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Pasco M. Bowman II
University of Georgia School of Law

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CORPORATE FINANCE UNDER THE GEORGIA BUSINESS CORPORATION CODE OF 1968

*Pasco M. Bowman II**

INTRODUCTION

THIS Article will review the financial provisions of the new Georgia Business Corporation Code (*B.C.C.*), which will become effective April 1, 1969.[1] On that date, the Code will automatically apply to virtually all existing domestic business corporations, other than banks, trust companies, railroads and the several other types of corporations which obtain their charters from the Secretary of State.[2] Existing domestic insurance companies will be subject to the *B.C.C.* to the same

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* Associate Professor of Law, University of Georgia School of Law. B.A., Bridgewater College, 1955; J.D., New York University School of Law, 1958. Member of the Georgia and New York Bars.

1 For a brief discussion of the *B.C.C.'s* background and legislative history, see Bowman, *An Introduction to the New Georgia Corporation Law*, 4 GA. ST. B.J. 419, 419-22 (1968). The need for revision of the existing Georgia corporation law is well documented. See Cohn & Leavell, *Georgia's Corporation Law: Is It Adequate?*, 2 GA. ST. B.J. 153 (1965); Hodgson, *Proposed for Georgia—A Business Corporation Act*, 4 GA. ST. B.J. 193 (1967); O'Neal, *Georgia's Urgent Need for a Modern Corporate Statute*, 3 GA. ST. B.J. 265 (1967). The article by Hodgson also contains a valuable summary of the *B.C.C.'s* pre-legislative history up to November 1967. Hodgson, *supra* at 194-96.

2 Concerning the application of the new act, see B.C.C. § 22-103. Under both the existing Georgia law and the *B.C.C.*, private corporations other than the so-called "Secretary of State" corporations obtain their corporate powers by petition and court order, rather than by application to the Secretary of State or a comparable administrative official. This unorthodox procedure is ordained by GA. CONST. art. III, § VII, para. xvii (GA. CODE ANN. § 2-1917 (1945)). The same constitutional provision permits charters to banking, trust, insurance, railroad, canal, navigation, express and telegraph companies to be granted *only* by the Secretary of State. Thus the incorporation procedures for the Secretary of State corporations have been, and until the constitution is amended in this respect will continue to be, separate and distinct from the incorporation procedures for ordinary business and nonprofit corporations. At present the various Secretary of State corporations are not only organized under, but also are in varying degrees regulated by, special statutes applicable only to corporations of a particular class. *See* GA. CODE ANN. §§ 13-101 to -9901 (1967) (banks); GA. CODE ANN. §§ 17-101 to -201 (1960) (canal and navigation companies); GA. CODE ANN. §§ 25-101 to -9903 (1956) (credit unions); GA. CODE ANN. §§ 41-101 to -201 (1957) (express companies); GA. CODE ANN. §§ 56-101 to -9901 (1960) (insurance companies); GA. CODE ANN. §§ 94-101 to -9901 (1958) (railroads); GA. CODE ANN. §§ 104-101 to -301 (1968) (telegraph companies); GA. CODE ANN. §§ 109-101 to -9901 (1959) (trust companies). In addition, railroad, express and telegraph companies are subject to regulation by the Public Service Commission. *See* GA. CODE ANN. §§ 93-101 to -9901 (1958). The *B.C.C.* does not in any way alter the legal position of the Secretary of State corporations. The way is open, however, for any class of Secretary of State corporations to seek new legislation making the *B.C.C.* applicable to such class to whatever extent is felt desirable. *See* B.C.C. §§ 22-103(a)(1), (b)(3).

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extent as they are now subject to the present general corporation law.[3]

The *B.C.C.* is only one part of a comprehensive revision and restatement of Georgia's corporation law. The omnibus bill passed by the General Assembly at its 1968 session repeals the present Title 22 (Corporations) *in toto*, and replaces it with a new Title 22 consisting of four major parts:

I. The *B.C.C.*
II. The Nonprofit Corporation Code
III. Provisions Relating to Corporations Chartered by the Secretary of State
IV. Miscellaneous Provisions of Corporation Law

The new Title 22 represents the first major revision of Georgia's corporation law in over thirty years. Parts I and II are entirely new. Parts III and IV, on the other hand, are merely re-enactments, without substantial change, of certain provisions of the present Title 22 which the General Assembly felt it would be desirable to retain. Part III applies only to "Secretary of State" corporations, and its provisions are cumulative of any other laws to which banks, railroads and other such corporations may be subject. Part IV contains general provisions applicable to all domestic corporations—business corporations, nonprofit corporations, and "Secretary of State" corporations alike.[4]

As indicated above, the *B.C.C.* is much more than just a simplification and recodification of the old law. Although the *B.C.C.* retains much of what is good in the present law, it is a far more comprehensive statute, covering many problems not heretofore resolved in Georgia by either court decision or statute. No single area of old Title 22 had greater need of a thorough overhaul than its provisions on corporate finance.

The entire *B.C.C.* reflects the pervasive influence of the Model Business Corporation Act.[5] But as in other areas of the *B.C.C.*, the new Code's provisions on corporate finance also reflect non-Model Act ap-

[3] *See B.C.C.* § 22-103(b)(3); GA. CODE ANN. §§ 56-1503, -1508 (1960).

[4] For example, Part IV re-enacts (as new § 22-5301) the present GA. CODE ANN. § 22-1102 (1966), which deals with venue and service of process in contract and tort cases against corporate defendants.

[5] This Act was prepared by the Committee on Business Corporations (Section of Corporation, Banking and Business Law) of the American Bar Association. First published substantially in its present form in 1950, the Model Act has been used as a basis for legislation in over twenty states, including Texas (1955), North Carolina (1955), Virginia (1956), Alabama (1959), South Carolina (1962) and Tennessee (1967). It has also had some influence in recent corporate law revisions in New York (1961) and Delaware (1968).

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proaches collected by sifting the laws of a number of states.[6] Its debt to the cohesive, well-conceived financial provisions of the New York Business Corporation Law is substantial.[7]

The financial provisions of the *B.C.C.* are found primarily in Chapter 22-5, entitled "Corporate Finance." Key financial and accounting terms are defined in section 22-102. Shareholders preemptive rights and the liability of subscribers and shareholders to pay full consideration for shares are covered in Chapter 22-6. Liabilities of directors and officers are set forth in Chapter 22-7, along with provisions relating to contracts of interested directors and officers and to the indemnification of corporate personnel. Amendments, mergers, and transfers of assets (including the creation of liens and security interests) are covered in Chapters 22-9, 22-10 and 22-11, respectively. The appraisal remedy of dissenting shareholders is set forth in Chapter 22-12. Dissolution, both voluntary and involuntary, is treated in Chapter 22-13. This article will focus mainly on Chapter 22-5.

I. Corporate Securities

A. *Classes and Series of Shares*

It may be well to note at the outset that the *B.C.C.* speaks in terms of "shares" and "shareholders" rather than "stock" and "stockholders."[8] With a number of clarifications and several important substantive changes, the *B.C.C.* continues the existing broad authorization[9] for the creation of various kinds of shares. Basically, the *B.C.C.* permits a corporation to create shares of one or more classes, with or without par value, and to fix their designations, preferences, limitations, and relative rights, all as stated in the articles of incorporation as originally filed or as subsequently amended.[10] Although nonvoting shares (including a class or classes of nonvoting common shares) may be created, no class of shares may be deprived of its statutory right to vote as a class in connec-

6 As the *B.C.C.* was being prepared, the existing Georgia law and the Model Act were compared, point-by-point, with the laws of California, Connecticut, Delaware, New York, North Carolina, Ohio, South Carolina and Virginia. On many points, the laws of other states also were consulted.

7 For an excellent analysis of the New York statute, see deCapriles & McAniff, *The Financial Provisions of the New (1961) New York Business Corporation Law*, 36 N.Y.U.L. Rev. 1239 (1961).

8 Note also that the existing law's familiar term "charter", in keeping with the Model Act and current fashions in state corporation laws, is discarded in favor of the term "articles of incorporation."

9 Ga. Code Ann. § 22-1828(i) (1966).

10 B.C.C. § 22-501(a).

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tion with certain amendments of the articles of incorporation.[11] Also permitted is the creation of classes of shares with special voting rights, such as the right to elect officers or to vote on other matters not usually subject to shareholder action.[12] This statutory authority to create both nonvoting shares and shares with special voting rights will undoubtedly be helpful in business and estate planning for the close corporation.

To protect investors, the *B.C.C.* requires honest labeling of shares, stipulating two specific requirements. First, shares that are not preferred as to dividends or other distributions are not to be designated as preferred shares. Second, where there is more than one class of shares, each class is to be designated so as to distinguish it from all other classes.[13] Thus, such designations as "Class A Common," "Class B Common," "Five Percent Convertible Preferred" and the like are mandatory under this provision. If shares of the same class are issued in series, each series must be so designated as to distinguish it from all other series and classes.[14]

Preferred or special classes of shares may be divided into and issued in series if the articles of incorporation so provide,[15] the *B.C.C.* here relying largely on the Model Act.[16] As between series of the same class, there may be variations as to dividend rates, redemption privileges, liquidation preferences, sinking fund provisions and conversion privileges; otherwise, all shares of the same class must have identical rights and preferences.[17]

The statute provides several alternative methods for fixing the permissible variations in the relative rights and preferences as between series. This may be done in the original articles of incorporation or an amendment thereto.[18] On the other hand, the articles of incorporation may provide for discretionary authority in the board of directors to establish series and to fix and determine the variations in their relative

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11 *See* B.C.C. § 22-903. Other fundamental corporate changes (except dissolution) may, but do not necessarily, entitle a nonvoting class of shares to a class vote; the test is whether the proposed resolution "contains any provision which, if contained in a proposed amendment to the articles of incorporation, would entitle such class of shares to vote as a class." B.C.C. § 22-1003(c) (mergers and consolidations); § 22-1102(c) (sale of all or substantially all the corporate assets).

12 B.C.C. § 22-501(a).

13 B.C.C. § 22-501(c).

14 B.C.C. § 22-502(a).

15 *Id.*

16 MODEL ACT § 15.

17 B.C.C. § 22-502(a).

18 *Id.*

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rights and preferences.[19] This is the so-called "blank share" provision. Its purpose is to enable the board of directors to gauge current market conditions before establishing the terms of a new issue, and thus to facilitate the raising of additional capital. Finally, if "blank shares" are established by the articles of incorporation but the articles do not expressly authorize the directors to "fill in the blanks," the statute empowers the shareholders to determine the relative rights and preferences by a resolution adopted at a shareholders' meeting by the affirmative vote of a majority of the shares of each class outstanding, whether or not such shares are otherwise entitled to vote.[20] Existing shareholders are protected not only by the class voting requirement, but also by an additional provision that voids any attempt by the directors or shareholders to use the "blank share" mechanism to create a series of "prior preferred."[21] If the interests of preferred shares are to be diluted by the issuance of a senior preferred not already authorized by the articles of incorporation, resort must be made to the formal amendment procedure, with all of its safeguards—including, under the *B.C.C.*, the appraisal remedy for dissenting holders of the affected classes of shares.[22] Moreover, once "blank shares" have been "filled in" and issued, their relative rights and preferences may not be changed except through formal amendment of the articles of incorporation.[23]

Before any "blank shares" may be issued, the resolution of the board of directors or the shareholders, as the case may be, fixing the relative rights and preferences of such shares, must be set forth in a statement filed with the Secretary of State.[24] Upon such filing, the resolution of the directors or shareholders is treated as an amendment of the articles of incorporation,[25] thus establishing an apparent exception to the rule that all amendments must be approved by the shareholders and granted by a superior court judge.[26]

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19 B.C.C. § 22-502(b)(1).

20 B.C.C. § 22-502(b)(2).

21 B.C.C. § 22-502(b)(3).

22 The appraisal remedy is treated in considerable detail in B.C.C. §§ 22-1201 to -1202.

23 B.C.C. § 22-502(e).

24 B.C.C. § 22-502(c).

25 B.C.C. § 22-502(d).

26 *See* B.C.C. §§ 22-902(b), -905(b). In reality, this so-called "amendment" is not an amendment at all, but merely a fleshing out of the articles of incorporation in accordance with an intention already spelled out in the articles. Indeed, it would be preferable if the statute did not refer to the "blank share" procedure as involving an amendment of the articles, for to do so suggests the necessity of a shareholder vote and a court order.

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The *B.C.C.* contains a set of very helpful rules of construction for preferred shares.[27] In effect, these rules establish presumptions which apply only in the absence of a contrary provision in the articles of incorporation or in a resolution adopted by the directors or shareholders pursuant to the "blank share" authority discussed above. For example, it is provided that in the absence of a contrary stipulation, shares which are preferred as to dividends shall be deemed cumulative preferred shares,[28] and that shares which have either dividend or liquidation preferences are nonvoting shares.[29] These rules of construction will resolve many of the troublesome questions that can arise when preferred share contracts are drafted with less than perfect attention to important details.

B. *Convertible Shares*

Like the existing law,[30] the *B.C.C.* authorizes the issuance of convertible shares.[31] Three significant changes are made by the new Act: (1) Departing from both the existing law and the Model Act,[32] it permits the so-called "upstream conversion," *i.e.*, the conversion of shares of one class into shares of another class having prior or superior rights or preferences. For example, a corporation may issue a class of common shares not entitled to participate in dividends but convertible into dividend-participating shares, or it may issue a class of common shares which are convertible into preferred. Any such conversion right exists, however, only to the extent provided in the articles of incorporation.[33] (2) The *B.C.C.* places the option to convert solely in the shareholder.[34] The reason for this restriction is that a "conversion" at the option of the corporation is in effect a redemption, and to refer to such shares as "convertible" is to engender confusion and perhaps mislead investors. (3) Under the new act, convertible shares are not to be issued unless the board of directors reserves, at the time of issuance, a sufficient number of authorized but unissued shares or treasury shares of the appropriate class or series to be issued only in satisfaction of the conversion privileges of the convertible shares.[35] This provision is in-

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27 B.C.C. § 22-503.
28 B.C.C. § 22-503(a).
29 B.C.C. § 22-503(b).
30 GA. CODE ANN. § 22-1828(i) (1966).
31 B.C.C. § 22-501(b)(5).
32 MODEL ACT § 14.
33 B.C.C. § 22-501(b)(5).
34 *Id.*
35 *Id.*

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tended to ensure that the corporation at a later date will not have to repurchase outstanding shares or amend its articles of incorporation in order to have available enough shares to satisfy the conversion privileges of its convertible shares.

Finally, the *B.C.C.* prohibits the conversion of no-par shares into par value shares unless the stated capital attributable to the no-par shares is at least equal to the aggregate par value of the shares into which the no-par shares are to be converted.[36] It is likely that this provision embodies what under the present law has been the prevailing practice (dictated by accounting requirements) with respect to the capital stock account. In any event, its purpose is to protect the integrity of stated capital, which is the *B.C.C.'s* equivalent of "capital stock" or "legal capital."

C. *Redeemable Shares*

As under the present law,[37] redeemable shares may be created.[38] In a significant change from the present law, the *B.C.C.* specifies that the option to redeem belongs solely to the corporation.[39] This is essentially a matter of honest labeling, since shares which entitle their holder to compel redemption suggest a debt security rather than an equity security. The only exception to this limitation on redeemable shares is in the case of open-end investment companies (mutual funds) regulated by the Securities and Exchange Commission. Such companies may issue shares which are subject to redemption at the option of the shareholder.[40] Note also that only mutual funds may issue redeemable common shares.[41] Other companies may issue redeemable preferred, but not redeemable common. The existing Georgia law is unclear on this point, but probably does not permit redeemable common.[42] Whatever the position may be under the present law, there are a number of

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36 *Id.*

37 GA. CODE ANN. § 22-1828(i) (1966).

38 B.C.C. § 22-501(b)(1).

39 *Id.*

40 B.C.C. § 22-514(a).

41 *Id.*

42 *Compare* GA. CODE ANN. § 22-1828(i) (1966) (corporation may issue "one or more classes of stock, with . . . such . . . redemption provisions as may be stipulated"), *with* GA. CODE ANN. § 22-1829 (1966) (corporation may redeem "any preferred or special class of stock [which under the charter is] subject to redemption"). *See also* Starring v. American Hair & Felt Co., 191 A. 887 (Del. Ch.), *aff'd per curiam*, 2 A.2d 249 (Del. Sup. Ct. 1937) (DEL. CODE ANN. tit. 8, § 243(a) (2 P-H CORP. SERV. (1968)), which permits "any preferred or special shares" to be made redeemable, does not permit redeemable common).

objections to the issuance of redeemable common shares by issuers other than mutual funds,[43] and the *B.C.C.* wisely prohibits it.[44]

The new act permits redeemable shares to be redeemed "at the price and within the period or periods and under any conditions fixed by the articles of incorporation for the redemption thereof."[45] Different series of the same preferred class of shares may vary as to "[w]hether shares can be redeemed and, if so, the redemption price and the terms and conditions of redemption."[46] Redeemable shares may always be redeemed in accordance with their terms (without regard to whether or not any earned surplus exists)[47] except in two cases: (1) When the corporation is insolvent or the redemption would render it insolvent, and (2) when redemption would reduce net assets below the aggregate liquidation preference of shares having a liquidation preference senior or equal to that of the redeemable shares.[48]

D. *Treasury Shares*

The *B.C.C.* defines "treasury shares" as "shares of a corporation which have been issued, have been subsequently acquired by and belong to the corporation, and have not, either by reason of the acquisition or thereafter, been cancelled."[49] Treasury shares may be disposed of for a consideration fixed by the board of directors, unless the articles of incorporation vest in the shareholders the right to fix the consideration.[50] Since treasury shares are already "issued" (although not "outstanding"), they are exempt from the basic requirement that par value shares shall not be "issued" at less than par.[51] A corporation may use treasury shares in connection with option plans,[52] may issue them as a dividend,[53] or may dispose of them in virtually any way that it

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[43] *See* Note, *Callable Common Stock*, 68 HARV. L. REV. 1240 (1955).

[44] This straightforward prohibition marks a departure from the Model Act, which is not clear on the question of whether redeemable common may be issued. The language of MODEL ACT § 14, which authorizes the issuance of redeemable shares "of preferred or special classes," is indistinguishable from that of the present GA. CODE ANN. § 22-1829 (1966) and DEL. CODE ANN. tit. 8, § 243(a) (2 P-H CORP. SERV. (1968)). *See* note 42 *supra*.

[45] B.C.C. § 22-501(b)(1).

[46] B.C.C. § 22-502(a)(2).

[47] B.C.C. § 22-513(d)(4).

[48] B.C.C. §§ 22-513(e), -514(b).

[49] B.C.C. § 22-102(i).

[50] B.C.C. § 22-505(c).

[51] B.C.C. § 22-505(a).

[52] B.C.C. § 22-507(a).

[53] This rule is subject to an important qualification: any treasury shares paid out as a dividend must have been acquired by the corporation out of surplus rather than out

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might dispose of other corporate property.[54] However, a corporation may not include treasury shares in computing its assets.[55] Since the shares of a financially embarrassed corporation will generally be a "bloodless turnip" for creditors to bite on, that prohibition is clearly justified.[56]

E. *Share Rights and Options; Preemptive Rights*

Under the present Georgia law, only if the charter so provides may a corporation issue rights or options entitling the holders thereof to purchase from the corporation shares of its stock.[57] The *B.C.C.*, on the other hand, grants authority to each corporation to create and issue such rights or options unless this authority is negated in the articles of incorporation.[58] As is the case under present law, it is not required that the creation and issue of share rights or options be connected with the issue and sale of shares or other securities of the corporation.[59] The consideration for and the terms and conditions of rights or options are to be fixed by the board of directors,[60] but shareholder approval or ratification is required for rights or options issued in favor of directors, officers or employees of the corporation of any of its subsidiaries.[61] Absent bad faith, the judgment of the board of directors as to the adequacy of the consideration[62] received for the issuance of rights or options is conclusive.

Share rights or options are not to be issued unless at the time of issuance the board reserves a sufficient number of authorized but unissued shares or treasury shares to satisfy the exercise of the rights or options.[63] The intent here is to ensure that the corporation will not have to go into the market to obtain the shares necessary to satisfy the demands of holders of rights or options.

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of stated capital. B.C.C. § 22-511(a)(3). As to when a corporation may purchase its own shares out of stated capital, see B.C.C. §§ 22-513(d) & (e).

54 B.C.C. § 22-513(a).

55 B.C.C. § 22-102(k).

56 When a corporation purchases its own shares, the *B.C.C.* requires that the appropriate surplus account be reduced by the cost of the shares. B.C.C. § 22-513(c). It would be anomalous to allow that required reduction of surplus to be offset by treating the acquired shares as an asset.

57 GA. CODE ANN. § 22-1828(i) (1966).

58 B.C.C. § 22-507(a).

59 *Id.*

60 *Id.*

61 B.C.C. § 22-507(c).

62 B.C.C. § 22-507(d).

63 B.C.C. § 22-507(a).

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Shares issued or sold to directors, officers or employees pursuant to validly issued options are not subject to preemptive rights,[64] nor are shares issued to directors, officers or employees pursuant to shareholder-approved stock bonus plans.[65] In general, the preemptive rights of a shareholder to acquire additional shares in proportion to his existing holdings may be expanded, restricted or denied to the extent provided in the articles of incorporation.[66] But like the existing Georgia law,[67] the *B.C.C.* establishes ground rules which define the scope of the preemptive right where the articles of incorporation are silent in that respect.[68]

F. *Subscriptions for Shares*

The *B.C.C.* establishes guidelines relating to share subscriptions.[69] These guidelines are, for the most part, subject to any contrary provisions that the parties may include in the subscription agreement. For example, the new act provides that preincorporation subscription agreements are irrevocable for a period of six months unless stipulated otherwise or unless all the subscribers consent to an earlier revocation.[70] That provision changes the rule of *National Bank v. Amoss*.[71] In *Amoss* the supreme court adopted the view that a preincorporation subscription is "a mere offer to the corporation not yet in existence, and is revocable by any subscriber until the organization of the corporation, which operates as an acceptance of the offer."[72]

To be enforceable, a subscription agreement must be in writing and signed by the subscriber.[73] Present Georgia law is uncertain on this point.[74] It is desirable that such a rule be included in the new law, especially in light of the irrevocability provision mentioned above.

The terms of payment of a share subscription are to be determined by the subscription agreement.[75] Absent a contrary provision in the

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64 B.C.C. § 22-602(d)(8).

65 B.C.C. § 22-602(d)(7).

66 B.C.C. § 22-602(a).

67 GA. CODE ANN. § 22-1831.1 (1966).

68 B.C.C. §§ 22-602(b), (d)-(e).

69 B.C.C. § 22-504.

70 B.C.C. § 22-504(a).

71 144 Ga. 425, 87 S.E. 406 (1915).

72 *Id.* at 433, 87 S.E. at 409.

73 B.C.C. § 22-504(b).

74 *Compare* Rogers v. Burr, 105 Ga. 432, 31 S.E. 438 (1898), *with* Hightower v. Ansley, 126 Ga. 8, 54 S.E. 939 (1906).

75 B.C.C. § 22-504(c).

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agreement, the subscription is payable on call of the board of directors,[76] which call must be uniform as to all shares of the same class or series.[77] In case of default on a subscription agreement, the corporation may proceed as in other cases involving debts due the corporation. The corporation is not limited to recovery of delinquent installments, but is entitled to collect its damages (if any) for breach of contract.[78] Additional sanctions for nonpayment may be written into the subscription agreement, the one limitation being that forefeiture of a subscription, or of the amounts paid thereon, is authorized only if the amount due remains unpaid for a period of twenty days after the corporation has made written demand.[79] When a forfeiture has been declared and shares sold by reason thereof, the delinquent subscriber is entitled to the sale proceeds less the sum of the amount due and unpaid on his subscription plus reasonable selling expenses.[80]

In a provision that is entirely new, the *B.C.C.* establishes that the board of directors may compromise any share subscription when to do so is, in the board's judgment, in the best interests of the corporation.[81] Thus, compromise is available as an alternative to the other remedies provided by the new law (*i.e.*, collection in the same manner as any other debt, suit for damages, penalties, forfeiture of the subscription and amounts paid thereon), but may be utilized only when the board determines that it is in the best interests of the corporation to compromise its claim against the deliquent subscriber rather than to pursue other permissible courses of action. This provision is designed to give the corporation flexibility in dealing with delinquent subscribers, and in particular to allow for the situation in which a subscriber finds himself unable to pay for all the shares for which he has subscribed but is able and willing to purchase part of them. In such a case, half a loaf may be better than none, and it is appropriate that the power of the board to make such a determination be recognized.

G. *Consideration and Payment for Shares*

Par value shares shall not be issued for a consideration less than their par value.[82] Subject to that limitation, which is consistent with the

76 B.C.C. § 22-504(c)(1).
77 B.C.C. § 22-504(c)(2).
78 B.C.C. § 22-504(d).
79 *Id.*
80 *Id.*
81 B.C.C. § 22-504(e).
82 B.C.C. § 22-505(a).

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present Georgia law,[83] par value shares may be issued for such consideration as the board of directors shall fix.[84] No-par shares may be issued for a consideration fixed by the board of directors.[85] In the case of both par value shares and no-par shares, the articles of incorporation may reserve to the shareholders the right to fix the consideration for which the shares are issued.[86] The new act also provides special rules relating to the consideration for issuance of shares as a share dividend[87] and to the consideration for shares issued upon the exchange or conversion of bonds or shares.[88] Imposing a requirement not found in the present law, the *B.C.C.* requires the keeping of a record of the consideration for which a corporation issues its shares.[89] Such a record should prove to be valuable to the corporation and to its counsel, who may be called upon from time to time to render an opinion as to whether the shares of the corporation are validly issued. It also may be useful to shareholders in the exercise of their right to inspect the corporate books and records.[90]

Consideration for the issuance of shares may be paid in money or other property received by the corporation, in labor or services received by the corporation, in labor or services performed for the benefit of the corporation (including services related to its organization or reorganization), or in several other enumerated ways.[91] A promise to perform future services is not a permissible method of payment. But once the minimum capital stated in the articles of incorporation has been paid in,[92] the promissory note or other obligation of a subscriber may be accepted by the corporation in payment for shares.[93] The existing Georgia law, on the other hand, permits a corporation to accept

83 GA. CODE ANN. § 22-1831 (1966).

84 B.C.C. § 22-505(a).

85 B.C.C. § 22-505(b).

86 B.C.C. §§ 22-505(a), (b).

87 B.C.C. § 22-505(e).

88 B.C.C. § 22-505(f).

89 B.C.C. § 22-505(h). This provision should not be construed as requiring the keeping of a separate record if this would be unduly burdensome, but as requiring only the keeping of accurate records and books from which the relevant information can be gathered.

90 *See* B.C.C. § 22-613.

91 B.C.C. § 22-506(a).

92 B.C.C. § 22-802(a)(7) raises the minimum capital requirement to $500 from the $200 figure specified by the present GA. CODE ANN. § 22-1802(d) (1966).

93 B.C.C. § 22-506(b). This represents a variance from MODEL ACT § 18, which flatly prohibits payment for shares by means of promissory notes of the subscriber.

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without limitation both promissory notes and future services of a subscriber as consideration for the issuance of its shares.[94] The mild restraint placed by the *B.C.C.* on the use of promissory notes applies only to notes of the subscriber or purchaser, not to third-party obligations received in payment for shares.[95]

The value of nonmonetary consideration accepted by the corporation in payment for its shares is to be fixed by the board of directors, which is to state by resolution its determination of the fair value to the corporation of the property or services received. This determination must be expressed in dollars. Unless the action of the directors is tainted by bad faith, it shall be conclusive.[96]

Covering a point not expressly treated by the present law, the *B.C.C.* recognizes that a corporation may pay or allow the reasonable expenses of its organization, reorganization and financing out of the consideration received by it for its shares.[97] This provision of the new act is derived from the Model Act,[98] but the language of the Model Act provision has been revised so as to eliminate any implication that if the expenses paid or allowed by the corporation are unreasonable then shareholders may be liable for additional payments, even though their shares otherwise are fully paid. Unless a shareholder has participated in a fraud on the corporation (as, for example, by using his "insider" position in order to acquire an exorbitant number of shares for modest preincorporation services), it is unfair to make his liability turn on whether or not the underwriting fees or organization expenses paid by his corporation were "reasonable." Unlike the Model Act, the *B.C.C.* would not permit that unfortunate result. In the General Assembly, however, language was added to the original bill which would hold underwriters liable when they receive shares in payment of "unreasonable" underwriting charges.[99] This change is probably an ill-advised one. First, the change makes it difficult for an underwriter to accept shares as payment for underwriting services. Second, the change makes it virtually impossible for counsel to render an opinion that shares issued to underwriters for underwriting services are fully paid and nonassessable.

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94 GA. CODE ANN. §§ 22-1830, -1831 (1966).

95 B.C.C. § 22-506(b).

96 B.C.C. § 22-506(c).

97 B.C.C. § 22-506(e).

98 MODEL ACT § 20.

99 See B.C.C. § 22-506(e).

H. *Unpaid and Partly-Paid Shares*

Under the *B.C.C.*, unpaid or partly-paid shares have no dividend or voting rights. A subscriber is not entitled to shareholder's rights or to a certificate representing his shares, until the corporation has received full payment for his shares.[100] The new act defines a shareholder to be "one who is a holder of record of shares in a corporation."[101] Until the shares are fully paid and a share certificate issued (the purchaser thereby becoming a "holder of record"), the purchaser is not a shareholder. This represents a significant change from the present Georgia law, which specifically permits the issuance of shares as partly paid and subject to call.[102] This provision has not been carried over into the *B.C.C.* because of the danger of loss to the corporation when a certificate representing unpaid or partly-paid shares is transferred to a bona fide purchaser.[103] Should it become desirable to grant voting or dividend rights to a subscriber prior to full payment of his shares, the corporation could issue a certificate for such portion of the subscribed shares as had been paid for (including fractions of a share) and the subscriber would become a shareholder *pro tanto*. For example, there appears to be no reason why such a practice could not be utilized in connection with shareholder-approved option plans.

I. *Fractional Shares*

The present Georgia law does not provide for the issuance of fractional shares or scrip. This omission is a rather glaring one, since share dividends, share reclassifications, mergers and other transactions frequently result in the creation of fractional share interests. Remedying this defect, the *B.C.C.* provides three alternative methods of dealing with fractional share interests. First, authority is given to issue certificates for fractional shares, such shares having voting rights and the right to participate in dividends and distributions on liquidation.[104] Second, the new act permits a corporation to satisfy fractional shares interests by paying those entitled to receive fractional shares the fair value thereof in cash. The new law places the authority to determine the fair value of fractional shares in the board of directors; absent

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[100] B.C.C. § 22-508(a).

[101] B.C.C. § 22-102(g).

[102] GA. CODE ANN. § 22-1832 (1966).

[103] The present statute, § 22-1832, does not require that the stock certificate contain any legend or notation showing that the shares it represents are partly-paid and subject to call.

[104] B.C.C. § 22-509(a).

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bad faith, the board's determination is conclusive.[105] This provision for cash payment should prove useful in enabling corporations to clean up fractional share interests resulting from share dividends and the like with a minimum of administrative bother. Finally, the *B.C.C.* permits the issuance of scrip in either registered or bearer form. Scrip issued in accordance with this provision may be exchanged for full shares in ratios as provided in the scrip.[106] Scrip holders are not entitled to any rights of a shareholder except to the extent that the terms of the scrip confer such rights.[107] The new act gives the board wide discretion to fix the conditions subject to which the scrip is issued, including the condition that the shares for which the scrip is exchangeable may be sold by the corporation and the proceeds of such sale distributed to the holders of the scrip in satisfaction of their fractional interests.[108] A corporation issuing scrip, however, has a statutory duty to provide reasonable opportunity for these holders either to sell their scrip or to buy such additional scrip as is needed to acquire a full share.[109] In the case of fractional shares, the issuer is permitted, but not required, to buy and sell fractional shares in order to assist the holders thereof in obtaining value for their fractional interests or in acquiring sufficient additional fractional shares to make a full share.[110] The new act also permits the issuing corporation to sell fractional shares for the account of the persons entitled thereto.[111] Although the intention here is that such a sale would be made only at the request of a person entitled to a fractional share, the statute is not as explicit on this point as might be desirable.

J. *Share Certificates*

The provisions of the *B.C.C.* on share certificates are similar to those of the existing Georgia law[112] in a number of respects. To the extent that the *B.C.C.* brings about changes in the existing law, none of those changes is intended to impair the validity of any share certificates issued before its effective date. All share certificates issued after its effective

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105 B.C.C. § 22-509(b).
106 B.C.C. § 22-509(c).
107 *Id.*
108 *Id.*
109 *Id.*
110 B.C.C. § 22-509(d).
111 *Id.*
112 GA. CODE ANN. § 22-1834 (1966).

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date; however, must be in conformity with the requirements of the new act.[113]

There are several noteworthy differences, between the *B.C.C.* and the existing Georgia law on share certificates. First, and most important, a corporation is prohibited under the new act from issuing share certificates until the shares represented thereby are fully paid.[114] This provision, of course, is designed to protect the corporation and its creditors.

Another significant change is that a corporation will no longer be required to set forth or summarize on its share certificates a statement of the relative rights and preferences of its various classes of shares. In many instances this has proved to be an unduly burdensome and costly requirement. The *B.C.C.* gives the corporation the option of either setting forth or summarizing the relative rights and preferences of its various classes of shares, or of stating on the share certificate that "the corporation will furnish to any shareholder upon request and without charge . . ." a full statement of such relative rights and preferences.[115]

Unlike the existing law, the new act prescribes with some particularity the information[116] which shall appear on the face of each share certificate. Included in this required information is a statement or notation that the shares represented by the certificate are nonvoting shares,[117] if such is the case, and, if applicable, a brief statement that the shares represented by the certificate are subordinate to shares of some other class or series with respect to dividends or liquidation preferences.[118] Once share certificates have been validly issued, however, the new act stipulates that they need not be recalled for revision and reissuance if changes are made in the capital structure of the corporation.[119]

The *B.C.C.* incorporates the substance of the existing law on the use of facsimile signatures,[120] and extends the use of facsimile signatures to bonds, debentures and other debt securities.[121]

It would, of course, be permissible for the articles of incorporation or the bylaws to establish any additional requirements for share certificates

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113 Those requirements are set forth in B.C.C. § 22-508.

114 B.C.C. § 22-508(a).

115 B.C.C. § 22-508(d).

116 B.C.C. § 22-508(c).

117 B.C.C. § 22-508(c)(6).

118 B.C.C. § 22-508(c)(7).

119 B.C.C. § 22-508(e).

120 B.C.C. § 22-508(b).

121 B.C.C. § 22-508(f). See text at notes 136-38 *infra*.

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not inconsistent with the provisions of the new act or any other law.[122] For example, the bylaws might stipulate that the corporate seal shall be used on share certificates, since under the new act the choice as to whether or not the seal shall be used lies with the corporation.[123] Similarly, the articles or bylaws could add to the categories of information required by the new act to be stated on the face of each share certificate.[124]

K. *Debt Securities*

Among the statutory powers granted by the *B.C.C.* to every Georgia corporation to which the new act applies is the power to "issue its notes, bonds, and other obligations, and secure any of its obligations by mortgage, deed to secure debt, pledge, creation of a security interest in, or other encumbrance of, all or any of its property, franchises and income."[125] Consistent with the present Georgia law,[126] the new act sanctions a mortgage, pledge or other hypothecation of corporate assets without any shareholder vote or consent, unless the articles of incorporation require shareholder approval of such transactions.[127] The new act also permits the bylaws to require shareholder approval of such transactions,[128] whereas the existing law refers only to "the charter or an amendment thereof."[129]

Although the *B.C.C.* does not explicitly authorize the issuance of bonds convertible into shares, the authority to do so may readily be implied from (1) the broad statutory power referred to in the immediately preceding paragraph, and (2) the provisions of the new law[130] dealing with the consideration for shares issued upon conversion of

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122 B.C.C. § 22-508(b).

123 *Id.* For the effect of using the corporate seal on corporate documents, see B.C.C. § 22-104.

124 When shares are issued subject to transfer restrictions, the existence of the restrictions should be noted conspicuously on each share certificate. *See* GA. CODE ANN. § 109A-8-204 (1962). The Uniform Commercial Code provides, in substance, that in the absence of such a notation transferees without actual knowledge of the restrictions are not bound by them. Similarly, the existence of a shareholder's agreement relating to the voting of shares or to any other phase of the affairs of the corporation should be noted on each share certificate held by the parties to the agreement. *See* B.C.C. § 22-611(d).

125 B.C.C. § 22-202(b)(11).

126 GA. CODE ANN. § 22-1870 (1966).

127 B.C.C. § 22-1101(a)(1).

128 B.C.C. § 22-1101(a).

129 GA. CODE ANN. § 22-1870 (1966).

130 B.C.C. § 22-505(f).

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bonds into shares. The latter provisions would be meaningless if the issuance of convertible bonds were not permitted. The new act, however, does not require a corporation issuing convertible bonds to reserve and retain unissued a sufficient number of shares of the appropriate class or series to satisfy the conversion privileges of the bonds, even though the act contains a similar requirement applicable to convertible shares.[131] It would be desirable for this lacuna to be filled.

A few states now allow a corporation in its articles of incorporation to grant voting rights (and other rights of shareholders) to bondholders.[132] The drafters of the *B.C.C.* were not convinced of the utility of such a provision and, accordingly, it is omitted from the new law. Individual lenders may prefer to take equity securities for tax reasons;[133] and if voting rights are important to the lender, the shares he takes can be voting shares. In close corporations, shareholders' agreements can be written to establish the desired checks and balances between the shareholders who actually operate the business and those who simply provide capital.[134] Large institutional investors can adequately protect their interests through representation on the board of directors or through agreement, whether formal or informal. There may be situations in which it would be helpful to issue bonds having voting rights, but on balance the drafters were not convinced that the usefulness of such a provision outweighed its dangers—especially since, as already indicated, the board of directors may issue bonds in any amount without shareholder approval.[135]

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131 B.C.C. § 22-501(b)(5).

132 See CAL. CORP. CODE § 306 (West 1954); DEL. CODE ANN. tit. 8, § 221 (2 P-H CORP. SERV. (1968)); MD. ANN. CODE art. 23, § 18(a)(8) (1957); N.Y. BUS. CORP. LAW § 518(c) (McKinney 1963).

133 *E.g.*, stock may qualify as § 1244 stock, losses in respect of which will be treated as ordinary losses; a distribution in respect of stock may be a nontaxable return of capital if the corporation has no earnings and profits, *see* INT. REV. CODE of 1954, §§ 316, 301(c), whereas interest paid upon a debt will be ordinary income to the holder even though the corporation has no earnings and profits; gain upon redemption of stock may be treated as capital gain, *id.* at § 302(a), whereas payments received in retirement of debt may be treated as ordinary income to the extent of any original issue discount, *see id.* at § 1232(a)(2). *But see* Commercial Capital Corp., 37 P-H TAX CT. REP. & MEM. DEC. ¶ 68,186 (1968). In this case the tax court held that a stock issue and repurchase agreement between a corporation and a lender was actually a secured loan arrangement, and that gain realized on the redemption was ordinary interest income.

134 For the provisions of the new Code with respect to shareholders' agreements, see B.C.C. § 22-611.

135 *See* B.C.C. § 22-1101(a)(1).

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The new statute sanctions the use of facsimile signatures of corporate officers on debt securities;[136] the present law permits the use of facsimile signatures only on share certificates.[137] There is no reason, however, not to treat share certificates and debt securities alike in this respect. In either case, the avoidance of manual signing through the use of facsimile signatures can save corporate officers a great deal of time and energy. As a safeguard against counterfeiting, the *B.C.C.* authorizes the use of facsimile signatures on a debt security only if the instrument is authenticated or countersigned by a trustee or transfer agent, or registered by a registrar, other than the corporation or one of its employees.[138] A similar restriction applies to the use of facsimile signatures on share certificates.[139]

II. Basic Financial Concepts

The *B.C.C.* introduces several financial concepts, all based on the Model Act, which are new to Georgia law. These concepts are "stated capital," "earned surplus" and "capital surplus." It is important that the corporate practitioner have a basic understanding of these concepts, and each of them will now be considered in turn.

A. *Stated Capital*

Although the terminology is new, stated capital is essentially equivalent to what most Georgia lawyers are accustomed to think of as "capital stock," which is the term used (without definition) in the present Georgia law. The new act defines stated capital to mean the sum of (1) the par value of all issued par value shares, (2) the consideration received by the corporation for issued no-par shares and not lawfully allocated to capital surplus, and (3) other amounts transferred to stated capital.[140] Although stated capital may be reduced in a number of ways, there are limitations[141] on the extent to which this may be done. Those limitations will be outlined later in the discussion of stated capital. Stated capital may not be used for dividends or other distributions to shareholders.[142] It is conceptually helpful to think of

136 B.C.C. § 22-508(f).
137 Ga. Code Ann. § 22-1834 (1966).
138 B.C.C. § 22-508(f).
139 B.C.C. § 22-508(b).
140 B.C.C. § 22-102(l).
141 B.C.C. §§ 22-510, -516.
142 *See* B.C.C. §§ 22-511, -512.

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stated capital as being the most permanent part of a corporation's financial structure—a basic fund for the protection of the rights of creditors and preferred shareholders.

The *B.C.C.* spells out in considerable detail the manner in which the amount of stated capital is to be determined.[143] As indicated by the above-mentioned definition of stated capital, the consideration received by a corporation for the issuance of par value shares constitutes stated capital "at least to the extent of the par value of such shares;" the balance of such consideration goes into capital surplus.[144] The quoted language is derived from the Model Act,[145] but the words "at least" were added by the drafters of the *B.C.C.* to make it clear that the corporation may allocate to stated capital any excess consideration for par value shares above their par value. Without that addition, the Model Act provision could be read as requiring all the consideration for par value shares over and above their par value to be allocated to capital surplus. It is doubtful that the draftsmen of the Model Act intended such a result, but the clarifying language placed in the new Georgia act is helpful.

In the case of no-par shares, the consideration received by the corporation for their issuance constitutes stated capital only to the extent that the board of directors does not allocate it to captial surplus.[146] The statute makes it clear that some part of the consideration for no-par shares must be left in stated capital,[147] but this could be as little as one cent regardless of whether the shares were sold for ten cents, ten dollars, or ten thousand dollars. There are only two significant restrictions in this regard. First, the consideration received for no-par shares having an involuntary liquidation preference may be allocated to capital surplus only to the extent that such consideration exceeds the stated preference. Second, where the consideration for no-par shares has been fixed by the shareholders pursuant to a right reserved in the articles of incorporation, an allocation to capital surplus may take place only if authorized by shareholder vote.[148]

The *B.C.C.* establishes a ready method for increasing stated capital from time to time—the transfer of surplus to stated capital by resolu-

143 B.C.C. § 22-510.
144 B.C.C. § 22-510(a).
145 MODEL ACT § 19.
146 B.C.C. § 22-510(b).
147 *Id.*
148 *Id.*

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tion of the board of directors.[149] The statute also authorizes the board to earmark the surplus so transferred as stated capital with respect to any designated class or series of shares.[150] Such earmarking of stated capital becomes important when reacquired shares are cancelled, for in that event it becomes important to know what portion of stated capital is attributable to the cancelled shares.[151] With that need in mind, a provision in the new act allows the directors to make clarifying determinations when there are shares of more than one class or series outstanding and there is doubt as to what amount of stated capital is attributable to a particular class or series.[152] Any such determination, of course, must be consistent with the rules relating to determination of stated capital which have already been discussed.

The *B.C.C.* deals comprehensively with the matter of changes in stated capital when reacquired shares are cancelled. The basic rule is that stated capital is reduced by the amount of stated capital represented by the cancelled shares plus any unallocated portion of stated capital which is allocated to such shares at the time of their cancellation.[153] The only exception to this rule is in the case of exchanged or converted shares. The cancellation of these shares does not entail any reduction of stated capital unless the amount of stated capital represented by the exchanged or converted shares is greater than that represented by the new shares issued in their place, in which event stated capital is reduced by the difference.[154] The reason for this exception is that exchanged or converted shares, by definition, are shares which have been exchanged for or converted into other shares. After the exchange or conversion and the cancellation of the exchanged or converted shares, at least some portion of the stated capital formerly attributable to the exchanged or converted shares is attributable to the new shares. (That conclusion is dictated by the rules previously discussed relating to the determination of the amount of stated capital.) In many instances, the amount of stated capital represented by the new shares will be exactly the same as that formerly represented by the old shares. In such a case, there is no change in stated capital. In other instances, the amount of stated capital represented by the new shares will be less than that

149 B.C.C. § 22-510(d).
150 *Id.*
151 See B.C.C. § 22-515(c)(1).
152 B.C.C. § 22-510(e).
153 B.C.C. § 22-515(c)(1).
154 B.C.C. § 22-515(c)(2).

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formerly represented by the old shares. That would be true, for example, if the new shares have a lower aggregate par value than the old shares. In that case, stated capital is reduced by the difference between the aggregate par value of the new shares and the aggregate par value of the old shares. A further possibility is that the amount of stated capital represented by the new shares will be greater than that formerly represented by the exchanged or converted shares, as where the new shares have a higher aggregate par value than the old shares. Obviously, in that event stated capital must be increased by the difference between the two amounts, or a sufficient amount of previously unallocated stated capital must be allocated to the new shares.[155]

In addition to providing for changes in stated capital when reacquired shares are cancelled, the *B.C.C.* also establishes a simplified procedure for reducing stated capital in certain cases. Specifically, the new act permits the board of directors, by resolution, to reduce stated capital in three ways: (1) by eliminating amounts previously transferred by the board from surplus to stated capital, and not allocated to any specific groups of shares; (2) by eliminating any amount represented by par value shares in excess of the aggregate par value of the shares; (3) by reducing the amount of stated capital represented by no-par shares.[156]

The new act does, however, place a limit on the extent to which stated capital can be reduced by board resolution: no such reduction is permissible unless after the reduction stated capital at least equals the aggregate liquidation preference of all issued preferred shares plus the aggregate par value of all issued par value shares.[157] This test would require treasury shares to be taken into account in determining whether a reduction of stated capital could be made.

The new act also requires that disclosure be made to the shareholders whenever a reduction of stated capital is effected by resolution of the board of directors, such disclosure to be made not later than twelve months from the date of the reduction.[158] A similar dis-

155 *Id.*

156 B.C.C. § 22-516(a).

157 B.C.C. § 22-516(b). There is a separate limitation on the reduction of amounts of stated capital represented by no-par shares: if the consideration for no-par shares was fixed by the shareholders pursuant to a right reserved in the articles of incorporation, the board may reduce stated capital represented by such shares only to the extent that the shareholders have authorized the board to allocate such consideration to surplus. B.C.C. § 22-516(a).

158 B.C.C. § 22-516(c).

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closure requirement is imposed when stated capital is reduced upon a cancellation of reacquired shares.[159]

The simplified procedures of the *B.C.C.* for the reduction of stated capital are to be contrasted with the provisions of the present Georgia law relating to the reduction of capital. Those provisions are not only highly confusing, but also require any such reduction to take the form of a charter amendment.[160] Similarly, the Model Act requires a vote of shareholders and a filing with the Secretary of State in order to accomplish a reduction of stated capital.[161] Thus the Model Act approach, like the approach taken by the existing Georgia law, is to assimilate a reduction of stated capital to an amendment of the articles of incorporation. That approach is anomolous inasmuch as the amount of stated capital would not ordinarily (if ever) be an item of information appearing in the articles of incorporation.[162] Moreover, there simply does not appear to be any sound reason for requiring the elaborate formalities of either existing Georgia law or the Model Act. Under the *B.C.C.*, preferred shareholders and creditors are protected by the limitations on the reduction of stated capital mentioned above, as well as by the restrictions which the new act places on distributions to shareholders out of capital surplus.[163] Shareholders are also protected by the already-mentioned provision for disclosure. These safeguards should be adequate to prevent any serious abuse of the discretion with respect to stated capital which the *B.C.C.* affords to the board of directors. So safeguarded, decisions as to reductions of stated capital in the situations contemplated by the new act appear to be well within the province of the board.

B. *Earned Surplus and Capital Surplus*

Under the *B.C.C.*, the term "net assets" is defined as meaning "the amount by which the total assets of a corporation, excluding treasury shares, exceed the total debts of the corporation."[164] Net assets minus

159 B.C.C. § 22-515(c)(3).

160 GA. CODE ANN. §§ 22-1854, -1855 (1966).

161 MODEL ACT § 62.

162 *See e.g.* B.C.C. § 22-802 (prescribes contents of articles of incorporation; no statement relating to stated capital required).

163 *See* B.C.C. § 22-512. Present Georgia law, on the other hand, freely permits dividends to be paid out of *any* surplus, *see* GA. CODE ANN. § 22-1835 (1966), and therefore presents a more compelling case for attaching a high degree of formality to reductions of capital stock.

164 B.C.C. § 22-102(k).

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stated capital equals "surplus."[165] Surplus is divided into two broad categories, "earned surplus"[166] and "capital surplus."[167] Earned surplus is the primary source from which a corporation may pay dividends and from which other payments to shareholders may be made.[168] Capital surplus, on the other hand, is less freely available for distributions to shareholders.[169] It is therefore important to understand thoroughly the *B.C.C.'s* definitions of earned surplus and capital surplus.

1. *Earned Surplus.* The *B.C.C.* adopts the Model Act's definition[170] of earned surplus. Essentially, earned surplus is that portion of surplus equalling the balance of the corporation's "net profits, income, gains and losses from the date of incorporation," less distributions to shareholders and transfers to stated capital and capital surplus which have been made from earned surplus.[171] In cases of mergers, consolidations or acquisitions of all or substantially all the shares or assets of another corporation, the acquiring corporation is permitted to bring the earned surplus of the acquired corporation into the acquiring corporation's earned surplus account.[172] This provision reflects the practice that has developed under the "pooling of interests" concept, but is not restricted to cases within that concept.[173]

The new act expressly sanctions the writing up of assets to reflect current values. When this is done, however, the unrealized appreciation of assets is to be treated not as earned surplus but as capital surplus,[174] thus eliminating it as a *direct* source of dividends. But revaluation surplus may become an *indirect* source of dividends, for if a corporation suffers losses in excess of its earned surplus the resulting deficit in earned surplus may be eliminated by an application of capital surplus effected by resolution of the board of directors.[175] Once the deficit in earned surplus is thus eliminated, earned surplus is computed from that date.[176] Accordingly, any profits thereafter realized by

165 B.C.C. § 22-102(m).

166 B.C.C. § 22-102(n).

167 B.C.C. § 22-102(o).

168 B.C.C. §§ 22-511(a)(1), -513(b).

169 *See* B.C.C. § 22-512.

170 Model Act § 2.

171 B.C.C. § 22-102(n).

172 *Id.*

173 *See* Model Bus. Corp. Act Ann. § 19 at ¶ 4. For an accounting treatment of the "pooling of interests" concept see America Institute of Certified Public Accountants, Accounting Research Bull. No. 48 (1957).

174 B.C.C. § 22-102(o).

175 B.C.C. § 22-517(b).

176 B.C.C. § 22-102(n).

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the corporation can be treated as earned surplus; the amount transferred from capital surplus to cure the deficit in earned surplus need not be restored to capital surplus.

The foregoing provision for the elimination of deficits in earned surplus is based on the Model Act.[177] Because shareholder approval for the elimination of such deficits by application of capital surplus is not required, the drafters of the *B.C.C.* added two safeguards against misuse of this provision which are not found in the Model Act. First, such an application of capital surplus may not be made except to the extent that net assets exceed the aggregate liquidation preferences of preferred shares.[178] The purpose here is to protect preferred shareholders whose shares have a stated liquidation preference in excess of the amount of stated capital attributable to such shares. Second, if capital surplus is applied to eliminate a deficit in earned surplus, shareholders must be notified of the application not later than twelve months after it is effective.[179]

The *B.C.C.* specifically provides that earned surplus may be decreased (or eliminated) by transfers to capital surplus pursuant to a resolution of the board of directors.[180] In addition, the new act confers authority upon the board of directors to create reserves out of earned surplus for any proper purpose or purposes.[181] The utilization of either of those provisions by the board will have the effect of making corporate funds less readily available for dividends. Although directors acting in bad faith could use such power to the detriment of minority shareholders, the traditional equitable right to compel a dividend affords a means of redress,[182] at least against the most serious abuses. Moreover, the federal tax on the unreasonable accumulation of profits[183] militates against unduly parsimonious dividend policies.

2. *Capital Surplus.* Since under the *B.C.C.* all surplus is either earned surplus or capital surplus, it follows as a definitional matter that capital surplus is any surplus that is not earned surplus. That is, indeed, the essence of the new act's definition of capital surplus.[184] In

177 MODEL ACT § 63.

178 B.C.C. § 22-517(b).

179 *Id.*

180 B.C.C. § 22-517(a).

181 B.C.C. § 22-517(c).

182 *See* R. BAKER & W. CARY, CASES AND MATERIALS ON CORPORATIONS 1038-49 (3d ed. abr. 1959); H. BALLANTINE, CORPORATIONS §§ 231-32 (rev. ed. 1946); H. HENN, CORPORATIONS § 327 (1961); N. LATTIN, CORPORATIONS 459-61 (1959).

183 INT. REV. CODE of 1954, §§ 531-37.

184 B.C.C. § 22-102(o).

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addition, however, the statute offers a number of more precise rules to assist in the allocation of corporate assets as between capital surplus and earned surplus and as between capital surplus and stated capital.

First, there is a cluster of rules relating to the generation of capital surplus by the sale of shares. When a corporation issues par value shares, the consideration received in excess of the aggregate par value of the shares (sometimes referred to as "paid in surplus") is capital surplus except to the extent that the board of directors chooses to allocate it to stated capital.[185] When a corporation issues no-par shares, the entire consideration received is stated capital unless some part, but less than all, of such consideration is allocated to capital surplus.[186] When a corporation sells treasury shares, the full consideration received is capital surplus, with one exception: if the treasury shares were acquired by the corporation out of its earned surplus, then upon a subsequent sale of such shares the corporation may restore to earned surplus all or part of the amount by which earned surplus was reduced at the time of purchase.[187]

Second, several rules relate to the creation of capital surplus through the reduction of stated capital. Without exception, when stated capital is reduced in one of the ways permitted by the new act, the surplus created thereby is deemed to be capital surplus.[188] Similarly, when reacquired shares are cancelled, any resulting reduction in stated capital produces a corresponding increase in capital surplus.[189]

Third, as has already been mentioned, the new act in dealing with the question of reappraisal surplus treats such surplus as capital surplus, not earned surplus.[190] The *B.C.C.* grants the board of directors a wide discretion to create capital surplus by writing up the corporate assets to reflect current values, the only limitation being that in making such a revaluation the board shall act in good faith.[191]

Finally, the new act authorizes the board of directors both to increase capital surplus, by resolving at any time that amounts be transferred to capital surplus from earned surplus,[192] and to reduce capital

185 B.C.C. § 22-510(a).

186 B.C.C. § 22-510(b). The restrictions imposed by this section on such allocations to capital surplus are mentioned in the text at notes 147-48 *supra*.

187 B.C.C. § 22-513(c).

188 B.C.C. § 22-102(o).

189 B.C.C. § 22-513(c).

190 B.C.C. § 22-102(o).

191 *Id.*

192 B.C.C. § 22-517(a).

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surplus, by resolving that capital surplus be transferred to stated capital.[193] The board of directors also may reduce capital surplus by eliminating a deficit in earned surplus,[194] as was mentioned in the earlier discussion of earned surplus. Also, in certain circumstances the *B.C.C.* permits both distributions to shareholders[195] and purchases of the corporation's outstanding shares[196] to be made out of capital surplus, such distributions or purchases necessarily reducing capital surplus.

III. Dividends, Other Distributions to Shareholders, and Repurchases of Shares

In regulating payments by a corporation to its shareholders, the *B.C.C.* imposes one limitation of overriding importance—a corporation may not declare or pay dividends, make other distributions to shareholders, or repurchase any of its outstanding shares when it is insolvent or would thereby be rendered insolvent.[197] The *B.C.C.* defines the term "insolvent" to mean either equitable insolvency (inability to pay debts as they become due in the usual course of business) or insolvency in the bankruptcy sense (having liabilities in excess of assets).[198] The prohibition against the impairment of equitable solvency marks, at least insofar as the payment of dividends is concerned, an important change from the existing Georgia law, which permits a corporation to declare and pay dividends in cash or property "out of its net assets in excess of its capital stock."[199] The present law thus embodies a simple balance sheet test and permits the payment of dividends without regard to the effect such payment may have on the ability of the corporation to meet its obligations to creditors. The existing law's capital-impairment limitation on dividends affords no real protection for creditors, especially in view of the prevailing practice of issuing shares with a low par value at prices far above par, so that the capital stock account bears little relationship to the amount of capital actually paid in by the shareholders. Accordingly, the *B.C.C.* follows the Model

193 B.C.C. § 22-510(d).

194 B.C.C. § 22-517(b).

195 B.C.C. § 22-512(a). Subject to certain limitations, accrued cumulative dividends on preferred shares may be satisfied out of capital surplus. B.C.C. § 22-512(b).

196 B.C.C. § 22-513(b).

197 B.C.C. §§ 22-511(a) (dividends), -512(a)(1) & (b) (distributions from capital surplus), -513(e) (share repurchases), -514(b) (redemptions).

198 B.C.C. § 22-102(p).

199 GA. CODE ANN. § 22-1835 (1966).

Act[200] in imposing an equitable solvency test for the legality of dividends and other payments to shareholders. The new act departs from the Model Act, however, by adding a balance sheet test for the legality of such payments; both tests must be satisfied before corporate cash or property may be paid out to shareholders.[201] The *B.C.C.* also imposes additional limitations on payments or distributions of corporate assets to shareholders. These limitations will now be discussed in relation to the particular transactions to which they apply.

A. *Dividends*

The *B.C.C.* authorizes dividends in cash, property, or shares of the corporation (including treasury shares), subject to two broad limitations: (1) the insolvency test discussed above; and (2) dividends may not be paid if prohibited by any special restrictions found in the articles of incorporation.[202] The *B.C.C.* also specifies the sources from which a corporation, in the absence of special restrictions in its articles of incorporation, may pay dividends. With respect to the rules as to permissible dividend sources, it is necessary to distinguish between dividends in cash or property, on the one hand, and share dividends, on the other.

1. *Dividends in Cash or Property.* The new act provides two basic sources from which a corporation may pay dividends in cash or property. First, such dividends may be declared and paid out of the corporation's "unreserved and unrestricted earned surplus."[203] Second, dividends in cash or property may be declared and paid out of the "unreserved and unrestricted net earnings of the current fiscal year or the next preceding fiscal year."[204] This "nimble dividend" provision is substantially in accord with the provision of the existing Georgia law permitting dividends out of net profits for the current fiscal year

200 MODEL ACT § 2(n).

201 To the extent that payments to shareholders may come only from surplus (excess of net assets over stated capital), it is arguable that the *B.C.C.*'s reference to insolvency in the bankruptcy sense is superfluous. *But see* R. BAKER & W. CARY, CASES AND MATERIALS ON CORPORATIONS 1025 (3d ed. abr. 1959). Note also that for some purposes the new act permits, subject to the insolvency test, share reacquisitions out of stated capital. B.C.C. § 22-513(d). Here the broadening of "insolvent" to include the bankruptcy sense of the term takes on added importance.

202 B.C.C. § 22-511(a).

203 B.C.C. § 22-511(a)(1).

204 *Id.*

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"and/or the preceding fiscal year."[205] In addition, the new act permits a corporation engaged in the business of exploiting wasting assets to pay dividends out of depletion reserves, provided that the articles of incorporation authorize the use of depletion reserves for dividend purposes.[206] The present Georgia law contains a similar provision,[207] but here the *B.C.C.* differs from present law in that it requires the source of the dividend and the amount per share paid from depletion reserves to be disclosed to the shareholders concurrently with the payment of the dividend.[208]

2. *Share Dividends.* The *B.C.C.* permits a corporation to pay dividends consisting of its own "authorized but unissued shares" out of any "unreserved and unrestricted surplus."[209] When a dividend is paid in the form of par value shares, the corporation is required to transfer to stated capital an amount of surplus at least equal to the aggregate par value of the shares to be issued.[210] Similarly, when a dividend is paid in no-par shares, the board of directors is required to fix the stated value of the shares to be issued and to transfer to stated capital an amount of surplus equal to the aggregate stated value so fixed; further, the new act stipulates that concurrently with the payment of the dividend shareholders shall be informed of the amount per share so transferred to stated capital.[211]

The requirement that a share dividend be supported by a transfer of surplus to stated capital has no precise analogue in the existing Georgia law; rather, the present law provides, somewhat enigmatically, that a stock dividend need not "be made out of the surplus or earn-

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205 GA. CODE ANN. § 22-1835 (1966). Indeed, the apparent inconsistency of the *B.C.C.* in, on the one hand, requiring that dividend payments come from earned surplus and, on the other hand, permitting "nimble dividends" from current net earnings whether or not stated capital is impaired, can be justified only on the ground that the "nimble dividend" test has long been part of the Georgia scene.

206 B.C.C. § 22-511(a)(2).

207 GA. CODE ANN. § 22-1835 (1966).

208 B.C.C. § 22-511(a)(2).

209 B.C.C. § 22-511(a)(4). Note that a distribution of treasury shares is governed by a separate provision. See B.C.C. § 22-511(a)(3). Unlike a dividend paid in "authorized but unissued shares," a dividend paid in treasury shares (which are already "issued" shares) does not require any transfer of surplus to stated capital; thus a dividend may be paid in treasury shares even though the corporation has no surplus, so long as the insolvency test is satisfied and such a dividend is not contrary to any restrictions found in the articles of incorporation.

210 B.C.C. § 22-511(a)(4)(A).

211 B.C.C. § 22-511(a)(4)(B).

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ings of the corporation but a deficit may not be created or increased thereby."[212] The quoted language would seem to refer to a deficit in capital stock, but its meaning is far from clear. Whatever the present law intends in this regard, the *B.C.C.* firmly establishes that share dividends require the transfer of surplus to stated capital in an amount consistent with the basic rules for the determination of the amount of stated capital.[213]

Note that the surplus used in support of a share dividend may be *any* surplus, so long as it is unreserved and unrestricted. This relaxation of the earned surplus test applicable to dividends in cash or property is justified since share dividends do not involve any disbursement of corporate assets. Instead, in the case of a share dividend the corporation merely makes bookkeeping entries transferring surplus to capital; the assets of the corporation are not reduced and the solvency of the corporation is in no way impaired.[214]

Although the *B.C.C.* permits share dividends to be paid out of any unreserved and unrestricted surplus, it does not permit them to be paid out of current earnings when there is a deficit in surplus. At first blush, that restriction may seem anomalous, since the new act clearly allows "nimble dividends" to be paid in cash or property. There is, however, a valid reason for not permitting a "nimble dividend" to be paid in the form of newly-issued shares: if a deficit exists in surplus, it necessarily follows that stated capital is impaired; to permit new shares to be issued and paid for by an accounting entry on the books of the corporation, would, so long as stated capital remains impaired, be inconsistent with the various provisions of the new act which attempt to maintain the integrity of stated capital as a basic fund for the protection of creditors and preferred shareholders.[215]

As far as the *B.C.C.* is concerned, if a corporation in distributing newly-issued shares to its shareholders supports the distribution by transferring the proper amount of surplus to stated capital, the corporation is entitled to characterize the distribution as a "share divi-

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212 GA. CODE ANN. § 22-1836 (1966).

213 *See* B.C.C. § 22-510.

214 *See* H. BALLANTINE, CORPORATIONS 481 (rev. ed. 1946). The United States Supreme Court recognized the true nature of share dividends in holding them not subject to federal income tax. Eisner v. Macomber, 252 U.S. 189, 219 (1920). *Cf.* Koshland v. Helvering, 298 U.S. 441 (1936). The Court held in *Koshland* that a dividend in common stock to holders of preferred stock is taxable as income, since it gives the shareholder an interest different from that which his former shareholdings represented.

215 See text at notes 140-63 *supra*.

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dend." For purposes of the new act, a "share split" is readily distinguishable from a share dividend: in a share split, the number of the outstanding shares of one or more classes is increased but the total amount of stated capital remains constant, there being no transfer of surplus to stated capital.[216] The *B.C.C.* draws this simple distinction between "share dividends" and "share splits" solely for the purpose of directing the allocation of corporate assets as between surplus and stated capital; it does not purport to establish definitions of those terms which would necessarily hold good in other contexts. For example, trustees are frequently confronted by the question of whether a given distribution of shares is a "share dividend" or "stock dividend" (and therefore allocable under the terms of the trust to let us say an income beneficiary) or a "share split" or "stock split" (and hence allocable to the principal of the trust for the ultimate benefit of remaindermen).[217] Such a question should be answered by reference to the law of trusts, not by a mechanical application of the *B.C.C.'s* provisions on share dividends and share splits. Also, the policy of the New York Stock Exchange with respect to the listing of additional shares distributed as a "share dividend" or "share split" may require that *earned surplus* in an amount equal to the *fair value* of the shares be transferred to either stated capital or capital surplus.[218] That policy is in accord with the accounting profession's views of good accounting practice[219] and has been embodied in a rule recently proposed by the Securities and Exchange Commission.[220] Although the *B.C.C.* requires much less in this regard, it does not create any obstacles to compliance with the

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216 *See* B.C.C. § 22-511(b).

217 For an interesting discussion and collection of authorities on this sometimes perplexing problem of fiduciary administration, see 32 N.Y.U.L. Rev. 878 (1957).

218 New York Stock Exchange, Company Manual § A 13, at 235 (June 15, 1966). The listing policy of the Exchange is, in part, as follows:

> The Exchange, in authorizing the listing of additional shares to be distributed pursuant to a stock dividend [or stock split] . . . representing less than 25% of the number of shares outstanding prior to such distribution will require that, in respect of each such additional share so distributed, there be transferred from earned surplus to the permanent capitalization of the company (represented by the capital stock and capital surplus accounts) an amount equal to the fair value of such shares. While it is impracticable to define "fair value" exactly, it should closely approximate the current share market price adjusted to reflect issuance of the additional shares.

Id. The Exchange imposes these restrictions to protect shareholders from being misled as to the effect of "stock dividends on their equity in the company, and of [stock dividends'] relation to current earnings. . . ." *Id.*

219 *See* American Institute of Certified Public Accountants, Accounting Research Bull. No. 43, at 51 (1953).

220 *See* SEC Exchange Act Release No. 8268 (Mar. 7, 1968) (proposing Rule 10б-12).

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views of the Stock Exchange, the Commission or the accounting profession.[221]

Only one other point need be mentioned in connection with share dividends. The *B.C.C.* contains an antidilution provision which protects shareholders by prohibiting dividends in shares of one class from being paid to shareholders of another class.[222] That prohibition, however, may be negatived by a contrary provision in the articles of incorporation.[223] And even where the articles of incorporation do not contain such a provision, the holders of a majority of the outstanding shares of the class in which the payment is to be made may waive this antidilution right by affirmative vote or written consent, thereby binding the entire class.[224]

B. *Distributions from Capital Surplus*

In keeping with the Model Act,[225] the *B.C.C.* permits a corporation to distribute at least part of its assets to its shareholders out of capital surplus.[226] There is no comparable provision in the existing Georgia law, inasmuch as the present law permits dividends in cash or property to be paid out of any surplus.[227] Under the new act, distributions to shareholders out of capital surplus are subject to a number of limitations: (1) no such distribution may be made when the corporation is insolvent or would thereby be rendered insolvent (in either the equity sense or the bankruptcy sense);[228] (2) the distribution must be authorized by the articles of incorporation or by the affirmative vote of a majority of the outstanding shares of each class (including any class or classes of shares which otherwise are not entitled to vote);[229] (3) no such distribution may be made unless all cumulative dividends accrued on preferred shares have been fully paid;[230] (4) no such distribution may be made to the shareholders of any class if it would impair the aggregate liquidation preferences of senior or equal pre-

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221 The *B.C.C.* freely permits the transfer of earned surplus to either capital surplus, B.C.C. § 22-517(a), or stated capital, B.C.C. § 22-510(d).

222 B.C.C. § 22-511(a)(5).

223 *Id.*

224 *Id.*

225 MODEL ACT § 41.

226 B.C.C. § 22-512.

227 GA. CODE ANN. § 22-1835 (1966).

228 B.C.C. §§ 22-512(a)(1), -102(p).

229 B.C.C. § 22-512(a)(2).

230 B.C.C. § 22-512(a)(3).

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ferred shares.[231] The foregoing limitations, taken together, should adequately protect preferred shareholders and should also afford at least some measure of protection for creditors. One additional limitation protects both preferred and common shareholders: each distribution from capital surplus, when made, is to be identified to the shareholders receiving it as being a "distribution from capital surplus"[232] rather than a "dividend." The principle underlying this disclosure requirement is one of fundamental fairness, namely, that a shareholder is entitled to know whether his dividend check represents a distribution of earnings or a distribution of something else.[233] In furtherance of that principle, the act requires that when a distribution from capital surplus is made the amount per share attributable to capital surplus also be disclosed.[234]

The *B.C.C.* permits the use of capital surplus to pay "dividends" in only one instance: dividend arrears on cumulative preferred shares may be paid from capital surplus when the corporation has no earned surplus, is not insolvent and would not thereby be rendered insolvent, and the aggregate liquidation preferences of shares having senior or equal liquidation preferences would not be impaired.[235] Again, at the time any such distribution is made the shareholders receiving it are to be informed that its source is capital surplus.[236]

C. *Statute of Limitations on Unclaimed Dividends and Distributions*

The *B.C.C.* deals with one aspect of the troublesome problem of the "lost" shareholder by placing limitations[237] on a shareholder's right to unclaimed cash dividends. It also places a similar seven-year limitation on actions for unclaimed share dividends and other unclaimed corporate distributions.[238] Once the statute of limitations has run, any unclaimed cash or other property becomes an asset of the corporation.[239]

231 B.C.C. § 22-512(a)(4).

232 B.C.C. § 22-512(a)(5).

233 Tax consequences to the shareholder may vary if the dividend is a return of capital rather than a distribution of profits. *See* INT. REV. CODE of 1954, §§ 301, 305, 316. Moreover, disclosure of the source from which the dividend is paid places the shareholder in a better position to evaluate his investment.

234 B.C.C. § 22-512(a)(5).

235 B.C.C. § 22-512(b).

236 *Id.*

237 B.C.C. § 22-511(c)(1). Section 22-519 treats another aspect of the lost shareholder problem by providing a method for the cancellation of redeemable securities which are called but not presented within a specified time.

238 B.C.C. § 22-511(c)(2).

239 B.C.C. § 22-511(c)(3). There is no applicable escheat statute in Georgia.

Although no similar statute of limitations is found in either the Model Act or the present Georgia law, its inclusion in the new act seems unobjectionable. It is difficult to maintain that, as an equitable matter, a corporation should remain liable in perpetuity for unclaimed dividends and distributions.[240] This portion of the original bill, however, was rewritten in the General Assembly in a manner which may create some confusion as to the date from which the seven-year period begins to run. It is to be hoped that the language of the new act will be clarified and simplified in this regard.

One further point is noteworthy in connection with unclaimed dividends and distributions. The new act contains a special provision which permits a corporation, pursuant to a plan of complete liquidation, to transfer all of its interest in any unclaimed dividends or other unclaimed corporate distributions to a trustee for the benefit of shareholders or creditors.[241] The purpose of that provision is to provide a mechanism for avoiding the adverse tax consequences that might flow from a post-liquidation return to the corporation of unclaimed dividends.[242]

D. *Repurchases of Shares*

The *B.C.C.* broadly authorizes a corporation to acquire, encumber and dispose of its own shares in any lawful manner. The new act specifically recognizes the right of a corporation to create a security interest in its own shares pursuant to the Uniform Commercial Code.[243]

In accordance with the Model Act,[244] the new act prohibits a corporation from purchasing its own shares for any purpose when it is insolvent or would thereby become insolvent.[245] Going further than the Model Act, the *B.C.C.* also prohibits a corporation from purchasing its own shares for any purpose when the purchase would impair funds for preferred stock liquidation rights.[246] This is a desirable safeguard for the holders of preferred shares, and one which is not clearly estab-

240 For a cogent expression of the need for statutory treatment of the lost shareholder problem, see N. LATTIN, CORPORATIONS § 27 (1959). *See also* Note, *The Lost Shareholder*, 62 HARV. L. REV. 295 (1948).

241 B.C.C. § 22-511(c)(3).

242 *See* INT. REV. CODE of 1954, §§ 332, 337.

243 B.C.C. § 22-513(a).

244 MODEL ACT § 5.

245 B.C.C. § 22-513(e). As throughout the *B.C.C.*, "insolvent" includes both equitable insolvency and insolvency in the bankruptcy sense. *See* B.C.C. § 22-102(o).

246 B.C.C. § 22-513(e). The same prohibitions apply to the redemption of redeemable shares. See B.C.C. § 22-514(b).

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lished by the existing Georgia law[247] dealing with the redemption or purchase of stock. If the two foregoing tests are satisfied, the new act permits a corporation to purchase its own shares out of unreserved and unrestricted earned surplus and also out of unreserved and unrestricted capital surplus provided that the latter source is permitted by the articles of incorporation or approved by an affirmative vote of the holders of a majority of the outstanding voting shares.[248] This new provision is only slightly more restrictive than the existing law, which permits a corporation to make such purchases "from the surplus of its assets over its liabilities, including capital stock."[249]

When the articles of incorporation permit the reacquisition of shares out of capital surplus, an interesting situation arises under the new act. As mentioned above, the board of directors has full power to cancel reacquired shares.[250] The cancellation of reacquired shares reduces stated capital and thereby generates capital surplus, which can then be used to repurchase more shares, which can then be cancelled, and so on. Theoretically, a corporation with only enough surplus to repurchase one share could, by means of a revolving cancellation and reacquisition program, continue to repurchase shares until it reached the limits imposed by the equitable insolvency test or the impairment-of-preferred-stock-liquidation-rights test. Although as an abstract matter that possibility exists, its real potential seems very small, if for no other reason than the strong likelihood that the stated capital attributable to a reacquired share will be far less than the price paid for the share by the corporation. It will be a rare case in which cancellation of a reacquired share will create enough capital surplus to reacquire another share.

Questions may arise under the new act concerning the status of proceeds derived from insurance procured by a corporation on the life of a shareholder for the purpose of providing the corporation with funds for the repurchase of its shares upon the shareholder's death. If the corporation's articles of incorporation do not authorize share repurchases out of capital surplus, could such insurance proceeds be regarded as earned surplus? The drafters of the *B.C.C.*, and the members of the legislative committees which reviewed the draft bill, clearly

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247 GA. CODE ANN. §§ 22-1828(d), -1829 (1966).

248 B.C.C. § 22-513(b).

249 GA. CODE ANN. § 22-1828(d) (1966).

250 B.C.C. § 22-515(b).

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intended an affirmative answer to that question.[251] Nevertheless, additional statutory language may be desirable to make this result certain.

For certain specific purposes enumerated in the new act, a corporation may purchase its own shares without regard to the earned surplus and capital surplus limitations which otherwise would apply. These enumerated purposes are as follows: (1) eliminating fractional shares or avoiding their issuance;[252] (2) collecting or compromising indebtedness owing to the corporation;[253] (3) paying dissenting shareholders;[254] (4) retiring redeemable shares at a price not in excess of their stated redemption price.[255] Similar exceptions from the rule that share purchases be made out of surplus are found in the existing Georgia law.[256]

The *B.C.C.* contains a very helpful provision[257] designed to shield agreements between a corporation and its shareholders for the repurchase of its shares from attack on the ground that the contract is lacking in mutuality of obligation. That provision lays to rest in Georgia the ghost of the famous *Topken* case,[258] in which the New York Court of Appeals held such an agreement to be unenforceable against the shareholder (an employee of the corporation) because the contract lacked mutuality. The court reasoned that the corporation might not be able to repurchase the employee's shares because at the time for performance it might not have funds legally available for that purpose, and that its promise to repurchase the shares therefore was illusory.[259] This point apparently has never been litigated in Georgia and should never have to be. The new act makes it clear that, although enforcement of a stock purchase agreement must be denied if the corporation lacks adequate funds from which to repurchase shares,[260] the agreement nevertheless is valid when made and is specifically enforceable (assuming no other defects in the agreement) to the extent that at the time for performance the corporation possesses such funds.[261]

Note that the *B.C.C.* requires certain types of reacquired shares

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251 B.C.C. § 22-513, Comment.
252 B.C.C. § 22-513(d)(1).
253 B.C.C. § 22-513(d)(2).
254 B.C.C. § 22-513(d)(3).
255 B.C.C. § 22-513(d)(4).
256 See GA. CODE ANN. §§ 22-1828(d); -1829 (1966).
257 B.C.C. § 22-513(f).
258 Topken, Loring & Schwartz, Inc. v. Schwartz, 249 N.Y. 206, 163 N.E. 735 (1928).
259 *Id.* at 208, 163 N.E. at 736.
260 B.C.C. §§ 22-513(b), (e).
261 This provision (B.C.C. § 22-513(f)) reflects the existing case law in a number of jurisdictions. See Baxter v. Lancer Indus., Inc., 213 F. Supp. 92 (E.D.N.Y. 1963), and cases cited therein.

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to be cancelled. Such shares fall into one of two broad categories: (1) shares reacquired out of stated capital and (2) exchanged or converted shares.[262] In addition, the new act requires the cancellation of reacquired shares if the articles of incorporation so require.[263] With these few exceptions, a corporation may choose either to hold reacquired shares as treasury shares or to cancel them by board resolution, as the new act makes clear.[264] The statute also allows the corporation to exercise its option to cancel either when the shares are reacquired or at any time thereafter.[265]

Upon the cancellation of reacquired shares as provided in the new act, such shares are restored to the status of authorized but unissued shares.[266] An exception to this rule is made, however, in the case of reacquired shares which the articles of incorporation prohibit from being reissued. In such a case the new law requires the corporation to execute a statement of cancellation and to deliver this statement to the Secretary of State for filing.[267] The filing of the statement of cancellation automatically reduces by the number of shares cancelled the number of authorized shares of the affected class.[268] This is the only situation in which under the *B.C.C.* the cancellation of reacquired shares involves filing a document with the Secretary of State; normally all that is required is action by the board of directors.[269] The purpose of requiring a statement of cancellation to be delivered to the Secretary of State in this instance is simply to provide a public record of the fact that, in accordance with the terms of the articles of incorporation, certain reacquired shares have lost their status as authorized shares and that the number of authorized shares thus has been reduced. Since the articles of incorporation compel this reduction in the number of authorized shares, the reduction does not amount to an amendment of the articles of incorporation and there is no reason to require adherence to the formal amendment procedure.

E. *Liability of Directors for Improper Payments to Shareholders*

The *B.C.C.* specifies a general standard of conduct for directors and officers: they are to discharge their duties "in good faith and with that

262 B.C.C. § 22-515(a).
263 *Id.*
264 B.C.C. § 22-515(b).
265 *Id.*
266 B.C.C. § 22-515(d).
267 *Id.*
268 B.C.C. § 22-515(e).
269 B.C.C. § 22-515(b).

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degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions."[270] Besides establishing that general standard of duty—violation of which may result in liability on the part of the culpable director or officer—the *B.C.C.* specifically makes directors personally liable to the corporation when the directors have voted for or assented to certain improper disbursements of corporate assets to shareholders.[271] Actions to enforce these specific liabilities may be brought either by the corporation, its receiver or trustee in bankruptcy, any officer, director or judgment creditor of the corporation, or a shareholder suing derivatively.[272] Any such action, however, must be brought within six years from the date of its accrual.[273]

The new act carefully delimits the extent of the above-mentioned specific liabilities imposed upon directors. For voting for or assenting to an unlawful dividend or other unlawful distribution, directors are liable to the extent that any creditor or shareholder suffers damage as a result thereof. The outer limit of this liability is the amount of the dividend illegally paid or the value of the assets illegally distributed.[274] Similarly, directors who vote for or assent to a purchase by the corporation of its own shares, under circumstances in which the purchase is not permitted by the *B.C.C.*, are liable to the extent that the unlawful purchase causes damage to any creditor or shareholder. Here the maximum liability is the amount paid for the shares in excess of the amount which could have been paid without violating the *B.C.C.*[275]

The new act exempts directors from liability for good-faith action taken in reliance upon financial statements or other financial infor-

270 B.C.C. § 22-713.

271 B.C.C. §§ 22-715(a)(1)-(3).

272 B.C.C. § 22-714(b).

273 B.C.C. § 22-715(f). All other actions against directors and officers for violation of their duties to the corporation are subject to a four-year statute of limitations. B.C.C. § 22-714(c).

274 B.C.C. § 22-715(a)(1).

275 B.C.C. § 22-715(a)(2). The statute also imposes liability upon directors who vote for or assent to (1) any distribution of assets to shareholders during liquidation without making adequate provision for the known debts, obligations and liabilities of the corporation, the quantum of liability here being the amount of such debts, *etc.*, which are not thereafter satisfied (B.C.C. § 22-715(a)(3)), or (2) the commencement of business before the corporation has received the minimum consideration for the issuance of shares fixed by its articles of incorporation, this liability being limited to the amount of such minimum consideration which was not received before commencing business (B.C.C. § 22-715(a)(4)) with the liability terminating when the corporation thereafter receives such minimum consideration. *Id.*

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mation of the corporation represented to be correct by the president of the corporation, by the officer in charge of its books of account, or by outside accountants.[276] Directors also are protected when in good faith they take assets at their book value in determining the amount available for dividends or other distributions.[277] These provisions should go far to assuage any lingering fears that the equitable insolvency test unduly exposes directors to liability. Admittedly, it may not be possible to ascertain equitable solvency from the balance sheet and income statement alone. The *B.C.C.*, however, permits directors to place good faith reliance not merely on standard financial statements but on "financial information of the corporation"[278] represented to them to be correct—a much broader concept. Thus directors can call for, and rely on, cash flow projections and other data from which equitable solvency can be determined with reasonable certainty. If any additional protection for directors is needed, it may be in the direction of statutory language expressly recognizing that in determining equitable solvency directors may take into account any normal expectations of borrowing by the corporation. Such a provision would safeguard directors in the event that an unexpected decline in the general economy, or some other unforeseen condition, should prevent the corporation from maintaining equitable solvency through normal short-term borrowing. When market conditions (or the corporation's individual borrowing power) have suddenly and unexpectedly deteriorated to that extent, however, it seems doubtful that the payment of a dividend prior to the crash could be viewed as the cause of the corporation's insolvency.[279] Thus, whether or not the additional statutory language referred to above would serve any useful purpose is at least questionable.

Directors against whom a claim is asserted for the unlawful payment of dividends or for other unlawful distributions have a right to contribution from shareholders who accept or receive any such distribu-

[276] B.C.C. §§ 22-713, -715(c).

[277] B.C.C. § 22-715(c). This provision eliminates any inference that directors have a duty to reappraise assets before authorizing payments to shareholders; instead, directors are entitled to rely on book value so long as they do so in good faith. *Id.*

[278] B.C.C. §§ 22-713, -715(c).

[279] *See* Hofkin v. United States Smelting Co., 266 F. 679 (3d Cir. 1920). The insolvency of the corporation was held not to have been caused by payment of the dividend but by an unforeseen decline in the price of raw material which the corporation had outstanding contracts to purchase at higher prices. "[H]ad the dividend not been paid, its retention would not have prevented the company from becoming insolvent by reason of these further causes." *Id.* at 682.

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tion knowing it to have been made in violation of the new statute.[280] Each director against whom a claim is asserted on any of these grounds also has a right to contribution from the other directors who voted for or assented to the action on which the claim is based.[281]

When has a director who has not actually voted for an action nevertheless "assented" to it? The *B.C.C.* creates a presumption that a director who is present at a board meeting has assented to any action taken thereat unless his dissent is entered in the minutes of the meeting or filed with the secretary of the meeting prior to adjournment or within 24 hours thereafter.[282] A director who votes for a particular action or who, being present, fails to vote against it is not allowed to escape responsibility by entering a dissent once the vote is final.[283] The new act does not create any presumption concerning a director who is absent from a board meeting at which action is taken. The draftsmen of the *B.C.C.* considered this point and concluded that the question of whether a director should be deemed to have assented to action taken in his absence is one which can best be dealt with by the courts on a case-by-case basis.[284]

IV. Financial Statements

A. *Required Financial Statements*

Under the existing Georgia law, a corporation has no obligation either to prepare financial statements of any kind or to make even the most basic financial information available to its shareholders. The *B.C.C.* brings about significant, and highly desirable, changes in this respect. First, the new act requires the keeping of "correct and complete books and records of account."[285] Shareholders may inspect such books and records subject to the terms and conditions set forth in the new law.[286] Second, the *B.C.C.* creates an affirmative duty to prepare an annual balance sheet and an annual profit and loss statement.[287] The corporation is to prepare these required financial statements not later than four months after the close of its fiscal year, but in any event

280 B.C.C. § 22-715(d).
281 B.C.C. § 22-715(e).
282 B.C.C. § 22-715(b).
283 *Id.*
284 B.C.C. § 22-715(b), Comment.
285 B.C.C. § 22-613(a).
286 See B.C.C. §§ 22-613(b)-(e).
287 B.C.C. § 22-613(f).

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before its annual meeting of shareholders.[288] The new act stops short of requiring that the annual financial statements be distributed to all the corporation's shareholders; instead, shareholders are given the right to request copies of the corporation's most recent annual balance sheet and profit and loss statement.[289] A corporation which refuses such a request is liable to the requesting shareholder in a penalty of $500.[290]

There are, however, two situations in which the *B.C.C.* requires financial statements to be given to shareholders without any request on their part. That requirement exists with respect to dissenting shareholders seeking to be paid the fair value of their shares.[291] It also exists when a corporation submits a proposal for merger or consolidation to its shareholders.[292]

In the case of publicly-held corporations subject to the jurisdiction of the Securities and Exchange Commission, the *B.C.C.*'s provisions on required financial statements are entirely superfluous; such corporations already are under far more stringent requirements. Nor will the *B.C.C.* bring about any drastic changes in this regard for the many close corporations which, as a matter of good business practice, are in the habit of keeping accurate financial records and preparing basic financial statements. The new act does, however, mark out new areas of responsibility for close corporations which presently are not meeting these minimal standards. Admittedly, there may be competitive risks in furnishing corporate financial statements to a shareholder whose basic economic interests are opposed to those of the corporation. Such risks, however, do not loom large as measured against the potential for abuse that exists when directors are not under any duty to account (even in a *pro forma* financial statement) for their stewardship of corporate property.

B. *Consolidated Financial Statements*

The preparation of consolidated financial statements is a somewhat controversial topic, especially in the case of today's acquisition-hungry conglomerates.[293] It was the view of the drafters of the *B.C.C.*, however, that in most cases a fairly prepared consolidated statement gives

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288 *Id.*

289 *Id.*

290 B.C.C. § 22-613(g).

291 B.C.C. § 22-1202(f).

292 B.C.C. § 22-1003(b)(2).

293 Even accountants find the financial statements of some conglomerates baffling. *See, e.g.*, The Wall Street Journal, Aug. 5, 1968, at 1, col. 1.

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a better financial picture of the economic entity represented by a parent corporation and its subsidiaries than can be obtained from a reading of the individual statements of each of the affiliated companies. Accordingly, the new act contains a provision which establishes that the financial statements of a corporation and its subsidiaries may (but need not) be prepared on a consolidated basis.[294] That provision has no counterpart in either the Model Act or the present Georgia law, and probably is unique to the *B.C.C.* In all likelihood, the authority to prepare financial statements on a consolidated basis exists without specific statutory recognition. Nevertheless, it is not undesirable that the new act provides specific legislative permission for this widespread practice.[295]

CONCLUSION

The financial provisions of the *B.C.C.* represent a distinct improvement over the archaic, incomplete and sometimes ambiguous provisions of the existing Georgia law relating to corporate finance. The new act gives Georgia business corporations broad authority to raise capital by issuing either equity or debt securities in virtually any recognized form, and to tailor their securities to meet current conditions in the money market. It permits the capital structure of a corporation to be as simple or as complex as may be appropriate to the needs of the corporation. Included in the new act are many flexible, nonmandatory provisions which will greatly facilitate business planning. Adequate safeguards for the rights of shareholders and creditors, and for the public interest, are not neglected. Minor flaws in the new law have been noted in the course of this Article,[296] but these may easily be remedied; perhaps the General Assembly will see fit to do so at its

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294 B.C.C. § 22-518.

295 The problem of standardizing the "generally accepted accounting principles" used in the preparation of corporate financial reports is now under study by the New York Stock Exchange and the Securities and Exchange Commission, as well as by security analysts and the accounting profession. *See* The Wall Street Journal, Aug. 5, 1968, at 1, col. 1.

296 *E.g.*, whether the filing of a resolution establishing the rights and preferences of a series of preferred shares should be characterized as an amendment to the articles of incorporation; whether it is wise to hold underwriters liable for shares received in payment of "unreasonable" underwriting charges; whether a provision should be added requiring the reservation of unissued shares to satisfy the conversion privileges of convertible bonds; whether the time from which the statute of limitations on unclaimed dividends and other unclaimed distributions starts to run is sufficiently clear; whether additional language is needed to establish that earned surplus includes the proceeds of insurance maintained by a corporation on the life of a shareholder to enable the corporation to perform a share repurchase agreement at the shareholder's death.

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1969 session. Even with these minor imperfections, the provisions of the *B.C.C.* on corporate finance are practical, workable, cohesive and clear. They should do much to encourage Georgia businesses to incorporate in Georgia, and they should also contribute significantly to sound economic growth and the maintenance of a healthy business climate within the state.

The Georgia State Bar, and particularly its Section of Corporate and Banking Law, is to be commended for its efforts in the preparation and enactment of this important new legislation.[297] The success of this endeavor affords a splendid example of what concerned lawyers, working within the framework of the organized bar, can do to bring about needed changes in long-neglected areas of the existing state law.

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297 The Georgia Bar committee which shouldered the burden of preparing the draft bill for submission to the General Assembly consisted of the following persons: Daniel B. Hodgson, (Chairman), Albert Anderson, George L. Cohen, Dr. Sigmund A. Cohn, Dean Lindsey Cowen, Ben W. Fortson, Jr., Elliott Goldstein, Arthur Howell, McChesney H. Jeffries, Malcolm Maclean, Louis Regenstein, E.S. Sell, Jr., James M. Sibley, L. Neil Williams, Jr. (Secretary), and Robert M. Wood. The author was reporter to the committee and received able assistance from L. Clifford Adams, Jr. and W.T. Millican, III. Dr. Sigmund A. Cohn, Professor Emeritus, University of Georgia School of Law, contributed many valuable ideas. James L. Eaton of the Secretary of State's office and Assistant Attorney General W. Wheeler Bryan met regularly with the committee and provided important administrative insights.

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