

# ON THE SHAREHOLDERS' RIGHT OF PREEMPTION: LAW AND PRACTICE

FLORENTINO P. FELICIANO \*

## I. THE RULE, ITS OPERATION AND RAISON D'ETRE

### 1. *The Rule Itself, Traditionally.*

There are definitions and definitions of stockholders' preemptive rights. About the most economical and concise is Stevens': "A shareholders' preemptive right is the option to subscribe to a new allotment of shares, in proportion to his holdings of outstanding shares, before the new shares are offered to others."<sup>1</sup> The situation contemplated by the rule is that of an issue or offering of shares by the corporation to its constituent stockholders. An entirely distinct matter is the right of preemption that may be accorded, frequently in the case of closely held or family corporations, by stockholders to one another or to the corporation where a stockholder desires to dispose of his holdings. This latter situation is discussed by texts and treatises under the heading of "Restrictions on the Transferability of Shares," and does not concern us.<sup>2</sup> The rule recognizes in shareholders an affirmative privilege of a prior opportunity to subscribe to new shares created by the corporation, and imposes on the latter the correlative duty to refrain from offering its new shares to the general public until its constituents' claim of priority has been satisfied. This broad statement is of course subject to important qualifications which will be discussed later.

The emergence and establishment of the right, which historically is of common law origin, came early in the development of American corporate law. The earliest discoverable judicial pronouncement on the existence of such a right seems to have been made in 1807 by Sedgwick, J., in *Gray v. President, Directors and Company of Portland Bank*.<sup>3</sup> In that case, the corporation, the Portland Bank, had an authorized capital stock of not less than \$100,000 and not

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\* A.B. (U.P.), LL.B. (U.P.), LL.M. (Yale); Yale Fellow 1952-1953.

<sup>1</sup> CORPORATIONS, 2 ed., (1949) p. 499.

<sup>2</sup> It is interesting to note that the shareholders' preemptive right is not mentioned at all in the law on private corporations, statutory or judge made, of the Philippines, while restrictions on transferability of shares in terms of a preemptive privilege of the corporation or other stockholders have been rather strictly dealt with, e. g. *Fleischer v. Botica Nolasco*, 47 Phil. 583. This is probably a reflection of the primitive stage of corporate economy in the Philippines. Such restrictions on transfer of shares have been regarded as a "projection of the doctrine of preemptive rights"; see Tuggle, L. H., in 10 *Ga. B. J.* 456 (1948).

<sup>3</sup> 3 Mass. 364, 3 Am. Dec. 156 (1807).

more than \$300,000, the shares having a par value of \$100 and being all of the same class. The plaintiff was a pre-incorporation subscriber for seventy shares. Upon incorporation, the bank issued 1000 shares and Gray received certificates for his seventy shares. To raise money for the purchase of a bank building, the shareholders voted to increase the capital stock to \$300,000 and resolved to offer the stock to the "original subscribers and those associated with them previous to the act of incorporation" at the ratio of two new shares for each old one. Gray offered to pay for 140 new shares, but the bank refused to issue the stock. The court decided that he was entitled to damages measured by the difference between the market and the subscription (par value in this case) prices. The value of this case as a precedent, the first of a line kilometeric in length, establishing the existence of a preemptive right has been seriously questioned.<sup>4</sup> In the first place, the resolution of the stockholders authorizing the increase of the capital stock specified to whom the new stock was to be offered, i.e. "original subscribers and their associates." The case could have been confined to a determination of whether Gray fell within this category, and it was clear that he did, the corporation having advanced no reason at all for his exclusion therefrom. In the second place, neither the reasoning employed by Sewall nor by Sedgwick would seem to warrant an inference that they meant to legislate and establish a legal right theretofore unrecognized and thereby compel the management to offer stock promiscuously to all the shareholders.<sup>5</sup> Sewall relied on equitable and contractual grounds. He held an incorporated bank

"to be a trust created with certain limitations and authorities, in which the corporation is the trustee for the management of the property and each stockholder a cestui que trust according to his interest and shares."

If so, then

"a limitation of the capital to be employed in the trust, that it shall not be less than one sum and not exceeding a certain greater sum, is not a power granted to the trustee to create another interest for the benefit of

<sup>4</sup> See Dwight, F., *The Right of Stockholders to New Stock*, (1908) 18 *Yale L. J.* 101 at 103; also Dicke, H. P., *Preemptive Rights of Stockholders*, (1941) 15 *Temple L. Q.* 287 at 287: "This case became the leading authority on preemptive rights but its rule thereafter was applied to situations from which the court expressly distinguished it." And Drinker, H. S., *The Preemptive Right of Shareholders to Subscribe to New Shares*, (1930) 43 *Harv. L. Rev.* 586 at 590-591 imputes much of the confusion of thought in the later cases to a failure of an adequate analysis of the "limited scope" of the Gray case.

<sup>5</sup> See Berle, *Corporate Powers as Powers in Trust*, (1931) 44 *Harv. L. Rev.* 1049 at 1056.

other persons than those concerned in the original trust, or for their benefit in any other proportion than those determined by their subsisting shares." <sup>6</sup>

Further, he equated a vote of the shareholders to increase the capital stock, "if it was not the creation of a new and disjointed capital," with a contract among the stockholders to enlarge their share, in number or in amount to the extent required to effect the increase. The vote to increase the capital stock to the maximum limit authorized by the charter he held to be a subscription contract *which the corporation could enforce against Gray*.<sup>7</sup> It is to be noted that the contractual aspect of the privilege of preemption here referred, in Sewall's view, not merely to the original contract of membership but also to an implicit agreement to subscribe for the new shares authorized by the shareholders' vote. The \$200,000 additional stock he treated as an unpaid portion of an original subscription to the total maximum of \$300,000 authorized in the charter. Sedgwick, on the other hand, rested his decision on familiar principles of partnership law. Given the proposition that the stockholders were partners at the time of their vote to augment the capital stock, it followed from the fiduciary quality of that relationship that the increase was intended for the profit of the joint concern, for the benefit of all the partners in proportion to their respective interests. For good measure, Sedgwick appealed to "natural justice" and the "reason and nature of the thing." Both Sewall and Sedgwick were quite preoccupied with working out a remedy.<sup>8</sup> The right of preemption and damages for its violation were arrived at after ruling out the possibility of specific performance and of cancellation of the shares which should have been issued to Gray. The bank had issued all the new shares, some of which had found their way into the hands of innocent third parties.

This then was the birth of the preemptive right, attended by analogical reasoning that seemed rather strained. In the last analysis, the weight of the case as a precedent rested on a single dictum

<sup>6</sup> 3 Mass. at 377.

<sup>7</sup> *Ibid*, at 378: "The shares first paid in became the first installment of the increased capital; and the subsequent payments might be reasonably enforced, by providing for a forfeiture of the delinquent shares, to be sold and accounted for to the stockholder; the proceeds to be carried to his account, deducting the installments, or additional payments required."

<sup>8</sup> BERLE AND MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY*, (1932) p. 256-257: "The thrust of the case was that, relying on equitable principles to find the right, the court used equal latitude in evolving a remedy compensating the particular plaintiff."

of Sedgwick.<sup>9</sup> But about sixty years later, Bigelow, C. J., could confidentially say that the preemptive right was "inherent in the shares in their very creation," that it was an "original incident or attribute appertaining to each share,"<sup>10</sup> and cite the Gray case as an authority. And by 1906, Vann, J., announced that *Gray v. Portland Bank* "has stood unquestioned for nearly a hundred years and has been followed generally by courts of the highest standing. It is the foundation of the rule upon the subject that prevails, almost without exception, throughout the entire country."<sup>11</sup> The right of preemption had reached the stature of "a strictly legal right." Obviously the rule of preemptive rights, however undistinguished its original rationalization was, satisfied some real need, served some substantial purpose; otherwise it would never have survived the period of time that it has. What that need and purpose is, is our present intention to inquire into.

A share of stock, in the light of an "economic analysis," represents a collectivity of rights.<sup>12</sup> Traditionally this collectivity is thought of as comprising (a) a right to vote, and thus to take part in the direction of the corporate affairs, (b) a right to a portion of the corporate surplus profits, if and when segregated in the form of dividends, (c) a right to participate in the distribution of the corporate assets upon dissolution and winding up. The orthodox rationale of the doctrine of preemptive rights is that it is a device safeguarding against dilution of the interests of shareholders in terms of the above three rights, that it is a stabilizing mechanism, as it were, to prevent disturbance of a hypothetical equilibrium or ratio contractually established when the shareholder first bought his way into the corporation.<sup>13</sup>

How an increase of the capital stock will, unless the shareholders' claim of preemption is deferred to by the corporation, diminish the relative voting strength of any particular shareholder is easily illustrated. The plaintiff shareholder in *Stokes v. Continental Trust*

<sup>9</sup> 3 Mass. at 382: "Then had the plaintiff, as a stockholder of the old stock, at the time of the vote to augment the capital of the bank, a right in the new stock, in proportion to his interest in the old stock, of which he might not rightfully be deprived by his partners, the other stockholders? I think that he had."

<sup>10</sup> *Atkins v. Albee* (1866), 12 Allen (Mass.), 359 at 361.

<sup>11</sup> *Stokes v. Continental Trust Co. of New York*, 186 N. Y. 285; 78 N. E. 1092; Note 18 *Harv. L. Rev.* 541 (1906).

<sup>12</sup> BERLE AND WARREN, *CASES AND MATERIALS ON THE LAW OF BUSINESS ORGANIZATION*, (1948) p. 335.

<sup>13</sup> E.g., STEVENS ON CORPORATIONS (1949), p. 500; 1 MACHEN, *MODERN LAW OF CORPORATIONS* (1908) § 603; 11 FLETCHER, *CYC. OF CORPORATIONS* (Perm. ed.), p. 221; BALLANTINE ON CORPORATIONS (1946), p. 488; Coppock, F. M., *Stockholders' Right to New Stock*, (1909) 7 *Ohio L. Reporter* 345 at 350.

Co.<sup>14</sup> held 221 shares out of a total authorized and outstanding capital stock of \$500,000 consisting of 5000 shares of the par value of \$100 each. Since all the old shares were voting shares, Stokes could exercise 221/5000 or 4.42% of the total voting power. The capital stock was increased to \$1,000,000 and all of the 5000 new shares, also voting shares, were issued and sold to Blair and Co., an outsider. Stokes' voting power was thereby reduced to 221/10,000 or 2.21%. It will be noticed that the fact of Blair and Co's being a non-stockholder is not material. Whether it was an old stockholder or an outsider, Stokes' voting strength would have been cut in half anyway, so long as he personally was denied the right to subscribe to the new issue.<sup>15</sup>

The function of preemptive rights as preventing diminution of the second right, i.e., to a portion of the surplus profits, is just as easily explained. In the Stokes case, the corporation just before the increase of its capital stock had a surplus of \$1,048,450.94. Assuming for the sake of illustration that this entire surplus would be distributed as cash dividends before the increase,<sup>16</sup> each old share

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<sup>14</sup> *Supra*, note 11.

<sup>15</sup> Ordinarily, the problem of dilution of stockholders' interests arises in case additional shares are issued. However the same problem may come up in cases of reduction of capital stock and of stock splitting, cases where preemptive rights cannot apply. But courts utilized the anti-dilution rationale and upheld stockholders' claims to a constant proportion of interests. Thus in *Page v. American and British Manufacturing Co.*, 129 App. Div. 346, 113 N. Y. S. 734 (1908), the corporation had an originally authorized outstanding capital stock of \$10,000,000 divided into 100,000 shares all of the par value of \$100, 80,000 shares being common and 20,000 preferred. Both classes were entitled to vote. Subsequently, the capital stock was reduced to \$2,000,000 consisting of 20,000 common and 20,000 preferred, both with a par value of \$50. The effect of the action taken was to give to the preferred stock which contributed  $\frac{1}{8}$  of the capital an equal vote with the common stock which contributed  $\frac{4}{5}$  of the capital. This the court held "clearly illegal, both on principle and under the Stokes case," and that it followed from the Stokes case that "a reduction (of capital stock) must be upon lines which will leave each stockholder the same property interest and right in the corporation as he had before the reduction." And in *Falk v. Dirigold Corp.*, 174 Minn. 219, 219 N. W. 82 (1928), the corporation was originally authorized to issue 1000 no par common shares and 100,000 preferred shares with a par value of \$10. Its charter was later amended increasing the number of no par shares to 35,000, and reducing the preferred shares to 10,000 with par value of \$100. The plaintiff who had held 100 no par shares or  $\frac{1}{10}$  of the common stock was held entitled to 3,500 no par shares after the amendment in order to maintain the 1 to 10 ratio.

<sup>16</sup> The assumption may be improbable but there seems to be no legal obstacle to it. Certainly it would benefit such stockholders as may not be able to exercise their preemptive rights; and eminently fair, since it was through the utilization of the capital investments of the old stockholders that the accumulation of the surplus was made possible and new shareholders would have no claim to any part of it. This of course is what Berle and Means (*op. cit.*, *supra* note 8 at 333) call the "traditional logic of property."

would have been entitled to \$209.69. After the increase, each share's participation in the accumulated surplus (disregarding the paid in surplus created by the \$450 issue price of the new shares) would have been reduced to \$104.84. The same diminishing effect would result where the surplus has not yet accrued but is still to be earned; it has to be spread thinner since the number of participating units is greater. Another way of diminishing the old stockholders' interest in surplus is through the creation of a new class of shares having preferential rights to dividends. The old shareholders whose claims on the corporation's profits is thus subordinated have a valid objection to exclusion from an opportunity to subscribe to the new issue of preferred stock. Exercise of their preemptive rights enables them to maintain a stable ratio in their claims to the profits of the corporation. But there the protection of the rule ends. A constant ratio is of little comfort should the absolute amount of the dividends decline through the unwise or improvident employment of the new capital. Dividends must be paid on the new stock, equal to or greater than those theretofore paid on the old; the new capital must have an earning power, or rate of return, equal to or greater than that of the capital previously invested,<sup>17</sup> if the prevention of dilution is to be really meaningful. Common stockholders however can assert no legal claim to any rate of return, let alone an unvarying rate. Even the rights of cumulative preferred stock depend on profits being made at all during an indefinite period of time; for blood cannot be squeezed out of a corporate turnip. Profit-making capacity is hardly susceptible of legal regulation.

The effect of the creation of additional shares on the old shareholder's relative interests in the assets of the corporation can be most clearly shown by the use of a balance sheet of a hypothetical company:

**Razzle and Dazzle, Incorporated.**

<i>Assets</i>	<i>Liabilities</i>
Total Assets ..... \$1,500,000	Capital Stock ..... \$1,000,000
	Liabilities ..... 200,000
	Surplus ..... 800,000

The net value of the company to its shareholders is the value of its assets less the amount of liabilities or debts, i.e. \$1,300,000. If a par value of \$100 is assumed, the book value of each share will be \$130. In case \$2,000,000 of new stock is issued at the same par value, the balance sheet will look like this:

<sup>17</sup> See 2 DEWING, A. S., *THE FINANCIAL POLICY OF CORPORATIONS*, (4 ed., 1941) pp. 1198-1199.

## Razzle and Dazzle, Incorporated.

<i>Assets</i>		<i>Liabilities</i>	
Old Assets .....	\$1,500,000	Capital Stock .....	\$3,000,000
Proceeds of new stock ..	2,000,000	Liabilities .....	200,000
		Surplus .....	300,000

The book value of the shares, old and new, will be \$110. The new stockholders will receive for \$100 a share worth \$110, while the old stockholder will suffer a reduction in value of their shares from \$130 to \$110. If the old shareholders are accorded preemptive rights and exercise those rights, each would receive two new shares for each old one, and theoretically will suffer no prejudice. The \$20 lost on the old shares is made up by the \$10 gained on each of the new shares. The above illustration is subject to the qualification that book value, determination of which is purely an accounting operation, has no necessary, or even usual, connection with actual market value. Hence the protection afforded by exercising preemptive rights, if reckoned in terms of book value, may possibly be more shadowy than substantial. The issuance of new securities to which "rights" attach will ordinarily cause a downward revision of the market price. This downward trend may be nullified, or emphasized, by often imponderable price determinants. New financing might be interpreted favorably as evidence of increased volume of business and of healthy growth. Rapid assimilation of the new issue will probably strengthen the position of the issuer's stock. On the other hand, the immediate downward tendency might not be attributed by the shareholders to a natural adjustment of supply and demand, and the skepticism of the uninformed might cause an unloading that would depress market prices lower than the level to which they would ordinarily fall.<sup>18</sup> In fine, while preemptive rights secure stockholders against dilution of their stock participations in terms of a theoretical book value, they may be inadequate where the economic value of such participations is concerned. However, the point may be made that without preemptive rights, the resultant prejudice to the shareholders will be even greater.

There is another component right in the bundle that is the share of stock—the right to invest new capital in the enterprise. Under favorable conditions, that is, when the corporation has demonstrated its capacity to maintain a rate of return on capital higher than cur-

<sup>18</sup> See GERSTENBERG, C. W., FINANCIAL ORGANIZATION AND MANAGEMENT OF BUSINESS, (1934) p. 346; 2 DEWING, *op. cit.*, *supra* note 17 at 1211-1212. FIELD, K., CORPORATION FINANCE, (1938) at 251-253 gives two methods of determining the long term effect of the issuance of stock with "rights": capitalization of total earnings method and price-earnings ratio method.

rent interest rates, and higher than that which the stockholder could secure were he to invest instead in the open market, the preemptive right becomes very valuable. To Berle and Warren, the preemptive right is economically the legal recognition of this right to supply new capital, the protection of this right being its "greatest reason."<sup>19</sup> This right becomes even more valuable where the shareholder holds on to his stock for an indefinite length of time and exercises his preemptive right every time new stock is issued. If he sells his rights in the open market, when the next issue is made, he can only receive the fixed proportion of his original holdings and thereby loses the real profit. Needless to say every increase of capitalization is based upon the total amount outstanding including the last issue, so that if the shareholder takes every subscription privilege offered, he will continually get rights upon rights. His capital investments will grow by a sort of geometric progression.<sup>20</sup> The stockholder of limited means, who can only sell his rights to the new stock, stands to lose.

This feature of the operation of preemptive rights was probably what has led to a fear of "compulsory reinvestment." It has been observed that a majority, by repeated creation of new shares, could force a minority shareholder to invest continuously to maintain his relative position.<sup>21</sup> Ordinarily this would afford little ground for apprehension, for capital stock would not be increased recklessly, merely to harass the minority. And the stockholder who cannot or is not willing to exercise his preemptive right could sell his "rights." In closely held corporations, this may not be a satisfactory way out, for a minority interest therein is rarely marketable save to the other shareholders. Hence the suggestions that only the amount of stock that will be initially issued should be authorized, that all the author-

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<sup>19</sup> *Op. cit.*, *supra* note 12 at 335; also FIELD, *op. cit.*, *supra* note 17 at 253. But cf. Garner, R. D., and Forsythe, A. S., *Stock Purchase Warrants and "Rights,"* (1931) 4 *So. Cal. L. Rev.* 269 at 277.

<sup>20</sup> Burgunder, B. B., *The Declaration and Yield of Stockholders' Rights*, (1910) 35 *Annals of Am. Acad. Pol. Soc. Sc.* 554 at 560, gives as example the case of The Great Northern Railway Co. during the turn of the century, a period of unusual industrial expansion. The company increased its capital stock eight times from 1893 to 1907. If the holder of an original 100 shares had sold his rights each time the capital was increased, he would have disposed of the privileges to 240 more shares and 100 ore certificates. But if he had held the stock and availed himself of each subscription privilege, he would, by 1907, have owned 693 shares and 495 ore certificates.

<sup>21</sup> Cline, S. J., *Preemptive Rights: Importance of Drafting in Protecting Shareholders Against Dilution of Interests and Compulsory Reinvestment*, (1952) 40 *Calif. L. Rev.* 132 at 139. Cf. MONTGOMERY, R. H., (ed.) *FINANCIAL HANDBOOK* (3 ed., 1937) 542: "Stock rights represent in reality a compulsory choice on the part of stockholders of one or the other of two courses of action—either to increase their investment in the company by the amount of the subscription price, or to dispose of the part of it represented by the stock rights."

ized shares be issued, and protection against amendment of the articles be provided by increasing the requisite amendatory vote to unanimity or near unanimity,<sup>22</sup> are especially applicable to close corporations.

In *Farmers' Loan and Trust Co. v. Hewitt*,<sup>23</sup> the court rejected a minority stockholder's plea of "compulsory reinvestment" in denying an injunction to stop a proposed increase of capitalization and bond issue. There the corporation had an authorized capital stock of \$6000, divided into 600 shares with par value of \$10, all held by six stockholders with 100 shares each. The company's mines were at a standstill, the company being faced with a choice of flooding the mines and a subsequent resumption cost of \$100,000, or continuing operations at a loss of \$150,000-\$300,000. Four of the stockholders who were also the directors, chose the latter alternative, and resolved to issue \$594,000 worth of redeemable and convertible bonds and to increase the capital stock to \$600,000 divided into 60,000 shares of par value of \$10. The effect of this resolution was practically to compel the dissenting minority to contribute their proportion of the proposed loan, for any who failed to respond would suffer tremendous loss in the depreciation of the stock values. Nonetheless, the court refused to enjoin the carrying out of the resolution on the ground that since there was to be an equal apportionment of the bonds, there would be no inequality of burden, and whatever loss the dissenters would suffer would be "of their own making." This is a "tough" decision for it apparently concedes to the majority the power to choose the greater evil. But since there was no intimation of any *mala fides*, the court probably felt itself constrained not to disturb the business judgment of the majority. The crucial question seems to be how far this deference to directors' discretion is to be carried. Assume for instance that there is no demonstrable need for new capital (admittedly a very difficult thing to prove) and that the faction in precarious control knew that the minority would be financially unable to subscribe to the new issue, should the court still refuse to interfere?<sup>24</sup>

<sup>22</sup> Cline, *loc. cit.*, *supra* at 140.

<sup>23</sup> (1922) 94 N. J. Eq. 65, 118 A. 267, *aff'd* 94 N. J. Eq. 187, 118 A. 926.

<sup>24</sup> *Schramne v. Cowin*, 205 App. Div. 20, 199 N. Y. S. 98 (1923) does not answer the question. For there the corporation was in urgent need of new capital. Its income was only \$1500 per year, while unpaid debts and taxes amounted to \$153,306. The mortgagees had commenced foreclosure suits. Besides the proposed increase was very modest, only \$50,000, considering the financial straits of the corporation. The fact therefore that the majority knew Schramne had not the means to purchase his *pro rata* share could not suffice for the grant of an injunction. Disregarding questions of "should" or "ought," courts will probably not interfere in the assumed situation. It seems that the preemptive right is not so much a right to maintain the shareholder's relative position, as a right to an opportunity to maintain such relative position.

## 2. *The Frey and Drinker Analyses.*

Thus far, we have discussed the bases most frequently asserted for the existence of the shareholders' right of preemption. No discussion of preemptive rights could pretend to completeness without noticing the comments of Frey and Drinker. The analyses offered by these two, though now more than two decades old, remain the most valuable in the field, because they are the most penetrating, scholarly without being ponderously erudite.

Frey would base the preemptive right on the preservation of relative voting strength alone. The preemptive right would then pertain only to holders of voting shares, and that only if the new shares to be created have voting rights.<sup>25</sup> He admits that the shareholder's right that his interest in the net assets be not diluted by the creation of additional shares is "a very real and important" right. But that right, he says, is entirely distinct from the preemptive right, concerning itself exclusively with the price at which the new shares are to be disposed of. This right would be adequately protected by recognizing in the old shareholders a power to enjoin the creation of additional shares at less than their reasonable sale value. Regarding the shareholder's interest in the surplus earnings of the corporation, Frey points out what has already been indicated above, that whatever protection preemption could offer would be futile unless the corporation can utilize the new capital at least as profitably as the old one already invested; and he concludes that this was a matter too speculative for the law to concern itself. All this on the one hand. On the other hand, voting rights, where they exist, warrant "the highest degree of protection," being one of the "few remaining forms of shareholder control over the enterprise." He then proceeded to specify three reasons why the preservation of voting rights is a practicable basis for the right of preemption. Firstly, there was "nothing speculative" about the diminution of relative voting control. Secondly, the preemptive right was the only way a voting stockholder could maintain his relative control when additional voting shares are to be created. Without preemption, his voting power would be diluted at whatever price the new shares may be offered and however profitably the new capital may be invested. Lastly, preemption based solely upon relative voting power was feasible, regardless of the complexity of the corporate share structure. "Mathematical

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<sup>25</sup> Frey, A. H., *Shareholders' Preemptive Rights*, (1929) 38 *Yale L. J.* 563 at 572-573. He defines voting shares as those "which have a right to vote in the election of directors regardless of other limitations on their voting rights, and excludes all shares the owners of which are not entitled to vote for directors, even tho they may have other voting rights." (at 578).

precision" was possible in determining the shareholders' several proportions of the total voting power.

It seems that this last point, i.e., the extreme difficulty (an impossibility, according to Frey, "irrational" and "unworkable"), in the light of intricacies of the capital structure of the modern corporation, of determining the proportionality of interests in terms of a combination of the three traditional rights, is what lies at the core of Frey's analysis.<sup>26</sup> He goes to great lengths to demonstrate that the possible number of classes of shares, based on varying combinations of different participations in surplus profits and net assets is indefinite.<sup>27</sup> Drinker agrees with Frey's observations, and adds that the problem is not soluble either by limiting preemption in new shares of a particular class to holders of shares of that class, or by a proportionate issue, to each class, of new shares of the same class.<sup>28</sup> In the former situation, apart from the obvious difficulty arising where the additional shares are of an entirely new class in which case none of the old stockholders would have a right of preemption, there still remains the problem of determining a fair issue price of the particular class of shares. The determination of the issue price will itself involve quantitative weighing of the relative value of the interest or interests common to all the existing classes of shares; the vice of circularity is evident. In the latter situation which was

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<sup>26</sup> *Ibid.*, at 574: "\* \* \* where a corporation has two or more classes of shares outstanding, the totality of interests represented by each class differs from the totality of interests of every other class; \* \* \*. The particular interests in voting control, dividend payments, and capital distributions of a share of a given class can no more be added together, in an attempt to arrive at the total 'interest' in the corporation represented by the share, than a doughnut can be added to the square root of two. A 'weighted average' of the differing interests of shares of various classes being impossible, there can be no rational method of apportioning additional shares—except on the basis of an interest (or interests) prevailing in all of the existing shares." See *N. Y. Stock Corp. Law (McKinney's Con. L. N. Y. Ann., 1951)s. 39(5): \* \* \** In case each share entitled to preemptive rights does not have the same voting rights or the same unlimited dividend rights, the board of directors shall apportion the shares or securities to be offered among the stockholders having preemptive rights \*\*\* in such proportion as in the opinion of the board of directors shall preserve as far as practicable the relative unlimited dividend rights and voting rights of the holder at the time of such offering. The apportionment made by the board of directors shall, in the absence of fraud and bad faith, be binding upon all stockholders.

<sup>27</sup> Ballantine, *Ripley's Indictment of Corporate Skullduggery*, (1928) 17 *Calif. L. Rev.* 35 at 38: "It has been estimated that something like 1630 varieties of preferred shares are possible. There is in general no legal limit to the classes or combinations of shares that may be provided for in the articles. The corporation may sell such relative rights or chances to participate in the enterprise as will appeal to the investing public."

<sup>28</sup> *Loc. cit.*, *supra* note 4 at 609-612.

suggested by the court in *Russel v. American Gas and Electric Co.*,<sup>29</sup> there is the practical impossibility of finding an underwriter to take such a "hodge-podge" issue as would result where there are several classes of preferred and two or more classes of common stock. Drinker lays great emphasis on the difficulties involved in a strict underwriting of "rights" offerings and asserts that a better price would be obtainable if instead, an immediate firm commitment is entered into.<sup>30</sup>

Drinker in analyzing the cases draws a sharp distinction between the "American corporate doctrine of preemptive rights" and the "universally accepted principle" of the fiduciary nature of directors' position in the corporation.<sup>31</sup> The first is essential to a decision only in those cases involving not merely the dilution of relative interests in corporate earnings and assets but also the dilution of relative voting control. The doctrine of preemptive rights is deemed necessary for the protection of voting rights. It is not necessary for the protection of relative interests in profits and assets; those are sufficiently protected by the fiduciary principle, requiring no new doctrine. The established legal rules regulating the conduct of fiduciaries would preclude directors from distributing actual and potential surplus and assets to outsiders by the issuance to the latter of new shares at a price "substantially less" than their book and market value.<sup>32</sup> Thus far, Drinker has gone along with Frey; here they part ways. For while Frey would keep preemptive rights based exclusively on considerations of voting power, Drinker would do away entirely with the doctrine, at least in large and widely held corporations, as "an unnecessary refinement which in the long run works to the disadvantage of the shareholders." Drinker would rely exclusively on the rule regarding directors as fiduciaries, and as such fiduciaries requiring them to issue additional shares only a fair value. The value of voting rights, he asserts, will be reflected and included in the total fair value of the share, or block of shares. Provided the corporation receives the fair value of the issued stock, the old shareholders lose nothing by the issuance to outsiders; the outsider pays for the interest in present and prospective assets and earnings and for the

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<sup>29</sup> (1912) 152 App. Div. 136, 136 N. Y. S. 602. Here the lower court dismissed a petition for injunction, filed by a holder of nonparticipating preferred stock to enjoin an issue of new common stock to common stockholders alone, on condition that sufficient new non-participating preferred shares be issued to the plaintiff to preserve his relative interest. The Supreme Court affirmed the decision of the lower court.

<sup>30</sup> This point requires a detailed treatment which is reserved for a subsequent portion of this paper. See *infra*, p. 474-479.

<sup>31</sup> *Loc. cit.*, *supra* note 4 at 586.

<sup>32</sup> *Ibid.*, at 588, 599.

quantum of control given up by the old shareholders.<sup>33</sup> And whatever "theoretical detriment" the old shareholders may suffer from dilution of their voting power (he is compelled to admit the possibility of dilution since he offers no method for the pecuniary measurement of voting rights if indeed that is possible) will be more than counterbalanced by the advantage to the shareholders as a whole from the freedom of action thus given to directors.<sup>34</sup>

It is apparent that Frey attaches great importance to voting rights, limiting the function of the preemptive right to the maintenance of relative voting power as a form of shareholder control. It is appropriate to point out that under present conditions of prevalence of quasi public corporations, use of proxy systems, voting trusts and other agreements relating to control, the right to vote incident to stock ownership has become increasingly less significant to the vast majority of small shareholders.<sup>35</sup> The small shareholder hardly thinks of bargaining for a right to control through his right to vote; all he probably wanted was to invest his money for an expected pecuniary return, to hire out his idle capital. And then it should be remembered that "control" is a very elusive concept, its existence or absence in any particular group of shareholders being a question of fact. The legal powers of shareholders, directors and officers may actually have little to do with the location of such control. It may not be dependent on the ownership of a certain amount of stock. Certainly with respect to the large publicly owned corpora-

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<sup>33</sup> *Ibid.*, at 601.

<sup>34</sup> *Ibid.*, at 615-616.

<sup>35</sup> An enthusiastic writer labelled the voting right as "absolute," and declared that Frey's basis for preemptive rights is a dictate of logic; Feinberg, I., Preemptive Right of Shareholders to Subscribe to New York Stock, (1933) *N.Y.U.L.Q. Rev.* 78 at 87. Drinker (*loc. cit. supra* note 4 at 598 n. 32) denies the "absolute" character of the right to vote, though he adds that it is "less qualified" than the shareholder's right to preserve his interest in assets and earnings. Recently a New Jersey court held that the right to vote was a "basic contractual right" and struck down a plan to re-classify the shares of a corporation by setting up two classes of common stock: Class A common without any voting rights prior to dissolution and Class B common with sole voting rights prior to dissolution and no right to share in profits or assets of the corporation. *Faunce v. Boost Co.* 15 N.J. Super. 534, 83 A. 2d. 649 (1951). The court held the plan to be an impairment of the original contract of membership, "implicit" in which was the "understanding that each common stockholder would have the right and privilege to a voice in the management and conduct of the affairs of the corporation." The decision has a rather quixotic flavor; see Note in 100 *U. Pa. L. Rev.* 902 (1952) deploring its lack of realism and its fascination with labels. Cf. Berle, Corporate Devices for Diluting Stock Participations, (1931) 31 *Col. L. Rev.* 1239 at 1257-1258: "The fact today is, of course, that the voting right is apt to be negligible; and the real argument for the preemptive right turns on the participation which the shareholder has in assets and in earning power. If both are limited, as is frequently the case with preferred stock, the thrust of the preemptive right rule would seem to have failed." Also

tions, it is no longer true that control is necessarily exercised by the stockholders who have invested the largest amount of capital in the enterprise. Where the stock of the corporation is widely dispersed among thousands of small stockholders, ownership of much less than 51 per cent of the stock will be sufficient to vest control in a "pre-dominant minority."<sup>36</sup> And where the device of non-voting stock is used, the necessary percentage of stock ownership becomes even less. Add to widespread ownership the factors of stockholder inertia and disinterest in management and distant places of meeting and it is easily seen that the privilege of voting has become largely "theoretical."<sup>37</sup> On the one hand, one can reasonably doubt whether the preservation of voting power in the large corporations through Frey's preemptive rights would constitute anything more than a nominal protection to the small shareholder. On the other, as far as the group in control is concerned, Frey's preemption privilege may only mean a legal mechanism for perpetuation of control, without the revocability of proxies and the objections arising from divorcing ownership from control in voting trusts.

It is in closely held corporations that the maintenance of relative voting control remains of vital importance. Here, recognition of preemptive rights to additional voting shares helps prevent the shifting of control from one faction to another and possibly tends to prevent deadlocks by assuring to the working majority a majority of any additional voting stocks. This of course assumes the financial capacity to exercise the preemptive rights which renders it an imperfect remedy; still, it is useful.<sup>38</sup> Further, preemptive rights in close corporations will give to the stockholders, who are in a position where they are, like partners, required to trust each other, added opportunity to keep out unwelcome strangers.

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Dodd, *The Modern Corporation, Private Property, and Recent Federal Legislation*, (1941) 54 *Harr. L. Rev.* 917 at 920-921.

<sup>36</sup> The term is used in T. N. E. C. Monograph No. 29, *The Distribution of Ownership in the 200 Largest Non-financial Corporations* p. 103, to designate a type of minority control, i.e. 30 to 50 per cent of the voting stock; other types are "substantial minority" (10 to 30 per cent) and "small minority" (less than 10 per cent).

<sup>37</sup> See Rohrlich, C., *Corporate Voting: Majority Control*, (1933) 7 *St. John's L. Rev.* 218; also Rutledge, W. B. Jr., *Significant Trends in Modern Incorporation Statutes*, (1937) 22 *Wash. U. L. Q.* 305, 3 *U. of Pitt. L. Rev.* 273 at 295-296: "Were it not for the necessity of finding some means for the selection of management, the writer would be almost ready to suggest the total elimination of the voting scheme in the large corporation and the provision of some other check upon the unsatisfactory conduct of officers and directors."

<sup>38</sup> See Winer, N., *Proposing a New York "Close Corporation Law,"* (1943) 28 *Corn. L. Q.* 313 at 316. Drinker, *loc. cit.* supra note 4 at 615 excepts the case of closely held corporations from his recommendation of abolition of preemptive rights.

Respecting the shifting of control through the manipulated issuance of additional shares in a corporation, it has been often held that such shifting will be proscribed as a breach of fiduciary obligations. In *Rowland v. Times Publishing Corporation*,<sup>39</sup> the Alpha Holding Corp. had an authorized capital stock of 2000 shares with a par value of \$100. Of the outstanding shares, the majority stockholder held 863 while the rest, 600 shares, were held by the tenants of Hall Office Building. The corporation's only asset was this building, and its tenants had been for years the directors and officers of the corporation. The majority stockholder, without authority from the board of directors, listed the building for sale. A buyer was found, who wanted to convert the building into a department store. This meant the eviction of the tenant stockholders and directors. The directors then issued 325 shares of the unissued stock at \$105 each to one of the tenants, giving the latter the majority of the outstanding stocks. The directors, supported by the new majority, cancelled the commitment for the sale of the building. The old majority stockholder thereupon sought the cancellation of the 325 shares as violative of his preemptive rights and of the directors' fiduciary duty. The court granted the relief sought. It did not discuss the question of preemptive rights and apparently preferred to rest its decision on a violation of fiduciary duty. The court seemed to imply that shifting or dilution of control by itself constitutes a violation of the fiduciary obligations of directors, although it was not attended by dilution of the shareholder's interest in the assets and earnings, nor by corrupt motives, say, of profiting from a secret contract,<sup>40</sup> or of cornering an accumulated surplus by a dividend declaration immediately after the issuance,<sup>41</sup> or of voting themselves back pay and excessive salaries.<sup>42</sup> If this is so, then the symmetry of Drinker's dichotomy is disturbed, but it tends to support his conclusion that the fiduciary principle is sufficient to protect all the interests of stockholders that could possibly be affected by an issuance of additional shares.<sup>43</sup> This tendency to merge the legal

<sup>39</sup> 35 So. 2d. 399 (1948).

<sup>40</sup> As in *Whitaker v. Kilby* 55 Misc. Rep. 337, 106 N.Y.S. 511 (1907), *aff'd*. 106 N.Y.S. 1149 (1907).

<sup>41</sup> As in *Arkansas Valley Agricultural Society v. Eichholtz* 45 Kan. 164, 25 P.613 (1891).

<sup>42</sup> As in *Jones v. Morrison* 31 Minn. 140, 16 N.W. 854 (1883). This implication of the Rowland case finds precedent in *Schmidt v. Pritchard* 135 Iowa 240, 112 N. W. 801 (1907) and in *Glenn v. Kittaning Brewing Co.*, 259 Pa. 510, 103 A. 340 (1918).

<sup>43</sup> Cf. Morawetz, V., *The Preemptive Right of Shareholders*, (1928) 42 *Harv. L. Rev.* 186, anticipating Drinker's position, put it succinctly and emphatically, (at 188): "It is the duty of directors as fiduciary agent, *irrespective of any rule giving preemptive rights to stockholders*, to exercise a power to issue additional shares, as well

rule of preemptive rights into the general equitable limitations on the powers of directors and of management was accepted by several writers as a wholesome one, as giving more freedom of action to directors and making for a more flexible and efficient corporate organization. Recommendations for the lopping off, by statutory enactments, of the old judge-made rule soon followed.<sup>44</sup>

There is an important characteristic of the rule on preemptive rights that was apparently overlooked or disregarded by all the writers, save Berle and Means.<sup>45</sup> That is, that the preemptive right was "a shorthand automatic device" against dilution of interests. The important word is "automatic." True the courts, under general principles of equity, would probably protect the participating stockholders from dilution even where the preemptive right had been cut off by statutory or charter provision, if, and only if, he files the proper bill in equity. To a small shareholder, one "automatic" right is worth a hundred bills in equity. There is the expenses involved in bringing a lawsuit. There are the obstacles which must be surmounted in order to discover the facts and to secure evidence. There is the reluctance of courts to interfere in the exercise of the powers of management and their willingness to concede a wide expanse of directorial discretion. There are certain characteristics of such suits which make them more satisfying to a stockholder who is seeking to be bought off (Drinker's "corporate pirates" exacting tribute) than to one genuinely desirous of protecting his own and the other stockholders' interests. These and similar considerations lead one at least to doubt whether the protection afforded by equitable judicial control over management is really adequate for small shareholders in large corporations with widely scattered stock holdings.<sup>46</sup> The

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as their other powers, in good faith for the benefit of the stockholders who constitutes the corporation.\*\*\**Irrespective of any rule of preemptive rights*, it is a breach of duty on the part of directors to issue additional shares or to sell treasury shares, not to benefit the stockholders, but to benefit themselves, or to enable particular stockholders or others to acquire voting control of the corporation, or to enable them to acquire shares at less than their value." (italics supplied). On the other hand, ROHRLICH, C., LAW AND PRACTICE IN CORPORATE CONTROL (1933) p. 123, says that the limitations on the powers of directors enumerated by Morawetz are "in addition to the limitations imposed by the doctrine of preemptive rights," without however, indicating what the latter consist of.

<sup>44</sup> See e.g., Ballantine, A Critical Survey of the Illinois Business Corporation Act, (1934) 1 *U. of Chi. L. Rev.* 357 at 363; id., Questions of Policy in Drafting a Modern Corporation Law (1931) 19 *Calif. L. Rev.* 465 at 469; id., Problems in Drafting a Modern Corporation Law, (1931) 17 *Am. Bar Assn. J.* 579 at 581; Hills, G.S., Model Corporation Act, (1935) 48 *Harv. L. Rev.* 1334 at 1375 n. 33. Also Luce, K.K., Trends in Modern Corporate Legislation, (1952) 50 *Mich. L. Rev.* 1291 at 1296-1297.

<sup>45</sup> *Op. cit.* supra note 8 at 177.

<sup>46</sup> Dodd in Statutory Developments in Business Corporation Law, 1886-1936,

courts generally have not in fact accepted Drinker's conclusion. In the absence of statutory and charter provisions abolishing the right of preemption, they have continued to recognize and apply the old common law rule. And Frey's recommendations have been adopted by only three states.<sup>47</sup>

### 3. *Preemptive Rights of Preferred Shareholders.*

In the previous discussion of the orthodox basis of preemptive rights, it was assumed that the corporation issuing the additional stock had but one class of shares, common shares, and that the additional shares were of the same class. Under such conditions, the operation of the rule was simple: the additional shares are to be offered first *pro rata* to the old stockholders. Where the additional shares are to be of a new class, they are also to be offered preemptively to the existing common stockholders, unless, perhaps, the additional shares are both non-voting and non-participating preferred stock. The difficult questions arise where the old shareholders include holders of common and of preferred stock. The important thing to remember is the reason of the rule, and that where such reason does not exist, the rule ought not to be applied.<sup>48</sup> This seems logical enough; but the cases certainly do not exhibit the symmetry of logic in dealing with preferred shareholders' rights of preemption.

The preemptive right is supposed to protect from impairment and dilution the shareholder's rights to voting control, to net earnings, and to net assets of the corporation. The impairment of any one of those three rights, it would be expected, would be sufficient to call for the application of the rule. An examination of the cases fails to disclose any where existing stockholders, including common and preferred, were accorded preemptive rights on the sole basis of

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(1936) 50 *Harv. L. Rev.* 27 at 51, had no doubts that it was not. Berle points out that where the preemptive right has been abolished (*loc. cit.*, *supra* note 35 at 1265) "for protection, the shareholder has only a set of expectations that the men who compose the management and control will deal fairly with his interest. He must rely for the most part, not on legal rights, but on economic significances—on an accumulation of conditions which will make it desirable or advantageous, for the purposes of the administration of the corporation, to recognize a participation more or less meeting his expectations." See also Hoshour, H., the Minnesota Business Corporation Act, (1933) 17 *Minn. L. Rev.* 689 at 697-698; and notes in 4 *Stan. L. Rev.* 449 at 450 (1952), and 1 *U. of Chi. L. Rev.* 645 at 647 (1934).

<sup>47</sup> *Louisiana Rev. Stat.* 1950. § 12:28 B(1); *Maine Rev. Stat.* (1944) c. 49 s. 71; and *Maryland Ann. Code* (Flack, 1951) art. 23, s. 26 (b) 6. limit preemptive rights to shares having voting rights unless the contrary is provided in the articles of incorporation.

<sup>48</sup> In Frey's phraseology (*loc. cit.*, *supra* note 25 at 569) the preemptive right is a "secondary" right, existing only where there is another "primary" right to be protected.

the diminishing effect of the additional shares on their interest in the corporation's net earnings. In *General Investment Co. v. Bethlehem Steel Corporation*,<sup>49</sup> the defendant corporation had an authorized capital stock of \$75,000,000, divided into \$15,000,000 of preferred stock and \$60,000,000 of common stock. The common stock was divided into two classes, \$15,000,000 called "Common" and \$45,000,000 called "Common Class B." The voting power was confined to the \$15,000,000 preferred and the \$15,000,000 "Common." The preferred stock was non-participating, i.e. had no right to the net assets save to the extent of par value and accrued dividends. The corporation proposed to issue \$30,000,000 worth of new preferred stock, entitled to 8 per cent cumulative dividends, redeemable at \$115 and convertible into "Common Class B." The proposed preferred stock would have no voting power, but was to be preferred, as to dividends, over the common and present preferred, *pari passu*. The plaintiff company held \$100 of present preferred, and sought injunction to restrain execution of the plan, alleging, *inter alia*, that the present preferred was not given a right to subscribe to the new preferred. Lane, V. C., in a concise opinion, denied the injunction. He reasoned that the preemptive right existed to prevent alteration of relative rights in the *assets* of the company and in its *control*. The present preferred was non-participating, hence its interest in the assets was not affected by the proposed issue. The proposed preferred was to be non-voting, hence it could not affect the present preferred's interest in control. Since the reason for the rule failed, the rule was not to be applied. A neat legal syllogism, which raises some interesting points.

Lane did not mention the shareholder's right to net earnings, presumably because the issuance of the new preferred would not impair the rights of the old preferred in that respect; this despite the postponement of the present preferred's claim to dividends until after the 8 per cent of the proposed preferred had been satisfied. Such subordination of rights would not seem then to constitute sufficient reason to grant preemption privileges.<sup>50</sup> And regarding the rights of the present preferred to net assets, there was no subordination since the present and the proposed preferred were to share

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<sup>49</sup> 88 N. J. Eq. 237, 102 A. 252 (1917).

<sup>50</sup> Crosby, R. H., in *The Rights of Stockholders to Subscribe to New Stock Issues*, (July, 1931) 3 *Corp. Prac. Rev.* 50 at 53, discussing the effect of issuance of preferred stock on the rights of existing common stockholders, suggests that subordination or postponement is "quite sufficient" to oblige the corporation to offer the preferred issue first to the holders of common stock. *New Jersey Stat. Ann.* (Perm. ed.) § 14:8-17 gives to holders of preferred stock entitled to limited preferential dividends and a fixed sum upon distribution of assets a preemptive right in case of issuance of additional shares with priority as to assets or dividends over the class of stock held by them.

simultaneously. Of course the present preferred remains entitled to its fixed percentage in dividends, and to its par value and accrued dividends in the distribution of net assets. The case indicates then that the preemptive right is a guarantee of fixed theoretical ratios and percentages rather than of absolute amounts. Subordination or postponement becomes relevant only when the amount available for dividends or return of principal is not enough to cover the claims of the old and the new issues; their respective percentages remain fixed in any case. There can be no legal guarantee of a stable rate of actual returns on capital, nor that the capital will be ultimately returned whole.

The Bethlehem case dealt with the question of the right of existing preferred shares to subscribe preemptively to a proposed preferred issue; and decided that voting, but non-participating, preferred shareholders have no preemptive rights to a proposed issue of non-participating, non voting preferred stock. The reasoning of the court can be extended to mean that there where the additional shares are of non participating, non voting preferred stock, the existing shareholders, whether common or preferred and of whatever class, will have no preemptive rights. Similarly, where the existing preferred shares are non participating and non voting, their holders will have no preemptive rights to any additional shares of whatever class. In the former case, the additional preferred shares being non participating and non voting cannot affect any interest of existing shareholders. In the latter case, the existing preferred shares being non participating and non voting do not have any rights that can be affected by any additional shares; they are roughly in the position of ordinary bondholders.

We come now to the question of the rights of existing preferred shareholders to subscribe preemptively to an additional issue of *common* stock. It is very difficult to draw out a rule of any definiteness from the cases on this point. It would seem that existing *non participating* preferred shareholders, though they may have voting rights, are not allowed to subscribe to additional common stock. In *Stone v. United States Envelope Co.*,<sup>51</sup> the share structure of the defendant corporation comprised 10,000 common shares and 40,000 preferred shares. According to its by-laws, the preferred stock had voting rights, and was entitled to 7 per cent cumulative dividends "before any dividends are declared or paid on the common shares," and to "preference over the common shares in any distribution of the assets of the corporation in liquidation." 2500 common shares remained unissued, until it was resolved to offer it to both the common and pre-

<sup>51</sup> 119 Me. 394, 111 A. 536, 13 A. L. R. 422 (1920).

ferred shareholders *pro rata* at \$150 per share, a price materially below its value. The plaintiff holding 1000 common shares sought to enjoin execution of the plan, on the ground that to give the preferred shareholders preemptive rights to the additional common at less than market or book value amounted to paying them a dividend in excess of the 7 per cent specified in the by-laws. The court accepted this argument, holding that the creation of preferred stock *prima facie* implies that the preferential rights are given in lieu of, and to the exclusion of, equality in participation which would otherwise exist. The preferred was entitled to 7 per cent dividends and no more, and the price differential at which the additional stock was offered was really a dividend to which the preferred had no rights.

The rationale of the Stone case was anticipated by *Niles v. Ludlow Valve Manufacturing Co.*<sup>52</sup> dealing with the case of issuance of common shares as a stock dividend. In the Niles case, the preferred stock was also voting and non participating. The plaintiff, holding 100 preferred shares, claimed he was entitled to share in the stock dividend. The court refused his claim, holding that the \$500,000 accumulated surplus belonged to the common shareholders, the preferred stock being entitled to no more than the stipulated 8 per cent accumulative dividends. Since the surplus could have been distributed in cash to the common stockholders, they were equally entitled to the corresponding share certificates where the surplus is capitalized, so the court reasoned.

The reasoning in the Stone and Niles cases does not appear to be quite satisfactory. For one thing, it severely circumscribes preemptive rights of preferred stock. As will be seen later, "rights offerings" are always at a price somewhat lower than the market price, for the differential is necessary to impart value to the rights. If so, then under the Stone-Niles doctrine, preferred stock, whether voting or not and whether or not it is entitled to share in the assets on dissolution beyond its par and accumulated dividends, would never have rights of preemption to additional common stock, unless, the court finds that the existing preferred is entitled to share in surplus profits in excess of the stated preferential dividends.<sup>53</sup> But it would seem to be a reasonable inference from *General Investment Co. v. Bethlehem*

<sup>52</sup> (2 Cir.) 202 F. 141 (1913), cert. denied 231 U. S. 748, 34 S. Ct. 320, 58 L. Ed. 465 (1913).

<sup>53</sup> In *Page v. Whittenton Mfg. Co.* 97 N. E. 1006 (1912), "non (asset) participating," preferred shares were given the right to subscribe to new shares of common issued pursuant to a plan to raise capital by reduction and subsequent increase of the capital stock. Here the preferred stock was entitled to 6 per cent cumulative dividends, and if more than 6 per cent on both classes was available, the preferred was to share in the excess equally with the common.

*Steel Corporation*<sup>54</sup> that preferred shares can have preemptive rights, where the existing preferred is either participating and/or voting, i.e. where the additional shares affects one or the other right. The approach used in the Bethlehem case commends itself as being more logical.<sup>55</sup> It will be remembered that both in the Stone and Niles cases, the existing preferred were entitled to vote. Presumably the proposed common shares carried voting rights. Clearly their issuance would upset the balance of managerial power, yet the court in each case refused to permit the preferred to participate in the issue of additional common.<sup>56</sup> In *Russel v. American Gas and Electric Co.*,<sup>57</sup> a case on all fours with the Stone case, the court recognized that the additional common would dilute the voting power of the existing preferred stock. But it dodged the point by relying on the qualification to the rule on preemptive rights referring to the unissued balance of originally authorized stock.<sup>58</sup> The court in the Stone case could have done the same but did not, and instead went

<sup>54</sup> *Supra*, note 49.

<sup>55</sup> To BERLE AND MEANS, (*op. cit.*, *supra* note 8 at 177), the Bethlehem case was the one case "which suggests a real understanding of the problem."

<sup>56</sup> In *Tennant v. Epstein*, 356 Ill. 26, 189 N. E. 864 (1934) where the court ordered the cancellation of the new common shares allotted as stock dividend to the non participating, voting preferred shareholders, the following dictum appears (at 189 N. E. 870): "It is strenuously argued that the stock dividend should be allowed to stand because, if declared pro rata, it would effect no change in voting control. While this is true, it very materially changes a more important right, viz., the right to dividends if and when declared." (Italics supplied)

The New York Stock Corporation Law (*Mckinney's Consol. L. N.Y. Ann. 1951*) in s. 39(2) and (3) recognizes that either of the two rights may serve as basis for grant of preemptive rights: (2) Except as otherwise provided in the certificate of incorporation \*\*\* and except as hereinafter provided, the holders of *equity shares of any class*, in case of the proposed issuance by the corporation of \*\*\* its *equity shares of any class* \*\*\* shall if the issuance of the securities proposed to be issued \*\*\* would adversely affect the unlimited dividend rights of such holders, have the right \*\*\* to purchase such shares or securities on the proportion determined as hereinafter provided. (3) Except as otherwise provided in the certificate of incorporation \*\*\* and except as hereinafter provided, the holders of *voting shares of any class*, in case of the proposed issuance by the corporation of \*\*\* its *voting shares of any class* \*\*\* shall, if such proposed issuance would adversely affect the voting rights of such holders, have the right \*\*\* to purchase such shares or securities in the proportion determined as hereinafter provided. (italics supplied)

<sup>57</sup> *Supra*, note 29. See Notes in 26 *Harv. L. Rev.* 75 (1912) and 13 *Col. L. Rev.* 146 (1913).

<sup>58</sup> Hills, G. S., Preemptive Right of Preferred Stockholders to Subscribe to New Stock, (1927) 5 *N. Y. L. Rev.* 207 at 213, implies that this was not necessary; for "strictly speaking, new stock is authorized but unissued stock, and the comparative lateness of its authorization should not be a determining factor in its qualification as a proper dividend on the common stock. It would seem to follow that an increase of

off on a point on the construction of the contract of preferred shareholders.

The existing preferred stock in both the Niles and Stone cases was non participating. This fact, (if we put aside the effects of the additional common shares on voting control), tends to explain the denial of preemptive rights to the existing preferred shareholders. Its significance as the absence of a primary right requiring the protection of a secondary one was not clearly brought out by the court. This was clarified by subsequent cases involving the preemptive right of *participating*, voting preferred shareholders to subscribe to additional common stock, the non participating character of the stock in the Stone and Niles cases serving as a decisive distinction.

In *Thomas Branch and Co. v. Riverside and Dan River Cotton Mills*,<sup>59</sup> the defendant corporation had an originally authorized and outstanding capital stock consisting of \$4,000,000 of common and \$6,000,000 of 6 percent cumulative preferred shares. The holders of both classes of stock had the same rights save that the preferred stockholders were limited in their dividend rights to the 6 percent cumulative rate. The charter was subsequently amended, increasing the capital stock to \$7,500,000 common and \$7,500,000 preferred. It was resolved to issue 20,000 common shares at par \$100, to the common shareholders exclusively, thus equalizing the outstanding amounts of both classes of shares. The plaintiff and other preferred shareholders sought to compel the corporation to issue to them a proportionate share of the new common stock. The court granted the relief prayed for. The reasoning employed was a complete turnabout of that in the Stone and Niles cases, but the court, as pointed out above, preferred to distinguish the latter on the ground that here the preferred stock was "participating." The court held that the expression of a preference and a limitation as to *dividends* did not deprive the preferred shareholder of his preemptive rights. The purpose of the limitation was to prevent the preferred shareholders from receiving dividends in excess of 6 per cent, and *not* to preclude them from becoming holders of common stock or from receiving the dividends on common stock. Further, the issuance of additional common at a price below the market value was *not* in legal effect a declaration of dividends out of surplus profits; it left the undivided profits untouched while adding \$2,000,000 as new capital. Lastly, the court *denied* that because the surplus profits could have been distributed in cash to the common stockholders exclusively after the preferred's 6 percent had been paid, the common shareholders

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capital stock and sale thereof for cash at par and at a price less than its market value would also come under the same rule."

<sup>59</sup> 139 Va. 291, 123 S. E. 542 (1924).

were equally solely entitled to the stock dividend in case of the capitalization of the surplus. A cash dividend was "essentially different" from a stock dividend. The distribution of the former could not affect the rights of the preferred, while distribution of the latter exclusively to common stockholders "seriously affects" the preferred's interests in both net assets and voting control. *Riverside and Dan River Cotton Mills v. Thomas Branch and Co.*<sup>60</sup> extended these principles to govern not only the issuance and sale of new common stock but also the declaration of stock dividends in the form of common shares.

It will be noticed that these two cases refine the concept of participating preferred shares and indicate the term's double reference to a right to share in profits beyond the fixed dividend percentage and to a right to share on dissolution in the net assets beyond the principal and accrued dividends. The absence of the former would not necessarily lead to a denial of preemptive rights, as the latter may exist and require protection.<sup>61</sup> The court in these two cases seemed to have used the term "participating" to refer to the latter right, for both in these two Branch and Co. cases and in the Stone and Niles cases the preferred shares were limited to their fixed rates in dividends. The latter right was not discussed in the Niles and Stone cases.

The two Branch and Co. cases indicated a closer adherence to Vice Chancellor Lane's technique in the Bethlehem case. Clearly additional common stock diluted the interests of the existing preferred where the latter had a right to participate in net assets in excess *ci par* and accrued dividends and had voting rights. Two primary rights existed, hence the secondary one of preemption could logically be invoked. Under the Stone, Niles and Russel cases, i.e. where the existing preferred is non participating but voting, it might seem that the existence of one primary right, that of voting, is insufficient to give rise to the secondary preemptive right. This, it is submitted, is at least doubtful, since neither the Stone nor the Niles case even touched this question while the Russel case evaded it. Thus Morawetz poses as a "debatable question" whether holders of non participating

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<sup>60</sup> 147 Va. 509, 137 S. E. 620, 52 A. L. R. 213 (1927).

<sup>61</sup> See STEVENS ON CORPORATIONS (1949) p. 507. But see Rowell, J. H., Rights of Preferred Shareholders in Excess of Preference, (1935) 19 *Minn. L. Rev.* 406 at 417: "One thing should be pointed out, that the value of the right to participate in assets on dissolution taken alone, is much overrated. It does not in fact add to the market value of a security appreciably unless the increased book value is reflected either in greater safety or in higher dividends. \*\*\* the dividends stays the same, no matter how high the book value may go. The market value cannot go up as does that of the common stock with an increase in book value. The market value of safe preferred stock remains constant at a figure set by capitalization of the annual dividend rate. This being so, the preferred stockholder has merely been robbed of a value he had not and which as a practical matter he may never realize."

shares with voting rights are entitled because of their voting rights to a preemptive right in an issue of additional shares with voting rights.<sup>62</sup> A corporation desiring to raise capital or to capitalize surplus profits can avoid this vexing question, either by making the additional shares non voting which it could then freely issue to common shareholders exclusively; or, a less satisfactory recourse, by issuing two classes of additional shares, the additional non participating voting shares to be offered to the non-participating, voting shareholders exclusively, and the additional common to the common shareholders solely. Morawetz's suggestion<sup>63</sup> that non participating preferred shareholders' preemptive right be limited to a right to take the additional stock only upon payment of its actual value is of dubious utility. For then, the stock "right" would be valueless, and the impecunious shareholder will be unable to compensate himself for the dilution of his voting power by selling the "right." On the other hand, the shareholders able and willing to preserve their voting power by paying the actual price of the additional shares could just as well buy in the open market.

The cases then apparently regard as crucial in determining the preemptive rights of preferred stockholders the participating or non participating (in net earnings or in net assets) character of the outstanding preferred stock. In other words, the contract limitation to a priority in earnings or assets over common stock would seem to negate the preemptive right of preferred stock issues.<sup>64</sup> Thus Morawetz sums up:

" \* \* \* it is a violation of the rights of holders of common and of holders of *participating* shares, with or without voting rights \* \* \* to issue additional common shares or participating shares, with or without voting rights, or (if *such* stockholders have voting rights) additional non participating shares carrying voting rights, unless either the additional shares are given to these stockholders pro rata as a share dividend, or subscription rights shall first have been given to these stockholders \* \* \* " <sup>65</sup>

<sup>62</sup> *Loc. cit. supra* note 43 at 194.

<sup>63</sup> *ibid*, at 195.

<sup>64</sup> See DEWING, A STUDY OF CORPORATION SECURITIES, (1934) p. 155.

<sup>65</sup> *Loc. cit. supra* note 43 at 192; italics supplied. A survey of state statutes reveals that only Ohio completely denies any preemptive right to holders of non participating preferred stock. (*Ohio Gen. Code Ann. [Page, Supp. 1952] § 8623-35*) Other states permit them a limited preemptive right, that is, to additional non participating preferred stock: e.g. *New Jersey Stat. Ann. (Perm. ed) § 14:8-17*; *Alabama Code, (1940) tit. 10 § 41*. *Rhode Is. Gen. L. (1938) c. 116. § 34* gives to non participating, non voting, preferred stockholders the right to subscribe preemptively to new non participating, non voting, preferred. Morawetz's summation should be modified to this extent.

It is submitted that in closely held corporations, the right to vote is of sufficient importance to warrant the application of the rule of preemptive rights to prevent its dilution, even though the outstanding preferred is non participating.

#### 4. *Price of the Additional Stock and of Stock Rights.*

It will be remembered that Frey and Drinker asserted that the fixing of a fair and reasonable price for the additional shares was protection enough for the shareholders' relative rights in the assets of the corporation, without the necessity of a rule on preemptive rights. This seems to assume that dilution of relative interests in the assets refers exclusively to the book value or possibly the market value of the stock at the time of creation of the additional shares. Obviously such value would not be altered so long as the corresponding value per share is paid in by the new stockholders. We have seen however that the preemptive right is more of an attempt to preserve existing ratios or relative positions rather than an effort to freeze theoretical stock values existing before the additional shares are issued. Assume X corporation has 1000 outstanding and authorized shares. Suppose A owns 100 of these shares, such that his relative claim to net assets is  $1/10$ . For purposes of simplicity, assume that the par, book and market values all stand at \$100. The corporation wishes to issue at par 1000 more shares of the same class. Before the issuance of the new shares, A's relative interest in the assets of the corporation was  $1/10$  of \$100,000, or \$10,000. After the issuance of the new shares, if A is denied participation therein, A's relative interest in the assets would be  $1/20$  of \$200,000 or \$10,000. Measured in terms of absolute amounts, A has suffered no prejudice. But his relative position or proportional claim on the assets has changed considerably. For the investor, asset values are ordinarily of no practical significance save at the time of dissolution. By that time, assets may have expanded or shrunk depending on the success of the enterprise. Then what matters to the shareholder is his relative proportional claim to the net assets, now  $1/20$  of whatever amount is left for distribution. He would not be interested in the fact that some time in the past the book value of his shares had remained at \$10,000 although his proportional claim had been cut down from  $1/10$  to  $1/20$ . Where the old shares were selling above par, and the additional shares are issued at par, the more the stockholders who exercise their preemptive rights the greater will be the reduction in book value. It is by the alteration of ratios rather than of book values that prejudice to the stockholders is to be determined.

It has been frequently held that stockholders are entitled, as a matter of right, to take the additional shares at par. In *Scheirich v.*

*Otis Hidden Co.*,<sup>66</sup> the plaintiff sought to set aside the increase and sale of capital stock, on the ground, among others, that the new shares were offered to the stockholders at par instead of book value. He had been unable to take his proportionate part of the new stock and sought to protect himself by maintaining the book value of his stock. If he had taken his pro rata share, the book value would have gone down further but his relative position would have been preserved. The court refused him relief saying that the old stockholders had the right to take the new stock at par without paying any premium, and that he could protect himself by selling his stock "right." In *Hammond v. Edison Illuminating Co.*,<sup>67</sup> the corporation offered an increase of \$1,000,000, of the par value of \$25 at \$31.25 per share to the stockholders. Hammond sought and obtained mandamus to compel issuance to him of his proportionate share at par instead of at the 25% premium. The court said that the right to take the new stock at par or to sell that right was one of the rights acquired by the stockholder when he first subscribed to the stock. If the business is profitable, the stock may be worth more than par; if so, it is because of the investment and use of the capital put in by the original stockholders. The surplus belongs to the old stockholders. If they are required to pay a premium for the new stock, the premium representing the surplus, they are in effect being charged for something to which they already had a legal right. This seems to have been the unexpressed assumption of the court.

Where the additional stock has a par value, the issue price usually cannot be below par under the ordinary rules prohibiting stock watering.<sup>68</sup> Where the market value is below par, it is obviously meaningless to say that the stockholders have the right to take the new shares at par. In such a case, an amendment of the articles of incorporation reducing the par value to a figure below the market value may have to be resorted to. True the corporation may in an emergency succeed in selling the new stock to the old stockholders at par and above market value. Such cases will be rare since the ordinary stockholder is very slightly impelled by loyalty to support his corporation.<sup>69</sup> But where the market value is above par, there seems to be no real reason why it cannot be sold above par. For one thing, when the corporation creates new shares, it is presumably in need

<sup>66</sup> 204 Ky. 289, 264 S. W. 755 (1924).

<sup>67</sup> 131 Mich. 79, 100 Am. St. Rep. 582, 90 N. W. 1040 (1902).

<sup>68</sup> *Kansas Gen. Stat.*, 1949, (Corrick) § 17-3211 and *Indiana Ann. Stat.* (Burns, 1948 *Recomp.*) § 25-205 (c) are exceptions permitting the issue price of additional par stock to be below par.

<sup>69</sup> The case of Hupp Motor Car Corp. is discussed in detail in 2 DEWING, *op. cit.*, *supra* note 17 at 1203 (note t)—1205.

of more capital to pay debts or for expansion purposes. It should be able to raise the money at the cheapest rate and most advantageous terms,<sup>70</sup> to get the maximum possible amount of cash. This would seem to be ordinary business prudence.

In *McClanahan v. Heidelberg Brewing Corp.*<sup>71</sup> the corporation increased its capital stock by 200,000 shares with a par value of \$1. The offering price to the stockholders was not less than \$1.25 and not more than \$1.50. The plaintiff stockholder demanded that she be sold her proportionate share of new stock at par. The court denied her prayer, saying that as a general proposition, in the absence of some particular reason for offering an additional issue to the shareholders at par, the "better business practice" would be to sell the additional issue at market value. The state (Kentucky) unlike some states,<sup>72</sup> had no statutory provision expressly permitting the issue price of new par value stock to be in excess of par. However, it had the quite common provision providing for the fixing of the subscription or issue price by action of the stockholders or the board of directors. The court relied on this provision as expressly authorizing the sale of a new issue at not in excess of market value. It is obvious that there where the subscription price is fixed at market value and preemptive rights are recognized, the shareholders are accorded the fullest possible protection against dilution. It is equally obvious that an issue price at par when market quotations are above par is in effect returning a portion of the shareholders' investment to the extent of the difference between market and par values, assuming that the shareholder either sells his "right" or the new stock through exercise of his "right." To require the corporation to do this, at the very moment when it needs new capital seems anomalous.

Actually, where preemptive rights are recognized by the issuer, the "better business practice" is not, as the *McClanahan* case suggests, to sell the new issue at market prices. The issue price is set below the market price, otherwise the "rights" become valueless, and the stockholders' psychological melon bursts. The issue should not be too close to the market price of the old stock, for should latter fall below the former, again the "rights" are valueless and the "rights" offering is a failure unless it was underwritten. Neither should the issue price be too far below the market price. The stock "rights" should not be given excessive values. Stockholders who are compelled

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<sup>70</sup> See Spencer, E. A., *The Application of the Preemptive Right to Additional Issues of Corporate Stock*, (1943) 8 *John Marshall L. Q.* 376 at 383.

<sup>71</sup> 303 Ky. 730, 199 S. W. 2d. 127 (1947).

<sup>72</sup> E. g. *Arkansas Stat.* (1947) § 64-218; *Florida Stat. Ann.* (1941) § 612.20; *Tennessee Code Ann.* (Williams, 1934) § 3734; *New Jersey Stat. Ann.* (Perm. ed.) § 14:8-17.

to sell their "rights" would be disposing of a considerable portion of their investment. While they can partially regain their former position by using the proceeds to purchase new stock "ex rights," they should not be compelled to make too large a turnover of their investment.<sup>73</sup> Moreover, those who from ignorance or neglect fail either to subscribe to the new stock or to sell their "rights" would be too heavily penalized. Suppose a corporation, whose stock is selling several times above par, is committed by its charter or required by statute<sup>74</sup> to sell the new issue to its shareholders at par. In such a case it may be desirable to depress the market temporarily by the declaration of a stock dividend preliminary to the "rights" offering,<sup>75</sup> should the amendatory procedure prove too slow or cumbersome.

It has been mentioned above that the stockholder who sells his "rights" really receives a return of a part of his investment to the extent of the value of the "right." This is made clear by a consideration of the process of valuation of stock "rights." Since a purchaser can either buy outstanding shares or buy "rights" and add cash to obtain similar shares, evidently he will give no more for "rights" than the difference between the cost of the old shares *ex rights* (after the date fixed by the corporation to determine record holders entitled to exercise the "rights") and the money he will have to put with the "rights" to get new shares. Before the stock sells *ex rights*, its market value carries with it the value of the attached right, i.e., the value of the stock *cum rights*. After the record date when the stock sells *ex rights*, the market price is marked down by the amount of the value of a right since the seller then keeps the "right." This decrease in value represents the return to the stockholder who sold his "right," or a loss if he allowed the "right" to lapse without selling or exercising it.

Assume that the stock is selling *cum rights* at \$150 a share and each old share is to receive the right to subscribe to one new share, (one Philadelphia "right" here coinciding with one New York "right," for purposes of simplicity)<sup>75a</sup> at \$100 per share. Then \$100 plus an old share worth \$150 entitles the holder to two shares, or a total cost of \$250. The value of each share will be \$125. Since \$100

<sup>73</sup> See MONTGOMERY, R. H. (ed.), FINANCIAL HANDBOOK (1937) at 543.

<sup>74</sup> See, for example, *Massachusetts Ann. L.* (1948 *Recomp.*) c. 155 § 20.

<sup>75</sup> MONTGOMERY, *loc. cit. supra* note 73.

<sup>75a</sup> GERSTENBERG, *op. cit. supra* note 18 at 345 n. 16: "A few years ago the Philadelphia Stock Exchange dealt, not in rights as they are dealt in on the New York Stock Exchange, but in warrants, which meant that the rights were quoted on a basis of the value attaching to a new share. The 'Philadelphia rights' always had as many times the value of a 'New York right' as was represented by one share divided by the fraction of the rate of increase in stock. Thus, if the stock were increased 40% or 2/5, the 'Philadelphia right' would be worth 5/2 times the 'New York right.'"

plus a "right" entitles a holder to a new share, the value of the "right" is \$125 minus \$100, or \$25. This is the amount by which the value of the old share is decreased when it sells *ex rights*. The process is expressible in convenient formula:<sup>76</sup>

$$\frac{\text{Premium of stock cum rights in excess of cost of exercising a "right"}}{\text{Number of old share "rights" needed to get one new share} + 1 \text{ (new share)}}$$

or

$$\frac{M \text{ (Market value cum rights)} - S \text{ (Subscription Price)}}{R + 1}$$

By substitution, we get

$$\frac{\$150 - \$100}{1 + 1} = \$25$$

Of course the "rights" will actually sell at a price somewhat lower than their theoretical value of \$25. For it is necessary to offer some inducement to a purchaser to buy the "rights" and then subscribe for the new stock rather than buy the stock *ex right* outright from the open market. In any case it is clear that the proceeds of the "rights" in no way represent pure profit to the old shareholder. He has merely received in cash a portion of the value of his stock; in truth, there has taken a partial liquidation of his previous stock holdings, because he failed to invest more capital by exercising the "rights" himself. The same thing is true where he exercises his "rights" and then sells the new shares. The apparent profit is really the value of the "right," itself broken off the old stock values.

For the old stockholder then stock "rights" are ordinarily no profit making mechanism. He however may utilize them as cheap means of speculation. If the stock is selling at a premium, that is, above its theoretical parity with the "rights," he can sell stock short and purchase the "rights." He can hold the "rights" until their expiration date when he will exercise them and cover the short sale with the new stock. If the stock should fall at a discount from parity with the "rights," he can undo his position by covering the short sale in the stock and at the same time sell the "rights" he holds. If the market price of the stock for some reason drops below the issue

<sup>76</sup> GRAHAM, B. AND DODD, D. L., SECURITY ANALYSIS, (1934) 673-674. The formula is modified slightly when the stock is selling *ex rights*:  $\frac{M - S}{R}$  The calculations

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must be refined to include factors like dividends declared on the old stock, interest savings where payment by installments is provided for, and brokers' commissions. Loss in SECURITY REGULATIONS, (1951) at 942 n. 235 adds that this formula does not apply to "rights" issued to holders of one class of securities to buy securities of another class. It is not quite clear whether he was referring to the absence of market price for an entirely new class of securities, in which case M is unknown, or to Frey's point on the impossibility of determining proportionality, so that R is unknown.

price, wiping out the market for the "rights," the short seller will profit to the extent of the drop minus the price he paid for the "rights." Normally, the market price of the stock tends to maintain a parity relation with that of the rights, and the two fluctuate sympathetically. Any deviation can be anticipated and exploited by short sellers, or minimized by arbitrage transactions by the issuer or the underwriter or both together.

It has been previously mentioned that the issue or subscription price should not be set too far below the market value of the stock. Under certain conditions, too big a gap may be held an abuse of discretion and a breach of fiduciary duty on the part of the directors. In *Steven v. Hale-Haas Corporation*,<sup>77</sup> the defendant corporation had an authorized capital stock of 35,000 non-voting, no par common shares, of which 19,770 were outstanding. The defendant's board of directors authorized the sale of 12,460 of the unissued common to an investment company at \$10 each, subject to the preemptive rights of defendant's shareholders, to pay a note held by it given by defendant's subsidiary. The plaintiff stockholders offered to purchase the entire stock issue at \$15 per share. Their offer was refused by the defendant's directors. The book value of the stock had been increasing steadily: 1939—\$11.06; 1940—\$12.34; 1941—\$14.19; 1942—\$16.13; 1943—\$18.24. The plaintiffs sought injunction to restrain the defendant from, *inter alia*, disposing of the common stock except at a "fair and suitable" price. The language of the court is not completely free of obscurity and ambiguity, but it seems to have recognized that preemptive rights as a protection of relative interests and the pricing of additional shares so as to prevent the dilution of stock values are different, though related, matters. Anyway, it held that the issuance of additional stock "at materially less than its value" may result in such injurious dilution to the shareholders as a whole that the preemptive right "will not be adequate protection to them," and in a proper case, the pricing of the new shares may constitute abuse of discretion and "fraudulent or oppressive actions against stockholders or actions taken in the interest of outsiders." Circumstances such as the character and situation of the corporation, the disparity between the issue price and the "true value" of the stock, the known ability of the stockholders to sell their "rights" or to invest further sums in the enterprise, and the liquidity of the stock are relevant in determining whether or not the new issue was an oppressive device to compel minority stockholders to keep on putting more money to prevent dilution of their equity. If it was, then preemptive rights "would not cure the difficulty." The court failed to find an abuse

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<sup>77</sup> 249 Wis. 9, 23 N. W. 2d. 620 and 768 (1946).

of discretion in the fixing of the \$10 issue price despite the book value of \$18 and the plaintiff's offer of \$15. Determination of the "true value" of stock is difficult, especially that of a closely held corporation, like the defendant, operating in a fairly limited territory, whose securities are not commonly dealt on in exchanges. Such stock usually sells for substantially less than book value due to the lack of liquidity and a ready market index. A short time prior to the new issue, stock had been sold at \$7.25 and \$10; hence the court could not bring itself to say that the setting of \$10 issue price was not honestly done.

How does a gross disparity in price operate as an oppression of the stockholders? Where preemptive rights are recognized, and *all* the stockholders actually subscribe to the new shares, the issue price no matter how far below the "true value" is quite immaterial. Whatever injury the shareholders suffer through dilution of book value is academic since the significant ratio is preserved. Indeed, the larger the gap between issue price and "true value," the smaller and the less objectionable is the compulsory reinvestment in the enterprise. However, the more common case is that not all the stockholders are able to subscribe to the new stock. In such case, dilution of stock values can be avoided by selling the rights, the proceeds representing the value torn off from the old stock. Of course the relative ratio of interest is disturbed. But the stockholder cannot be compelled to subscribe; the law can only afford him opportunity to maintain that ratio. So long therefore a market for the rights exist, gross price disparity may be an oppression only in the sense that it compels too heavy a partial liquidation, or too large a turnover of investment (if the proceeds of the rights are used to buy new stock) for the stockholder who fails to subscribe. It is quite doubtful whether that would constitute such damage as would give rise to a pecuniary liability of the directors. Where there is no market for the rights, there is still no oppression so far as the stockholders who can afford to subscribe are concerned. However, here the shareholders who do not have the money with which to subscribe are defenseless against dilution of stock values. Only in this case will gross disparity in price have an oppressive effect. The poorer stockholders will practically be compelled to incur debt in order to preserve their proportional interests. Can the directors say that the poverty of the stockholder is no concern of theirs? Probably they can, if the need for new capital is shown to be real and legitimate, but in any case the court may require them to minimize the harm by raising the issue price closer to the "true value." Where such need is not shown, the *Steven* ruling should be used to permit the impecunious stockholders to restrain the stock issue.

The Steven ruling then is of rather limited application.<sup>78</sup> The situation where it can be brought into play is really the same as that where no preemptive rights exist such that the court is compelled to invoke equitable principles and hold the directors to fiduciary standards in setting the subscription price. It is precisely the important virtue of preemptive rights that the protection it gives to the old stockholders is independent of directors' discretion, which, amoeba-like, is difficult to contain within definitive limits.

##### 5. *Distribution Techniques in Rights Offerings.*

One point that is frequently put forward to support the cutting off of the preemptive right is that the surrender of this right is necessary in order to give the directors more flexible powers in the issuance and distribution of the additional stock. It is said that it is a wise policy to recognize in directors a wide expanse of discretionary authority in procedures for obtaining new capital as by arrangements with underwriting and banking concerns, that the preemptive right may operate as a hindrance to "legitimate financing."<sup>79</sup> The soundness of this argument has been doubted.<sup>80</sup> It would be unduly presumptuous for the writer to attempt to resolve this controversy. All that will be attempted is a presentation of a few points involved in distribution practices where the preemptive right has not been abrogated by charter or statutory provision.

A rights offering may or may not be underwritten. If it is not, the corporation relies wholly on the existing shareholders exercising their rights, or selling them to others who will exercise them. Hence there is no assurance that all the stock offered will be sold. If only a small per cent is left unsold, the unsubscribed shares are usually disposed of to an investment banker after the lapse of the rights period.

<sup>78</sup> It seems a reasonable inference that the court had in mind the special situation of the non-salability of the "rights" when it spoke of inadequacy of the preemptive right. Thus (23 N. W. 2d. 620 at 630-631): "Even where there is a great disparity between the price at which the new stock is to be sold and its true value, the circumstances may be such as to warrant different conclusions in different situations. For example, in a corporation in which the stock is listed, widely held and frequently dealt in, the sales rights issued in recognition of the preemptive rights \*\*\* may be readily sold for their full value, or the stock acquired by such a small payment that the stockholders are not damaged and the disparity may not indicate an abuse of discretion. \*\*\* in a closely held corporation \*\*\* the same factor that makes it difficult to appraise the value of the stock may make it equally difficult in the event that new stock is issued for substantially less than its true value to get any substantial protection from the exercise of the preemptive right. This, for the reason that there will be no greater sale for subscription rights than there is for the stock itself \*\*\*."

<sup>79</sup> BALLANTINE AND STERLING, CALIFORNIA CORPORATION LAWS, 1949 ed., 142-143; BALLANTINE, *op. cit.* supra note 13 at 491.

<sup>80</sup> See GRAHAM AND DODD, *op. cit.* supra note 76 at 552 n. 1.

The corporation must be firmly established, its stock highly desirable and the rights very attractive. Even then, an "oversubscription privilege," i.e. privilege to subscribe, after having taken a pro rata share, to an unlimited number of additional shares not taken by the other shareholders, is usually included.<sup>81</sup> The saving of the underwriting commission is counterbalanced by the discount from market value at which the issue price is fixed. To enhance the likelihood of a 100% subscription, the corporation may pay dealers a per-share commission for bringing in subscriptions.<sup>82</sup> A "dealer-manager" may handle the operation for an additional fee and may also agree to use his best efforts to sell the unsubscribed shares. Since then there is greater probability of a full subscription, the issue price may be raised nearer to the market price, allowing larger net proceeds for the corporation.

But the corporation is still not certain of selling or disposing of the entire new issue. It can be assured of this only if the rights offering is underwritten. Further, the stockholders may wait until near the end of the rights period to see if the offering price is still attractive. During this period there is substantial risk of a drop in market prices. This risk is shifted from the corporation to investment bankers by "strict" or "stand-by" underwriting. The corporation pays a premium or fee and the underwriter agrees to stand by during the offering period, and thereafter to take up whatever portion of the issue is not subscribed for by the stockholders. For compensation, the underwriter may receive a fixed percentage of the entire issue or a fixed amount per share on all shares whether subscribed for or not, or a smaller percentage or amount plus an additional amount per unsubscribed share which the underwriter is compelled to take up.<sup>83</sup> Sometimes there is an agreement on the part of the underwriters to refund to the corporation a part of their profits on selling unsubscribed shares for more than the subscription or issue price.

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<sup>81</sup> It is sometimes called "supplemental subscription privilege" or "conditional purchase privilege." See Chandler, M., *Methods of Selling Utility Common Stock*, (1950) 45 *P. U. Fort.* 829.

<sup>82</sup> Loss, *op. cit. supra* note 76 at 108 n. 3. Hyde, W. T., and Abrams, E. R., in *Sale of Utility Common Stock through Warrants*, (1948) 42 *P.U. Fort.* 703 at 706-707 explains that without this feature, it is to the advantage of the dealer to advise his customer to sell the right rather than to exercise it: "But if he tells the customer to exercise his rights, he is taking bread out of his own mouth in two ways. If he tells the customer to buy the stock, the signed right will be handed to him with the request that he handle the transaction for the customer. And doing so will mean an actual loss of time and out-of-pocket expense in mailing the warrant with its accompanying check to the transfer agent and delivering the certificate for the new shares to the customer when it arrives. But, more important, by asking whether to exercise the right, the customer has indicated that he has some extra cash for investment, out of which the dealer could make a profit by selling him something 'on the shelf.'"

<sup>83</sup> Loss, *op. cit. supra* note 76 at 108; MONTGOMERY, *loc. cit. supra* note 73 at 549.

Drinker said that the willingness of investment bankers to underwrite issues is usually predicated on the prospect of at once protecting their commitment by an immediate distribution, and suggested that a better price is obtainable under an immediate firm commitment for a specified number of shares than where the underwriter cannot be certain of the number he has to take up until the end of the offering period.<sup>84</sup> It is interesting to note that in the case of common and preferred stock issues, there is a pronounced tendency for the compensation of an underwriter of a *non rights* offering to be a higher proportion of the selling price. A recent comprehensive study of the cost of flotation of 3444 issues of all kinds of securities, registered under the Securities Act of 1933 during the period 1945-1949, totalling nearly 30 billion dollars has been published.<sup>85</sup> The study shows that in non rights offerings, that is, where the securities are issued through investment bankers and underwriters either on the firm commitment or best efforts basis to the general public, the flotation cost of common stock was 9.61 per cent of the gross proceeds. This figure includes 8.47 per cent for commission and discounts, and 1.14 for other expenses. For preferred stock, the total cost was 4.21 per cent, of which 3.46 per cent is represented by commissions and discounts. On the other hand, the cost of offering stock for cash through subscription rights to the existing shareholders was significantly lower. The flotation cost of common stock so offered through standby underwriters was 3.72 per cent of the total subscription price; of this, 2.48 per cent was for commissions and discounts. The cost of floating preferred stock by this same method was 2.48 per cent of 1.56 per cent was for commissions and discounts. Common stock offered directly to the stockholders without the aid of standby underwriters cost even less, only 0.69 per cent of the gross proceeds.

Moreover, the flexibility and adaptability of the investment banking business has enabled it to formulate techniques for minimizing the risks attendant to a rights offering. The ordinary method of reducing standby risks is by anticipating the probability that not all the rights will be exercised. The underwriter begins distribution during the subscription period, selling stock short against shares that may be left unsubscribed at the termination of the period. This however is subject to the danger of underestimating the amount of subscription by the stockholders, with the underwriter possibly finding himself

<sup>84</sup> *Loc. cit.*, supra note 4 at 613-614.

<sup>85</sup> The study is summarized in *Sec. Act Release No. 3412*, April 24, 1951. The figures here given are taken from this summary. Chandler gives the following figures for public utility common stock, (*loc. cit.* supra note 81 at 840): underwriting fees in *non rights offerings* amounted to an average of 6.3 per cent of the selling price; 3 per cent adjusted average in *rights offerings*.

short with the market price rising. This method has been refined and modified, under the label of the Shields Plan, to reduce the risk of underestimation. The Shields Plan was formulated in late 1946 by a committee of the Investment Bankers Association headed by Shields and Co. The Plan permits underwriters, through the syndicate manager, to buy rights during the subscription period. The underwriter may exercise the rights prior to their expiration and sell the securities thus acquired during the offering period at a price consistent with the prevailing market. This way the underwriter's period of commitment is shortened, and the risk of an inaccurate guess of the amount of stock that can be sold short is removed. Their purchases of rights are channeled through the manager in order to retain control of the situation and to avoid the members of the underwriting group bidding against each other for the rights.<sup>86</sup>

Another distribution technique, an outgrowth of the Shields Plan, the Columbia Gas Plan or participating dealers plan, dispenses altogether with standby underwriting of the unsubscribed shares. The Columbia Gas Plan fuses into the Shields Plan the "dealer management" arrangement previously noticed in connection with rights offerings not underwritten. Instead of having the issue underwritten, the issuer pays dealers a commission for placing the stock. The commission is earned either by persuading the original stockholder to exercise their rights or by purchasing the rights for the dealer's own account to cover previous short sales of the stock obtainable by exercise of the rights. A safeguard against excessive buying of rights, which would result in a substantial run-up of the market price in violation of the anti-manipulative provisions of the Securities Exchange Act of 1934,<sup>87</sup> is provided by requiring that the purchase of rights can be made only after the short sale of the stock at a price fixed by the manager. The participating dealers may not buy rights if they are not short of stock, and of course they may not trade in the stock. The price fixed by the manager is agreed to by the dealers, which price is to hold good for twenty-four hours.<sup>88</sup> Since there is no underwriting of unsubscribed shares under this Plan, some disposition has to be made of shares not taken up. The

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<sup>86</sup> McDonald, H. A., *What Can Traders Do in a Right Offering?* (Oct. 27, 1949, N.S.T.A. Convention Number) 170 *Com. and Financial Chronicle*, (part 2), p. 6.

<sup>87</sup> Secs. 9(a) (2) and 9(a) (6); 15 U.S.C.A. § 78; (a) (2) and (6). McDonald, *loc. cit. supra* at 6: "It is important to bear in mind that these provisions have in no way been suspended for the right operations \* \* \* the statute remains in full force and effect.—the same rules apply as govern in the ordinary security distribution. They apply to both the rights and the stock."

<sup>88</sup> McDonald, *loc. cit.*, *supra* note 86 at 62.

"oversubscription privilege" reduces the likelihood of there remaining an unsubscribed residue. If there should be such residue, the shares, if the number is small, may be disposed of in the open market; or if the number is large, they may be made the object of a separate underwriting agreement, this time no longer of the standby type since the rights period has lapsed. There follows the ordinary procedures of forming the underwriting syndicate and the purchase and selling groups to spread the risk around and pool sufficient retailing capacity to insure complete absorption of the shares.<sup>89</sup> Both the Shields and the Columbia Gas Plans are still undergoing variation and modification, adjusting the basic theories to particular corporation and market situations. There is no reason to believe that experimentation to devise more efficient and economical means to reduce underwriting risks has stopped.

Quite apart from the Shields and Columbia Gas Plans, the underwriter in a standby agreement may engage in stabilization transactions to support the current market price. It is permissible to stabilize both the rights and the security which they call for. It will be noticed that stabilization will generally be an incidental result of the purchase of rights under the Shields Plan. The distinction depends upon the purpose of the purchases.<sup>90</sup> If the purpose is to lessen the standby risks, as shown by the sale of the shares called for by the rights, stabilization reports are not required by the Securities Exchange Commission; but such purchases must not be in excess of the underwriter's intention and ability to lay off stock, since such excess may be an unnecessary creation of activity and hence manipulative. The manager under the Shields Plan may not enter the market for rights until purchases by others have established the price at a free level. Neither may he raise his bid unless the independent market has moved above his bid and then only after the lapse of the 24 hours after his last purchase at the old price. Under the Columbia Gas Plan, all dealer activity save the solicitation of subscriptions, must be suspended during the period of stabilization. The manager's supporting bid would cause the members of the group, who were attempting to purchase rights to cover their sales of new stock, to make numerous raises in the price.<sup>91</sup>

From all the foregoing, it would seem that neither the cost nor the difficulties of distributing a rights offering is so prohibitive or so darkly insuperable as to necessitate abrogating preemptive rights

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<sup>89</sup> See Douglas, W. O., and Bates, G. E., *Some Effects of the Securities Act Upon Investment Banking*, (1933) 1 *U. of Chi. L. Rev.* 283 at 287-288.

<sup>90</sup> Loss, *op. cit.* supra note 76 at 944.

<sup>91</sup> McDonald, *loc. cit.*, supra note 86 at 63.

of shareholders. Certainly it seems reasonable to believe that satisfied shareholders would offer less sales resistance than complete strangers, and should generally prove easier to sell to.

## II. QUALIFICATIONS OF THE RULE.

The rule on preemptive rights is ordinarily defined in terms of a general rule with certain acknowledged exceptions or qualifications. What have been recognized as exceptions, as we shall see later, do not always satisfy logical consistency. The impression of syntactic unity yielded by the ordinary presentation as "general rule-exceptions" is often inaccurate, and productive of conceptual rigidity that may hamper adjustment to specific fact situations. Recognizing this, a more pliable conception of the preemptive right has been put forward.<sup>92</sup> The preemptive right is viewed as the end product of a process of balancing the claims of individual shareholders against the interests of the whole corporate polity, where the former are found to preponderate over the latter.<sup>93</sup> Under this view, the supposed exceptions are regarded as cases where the interests of the whole body of shareholders rise above individual claims, such that the balance being tipped in favor of the group, the preemptive right is not recognized. In more familiar judicial language, the question is whether the right of preemption "can be exercised consistently with the object which the disposition of the additional stock is legally designed to accomplish."<sup>94</sup> Consistency here seems to be synonymous with expediency and business convenience.

In *Todd v. Maryland Casualty Co.*,<sup>95</sup> the corporation, being in great need of capital to avoid financial disaster and having exhausted its credit, had turned to the Rehabilitation Finance Corporation from which it borrowed \$17,500,000. As security for the loans, 174,487

<sup>92</sup> STEVENS ON CORPORATIONS (1949) p. 500, 504. The conception is not entirely new; see 20 *Harv. L. Rev.* 398 (1907).

<sup>93</sup> Sometimes it is the interest of creditors, rather than of the corporation, that is balanced against the shareholders' individual claims. *In re McCrory Stores Corp.* (D.C.-S.D.N.Y., 1935) 14 F. Supp. 739, the plan for the reorganization of the corporation made provision for payment of a creditor's claim with stock at a fixed price. Some stockholders presented an alternative plan and objected to the stock issue alleging violation of their preemptive rights. The court held that the corporation being insolvent, the preemptive right must be dispensed with where necessary to do justice to creditors "whose unpaid claims are paramount to the preemptive right or any other right of stockholders." If the stockholders insist on the right to subscribe to all the new shares of the reorganized corporation, they would be required either themselves to deposit the money to pay creditors or to tender a firm commitment by others that on confirmation the money will be put up. See *N.Y. Stock Corp. Law* § 39-4 (e); and *Maine Rev. Stat.* (1944) c. 49 s. 71.

<sup>94</sup> *Thom v. Baltimore Trust Co.* 158 Md. 352, 148 A. 234 at 235 (1930).

<sup>95</sup> 155 F. 2d 29 (7 Cir., 1946).

Class A preferred shares had been issued to and held by the R.F.C. Finding that it needed more capital, the corporation negotiated a further loan from the R.F.C. of \$12,500,000. It was proposed that the corporation authorize and issue 299,487 preferred shares in the name of the R.F.C., the latter to surrender for cancellation the shares it previously held. The plan was approved by the requisite majority. The plaintiffs, dissenting stockholders, sought to set aside these transactions, raising, among other questions, that of the denial of their preemptive rights. The court, relying on the broad test of consistency with the legal object of the new issue, refused to recognize a right of preemption in the plaintiffs. There was no showing (it was "fantastic," according to the court, to think) that 12.5 million dollars could have been raised if the new shares were offered to the shareholders. One of the plaintiffs said he offered to purchase 40,000 common shares at \$2 per share. \$80,000 was insignificant compared to the amount needed to aid the rehabilitation of the corporation. "The only possible source" where 12.5 million could be obtained was the R.F.C., and the R.F.C. was entitled to require the security proposed. It will be noticed that the new shares were pledged as security for the corporation's total debts. They were not sold outright for cash. There was no indication that the corporation would not be able to redeem them; precisely, the additional loan was granted because the corporation had demonstrated remarkable financial recovery. From this viewpoint, the ordinary objections to a denial of preemptive right based on dilution of interests are not important. However, it should also be noticed that there was apparently no grave detriment that would result to the corporation from allowing the stockholders who had money to purchase some of the shares, and thereby reduce the amount of the proposed indebtedness. The negotiations with the R.F.C. had been protracted, and there was no evidence that the need for new capital was so gravely urgent as to make a reasonable offering period an intolerable delay. Possibly it was felt that the anticipated stockholder response would not warrant the expense of a prior rights offering; this point however was not raised by the corporation. Of course there is no cut and dried standard for determining the degree of convenience and expediency sufficient to justify disregard of preemptive rights. The test is necessarily a vague one, the permissible limits ill defined. One more point. At the time of the decision, there was no statutory provision in Maryland expressly recognizing preemptive rights. The charter of the corporation also was silent on the matter. The court could thus make the dictum in the Thom case its own, since it was appli-

cable "independently of the charter(s)." Since then, the above mentioned test has been incorporated into the Maryland statutes.<sup>96</sup>

### 1. *Unissued Balance of Originally Authorized Shares.*

A distinction is often drawn between additional shares as the balance of the originally authorized capital stock and additional shares newly authorized after going through the corporate ritual of charter amendment. In the issuance of the first, it is asserted, the corporation need not offer the shares preemptively to its stockholders, as it must in the second case. The sweeping assertion is that "a corporation may use its original unissued capital stock for any legitimate or lawful purpose it sees fit,"<sup>97</sup> without the burden of a preemptive offer to the shareholders. The distinction is explained in terms of a supposed "clear understanding" with which subscribers take shares constituting part of the initially authorized stock that the subscription be completed before they may rely on the freezing of their relative status.<sup>98</sup> The original subscriber is supposed to have calculated his proportionate interests on the basis of the total number of shares which the corporation could issue, presumably under its charter in its original terms. Otherwise, as an early case, fearful of its own logic, put it, the first subscriber might compel all the stock remaining untaken after his subscription to be sold to him-

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<sup>96</sup> *Maryland Ann. Code (Flack, 1951) art. 23 s. 26 (b)*: Unless otherwise provided in the charter, no preemptive right shall, in any event, accrue to a stockholder with respect to: (8) Any other issuance of shares where the applicability of preemptive rights is impracticable.

<sup>97</sup> *Archer v. Hesse*, 164 App. Div. 493, 150 N.Y.S. 296 at 299 (1914). An examination of the facts seems to show that the dictum was *obiter*. The plaintiff stockholders had previously sued the corporation and its directors to set aside a resolution providing for the issuance of 197 preferred shares to Hesse, a director, and to compel the surrender and cancellation of said shares. The court had rendered judgment for the plaintiffs and had ordered Hesse to surrender the shares for cancellation which Hesse did. The directors then issued 55 preferred shares to the attorneys for services rendered to the corporation and directors in the cancellation proceedings. Plaintiffs then obtained an order to show cause why the directors should not be punished for contempt. The lower court found defendants guilty of contempt, but was reversed by the Supreme Court. The plaintiffs claimed that the issuance of stock to the attorneys was unlawful because violative of their preemptive rights and sought to have the judgment sustained on that ground. Even if their preemptive rights had been violated, the issuance to the attorneys would not have been contemptuous, since Hesse had fully complied with the prior judgment. There was no need to discuss preemptive rights; and assuming the right existed, a contempt proceeding is hardly an appropriate way of enforcing the right or redressing its violation.

<sup>98</sup> *Dunlay v. Avenue M. Garage and Repair Co.*, 253 N.Y. 274, 170 N.E. 917 (1930).

self or at least would have a right to exclude any other person from subscribing.<sup>99</sup>

A curious fact may be pointed out. In *Grey v. Portland Bank*<sup>100</sup> to which, as previously noticed, the rule on preemptive rights is commonly traced, the shares involved were part of the originally authorized capital stock. Indeed Judge Sewall seemed to base his reasoning on the fact that their issuance "was not a creation of a new and disjointed capital." The exception we are now considering seems to have inverted Sewall's notion, for it would deny preemptive rights unless the shares were "a new and disjointed capital," i.e. newly authorized by a charter amendment.

The explanation of the alleged exception is not overly persuasive. For one thing, if pushed to the limits of its logic, it could explain away the preemptive right entirely. The statutory and charter provisions on amendment of the articles of incorporation form part of the subscribers' contract. The subscriber could be supposed to have taken into consideration the possibility of amendment, and the subsequent increase of the capital stock. Conceivably he could be regarded as having determined his relative interests, not on the basis of the charter as it was at the time of his subscription, but on the basis of the charter as it may stand amended at any time in the future. Furthermore, as Stevens points out,<sup>101</sup> the subscriber does not really fix his position in relation to the number of shares authorized at the time of his subscription, but rather in relation to the number of shares then offered for subscription. He could not have insisted on subscribing to more than what was initially allotted for subscription. And then again, if the alleged exception be accepted, the shareholders can be unwittingly stripped of the protection of the rule by the simple expedient of specifying in the articles, at the time of incorporation, a number large enough to take care of any possible future capital need, thereby obviating the necessity of amending the articles whenever an increase of capital stock is desired. There is no legal necessity to issue initially, or at any one time, the entire authorized number of shares. Such smaller number as the business may require may be issued from time to time, and each time free of preemptive rights.<sup>102</sup>

*Dunlay v. Ave. M. Garage and Repair Co.*,<sup>103</sup> while recognizing the above supposed exception, attempted to prick out confining lines. There, the corporation had an authorized capital stock of 800 shares,

<sup>99</sup> *Curry v. Scott* 54 Pa. 270 at 276 (1867).

<sup>100</sup> *Supra*, note 3.

<sup>101</sup> CORPORATIONS, (1949) at 510.

<sup>102</sup> See COMMENTARIES, RESTATEMENT OF THE LAW OF BUSINESS ASSOCIATIONS, Tentative Draft No. 1, (1928), sec. 12, comment c, p. 28.

<sup>103</sup> *Supra*, note 98; Note in 29 *Mich. L. Rev.* 107 (1930).

all of which were outstanding except 76 shares. The directors issued 50 of the remaining shares at par to one Graham in satisfaction of a debt owing to him from the corporation for services rendered as salesman. The other 26 shares were issued also at par to defendant Ageno, a director, and president of the corporation, for cash to meet certain debts of the corporation. The corporation was wrecked by a contest for control between the plaintiff's and Ageno's factions. The sale of the 26 shares to Ageno was not sufficient to give his faction control. But subsequently, the other 50 shares found their way from Graham to Montalbine, the latter being of Ageno's group, such that this group acquired control. The plaintiffs then sought the return to the corporation of the 76 shares and their cancellation, alleging their improper issuance. Justice Pound acknowledged the above exception referring to the unissued balance of the originally authorized shares and its explanation in terms of the subscriber's theoretic "understanding." However, he added, the understanding may be otherwise. He then proceeded to draw fine distinctions between the release of the unissued original shares when "reasonably necessary to raise money to be used in the business of the corporation," and the allotment of the same shares for the "expansion of such business beyond the original limits."<sup>104</sup> The inference is that in the first case, preemptive rights were not available, while in the second, the shareholders could lay claim to maintaining their relative positions. Here the sale of the stock to Ageno was for "a reasonably necessary purpose and beneficial to the corporation" there being no sinister purpose of serving the personal ends of the directors in obtaining control.

The line between the use of capital "in the business" and that for the "expansion of the business" is not always as sharp as may be desired. Consider, for example, the purchase of new machines to replace worn out ones where the new machines have a higher output. The term "expansion" may not necessarily be limited to pursuance of a line of business distinct from the old enterprise; it could reasonably cover the acquisition of more units of production. Of course where the issuer specifies the volume of the initial issue, by stating in the pros-

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<sup>104</sup> Cf. *Thurmond v. Paragon Colliery Co.* 82 W. Va. 49, 95 S. E. 816 (1918) at 819: "the rule of preemptive rights does apply \*\*\* to such part of the capital stock as is issued long after the corporation has commenced business \*\*\*." (Italics supplied) See note in 18 *Tenn. L. Rev.* 716, 717 (1945). The inference seems to be that capital desired long after the corporation has started business would be for expansion purposes. The distinction has apparently been wiped out by *Hall v. McLuckey* 60 S.E. 2d 280 (1950) at 288: "In this state (W.Va.) we are committed to the principle that the preemptive right \*\*\* is applicable to stock originally authorized and unissued." And see *Spencer, loc. cit. supra* note 70 at 379, who denies the correctness of the Dunlay doctrine but failed to adduce reasons for his denial.

pectus "authorized capital stock \$10,000,000; amount to be initially issued \$1,000,000," the Dunlay test assumes greater significance. In that case, the corporation itself may be deemed to have marked the line between shares issued for the contemplated "business" and those set aside for "expansion of the business."<sup>105</sup> Perhaps something of the sort was meant by Drinker when he said that:

"The proper test is not whether the shares were originally or subsequently authorized, but *whether they are part of the capital with which it was contemplated to launch the enterprise, in which all, whether joining first or last, might properly count on obtaining and keeping a proportionate part.*"<sup>106</sup>

The Dunlay test, and Drinker's refinement of it, seem to assume a hypothetical break, a breathing spell, between establishment and expansion, some point at which the corporate management can lean back and say "now we can think about expanding the business." Where that point has not been reached, it would seem clear that the preemptive right is not yet available. In *Yasik v. Wachtel*,<sup>107</sup> the corporation, a brewing company, was organized in 1933 with an authorized capital stock of 800,000 Class A shares, par \$1.00, and 200,000 Class B shares, par \$.25, with exclusive voting rights. The corporation had been unable to sell its stock and raise money to purchase necessary equipment. In 1934, the company employed Wachtel as exclusive salesman with a 35 per cent commission. Wachtel's efforts were continuous, not very successful, though the company finally began to produce beer. In 1937, he had become general manager and presented a bill for \$9490 for his services. Since the company had no cash, 58,400 Class B shares were issued to him in payment of the bill. The plaintiff, holder of 12 Class B shares, sought the cancellation of those shares, on the ground, among others, that their issuance was violative of his preemptive rights. The court refused to order their cancellation, holding that the preemptive right does not come into being until the termination of the original issue or offering and therefore applies only to a new issue or offering. Here the original offering had not yet ended, though 4 years had elapsed since first the corporation started soliciting subscriptions. From the very beginning, the company was continuously in need of capital, and had continuously offered its shares in the effort to start production. In terms of the Dunlay-Drinker test, the enterprise was still in the process of establishment; clearly the corporation was not in a position to consider expansion. The corporate debt paid by the issuance of the shares had accrued

<sup>105</sup> See BERLE AND MEANS, *op. cit.*, supra note 8 at 179-180 n. 46.

<sup>106</sup> *Loc. cit.*, supra note 4 at 603; emphasis supplied.

<sup>107</sup> 17 A. 2d 309 (Del. Ch. 1941), Noted in 40 *Mich. L. Rev.* 115 (1941).

for four years. There was "one continuous effort to create shares" during which the corporation could dispose of them to any person; preemptive rights would attach only after the conclusion of the "one continuous effort." It would not seem necessary that the directors must be always actively striving to create the additional shares, as in this case. It would seem enough that they have not as yet expressed an intention not to issue any more shares.<sup>108</sup> Such intent could be expressed in a resolution announcing the termination of the offering; but more practically, the resolution authorizing the offering, or the prospectus as above suggested, would specify the number of shares initially offered.

A terminating resolution, while convenient, is not necessary. Nor it seems, any explicit manifestation of the corporate intention to terminate the original offering. Suppose Wachtel instead of the mediocre salesman he was, turned out to be a phenomenal success in peddling the shares. Assume that the company was doing a booming business, selling all the beer it could produce. Would the payment of his commission in stock have been then justified, there being no contract calling for payment in stock? Could the "one continuous effort" still be held in progress, the original offering still held open, in the absence of expression of intention to terminate it? Under the dictum in *Ross Transport, Incorporated, v. Crothers*,<sup>109</sup> it seems that it could not. In that case, the corporation was organized in January, 1942, to operate a fleet of buses to transport the employees of a munitions company to and from its plant. The corporation had an authorized capital stock of 5000 no par shares. At the organizational meeting, a resolution was passed authorizing the issuance of 1500 of the shares at \$20 per share. Of this number, 1035 shares were actually issued. The company was an immediate financial success, since it had a monopoly of its business. By August, 1942, it had a net surplus of \$15,000, 75 per cent of the original investment. That month, 365 shares were issued at \$20 to one of the directors and to the wife and daughters of another director, increasing the outstanding stock to 1400 shares. In the action for cancellation of the 365 shares, the issuance was defended on the ground that it was originally planned, i.e. that it was part

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<sup>108</sup> RESTATEMENT, TENTATIVE Draft No. 1, sec. 12(1) comment c, p. 35-36.

<sup>109</sup> 45 A. 2d 267 (Md. 1946). A caveat must be added. Here the court explicitly preferred to base its decision on a violation of the fiduciary duties of corporate directors as the controlling consideration. Examination of the cases dealing with unissued originally authorized shares discloses that only one case squarely and explicitly decided affirmatively on the question whether preemptive rights attach thereto: *Titus v. Paul State Bank* 32 Idaho 23, 179 P. 514 (1919); others contain dicta more or less obiter. The *Titus* case, however, contained no discussion on the matter, and simply held that preemptive rights exist in such a case.

of the original issue of 1500 shares, and that the money was needed to buy additional buses. The court rejected this argument, pointing to the exceptionally favored condition of the company. It acknowledged the exception to the rule on preemptive rights, where the stock involved was part of the "original issue"; note that it did not say "originally authorized stock." The case, however, was an "exception to the exception," because "conditions have changed since (the start of) the original issue." The changed conditions consisting of the accumulation of surplus and the distribution of large dividends made it unnecessary to use the remaining 465 shares to obtain capital, and sufficed to signify the termination of the original issue quite apart from any action on the part of the directors.

In summation, it is submitted that what is significant is not the time of the authorization of the shares, at the time of incorporation or at a subsequent amendment of the articles. Rather, it is the time of the offering of the shares, that is, whether or not they form a part of the original offer or allotment. Original offer should be understood to mean the offer of such shares as may be required to raise the initial capital outlay necessary to place the corporation on a working basis. The number specified in the resolution providing for the original offer is not necessarily conclusive. The actual condition of the corporation may be examined, to determine whether it has been established on a reasonably solid basis, so that acquisition of their capital could be regarded as expansion. It must be admitted that the lines drawn are fine ones. New York has cut through all of them, and has fixed an arbitrary period of two years from the date of filing of the certificate of incorporation within which shares originally authorized can be sold free of preemptive rights.<sup>110</sup> This has at least the virtues of certainty and simplicity, permitting the relative status of shareholders to crystallize at a definite time instead of remaining in a state of flux pending exhaustion of the original offer, a time which may not be at all certain.

## 2. *Issuance of Stock for Consideration Other Than Cash.*

It is in this area of the law on preemptive rights that the conception of an equitable equilibrium of interests, the individual share-

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<sup>110</sup> *Stock Corporation Law, McKinney's Consol L. N.Y. Ann.*, 1951 s. 39 (4) (d). *Louisiana Rev. Stat. of 1950*, § 12:28 D simply provides that the preemptive right applies alike to all shares, regardless of the time when such shares were authorized. *Maryland Ann. Code (Flank, 1951)* art. 23 s. 26 (b) (1) has enacted the Dunlay-Drinker rule, denying preemptive rights in "shares issued to obtain all or a portion of the capital required to initiate the corporate enterprise." Only *South Carolina Code of Laws, 1952*, § 12-275, seems to require explicitly a subsequent authorization by amendment of the articles of incorporation before preemptive rights become available.

holder's and those of the body corporate, is most useful. The text-writers<sup>111</sup> commonly assume, and the bar and corporations<sup>112</sup> have acted on the theory that shares issued for consideration other than cash are not subject to preemptive rights. This has been assailed vigorously. Frey denies that it is supported by either logic or authority.<sup>113</sup> Assume a corporation with 100,000 shares outstanding, held by 10 holders with 10,000 shares each, such that each of them has a 1/10 proprietary interest and voting power. If 50,000 new shares are issued to an outsider, the ratio is cut down to 1/15 and this effect follows whether the corporation received cash or property or services or other stock. The character of the consideration is immaterial as far as the net effect of dilution is concerned. On purely logical grounds, the objection seems unshakable. However, corporate law and practice, like the rest of human things, are not impelled solely by logic. The point is made that the reason back of this exception is practical necessity or business convenience.<sup>114</sup> Since money is fungible, the cash of one is just as good as that of any other, and the corporation suffers no inconvenience by accepting the shareholder's dollars rather than those of another. However, the property desired may be held by a person who stipulates that he will transfer it only in exchange for shares of stock. In such a case, it is not feasible to issue shares to the stockholders for cash and then use the cash to purchase the property, since the property must be exchanged directly for the shares. Or the option or opportunity to purchase may be so limited in time as to preclude the ordinary delay arising from an offering period. In these cases, the necessity or desirability of the corporation's owning the property must be weighed against the harm from dilution of stockholder interests. If the board of directors, in an honest exercise of business judgment, decides that the former outweighs the latter, preemptive rights should not prove an insuperable obstacle. The corporation should not be required to issue more shares than is necessary to acquire the property in an effort to restore as closely as possible the disturbed ratio. The harm from dilution can be mitigated by a strict insistence on a fair valuation of the property, and by the profitable use thereof. And so long as the corporation is run efficiently and honestly, reduction of voting power does not seem an overwhelming evil. Of

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<sup>111</sup> 11 FLETCHER, *CYC. OF CORPORATIONS* (Perm. ed.) p. 223; BALLANTINE, *CORPORATIONS* (1946) p. 480. See 1 MACHEN, *MODERN LAW OF CORPORATIONS* (1908) p. 499 n. 3.

<sup>112</sup> BERLE AND MAGILL, *CASES AND MATERIALS ON THE LAW OF CORPORATION FINANCE* (1942), note at p. 263.

<sup>113</sup> *Loc. cit.*; supra note 25 at 579; also Spencer, *loc. cit.* supra note 70 at 384; Coppock, *loc. cit.* supra note 13 at 362; Dwight, *loc. cit.* supra note 4 at 107; Morawetz *loc. cit.*, supra note 43 at 196.

<sup>114</sup> Drinker, *loc. cit.* supra note 4 at 607; see also 78 *U. of Pa. L. Rev.* 1026 at 1027.

course fiduciary standards must be rigidly adhered to, especially so in view of the sacrifice of the automatic right.

Turning to an inquiry into the cases, the paucity of direct support for the exception must be admitted, a surprising thing in view of the firmness with which it is supposed to be embedded in the law of corporations. With specific reference to an issue for property, not involving a merger or consolidation, only *Meredith v. New Jersey Zinc and Iron Co.*<sup>115</sup> is cited as direct authority. In that case, the corporation owned, jointly with another mining company, certain mineral properties containing franklinite and zinc. It being supposed that franklinite and zinc were metallurgically separate, the title to one had been sold apart from the title to the other. When actual mining operations started, it was found practically impossible to separate one from the other, and a serious dispute arose as to the nature and ownership of particular veins or portions of veins. A series of complex litigations commenced and was carried on, until the defendant held undisputed title over both franklinite and zinc in half of the property and over the zinc ores in the other half. Another suit was brought to establish title to the remaining franklinite ores, but was decided against the defendant corporation. At this stage, the defendant entered into a contract to settle the matter by the purchase by the defendant of the mineral properties held by the other company. Defendant was to pay \$1,250,000 in cash and to issue 32,934 shares, par \$100, to be distributed among the stockholders of the other company. Plaintiff shareholders of the defendant corporation sought injunction to restrain performance of the contract, on the ground among others, that the issuance of shares violated their preemptive rights. Pitney, V. C., denied the injunction, relying firstly, on the statutory provision authorizing payment for stock in property, and secondly on the above exception to preemptive rights. The first point is at

<sup>115</sup> 55 N. J. Eq. 211, 35 A. 539; aff'd without opinion 56 N. J. Eq. 454, 41 A. 1116 (1897). There are a few cases containing dicta to this effect: e.g. *Stokes v. Continental Trust Co.* 186 N.Y. 285, 78 N.E. 1090 at 1093 (1906); *Archer v. Hesse* 164 App. Div. 493, 150 N.Y.S. 296 at 300 (1914) (unissued balance of originally authorized shares); *Thom v. Baltimore Trust Co.* 158 Md. 352, 148 A. 234 at 235 (1930) (merger and consolidation); *Milwaukee Sanitarium v. Swift* 238 Wis. 628, 138 A.L.R. 521, 300 N. W. 760 at 763 (1941) (employee stock purchase plans). The matter may be covered by statutes which either specify shares issued for cash in defining preemptive rights, as in *New Jersey Stat. Ann. (Perm. ed.)* § 14:8-17, *Arkansas Stats.* (1947) 64-218, *Florida Stat. Ann.* (1941) § 612.20, *Tennessee Code Ann.* (William, 1934) 3734); or specify as an exception shares for consideration other than cash, as in *Ohio Gen. Code (Page, Supp. 1952)* § 8623-35 (c), *Michigan Stat. Ann. (Henderson, 1937)* § 21.31 (a) (as amended by Pub. Acts 1947 no. 209), *Idaho Code* (1947) § 30-120 (6) (b), *Louisiana Rev. Stat.* (1950) tit. 12 § 28 B (2) (a), *Maryland Code Ann. (Flack, 1951)* art. 23 s. 26(b) (2), *New York Stock Corp. Law (McKinney, 1951)* § 39.4 (a).

most only of oblique relevance, for the grant of power to accept property in payment for stock does not decide whether the rule of preemption applies therein. As to the second, there was no discussion of any basis for the exception beyond the observation that since the property would become part of the corporation assets, the dissenting stockholders would receive the same benefits as the others. The observation is commonplace, and certainly not of decisive significance since it holds true whether the consideration was property or cash. The force of the opinion, never really strong, was considerably weakened by *Wall v. Copper Co.*,<sup>116</sup> where the Vice Chancellor deprecated and all but repudiated his Meredith opinion, saying that the question on preemptive rights had been hastily considered (at most ten minutes during the lunch hour) and that anyway it was not necessary for the decision of the case. Be that as it may, the point here attempted to be made is that the factual situation justified, under the theory of an equilibrating process, the denial of preemption. The complex litigations had disrupted the operations of the corporation and were eating up its capital. The directors had decided that there was no practicable solution save to buy up all the mineral properties.

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<sup>116</sup> 70 N. J. Eq. 17, 62 A. 533 (1905) This case dealt with the issuance of bonds convertible into common stock at the holder's option at any time within 5 years. The Vice Chancellor held that the bonds were subject to the preemptive rights of the shareholders, pointing out that an option period held a peculiar danger of dilution since by then, the conversion price though at present adequate might have become inadequate due to a rise in the value of the common stock. Suppose the convertible bonds are issued for property, are they subject to preemptive rights? Berle in *Convertible Bonds and Stock Purchase Warrants*, (1927) 36 *Yale L. J.* 649 at 661 suggests they are: "(the corporation) can issue promises to pay in return for property; but a conversion privilege attached to such an obligation will not mean that the stock issued on the exercise of the conversion right is issued for property. The stock is issued for cash, the cash being applied to the liquidation of the obligation to pay." However, conditions that may require subordination of the right in stock issued for property may be equally compelling in an issue of convertible bonds for property.

The statutes frequently include among the exceptions to preemptive rights the issuance of shares in satisfaction of conversion or option privileges. The exception seems more apparent than real since the convertible securities previously issued were already subjected to preemptive rights (save in Maryland; see *Md. Ann. Code* [Flack, 1951] art. 23 s. 28 (c) (1)). The holders of the convertible securities are not entitled to preemption in case of a new issue of stock. The right belongs to stockholders, and they are not stockholders unless and until they exercise the privilege of conversion. This seems to be the accepted opinion: see Hills, G. S., *Convertible Securities-Legal Aspects and Draftsmanship*, 1930) 19 *Calif. L. Rev.* 1 at 11, and Feinberg, *loc. cit.*, supra note 35 at 83. This may be unobjectionable so long as the privilege is exercisable at any time. But where conversion cannot be had until a certain time, a stock issue prior to the permissible time for conversion may conceivably dilute or destroy the conversion privilege without the privilege holders having an opportunity to protect the value of their privilege.

There was no suggestion of any bad faith or corrupt motives. The valuation had been carried out by experts indifferent as between the parties, and was not at all questioned. The contract had been approved and the increase in capital stock authorized by 8/10 of the stockholders. Under these circumstances, it was entirely reasonable to subordinate preemptive rights of the dissenting two tenths to the legitimate needs of the corporation.

The exception relative to shares issued for property has been extended to those issued in payment of a corporate debt. In *Musson v. New York and Queens Electric Light and Power Co.*,<sup>117</sup> the corporation had an authorized and outstanding capital stock of 12000 preferred and 12000 common shares, each of the par value of \$100. It was indebted to Consolidated Gas Co., the majority stockholder, to the amount of \$7,100,000. A shareholders' meeting was held in 1922 to authorize the creation of 71,000 new common shares and their issuance to Consolidated Gas Co. in return for the cancellation of the debt. In 1931 plaintiff, holder of 10 shares, sought the cancellation of the 71,000 shares and demanded that he be allowed to exercise his preemptive right. The court refused him relief, holding that the shares were issued, not for money, but for property, that is, the claims of Consolidated Gas against the corporation, and hence were not subject to preemptive rights. The step from tangible to intangible property is short, but it may be a strained and artificial one where the intangible is a money claim. Such a situation may be indistinguishable from a direct sale of stock for cash. Ordinarily it is feasible to raise the needed cash by shareholder subscriptions and to use the cash to pay off the claims. Here there was no showing that this was impracticable. On the contrary, the market value of the stock was rising with the increasing volume of business that came with the rapid growth of the population of Queensborough. Presumably the stockholders would have found it an attractive proposition to increase their holdings. The court probably felt that \$7,100,000 was too large an amount to be absorbed by the shareholders. Besides, the creditor was its largest stockholder, holding a majority of both the preferred and common shares, so that a prior rights offering might have been deemed a circuitous formality. The plaintiff failed to prove his allegation of bad faith or fraud, and had waited for 9 years before bringing the suit despite his full knowledge of the action taken in 1922. Under these circumstances, it would seem that the extension of the exception to money claims was too broad a ground for the

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<sup>117</sup> 138 Misc. Rep. 881, 247 N.Y.S. 406 (1931). There is also dicta to this effect in *People ex. rel. New York Trust Co. v. Graves* 265 App. Div. 94, 37 N. Y. S. (2d) 900 at 903 (1942).

court's decision. Waiver or estoppel by laches would have been a sufficient answer to the plaintiff's complaint.<sup>118</sup> Further, it may be necessary, assuming the validity of the extension, to discriminate between a debt incurred bonafide in the operation of the enterprise and a disguised advance on an outsider's subscription. Here again, the conception of an equitable equilibrium of individual and corporate interests seems much more helpful than a straining of judicial logic. Circumstances are conceivable where the cheapest, most convenient and practicable way of liquidating a corporate debt would be the issuance of stock to the creditor and where the harm to the existing shareholders would be relatively slight.

*Hodge v. Cuba Co.*<sup>119</sup> is an interesting application of this balancing process, though here the court inferentially held that the dilution of stockholder interests was sufficiently great to override considerations of expediency. Debentures of the Cuba Co., a holding company, were payable January 1, 1949 in the sum of \$6,937,077. On 1948, the directors formulated a plan for refunding the greater part of the debt, the company having been unable to pay interest thereon since 1932. The plan offered an alternative to the debenture holders: (a) \$1,800 in new 6% debentures and \$18.37 in cash for each old debenture, or (b) \$1,475 in new debentures and \$20.87 in cash plus 150 common shares. The authorized capital stock of the company was 1,100,000 shares, of which 640,000 were outstanding. If the holders of 2400 out of the 4000 debentures elected to accept the second alternative, the entire unissued balance of 360,000 shares would go to the debenture holders

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<sup>118</sup> Under certain circumstances, laches or waiver may not mean a total loss of the right. *Oppenheimer v. Wm. F. Chiniquy Co.* 335 Ill. App. 190, 81 N. E. 2d 260 (1948) held that although the plaintiff may have been guilty of laches or implied waiver, unless there was positive refusal to take the shares or consent to their being withheld from him, still he would be entitled to demand that he be allowed to subscribe provided the new stock, or part thereof, was still undisposed of. See Adamson, F. L., Preemptive Right to Subscribe to Stock Issues—Necessity of Action by the Shareholder, (1949) 47 *Mich. L. Rev.* 805 at 809-811. It should be noted that waiver may be implied not only from passive acquiescence but also from an express agreement not to acquire a majority of the shares. In *Heylandt Sales Co. v. Welding Gas Products Co.*, 180 Tenn. 437, 175 S. W. (2d) 557 (1943), the plaintiff had agreed not to acquire more than 46% of the defendant's capital stock. But plaintiff by various means acquired 958 shares of the 1420 outstanding shares. Defendant then issued 580 shares to other stockholders excluding the plaintiff therefrom. On a suit for cancellation of the 580 shares, the court held that the agreement constituted a waiver of preemptive rights. More precisely, it would seem that it was the violation of the agreement that worked a forfeiture of preemption since the pro rata character of preemptive rights would ordinarily suffice to preserve the agreed maximum percentage. The equitable doctrine of unclean hands is also relevant.

<sup>119</sup> 142 N. J. Eq. 340, 60 A (2d) 88, 1948).

without the present shareholders having an opportunity to subscribe thereto. The outstanding common stock would be increased by more than 50%. The plan for refunding had not been submitted for the approval of the shareholders, a group of whom owning 6% of the outstanding stock brought action to enjoin execution of the plan. The court inquired into various alternatives suggested by the plaintiffs for the payment of the debt, like subscription by the shareholders, and borrowing from the railway and sugar companies which were the base of the corporate pyramid of which the Cuba Co. was the apex. Each of these it found inadequate and impracticable, and although there seems to have been other possibilities not explored by the directors, the court did not find bad faith and was disinclined to set aside the plan chosen by them. Despite all that, an interlocutory injunction was granted, principally, it seems, because of the extent of dilution that would take place if one of the alternatives be chosen. The preemptive right was thus recognized, unless it was cut off by a charter or by-law provision inserted by two-thirds in interest of the shareholders. There was no direct ruling on the precise question of the availability of preemptive rights in stock issued in payment of a debt, but there is discernible a distinct reluctance to extend the exception relative to shares issued for property. The *Muson* case was distinguished on the ground that there the stockholders had voted approval of the stock issue and that "the New York rule is materially different from ours."

In case of an issuance of stock in exchange for stock of another corporation, that is, in case of a merger or consolidation, no sophisticated test is necessary to show the inapplicability of the rule on preemptive rights. In *Thom v. Baltimore Trust Co.*,<sup>120</sup> the defendant corporation entered into a merger agreement with the National Union Bank of Maryland. Defendant was to issue to the latter 15000 shares at a valuation of \$168 per share. The merger plan was duly approved by the requisite majority of the defendant's stockholders, and the charter amended to authorize the increase of its capital stock. The plaintiff shareholder voted against the merger, and then demanded that he be allowed to exercise his preemptive right with respect to the new stock. The court formulated its test of consistency with the object of the issue which we have discussed above, and quickly disposed of the plaintiff's claim. Obviously the merger agreement was impossible of execution if the new shares were subject to preemptive rights, unless the increase is such that the unsubscribed shares would number at least 15,000, which of course would be a mat-

<sup>120</sup> 158 Md. 352, 148 A. 234 (1930); noted in 30 *Col. L. Rev.* 569; 39 *Yale L. J.* 905; *U. of Pa. L. Rev.* 1026; 4 *Temple L. Q.* 395.

ter of guesswork. It is not to be gainsaid that merger or consolidation may result in a shifting of control and a disturbance of the ratio of interests.<sup>121</sup> The point is that one, in practical effect, excludes the other and the approval of a merger or consolidation plan by the statutory majority constitutes a determination that its advantages outweigh the disadvantages of any resulting dilution of interests. Waiver of preemption may reasonably be predicated on a vote of approval, at least where the consenting majority is concerned. What about the dissenting minority? A partial answer is that the statutes generally provide in such case for a right of withdrawal and appraisal of his stock.<sup>122</sup> Where the statute or the charter expressly negatives preemptive rights in case of merger or consolidation, no difficulty arises since the statute and the charter forms part of his contract. In other cases, an amendment of the articles of incorporation cutting off preemptive rights in a merger or consolidation may be necessary prior to the approval of the plan. In a few states, a formal charter amendment does not seem necessary although the statute and the articles recognize preemptive rights. For example, Alabama permits a provision denying preemptive rights to be inserted in "a joint agreement of merger or consolidation."<sup>123</sup> Michigan<sup>124</sup> and Ohio<sup>125</sup> permit the holders of 2/3 of the shares entitled to preemptive rights to waive such rights in any particular issue of shares, the waiver being binding on all the shareholders.

The issuance of stock pursuant to employee stock purchase plans provides another illustration of the usefulness of the notion of an offsetting of individual by corporate interests. Such issuance does not strictly fall under the category of issues for consideration other than cash, for employees pay for the shares in money, but the considerations permitting subordination of preemptive rights in the two cases appear substantially identical. In *Milwaukee Sanitarium v. Swift*,<sup>126</sup> the corporation had an authorized capital stock of 4000

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<sup>121</sup> Coppock, *loc. cit.*, supra note 13 at 363. The dilution that Berle was worried about in *loc. cit.*, supra note 35 at 1254 where one of 2 corporations sells all its assets to the other in return for stock of the buyer representing a greater proportion of the latter's outstanding stock than the assets sold bear to the assets of the merged enterprise, can be dealt with by insisting of fiduciary standards in the valuation of the acquired assets. And see Spencer *loc. cit.*, supra note 70 at 386 where he suggests that merger or consolidation is really "in all around acquisition of cash or property for shares."

<sup>122</sup> But cf. Dissenting Common Stockholders Right of Appraisal and Payment, (1947) 1 *Vanderbilt L. Rev.* 124.

<sup>123</sup> *Ala. Code* (1940), tit. 10 § 41.

<sup>124</sup> *Mich. Stat. Ann. (Henderson, 1952 Supp.)* § 21.31 (d).

<sup>125</sup> *Gen. Code Ann. (Page, 1952 Supp.)* § 8623-35 (d); here the waiver is effective for the time specified in the vote, but not exceeding one year.

<sup>126</sup> 238 Wis. 628, 138 L. R. 521, 300 N. W. 760 (1941).

shares, par \$100, of which 3600 were outstanding. A resolution amending the articles of incorporation permitting the issue of the unissued balance of 400 shares to officers and employees of the corporation and eliminating preemptive rights to such shares was approved by holders of more than 96 per cent of the outstanding stock. Defendants, holders of 128 shares, objected to the amendment, claiming they were entitled to a prior opportunity to subscribe thereto *pro rata*. The corporation brought proceedings for a declaratory judgment respecting the validity of the amendment and the powers of the directors thereunder. The court declared the efficacy of the amendment and of the resolution offering 30 shares at \$185 each to the assistant medical director. The purpose of the plan was to secure the permanency of the officers, doctors and other personnel of the Sanitarium, and to heighten their efficiency by giving them a personal, financial interest in the corporation. The value of the stock depended largely on the quality of the medical staff and management. The corporation had taken 7 or 8 years looking for a suitable assistant medical director, and desired to ensure that the incumbent would not seek employment elsewhere. There was no issue as to the good faith of the directors. Clearly the advantages of the plan to the corporation preponderated over individual claims of preemption.<sup>127</sup> The court had no trouble holding the amendment binding on the dissenting minority. The statute authorizing amendment constituted part of the corporate charter and of stockholder's contract. The shareholder acquiring his stock consents in advance to such amendments as could lawfully be made under the statute existing at the time of acquisition. The reasoning could be extended, in view of the reserved power of the state which itself is part of the charter and contract, to imply consent to such amendments as the statute, as it may exist at any time in the future, may authorize. *Albrecht, Maguire and Co. v. General Plastics, Inc.*<sup>128</sup> now seems to be of dubious utility. The matter is much regulated by statute. Some states have expressly provided for waiver of preemptive rights in connection with employee stock purchase plans by vote of the

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<sup>127</sup> See Fordham, J. B., Some Legal Aspects of Employee Stock Purchase Plans (1930) 8 *N. Car. L. Rev.* 161 at 163-165; also Cooper, J. D., Abuses of Employee Stock Purchase Plans by Management, (1933) 21 *Calif. L. Rev.* 358 at 359.

<sup>128</sup> 256 App. Div. 134, 9 *N. Y. S. 2d.* 415 (1939); *aff'd* without opinion 280 *N.Y.* 840, 21 *N.E. 2d.* 887 (1939); noted in 25 *Corn. L. Q.* 124. This case held that under the *Gen. Corp. Law art. 2 s. 13 (2)* providing that "the certificate of incorporation \*\*\* may contain \*\*\* any limitation \*\*\* upon the rights of its stockholders \*\*\*," the certificate could be amended so as to deprive consenting stockholders of their preemptive rights, but that such an amendment could not bind a stockholder who opposed its adoption.

stockholders.<sup>129</sup> In such states, an amendment of the charter would not be necessary, as otherwise it would seem to be where the statute merely authorizes such amendment to define, limit, or deny preemptive rights.<sup>130</sup> And of course where the statute denies preemptive rights except to the extent they are provided for in the charter,<sup>131</sup> there is no problem at all, unless the charter had explicitly provided for preemptive rights in which case an amendment would also be necessary. Perhaps the matter will be greatly simplified by considering the statutory provision authorizing the adoption of employee stock ownership plans as part of the subscriber's contract and thereby constituting an implied qualification of preemptive rights.

### 3. Treasury Stock.

Not infrequently, one finds in the cases an imprecise and equivocal use of the term treasury stock. For the purpose of discussing whether preemptive rights attach, or should attach, to treasury shares, it seems desirable to limit the term to shares pre-

<sup>129</sup> *Idaho Code*, (1947) § 30-120 (7) (by majority vote); *Louisiana Rev. Stat.* (1950) tit. 12 § 28 B (4) (by majority vote); *Maryland Ann. Code* (Flack, 1951) art. 23 s. 26 (b) (7) (by 2/3 vote); *Illinois Ann.* (Smith Hurd, 1952 Supp.) c. 32 § 157.24 (by 2/3 vote); *Ohio Gen. Code Ann.* (Page, 1952 Supp.) § 8623-35 (b) (by 2/3 vote). *Colorado Stat. Ann.* (Michie, 1935) c. 41 § 42 as amended by L. 1949 p. 319 § 1 seems alone in permitting a dissenting stockholder to demand his preemptive right within 30 days from the approval of the stock purchase plan. See also *Model Bus. Corp. Act.* (Rev. 1950) s. 24.

<sup>130</sup> E.g. *Maine Rev. Stat.* (1944) c. 49 s. 71; *Nebraska Rev. Stat.* (1951 Supp.) § 21-1,158 (3); *Tennessee Code Ann.* (Williams, 1934) § 3734; *Florida Stat. Ann.* (1941) 612.20; *Arkansas Stat.* (1947) § 64-218; *Nevada Comp. Laws* (Hillyer, 1929) § 1622. It seems that such a provision is not absolutely necessary. *Gottlieb v. Heyden Chemical Corp.* 83 A. 2d 595 (1951), noted in 65 *Harv. L. Rev.* 507, 4 *Stan. L. Rev.* 499, 3 *Utah L. Rev.* 140, 100 *U. Pa. L. Rev.* 902. The Delaware statute provides that preemptive rights may be denied in the original articles, but there is no specific provision relating to the removal of these rights by later amendment. However *Del. Rev. Code* c. 65 s. 26 authorizes amendments by majority vote changing the "designations, preferences, relative, participating, optional or other special rights of the shares." The court held that the preemptive right was included in "other special rights," being "on no higher a qualitative level than rights which may be changed." The charter amendment exempting from preemptive rights a maximum total of 50000 shares to be issued to officers and employees pursuant to a stock purchase plan was binding on the plaintiff, a dissenting stockholder. But cf. *Klopot v. Northrup* 131 *Conn.* 14, 37A. 2d 700 (1944); here the charter of the old corporation could have been amended to cut off preemptive rights. Despite this, the court held that denial of preemptive rights in the charter of the new corporation formed to take over a part of the business of the old corporation rendered the whole plan inequitable to the dissenting minority stockholders, and granted injunction to restrain its execution.

<sup>131</sup> E.g. *California Corp. Code Ann.* (Deering, 1947) § 1106; *Indiana Ann. Stat.* (Burns, 1948) § 25-205 (i); *Oklahoma Stat. Ann.* (Perm. ed., 1952 Supp.) tit. 18 § 1.45; *Pennsylvania Stat. Ann.* (Purdon, Perm. ed.) § 2852-611.

viously issued by the corporation and subsequently acquired by it. The shares reacquired may either be "retired" or cancelled, that is, the corporation goes through the ritual prescribed by statute for the reduction of its capital stock, or simply held "in the treasury," uncanceled, and subject to reissue. Where the shares are formally retired, no difficulty concerning preemptive rights arises. The retired shares cease to exist, and if the corporation later wish to issue new stock, it will have to increase its capital stock by a proper amendment of its articles of incorporation. In such case, there is no doubt that the new shares are subject to the shareholders' right of preemption, unless of course such right is negated by statute or charter. It is the retention of the reacquired shares in the corporate treasury that poses vexing problems, the share structure being effectively altered though, in contemplation of law, remaining virginally intact as it was prior to the acquisition. The correct legal implications and appropriate accounting treatment of treasury shares are by no means settled matters.

In broad terms, the basic question is: do treasury shares upon their subsequent sale or reissue have to be offered preemptively to the shareholders? Judge Learned Hand in *Borg v. International Silver Co.*<sup>132</sup> gave a negative answer. In that case, the defendant corporation had an authorized capital stock of \$20 million, \$9 million non-participating, cumulative preferred and \$11 million common, both classes having voting power. Each common share had 1/2 vote while a preferred share had a full vote. Of this, \$6,607,500 of the preferred and \$9,944,700 of the common had been issued. By a series of subsequent transactions not relevant for our purpose, the corporation reacquired \$578,912.50 of its preferred and \$9,249,300 of its common stock. The capital stock item in its December 31, 1908 balance sheet ran this way:

Capital stock, preferred (issued) .....	\$6,607,500.—	
Less in treasury .....	578,912.50	\$6,028,587.50
Capital stock, common (issued) .....	\$9,944,700.—	
Less in treasury .....	9,249,300.—	695,400.—

A corresponding reduction in the asset side of the balance sheet was made. For 15 years, the treasury stock was so carried in the annual balance sheets. In 1923, the board of directors desired to sell stock to raise some \$800,000 or \$900,000 for its "corporate purposes," the initial sale to be of 6000 common shares at \$50 per share. The par value of the common was \$100, while it sold as high as \$140. The 6000 shares were to be offered *pro rata* to both the preferred and

<sup>132</sup> 11 F. 2d. 147 (2 Cir. 1925); noted in 36 *Yale L. J.* 1181 (1927).

the common stockholders. Some holders of common stock brought action to restrain the sale, claiming among other things that the common stockholders alone were entitled to preemptive rights to the 6000 shares.<sup>133</sup> The court in effect held that no one was legally entitled to preemption. The shares had not been retired. The procedure set forth in the statute for the reduction of capital stock had not been attempted to be followed. Such reduction could not be presumed since the resulting ratio between the preferred and the common would have been violative of the section of the statute limiting preferred stock to 2/3 of the actual paid-in capital. The shares had continued to exist, and having "by hypothesis" once been issued, they had diluted the voting power of shareholders *ab initio*. Their resale, it was said, gave rise to no preemptive rights since that merely restored the status the shareholder had originally accepted; all that he could demand was that they bring to the corporate treasury their existing value.

It seems that Judge Learned Hand considered shareholders as fixing their relative positions on the basis of the capital stock authorized at the time of subscription. The proportionate voting status the preservation of which stockholders are supposed to have a right to rely on is, in arithmetical terms, a fraction whose denominator includes the treasury shares. On this theory, the situation is closely analogous to that involving the unissued balance of the shares originally authorized. The realism of this viewpoint has been discussed previously. Whether or not it is a plausible supposition, it seems important to remember that the acquisition by a corporation of its own shares, just as a release of the balance of authorized shares, alters the effective structure of shareholder interests. Referring only to voting power, assume a corporation with 10,000 outstanding shares which later acquires 2000 of its shares. After the acquisition, a minority group owning 1000 shares would be able to elect, under cumulative voting, at least one director to an eight-man board. The purchase of its shares by the corporation increases the voting power of the remaining shares.<sup>133a</sup> This is true even in the Borg case. Before the acquisition, one share represented 1/71,047 of the total voting power; after the acquisition, each share had 1/63,763. (However, *as a class*, the common shareholders' voting strength was cut down severely so that they could not elect even one out of ten directors.) If the preservation of proportionate minority voting strength is regarded as a desirable thing, then a

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<sup>133</sup> Preliminary injunction was granted in 2 F. 2d. 910 (D.C.S.D.N.Y., 1924); Note 20 *Ill. L. Rev.* 288 (1925).

<sup>133a</sup> See *Anderson v. Albert and Anderson Mfg. Co.* 90 N. E. 2d. 541 (Mass. 1950).

strong case can be made out for subjecting treasury shares, upon their resale, to the preemptive rights of the shareholders. Where the new relative status induced by the acquisition of the shares has crystallized over a period of time, the case against a second disturbance of that status becomes stronger. Certainly 15 years, the period in the Borg case, is long enough to give rise to reasonable expectations of permanency.

This point on a claim or expectation of permanency seems to have been implicitly dealt with by the court in discussing whether or not the shares had been retired. If the shares had been retired, i.e. cancelled and the capital stock reduced, there is no question that the new status was stabilized and hence to be protected through the mechanism of preemption. Judge Hand pointed to the accountant's description "in the treasury" as showing that the corporation did not suppose the shares were retired or were to be.

"If so, it would not have carried them as treasury stock for 15 years. We can construe the balance sheets in no other way. The shares should not have appeared in the sheets at all, or if they did, only as held for retirement. To mark them as held 'in the treasury' was to ticket them as treasury shares; it could mean nothing else."<sup>134</sup>

The label "in the treasury" then was supposed to be an indication of a reservation of the power to recreate the shares, a *caveat* to the stockholders not to rely on the present status, it being temporary and subject to change by the reissue of the treasury shares.

*Dunn v. Acme Auto and Garage Co.*<sup>135</sup> gave a different answer to the question posed above. There the corporation had an authorized capital stock of 1000 shares, of which 462½ shares had been issued. The corporation had repurchased 162½ shares leaving 300 outstanding. About two years after the repurchase, the directors resolved to sell the 162½ shares. The plaintiff, a minority stockholder and director, brought an equitable action for accounting and sought preliminary injunction to restrain the sale of the shares pending determination of his allegations of breach of fiduciary standards. The lower court denied the injunction and authorized the sale of the shares at public auction. On appeal by the plaintiff, the supreme court granted the injunction, holding that the sale at auction violated the preemptive rights of the shareholders. The value of Judge Rosenberg's opinion seems somewhat vitiated by a certain obscurity in its phraseology. He said:

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<sup>134</sup> 11 F. 2d. 147 at 150.

<sup>135</sup> 168 Wis. 128, 169 N. W. 297 (1918).

"What is the effect, then, of a lawful purchase of its own capital stock by a corporation? If retired, cancelled, and placed in the treasury \*\*\* and not reissued, manifestly its effect is to decrease the outstanding capital stock. When the capital stock of a corporation has been decreased, and it is proposed to reissue the repurchased shares, every reason for making such reissue proportionate to the holdings of the then stockholders exists that would exist if such increase were of stock not theretofore issued or an increase in the authorized capital. \*\*\* The corporation having lawfully purchased and then retired its own shares, and having statutory power to diminish its capital stock, it must be held that its outstanding capital stock is thereby diminished."<sup>136</sup>

Of course the purchase of the shares, in itself, did not retire or cancel them in the sense that thereby the authorized capital stock is reduced. Judge Hand had pointed out that such shares are "retired" only in the sense that they are no longer outstanding, that is, they no longer constitute a liability of the corporation. To effect a reduction of capital stock, as distinguished from a diminution of the number of outstanding shares, the procedure set forth in the statute must be complied with, which was not done in this case. The shares were not carried on either side of the balance sheet and it does not appear what the stated amount of outstanding stock was. Under Judge Hand's view above quoted, this would seem to indicate retirement, either in the sense of a formal reduction of authorized capital stock,<sup>137</sup> or an informal and indefinite laying up of the shares the authorized capital remaining the same, rather than repurchase and retention "in the treasury" with tacit assumption of power of reissue. The term retirement is mischievously equivocal, but it seems in either sense the retirement of shares renders available preemptive rights in case of a subsequent stock issue.

A plausible explanation of the differing results reached by the two cases seems to be that in the Borg case, the accounting treatment and the label "in treasury" could be regarded as an expression of an intention to reissue the shares albeit at some vague time in the future. In the Dunn case, the court found no circumstance, accounting or otherwise, indicating such an intention. Judge Rosenberry admitted that

"A different question would have been presented if the shares of its own stock purchased by the corporation had been carried upon its books as a liability and they had been treated as an asset of the corporation \*\*\*"<sup>138</sup>

<sup>136</sup> 169 N. W. at 300.

<sup>137</sup> See Katz, W. G., *Accounting Problems in Corporate Distributions*, (1941) 89 *U. of Pa. L. Rev.* 764 at 786.

<sup>138</sup> 169 N. W. at 300. Cf. Hills, G. S., *Model Corporation Act (1935)* 48 *Harv. L. Rev.* 1334 at 1342. BALLANTINE AND STERLING, *CALIFORNIA CORPORATION LAWS* (1949 ed. 225: "An honest method of accounting is to show treasury shares simply as

It seems then that the accountant's description of the shares could be decisive in determining whether preemptive rights are available. This seems such a slender reed to lean on. Suppose the balance sheet in the Borg case had read:

Capital stock, preferred (issued) .....	\$6,607,500.—	
Less shares repurchased .....	578,912.50	\$6,028,587.50
Capital stock, common (issued) .....	\$9,944,700.—	
Less shares repurchased .....	9,249,300.—	695,400.—

Is the phrase "in treasury" to be regarded as cabalistic? Again, suppose a balance sheet reads:

Assets .....	\$200,000	Capital stock, issued ..	\$1,00,000
Shares repurchased ...	500,000	Less shares retired ....	500,000
			\$500,000
		Liabilities .....	200,000
	\$700,000		\$700,000

Does the description of the shares as an asset<sup>139</sup> offset whatever effect the word retired is supposed to have? It will be remembered that the period of time between acquisition and reissue in the Borg case was 15 years, while that in the Dunn case was at most two years. Assume that for 15 years, the balance sheets had carried the item "less shares retired," would Judge Hand then have followed Judge Rosenberry's decision? On the other hand, would not the retention of the item for 15 years, whatever the label used, reasonably show an intention to reserve the power of reissuing the shares at some indefinite time? A resolution of the board of directors at the time of acquisition declaring the shares treasury stock and subject to reissue would perhaps be a more appropriate indication of non-retirement. In any case, it is not indispensable. In *State ex rel.*

a deduction from the number of shares outstanding without any entry in the asset column or liability column of the balance sheet." See also Bowles, H. G., *Treasury Shares on the Balance Sheet*, (1934) 58 *J. of Acctcy.* 98 at 101 et seq.

<sup>139</sup> Since the *Dunn* case (1918), the practice of listing treasury shares as an asset has been subjected to severe criticism; Katz, *loc. cit. supra* note 137 at 781 says that now under S. E. C. Regulation S-X, rule 3.16, it is inferentially forbidden. The main objection seems to be that such a treatment is apt to be misleading as to the amount of unrestricted surplus available for dividend distribution. In the hypothetical balance sheet given above, assume the restricting effect on surplus is shown; the point is whether the balance sheet gives rise to any inference of *de facto* "retirement," or whether treatment as an asset negatives any such inference. Hills, G. S., *Stated Capital and Treasury Shares*, (1934) 57 *J. of Acctcy.* 202 at 209; "\*\*\* the practice of carrying treasury shares as an asset has been supported on the ground that shares which are acquired with the intention of holding them for resale are, in effect, an asset pending their disposition. But the purpose for which shares are acquired or held has no legal effect

*Page v. Smith*,<sup>140</sup> the shares were transferred to the corporation in its books and there carried as an asset. The corporation had no power to reduce its authorized capital stock; nor, the court felt, to "retire" *de facto* the shares, whose "identity has been preserved," the corporation being in the hands of a receiver. In *Crosby v. Stratton*,<sup>141</sup> the entire authorized capital stock had been issued upon incorporation of the company in consideration of the mining claims transferred to it. The mining claims were the only assets of the corporation. A portion of the shares were donated back to the corporation to be sold for the acquisition of working capital. Retirement of the shares was entirely out of the question. In both cases, the facts gave rise to an inference of intention to reissue the treasury cases, and in both cases, preemptive rights were denied.

Attempting now a restatement of the Dunn doctrine, it may be said that where there is not manifested an intention to reissue, the shares being held indefinitely (but not necessarily for a protracted period), they are deemed informally "retired" although the statutory ceremony for reduction of capital stock is not observed. Such shares may be resurrected and reissued, without need of increasing the capital stock, but they are to be offered first to the shareholders in ratable proportions.<sup>142</sup> Possibly the implication is that the directors may not avoid the preemptive right which would otherwise attach simply by failing to comply with the procedure for formal reduction of capital stock.

*Hammer v. Werner*<sup>143</sup> is not too successful in shedding light on the problem. There the corporation purchased 2130 shares of its stock. Of this block, 445 shares were sold *pro rata* to the share-

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except in a few states and then only in circumstances defined by statute. There is no legal authority applicable to the ordinary purchase or acquisition of shares which supports a differentiation of treatment based on intent or purpose."

<sup>140</sup> 48 Vt. 266 (1876).

<sup>141</sup> 17 Colo. App. 212, 68 P. 130 (1902).

<sup>142</sup> Cf. Legal Status of Treasury Shares, (1937) 85 *U. of Pa. L. Rev.* 688 at 623. RESTATEMENT OF THE LAW OF BUSINESS ASSOCIATIONS, Tentative Draft No. 1, sec. 17: "No shareholder has a preemptive right where the corporation creates shares in lieu of shares acquired by it, if at the time of acquisition, the circumstances are such as reasonably to indicate an intention to recreate the said shares and nothing has subsequently occurred to indicate that the intention has been abandoned." *Id.* Comment at p. 45: "But a lapse of time or a subsequent manifestation of corporate policy or other similar circumstances which reasonably lead the voting shareholders to believe that the proportion of voting control now represented by each voting share now remaining outstanding will not be altered by the corporation may create preemptive rights which did not exist at the time of the cancellation."

<sup>143</sup> 239 App. Div. 38, 265 N. Y. S. 172 (1933); Note 32 *Mich. L. Rev.* 110 (1933), 8 *St. John's L. Rev.* 153 (1933), 3 *Bklyn. L. Rev.* 337 (1934), 1 *U. of Chi. L. Rev.* 645 (1934).

holders, while the remaining 1,685 shares "continued in the treasury of the company." These latter shares the defendant directors turned over to themselves "on a fraudulent basis." In deciding on a motion to dismiss a stockholder's complaint for damages, the court stressed the fiduciary obligation of directors, holding that

"Where that obligation has been violated, the special circumstances or acts constituting the breach of duty may generate a preemptive right which would not otherwise exist, although the wrong may be redressed as a breach of duty independent of the existence of a preemptive right."<sup>144</sup>

It is not easy to see a causal connection between the director's breach and the shareholders' right of preemption; Drinker had insisted that the two be kept clearly distinct from each other.<sup>145</sup> The harm which the right seeks to avert is quite independent of the good or bad faith of the directors and would ensue in either case if preemption is not recognized. Proof of inequitable conduct on the part of the directors would require the return of the shares to the treasury; it is another thing to say that upon their reissue they must be offered preemptively to stockholders. As has been discussed earlier, reliance solely on fiduciary standards does not seem an adequate substitute for the preemptive right. It seems hardly more satisfactory to make availability of the right contingent on a violation of those standards. The court attempted to square its ruling with that of Judge Rosenberry on the factual "retirement" of treasury shares by suggesting, that the resurrecting of "what had in fact been retired" is itself a breach of fiduciary duty.<sup>146</sup> Which is not a self-evident proposition. It is not inconceivable that legitimate financial need may require reissue of "retired" shares.

Possibly a more economical approach to the whole question is to recognize that treasury shares are really shares restored to the status of authorized and unissued shares. As such, they are an opportunity to acquire new assets by creating new obligations.<sup>147</sup> It seems only productive of confusion to continue the fiction that the treasury shares issued to the purchaser were the old shares acquired by the corporation, the corporation being regarded as merely an intermediate transferee.<sup>148</sup> The fiction of the continuing identity

<sup>144</sup> 265 N. Y. S. at 177.

<sup>145</sup> *Loc. cit.*, *supra* note 4 at 600.

<sup>146</sup> 265 N. Y. S. at 177.

<sup>147</sup> *Borg v. International Silver Co.*, 11 F. 2d 147 at 150.

<sup>148</sup> Ballantine, *The Curious Fiction of Treasury Shares*, (1946) 34 *Calif. L. Rev.* 536 at 538-539. BALLANTINE AND STERLING, *op. cit.*, *supra* note 138 at 224-225: "The only difference between re-acquired shares held 'in the treasury' and those which have

of the shares quite naturally leads to the notion of "dilution *ab initio*" and tends to obscure the *de facto* alteration of the ratio of shareholder interests.<sup>149</sup> Actually the contract represented by the old share was extinguished by the merger of the characters of obligor and obligee in the same person, the corporation, the share issued being a new unit of interest created in its place. So considered, the problem of preemptive rights in treasury shares would not seem *sui generis*, but rather as subsumable under the previous heading of unissued balance of originally authorized shares; the standards there indicated would then be applicable. And where the consideration received for the treasury shares is something other than cash, that other category and its appropriate tests could then be invoked. There seems to be no especially useful purpose served by adding a separate class to the list of exceptions or qualifications to the rule on preemptive rights, unless of course the classifier starts from an assumption that preemptive rights are to be as closely circumscribed as possible. Which brings us to a final point.

Each time the court decides on the recognition or denial of preemption in any particular issue of additional shares, it is choosing between competing considerations. Which is the more desirable, which the wiser, a self acting, more or less rigid device of freezing the relative voting control and the proportion of proprietary interests, or an expansive and flexible directorial discretion limited only by the business judgment rule and by the judge's conceptions of fiduciary norms?<sup>150</sup> Perhaps it is misleading to juxtapose alternative

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been 'retired' is that the first may be 'resold' by the corporation for what they will bring on the market, without preemptive rights, while the retired shares have disappeared and the issue of shares in their stead must be an original issue (normally at par). \* \* \* Their (treasury shares') existence as issued shares is a pure fiction, a figure of speech to explain the special rules and privileges as to their reissue."

<sup>149</sup> See *Crosby v. Stratton*, 17 Colo. App. 212, 68 P. 130 at 133.

<sup>150</sup> The discernible trend in recent statutes seems to be in the direction of limitation and gradual abolition of preemptive rights. A few statutes provide that stockholders have no preemptive rights unless affirmatively provided for in the charter (*supra*, note 131); others limit the right to new shares of the same class, e.g. *Idaho Code* (1947) § 30-120(6), *Nevada Comp. L.* (Hilyer, 1929) § 1622, *Tennessee Code Ann.* (Williams, 1934) § 3734, *Arkansas Stat.*, (1947) § 64-218, *Florida Stat. Ann.* (1941), § 612.20, *Ohio Gen. Code Ann.* (Page, 1952 Supp.) § 8623-35; all of the statutes permit provisions in the charter limiting or denying the right. Dicke, *loc. cit.*, *supra* note 4 at 293 concluded that: "There is no uniformity of thought on the question, but that with varying impetus, the trend is away from the inherent right doctrine, leaving only the contractual relationship between stockholder and corporation."

However, even where the statutes abolish preemptive rights or permit their elimination by provision in the articles of incorporation, a public service commission which has broad statutory powers over issues of securities by a public utility corporation may have power to require a prior offer to shareholders and may exercise that power generally or in particular cases; see DODD AND BAKER, CASES AND MATERIALS ON COR-

extremes, perhaps there are intermediate gradations. The point is, considering that private corporations are established primarily for the pecuniary benefit of the stockholders, they in the first instance should answer for themselves the question posed. At the time of drafting the articles of incorporation, they should decide to what extent they are willing to entrust their stock participations to the directors and to dispense with the machinery of preemptive rights. When their decision is clearly set forth in the charter, those joining the enterprise thereafter are chargeable with notice of that decision. If they decide to provide for preemptive rights, and the corporation is one closely held, the draftsman will probably be wise in protecting the right by the requirement of a special majority in the amending procedure.<sup>151</sup> Where, on the other hand, the corporation is a quasi public one, it will perhaps be desirable to include provisions permitting waiver of the right in any particular stock issue by an ordinary working majority. While a determined management can in such case practically dispense with the right, still the shareholders will at least have the opportunity of insisting on preemption should they think the management somewhat less than completely fair and honest.

#### POST SCRIPT.

In an early footnote, it has been indicated that in the Philippines, our statute and case law are altogether silent on stockholders' preemptive rights. Now, there is no reason to doubt that the evils of dilution of stock interests which the preemptive right is designed,

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PORATIONS (1951) 928 at n. 2. On the attitude of the Securities and Exchange Commission, in the exercise of its power under the Public Utility Holding Co. Act of 1935, see Ureck, J. E. and Cary, W. L., Regulation of Corporate Finance and Management Under the Public Utility Holding Company Act of 1935, (1938) 52 *Harr. L. Rev.* 216 at 230-231: "In striving to protect the interests of stockholders without unduly hampering financing, the Commission may be expected to propound its own standards of judgment under secs. 7(d) (6) and 7(e) as to whether the denial of the preemptive right in a particular case is 'detrimental to the public interest or the interests of investors or consumers.' \*\*\*. (That) as to future issues, the S.E.C. might require a prior offering to existing stockholders if it was deemed necessary to protect their interests in assets, earnings or voting power. Indeed, the Commission stated that as to future issues, the burden would be on the declarant to establish that such a prior offering was not necessary or appropriate to protect the interests of existing stockholders. So far as issues of stock for cash are concerned, the opinion in National Gas and Electric Co. definitely rendered ineffective the elimination of the preemptive right. As a result, if the case is at all prophetic, it is entirely immaterial whether or not the certificate of incorporation of any public utility or holding company already has eliminated the preemptive right. Regardless of charter provisions, the Commission will act to afford what amounts to the preemptive right where it is deemed necessary for the protection of existing stockholders against dilution of their interests."

<sup>151</sup> See *Sellers v. Bancroft and Sons, Co.* 2 A. 2d 108 (Del. Ch., 1938); Cline, *loc. cit.* supra note 21 at 140.

to prevent are just as real in the Philippines as elsewhere. It is submitted that the preemptive right, appropriately qualified, would be a desirable addition to the legal devices we now have for the protection of stockholder's interests. Business corporations in the Philippines are, for the most part, of the closely held or family type. As has been pointed out, it is in this kind of corporations that the preemptive right is especially significant.

There is nothing in our present law to preclude the shareholders from contractually establishing the right, either originally in the articles of incorporation or in an amendment thereto. And conceivably our courts may be willing to discover the right among the equitable implications of the shareowners' contract though it be not set forth in print. However, since the courts and the bar in general, and the investing public, do not seem particularly aware of the device and its operation, it is further submitted that a statutory declaration would be the most economical and efficient means of introducing the right. The statutory right should not, it is submitted finally, be too inflexible. Provision should be made for permission to qualify or limit the right to the extent the shareholders may deem desirable.