QUALIFICATIONS TO THE RULE ON THE PRE-EMPTIVE RIGHT OF SHAREHOLDERS

REGINA P. PADILLA*

I. INTRODUCTION —

The pre-emptive right of stockholders is not expressly mentioned in the Corporation Law of the Philippines; neither have our courts had occasion to rule on the nature, scope and ramifications of this right. Nevertheless, the trend towards increased utilization of the corporate form of business organization in the Philippines justifies an examination of American jurisprudence to shed light on its subtle nuances.

A stockholder's pre-emptive right has been defined as "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."[1] 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.[2]

The doctrine traces its origins to the leading case of *Gray v. Portland Bank*,[3] decided in 1807. In permitting a stockholder who was refused the right to subscribe for and take new stock in proportion to his shares to recover the excess of the market value above the par value, with interest, the court anchored its arguments on the principle that:

> A share in the stock or trust when only the least sum has been paid in is a share in the power of increasing it when the trustee determines or rather when the cestuis que trustent agree upon employing a greater sum....A vote to increase the capital stock, if it was not the creation of a new and disjointed capital, was in its nature an agreement among the stockholders to enlarge their shares in the

* *Member*, Student Editorial Board, Philippine Law Journal.

1 STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS 499 (1949, 2d ed.).

2 Feliciano, *On the Shareholders' Right of Pre-emption: Law and Practice*, 28 PHIL. L.J. 443 (1953).

3 3 Mass. 364, 3 Am. Dec. 156 (1807).

> amount or in the number to the extent required to effect that increase....[4]

The value of this case as a precedent establishing the existence of the pre-emptive right was assailed from many quarters. The critics alleged that Justice Sedegewick's reasoning was grounded not so much on any intention to legislate and establish a legal right theretofore unrecognized as on an adherence to equitable and contractual principles of partnership law.[5] Nevertheless, by 1906, Justice Vann announced that *Gray v. Portland* "has stood the unquestioned test 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."[6]

Admittedly, the evolution, survival and subsequent acquisition of a "legal right" status meant that it satisfied some real need, served some substantial purpose.[7] Nonetheless, critics were inclined to view the recognition of pre-emptive rights as an attempt by the courts to create an automatic remedy for unfairness and dilution of existing shares by abuse of power, and that being an attempted codification of equities, it should never have hardened into a rigid rule of law. In *Yoakam v. Providence Biltmore Hotel Co.* the court held that justice will be best served, under present day conditions, by disregarding in this connection legal dogma and by asserting an equity jurisdiction to hold, in respect to the facts of each case, directors and majority stockholders to a high standard of reasonableness and fairness in issuing shares.[8]

II. THE UNDERLYING PRINCIPLE OF THE RULE —

The orthodox rationale for the doctrine of pre-emptive rights is grounded on the nature of the right acquired by a stockholder through the ownership of shares of stock:

> While he does not own and cannot dispose of any specific property of the corporation, yet he and his associates own the corporation itself, its charter, franchises, and all rights conferred thereby, including the right to increase the stock. He has *an inherent right to his proportionate share of any dividend declared,* or of *any surplus arising upon dissolution,* and he can prevent waste or misappropriation of the property of the corporation by those in control. Finally, he has the *right to vote for directors and upon all propositions* subject

---

[4] *Ibid.*, pp. 377-78.
[5] Feliciano, *op. cit., supra,* note 2 at 445.
[6] Stokes v. Continental Trust Co., 186 N.Y. 285, 78 N.E. 1090 (1906).
[7] Feliciano, *op. cit., supra,* note 2 at 446.
[8] 34 F. 2d 538 (1929).

> by law to the control of the stockholders and this is his supreme right and main protection....each of said rights is an inherent, pre-emptive and vested right of property which can neither be taken away nor lessened without consent, or a waiver implying consent.[9] (emphasis supplied)

A share of stock, therefore, entitles a stockholder to the exercise of three basic property rights: 1) a right to vote, and thus to indirectly control and manage corporate affairs; 2) a right to a portion of the corporate surplus profits declared as dividends; 3) a right to participate in the the distribution of the corporate assets upon dissolution and winding up.

The principle underlying the doctrine of pre-emptive rights assumes that it is a device safeguarding against dilution 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.[10]

Recently, however, economic analyses of a share of stock tend to establish a fourth right — the right to invest capital in the enterprise. Berle and Warren maintain that in recent times the right to invest new capital is the greatest reason for the pre-emptive right. Without intending to disparage the authority of *Gray v. Portland,* which recognized the foundation of the pre-emptive right on the need to preserve the three traditional rights of shareholders, they are of the view that the doctrine may have been true at the time it was propounded but need not be controlling today:

> ....in 1803, public markets, as known today, were only in their infancy, and the value of the right to invest capital at a high rate of return was not instantly discounted by the stock market.[11]

In contrast, today, the right to subscribe to a share of stock in a company which has demonstrated its ability to earn a high rate of return on the capital than the stockholder could get on that capital were he to reinvest it in the open market is thus extremely valuable and is one of the recognized profitable features of that stock.[12]

---

[9] *Supra,* note 6 at 1092.

[10] STEVENS, *op. cit., supra,* note 1 at 500; 1 MACHEN, MODERN LAW OF CORPORATIONS 603 (1908); 11 FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS 221 (1958, Rev. Ed.); BALLANTINE, BALLANTINE ON CORPORATIONS 448 (1946); cited in Feliciano, *loc. cit., supra,* note 2.

[11] BERLE & WARREN, CASES AND MATERIALS ON THE LAW OF BUSINESS ORGANIZATION (CORPORATION) 335 (1948).

[12] *Ibid.*

III. DILUTION AND IMPAIRMENT OF SHAREHOLDERS' INTEREST —

The manner in which the denial of the pre-emptive right dilutes or impairs the interests of shareholders may be concretely illustrated by the following example:

a. the right to vote — In *Stokes v. Continental Trust Co.*, the plaintiff shareholder owned 221 shares out of a total authorized and outstanding capital stock of $500,000, consisting of 5,000 shares having a par value of $100 each. Since all of the old shares were voting shares, Stokes could exercise 221/5,000 or 4.42% of the total voting power. The subsequent increase of the capital stock to $1,000,000 and the issuance and sale of 5,000 new shares (all voting shares) to Blaire and Co., an outsider would have reduced Stoke's voting power to 221/10,000 or 2.21%, one half of his original voting strength.[13]

b. the right to surplus profits as dividends — In the Stokes case, just before the increase of its capital stock, the Corporation had a surplus of $1,048,450.94. Had the entire surplus been distributed before the increase, each shareholder would have received $1,048,450.94/5,000 or $209.69 per share as dividend. After the increase the amount of the dividend per share would be reduced to half — $1,058,450.94/10,000 per share.[14]

c. the right to participate in corporate assets after liquidation — The net value of the company to its shareholders is the value of its assets less the amount of liabilities or debts. The balance sheet of a hypothetical corporation registers the following:

Assets		*Liabilities*	
Total Assets	$2,000.000	Capital Stock	$1,000,000
		Liabilities	400,000
		Surplus	600,0000

If we assume that there are 1,000 shares having a par value of $100, the book value of such share is $160. In the event that 2,000 shares of new stock are issued at the same par value to outsiders denying the stockholders their right of pre-emption, the balance sheet will register the following:

[13] *Supra*, note 6.
[14] *Ibid.*, p. 1091.

Assets		*Liabilities*	
Old Assets	$2,000,000	Capital Stock	$3,000,000
Proceeds of New Stock	2,000,000	Liabilities	400,000
		Surplus	600,000

The book value of all the shares both old and new will be $130. The new stockholder will receive for the $100 he paid for each share, a share worth $130, while the old stockholders will suffer a reduction in value of their shares from $160 to $130. If the old stockholders were accorded and exercised their pre-emptive rights, each would receive two new shares for each old one and theoretically will suffer no loss. The $60 lost on the old shares is made up for by the $30 gained on each of the new shares.[15]

It can be gleaned from the simplified illustrations above that, in a corporation where all the issued shares belong to only one class, the preservation of the extent or the relative strength of a stockholder's right to vote, to receive dividends and to participate in corporate assets after liquidation depends upon the preservation of his proportionate interest, *i.e.*, the proportion between the number of shares owned by him to the total number of shares issued.

Hence, if the capital stock of a corporation is increased and new shares of stock are issued, a holder of original stock is entitled to subscribe to the new issue in preference to non-holders and on equal terms with other holders of the original stock in the proportion that the number of the original shares held by him bear to the total number of outstanding original shares.[16] To dispose of the new stock to strangers or to other stockholders without affording him an opportunity to take his pro rata share would be, without his consent to impair his interest and influence in the corporation and to diminish the relative value of his holdings. Such a disposition touches the stockholder in such a way as to deprive him of a right of property.[17]

IV. The Scope of Pre-emptive Rights —

A perusal of American court rulings dealing with preemptive rights fails to establish hard and fast rules governing its grant

[15] Feliciano, *op. cit., supra*, note 2 at 448.
[16] Miles v. Safe Deposit and Trust Co., 259 U.S. 247, 42 S.Ct. 483, 66 L.Ed. 923 (1923).
[17] *Supra*, note 6 at 1093.

or denial. Thus, it would seem more helpful and more accurate to conceive of the pre-emptive right not in absolute terms, but as the result of a process of balancing the interests of a single shareholder or class of shareholders against the interests of the whole body of shareholders. If the right is recognized it is because the court is satisfied that an exclusion of a shareholder from the privilege of subscribing would be not only prejudicial to him, but prejudicial to him under circumstances which constitute a violation of his contract of membership. On the other hand where the existence of the pre-emptive right is denied, it is because the court is satisfied that the corporation's denial of the privilege of subscribing, though prejudicial to the particular stockholder, is in furtherance of the interests of the entire body of shareholders, and there is therefore no violation of the membership contract of the particular shareholders.[18]

A. *Limitations Imposed by Statutes, Charter, By-laws and Stockholder Action* —

While the pre-emptive right is generally recognized as a vested and inherent attribute of stock ownership, such right may be precluded and abrogated by statutory or charter provisions. In this respect, some statutes authorizing amendments of certificates of incorporation by stockholders appear broad enough to permit an amendment destroying or cutting off pre-emptive rights of stockholders.[19] Thus, a statute permitting corporations to amend its certificate by changing the designation, preference or "other special rights" of the shares may include pre-emptive rights. It has been held that such statutes permitting a corporation to limit or deny pre-emptive rights by amendment of its charter is not unconstitutional as to stockholders who acquired their stock prior to the enactment of the statute, where the state constitution reserves the power in the legislature to amend, alter or repeal corporate charters.[20]

Where the right to take new stock is expressly given by the charter of the corporation or by statute, the right and the exercise thereof depend on the terms of the charter or statute;[21] where it is given by the terms of the resolution providing for the issue of the new stock, then the right and the exercise thereof depend on the terms of said resolution.[22] On the other hand, reasonable con-

[18] *Supra*, note 1 at 503.
[19] Gottlieb v. Heyden Chemical Corp., 32 Del. Ch. 231, 83 A. 2d 595 (1951).
[20] *Ibid.*
[21] Real-Estate Trust Co. v. Bird, 44 A. 1048, 1049 (1899).
[22] Smith v. Franklin Park Land & Improvement Co., 47 N.E. 409 (1897).

ditions on the exercise of the right may be imposed by a majority of the stockholders authorizing the increase.[23] The right may be curtailed by the by-laws to which complaining stockholders have expressly or impliedly consented[24] or it may be reasonably limited as to the time within which it is to be exercised.[25] The directors or a majority of the stockholders cannot, however, either wholly deprive a stockholder of such right[26] or burden it with unreasonable conditions authorized by the charter.[27] It is apparent from the doctrines laid down in the foregoing cases that while statutory and charter provisions may totally abrogate pre-emptive rights, only reasonable limitations and conditions can be imposed by directors or majority stockholders.

Nevertheless, even where the pre-emptive right has been abrogated or precluded, by express statutory and charter provisions, a shareholder who may have been prejudiced by the creation of a new block of shares may base his cause of action on an abuse of power by the majority stockholders or by the directors.[28] In other words, the exercise of the pre-emptive right is not the exclusive remedy that may be resorted to by a prejudiced stockholder, the fiduciary principle being sufficient to protect all the interests of stockholders that could possibly be affected by an issuance of additional shares.

B. *Qualifications of the Rule* —

As has already been mentioned in a previous section, although in the past, the doctrines on pre-emptive rights could be more definitely described and formulated as a rule which had its exceptions, the increasing complexity of the structure of corporations makes it now impracticable to think of the pre-emptive right except in terms of a general principle. Thus, Ballantine comments:

> ...as a practical matter, few public issue corporations are organized today in which pre-emptive rights are preserved to the shareholder. The common-law doctrine has proved too uncertain when applied to a complex stock structure; and application of the doctrine might hamper legitimate corporate financing. On the other hand, shareholders in the closely held corporations have a real need for an automatic protection against unfair issuance of shares which the pre-emptive right affords.[29]

---

[23] Hoyt v. Great American Insurance Co., 194 N.Y.S. 449 (1922).
[24] Ohio Insurance Co. v. Nunnemecker, 15 Ind. 294 (1878).
[25] Hart v. St. Charles Street and Railroad Co., 30 La. Ann. 758 (1878).
[26] *Supra*, note 19.
[27] Hammond v. Edison Iluminating Co., 131 Mich. 79, 90 N.W. 1040 (1902).
[28] Morawetz, *The Pre-emptive Right of Shareholders*, 42 HARV. L. REV. 186, 188 (1928).
[29] BALLANTINE, LATTIN & JENNINGS, CASES AND MATERIALS ON CORPORATIONS 675 (1953, 2d Ed.).

It will be proper to keep in mind these observations in the succeeding discussions on the exceptions. A reliance on the principle that corporate action which is unreasonably prejudicial to particular shareholders is to be curbed, whereas corporate action which reasonably promotes the interests of the entire group is to be permitted, even though it be prejudicial to particular shareholders is necessary in order to reduce the various court rulings to logical consistency.

1. *As to the Nature of the Shares Issued*—

a. *Common v. Preferred Shares* — The pre-emptive right is most frequently granted to the holders of common shares. Ordinarily, the pre-emptive right has been held to be an incident of fully voting, participating stock only, the right never having been consistently extended to non-voting stocks as to non-participating preferred stock.[30] Where, however, preferred stockholders stand in all respects in the same position as do common stockholders, save only as to preference to dividends, they are entitled to the same preferential right of purchase of unissued common stock of the company as are the common stocks.[31] However, if a preferred stockholder with full voting rights has no participating rights as to surplus, he should be clearly required to pay the full value of new common shares if he wishes to protect his relative interest in voting control. Where the preferred shares have no rights as to assets in liquidation except to the extent of past and accrued dividends, and the relative interest in voting with the old preferred shares would not be affected by the issue of a new class of prior preferred shares without the voting power, it was held that the present holders need not be given a prior right to subscribe.[32] Moreover, the conditions under which preferred stock is issued may be such that holders thereof may be deprived of the right to subscribe to an increase of stock on the terms extended to holders of common stock.[33] On the other hand prior rights of subscription must be given to common shareholders to take preferred shares in some states. The confusion and uncertainty about such matters is one reason for the permitted waiver or abrogation of pre-emptive rights by charter provisions and by statutes.[34]

---

[30] BALLANTINE, *op. cit., supra*, note 10.

[31] Riverside & Dan River Cotton Mills, Inc. v. Thomas Branch & Co., 147 Va. 509, 137 S.E. 620 (1927).

[32] General Investment Co. v. Bethlehem Steel Corp., 88 N.J.Eq. 237, 102 A. 252, 254 (1917).

[33] BALLANTINE, *op. cit., supra*, note 10.

[34] *Ibid.*

b. *Newly Authorized Shares v. Newly Issued Portion of Originally Authorized Shares* — A distinction is often drawn between additional shares as the unissued portion of the originally authorized shares and additional shares newly authorized. While there are conflicting opinions, the prevailing view seems to be that in the issuance of the first the corporation need not offer the shares pre-emptively to its stockholders, as it must in the second case.[35] To rationalize this distinction, it is asserted that, when one subscribes for shares in a corporation, he realizes that his position is fixed by the relation which the number of shares for which he subscribes bears to the total number of authorized shares. The further allotment of authorized shares, it is said, is not an unexpected change in his position, and consequently he is entitled to no pre-emptive right. When, however, the articles are amended to increase the number of authorized shares, there is a change in the original situation, entitling him to a pre-emptive right in the allotment of the newly authorized shares.[36]

Stevens criticizes this distinction between shares already authorized and newly authorized shares as unwarranted. If the distiction is established as a rule, then, by having the articles originally authorize more shares than it is intended to allot immediately and enough shares to take care of future development, shareholders could be deprived of the protection which the pre-emptive right was devised to give. Furthermore, it is fallacious to assert that a shareholder establishes his position in relation to the number of shares authorized at the time that the original allotment is offered for subscription. He establishes his position only in relation to the number of shares which are then offered for subscription. He, as well as other members have no opportunity to subscribe to a portion of the balance of the authorized shares until it is decided to increase the capital by a further allotment of those shares. A distinction should not be taken between previously authorized and newly authorized shares. The distinction should be between those shares constituting the original allotment and those shares constituting a distinctly separate subsequent allotment for the purpose of raising additional capital.[37]

The case of *Dunlay v. Ave. M. Garage and Repair Co.*,[38] is in point insofar as it recognized such an exception based on the fine distinctions drawn by Justice Pound as to the purpose of the issuance:

---

35 Yasik v. Wachtel, 25 Del. Ch. 247, 17 A. 2d 308 (1941).
36 Archer v. Hesse, 164 App. Div. 493, 497, 150 N.Y.S. 296 (1914).
37 STEVENS, *loc. cit.*, *supra*, note 1 at 510.
38 253 N.Y. 274, 170 N.E. 917 (1930).

> If the issue of the unissued original shares, whenever authorized, is reasonably necessary to raise money to be used in the business of the corporation rather than the expansion of such business beyond the original limits, the original shareholders have no right to count on obtaining and keeping their proportional part of the original stock.

The line between the use of capital "in the business" and that for the "expansion of the business" is however, seldom clearly drawn. Prof. Feliciano submits 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 of such shares as may be required to raise the initial capital outlay necessary to place the corporation on a working basis. 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.[39]

It must be mentioned, however that some decisions recognize the pre-emptive right where "the directors have authorized the sale of authorized capital stock that has never been issued, with the result that whenever a corporation fails to issue the entire amount of stock authorized, it must, if it is subsequently decided to issue that stock, or any part thereof, give the old stockholders reasonable opportunity to take it up.[40] To hold that additional stock over and above that outstanding and up to the amount originally authorized, could be disposed of solely by the action and in the sole discretion of the board of directors and without any pre-emptive rights, would place in the hands of the directors the power practically to destroy the property rights of stockholders by the arbitrary and capricious sale of stock to friends and relatives at far less than its actual value.[41] The situations contemplated in the last two decisions, in addition to giving rise to the pre-emptive right, are within the purview of the fiduciary relationship between directors and stockholders and the consequent duty of the fiduciary to observe good faith and honesty in his dealings with the property of his cestui que trust.

It will be seen from the foregoing discussion that where the interests of the individual shareholders are not endangered, where there is no threatened dilution of his property rights as in the

---

[39] Feliciano, *op. cit., supra*, note 2 at 486.

[40] Humboldt Driving Park Association v. Stevens, 34 Neb. 528, 52 N.W. 568 (1892).

[41] Carlson v. Ringgold County Mutual Telephone Co., 252 Iowa 748, 108 N.W. 2d 478 (1961).

case of originally authorized but unissued shares which the shareholder took into consideration in determining his proportional interests in the corporation, the pre-emptive right is not recognized; at least, not by the majority of the courts. However, where the issuance of such shares is for the expansion of the business beyond its original limits, beyond the limits which were within the contemplation of the shareholder when he bought his shares, and which presumably is aimed at the accumulation of a large surplus, the balance of interests between the stockholder and the corporation tilts towards the latter's advantage — hence the shareholders's right of pre-emption is recognized.

c. *Treasury Stock* — The term refers to shares previously issued by the corporation and subsequently acquired by it. The shares reacquired may either be retired, cancelled or simply held "in the treasury" uncancelled and subject to reissue.[42] Where the shares are formally retired, there is no difficulty concerning pre-emptive rights. It is the retention of reacquired shares in the treasury which poses vexing problems, the share structure being effectively altered, although, in contemplation of law, remaining virginally intact as it was prior to acquisition.[43]

In *Borg v. International Silver Co.*, Judge Hand held that treasury shares, upon their subsequent sale or reissue need not be offered pre-emptively to stockholders.[44] This pronouncement was based on the fact that he considered shareholders as fixing their relative positions on the basis of the capital stock authorized at the time of subscription. He believed that their resale gave rise to no pre-emptive right since that merely restored the status the shareholders had originally accepted; he regarded the proportionate voting status the preservation of which stockholders are supposed to have a right to rely on in arithmetical terms, a fraction whose denominator includes the treasury shares.[45]

Prof. Feliciano assails the realism of such a viewpoint in 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.[46] Thus, in a corporation with 10,000 outstanding shares, the acquisition by the corporation of 2,000 of its shares would enable a minority group owning 1,000 shares to elect, under cumulative voting, at least one director to an eight-man board.[47] The purchase of its shares by the corporation increases

---

[42] Feliciano, *op. cit., supra*, note 2 at 496.
[43] *Ibid.*
[44] 11 F. 2d 147 (1925).
[45] Feliciano, *op. cit., supra*, note 2 at 497.
[46] *Ibid.*
[47] *Ibid.*

the voting power of the remaining shares. Where the new relative status induced by the acquisition of the shares has crystallized over a period of 15 years, for example, the desirability of preserving voting strength would call for the recognition of pre-emptive rights upon the resale of the treasury shares. It must be noted that in the Borg case the treasury shares were not retired and the capital stock reduced; the label "in the treasury" indicated a reservation of the power to recreate the shares, to change its present status by reissuing the same.[48]

A different conclusion was reached by the court in *Dunn v. Acme Auto and Garage Co.*[49] There, it was held that from the standpoint of voting power, the shareholders are originally affected when the corporation acquires its own shares because shares held by a corporation may not be voted. If the acquisition of the shares is justifiably in the interests of the shareholders and if they become adapted to the new situation in which a smaller number of shares may be voted, then there will be a second disturbance of the relative voting strength when the treasury shares are reissued. Consequently, it would seem reasonable that, under such circumstances, shareholders should not be denied a pre-emptive right to subscribe to the treasury shares. Thus, Justice Rosenberg concludes, 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.[50]

The difference in the results reached in both cases could be attributed to the fact that in the Borge case the accounting treatment and the label "in treasury" could have been regarded as an expression of an intention to reissue the shares albeit at some vague time in the future whereas no circumstance indicating such an intention could be found in the Dunn case.[51]

Prof. Feliciano submits that treasury shares are really shares restored to the status of authorized and unissued shares. The fiction of the continuing identity of the old shares acquired by the corporation and those issued to the purchaser is only productive of confusion. Thus considered, pre-emptive rights in treasury shares would be subsumable under the heading of unissued balance of originally authorized shares and the standards there indicated would be applicable.[52]

---

[48] *Ibid.*
[49] 168 Wis. 128, 169 N.W. 297 (1918).
[50] *Ibid.*
[51] Feliciano, *op. cit., supra*, note 2 at 499.
[52] Feliciano, *op. cit., supra*, note 2 at 503.

2. *As to the Consideration for the Issuance of Stock* —

It is in this area of the law on pre-emptive rights that the equitable equilibrium of interests, *i.e.*, those of the individual shareholder's and those of the body corporate are most useful. While many courts have upheld the doctrine that shares issued for consideration other than cash is not subject to pre-emptive rights, the doctrine has been vigorously criticized as being illogical, for the nature of the consideration is immaterial as far as the net effect of dilution is concerned.[53] The theory is grounded more on practical necessity and business convenience.[54]

a. *Property as the Consideration for the Issuance of Stock* — Drinker asserts that the reason for the exception relative to issues for property, is practical necessity:

> . . . Where the shares are to be issued for cash, the cash of one is as good as that of another. But the desired property is all held by a single person; he can only transfer it to the corporation. Usually it is not feasible to issue the shares for cash and then to use such cash to acquire the property, since the prospective stockholders will probably have stipulated that the property must be exchanged directly for shares. Unless the share can be so issued directly, the property often cannot be acquired.[55]

In these cases the necessity or desirability of the corporation's ownership of 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, the pre-emptive right would not pose an insuperable obstacle.[56] 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.[57]

As direct authority for the issuance of shares in consideration of property, *Meredith v. New Jersey Zinc and Iron Co.* is cited.[58] Beyond the observation that since the property would become part of the corporation assets, the dissenting stockholders receiving the same benefits as the others, no discussion on the basis for the exception from the right of pre-emption is made.[59] However, in *Fox*

---

[53] *Ibid.*
[54] Drinker, *The Pre-emptive Right of Shareholders to Subscribe to New Shares*, 43 HARV. L. REV. 607 (1930).
[55] *Ibid.*
[56] Feliciano, *op. cit., supra*, note 2 at 487.
[57] *Ibid.*
[58] 55 N.J. Eq. 211, 37 A. 539 (1897).
[59] *Ibid.*

v. Mckeoun, it was held that the distribution of the stock of a corporation among shareholders in proportion to the amount contributed by each for the acquisition and improvement of property which forms the basis of the capitalization is not forbidden by public policy or otherwise. The doctrine in *Meredith v. New Jersey Zinc and Iron Co.* was affirmed and elaborated upon in *Thom v. Baltimore Trust Co.*[60] where the court held that the pre-emptive right of the holder of the original stock does not extend to stock issued for the purchase of property which will become a part of the common property since the reason for the rule requiring an equal distribution of the new stock for the purpose of preventing any particular stockholder or clique of stockholders, from appropriating to themselves the right to subscribe to new stock at par at a time when such a privilege is worth a premium does not in such case exist. The property involved in said case consisted of shares of stock of a bank issued in exchange for shares of stock of a trust company, in pursuance of a plan to merge the interests of the 2 corporations. Subsequently the same doctrine was restated in *Mussoon v. New York and Queens Electric Light and Power Co.* where the court held that the right of existing stockholders to claim a ratable distribution does not apply to new stock issued for the purchase of property which will become a part of the common property of the corporation and from which each shareholder will receive the same benefits as his association;[61] neither shall such right apply to new stock lawfully issued in order to effect a consolidation[62] or a merger by purchasing stock of another corporation.[63]

b. *Payment of Debt as the Consideration for the Issuance of Stock* — The exception pertaining to shares issued for property has been extended to those issued in payment of a corporate debt. Thus in *Mussoon v. New York and Queens Electric Light and Power Co.*, in consideration of the cancellation of a money debt owed by the Corporation to the Consolidated Gas Co., the issuance of 71,000 common shares to the creditor was authorized. The court in denying the shareholder the right of pre-emption held that the shares were issued not for money, but for property, *i.e.*, the claims of the Consolidated Gas Co. against the corporation.[64] While such a situation may hardly be distinguishable from a direct sale of stock for cash, the pre-emptive right is denied 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

---

[60] 158 Md. 352, 148 A. 234 (1930).
[61] 138 Misc. Rep. 881, 247 N.Y.S. 406 (1931).
[62] *Supra*, note 6.
[63] Thom v. Baltimore Trust Co., 158 Md. 352, 148 A. 234 (1930).
[64] *Supra*, note 61.

to the existing shareholders would be relatively slight.[65] In *Hodge v. Cuba Co.*, the company having been unable to pay interest on debenture, the directors formulated a plan for refunding the greater part of the debt by giving debenture holders the option of accepting common shares in exchange for the old debentures. In that manner the entire unissued balance of 300,000 shares would go to the debenture holders without the present shareholders having an opportunity to subscribe thereto. The scheme was enjoined by the court because the dilution of stockholder interests was too great to be overridden by considerations of expediency. Here, the pre-emptive right of shareholders was recognized.[66] Likewise in *Fuller v. Krough,* the court held that in cases of stock issued in payment of a pre-existing debt, we do not see any reason why pre-emptive rights should be denied. A debt calls for payment in money which the recognition and exercise of the pre-emptive rights would furnish.[67]

c. *Issuance of Stock for Exchange in Merger or Consolidation* — The rule on pre-emptive rights is inapplicable in cases of merger or consolidation. The reason is that the merger agreement would be impossible of execution if the new shares were subject to pre-emptive rights such as in the case of *Thom v. Baltimore.* In that case it was held that upon a merger, the ability to issue corporate shares to the members of other corporations may be necessary as a means of effecting the plan. If the pre-emptive right be regarded as excercisable only when not inconsistent with the interests and welfare of the corporate group as a whole, then it may be properly held that a pre-emptive right cannot be enforced so as to prevent an advantageous merger or consolidation.[68]

While it cannot be denied that a merger or consolidation may result in a shifting of control and a disturbance of the ratio of interests,[69] 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.[70]

d. *Employee Stock Purchase Plans as Consideration for Issuance of Stock* — While such issuance does not strictly fall under the category of issues for consideration other than cash, for employees pay for the shares in money, the consideration permitting

---

[65] Feliciano, *op. cit., supra,* note 2 at 493.
[66] 142 N.J. Eq. 340, 60 A. 2d 88 (1948).
[67] 15 Wis. 2d 412, 113 N.W. 2d 25 (1962).
[68] *Supra,* note 60.
[69] Coppock, *Stockholder's Right to New Stock,* 7 OHIO L. REV. 345 (1909).
[70] Feliciano, *op. cit., supra,* note 2 at 493.

subordination of pre-emptive rights in the two cases are similar. In *Milwaukee Sanitarium v. Swift*, the shareholders approved a resolution amending the articles of incorporation permitting the issue of the unissued balance of 400 shares to the officers and employees of the corporation and eliminating pre-emptive rights thereto. In an action filed by a shareholder claiming pre-emptive rights, the court upheld the validity of the resolution. It appeared that the purpose of the plan was to secure the permanency of the officers, doctors and employees of the Sanitarium and to heighten their efficiency by giving them a personal, financial interest in the corporation. The value of the stock depended on the quality of the medical staff and the corporation wanted to insure that the incumbent medical director would not seek employment elsewhere. Clearly, the advantages of the plan to the corporation prevailed over individual claims of pre-emption.[71] In *Gottlieb v. Heyden*, it was ruled that because it is sometimes difficult to obtain the services of a skilled executive who already holds a responsible position at a good salary with valuable retirement rights, a substantial option to subscribe for shares of stock may serve as an incentive to accept or continue employment. But the question of waiver of pre-emptive rights may have to be submitted to the shareholders, as by an amendment to the articles of incorporation. In Delaware it has been held that a corporation may amend its charter and deny pre-emptive rights to shares to be used for stock option plans. The value of the option should of course have some reasonable relation to the value of the services agreed to be given.[72] In the case of *Fuller v. Krough* the doctrine laid down by the court justified a denial of the pre-emptive right on the issuance of stock for services or property only where such issuance is a matter of practical necessity.[73]

e. *Convertible Securities as Consideration for the Issuance of Stock* — Similar reasoning which justifies the denial of pre-emptive rights in cases of shares issued in consideration for stock purchase plans applies to the allotment of shares in satisfaction of conversion privileges. If new money must be raised through a bond issue, the addition of the privilege of converting the bonds into shares make the bond more attractive and salable. This again redounds to the benefit of all shareholders.[74] In *Todd v. Maryland Casualty Co.*, it was held that where the corporation needed a large amount of money for financial rehabilitation purposes and could obtain it only by issuing preferred stock convertible into 50 shares of com-

[71] 238 Wis. 628, 300 N.W. 760, 138 A.L.R. 521 (1941).
[72] *Supra*, note 19.
[73] *Supra*, note 67
[74] Venner v. American Telephone & Telegraph Co., 110 Misc. 118, 181 N.Y.S. 45 (1920).

mon for each share of preferred, all voting stocks, the court held that the common stockholders had no pre-emptive right, using the test of whether the right could be exercised "consistently with the object which the disposition of the additional stock was legally designated to accomplish.[75] At times, the interests of existing shareholders themselves may demand protection by offering them the privilege of subscribing for bonds convertible into shares.[76] At other times, expediency and the welfare of the group may justify a denial of the right of pre-emption when money is needed from outside and can be attracted only by bonds in which the convertible features are incorporated.[77]

V. *Conclusion* —

From the foregoing discussions the only conclusion that must be reached is that the shareholder's pre-emptive right is not susceptible of precise definition as a general rule with a limited number of exceptions. It should not be codified in terms which negate flexibility in its application—its expansion or contraction necessary for the accomplishment of the purpose which this right was designed to serve. The interests or claims of individual shareholders must, at times, yield to the interest of the group as a whole. The complicated corporate structures that are now permitted render impracticable an enforcement of the pre-emptive right as defined in the early cases. Emphasis is always to be placed upon the purpose which gave birth to a remedy, and courts should not be restricted by the language of rules formulated upon the basis of the results of specific cases in which that remedy has been sought. In other words, the application of the principle should be founded on a consideration of all the surrounding circumstances of each case.[78]

---

[75] 155 F. 2d 29 (1946).
[76] Wall v. Utah Copper Co., 70 N.J. Eq. 17, 62 A. 533 (1905).
[77] *Ibid.*
[78] STEVENS, *op. cit., supra,* note 1 at 513.