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SUGGESTED PROVISIONS FOR A FEDERAL CORPORATIONS LAW:

PROVISIONS RELATING TO THE CORPORATE CHARTER.

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INTRODUCTORY

This memorandum deals with those portions of a federal corporations law which concern the conduct of corporate affairs and the relationships between the corporation and the stockholders. The topics dealt with here do not cover all the matters which will have to be considered in writing a corporations law, but it is felt that these topics are the most important points towards which effort for the reform of existing law must be directed. Some of the matters not here considered are of undeniable importance, e.g.: the question of ultra vires acts, but such matters can conveniently be left for discussion after the more pressing aspects of the problem have been dealt with.

Since this memorandum is designed for the committee, no attempt has been made to outline the existing law or to discuss the abuses of existing practice. These will of course have to be included in any final report which may be submitted. The author of this memorandum has confined himself to making tentative suggestions with occasional comment where such appeared necessary.

In preparing the suggested provisions, the author of the memorandum has proceeded on the assumption that the field for legislative action is wholly free, i. e.: the provisions here suggested are primarily applicable only to corporations to be formed after a federal act is passed. It is believed that a clear view of the objectives to be obtained can only be gained by commencing with this viewpoint. The question, then, as to what provisions shall be made for existing corporations is put aside for the present. After we know just what we want to achieve we will be able to approach the problem of the transition between the old situation and the new.

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I.

PROTECTION AGAINST STOCK WATERING

A. Acquisition of Property by New Corporation

1. Disclosure in the Articles of Incorporation. Any agreement by which a corporation about to be formed undertakes to issue stock in return for property and any agreement to acquire property in return for cash must be set forth in the articles of incorporation. Disclosure must be made of the nature of the property, the person from whom it is to be acquired, and the amount and kind of stock to be turned over or the amount of cash to be paid. Any such agreement not set forth shall be inoperative as against the corporation.

2. Promoters' Declaration. The promoters shall make a written declaration setting forth: (a) the price paid for the property by the persons from whom the company is to acquire it; (b) the method used to arrive at the price to be paid by the corporation; (c) the legal transactions which led up to the acquisition of the property by the corporation; (d) if the property is a going business, the results of operation of such business during the three proceeding years.

3. Definition of Promoters. The promoters shall include the incorporators, all persons for whose account the incorporators have subscribed to shares, and all persons from whom the corporation is to acquire property in return for shares.

4. Directors' Reports. The members of the first board of directors shall undertake an independent investigation of the circumstances of the promotion and shall draw up a report stating whether or not they considered the value placed on the property to be a reasonable one and the reasons on which this conclusion is based.

5. Documents to be Filed. The incorporators shall file with the Corporation Commission copies of the articles of incorporation, the promoters' declaration, directors' report, all agreements relating to the acquisition of property by the corporation, and all reports from appraisers or auditors upon which reliance was had in evaluating the property.

6. Independent Assessment. The Corporation Commission shall then appoint assessors to render a report regarding the reasonableness of the valuation placed on the property. The assessors shall have full power to investigate the circumstances of the promotion.

7. Powers of the Corporation Commission. If the assessors' report is to the effect that the valuation placed on the property is unreasonable, the Corporation Commission may refuse to register the corporation. Provision should be made for judicial review of an unfavorable decision. In any event the assessors' report shall be a matter of public record.

Comment: The suggestions 1-6 are based on the existing German law. The German law, however, gives no power to refuse registration in the event of an unfavorable report. The suggestion here made is based on the German Draft Law of 1930. Several of the bills on federal incorporation introduced into Congress contained provisions for independent assessment and went so far as to make this assessment conclusive. It is believed, however, that such a provision would be impracticable. It is impossible to set down a satisfactory legislative standard of evaluation and without it, a conclusive valuation by assessors would be unfair and difficult to arrive at.

B. Issue of Stock for Property by a Going Corporation. When any corporation intends to issue stock for property, the following should be required:

1. Stockholders' Assent. No stock may be so issued without securing a three-fourths vote of a stockholders' meeting. Stockholders who are to receive shares in the proposed issue in return for property may not vote.

2. Directors' Report. Before calling this meeting, the directors shall draw up a report setting forth the persons from whom the property is to be acquired, the method of evaluation, and, if a going business is to be acquired, the results of operations of that business for the preceding three years.

3. Auditors' Report. The corporations auditors shall prepare a report on the valuation placed on the property by the directors, to be submitted to the stockholders in advance of the meeting.

4. Powers of the Corporation Commission. The directors' and auditors' reports, the resolutions of the stockholders' meeting, and all documents relating to the transaction shall be filed with the Corporation Commission. The latter shall appoint assessors, and shall have power to order the stock not to be issued in the event of an unfavorable report from the assessors.

C. Purchases of Property Within Two Years of Commencement of Business. If within two years after the commencement of business a corporation enters into a contract for the purchase of a plant to be permanently used in its business, or for the purchase of patents or real property at a price in excess of 10% of the issued capital stock, the contract shall not be operative until it has been registered with the Corporation Commission following the steps described under B above.

Comment: The purpose of this provision is to prevent the promoters issuing stock to themselves for cash and then selling the property to the corporation after incorporation, receiving in return a credit against payment on the shares which they

hold. The limitation of this provision to two years after commencement of business is taken from the German law. It may be possible to extend this to cover all purchases by the corporation of the character here referred to.

D. Liabilities of Promoters, Directors and Others.

1. Civil Liabilities of Promoters. The promoters (as defined under A 3) should be jointly and severally liable to the corporation for damage caused by the incorrectness or incompleteness of statements made by them. All persons knowingly assisting the promoters shall be jointly and severally liable with them.

2. Civil Liabilities of Directors. The directors shall be liable to the corporation for damage caused by their failure to exercise reasonable care in the investigation of the circumstances of promotion.

3. Civil Liabilities of Assessors. Assessors shall be liable for negligent misstatements or omissions.

4. Civil Liabilities for Sellers of Stock. All persons offering stock for sale to the public (within a specified time after issue) who know or have reason to know that the promoters' declarations, or directors' reports in case of property acquired after incorporation, are incorrect or incomplete shall be liable, jointly and severally with the promoters, to innocent purchasers of the stock.

5. Original Penalties. Willful misstatement or omission by promoters or directors should be made a crime.

E. Promoters' Fees.

1. Disclosure in Articles of Incorporation. The articles of incorporation shall set forth the total sums to be paid by the corporation in respect of (a) fees or profits of promoters, (b) commissions on sale of shares; (c) other expenses of organization.

2. Promoters' Declaration. The promoters' declaration referred to under A 2 shall contain an itemized list of promoters' fees and organization expenses. No sum claimed as an item of organization expenses shall be paid unless listed.

3. Assessors' Report. The report of the assessors appointed by the Corporation Commission shall comment on whether or not the amount of promoters' fees and organization expenses is unreasonable.

4. Powers of the Commission. The Corporation Commission shall have power to disallow or reduce unreasonable promoters' fees or organization expenses.

5. Method of Paying Promoters' Fees. Promoters' fees may be paid for in cash or by the issue of founders' certificates. These certificates shall be non-transferable. They shall give a right of participation in net profits after dividend payments are made to stockholders. The certificates shall have a face value equal to the amount fixed for promoters' fees in the articles of incorporation. The payments made out of profits on these certificates shall be in the nature of amortization, i.e. when the face value of the certificate is paid it shall be cancelled. But in no case may full payment be made on such certificates before the expiration of five years from the commencement of business.

II.

SHARES

1. Par Value. The capital stock shall be divided into shares of a stated par value which shall not be less than $10. No par shares are prohibited.

Comment: The advantages claimed for no par shares boil down to this: They make for flexibility in corporate financing since the removal of par value makes it legal and proper for a corporation to sell its stock at whatever price it can secure. It is argued that par value has become meaningless in view of widespread stock watering and in view of the rule of Handley v. Stutz permitting the issue of shares below par where the corporation cannot sell at par. Remove par value and the temptation to water the stock is gone. The dangers of no par shares have become sufficiently apparent in the last few years. The remedies which are necessary to prevent abuses are a stated capital which is made up of the par value plus the amount of consideration paid for the no-par shares (Ohio Act § 37), and a strict limitation on the crediting of part of the consideration paid for the shares to paid in surplus. It is submitted that if the necessary protection against abuse is adopted the no-par value share is in practical effect a par value share with the dollar sign removed from the certificate. It would be much simpler to return to par value. It is believed that the suggested provisions regarding protection against stock-watering will remove the paramount objection to par value shares from the standpoint of creditors and investors. The advantage of flexibility in corporate financing must be sacrificed to some extent. Yet complete rigidity and the consequent necessity for resorting to bond financing can be avoided by resort to reduction of capital as provided in the selection on "Amendment of Articles" and by issuing shares at a discount as provided below.

It will be noted that a minimum par value of $10 is required. Unless a minimum is required much of the advantage of par value disappears. Where the book value of shares falls below $10 and it is desired to issue new shares, the corporation can reduce its capital by consolidating the outstanding shares.

2. Issue of Shares at a Discount. A corporation may issue at a discount shares of a class already issued. The issue must be authorized by a resolution of the shareholders, the resolution specifying the maximum rate of discount at which the shares are to be issued. After the resolution has been passed the corporation must apply to the Corporation

Commission [or a court] to sanction the issue. The Commission [or court] may sanction the issue on such terms and conditions as it thinks fit. The shares to be issued at a discount must be issued within one month after the date on which the issue is sanctioned by the Commission [or court]. Every prospectus relating to the issue of the shares and every balance sheet issued by the corporation subsequently must contain particulars of the discount allowed on the issue of shares or of so much of that discount as has been written off at the date of the issue of the document in question.

Comment: This provision is copied from the English Act, sec. 47. It is intended as a substitute for the rule of Handley v. Stutz. Instead of permitting the corporation to be the sole judge as to whether or not it can sell its shares at par, the sanction of the Commission or a court is to be required.

3. Authorized and Issued Capital. No corporation shall be permitted to commence business until 50% of the authorized capital has been subscribed for and allotted.

Comment: It is recognized that the existence of authorized unissued stock has some value, though it does not obtain under Continental systems. This provision limits the amount of unissued stock to 50% of the authorized stock.

4. Initial Cash Payment. Where shares are sold to the public, the prospectus shall state the minimum initial payment in cash which, in the opinion of the directors, is necessary to provide the money to pay for organization expenses and provide working capital until the next call on the shares. In no case shall this minimum subscription be less than 10% of the nominal amount of each share. No corporation shall commence business until the minimum subscriptions have been paid in cash and the total sum is at the disposal of the corporation. If these conditions are not complied with after 40 days of taking effect of the registration statement required under the Federal Securities Act, all money received from applicants for shares must be repaid to them.

Comment: This is based on the English Act. (Fourth Schedule, Part I, No.5; Sec. 94, par. 1). The principal change is the requirement of 10% as an initial payment instead of 5%.

III.

REDEMPTION OF PREFERRED SHARES

1. Issue of Redeemable Shares. If the articles so provide, or on a vote of three-fourths of the shareholders of every class, a corporation may issue redeemable preferred shares.

2. How Redeemed. Such shares may be redeemed and cancelled by a resolution of the board of directors at a price not in excess of that provided in the articles, or in the shareholders' resolution. When shares are redeemed the corporation may apply to such redemption a sum out of its capital not exceeding the price at which the shares were issued. But, in any one year the amount charged to capital for this purpose shall not exceed the profits available in that year for distribution in cash dividends.

Comment: This is a novel provision designed as a middle course between American statutes and the English Act. Recent American laws (e.g. Ohio, Pennsylvania, Uniform Act) permit the amount used for redemption, minus redemption premiums, to be taken out of capital. Under the English Act (sec. 46) shares may be redeemed only out of profits available for dividends unless a fresh issue for purposes of redemption is made. The English rule seems unduly restrictive. On the other hand, the American provisions involve the danger that the directors will apply all the available liquid assets for redemption and will leave the common stockholders with the frozen assets on their hands. Under the suggested provision this possible abuse is obviated. The corporation will always be able to retire shares by going through the process of reducing capital. If the directors do not desire to do this in the case of redeemable shares, they will be able to retire the shares by the use of profits or paid-in surplus.

The avowed purpose of the American provisions is to preserve the dividend rights of the junior shareholders. The suggested provision does not do away with this; it merely limits it. Thus if a corporation has $1,000,000 available for dividends, it could redeem $1,000,000 of preferred, charge the cost to capital, and then distribute all the profits in dividends.

3. Where Redemption Cannot be Made. No redemption of shares shall be made which will reduce the remaining assets of the corporation below an amount sufficient to pay all debts and known liabilities of the corporation as they mature, except such debts and liabilities as have been otherwise adequately provided for, or which will reduce the net assets below the aggregate amount payable to the holders of shares having prior or equal rights to the assets of the corporation upon dissolution.

Comment: This is copied from the Pennsylvania Act, sec. 705.

4. Disclosure:

(a) Where redeemable shares have been issued, every balance sheet of the corporation shall include a statement indicating the number and amount of such shares outstanding.

(b) The directors of the corporation shall file with the Corporation Commission a statement of redemption where any shares are redeemed. The statement shall set forth the original issue price and the redemption price and shall indicate the fund out of which the shares were redeemed.

IV.

PREEMPTIVE RIGHTS

1. Issue of New Voting Shares. Every holder of shares entitled to vote on the election of directors shall have the right that the corporation shall not create any voting shares, or other securities convertible into such shares, without first offering to him that proportion thereof which the number of votes possessed by him beare to the total number of votes possessed by all voting shareholders.

   Comment: This provision is based on the rule suggested by Prof. Frey (Shareholder' Preemptive Rights, 58 Yale L. J. 563, 573). The basis of the rule is that the purpose of the preemptive right is to prevent dilution of voting rights. It is true that in the existing law voting rights are of diminishing importance, but the proposed federal law will restore voting rights and place them in a position where their protection will be of paramount importance. The provision suggested preserves the right of preemption to all holders of voting shares where new voting shares are to be issued. This right cannot be excluded under any circumstances whatever. It should be mentioned that it is proposed that all common stock must have voting rights. Preferred stock may be non-voting.

2. Issue of New Non-Voting Shares. No right of preemption need be specified for non-voting shares, or for other securities convertible into non-voting shares. But, in the event of a new issue, no shares shall be sold until thirty days after notification of the resolution of the stockholders authorizing such issue has been given to the Corporation Commission. During such period any stockholder may apply to a court to direct the Commission to refuse confirmation of the resolution on the ground that his rights to participate in the profits or assets will be unduly prejudiced by the issue. The court may, after hearing, direct that the issue be confirmed on such terms and conditions as it shall think just.

Comment: This provision is intended to meet the criticism that the rule of preemption cannot be applied in the modern complex corporate structure. A rigid rule is avoided. Instead the stockholder is provided with a ready remedy against undue dilution of his participation. Attention is called to the fact that the section on "Amendment of Articles" provides other protective devices. Thus, new issues of stock must be voted by the stockholders' meeting, and the notice of meeting must give specific indication of the matters to be brought before the meeting. If it is intended that the right of preemption is to be limited or excluded, the notice of meeting would have to mention this.

3. Issue of Stock for Property. The preemptive right provided in No.1 and the remedies provided in No. 2 shall also apply to issues of stock in return for the acquisition of property by the corporation.

4. Authorized Stock. Preemptive rights shall apply to an issue of stock previously authorized. If authorized stock is non-voting and not subject to preemption, the directors shall give notice to the stockholders of the intention to issue such stock. After two weeks have elapsed, the directors shall file their resolution providing for such issue with the Corporation Commission. The provisions of No. 3 shall then apply.

Comment: The provisions in Nos. 3 and 4 are intended to abolish two of the illogical exceptions to the right of preemption. A third exception is in regard to treasury stock which will be treated separately.

5. Unsubscribed Shares. Where shares are subject to preemption, any stockholder subscribing to the new issue may offer to take up his pro-rata share of any shares which stockholders refuse or fail to take up within the time set for subscription.

Comment: This provision is designed to supersede the present rule that unsubscribed shares may be offered to outsiders at or above the subscription price, without first pro-rating them among the other stockholders. This rule is justified on the ground of the practical inconvenience of offering and re-offering shares in progressively more minute fractions (See Drinker, Preemptive Right of Shareholders, 43 Harvard L. Rev. 586, 605). The suggested provision does not seem to involve this practical objection. If any shares are not subscribed for, the corporation must offer a pro-rata share only to those stockholders

who previously indicated a willingness to take them up. If these latter should then refuse them, the corporation may go ahead with the sale to outsiders.

V.

ACQUISITION BY A CORPORATION OF ITS OWN SHARES (TREASURY STOCK)

1. Acquisition by Purchase or Pledge. A corporation shall not require its own shares by way of purchase or pledge except:

   (a) As a result of forfeiture of shares for non-payment of calls or assessments.

   (b) To collect or compromise a debt or claim in good faith.

   (c) From dissenting shareholders who are entitled to be paid the fair value of their shares.

2. Acquisition by Gift or Bequest. A corporation may acquire its own shares by way of gift or bequest.

3. Cancellation. Any shares acquired as provided above may be cancelled by the corporation without resorting to the procedure required for reduction of capital.

4. Resale. In no case may shares acquired under the above provisions be sold by the corporation below par nor may they be sold otherwise than for cash.

5. Bookkeeping. Where a corporation acquires its own shares they shall be carried on its books as treasury shares until disposed of by sale or reduction of capital. The annual balance sheet shall indicate the number of treasury shares with a brief indication of the way in which they were acquired.

6. Voting Rights of Treasury Stock. The voting rights of treasury shares may not be exercised.

7. Preemptive Rights in Treasury Stock. Preemptive rights shall apply to reissue of treasury shares as in the case of new issues. (See section on Preemptive Rights).

Comment: The above provisions are intended to restrict substantially the present practices in regard to treasury stock. The fundamental principle of the English law that a corporation may not purchase its own shares is adopted. (See Trevor v. Whitworth, 12 A. C. 409). The four exceptions allowed are in cases in which no impairment of capital will take place by the acquisition. (See Levy, Purchase by a Corporation of its Own Stock, 15 Minn. L. Rev. 1).

No. 4, requiring resale at not less than par and for cash, is designed to do away with the many abuses attendant on the donation of treasury stock by promoters.

No. 6, in regard to voting rights, is a restatement of the prevailing rule.

No. 7, allowing preemptive rights in reissues of treasury stock, adopts the view urged by the American Law Institute.

VI.

CONVERTIBLE BONDS

1. A corporation may issue securities convertible into shares of the corporation. Such bonds may not be issued without the consent of three-fourths of the shareholders of each class.
2. If at the time of conferring such conversion rights, the corporation shall not have authorized and unissued shares sufficient to meet such rights, if and when exercised, the corporation shall be required to apply to the Corporation Commission for confirmation of the issue as in the case of an increase of capital.
3. Where convertible bonds are issued for property, the procedure for evaluation described under “Protection Against Stock-Watering” shall apply.

VII.

AMENDMENT OF ARTICLES

1. Change of Object of Corporation. A corporation may by a vote of three-fourths of the stock of each class voting at a stockholders' meeting, amend the articles of incorporation with respect to the objects of the corporation where such amendment is necessary:

(a) to carry on its business more economically or more efficiently; or

(b) to attain its main purpose by new or improved means; or

(c) to carry on a business which may be conveniently or advantageously combined with the existing business of the corporation; or

(d) to restrict or abandon any of the objects specified in the articles.

Before calling a stockholders' meeting to vote on an amendment, the directors must give due notice to the stockholders with specific indication of the amendment proposed. After the resolution has been adopted the corporation must give notice to all creditors whose rights may be affected.

No amendment shall take effect until it has been approved by the Corporation Commission.

The Commission shall not approve any amendment until it is satisfied that the consent of objecting creditors has been obtained or their claims have been discharged or security satisfactory to the Commission has been furnished.

The Commission may confirm the amendment either wholly or in part, and on such terms and conditions as it thinks fit. In exercising its discretion, the Commission shall have regard to the rights and interests of stockholders and may refuse to confirm until an arrangement has been made for the purchase of shares of dissenting stockholders.

2. Increase of Capital. The capital of a corporation may be increased by a vote of three-fourths of the stockholders of each class whose rights would be affected by the increase. Due notice must be given to the stockholders before the meeting. The capital may be increased either by issuing new shares or by increasing the par value of existing shares. Where new shares are to be issued in return for property, the procedure designed to prevent stock watering must be gone through.

3. Reduction of Capital. A corporation may reduce its capital on a vote of three-fourths of the stock in each class. Capital may be reduced either by reducing the par value of all or some shares, or by cancelling some of the outstanding shares. In order to reduce its capital, a corporation may:

   (a) Extinguish or reduce liability with respect to amounts to be paid for stock not fully paid up;

   (b) Cancel paid up shares when a portion of the capital has been lost;

   (c) Pay off paid up capital which is in excess of the needs of the corporation.

   After a resolution to reduce capital has been passed, the corporation shall apply to the Corporation Commission to confirm the reduction. Where the resolution proposes that liabilities in respect of unpaid parts of shares be diminished or that paid-up capital be returned to the stockholders, the Commission shall not confirm the reduction until it is satisfied that the consent of objecting creditors has been obtained, or their claims have been discharged or security satisfactory to the Commission has been furnished.

4. Variations of Stockholders' Rights. Where shares have been issued with a stipulation that the rights attached to such shares may be varied, such variation shall not be allowed without the assent of three-fourths of the stock the rights of which are to be varied. Dissenting stockholders holding five per cent of the stock to be affected may apply to a

court [or to the Commission] to have such variation cancelled. Such application must be made within two weeks after the passage of the resolution, and pending the disposition of the application, the variation shall not take effect. If the court [or the Commission] is satisfied that the proposed variation would unfairly prejudice the shareholders of the class represented by the application, it may disallow the variation, or it may confirm it on such terms and conditions as it shall deem desirable.

VIII.

DIVIDENDS

A. Cash Dividends.

1. When Cash Dividends May be Paid. No dividends shall be paid in cash or property except out of profits resulting from the operations of the business of the corporation.

2. Deductions to be made in Computing Profits. In computing such profits the board of directors shall determine and make proper allowance, in accordance with the provisions of this law and the rules and regulations of the Corporation Commission, for depletion, depreciation, obsolescence, losses and bad debts. Deferred assets and prepaid expenses including organization expenses, promoters' fees and expenses incurred in the issuing of stock, shall be written off at least annually in proportion to their use as may be determined by the board of directors in accordance with the rules and regulations of the Corporation Commission.

3. Unrealized Profits. No cash dividends shall be paid out of surplus due to arising from:

(a) Any unrealized appreciation or revolution of fixed assets; or

(b) Any unrealized profits due to increase in valuation of inventories before sale; or

(c) The unaccrued portion of unrealized profits on notes, bonds, or obligations for the payment of money purchased or acquired at a discount unless such notes, bonds, or obligations are readily marketable, in which case they may be taken at their actual market value; or

(d) The unaccrued or unearned portion of any unrealized profit in any form whatever, whether in the form of notes, bonds, obligations for the payment of money, installment sales, credits or otherwise.

4. Past Losses to be Made Up. Past losses of capital must be made up before dividends may be declared. Such losses may be made up by:

(a) Transferring part of paid-in surplus to capital; or

(b) Transferring the compulsory reserve (as defined below) to capital; or

(c) Reducing the capital in accordance with this law; or

(d) Revaluation of assets after application to the Corporation Commission under such rules and regulations as the latter shall prescribe.

5. Compulsory Reserve. Every corporation shall set aside a reserve of 10% of the annual profits until the total reserve equals 10% of the issued capital. This shall be known as the compulsory reserve and shall be used for making up past losses of capital.

6. Compelling Payment of Dividends. Any excess of profits remaining after the deductions required by this law have been made and after the compulsory reserve and other proper reserves have been set aside must be distributed in dividends. If the directors believe that all or part of such excess of profits should be withheld from distribution, a statement of the reasons therefor, or in lieu thereof, a statement that the interests of the corporation demand that no disclosure shall be made of the reasons for withholding a dividend, must be contained in the annual statement of the corporation. Where a dividend has been withheld, the Corporation Commission may, on the application of 10% of the shares of any class, appoint a referee to examine the affairs of the corporation and, after hearing, to report whether or not the dividend was properly withheld. The Commission may then order a dividend to be paid in such amount and under such terms and conditions as it shall deem desirable.

7. Power to Pay Interest out of Capital. Where any shares of a corporation are issued for the purpose of raising money to defray the expenses of the construction of any works or buildings or the provision of any plant which cannot be made profitable for a lengthened period, the corporation may pay interest for the period on any such shares as are paid up and may charge the sums so paid by way of interest to capital as part of the construction of the work or building, or the provision of the plant. No such payment shall be made unless authorized by the articles of incorporation or a vote of three-fourths of the voting shares and sanctioned by the Corporation Commission. The payment shall be made only for such period as may be determined by the Commission, such period not to extend beyond six months following the completion of the works or buildings or provision of the plant.

Comment: The suggested provisions are based on the old rule that dividends presuppose profits. The more recent corporation laws (e. g. Ohio Act and Uniform Act) use excess of assets over liabilities plus stated capitals, i. e. they use a surplus test and require a disclosure of the source of dividends paid otherwise than out of earned "excess". It is believed that the possibilities of abuse militate against the adoption of this principle. The chief difficulty with the "profits" test in England has been the doubt as to whether past losses must be made up. The present suggestions make express provision for making up losses. The provisions regarding depreciation, etc., and unrealized profits are modeled on the Uniform Business Corporations Act with the following major changes:

(a) Prepaid expenses are expressly stated to include organization expenses, promoters' fees and expenses for issuing stock.

(b) Depreciation, etc., is to be valuated in accordance with any regulations which the Corporation Commission may issue.

(c) The Uniform Act contains an exception permitting dividends to be paid out of capital where a corporation is engaged

in working a wasting asset, such as a mine. The defense of this position is that shareholders investing money in a mine do not expect to get all their money back when the mine is exhausted.

If this argument has any validity it would apply to a corporation operating a single mine. But it is hardly conceivable that such a corporation could be large enough to come under the operation of the Federal Corporation Act.

The provision requiring the setting up of a compulsory reserve is taken from the German Law. It is undeniably a desirable thing from the standpoint of stability of the corporation's dividend policy.

It will be noted that provision is made for compelling the payment of dividends. This is important in order to prevent the passing of dividends during prosperous years in order to deprive the holders of non-cumulative preferred stock of a fair share of the earnings.

The provision for permitting payment of interest out of capital is an innovation in American law. It is based on Section 54 of the English Act, and a similar provision is contained in almost all Continental laws.

B. Stock Dividends. A corporation shall not declare dividends payable in shares of the corporation.

Comment: It is believed that stock dividends serve no useful purpose and should be prohibited. However, if stock dividends are to be permitted, the following alternative provisions are suggested:

(1) No stock dividends shall be paid without the authorization of the Corporation Commission. Such authorization shall not be granted unless it be shown that –

(a) A proper portion of the corporation's surplus has been transferred to capital; and that

(b) The stock dividend is not to be made out of surplus arising from unrealized appreciation or revaluation of fixed assets.

(2) No stock dividends shall be paid to the holders of any class of shares except in shares of that class.

IX.

ACCOUNTS AND STATEMENTS

1. Statements Required. Every corporation shall draw up the following statements:

   (a) Balance Sheet (annually)

   (b) Profit and loss statement (annually)

   (c) Statement regarding directors (annually)

   (d) Register of shareholders

   (e) Changes in Register of Shareholders (annually)

   (f) Quarterly statement of earnings

2. Auditors' Reports. An auditor's report must accompany the balance sheet, profit and losses statement and quarterly statement of earnings.

   Comment: For appointment, duties, etc. of auditors see section on "Auditors".

3. Submission to Shareholders. The directors shall submit to all shareholders of record at least 14 days before the annual meeting the balance sheet, profit and loss statement and the statement regarding directors, with accompanying auditors' reports. Any shareholder shall have the right to receive without charge copies of these statements.

4. Submission to Corporation Commission. All statements required to be submitted annually shall be filed with the Corporation Commission within 10 days after the annual meeting. Quarterly statements shall be filed at such times as the Commission shall direct.

5. Powers of the Corporation Commission. The Corporation Commission may, by rules and regulations, define accounting terms and prescribe standard forms for balance sheets, profit and loss statements and other statements not inconsistent with the provisions of the law.

6. Balance Sheet. The balance sheet shall give a clear and correct view of the affairs of the corporation. The following shall be particularly required:

(a) Assets. The nature of each class of assets shall be clearly indicated. In every case a brief indication shall be given of the principle of valuation adopted (e.g. cost price, market value as of a certain date, etc.)

(b) Capital Stock. This term shall include only issued outstanding stock. Treasury stock shall be separately listed with an indication of the way in which it was acquired (e.g. forfeiture for non-payments, gift, etc.) The number and par value of non-voting shares shall be set forth. Authorized but unissued stock shall be separately listed.

(c) Surplus. The source of surplus shall be clearly set forth (e.g. from operations, as a result of reduction of capital or premiums on new issues, etc.)

(d) Contingent Liabilities shall be separately stated with appropriate explanations.

(e) Reserves. Proper reserves for depreciation, obsolescence, depletion, bad debts, contingent losses, amortization, etc., shall be set up. The principle on which such items are determined shall be clearly stated. If a different principle was followed in the balance sheet for the proceeding year, a statement of the change of principle must be made.

(f) Secret Reserves. No corporation shall create secret reserves by undervaluing assets or over valuing liabilities, and it shall be the duty of auditors to include in their reports any cases in which it appears to them that such reserves have been created.

Comment: Existing laws make no attempt to deal with secret reserves. Palmer is of the opinion that under the English Act an auditor who is aware of a secret reserve may not report that the balance sheet exhibits a "true and correct view". (Company Law, 13th ed., p. 242). But of. Newton v. Birmingham Small Arms Co. (1906), 2 Ch. 378, where a different view was expressed under the 1906 Act. The suggested provision may work out in practice as nothing more than a pious wish. The problem is one which must be met, and it is suggested that the Committee give particular attention to this point.

(g) Organization Expenses shall be separately listed and carried on the balance sheet until written off. They may not be listed as assets.

Comment: With regard to the writing off of organization expenses, see the section on "Dividends".

7. Profit and Loss Statement. This shall give a clear picture of the operations of the corporation during the past year. Recurring and non-recurring items of income should be clearly distinguished.

8. Quarterly Statements of Earnings. Every corporation shall submit to the Corporation Commission a quarterly statement of earnings, unless the Commission shall determine that the nature of the business does not permit of the making of such a statement.

9. Statement Regarding Directors. The annual statement shall contain a report on the directors setting forth the following:

   (a) The amount of compensation paid to every director in any form, including dividends on stock holdings, and the amount of compensation paid to any officer or employee receiving more than $85,000 per year.

   (b) All loans secured or unsecured made to a director or to a corporation in which a director of the reporting corporation is also a director or which he controls through stock ownership or otherwise, including the terms of such loans and the rate of interest. If any such loans were made and repaid during the accounting period they shall also be set forth.

   (c) The existence and extent of any interest of a director in contracts made by the corporation.

   (d) A detailed list of all purchases and sales of the corporation's stock or of the stock of a subsidiary or parent corporation made by, or for the account of, directors during the year, including the purchase or sales prices and the amount of margins if any.

10. Register of Shareholders. Within one year after commencement of business as a federal corporation, every such corporation shall file with the Corporation Commission a list of all persons entered on the books of the corporation as owners of shares. The list must state the names and addresses of the shareholders, and the number of shares held by each. If a shareholder is a director, officer or employee of the corporation or of a subsidiary or

affiliated corporation as defined in this law, an indication of the position held by the shareholder must be made. At least once in every year thereafter, the corporation shall file with the Commission a list of changes in the shareholders' list, specifying new shareholders, persons who have ceased to become shareholders, and acquisitions or disposals of shares.

Comment: This is an adaptation of Sec. 102 of the English Act. The latter provides for an annual return listing all shareholders and changes in ownership of shares during the year. This would be an impossible requirement for corporations with great numbers of shareholders. It is therefore provided that each corporation shall file, at the beginning, a complete list of shareholders and shall then file an annual list of changes.

11. Holding Company Accounting is considered separately under "Holding Companies".

12. Criminal Penalties. Failure to prepare the required statements and willful misstatements or omissions should be punished by appropriate penalties.

X.

AUDITORS

1. Appointment of Auditors. Every corporation shall elect one or more auditors at its annual meeting. The first board of directors may appoint auditors to serve until the first stockholders' meeting is held. If a corporation fails to elect auditors, the Corporation Commission shall appoint an auditor at the request of any stockholder.

2. Compensation. The compensation of auditors shall be fixed by the annual meeting. In the case of auditors appointed by the Corporation Commission, the Commission shall fix reasonable compensation to be paid by the Corporation.

3. Qualifications of Auditors. No person may be elected or appointed an auditor who:

   (a) is a director, officer or employee of the corporation;

   (b) is related to or employed by a director or officer or is employed by another corporation in which a director or officer is also a director or officer or which he controls by stock ownership or otherwise.

   (c) has not been admitted to practice as a corporate auditor by the Corporation Commission.

   The Corporation Commission may draw up a list of persons qualified to serve as auditors or may be rules and regulations prescribe the general qualifications of auditors.

4. Rights of Auditors. Auditors shall be entitled to access of all corporate records and to require from the directors and officers such information and explanation as may be necessary for the performance of their duties. They shall be entitled to attend any stockholders' meeting at which any accounts examined or reported on by them are to be submitted, and to make any statement or explanation they desire.

5. Duties of Auditors. Auditors shall be required to examine the books and accounts of the corporation and shall prepare a report stating whether:

   (a) The balance sheet and profit and loss statement give a true and accurate view of the corporation's affairs.

   (b) The required statements have been prepared in accordance with the provisions of this law and the rules and regulations of the Corporation Commission.

   (c) The directors and officers have furnished or refused to furnish the information which they requested.

6. Liabilities of Auditors. Auditors shall be liable to the corporation for any damage resulting from their failure to exercise their duties competently and impartially.

7. Removal of Auditors. On the application of the board of directors, or of one-tenth of the stockholders entitled to vote, or of one-tenth of the stockholders of any class, the Corporation Commission may, after hearing, remove any auditor.

   Comment: These provisions are patterned after the English Companies Act with some reliance on the German Law of 1931. Attention should be given to the desirability of limiting the liabilities of auditors to a specific sum. The German law imposes a maximum liability of 100,000 marks.

XI.

INSPECTION

1. Appointment of Inspectors by Commission. On the application of shareholders holding one-tenth of the issued shares the Corporation Commissioners may appoint one or more inspectors to investigate the affairs of a corporation and report thereon in such manner as the Commission shall direct.

2. Requirements of Showing by Applicants. The Commission may require that the application shall be supported by evidence that the request for investigation is based on sufficient cause and is not actuated by malicious motives. The Commission may require the applicants to post security for the costs of the investigation.

3. Powers of Inspectors. Inspectors shall be empowered to examine all the books and accounts of the company or of any of its directors or officers and to take testimony under oath.

4. Appointment of Inspectors by Corporation. By a two-thirds vote, the stockholders of a corporation may appoint inspectors who shall have all the powers of inspectors appointed by the Commission.

Comments: These provisions are copied from the English Companies Act.

5. Inspectors of Records by Shareholder. Every shareholder shall have a right to examine in person or by agent or attorney, for any reasonable purpose, the share register, books or records of account, and records of the proceedings of the shareholders and directors, and make extracts therefrom.

Comment: This is copied from Sec. 35 of the Uniform Act. It is based on the common law rule and the right is dependent on reasonableness of motive and purpose. The suggested provisions for inspection by the Commission and for the annual statements by the corporation make it unnecessary to do more than restate the common law rule.

XII.

VOTING RIGHTS AND SHAREHOLDERS' MEETINGS

A. Voting Rights

1. Common stock. Every paid up share of common stock shall have one vote. Non-voting and plural voting shares cannot be issued. Shares of stock which have been partly paid up may be added together to make up the requisite nominal value (i.e., ten shares of stock on which 10% has been paid may have one vote).

2. Preferred shares. Non-voting preferred shares may be issued, but holders of such shares must be permitted to vote on matters especially affecting their rights. In no case may the non-voting shares of a corporation exceed two-thirds of the issued capital.

> Comment: The issue of non-voting preferred is defended on the ground that preferred shareholders are more ____ to creditors of the corporation then owners. It is submitted, with some difference, that a corporation should be permitted to finance itself through issuing preferred shares without subjecting the management to a loss or dilution of control. It would be advisable for the Committee, however, to consider whether any type of non-voting shares should be permitted.

3. Bonds. It may be desirable to give certain voting rights to bondholders. No recommendations are made here.

4. Voting trusts. The vote may not be separated from the beneficial ownership of the shares. Voting trusts are abolished.

B. PROXIES. The articles or by-laws may provide for voting by proxy. Proxies may be given only for one meeting. Consent to vote must be given specifically for each of the

matters set out in the notice of meeting. No proxy may be made irrevocable. The appearance of a shareholder at a meeting revokes the proxy ipso facto. The payment of a consideration for a proxy should be made a crime. Proxies are not to be permitted for the election of directors.

Comment: The reform of the proxy machinery is one of the most important matters to be considered in a Federal Corporation Law. Two main suggestions are made here: (a) the substitution of absentee for proxy voting in the election of directors (see below); and (b) the various changes in the use of proxies in voting on other matters set forth immediately above. These latter changes do not appear very drastic, but it is believed that they would have an important effect on the present system. It is to be noted that a separate proxy will have to be asked for each meeting. Further that the proxy will not be a blank authorization to vote the stock. There will have to be specific authorization for every matter to be voted upon.

C. ELECTION OF DIRECTORS.

1. Absentee voting. The notice of a meeting at which directors are to be voted upon shall be accompanied by a ballot setting forth the candidates for office. Every shareholder entitled to vote may do so by use of the ballot. A shareholder may cumulate his votes for one director.

2. Counting of ballots. The ballots shall be counted at the meeting called for the election of directors. Counting shall be done by tellers elected ad hoc by the shareholders present at the meeting. Shareholders who do not wish to vote by absentee ballot may record their votes at the meeting.

3. Challenge of election. Shareholders holding 10% of the stock may challenge the legality of the election on the ground of fraud or mistake in counting the ballots, by an application to the Corporation Commission (and/or a court). The latter shall appoint a referee to supervise a recount.

4. Removal of directors. At least 10 days before an extraordinary meeting, 10% of the shareholders may request that notice of a vote on the removal of directors be given to shareholders. Voting on this motion shall be as in the case of election of directors. A two-thirds vote of the shareholders voting shall be required. If the two-thirds vote is not secured, the requesting shareholders shall be liable for the expenses incurred.

D. SHAREHOLDERS' MEETINGS.

1. Annual Meetings. A shareholders' meeting shall be held once in every calendar year and not more than 13 months after the holding of the last preceding annual meeting. If no meeting is called, the Corporation Commission (and/or a court) may call or direct the calling of a meeting on the application of any shareholder.

Comment: This is copied from the English Act, Section 112.

2. Extraordinary meetings. On request of 10% of the shareholders, the directors shall call an extraordinary meeting. If the directors do not comply with the request within one month, the requisitions or any of them holding more than half the capital of the group may themselves call the meeting. The expenses of such a meeting shall be borne by the corporation. But the corporation may apply to the Corporation Commission to assess the expenses of the meeting on the shareholders who convened it, if the meeting was called without sufficient cause.

Comment: This is a modification of Section 114 of the English Act.

3. Notice of meetings. At least three weeks before the annual meeting, the directors shall give notice to shareholders entitled to vote. The notice shall contain specific

indication of each matter to be considered, and no matter may be voted upon which is not so indicated in the notice.

4. Shareholder's right to designated matters. Any shareholder may, by notice in writing to the board of directors at least 10 days before the date of the meeting, require that a particular matter, other than a motion of removal of directors, be put on the agenda.

5. Request for information at meetings. At any meeting, any shareholder may demand information on the affairs of the corporation in regard to a matter under discussion. The directors may refuse to give such information only on the ground that disclosure will be harmful to the essential interests of the corporation or would be contrary to the public welfare. If the information given is insufficient or is refused, 10% of the shareholders present may demand an adjournment of the meeting. Whether or not a motion for adjournment is carried, the shareholder who requested the information may apply to the Corporation Commission for an order to set aside a resolution passed without the rendering of the information requested. In the event of such application, the corporation may request the appointment of a referee by the Corporation Commission to hear evidence as to whether the information was properly withheld. The decision of the referee shall be final and without appeal.

Comment: This is based on the German Draft Law of 1930, Sections 88-90.

XIII.

DIRECTORS

A. Appointment and Tenure.

1. Election. Directors are to be elected annually by the stockholders' meeting. The Articles of Incorporation may designate the first board of directors who are to serve during the first two years.

Comment: The election machinery is discussed under Voting Rights.

2. Removal. Directors are to be removable at any time by a vote of two-thirds of the stockholders.

Comment: Quere as to whether the Corporation Commission should be given power to remove directors in certain cases.

3. Qualifying Shares. The articles of incorporation shall state the number of shares which each director must hold in order to qualify. No director may take office until the qualifying shares have been paid up in cash. These shares shall be stamped non-transferable and shall be placed in the corporation's treasury as security for the satisfaction of liabilities incurred by directors. If it should be provided by this law that representatives of the employees are to sit on the board of directors, this provision should not apply to such representatives.

Comment: This is based on the French Law of 1869, Art. 26.

B. Compensation.

1. Salaries. All directors are to receive salaries to be fixed annually by the stockholders' meeting.

2. Profit-Sharing. By a vote of two-thirds of the stockholders, the directors may be given a share of the profits. The directors may receive such shares only after a stipulated percentage (say 5%) has been deducted from the net profits for the payment of dividends. In no case may such payments out of profits be made to any director who does not participate actively in the management of the business. The share of any director may not be more than twice his annual salary. The total sum granted to the directors under this provision may not exceed 5% of the net profits.

3. Stock Sales to Directors. A corporation is not to be permitted to sell stock to a director at a price below the market price or the price at which stock is offered to the public. A director is not to be permitted to participate in any employees' participation scheme.

4. Publicity for Compensation. The annual reports of the corporation shall set forth in detail the amount of compensation paid to the directors in any form, including dividends on stock holdings, and the amount of compensation paid to any officer or employee receiving more than $25,000 per annum.

Comment: The committee on the revision of the English Companies Act considered at some length the question of disclosure of compensation paid to directors. The Committee stated in its Report that:
"the disclosure of remuneration paid to e.g. managing directors, might be harmful to the company, since cases not infrequently occur of attempts by competitors to induce a managing director to change his employment by offers of higher remuneration, and this practice would no doubt tend to increase if companies were compelled to disclose as a matter of course the remuneration which they pay."
Accordingly the Companies Act provides (Sec. 148) that upon the demand of one-fourth of the stockholders, the directors must disclose the aggregate amount received as compensation by the directors during the last three years,

but the amount received by any individual need not be specified.

The 1931 Amendments to the German Commercial Code provide that the annual report of the Corporation must set forth: "The total compensations of the members of the management and those of the members of the directorate (salary, compensations consisting of a participation in the annual profits, representation expenses, commissions and other compensation of any kind).

The provision suggested here goes beyond the English Act. In view of the similar provision for disclosure in the Federal Securities Act (Schedule A, No. 14), it is submitted that such a provision should be included in the Corporation Law.

C. Loans to Directors.

1. Prohibition of Loans to Directors. No corporation shall make any loan, secured or unsecured, to any director.

2. Publicity for Loans to Corporations Controlled by Directors. The annual report of the corporation shall list all loans, secured or unsecured, made or credits extended to a corporation in which a director of the creditor corporation is also a director or which he controls through stock ownership or otherwise. The terms of the loans and the rate of interest must be set forth.

Alternative Provisions:

1. Authorization of Loans to Directors. No corporation may make any loan for a term exceeding ninety days to a director or to a corporation in which one of its directors is also a director or which he controls through stock ownership or otherwise, without securing the assent of two-thirds of the stockholders.

2. Publicity. Similar to No. 2 above.

D. Duty of Directors.

1. Duty to Corporation. Directors shall stand in a fiduciary relation to the corporation and shall discharge their duties in good faith and with that diligence, care and skill which ordinarily prudent men would exercise under like circumstances.

Comment: This provision follows the Uniform Business Corporations Act.

2. Duty to Stockholders. Directors shall stand in a fiduciary relation to stockholders.

3. Disclosure of Interest. Where a director has an interest, direct or indirect, in any contract about to be made by the corporation, or if he should acquire a direct or indirect interest in a subsisting contract, he shall disclose such interest, in writing, to the board of directors. If, notwithstanding such disclosure, the board of directors concludes the contract, the existence and extent of such interest shall be disclosed in the next report of the corporation.

Comment: The provision regarding disclosure to the board of directors follows many existing corporation laws in particular §149 of the English Act. The provision regarding disclosure in the corporation's report is new.

4. Disclosure of Transactions in Securities. A director, manager or officer who buys or sells securities of the corporation, or for whose account securities are bought or sold, shall be required to report each such transaction to the board of directors within six days after any transaction. He shall state the purchase or sale price and the amount of margin, if any. The annual report of the corporation shall list in detail all purchases and sales by or for directors, managers and officers during the past year.

E. Liabilities of Directors.

1. General liabilities to corporations. The directors shall be jointly and severally liable to the corporation for a failure to carry out their duties in good faith, and with that diligence, care and skill which ordinarily prudent men would exercise under like circumstances.

2. Specific liabilities to corporation. In particular, the directors shall be jointly and severally liable where, contrary to the provisions of this law, the following acts are undertaken:

(a) Contributions made by stockholders are repaid.

(b) Provisions regarding the acquisition by the corporation of its own stock are violated

(c) Shares are issued before being fully paid up.

(d) Dividends are paid out of capital as defined in this Law.

(e) Payments are made after the corporation has become insolvent, provided such action is irreconcilable with careful business judgment.

(f) A loss has resulted to the corporation in consequence of failure to disclose an interest of a director in a contract.

3. Liabilities to Creditors. Directors shall be liable to creditors of the corporation for any action resulting in loss to the corporation which is mentioned in No. 2 above, provided satisfaction cannot be secured from the corporation.

4. Liabilities to Stockholders. A director who purchases stock from or sells stock to a stockholder while in a position to profit from this purchase or sale as a result of information known to him by reason of his position as a director, without disclosing such information, shall be liable to the stockholder for the amount of profit made by him

through such purchase or sale unless the disclosure of such information would be injurious to the interests of the corporation.

Comment: This provision attempts to state a principle long urged by Professor Berle. The difficulty with requiring disclosure in such a situation is that disclosure where purchases are made on an exchange would have to be public and might often result in injuring the corporation. For this reason the bracketed clause is added. Unfortunately that clause might render the provision nugatory since it would always be a question of fact whether or not it was proper to withhold the information. If the bracketed clause were omitted, the effect of the provision would undoubtedly be to discourage directors from dealing in the corporation's shares, which would probably be the result we desire to achieve.

5. Enforcement by Stockholder of Liability to Corporation. Any stockholder may sue on behalf of the corporation to enforce a liability of the corporation against a director, provided the demand has been made on the board of directors and the latter has indicated its refusal to bring suit.

6. Release from Liability. Any provision contained in the articles or by-laws of a corporation or in any contract with a corporation or otherwise, for exempting any director, manager or officer from, or indemnifying him against, any liability which by virtue of any rule of law would otherwise attach to him in respect of any negligence, default, breach of duty, or breach of trust of which he may be guilty in relation to the corporation, shall be void. But a corporation should be permitted to indemnify such persons against liability incurred in defending proceedings in which they are acquitted or in which judgment is given in their favor.

Comment: This is based on Sec. 152 of the English Act.

XIV.

DOMINANT SHAREHOLDERS

1. Definition of Dominant Shareholders. A dominant shareholder or shareholders are defined as any shareholder or group of shareholders who, by reason of ownership of shares or otherwise, are in a position to exercise a controlling influence over the acts of directors or over the affairs of the corporation.

2. General Duties of Dominant Shareholders. Dominant shareholders shall be held to stand in a fiduciary relation to the corporation and to the remaining shareholders.

3. Liabilities of Dominant Shareholders for Acts of Directors. Where dominant shareholders induce or direct the directors of a corporation to commit acts which would render the directors liable to pay damages to the corporation, then such shareholders shall be jointly and severally liable with the directors.

4. Disclosure of Interests in Contracts. Where a corporation makes a contract in which dominant shareholders have an interest, it shall be the duty of such shareholders to disclose the existence and extent of their interest in the contract to the board of directors. Failure to disclose shall subject the shareholders to liability to the corporation for their proportion of the profit resulting from the contract at the expense of the corporation. The existence and extent of such interests when disclosed must be noted in the annual report regarding directors as in the case of directors. Where the directors are aware of such interest of dominate shareholders they shall be required to include it in the annual report even if the shareholders have failed to make disclosures.

5. Liabilities of Dominant Shareholders to Other Shareholders. A dominant shareholder who purchases from or sells shares to another shareholder while in a position to profit from this purchase or sale as a result of information known to him by reason of his dominant position, without disclosing such information, shall be liable to the shareholder for the amount of profit made by him through such purchase or sale, unless the disclosure of such information would be injurious to the interests of the corporation.

6. Power of Commission to Require Disclosure of Dealings in Securities. On the application of holders of five per cent of the shares of a corporation, the Corporation Commission may order a dominant shareholder to file a list of all purchases or sales of securities of the corporation or of a subsidiary or parent corporation made by him or for his accounts during a specified period.

Comment: This section deals only with the position of "dominant" shareholders. It does not attempt to go into the more delicate problems of "control". The author of this memorandum earnestly desires an expression of the views of the Committee as to the possibility of defining and dealing with "control" before making any suggestions with regard to it.

XV.

HOLDING COMPANIES

A. Prohibition of Holding Companies. No federal corporation (with appropriate exceptions for banks, insurance companies and investment trusts) may own stock in a corporation incorporated under the laws of the United States or of any State or territory thereof. Nor may it own any participation in any joint stock company, unincorporated association or business trust created under the laws of the United States or of a state or territory. No state corporation may own stock in a federal corporation.

Comment: It is submitted that the best way to deal with the holding company is to abolish it. The one advantage of the holding company from a social point of view is that it aide decentralization of management. But the same result can be achieved by establishing divisions or branches of a single corporation. Whatever psychological advantages for decentralization may exist in the subsidiary device, these advantages are more than counterbalanced by the enormous possibilities of abuse. It will be noted that a federal corporation is not prohibited under this provision from holding stock in a corporation of a foreign country. This exception is necessary in order to meet the situation where the laws of other countries require reincorporation.

If the committee believes that the abolition of the holding company is undesirable or impracticable, the following alternative provisions are suggested. Even if holding companies are abolished the following provisions will be necessary in order to regulate existing holding companies during the transition period.

B. Alternative Regulatory Provisions.

1. Federal Holding Companies.

(a) Definition of Holding Company. For the purposes of this section a holding company is a federal corporation which holds, directly or through a nominee, more than 50% of the voting shares of another corporation

whether federal, state or foreign, or which has power, directly or indirectly, to appoint the majority of the directors of that other corporation.

(b) Balance Sheets of Holding Companies. The balance of a holding company shall set out in detail the shares of subsidiary corporations which it owns, indebtedness due from and indebtedness due to subsidiary companies. There shall be annexed to the balance sheet of the holding company a statement showing how the profits and losses of the subsidiary companies have been dealt with in, or for the purposes of, the accounts of the holding company and in particular how and to what extent provision has been made for the losses of a subsidiary company, either in the accounts of that company or of the holding company, or of both, and losses of a subsidiary company have been taken into account by the directors of the holding company as disclosed in its accounts. The Corporation Commission may prescribe by rules and regulations the form in which accounts of holding companies shall be submitted and may require a consolidated balance sheet or such other form of statement of accounts as it may deem suitable.

Comment: These provisions deal with the simpler cases of holding companies, those involving legal control. The provisions regarding accounting are modeled on Sections 125 and 126 of the English Act and the definition of holding company from Section 127 of that Act. The suggested provisions go further than the English Law in giving the Corporation Commission power to enforce uniform accounting.

2. Corporations Affiliated with Federal Corporations.

(a) Definition of Affiliated Corporations. For the purposes of this section an affiliated corporation shall include:

i. Every corporation whether federal, state, or foreign, owning or holding, directly or indirectly, 10% or more of the voting shares of a federal corporation and every corporation 10% or more of whose voting shares are held by a federal corporation.

ii. Every corporation in any chain of successive ownership of 10% or more voting shares of a federal corporation.

iii. Every corporation 10% or more whose voting shares are owned by any person or corporation owning 10% or more of the voting shares of a federal corporation, or by any person or corporation in any such chain of successive ownership of 10% or more of the voting shares of a federal corporation.

iv. Every corporation which has one or more officers or one or more directors in common with a federal corporation.

v. Every corporation which the Corporation Commission may determine as a matter of fact, after investigation and hearing, is actually exercising any substantial influence over the policies and actions of a federal corporation, even though such influence is not based upon stockholders or directors or officers to the extent specified in this definition and every corporation influenced in a like manner by a federal corporation.

vi. Every corporation which the Corporation Commission may determine as a matter of fact, after investigation and hearing, is actually exercising any substantial influence over the policies and actions of a federal corporation in conjunction with one or more corporations with which they are related by ownership or by action in concert, that together they are affiliated with such federal corporation within the meaning of this definition, even though no one of them alone is so affiliated.

Comment: This definition is modeled on the recommendations of the New York Commission on the Revision of the Public Service Commissions Law (Report 1930, Volume 1, Page 26). The corporations reached by this definition are those in a holding company set-up built on factual, rather than legal, control. In such a set-up it is difficult and often impossible to lay down a uniform rule regarding the form of accounts. It is believed, therefore, that such affiliated companies should be subjected to the type of regulation set forth subsequently.

(b) Disclosure by Affiliated Corporations. Upon the application of any stockholder in a federal corporation or, where the public interest requires it, upon its own motion the Commission may order a state or foreign corporation affiliated with a federal corporation to file with the Commission a balance sheet, profit and loss statement, and any other statement required by this law for federal corporations, and may order affiliated corporation to submit to the provisions of this law regarding the audit and inspection as if it were a federal corporation.

Comment: This provision is designed to force the disclosure of the affairs of state corporations which are affiliated with federal corporations. It is perhaps not a very satisfactory provision since it might involve an enormous amount of work for the Commission and some doubts

might be raised as to its constitutionality. However, it is believed that without some such provision no effective control can be exercised over holding companies. If this provision seems cumbersome, it can only be said that its inconveniences are some of the penalties one must pay for retaining the holding company in any form.