outset. At no time was existing capital withdrawn and converted into debt.

Moreover, it is not disputed that Richmond was not at all active in the operation of the enterprise. Before the legitimate claim of an officer, director, or shareholder of a bankrupt corporation may be subordinated to the claims of other creditors, not only must that person have the ability and intent to control the corporation, but he must in fact exercise that control to the detriment of other creditors. The record is devoid of any evidence whatsoever that Richmond exercised such control.

In our view, mere undercapitalization, standing alone, is not enough to justify the subordination of the legitimate claims of officers, directors, and shareholders of a bankrupt corporation to those of other creditors. We acknowledge that a claim may be subordinated even in the absence of fraud or mismanagement, * * * Nevertheless, a Bankruptcy Court is a court of equity, and subordination requires some showing of suspicious, inequitable conduct beyond mere initial undercapitalization of the enterprise. * * *

B. AUTHORIZATION AND ISSUANCE OF EQUITY SECURITIES

First some terminology: "*Authorized*" shares are those shares of stock created by an appropriate clause in the articles of incorporation. Until shares are first sold to stockholders, they are "*authorized but unissued.*" When sold, they are "*authorized and issued*" or "*authorized and outstanding.*" If they are repurchased by the corporation, they become "*authorized and issued, but not outstanding.*" Shares that are authorized and issued, but not outstanding are commonly referred to as "*treasury shares*" (a term not used in the RMBCA but used in other statutes).

Corporation statutes do not dictate how many or what kind of shares are authorized; the statutes do require that the articles of incorporation include the number of shares that a corporation is authorized to issue and describe certain characteristics of those shares. RMBCA §§ 2.02(a)(2), (b)(2)(iv); DGCL § 102(a)(4). *See also* Article Four of the Model Articles of Incorporation in Adams & Matheson, CORPORATIONS AND OTHER BUSINESS ASSOCIATIONS: STATUTES, RULES AND FORMS.

If a corporation issues all the shares authorized in its articles of incorporation, it must amend the articles to authorize additional shares before it can issue more stock. An amendment must be recommended by the board of directors and approved by holders of at least a majority of its outstanding stock. (RMBCA § 10.03; DGCL § 242.) Recall that in the Chesapeake Marine Services Problem in Chapter 3, the corporation had sold all of its authorized stock and could not itself sell any more because a minority shareholder held sufficient stock to veto any amendment to the articles of incorporation.

1. THE SIGNIFICANCE OF AUTHORIZING STOCK

Should the organizers of a corporation authorize more shares than they initially plan to issue? The corporation may want to issue additional shares at a later date to raise new money, to use for employee benefit plans, or to acquire other companies. As a practical matter, it may seem tempting to authorize a large number of shares at first so the corporation can issue additional shares in the future without the bother of amending the articles.

However, when deciding how many shares to authorize, one should consider more than questions of convenience. A corporation's board of directors normally has sole power to decide whether additional shares should be issued. Consequently, if a corporation's original shareholders "authorize" more shares than they initially plan to purchase, they also delegate to the board of directors authority to decide if and when additional shares should be issued.

In a close corporation where there is often a substantial overlap between shareholders and directors, the decision on how much stock to authorize requires some thought. Shareholders may wish to retain control over the issuance of new shares by limiting the original authorization to the number of shares contemplated to be issued immediately. The issuance of any new shares will then require an amendment of the articles and thus a shareholder vote. Recall that it was just such a requirement that gave Apple the power to veto an increase in the authorized capital of Chesapeake Marine Services. Such a limitation can protect minority shareholders and will preserve existing control relationships. *See* Chapter 13.

In large corporations, however, shareholders have relatively little influence over day-to-day management, and yielding the power to issue common stock may not constitute the surrender of much real power. Convenience usually decides the question in favor of an initial authorization of a large number of shares. Shareholders do retain some power over the issuance of additional shares of common stock if the corporation is incorporated in a state whose laws require shareholder approval for the issuance of a large number of shares, *see, e.g.*, 15 Ohio Rev.Code Ann. § 1701.83(A), or is listed on the New York Stock Exchange, whose rules require listed companies to obtain shareholder approval before they increase outstanding stock by more than 18.5%. *See* N.Y.S.E. COMPANY MANUAL, § 312.00.

Note: Blank Check Preferred Stock and Poison Pills

Recall "blank check preferred" stock described in Section A.2.b. Such stock was often used as consideration in corporate mergers. As you will see in other chapters, in the mid–1980s, however, corporations developed "*poison pill*" plans which constituted relatively powerful defenses against uninvited takeover bids. Many such plans were based on the availability of authorized but unissued blank check preferred. A corporation's board of directors would create a new class of preferred stock with unusual features, such as a right to require the corporation to redeem the preferred at a price equal to twice its fair market value. Then the corporation would distribute to its shareholders "rights" to purchase shares of the newly-created preferred, usually by exchanging their shares of common stock for the preferred. Shareholders could exercise the rights only if some triggering event occurred, such as the announcement of an uninvited takeover bid. Until such an event occurred, the corporation would have the option of redeeming the rights for a nominal payment, usually no more than $0.05 per share. But while the rights remained outstanding, they were a powerful deterrent to uninvited takeover bids because, combined with the newly-created preferred stock, they had the potential to make a takeover prohibitively expensive.

In *Moran v. Household International, Inc.*, 500 A.2d 1346 (Del.1985), the court held that nothing in the Delaware statute made adoption of a poison pill plan unlawful and that a decision to adopt such a plan would be reviewed under the enhanced business judgment rule applicable to defensive tactics in tender offers. *See* Chapter 22. After *Moran*, many state legislatures explicitly authorized the creation of poison pill plans. Consequently, shareholders in publicly-held corporations must think twice before approving proposals to authorize blank check preferred because of the varied uses to which it can be put.

2. PREEMPTIVE RIGHTS AND OTHER DUTIES IN THE ISSUANCE OF SHARES

The precise number of shares that a shareholder owns in a corporation at a particular time determines her position relative to other stockholders. What is important, however, is not the absolute *number* of shares the stockholder owns, but the *percentage* of the corporation's outstanding stock those shares represent. Consider two corporations that are otherwise identical, except that A has 200 shares of common stock outstanding and B has 1,000 shares outstanding. Fifty shares of A, representing 25% of its outstanding stock, clearly have greater proportionate voting power than 50 shares of B, representing 5% of its outstanding stock.

A shareholder may be concerned that if additional shares are sold to other investors, her interest in the corporation will be diminished or "diluted." This concern will be valid if the shareholder is interested primarily in maintaining her proportionate ownership interest because, for example, it allows her to exercise a degree of control. (Again, recall Chesapeake Marine Services.) We will refer to this as a concern about "equity dilution."

A shareholder also may be concerned about "economic dilution"—the possibility that sales of additional shares will reduce the value of the shares she holds. This concern is most salient in two situations. First, other shareholders, particularly if they control the board of directors, may arrange to purchase additional shares at less than fair market value and thus appropriate to themselves a portion of the value of the corporation's assets. Second, the board of directors may sell shares to unrelated persons at prices that the board believes to be fair, but that the non-controlling shareholders believe is too low.

On the other hand, if a corporation sells additional shares at a price that reflects their fair market value, and if the corporation uses the funds received for those shares to produce income at a rate at least equal to the return it is generating on its existing capital, shareholders' economic interests will not be diluted. For example, if a company with 1000 shares of common stock issued and outstanding has a fair market value of $10,000, then the fair market value of each share will be $10. The sale of 500 additional shares at $10 per share will not dilute the economic value of existing shareholders' stock, if the fair market value of *all* the shares, after investing the additional $5,000, is at least $10 per share. If, however, the company sold new shares for less than $10, or if the company's fair value was more than $10,000, there would be economic dilution.

The common law doctrine of "*preemptive rights*" addressed concerns about equity dilution. Courts held a shareholder had an inherent right to maintain her interest in a corporation by purchasing a proportionate share of any new stock issued for cash; i.e., a shareholder who owned 100 shares in a corporation with 1,000 shares issued and outstanding would be entitled to purchase 10% of any new issue of stock by that corporation. *See Stokes v. Continental Trust Co.*, 186 N.Y. 285, 78 N.E. 1090 (1906). The doctrine worked reasonably well for corporations with few shareholders and simple capital structures. It became problematic where a corporation had several classes of stock outstanding, or sought to issue stock in exchange for property to be used in its business. Preemptive rights also were of questionable value in publicly-held corporations: a typical public shareholder, owning far less than 1% of the outstanding stock, presumably would care little that a new issue would reduce her proportionate interest in the firm from 0.001% to 0.0009%. Moreover, if she believed the firm was selling new stock at too low a price, she could protect herself by purchasing additional shares on the open market.

Courts and legislatures both addressed the problems posed by preemptive rights. Courts developed several exceptions to the rule that shareholders always were entitled to preemptive rights. Legislatures modified state corporate laws to provide corporations with the option of abolishing preemptive rights.

RMBCA § 6.30 adopts an "opt-in" approach. To provide shareholders with preemptive rights, a corporation must include an appropriate provision in its articles of incorporation. A simple declaration, such as "The corporation elects to have preemptive rights," will do. But absent such a declaration, no preemptive rights exist. RMBCA § 6.30(a). Delaware law no longer explicitly addresses preemptive rights. *See* DGCL § 161. However, DGCL § 157 authorizes a corporation to issue rights to purchase its stock. These could include preemptive rights, and a provision requiring such rights could be included in the articles of incorporation. *See* DGCL § 102(b)(1).

The RMBCA also addresses some of the problems associated with preemptive rights. Unless the articles provide otherwise, no preemptive rights exist with respect to shares issued to compensate executives, shares issued within six months after a company is organized, or shares sold for other than for money. RMBCA § 6.30(b). Similarly, preemptive rights are limited in corporations with multiple classes of stock. *Id.*

Most public corporations have abolished preemptive rights; a shareholder who wishes to maintain her proportionate interest can do so by purchasing additional shares in the market. In a closely held corporation, however, preemptive rights can provide significant protection to minority shareholders. A lawyer organizing a close corporation should consider and discuss with her clients, when preparing the articles of incorporation, whether preemptive rights should be adopted and, if so, what the terms of those rights should be. For an excellent discussion of relevant considerations, *see* F. Hodge O'Neal & Robert B. Thompson, O'NEAL'S CLOSE CORPORATIONS § 3.39 (3d. ed. 1992).

At times, preemptive rights alone are not sufficient to protect minority shareholders' interests. In *Katzowitz v. Sidler*, 24 N.Y.2d 512, 301 N.Y.S.2d 470, 249 N.E.2d 359 (1969), two of the three shareholders in a corporation with preemptive rights hatched a plan to eliminate the third, who was short of funds. Although the corporation's stock was worth $1300 per share, they approved a new issue at par value of $100 a share. The cash-short shareholder, who could not afford to purchase any additional stock, sued to enjoin the offer, claiming that the new issue was designed to dilute his interest. The court granted the requested relief, stating: "The price was not so much a bargain as it was a tactic, conscious or unconscious on the part of the directors, to place Katzowitz in a compromising situation." 249 N.E.2d at 365. *See, also, Bennett v. Breuil Petroleum Corp.*, 34 Del.Ch. 6, 99 A.2d 236 (1953) (holding shareholder with preemptive rights also had "right not to purchase" stock, which was wrongfully impaired by offering at substantially less than stock's fair value); *but see Hyman v. Velsicol Corp.*, 342 Ill.App. 489, 97 N.E.2d 122 (1951) (holding preemptive rights adequately protected minority shareholder's interests and declining to inquire into fairness of stock issue).

Courts also have shown a willingness to intervene, in situations where preemptive rights do not apply, to protect shareholders' proportionate interests in the control of close corporations. In *Schwartz v. Marien*, 37 N.Y.2d 487, 373 N.Y.S.2d 122, 335 N.E.2d 334 (1975), control of the corporation was divided between two family groups, each of which owned 50 shares of stock and had two seats on the board. When one director died, the two directors representing the other (Marien) family elected a third director to fill the vacancy on the board. The board then approved the sale of one share each to the two Marien directors and the new director and two shares to a long-time corporate employee.

Schwartz, the surviving director from the other family, sought to buy five additional shares so as to maintain her family's 50% interest. The board refused.

The court held that directors of a close corporation have a fiduciary duty to protect shareholders' proportionate equity interests when they issue stock, whether or not shareholders have preemptive rights. Shares can be issued in a manner that treats existing shareholders differently only to advance a bona fide business purpose. Moreover, the board has the burden of proving not only that the stock issue was approved "to achieve a bona fide independent business objective, but as well that such objective could not have been accomplished substantially as effectively by other means which would not have disturbed proportionate stock of ownership." 335 N.E.2d at 338.

On the other hand, *Yasik v. Wachtel*, 25 Del.Ch. 247, 17 A.2d 309 (1941), denied cancellation of shares that allegedly had been issued to shift control of a close corporation. There, however, the complaining shareholder could not alone exercise control and had never combined with others to exercise control.

For discussion of similar issues, as they relate to contests for control of public corporations, see Chapter 22.

C. REGULATION OF LEGAL CAPITAL

As we have seen, a creditor's claims against a corporation's income and assets have priority over the claims of equity securityholders. This priority is valuable, however, only if (1) the debtor corporation has received all amounts it claims to have been paid for its equity securities, and (2) the corporation is barred from jeopardizing the creditor's interests by distributing to its equity securityholders, in the form of dividends or otherwise, assets that it needs to satisfy the creditor's claims. Creditors, not surprisingly, usually seek to protect their interests by contract. But state corporation laws also provide some protection for creditors by regulating *legal capital*—the terms and conditions on which a corporation is permitted to sell stock and pay dividends.

In fact, protecting creditors was a major preoccupation of corporate law during the 19th century and most of the 20th century. However, by the 1970s, if not earlier, it became clear that the legal capital rules no longer protected creditors and probably never had. Bayless Manning's Legal Capital played a leading role in debunking these rules. California was the first state to revise its statute to take account of this new learning. Many others followed, stimulated by the revision of the legal capital provisions of the RMBCA. But in many others, including Delaware, the traditional rules remain in force.

Lawyers need to understand these rules, both the old and the new, for two reasons. First, as a condition of many financing transactions, a corporation's lawyer will be asked to opine that all of a corporation's stock is "validly issued, fully paid and nonassessable." To render such an opinion, a lawyer must review all transactions in which the corporation issued stock and to see whether they were effectuated in compliance with the governing statutory provisions.

Second, most corporation statutes explicitly provide that directors can be held liable if they approve issuance of stock or distribution of a dividend in violation of applicable statutory standards. These provisions heighten directors' concerns about their personal liability, and often lead them to seek advice of counsel in connection with decisions that might otherwise seem to involve no more than garden variety business judgments. Indeed, today the principal purpose of the legal capital rules is to provide a benchmark for the propriety of the declaration of dividends.

PROBLEM

PRECISION TOOLS—PART VI

Recall that Michael, Jessica and Bernie have agreed to pay a total of $500,000 for the common stock of PTC. They also have agreed that PTC initially will issue 5,000 shares of common stock. Jessica will pay $200,000 in cash for 2,000 shares (*i.e.*, $100 per share). Michael will pay $100,000 in cash and give PTC a note for $100,000 in exchange for another 2,000 shares. Bernie will pay $100,000 in cash for the remaining 1,000 shares. Bernie also will invest an additional $500,000 in 20-year subordinated notes.

1. Prepare a balance sheet for PTC that reflects its financial position after Bernie, Jessica and Michael make their investments and the bank completes its loan to PTC. Then prepare a balance sheet that reflects PTC's financial position after it completes the acquisition of PT's business for $2 million.

2. Prepare answers to the following questions on the assumption that PTC is organized under Delaware law. *See* DGCL §§ 102(a)(4), 152–154.

a. Is it necessary for PTC to set a par value for its common stock?

b. What would be the consequence of setting the par value of PTC's stock at $100 per share—the price for which the stock will be sold—or at some lower value, such as $1 per share? Does the statute limit PTC's choice? How would PTC reflect the transaction on its balance sheet if it sets the par value at $100 per share? At $1 per share?

c. If PTC decides to issue no par stock, is its board of directors required to take any further action? Would any such action be desirable?

d. Can PTC accept Michael's note as partial payment for the 2,000 shares he will receive? Does your answer depend on whether the par value is $100 per share or $1 per share? Could any problem with the note be remedied by substituting Michael's promise to serve as president of PTC for the next five years?

3. Prepare answers to the following questions on the assumption that PTC is organized under Columbia law. *See* RMBCA §§ 6.21–6.22.

a. Is it necessary for PTC to set a par value for its common stock?

b. How would PTC account on its balance sheet for the proposed sale of stock?

c. Can PTC accept Michael's note as partial payment for some of the 2,000 shares he will receive? Could PTC also issue stock in exchange for Michael's promise to serve as president of PTC for the next five years?

1. A CONCISE HISTORY OF LEGAL CAPITAL AND PAR VALUE

Bayless Manning with James J. Hanks, Jr., LEGAL CAPITAL
(3d ed. 1990) pp. 5–40.

The ideal world as conceived by the creditor of the corporation is a world that is normally wholly unacceptable to the shareholder. The investor who buys shares of stock in the incorporated enterprise and the investor who lends money to the incorporated enterprise, are, as a matter of economics, engaged in the same kind of activity and are motivated by the same basic objectives. They are both making capital investment; they both expect or hope to get their money back in the long run, either by liquidating pay-out or by sale of the security; and they both expect and hope to receive income from their investment in the interim before their capital is returned to them in full. In the stereotypic model transaction, the investor who chose to take a shareholder's position rather than a creditor's position in a particular transaction, simply made a calculated economic judgment that was different from the creditor's. The shareholder estimated that he could make more money by relinquishing to creditor investors a "prior" claim for interest and a fixed principal payment on maturity, and, by opting for uncertain "dividends" and the residual claim to the assets of the enterprise that would remain after all creditors, with their fixed claims, had been paid off. The shareholder is willing to admit the "priority" of the creditor's interest claim and claim for principal payment on maturity. That does *not* imply, however, that the shareholder is willing to stand by chronologically until such time as the creditors have been paid in full. The shareholder will usually insist, that if, as he hopes, the enterprise makes money (and perhaps even if it does not), the shareholders will receive some return on (or of) their investment from time to time, regardless of the fact that there are creditor claims outstanding. Such periodic payments to shareholders are characterized as "dividends;" and, in the usual and normal case of the healthy incorporated enterprise, it is assumed that some assets will be regularly distributed out from the corporate treasury to the shareholder investors in dividend form.

Simple as this observation may be, its implications are far-reaching. If it were the case that all creditors had to be paid off before *any* payment could be made to shareholder investors, and if shareholders received nothing until ultimate liquidation of the enterprise when they would divide the residuum left after payment of all creditors—if, in other words, the terms "prior" and "before" were chronological as well as hierarchical—the creditor would not have to worry about assets being drained away into the hands of junior claimants and he would sleep better at night. But that arrangement would be wholly unacceptable to shareholders. Shareholders insist—and ultimately creditors must concede—that *during the life* of the creditor's claims, assets may be passed out to an investing group that hierarchically ranks below the creditors. The question becomes unavoidable: How much of the assets in the treasury of the incorporated enterprise may be distributed to shareholders, when and under what circumstances?

* * *

The nineteenth century pattern of corporate financing provided a ready suggestion to judges and statutory draftsmen for a way to gauge the quantity of assets that shareholders had, at some time or another, put into the corporate treasury. According to that pattern of corporate practice, an entrepreneurial organizer, the "promoter" who had conceived of an idea for a new business would make the rounds of people who had money to invest ("capitalists" all, whether little grey widows or sturdy yeomen), and seek to persuade them to invest in stock of the proposed enterprise. If the idea had appeal, and if the promoter was persuasive, * * * the subscriber, would, on call of the future board of directors of the corporation when organized, put in a set amount of money, or other assets, and would receive a set number of shares of the newly formed corporation. Given this practice, it was to be expected, and was perhaps inevitable, that in drawing up the subscription agreements for any single enterprise, a fixed mathematical relationship would be set between the amount of dollars to be invested by a subscriber and the number of shares he would receive: so many dollars to be put in for each share issued. That relationship produced the concept of the "par value" of the stock to be issued. In the normal situation, no equity investor could expect to obtain a share of stock for less than the par value of it, since presumably all other purchasers were paying that amount. Similarly, no share subscriber could be persuaded to agree to pay more than the par value for a share since other investors were receiving a similar share by paying in the par value. * * *

* * * In time, the par value of the stock was required by statute to be stated as a provision in the corporate charter.

The essentially arbitrary character of this number must be understood. If, for example, each of three investors agreed to invest \$10,000 in stock of a new company, the number of shares to be issued, N, and the par value \$P, could be anything—could be any number that the promoters might set so long as $N \times \$P = \$30,000$. Further, so far as the shareholders in this case were concerned, it was immaterial what "par" was so long as each one received the same number of shares for his $10,000 investment.

Against this familiar background of practice, however, it was easy for the courts—and legislatures—to take a next assumption, and it early became a matter of common understanding, that the "par value" was what the shareholder *ought* to have paid for his stock. Stock which was issued without a corresponding pay-in of assets valued at an amount equal to par was called "watered stock"—stock issued not against assets but against water. (The term also echoed an ancient sharp practice in another field, the aquatizing of livestock before weighing them in for sale.) * * *

It will be clear to the reader that the development of the "par" concept just described arose as a response to the problems of assuring equitable contribution among shareholders. But development of the shareholder's par payment obligation served, in a somewhat fortuitous and naive way, to further the corporate creditor's interest in seeing shareholder assets committed to the enterprise. One can spin at least a hypothetical argument as to why this should be and how it came to be.

The argument would go in this wise: If a creditor extends credit immediately after the incorporation of the new enterprise and if he has been informed that the par value of the shares is $P and the number of shares that have been issued is N, it is not unreasonable for him to assume that the shareholders have collectively contributed into the corporate treasury an amount of dollars equal to the par value of the shares issued multiplied by the number of shares that were issued, or $PN. In a kind of rough and ready way, assuming that there have been no other transactions, the creditor might infer that the number $PN is an approximation of the total assets of the corporation, and on that basis might conclude that he could safely lend a certain amount of funds to the enterprise.

Did any rational creditor ever in fact act that way or extend credit on such a naive basis? The answer has to be "no." But * * * in time, this much became clear:

(1) The courts came to recognize that purchasers of shares from the corporation have some obligation to invest in the corporate enterprise;

(2) It came to be understood (perhaps "assumed" is a better word) that the measure of the investment liability of such a shareholder was the number of shares issued to him times the par value of the shares; and

(3) It came to be recognized that at least some creditors could in at least some circumstances enforce this obligation of the purchasing shareholder in some way. * * *

In the nineteenth century pattern of corporate financing, it was simply assumed that good companies—respectable companies—solid investments—would have stock with a high par value. * * * Nonetheless, eventually the practical argument prevailed and the invariable practice of using high par value common stock gradually gave way to the use of low par common stock. * * *

* * * [T]he separation of par and purchase price has the effect of opening a chasm between the lawyer's perspective and economist's concept of the entrepreneur's capital investment. If there are ten subscribers in a newly incorporated enterprise each of whom buys 10 shares of stock at a price of $50 per share, the economist, or the businessman would say that the company's beginning "capital" is $5,000. But the lawyer (and later the accountant) will tell the economist or the businessman that the "capital" is determined by par, and in this case is the number of issued shares, 100, multiplied by the par value of each share, $10, for a total of $1,000; the other $4,000 is something else about which we will hear more later. With the evolution of low par stock, came the evolution of that strange lawyer's convention * * *—"legal capital"—the $1,000 in the example just given. * * *

It was not until 1912 that analysis of the matter had reached a sufficiently wide circle to produce statutory authorization of no par stock. The advent of no par stock did not, however, have the effect of eliminating the concept of legal capital. It was, and still is, statutorily necessary to designate some dollar number on the corporate balance sheet as "capital." * * * The responsibility for making that statement, and the power to make it, is placed by corporation statutes with the board of directors, and the dollar number declared by them made in the customary form of a board resolution, is the "stated capital" of the corporation. * * *

What does the law do to prevent shareholders of a distressed company from pulling assets out of the corporate treasury just when the creditor needs them? * * *

Two basic propositions slowly emerged: (1) The measuring rod for judging the propriety or impropriety of the distributions to equity holders is the corporation's "capital"; and (2) "capital" refers not to assets but to that abstract number that is obtained by multiplying the number of shares of stock outstanding by the par value assigned to each share. * * *

The general idea of the legal capital scheme is that no distribution may be made to shareholders unless, after the distribution, the corporation has not only enough assets to pay its creditors but also an additional specified amount. This amount is called "stated capital". Anything over the sum of stated capital and liabilities is known as "surplus." * * *

The following statements may now be made about "legal capital."

a. Legal capital is a number expressed in dollars.

b. That number is initially the product of par value—itself an arbitrary dollar amount printed on the stock certificate and recited in the certificate of incorporation—multiplied by the number of shares "outstanding."

c. Legal capital is a number that appears on the *right-hand,* or claimant's side of the balance sheet, *not* on the left-hand asset side. "Legal capital" is *not* an asset, a fund, or a collection of assets. And it does not refer to an asset, a fund, or a collection of assets. (The same is true of "surplus.")

d. Legal capital is a number that implies that a valuation of at least that amount was placed upon some indeterminate assets that were transferred to the corporation at some indeterminate past time in exchange for shares then issued. Legal capital can at best be read to convey a message by implication—a message about a historical event.

Legal capital is entirely a legal invention, highly particularized in its meaning, historical in reference, *and not relatable in any way to the ongoing economic condition of the enterprise.* For most purposes, it is best thought of simply as a dollar number—a number having certain consequences and derived by specified statutory procedures, but just a number.

The law makes use of the concept of "legal capital" in two ways:

a. It is the maximum number of dollars up to which someone might in certain circumstances be able sometime to hold some shareholders liable if the implied statement in [a-d] above could be proved to be false.

b. It is a datum line, or water table, or bench mark, or nock on a measuring stick laid alongside the total number on the asset side of the balance sheet, on the basis of which lawyers will—or will not—sign an opinion that a proposed distribution of corporate assets to shareholders is valid, legal, and generates no liabilities either for the board of directors that declares it or the shareholders who receive it.

And here is the real bite. In the world of corporate finance, the closure of any significant transaction is utterly dependent upon opinions of legal counsel that are delivered at the closing, stating that the transaction is valid and legally enforceable. Whenever a corporate financial transaction requires the lawyers to inquire into a company's legal capital position, the impact of the statutory schemes of legal capital is enormously magnified by the Go/No-go function performed by opinions of counsel. The lawyers, in turn, are compelled to develop an understanding of the statutory scheme and of its application. From that state of affairs "legal capital" draws its perverse vitality. * * *

2. THE ISSUANCE OF STOCK AND STOCKHOLDERS' LIABILITY

a. *Quantity of Consideration*

Under a regime of legal capital characterized by sales of stock at par, corporation law was much consumed with questions relating to "watered stock." Promoters frequently acquired stock in exchange for property worth less than the par value of the shares they received and then sought to mislead other investors about the value of their contributions. Knowing that capital must be equal to the par value of all shares issued and outstanding, promoters would report the property they contributed as an asset equal in value to the par value of the shares they received. That is, a promoter who contributed land worth $5,000 to a newly-formed corporation in exchange for 100 shares of $100 par value common stock would record the transaction as follows:

Assets		Liabilities and Equity	
Land	$10,000	Capital (100 shares common stock, $100 par value)	$10,000
Total	$10,000	Total	$10,000

Courts, operating on the flawed premise that investors and creditors deal with a corporation on the basis of its stated capital, focused their attention on the right-hand side of the balance sheet and held promoters liable for "watering" the capital account. But "capital," of course, was computed mechanically—by multiplying the number of shares issued and outstanding by the par value of those shares. The real fraud was on the left-hand side of the balance sheet—in the overvaluation of the property contributed by the promoter.

States that retain traditional legal capital rules all have now adopted statutory provisions governing shareholders' liability for watered stock. DGCL § 162 is typical. It provides that shareholders are liable for "the sum necessary to complete the amount of the unpaid balance of the consideration for which shares were issued or are to be issued by the corporation." Interesting interpretative questions relating to this section can be posed, but in practice they virtually never arise. Corporate lawyers avoid the problems associated with watered stock by setting the par value far below the price at which the corporation plans to sell its stock and by monitoring carefully transactions in which stock is issued. The most salient question today often is whether to use low-par or no-par stock. The choice usually depends on the manner in which the relevant jurisdiction calculates the tax or "franchise fee" payable on incorporation. That fee frequently is calculated on the basis of the aggregate authorized capital of the corporation, with no-par stock "deemed" to have some arbitrary par value for this purpose.

Another reason valuation problems rarely arise in this context is that most statutes now provide that the board's judgment as to the value of property exchanged for stock is conclusive, absent fraud, or, as in DGCL § 152, absent "actual fraud." This language suggests that courts should treat as dispositive any good faith determination by a board of directors concerning the value of property. The last important case holding shareholders liable for watered stock was *Bing Crosby Minute Maid Corp. v. Eaton, 46 Cal.2d 484, 297 P.2d 5 (1956).*

b. Quality of Consideration

A question closely related to the quantity of consideration is the quality or type of consideration for which stock may validly be issued. Cash is always acceptable. Services rendered and real or personal property are also permissible because they are either convertible to cash (property) or they have already contributed to the corporation's assets (services).

Under many state statutes (e.g. DGCL § 152), however, an executory contract to render *future* services is invalid consideration. Professor David Herwitz explains:

> The traditional concern about future services as consideration for stock lies chiefly in the fact that such services can prove valuable to a business only as a going concern and are totally devoid of realizable value for creditors or stockholders in the event of a liquidation of the enterprise. While of course other intangible items, notably goodwill, may prove worthless upon the failure of an enterprise, promised future services are subject to the special objection that they have no realizable value from the outset.

David R. Herwitz, *Allocation of Stock Between Services and Capital in the Organization of a Close Corporation*, 75 HARV.L.REV. 1098, 1105–6 (1962).

But a corporation certainly can pay a substantial salary advance to a person with some particular skill to induce her to come to work for the enterprise. And it also can pay her a bonus to acquire her services. If such an advance payment or bonus could be then used by the employee to purchase stock, why not just short-circuit the process and allow the corporation to issue the stock directly in exchange for the promise of future services? *Petrishen v. Westmoreland Finance Corp.*, 394 Pa. 552, 147 A.2d 392 (1959), relied on that analogy to approve stock issued for future services under a traditional statute. *Rooney v. Paul D. Osborne Desk Co., Inc.*, 38 Mass. App. 82, 645 N.E.2d 50 (1995), adopted a more straightforward approach. The court refused to allow a corporation to void an agreement to issue stock for future services where plaintiff had accepted a job with the corporation in reliance on that agreement and issuing the stock did not harm any creditor of the corporation.

Many states also prohibit corporations from accepting promissory notes as consideration for stock, especially unsecured notes signed by a purchaser-shareholder. Suppose the note is secured? Calif.Corp.Code § 409(a)(1) provides that a promissory note "adequately secured by collateral other than the shares acquired * * * "is good consideration for the purchase of shares. Suppose the note is unsecured, but guaranteed? The court in *Eastern Oklahoma Television Co., Inc. v. Ameco, Inc.*, 437 F.2d 138 (10th Cir.1971) held a personal guarantee of an obligation of the corporation was, in part, adequate consideration for the issuance of stock. *See also Citizens Bank of Windsor v. Landers*, 570 S.W.2d 756 (Mo.App.1978).

Whether a note is given for par value, or only the excess of the purchase price over par value, may be critical. In *Shoen v. Shoen*, 167 Ariz. 58, 804 P.2d 787 (App.1990), certain "key employees" of a Nevada corporation were allowed to purchase stock by making cash down payments equal to par value, which was less than 4% of the price for which the shares were issued, and giving the corporation non-recourse notes for the balance. Thus, if the purchasers defaulted, the corporation's only remedy was to return the down payments and recover the stock. Other shareholders sued to have the stock issuance declared unlawful because the corporation could not recover from the key employees "the unpaid balance of the consideration for which the shares were issued." The court rejected this claim, pointing out that the key employees had paid cash equal to the par value of the shares they purchase, the notes were legally enforceable obligations and it was not inconsistent with the Nevada statute (which is virtually identical to Delaware law in this respect) to treat the notes as valid consideration for stock.

c. *Legal Capital Under the Revised Model Act*

The RMBCA jettisons the traditional approach to legal capital. RMBCA § 6.21 abolishes the concepts of "par value" and "stated value," although a corporation may retain par value if it so elects in its articles of incorporation. RMBCA § 2.02. Shares may be issued for such consideration as the board may authorize, at a fixed price, a minimum price, a formula price or any other method of price determination. Business conditions—and not the artificial notion of par value—determine the price for which shares may be issued. According to the Official Comment to RMBCA § 6.21, "there is no minimum price at which specific shares must be issued and therefore there can be no 'watered stock' liability for issuing shares below an arbitrarily fixed price." Clearly, the drafters believed that the old system of legal capital did not protect creditors' interests. What remains unclear is whether any system is needed, whether a fiduciary approach provides greater protection than the outmoded legal capital regime, or whether creditors are better protected through their own ability to contract rather than through a corporate law mechanism.

The issuance of shares still requires valid consideration, but the board of directors no longer needs to translate the consideration into dollars (for corporate law purposes, anyway) nor must it declare the consideration adequate. According to the Official Comment, shareholders' interests are protected by the business judgment of the board of directors rather than by formal statutory and accounting rules.

The RMBCA also abandons traditional restrictions on the quality of consideration. RMBCA § 6.21 permits sale of stock for future services or promissory notes. Again, the statutory scheme relies on the directors' judgment that the values exist. § 6.21(c) makes clear that shares are fully paid and non-assessable after the corporation has received the bargained-for consideration. The Official Comment notes that whether shares are validly issued depends solely on whether proper corporate procedures have been followed.

Of course, in addition to satisfying the requirements of the RMBCA, a corporation ultimately will have to prepare a financial statement. Then, if not before, it will have to place a dollar value on the property paid for stock. If those values are inflated, no liability will result under the RMBCA, but liability may exist under common law fraud or under the federal securities laws. (See Chapters 10 and 19.)

Liability of shareholders for payment of their shares is similar to that under Delaware law, except that there is no requirement that shareholders pay at least par value. RMBCA § 6.22 limits shareholders' liability to "payment of the consideration for which the shares were authorized to be issued or specified in the subscription agreement."

For a good explanation of the Model Act's approach, *see* the Official Comments to RMBCA §§ 6.21 and 6.22, reprinted in Adams & Matheson, CORPORATIONS AND BUSINESS ASSOCIATIONS: STATUTES, RULES AND FORMS.

3. DIVIDENDS AND OTHER DISTRIBUTIONS

PROBLEM

PRECISION TOOLS—PART VII

After three years of operations, the relevant entries on PTC's balance sheet, prior to the payment of any dividend, are as follows:

Assets		**Liabilities and Equity**	
Cash	$ 200,000	Current Liabilities	2,650,000
Other Current Assets	3,135,000	Long-Term Liabilities	3,750,000
Total Current Assets	3,335,000	Total Liabilities	6,400,000
Net Fixed Assets	3,481,750	Common Stock (5,000 shares authorized and outstanding	500,000
Good Will	83,250		
Note Receivable	100,000	Retained Earnings	100,000
		Total Equity	600,000
Total Assets	7,000,000	Total Liabilities and Equity	7,000,000

PTC earned net profits of $90,000 in its most recent year.

How would you answer the following questions under each of the following assumptions:

(a) PTC is organized under Delaware law and its common stock is $100 par value;

(b) PTC is organized under Delaware law and its common stock is $1 par value; and

(c) PTC is organized under Columbia law.

See DGCL §§ 160, 170, 172–174, 242(a)(3), 244; RMBCA §§ 6.31, 6.40 and Official Comment to § 6.40.

1. Can PTC pay a dividend of $200,000 to its shareholders at this time? What steps, if any, could it take to make lawful any dividend that otherwise would be unlawful?

2. A dispute has arisen between Bernie and the other shareholders over the continued employment of Bill Gould. The parties have decided to resolve their differences by having the company repurchase Bernie's 1,000 shares for $500,000. Assuming that the corporation can borrow sufficient money on a long term basis to finance the purchases, can it buy the stock?

3. Assume the balance sheet shown above is for a date five years after the organization of PTC and that PTC has paid no dividends and has never repurchased any of its stock. Michael, Jessica and Bernie continue to own their stock, but Michael and Jessica actually control PTC. Michael and Jessica are paid substantial salaries; Bernie receives no salary. Michael and Jessica would like to accumulate income in PTC with a view to buying the business of one of PTC's major customers. Bernie wants PTC to pay some dividend. Is it likely that Bernie would succeed in a suit to compel payment of a dividend?

a. the Rationale for Regulating Dividends

Investors purchase a corporation's stock in the hope that they will realize gains in the form of dividends received while they hold that stock, capital appreciation when they sell it, or some combination of the two. For various reasons shareholders may be willing, or even eager, to forego dividends and realize most of their gain in the form of capital appreciation, particularly in closely-held corporations where shareholders are employees and can take out profits in the form of salaries and other compensation. In the case of publicly-held corporations, however, many investors are reluctant to rely entirely on capital gains; changes in the fortunes of a particular company, in business conditions generally, and the tenor of the stock market make such reliance too risky. Moreover, many investors, depend on dividends from their investments for current income, and try to invest in companies with stable businesses, such as public utilities, that pay regular and substantial dividends.

When a corporation seeks to raise capital by selling stock, it must compete with alternative uses of prospective investors' funds—including consumption, the purchase of gold bars, savings accounts, money market funds, government debt obligations, real estate, and wagering at a casino—to mention just a few. Consequently, corporations try to maximize the appeal of their stock, and thus to minimize their cost of capital, by paying careful attention to their dividend policies.

Corporate law does not leave decisions concerning the payment of dividends entirely to the workings of the market place and the discretion of corporate managers. As Dean Manning points out, shareholders and creditors have sharply conflicting interests with regard to the size and frequency of dividend payments. Because directors are elected by and are accountable to shareholders, they clearly would be inclined to favor shareholders' interests if their power to declare dividends was unrestricted. To counter this tendency, corporate law traditionally has sought to protect creditors' interests with regard to dividend payments, as it has with regard to issuance of stock. Recognizing that preferred stockholders also can be jeopardized by overly-generous dividend payments, corporate law also has sought to protect their interests.

b. the Traditional Approach to Regulating Dividends

The traditional approach to restricting dividend payments relied on the concept of legal capital and the associated notion of "surplus." Some states permit dividends to be paid only to the extent that a corporation has "earned surplus." This term is generally defined to mean a surplus which arises from the accumulation of profits during the life of the enterprise. While there are difficult interpretative questions involved in the meaning of the operative terms, the policy is plain enough. Dividends are supposed to be the fruit of the tree, and unless fruit has been borne, nothing can be picked.

More common are statutes that allow dividends to be paid out of "surplus," without regard to whether it is "earned" or not. *See, e.g.*, DGCL § 170, N.Y.B.C.L. § 510. The theory underlying such provisions is that the only cushion on which creditors can rely is a corporation's "stated" or "legal" capital. The rest of the shareholders' equity account is "surplus" (usually called either "earned" or "capital" surplus) and is at the disposition of the shareholders.

In addition to the payments that might be made under one of the foregoing provisions, some states also permit the payment of dividends whenever a corporation has current earnings. *See* DGCL § 170. Their statutes define current earnings in various ways, sometimes looking only to the most recent fiscal year, and sometimes looking to the preceding year, either alone or in combination with the current year. Such so-called "nimble dividend" provisions in effect allow the payment of dividends by currently profitable corporations even where such payments impair stated capital.

As should be clear by now, restrictions on dividends based on the concept of legal capital are unlikely to be effective. The Delaware and New York statutes, which limit the protection for senior security holders to legal capital, can be easily manipulated. For example, a corporation can reduce the par value of its outstanding stock by amending its articles of incorporation, thereby reducing stated capital and increasing surplus in an account usually called "reduction surplus." This increases the amount of dividends the corporation lawfully can pay.

Courts may go even further in weakening restrictions on dividend payments based on the concept of legal capital. Suppose a corporation's real estate increases in value. Can the corporation reflect the higher value on its balance sheet? If it does, the corporation will have to match the increase on the left-hand (asset) side of its balance sheet with an equivalent increase on the right-hand-side of its balance sheet. The account it will increase is shareholders' equity—more specifically, "surplus." It probably will call this increase "revaluation surplus," rather than "earned surplus." But whatever the label, surplus, and the corporation's dividend paying power, will be increased. The celebrated case of *Randall v. Bailey*, 23 N.Y.S.2d 173 (Sup.Ct.1940), *aff'd* 288 N.Y. 280, 43 N.E.2d 43 (1942), sustained payment of a dividend based on the existence of a revaluation surplus created in this manner. *Klang v. Smith's Food & Drug Centers, Inc.* 702 A.2d 150 (Del. 1997), involved a similar issue. Smith's Food & Drug ("SFD") had repurchased a large block of its stock through a tender offer. Prior to authorizing the tender offer, SFD's board had revalued the corporation's assets and liabilities. Absent that revaluation, the repurchase would have caused a deficit in surplus in violation of DGCL § 160. The Delaware Supreme Court affirmed a trial court decision rejecting a shareholder's challenge to the repurchase, stating:

> * * * In cases alleging impairment of capital under Section 160, the trial court may defer to the board's measurement of surplus unless a plaintiff can show that the directors "failed to fulfill their duty to evaluate the assets on the basis of acceptable data and by standards which they are entitled to believe reasonably reflect present values." In the absence of bad faith or fraud on the part of the board, courts will not "substitute [our] concepts of wisdom for that of the directors." Here, plaintiff does not argue that the SFD Board acted in bad faith. Nor has he met his burden of showing that the methods and data that underlay the board's analysis are unreliable or that its determination of surplus is so far off the mark as to constitute actual or constructive fraud. Therefore, we defer to the board's determination of surplus, and hold that SFD's self-tender offer did not violate 8 *Del.C.* § 160.

As we saw in Chapter 6, generally accepted accounting principles stress historic cost and would not allow such an upward revaluation. But statutes based on legal capital do not require corporations to employ generally accepted accounting principles (GAAP). They can keep separate and completely legal sets of books to compute the amount available for distribution to shareholders. However, consistent with GAAP, a corporation that based its dividend payments on such books almost surely is obliged to write-down the book value of any assets worth significantly less than their cost (or cost less accumulated depreciation).

c. *Protection Against Excessive Dividends Under the Model Act*

The RMBCA abandons restrictions based on legal capital or surplus tests altogether. Instead, unless the articles provide otherwise, RMBCA

§ 6.40(c) simply prohibits "distributions," as defined in § 1.40(6), if after the distribution (1) "the corporation would not be able to pay its debts as they become due in the usual course of its business," or (2) "the corporation's total assets would be less than its total liabilities plus" any sum needed to satisfy the claims of preferred stockholders in the event of dissolution. The Official Comment to § 6.40 characterizes these as the "equity insolvency test" and the "balance sheet test." Neither test can be applied mechanically; both require the exercise of judgment. That judgment is exercised by a corporation's board of directors.

Dean Manning calls this provision "the big bomb" because directors face personal liability if they judge wrong. The RMBCA, and more specifically the Official Comment to § 6.40, recognizes this danger and attempts to reduce it by stating that decisions concerning distributions should be evaluated as would any other exercise of business judgment.

In evaluating the corporation's ability to meet its obligations as they come due, directors generally can assume that the company will remain a going concern. The Official Comment suggest several benchmarks directors may wish to consider, but no bright line tests. Where solvency appears to be a matter of concern, directors may find it helpful to analyze a company's liquidity and cash flows, using both reports on the results of operations and any forecasts or budgets management has prepared.

The balance sheet test is to be made on the basis of (1) specified financial statements or (2) fair valuation or other reasonable methods. The RMBCA leaves this determination to the directors and does not mandate the use of GAAP. Of course, directors can protect themselves by relying on financial reports prepared in accordance with GAAP. *See* RMBCA § 8.30. California law involves similar tests, but does require use of GAAP. *See* Calif.Corp.Code §§ 114 and 500(b).

Clearly a policy that turned on concepts of par value provided little protection to creditors because of the ease with which restrictions could be circumvented. The law as now reflected in RMBCA § 6.40 seems more realistic, but does it furnish meaningful protection to creditors? Directors cannot render the corporation insolvent by approving a distribution, but the RMBCA does not preclude them from going to the edge. No cushion is required. By contrast, consider Calif. Corp. Code § 500 which requires that a corporation's liquid and hard assets (total assets less certain intangibles) after a distribution equal at least 125% of liabilities and that directors employ GAAP in making this computation. One explanation for the different approaches is that the drafters of the RMBCA appear to have decided that corporate law is not the vehicle through which creditors should be protected. They can rely on contract, or on fraudulent conveyance law, such as the Uniform Fraudulent Conveyance Act. A similar attitude is reflected in other aspects of corporate law, which provides that managers' fiduciary duties run only to shareholders, allow only shareholders to bring derivative actions and rarely allow creditors to "pierce the corporate veil" and reach the assets of shareholders of insolvent corporations. For an excellent discussion of these issues, see Robert C. Clark, CORPORATE LAW, Chap. 2 (1986).

d. Stock Dividends

Not all dividends involve the distribution of cash to stockholders. Corporations occasionally pay what are known as "stock dividends" in which additional shares of stock are distributed. In economic terms, such a dividend produces no meaningful change in the financial status of the corporation or its shareholders. It merely divides shareholders' ownership interests in the corporation into a greater number of shares while leaving each shareholder's proportionate interest unchanged. Indeed, the reason for paying such a "dividend" often is to produce the appearance that shareholders are receiving something when the corporation is not in a position to pay a dividend in cash.

Since a stock dividend does not result in the distribution of any of the corporation's assets, there is no need to place limitations on it for the protection of creditors. Indeed, because the par value (if any) of the shares distributed must be added to stated capital (see, e.g., DGCL § 173) a stock dividend can actually benefit creditors. RMBCA § 6.23 recognizes that a stock dividend involves the issuance of shares "without consideration." RMBCA § 1.40(6) excludes such a dividend from the definition of a "distribution."

e. Repurchase of Shares

A corporation may want to repurchase some of its outstanding stock for a variety of reasons. If the repurchase is pro rata from all shareholders, it will have almost exactly the same effect as a dividend; the only difference will be a reduction in the number of shares outstanding. But whether a repurchase is pro rata or from less than all shareholders, its impact on creditors will be the same as if the corporation paid a dividend. Consequently, corporation statutes generally impose restraints on the repurchase of stock similar to those imposed on dividends. N.Y.B.C.L. § 513 for example, generally permits repurchases only out of surplus, although it allows repurchase or redemption of redeemable shares out of capital. DGCL § 160 prohibits the repurchase of common stock if it would impair capital, which amounts to essentially the same thing. The RMBCA defines the repurchase of shares as a "distribution" in § 1.40(6) and subjects it to the limitations contained in § 6.40.

Traditional statutes classify reacquired shares as "treasury stock." Treasury stock remains "issued," but is not "outstanding." If treasury shares are resold (technically they are "sold" and not "issued" although there seems to be little or no practical distinction), the restriction imposed on surplus when they were purchased is eliminated. On the other hand, preemptive rights ordinarily do not extend to sales of treasury shares and a corporation generally may not vote treasury shares. *See, e.g.*, DGCL § 160(c).

The RMBCA eliminates the concept of treasury shares. § 6.31 provides that reacquired shares automatically revert to the status of authorized but unissued stock, thereby avoiding the complexity of prior law.

f. Liability for Unlawful Distributions

When a corporation makes an unlawful distribution to shareholders, creditors' interests usually are placed in jeopardy. When an unlawful distribution results in actual losses to creditors, the directors who authorized that distribution can be held liable. *See, e.g.*, RMBCA § 8.33 which imposes liability on the directors who voted for a dividend, distribution, or repurchase of stock that violates the restrictions of the Act. *See also* DGCL § 174; and N.Y.B.C.L. § 719.* A director held liable for an unlawful distribution has an action for contribution against shareholders who received a distribution knowing that it was improper. RMBCA § 8.33(b); DGCL § 174(c). While shareholders of a Delaware corporation can exculpate directors from liability for many breaches of the duty of due care, they cannot provide such exculpation for unlawful distributions. *See* DGCL § 102(b)(7).

D. CORPORATE DIVIDEND POLICY: LEGAL AND ECONOMIC ISSUES

Decisions as to whether dividends lawfully can be paid arise only when corporations are in financial difficulty. In solvent corporations, decisions relating to dividends involve a basic financial policy issue: should cash not needed for current operations be reinvested in the business or distributed to shareholders? Professors Klein and Coffee observe that, apart from changing the corporation's capital structure,

> there is no necessary connection between the dividend decision and the investment decision. If a corporation lacks spare cash, because it has paid dividends or for any other reason, it can still take advantages of investment opportunities as long as it is able to finance those investments by selling new securities.

William A. Klein & John C. Coffee, Jr., BUSINESS ORGANIZATION AND FINANCE 375–76 (6th ed. 1996). Nonetheless, courts traditionally have examined the investment opportunities available to a corporation when evaluating a challenge to its dividend policy.

1. CLOSE CORPORATIONS

DODGE v. FORD MOTOR CO.

204 Mich. 459, 170 N.W. 668 (1919).

[The factual background of this famous action is set forth in Chapter 5, as is the portion of the court's decision refusing to enjoin Ford's plans

* New York also makes the violation of the restrictions on distributions a criminal offense under some circumstances. See N.Y.Penal Law § 190.35.