debt it owed B, and issued to A 375,000 of shares in B. A then offered its shareholders B's shares in exchange for its shares. By February, 1932, all but 22,677 of its shares had been exchanged, and its exchange agent held that many shares of B company with which to exchange for A shares still outstanding. The rest of the A shares had been cancelled. A was assessed on the full amount received on its 500,000 shares, but recovered a refund, the court holding that the amount due should be based on its assets representing the 22,677 shares of B stock plus $1000 it had on hand. The statute did not expressly cover such a situation so the court construed the statute strictly. This was held not to be a reduction of capital stock which required an amendment to the charter, but was held to be a retirement and cancellation of shares by a transfer of its assets to another company. This was distinguished from a purchase of its own shares on which it paid a franchise tax, the court thought it unfair to impose a like tax on A company where both issues involved the same assets and A was retiring from business, having done no corporate business since the contract was made.

50 The various views taken by leading writers on this subject are clearly presented in Dodd & Baker, Cases on Business Associations, (1940) I, 730-772. To avoid unnecessary repetition, reference will be made to that presentation. Another presentation is given by Wilber G. Katz, "Accounting Problems in Corporate Distributions," 89 U. of Pa. L. Rev. 764, 779-788 (1941).
plus, and $1,000,000 earned surplus. This would appear on a balance sheet as follows:

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>Liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Assets</td>
<td>$4,000,000</td>
</tr>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>$4,000,000</td>
<td></td>
</tr>
</tbody>
</table>

Corporation A purchases for cash $500,000 worth of its own shares at par. The accounting entries would be as follows:

- Stated Capital—Issued and Outstanding: $500,000
- Stated Capital—Issued: $500,000
- Restriction for Cost of Own Shares Acquired: $500,000
- Cash: 500,000

Since the chief items of interest here are stated capital and the various surplus accounts, no attempt is made to present a complete balance sheet with subdivisions for various types of assets and liabilities. The names of the accounts used here are probably not those presently used by accountants, but they are used here primarily for legal analysis. The number of shares, their nature, par, etc., should be disclosed on the balance sheet. The presentation of surplus could be varied considerably.

This title is used to conform with the principle expressed in § 2 (j), that shares belonging to a corporation shall be considered to be issued but not outstanding. See also note 54, infra.

"Treasury Stock" is not used as an account for two reasons: (1) The Act contains no language with reference to such an account; (2) Such an account generally denotes a debt balance.

Various other titles could be and have been suggested for such an account: Restricted Surplus, Surplus Reserved for Treasury Shares, Reserve for Treasury Shares, Surplus Reserved as Capital, Surplus Applied in Acquisition of Treasury Shares. See Dodd & Baker, Cases on Business Associations (1940) I, 748,763.

The title used here avoids a "surplus" or "reserve for surplus" tag, chiefly because such accounts generally denote credit balances. See also note 55, infra.
The balance sheet would then appear as follows:

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>LIABILITIES</th>
</tr>
</thead>
<tbody>
<tr>
<td>$3,500,000</td>
<td>$1,000,000</td>
</tr>
</tbody>
</table>

Shareholders' Interest:
Stated Capital, Issued and Outstanding $500,000
Stated Capital, Issued 500,000 $1,000,000

Surplus
Paid-in 1,000,000
Earned $1,000,000
Restriction for cost of 500,000 own shares acquired

Available for Dividends 500,000 1,500,000 2,500,000

$3,500,000 $3,500,000

If the shares were resold at cost, the entries heretofore given would be reversed. If they were resold at a loss, earned surplus would probably be charged for the amount of the loss; if they were resold at a profit, earned surplus

54 Stated Capital is thus shown as not reduced by the purchase. See George S. Hills, “Accounting in Corporation Law” (1937) 12 Wis. L. Rev. 494 at 511: “To carry treasury shares which can be acquired only from surplus as a deduction from stated capital account has the same effect as if they were carried as an asset. Both practices vitiate the rule of law and reason that surplus must be reduced when expended.” See § 2 (m); also note 55, infra.

55 This is designed to meet the objection raised to the example in Dodd & Baker, Cases on Business Associations (1940) I, 756, and at the same time benefit by the suggestion there given for presenting stated capital.

It is very similar to one of the examples given by Wilbur G. Katz, “Accounting Problems in Corporate Distributions,” 89 U. of Pa. L. Rev. 764, 785 (1941).

The amount restricted is not charged directly to earned surplus but is kept in a separate account. It is deducted on the balance sheet to show what has occurred and the amount of earned surplus still available for dividends. By using a separate account, there would be less danger of freezing that amount of earned surplus in case the shares were resold. See Charles G. Little, “The Illinois Business Corporation Law” (1934) 28 Ill. L. Rev. 997, 1006-1011; also Dodd & Baker, Cases on Business Associations (1940) I, 746-764. Of the many alternative methods, some accountants would prefer to debit Treasury Stock for the cost of the shares, and deduct that account from the total stated capital and surplus.

56 This assumes earned surplus would not be frozen. See note 55, supra; also, note 60, infra.
could be credited, but it would probably be desirable to use a separate account.\textsuperscript{57}

The shares may cost more or less than par. Regardless of the amount paid, the amount of stated capital should not be affected. The cost would be deducted from earned surplus on the balance sheet. If the original purchase had cost $400,000, the entries would be as follows:\textsuperscript{58}

\begin{center}
\begin{tabular}{ll}
Stated Capital—Issued and Outstanding & $500,000  \\
Stated Capital—Issued & 500,000  \\
Restriction for Cost of Own Shares &  \\
Acquired & 400,000  \\
Cash & 400,000  \\
\end{tabular}
\end{center}

The following would be the balance sheet:

\begin{center}
\begin{tabular}{ll}
ASSETS & LIABILITIES  \\
Assets $3,600,000 & Liabilities $1,000,000  \\
Shareholders' Interest: &  \\
Stated Capital, &  \\
Issued and Outstanding $500,000 &  \\
Stated Capital, &  \\
Issued 500,000 1,000,000 &  \\
Surplus: &  \\
Paid-In 1,000,000 &  \\
Earned 1,000,000 &  \\
Restriction for cost of own shares acquired 400,000 &  \\
Available for Dividends 600,000 1,600,000 $2,600,000 &  \\
\hline
$3,600,000 &  \\
$3,600,000 & \\
\end{tabular}
\end{center}

\textsuperscript{57} Earned surplus would probably be charged for such losses on the theory that the losses are substantially in the nature of special dividends to the selling shareholders. If profits on resale were not considered as paid-in surplus, earned surplus could probably be credited for such profits. If a separate account were to be used, but a former loss had been charged to earned surplus, probably a credit to that extent would be made to earned surplus with respect to a later profit. An alternative way, if permissible, would be to reverse the previous entry as to a loss, and record all of the gains and losses in the separate account.

\textsuperscript{58} If cost had been more than par, as, for example, $600,000, then the second entry only would be changed to that amount.
Upon a formal cancellation of the shares,\textsuperscript{59} the entries would be as follows:

<table>
<thead>
<tr>
<th>Stated Capital—Issued</th>
<th>$500,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Restriction for Cost of Own Shares Acquired</td>
<td>$400,000\textsuperscript{60}</td>
</tr>
<tr>
<td>Paid-In Surplus</td>
<td>100,000</td>
</tr>
</tbody>
</table>

Following is the balance sheet:

<table>
<thead>
<tr>
<th>ASSETS</th>
<th>3,600,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liabilities</td>
<td>1,000,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shareholder's Interest:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stated Capital, Issued and Outstanding</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Surplus:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paid-In</td>
</tr>
<tr>
<td>Earned— Available for Dividends</td>
</tr>
</tbody>
</table>

\textsuperscript{59} See §§ 52 (f) and 60.

\textsuperscript{60} This assumes that earned surplus is not frozen for the cost. See The Illinois Business Corporation Act Annotated, (Foundation Press, Chicago, (1934) 40-41; also Dodd & Baker, Cases on Business Associations (1940) I, 759 n. 41. Wilber G. Katz, "Illinois Business Corporation Act," 12 Wis. L. Rev. 473 at 478 (1937), says that the surplus becomes free upon formal cancellation; if the cost was more than the stated capital, such excess is not free, but if it is less than stated capital, that difference becomes paid-in surplus. "This seems clearly the result under the Illinois statute; the 'freezing' of surplus lasts only so long as the treasury shares are held." Wilber G. Katz, "Accounting Problems in Corporate Distributions," 89 U. of Pa. L. Rev. 764, 787 (1941).

The undesirable feature to such a result is that assets have been depleted for the cost price and have not been replenished by a cancellation of the shares. If such a formal cancellation of stated capital successfully removes the restriction on earned surplus, then it would be theoretically possible to make a cycle of successive purchases and reductions in stated capital, with no net effect on earned surplus, so that the latter would still appear available for dividends.

On the other hand, if the restriction were not removed upon a formal cancellation, then there would be some type of a reduction surplus resulting. That amount would then probably be available for future purchases. The net result then would be that earned surplus would be restricted only to the extent of the original purchase unless later purchases exceeded that amount, and the restriction would only extend to that excess.

No example has been given with reference to surplus arising from surrender to the corporation of its own shares.

Ordinarily an accountant would probably record a donation of treasury shares by a debit to Treasury Stock and a credit to Donated Surplus. But it has been suggested that such surrender surplus would not come into existence under the Act until the shares were sold by company. The Illinois Business Act Annotated, (Foundation Press, Chicago, 1934) 40. The entries under
ULTRA VIRES AND ITS RELATION TO DIRECTOR'S LIABILITY

The previous discussion has dealt with a corporation's power to purchase its shares under Section 6. The next question that will be considered is the effect of violating Section 6 with reference to the corporation, seller, creditors, shareholders, and directors. Of necessity, this involves the doctrine of ultra vires, which has been considerably modified by Section 8.61

A transfer or conveyance of property cannot be upset by resort to ultra vires as long as the test is met as to authority or apparent authority in the officers or directors purporting to act for the corporation.62

Provision has been made in the event of a suit on a contract to which a corporation is a party—where the suit is between the corporation and a third person or between a shareholder and a third person, it is no defense that the business, purposes, or powers have not been kept within the limits imposed impliedly by law, or expressly or impliedly by the articles of incorporation.63 There are three provisions for testing the corporation's powers. The first, (a), allows a shareholder to obtain an injunction against the corporation in order to prevent its entering or continuing in unauthorized business. The court is given discretion to enjoin the performance of the contract if all the parties to the con-

<table>
<thead>
<tr>
<th>Stated Capital—Issued and Outstanding</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stated Capital—Issued</td>
<td>100,000</td>
</tr>
<tr>
<td>(For surrender to the corporation)</td>
<td></td>
</tr>
<tr>
<td>If the company resells the shares at par for cash, two entries would then be necessary, assuming the surplus does not arise until then:</td>
<td></td>
</tr>
<tr>
<td>Stated Capital—Issued</td>
<td>100,000</td>
</tr>
<tr>
<td>Stated Capital—Issued and Outstanding</td>
<td>100,000</td>
</tr>
<tr>
<td>Cash</td>
<td>100,000</td>
</tr>
<tr>
<td>Surplus Arising from Surrender to the Corporation of its Shares</td>
<td>100,000</td>
</tr>
</tbody>
</table>

61 For a thorough discussion of the history of ultra vires in Illinois, see The Illinois Business Corporation Act Annotated (Foundation Press, Chicago, 1934) 49-60. The various theories that have been used are there pointed out and analyzed. Some partially executed contracts were upset by holding them "void"; others were upheld by the application of "estoppel" or "abuse of power" theory. For a criticism of the doctrine of ultra vires in general and of the Illinois view in particular, see Charles G. Little, "The Illinois Business Corporation Law," 28 Ill. L. Rev. 997, 1003 (1934).


63 § 8, second paragraph.
tract are parties to the proceeding and if such relief would be equitable. The injured party, which may be the corporation or the other party, is to receive compensation for the loss or damage sustained from such action by the court—anticipated profits are not to be awarded. Both before and after the Act was passed, there have been dicta that the injunctive remedy was available to a shareholder to prevent directors or officials from entering into an ultra vires transaction. The second, (b), deals with a suit by a corporation (or its legal representative or its shareholders in a representative suit) against its officers or directors for exceeding their authority. The third, (c), deals with a suit by the state to dissolve a corporation under the Act or to enjoin its doing unauthorized business.

64 Henry Winthrop Ballentine, "A Critical Survey of the Illinois Business Corporation Act," 1 U. of Chi. L. Rev. 357, 382 (1934), criticizes § 8 (a) for allowing the defense to be set up by the corporation indirectly through a shareholder. But the drafters desired a more flexible rule than merely having the defense abolished, so they left the matter to be applied by the court in its equitable domain. For an answer to Ballentine's criticism, see Charles G. Little, "The Illinois Business Corporation Act," (1934) 28 Ill. L. Rev. 997, 1003-1004 n. 6.

The writer of the note in 29 Ill. L. Rev. 1075 suggests that the court should make the equitable requirements strict before granting an injunction, in order to prevent the corporation from speculating at the third party's expense. Also that if the shareholder can show no injury in fact, then an injunction should be denied; if the third party had knowledge or actual notice that the contract was ultra vires, then probably relief should be given (constructive notice should not be enough); if no hardship would result when the contract was wholly executory, then an injunction should be available. He concludes that the old distinction between "void" and "abuse of power" should not be revived.

65 Smith v. Bangs, 15 Ill. 399 (1854); Avery v. City of Chicago, 345 Ill. 640, 178 N.E. 351 (1931). Schipper v. Block & Kuhl Co., 283 Ill. App. 486 (1936). The court said at p. 494: "Section eight . . . does not give the complainants a right to sue in equity which they did not have at common law. The section reserves to the complainants in a suit of this kind the prior existing right to urge the alleged ultra vires acts. . . ." The corporation had procured a 99 year lease on July 1, 1920 and had agreed to erect a building by July 1, 1934. It sought to get the lease judicially cancelled by having its shareholders obtain an injunction in 1933 under Section 8. The chancellor dismissed the bill for want of equity and this was affirmed. The lease was said to be intra vires. The court then pointed that there was no need to enjoin the corporation from performing, as it had already refused to perform, which necessitated a suit by the landlord for rent. The shareholders were told that they could have obtained an injunction when and if the corporation had exceeded its powers, but instead they had waited until the lease became unprofitable.

66 In People v. United Medical Service, Inc., 362 Ill. 442, 200 N.E. 157, 103 A. L. R. 1229 (1936), the court held that § 8 did not impliedly overrule § 1 of the Quo Warranto Act, Ill. State Bar. Stat. 1935, p. 2518. The state successfully brought a proceeding in quo warranto against a corporation unlawfully usurping the franchise of engaging in the practice of medicine. On the agreed statement of facts, one of the objects stated in its certificate of incorporation was the pre-
The importance of complying with the statutory provisions becomes more apparent when one considers the sanctions imposed on directors for failure to comply. Section 42 imposes civil liability for wrongful payment of dividends or for wrongful distribution of assets. The time test of wrongfulness is when the payment or distribution was actually made and not when declared or authorized. Liability is joint and several, to the corporation, and is based on the amount paid or distributed if the corporation was insolvent or had net assets below stated capital at the time; if the payment or distribution rendered the corporation insolvent or reduced its net assets below its stated capital, then the directors may be liable to that extent. Directors who vote for or assent to a loan by the corporation to an officer or director are made jointly and severally liable to the corporation until the loan is repaid.

Defenses to such civil liability are provided: reliance in good faith upon the book value of the assets; or

vention and the treatment of disease for profit. It maintained licensed physicians in its clinic, although the corporation itself had no license to practice medicine. § 8 (c) was said to be controlled and limited by the preceding qualifying language, so that if referred to a case at law or equity between the corporation and a third person or between a shareholder and a third person, involving a contract to which the corporation was a party. The remedy of an injunction under § 8 (c) was thus held not applicable. §§ 82-85 were also held inapplicable as they covered dissolution by the Attorney General or receivership proceedings; here an ouster as to practicing medicine was sought. Furthermore, the act complained of was held ultra vires as determined by the general statute despite any statement in the corporation's certificate as to its objects. The Medical Practice Act which provided for criminal sentence or a fine was held not to be an appropriate remedy against a corporation as it could not be imprisoned. The court said at p. 450: "It is equally well established that the repeal of laws by implication is not favored, and it is only where there is a clear repugnance between two laws and the provisions of both cannot be carried into effect that the later law will prevail and the earlier one be considered repealed by implication." See The Illinois Business Corporation Act Annotated (Foundation Press, Chicago, 1934), p. 62 for a correct prediction that quo warranto is not affected by § 8 (c), but that the latter makes an alternative remedy available.

68 §§ 42 (a) and 42 (b).
69 §§ 42 (a) and 42 (b). An improper purchase of a corporation's own shares would probably come within this provision since there is no other provision that covers such a violation of § 6. § 42 (h) provides that a director who is liable under § 42 is entitled to contribution from the other directors who are also liable and from the shareholders in proportion to the amount they received with knowledge that it was improper payment or distribution. Since contribution is probably intended to mean reimbursement the corporation or creditors should be able to reach such shareholders. The Illinois Business Corporation Act (Foundation Press, Chicago, 1934), p. 170.
70 § 42 (d).
71 §42 (h).
(2) reliance in good faith upon a balance sheet and profit and loss statement certified as being correct by an independent public or certified public accountant or represented as being correct by the corporation president or officers having charge of the books.\footnote{If a director is president or secretary, he would be able to rely only on book values or on a certification by an independent public accountant. See Charles G. Little, "The Illinois Business Corporation Law," 28 Ill. L. Rev. 997, 1016 (1934).}

Criminal liability is also imposed by Section 42 on directors who vote for or assent to a declaration of a dividend or a distribution of assets which is prohibited by the Act or who vote for or assent to a loan by the corporation to an officer or director.\footnote{\S 42 (h). Provision is made as to when there will be a conclusive presumption of assent.}

The interesting feature about Section 42 is that the defenses provided refer to civil liability and not to criminal liability.\footnote{The defenses are made with reference to \S\S 42 (a) and 42 (b).} An explanation for this is the manner in which the Act was drafted. Originally, there were no criminal provisions. The House of Representatives added the paragraph for criminal penalties as an amendment,\footnote{The Illinois Business Corporation Act Annotated (Foundation Press, Chicago, 1934), 168.} but the paragraph for defenses was not altered. No one now can be sure if that was an oversight or intentional.\footnote{See the scathing criticism by Charles G. Little, "The Illinois Business Corporation Law," 28 Ill. L. Rev. 997, 1016-1017 (1934). He thinks that the amendment reflects little credit on the legislature's intelligence. He says that at the time, people were emotional, due to stories in the press about Insull and others who had similar ventures. But since civil penalties are usually drastic enough for ordinary directors, and penal laws won't deter men like Insull, Krueger, Wiggin, and Mitchell, he concludes that it is harsh to impose the risk on directors of ambitious prosecutors and dumb juries declaring such acts to be crimes in the light of after events. See also Henry Winthrop Ballentine, "A Critical Survey of the Illinois Business Corporation Act," 1 U. of Chi. L. Rev. 357, 371-372 (1934).}

As Section 42 now stands, civil liability and criminal liability are based on somewhat different things. A dividend may violate Section 41 and a distribution of assets may violate Section 6 without any civil liability resulting. If the corporation is still solvent and has net assets in excess of stated capital after the prohibited payment or distribution, there would be no basis for civil liability. Similarly, if a loan to an officer or director is repaid by the borrower, there would
be no civil liability. But nevertheless, if directors vote for or assent to a distribution or payment prohibited by the Act, there is a basis for criminal liability, just as where a loan is made to an officer or director, since there is no defense provided for repayment by the debtor.

Even if the courts find no basis for implying the same defenses for criminal liability as are available for civil liability because of the different bases for such liability, there is precedent for protecting directors through a favorable construction of "assent." Thus where an Illinois statute

77 § 42 (d).

78 Previous cases have implied defenses to civil liability imposed by similar phraseology. In Lewis v. Montgomery, 48 Ill. App. 282 (1892), Section 16 of the statute then in force provided: "If the indebtedness of any stock corporation shall exceed the amount of its capital stock, the directors and officers of such corporation assenting thereto, shall be personally and individually liable for such excess to the creditors of the corporation." The appellate court held that assent was predicated on knowledge, and negligence was not enough. This was affirmed in 145 Ill. 30, 33 N.E. 880 (1893). The Illinois Supreme Court said that negligence in not preventing such indebtedness was not assent, and that assenting to such excess meant assenting to the creation of such indebtedness. Thus, a later recognition of the indebtedness, created without their knowledge, would not be an assent to its creation. Instead it would be a fulfillment of their duty to recognize its validity and provide for payment to the extent of their power to do so.

In Woolverton v. Taylor, 132 Ill. 197, 23 N.E. 1007, 22 Am. St. Rep. 521 (1890), the court had previously held that Section 16 was not penal in effect. Therefore, the 5 year statute of limitations was applied instead of the 2 year statute which was applicable to statutory penalties. The question of assent did not have to be decided. The court held that the cause of action accrued when the debt was due and not when incurred, so that the suit could be brought within 5 years of the maturity date. The other view was rejected as being too harsh on the directors and creditors, as the former would be liable long before the debts were due, while the latter would have no reason to know at once that the debts exceeded the capital stock since the corporation might be solvent for some time.

In Loverin v. McLaughlin, 161 Ill. 417, 44 N.E. 99 (1896), § 18 of the statute then in force provided: "If any person or persons being, or pretending to be, an officer or agent or board of directors of any stock corporation or pretended stock corporation, shall assume to exercise corporate powers, or use the name of any such corporation, or pretended corporation, without complying with the provisions of this act, before all stock named in the articles of incorporation shall be subscribed in good faith, then they shall be jointly and severally liable for all debts and liabilities made by them, and contracted in the name of such corporation or pretended corporation." The court held that there was a basis for liability for failure to file a certificate even though all the stock had been subscribed to in good faith. By interpolation, "or" was impliedly inserted between "act" and "before." The court said that the effect of the statute was penal. Nevertheless, by implying "or" the court apparently did not construe the statute strictly (note that § 16 imposed liability for the excess of debt over capital stock, while § 18 imposed liability for all the debts). In M. H. Vestal Co. v. Robertson, 277 Ill. 425, 115 N.E. 629 (1917), the court held that since § 18 was penal, liability under it was barred by the 2 year statute of limitations which applied to a suit to recover a statutory penalty.

See Arthur A. Marer & Co. v. Estate of Wolford, 350 Ill. 240, 194 N.E. 517 (1935), where the court reversed the Appellate court on a jurisdictional point
provided that the directors who assented to the debts exceeding the capital stock would be liable for such excess, that was construed by a federal court to impose no liability on directors who were not negligent. Assent has been held to be based on knowledge and not mere negligence where the liability was for such excess, and also where the liability would extend to all the debts of the corporation.

Sections 6, 8, and 42 may all become important when a corporation contracts to purchase some of its own shares which would violate Section 6 if performed. If the corporation paid the seller, the directors would be under risk of either civil or criminal liability or both under Section 42.

If the corporation refused to perform, and the seller sued on the contract, what effect would Section 8 have upon a plea of ultra vires? A careful reading of the second paragraph of Section 8 which precedes (a), (b), and (c), will reveal that an express limitation on a corporation's powers is not covered. Since Section 6 is an express limitation, based on the pleadings, and so did not pass on the lower court's holding that a statutory liability in the nature of a penalty ceased at the debtor's death and that his estate would not be liable.

References:
79 Chick v. Fuller, 114 F. 22 (1902).
81 White-Wilson-Drew Co. v. Lyon-Ratcliff Co., 268 F. 525 (1920). The directors were sued under § 19 of the 1917 Illinois statute (Ill. Rev. Stat. 1917, Ch. 32, § 19) which provided: "If the directors or other officers or agents of any stock corporation shall declare and pay any dividend when such corporation is insolvent, or any dividend the payment of which would render it insolvent, or which would diminish the amount of its capital stock, all directors, officers or agents assenting thereto shall be jointly and severally liable for all the debts of such corporation then existing, and for all that shall thereafter be contracted, while they shall respectively continue in office." The lower court held that knowledge by the directors was a condition precedent to recovery against them for such assenting. This was affirmed on appeal. After referring to §§ 16 and 18 which had been construed by the Illinois courts (see note 78, supra), the upper court construed "assenting thereto" to mean the conscious approval of facts already known. See also: notes, 32 Col. L. Rev. 905, 35 Yale L. J. 879. Presumably, the court would hold that by using "assent," the legislature was adopting the previous judicial interpretations of it. Probably the court would treat "voting" and "assenting" alike.
82 Even if there were such a violation, a transfer of the shares to the corporation would presumably be valid under the first paragraph of § 8, as its own shares would probably come within the meaning of "property, real or personal of any kind or description." See note 62, supra, as to the agency question.
83 The seller would be subject to the contribution clause of § 42(h) unless he did not know that § 6 had been violated. He would probably fail in an attempt to convince the court that he was a third party and not a shareholder within that clause. See note 84, infra.
84 See note 67, supra, for an indication that the second paragraph controls (a), (b), and (c). If the seller were considered a shareholder and not a third person
and not implied, Section 8 will probably be construed not to preclude a plea of ultra vires as to an improper purchase of a corporation’s own shares. An express prohibition by statute or illegality has been used as a basis for sustaining the plea of ultra vires in analogous situations. 85

It would be possible for the test of Section 6 to be met at the time when the contract was made but not at the time for performance. 86 The contract might provide for a sufficient reserve to be set up out of available surplus. If operating losses could be charged to paid-in surplus when there is an earned surplus, 87 then surely such losses could be charged to paid-in surplus before this reserve would have

for the purposes of the suit, the second paragraph of § 8 would not be applicable. If he were considered to be a shareholder within the contribution clause of § 42(h), it would apparently be inconsistent to hold that he was a third party within § 8. If the court held he was a third party within § 42(h), the result obtained by the trust fund theory could still be reached to protect creditors.

85 In Pattison v. Illinois Bankers Life Ass’n, 360 Ill. 616, 196 N.E. 882 (1935), the court refused to apply “estoppel” to an ultra vires contract made by an insurance company. The applicable 1933 statute expressly prohibited an insurance company that wrote life and accident policies from writing disability insurance. “Estoppel” was said not to apply when the contract was immoral, illegal, prohibited by statute, or against public policy. The contract in question was expressly prohibited by statute. See The Illinois Business Corporation Act Annotated (Foundation Press, Chicago, 1934), p. 60, for a suggestion that expressly prohibited transactions are illegal and so the defense of illegality could be set up. The appellate court of the first district has remarked several times in recent years that the doctrine of ultra vires has tended to be restricted and looked upon with disfavor where the contract was not expressly prohibited by statute and where the defendant has received the benefit of the plaintiff’s performance. Royal Drug Co., Inc. v. Levin, 273 Ill. App. 231 (1934), and Warner v. Munson, 280 Ill. App. 484 (1935) (in each case the contract was held intra vires). See also Van Deventer v. North American Union Life Ins. Society, 284 Ill. App. 1, 1 N.E. (2d) 861 (1936), which involved a fraternal benefit society which was not within the Act. The appellate court applied the “estoppel” cases and did not use the “void” approach, emphasizing the hardship that would otherwise result to the plaintiff who had fully performed (the contract was not expressly prohibited by statute). For a recent case, see Highway Mut. Casualty Co. v. Stern, 306 Ill. App. 506, 29 N.E. (2d) 281 (1940). See note, 13 CHICAGO-KENT LAW REVIEW 377. In Holsman v. Campbell Realty Co., 371 Ill. 614, 21 N.E. (2d) 744 (1939), a question arose as to whether § 8 did or could apply to contracts made before the Act. On the appeal from the trial court to the Illinois Supreme Court on this constitutional question the latter held that it had no jurisdiction to pass on the question because the record did not affirmatively disclose that the question had been presented and actually passed upon by the trial court.

86 See E. Merrick Dodd, Jr., “Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law,” 89 U. of Pa. L. Rev. 697, 702 (1941) for the view that if a jurisdiction requires a corporation to be solvent to purchase its own shares, then that test should be applied as of the date of performance, i.e. it should not suffice that the corporation was solvent at the time the executory contract was made.

87 See note 28, supra.
to be used. If there is a provision for liquidated damages and the payment of that amount would not render the corporation insolvent or reduce its net assets below stated capital, would that involve an indirect purchase under Section 6 and fall within the criminal penalties of Section 42(h)? Would there be "assent" to such a distribution of assets when payment is made on a judgment recovered at law based on the liquidated damages provision? A preliminary question would be if such a provision would be enforceable in case a direct purchase under the contract would be ultra vires and unenforceable. If the whole contract were vitiated, then there would be no basis for the seller to recover on the contract's provisions. If the liquidated damages clause were separable, then the question would arise as to the application of Sections 6 and 42(h).

CONCLUSION

Accountants, as well as lawyers, will probably play their part in future legal developments under the Act, while the Securities and Exchange Commission will undoubtedly influence both accounting and legal progress. Even a quick reading of the Act will reveal that interesting questions may arise revolving about the familiar question of the extent of a corporation's power to purchase its own shares. The adoption of a strong public policy construction by the Illinois courts will prevent any circumvention of the apparent objectives of the Act. It would be easy for the courts to rationalize that a seller at all times bears the risk of a corporation's having the requisite power set forth in Section 6.

88 The reserve would probably be a portion of earned surplus.
89 See note 78, supra.
90 See Williston, Contracts (Rev. Ed.), III, 2194, § 781.
91 The amount of liquidated damages, if collected, might render the corporation insolvent or reduce its net assets below stated capital. Could the seller get a judgment only to the extent that these results would not occur? What effect would the contribution clause of § 42(h) have as to the amount of recovery the seller would get?