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Initial Capitalization and Financing of Corporations

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INITIAL CAPITALIZATION AND FINANCING OF CORPORATIONS*

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The primary function of the capitalization of a business is the raising of its required funds or capital.[1] The word "capital" is loosely used in many senses. In its strict legal corporate sense it does not include debt; it is

> the sum of the aggregate par value of all shares of stock having par value issued by the corporation and/or the aggregate amount of consideration received by the corporation for the issuance of shares without par value, together with such additional amounts, if any, as from time to time by resolution of the hoard of directors may be transferred to capital; provided, however, that any corporation may, by resolution of its board of directors, allocate to surplus, in lieu of capital, the amount or value of any part of the consideration received for the issuance of shares without par value.[2]

The second function of capitalization, no less important than the first function, is the distribution among the contributors of such funds of their respective participations in the profits and losses, in the ownership of the assets, and in the control of the enterprise. Indeed, the lawyer's chief concern is with these aspects of the matter rather than with the economic and banking questions as to how much

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1. See *Symposium—The Close Corporation—Capitalization,* 52 Nw. U. L. REV. 345, 365 (1957). For tax aspects, see Weyher & Weithorn, *Capital Structure of New Corporations,* N.Y.U. 16TH INST. ON FED. TAX 277 (1958).

2. TENN. CODE ANN. § 48-201 (1956). But "in common financial parlance the long term funded debt of a corporation is usually regarded as forming part of its capital structure," Commissioner v. Neustadt's Trust, 131 F.2d 528, 530 (2d Cir. 1942); cf. Anhalt v. Stein, 223 App. Div. 767, 227 N.Y.S. 606 (1928). "Capitalization" is an accounting rather than a legal term and means "the total permanent liabilities of a business, including outstanding stock," WEBSTER'S NEW INT'L DICTIONARY (2d ed. 1954). It will be observed that while "capitalization" is more inclusive than "capital," it too is not sufficiently broad to encompass the corporate surplus which in a very real sense is also part of the owner's equity in the business. See Crouch, *The Significance of Capital Surplus to the Investor,* 1 VAND. L. REV. 583 (1948). For a statutory definition of "equity capital," see INT. REV. CODE of 1954, § 1244(c)(2)(b). For non-legal discussions of these and related terms, see 1 DEWING, FINANCIAL POLICY OF CORPORATIONS 47 (4th ed. 1941); GERSTENBERG, FINANCIAL ORGANIZATION AND MANAGEMENT OF BUSINESS 76-77 (3d rev. ed. 1951); GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 72-77, 337 (3d ed. 1955); LINCOLN, APPLIED BUSINESS FINANCE 96 (5th ed. 1941).

capital the enterprise requires[3] or from what sources it should be sought.[4]

Methods of Financing

The commercial bank is the main source of so much of the cash working capital[5] for most businesses as is not supplied by its shareholders[6] and has become, to an increasing extent, a source of long-term funds as well.[7] This basic method of financing is supplemented in many directions, dependent in the main on the size, rather than the form, of the particular business. The small business may also have recourse to its suppliers of equipment and the like and to industrial banks or small loan or finance companies,[8] and to special governmental assistance currently available.[9] Businesses of all sizes, of course, obtain and count on trade credit and may resort to accounts receivable financing[10] or to factoring.[11] Whenever real estate is involved, the traditional bond[12] and mortgage is ordinarily available.

3. For a brief listing of "reasons for differences in working capital requirements," see Lincoln, *op. cit. supra* note 2, at 337. State requirements for industrial corporations (as distinguished from banks, insurance companies and the like) are not significant. Typical are requirements in a few states of a specified minimum authorized or paid-in capital as a condition precedent to doing business.

4. See Burgess, *Raising Capital for Small Business Corporations*, 27 DICTA 89 (1950); Cahn, *Capital for Small Business: Sources and Methods*, 24 LAW & CONTEMP. PROB. 27 (1959); Grossman, *Some Modern Trends in Industrial Corporation Financing*, 15 A.B.A.J. 127 (1929); Herold, *Financing Closely Held Corporations*, 47 ILL. B.J. 288 (1958); Masslich, *Financing a New Corporate Enterprise*, 5 ILL. L. REV. 70 (1910); Weaver, *Equity Financing for the Small Firm*, Harv. Bus. Rev., Mar.-Apr., 1956, p. 91; Wilhelm, *How Small Business Competes for Funds*, 11 LAW & CONTEMP. PROB. 220 (1945); Murphy, *The Big Worry for Small Business—Money*, Fortune, July, 1957.

5. "Working capital" is the excess of current assets over current liabilities. MCLAREN, ANNUAL REPORTS TO STOCKHOLDERS 339 (1948). It is therefore "that fraction of the current assets which has been supplied by the permanent investors." GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 387 (3d ed. 1955). It is sometimes referred to as consisting of cash and other quick assets, Crocker v. Waltham Watch Co., 315 Mass. 397, 53 N.E.2d 230 (1944), although in certain contexts it may be construed to refer to cash only, Janney v. Pancoast Int'l Ventilator Co., 122 Fed. 535 (C.C. Pa. 1903).

6. Andrews, Friedland & Shapiro, *Working-Capital Financing of Small Business*, 24 LAW & CONTEMP. PROB. 68 (1959); Drew, *The Role of the Commercial Bank*, 11 LAW & CONTEMP. PROB. 386 (1945).

7. Drew, *supra* note 6; JACOBY & SAULNIER, TERM LENDING TO BUSINESS (1942).

8. See SEIDMAN, FINANCE COMPANIES AND FACTORS (1956); RYAN, USURY AND USURY LAWS chs. XV, XVI (1924), reviewed by the author, N.Y. Times, Jan. 18, 1925. See Rohrlich, *New Usury Laws for Old*, N.Y.L.J. (Feb. 9, 1925).

9. Barnes, *What Government Efforts Are Being Made to Assist Small Business*, 24 LAW & CONTEMP. PROB. 3 (1959).

10. PHELPS, ACCOUNTS RECEIVABLE FINANCING AS A METHOD OF BUSINESS FINANCE (1957); SAULNIER & JACOBY, ACCOUNTS RECEIVABLE FINANCING (1943); Seidman, *op. cit. supra* note 8.

11. PHELPS, THE ROLE OF FACTORING IN MODERN BUSINESS FINANCE (1956).

12. The use of a "note" instead of a "bond" may avoid the federal tax on corporate bonds, see United States v. Leslie Salt Co., 350 U.S. 383 (1956), 25 GEO. WASH. L. REV. 109, 70 HARV. L. REV. 188. The distinction may also be

A modern alternative to the traditional bond and mortgage loan is the "sale, lease-back" arrangement which serves to reduce capital requirements.[13] This alternative also permits the corporation to show a stronger balance sheet since future rent obligations are ordinarily not shown as liabilities.[14] The large business may also resort to the sale of its commercial paper[15] and, more commonly, for long-term capital, to the sale of its securities. "Generically, the word [securities] has reference to written instruments, usually for the payment of money or evidences of a debt, and being more than a mere promise of the debtor of a general liability on his part, but having as collateral to it a pledge of property or some additional obligation."[16] But, "in the general usage of speech employed by men of business affairs, the word 'securities' is used in its widest sense to describe the broad class of financial investments. As so employed it imports the inclusion of stocks—common and preferred—as well as secured investments."[17] Legal considerations are rarely determinative of the method of financing to be used.[18]

Fundamental Considerations

The basic decisions to be made in respect of the capitalization of a business are suggested by its functions as outlined above.

First among such decisions is the allocation between equity capital and debt. Except in the unusual situation where creditors are given voting rights,[19] that decision will also in very large part place the control of the enterprise. Many considerations, nonlegal as well as legal, will influence the decision.

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important for recording purposes, see *In re* Algonquin Elec. Co., 36 F.2d 603 (S.D N.Y. 1929); Sanford v. Boland, 262 App. Div. 926, 28 N.Y.S.2d 870 (1941), *rev'd*, 287 N.Y. 431, 40 N.E.2d 239 (1942). The New York statutes have been amended so as to obviate these distinctions, see N.Y. LIEN LAW § 231, par. 1; N.Y. BANKING LAW §§ 100(b), 225(6), 380(3); N.Y. DEBTOR AND CREDITOR LAW § 166(4). See also In the Matter of International Utilities Corp., 5 S.E.C. 765 (1939).

13. See Cary, *Corporate Financing Through The Sale and Lease-Back of Property: Business, Tax, and Policy Considerations*, 62 HARV. L. REV. 1 (1948); Note, *Some Economic and Legal Aspects of Leaseback Transactions*, 34 VA. L. REV. 686 (1948).

14. "Future installments of rent and taxes under a lease are not liabilities." HILLS, THE LAW OF ACCOUNTING AND FINANCIAL STATEMENTS 122 n. 8 (1957). But see Note, *Disclosure Problems in Sale and Leaseback Transactions*, 16 U. CHI. L. REV. 482 (1949).

15. See GREEF, THE COMMERCIAL PAPER HOUSE IN THE UNITED STATES (1938).

16. Matter of Waldstein, 160 Misc. 763, 766, 291 N.Y.S. 697, 700 (1936).

17. Matter of Loose, 167 Misc. 764, 4 N.Y.S.2d 611, 614 (1938). See also the very broad definitions in the Securities Exchange Act of 1934, 48 Stat. 883-84 (1934), 15 U.S.C. § 78(c)(10) (1952), and the Securities Act of 1933, 48 Stat. 74 (1933), 15 U.S.C. § 77(b)(1) (1952). See Annot., 163 A.L.R. 1050 (1946); Best, *"Securities" in Section 112(b)*, 28 TAXES 315 (1950).

18. See Silberman, *The Fine Art of Raising Capital*, Fortune, July, 1956.

19. See *infra* notes 100-102.

Among the nonlegal factors which play a part in balancing equity and debt are:

(1) The size of initial debt burden, which must not be so large as to preclude the possibility of obtaining credit in the future;[20]
(2) The views of investors as to what constitutes an "optimum capitalization";[21] and
(3) Generally, the current "fashion"[22] and, more particularly, the economic climate of the time.[23]

In the legal arena,[24] conflicting forces are at work within the very free choice allowed to ordinary business firms.[25] Because, in the last analysis, debt and equity securities are both dependent for their value upon the success of the corporation, it has been suggested that the identity of their interest overshadows the technical differences.[26] The realism of the observation that shareholders are becoming more and more investors rather than managing owners, and bondholders less inclined or able to stand on the letter of their bond, does not, however, warrant any lessening concern with the fundamental legal differences. Witness the "absolute priority rule," even when financial difficulties have intervened.[27]

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20. For a brief discussion of the tests usually applied by the short-term lender, see GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 407 (3d ed. 1955).

21. See GRAHAM & DODD, SECURITY ANALYSIS (3d ed. 1951).

22. In 1910, it was said, "methods of corporate finance are continually changing and, as new questions are decided by the courts, they must necessarily change." Masslich, *Financing a New Corporate Enterprise*, 5 ILL. L. REV. 70, 86 (1910). And in 1916, Lyon, in introducing the second volume of his *Corporation Finance*, wrote, "The passage of a few years with the varying economic, social and personal winds, make the facts presented in an old corporation manual resemble the snows of yesterday." It is difficult to imagine the creation today of corporate structures comparable to those of the "twenties." See Note, *High Finance in the 'Twenties: The United Corporation*, 37 COLUM. L. REV. 785, 936 (1937); Note, *High Finance in the 'Thirties: New Deal Legislation*, 37 COLUM. L. REV. 1137 (1937).

23. See Schram, *American Business and Risk Capital*, 1 VAND. L. REV. 512 (1948).

24. "Lawyers are apt to exaggerate their own importance and the significance of their legal machinery . . . ." 2 DEWING, THE FINANCIAL POLICY OF CORPORATIONS 1292 (4th ed. 1941).

25. Very few states have debt restrictions; but see ARIZ. REV. STAT. § 10-173 (1956); TENN. CODE ANN. § 47-1606 (1956). See note 3 *supra*.

26. Greene, *The Commercial Basis for Railway Receiverships*, 33 AMER. LAW REG. & U. PA. L. REV. 417, 425 (1894); Isaacs, *Business Security and Legal Security*, 37 HARV. L. REV. 201, 210 (1923). *Cf.* Berl, *The Vanishing Distinction Between Creditors and Stockholders*, 76 U. PA. L. REV. 814 (1928).

27. " '[A]ny arrangement of the parties by which the subordinate rights and interests of the stockholders are attempted to be secured at the expense of the prior rights' of creditors 'comes within judicial denunciation'." Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510, 527 (1941). But see Billyou, *Priority Rights of Security Holders in Bankruptcy Reorganization: New Directions*, 67 HARV. L. REV. 553 (1954); Blum, *Full Priority and Full Compensation in Corporation Reorganizations: A Reappraisal*, 25 U. CHI. L. REV. 417 (1958); Note, *The Full Compensation Doctrine in Corporate Reorganizations:*

With its limited jurisdiction, the influence of the Securities and Exchange Commission is in the direction of "a balanced capital structure with a substantial amount of common stock equity."[28] One aspect of the "Deep Rock Doctrine"[29] as evolved by the courts is in the same direction.[30] The doctrine narrowly stated

> is at least this: Where a showing can be made that a subsidiary corporation having public preferred stockholders [or creditors] was inadequately capitalized from the outset, and was managed substantially in the interest of its parent, rather than in its own interests, the parent will not, in a bankruptcy or reorganization proceeding affecting the subsidiary, be permitted to assert a claim as a creditor, except in subordination to the claims of preferred stockholders [or creditors].[31]

Although the "Deep Rock Doctrine" has thus far been most commonly applied in the corporate parent-subsidiary relationship and there may be reasons of social policy for distinguishing between a corporate parent and individual shareholders,[32] it should not be assumed that the underlying principles are not also applicable to individual shareholders in one-man or close corporations.[33] It is precisely in these situations that the courts are, as we shall see later

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A Schizophrenic Standard, 63 YALE L.J. 812 (1954); Note, *Absolute Priority Under Chapter X—A Rule of Law or a Familiar Quotation?,* 52 COLUM. L. REV. 900 (1952).

28. 10 SEC ANN. REP. 99 (1944). For a critique of the preference for equity as against debt capital, see Louchheim, *The Problems of Long Term and Equity Capital,* 11 LAW & CONTEMP. PROB. 248 (1945); Kraemer, *Advantages of High Debt and Preferred Stock Financing,* 62 PUB. UTIL. FORT. 375 (1958). For the work of the older regulatory commissions, see SHARFMAN, THE INTERSTATE COMMERCE COMMISSION (1931); Heilman, *The Development by Commissions of the Principles of Public Utility Capitalization,* 23 J. POL. ECON. 888 (1915).

29. So called from the name of the subsidiary involved in Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939). Bayne, *The Deep Rock Doctrine Reconsidered,* 19 FORDHAM L. REV. 43, 152 (1950); Israels, *The Implications and Limitations of the "Deep Rock" Doctrine,* 42 COLUM. L. REV. 376 (1942); Hornstein, *A New Forum for Stockholders,* 45 COLUM. L. REV. 35 (1945); Krotinger, *The "Deep Rock" Doctrine: A Realistic Approach to Parent-Subsidiary Law,* 42 COLUM. L. REV. 1124 (1942); Sloman, *Deep Rock Duz Everything,* 29 TEXAS L. REV. 71 (1950); Sprecher, *The Conflict of Equities Under the "Deep Rock" Doctrine,* 43 COLUM. L. REV. 336 (1943); Note, *The Deep Rock Doctrine: Inexorable Command or Equitable Remedy?* 47 COLUM. L. REV. 800 (1947); Comment, *Right of Parent or Subsidiary to Share with Other Creditors in Assets of Associated Corporation on the Latter's Insolvency,* 37 MICH. L. REV. 440 (1939). It has been said that the burden of proving inadequacy of capitalization (tantamount to a "sham") is upon the party seeking to pierce the corporate veil. Carlesimo v. Schwebel, 87 Cal. App. 2d 482, 197 P.2d 167 (1948).

30. The important element of "dereliction of duty" on the part of the parent is outside the scope of this article. See *In re* American & Foreign Power Co., 80 F. Supp. 514, 529 (S.D. Me. 1948).

31. Israels, *supra* note 29, at 379.

32. See LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 196 (1936).

33. *Cf.* Pepper v. Litton, 308 U.S. 295 (1939); see also Dixie Coal Mining & Mfg. Co. v. Williams, 221 Ala. 331, 128 So. 799 (1930); Mosher v. Salt River Valley Water Users' Ass'n, 39 Ariz. 567, 8 P.2d 1077 (1932).

in this discussion, beginning to attach importance to the ratio of debt to capital in determining whether a particular security is in fact, regardless of its designation by the parties, a share of stock or an evidence of debt.[34]

In *Arnold v. Phillips*,[35] these principles were applied in the case of an individual shareholder so as to deny him the position of creditor with respect to moneys advanced at the time of the organization of the corporation. The court treated these advances as invested capital but sustained the shareholder's claim as creditor with respect to loans made by him to the corporation several years after its organization.[36]

In direct opposition to these legal impulses towards more equity and less debt is the influence of the tax laws which is strongly in the direction of the smallest possible equity and the largest part of the total capitalization in the form of debt.

In practice, these tax considerations are of controlling importance only in those situations where the total capitalization is being obtained from the same ownership group and the question is as to the form which will be to their greatest advantage.[37] In a Federal Reserve Bank of Philadelphia study[38] it was concluded:

> Taxation is only one of several factors which affect the proportion of capital funds obtained from debt and equity sources. The type of industry making the investment, the relative yields on stocks and bonds, the amount of savings going into investments via savings institutions, and the temper of the security market are important also.

Four aspects of the federal income tax laws suggest the advantages of small equity and large debt.[39]

Interest paid by a corporation on its outstanding debt is deductible

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34. See Annot., 63 A.L.R.2d 1051 (1959).

35. 117 F.2d 497 (5th Cir. 1941), *cert. denied*, 313 U.S. 583 (1941).

36. *Accord*, *In re* Madelaine, Inc., 164 F.2d 419 (2d Cir. 1947). See also Goldstein v. Wolfson, 132 F.2d 624 (2d Cir. 1943). *Cf.* Hanson v. Bradley, 298 Mass. 371, 10 N.E.2d 259 (1937).

37. Although the right of corporations to make loans to shareholders is commonly subject to statutory prohibitions or limitations (*e.g.*, 8 DEL. CODE ANN. § 143 (1953); N.Y. STOCK CORP. LAW § 59), corporations are free to borrow from their shareholders and officers. See Dean v. Kellogg, 394 Ill. 495, 68 N.E.2d 898 (1946); Harr v. Wells-Newton Nat'l Corp., 224 App. Div. 288, 278 N.Y.S. 933, *aff'd*, 269 N.Y. 531, 199 N.E. 521 (1935). Also cases cited *supra* notes 35, 36. But note the "good faith" requirement implicit in the text discussion. See Holland, *Tax Effects of Stockholder Loans to Corporation*, N.Y.U. 9TH INST. ON FED. TAX. 1083 (1951).

38. The Business Review (Dec. 1948).

39. INT. REV. CODE OF 1954, § 163.

as an expense[40] but dividends paid are not.[41] Hence, the obvious tax minimization possibilities in more debt and less equity in the capitalization. Under the temptation of this tax saving, there has been a reluctance to use stocks even though otherwise indicated. Such other factors as, for example, an understandable desire not to subject the enterprise to the implacable hazards of a fixed interest obligation payable at all events on a stated date have, however, in many instances prevented the use of the ordinary forms of debt obligations. The result has been "divers types of securities with many overlapping characteristics . . . . [so that] it is not always easy to draw the line between that type of proprietary interest known as a preferred stock and that type of corporate debt known as a debenture."[42] The decisions by the Supreme Court[43] in the *Kelley*[44] and *Talbot*[45] cases on the deductibility under former section 23(b), Internal Revenue Code,[46] of certain payments to security holders are not very helpful because, without "a substantial differentiating factor,"[47] they sustained

40. Anderson, *'Thin' Corporate Capitalizations,* 1957 So. CALIF. TAX INST. 35; Caplin, *The Caloric Count of a Thin Incorporation,* N.Y.U. 17TH INST. ON FED. TAX. 771 (1959); McCrea, *The "Thin Corporation" Problem,* 12 SW. L.J. 373 (1958); Schlesinger, *Acceptable Capital Structures: How Thin is Too Thin?* 5 U. FLA. L. REV. 355 (1952); Weyher & Weithorn, *Capital Structure of New Corporations,* N.Y.U. 16TH INST. ON FED. TAX. 277 (1958); Note, *Corporate Debt Financing Under the Tax Law,* 7 BUFFALO L. REV. 289 (1958).

41. See generally, 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 26.10 (1954). *Cf.* Bowersock Mills & Power Co. v. Commissioner, 172 F.2d 904 (10th Cir. 1949), 29 B.U.L. REV. 440 (1949).

42. Commissioner v. H. P. Hood & Sons, 141 F.2d 467, 469 (1st Cir. 1944). See also Moore v. American Fin. & Sec. Co., 31 Del. Ch. 335, 73 A.2d 47 (1950); Northern Fire Apparatus Co. v. Commissioner, 11 B.T.A. 355 (1928). For general discussions of hybrid securities, see Berl, *The Vanishing Distinction Between Creditors and Stockholders,* 76 U. PA. L. REV. 814 (1928); Hanse, *Hybrid Securities: A Study of Securities Which Combine Characteristics of Both Stocks and Bonds,* 13 N.Y.U.L. Q. 407 (1936); Ulhman, *The Law of Hybrid Securities,* 23 WASH. U.L.Q. 182 (1938); Comment, *Status of Holders of Hybrid Securities: Stockholders or Creditors?* 45 YALE L.J. 907 (1936). See also, Wilshire & Western Sandwiches, Inc. v. Commissioner, 175 F.2d 718 (9th Cir. 1949), *reversing* 7 CCH Tax Ct. Mem. 406 (1948); Ruspyn Corp., 18 T.C. 769 (1952).

43. John Kelley Co. v. Commissioner, 326 U.S. 521 (1946), 44 MICH. L. REV. 827 (1946), 94 U. PA. L. REV. 339 (1946). Historically, the greatest significance in these opinions may well lie in the cautionary dictum of Mr. Justice Reed: "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessive debt structure." 326 U.S. at 526.

44. John Kelley Co., 1 T.C. 457 (1943), *rev'd,* 146 F.2d 466 (7th Cir. 1944), *rev'd,* 326 U.S. 521 (1946).

45. Talbot Mills, 3 T.C. 95 (1944), *aff'd,* 146 F.2d 809 (1st Cir. 1944), *aff'd,* 326 U.S. 521 (1946).

46. Now INT. REV. CODE OF 1954, § 163.

47. Mr. Justice Rutledge, 326 U.S. at 533. The "evidentiary facts [were] almost identical." Lowenthal v. Commissioner, 169 F.2d 694, 698 (7th Cir. 1948). The Court attached no significance to the fact that in one of the cases some of the debentures were issued in exchange for stock instead of being sold for cash. Lansing Community Hotel Corp., 14 T.C. 183, 190 (1950), *aff'd,* 187 F.2d 487 (6th Cir. 1951).

diverse holdings by the Tax Court.[48]

It is therefore necessary to deduce the controlling factors from the later lower court decisions. No one factor is controlling.[49] All the relevant facts and circumstances must be considered.[50] The most important single factor is whether the obligation provides for certainty of payment of a fixed sum on a fixed date.[51] The maturity date must be realistic and a ninety-nine year term has been rejected (when the obligations were held by the shareholders).[52] In the face of a fixed obligation,[53] the debt character of the instrument will not be disregarded merely because it was issued to shareholders in exchange for stock[54] or as a dividend[55] or because the interest is payable only if earned but is cumulative[56] or because it is subordinate to the claims of other creditors[57] or because the issuance of the obligation (instead of stock) represented a tax advantage to the shareholders.[58] One possible exception to the controlling importance of the fixed obligation appears in those cases where the loan is unsecured and the amount of the debt (owing to shareholders pro rata) represents virtually the total capitalization of the corporation.[59]

48. See Lincoln Elec. Co. v. Commissioner, 162 F.2d 379 (6th Cir. 1947); Anderson v. Commissioner, 164 F.2d 870 (7th Cir. 1947).

49. Sabine Royalty Corp., 17 T.C. 1071 (1951); Pierce Estates, Inc., 16 T.C. 1020 (1951), *rev'd on other grounds,* 195 F.2d 475 (3d Cir. 1952).

50. "[T]he name given to the security, maturity date, source of payment, certainty of payment, status of the security holder as compared to other creditors, interest of the holder in management, intent of the parties, and business purpose." Sabine Royalty Corp., *supra* note 49, at 1076.

"The maturity date if any, the method used in accounting for the securities on the books, the designation of the security, the ratio of these securities to capital stock, the interest rate, subordination of interest payments, specified designation of the source of the interest payments, right of action by the holder in case of default, voting rights, and consideration." Pierce Estates, Inc., *supra* note 49, at 1023.

51. "The final criterion of distinction between the creditor and the stockholder is the certainty of payment before insolvency or liquidation." Washmont Corp. v. Hendricksen, 137 F.2d 306, 308 (9th Cir. 1943); see also Bowersock Mills & Power Co. v. Commissioner, *supra* note 41.

52. Swoby Corp., 9 T.C. 887 (1947). This was not the only element relied on by the Court in disallowing the interest deductions.

53. The maturity date may be subject to extension for good business reasons. Cleveland Adolph Mayer Realty Corp., 6 T.C. 730 (1946), *rev'd on other grounds,* 160 F.2d 1012 (6th Cir. 1947).

54. Sabine Royalty Corp., *supra* note 49; Toledo Blade Co., 11 T.C. 1079 (1948), *aff'd,* 180 F.2d 357 (6th Cir.), *cert. denied,* 340 U.S. 811 (1950). See also Tribune Pub. Co., 17 T.C. 1228 (1952).

55. Lansing Community Hotel Corp., *supra* note 47.

56. Lansing Community Hotel Corp., *supra* note 47; Pierce Estates, Inc., *supra* note 49; Bowersock Mills & Power Co. v. Commissioner, *supra* note 41.

57. Sabine Royalty Corp., *supra* note 49; Lansing Hotel Corp., *supra* note 47.

58. This is especially true when there is also another "business purpose" for the debt. Sabine Royalty Corp., *supra* note 49.

59. Kipsborough Realty Corp., 10 CCH Tax Ct. Mem. 932 (1951); Swoby Corp., *supra* note 51; 1432 Broadway Corp., 4 T.C. 1158 (1945), *aff'd* 160 F.2d 885 (2d Cir. 1947).

The name given to the security is only of slight evidentiary value[60] and there are cases where "guaranteed dividends" on "preferred stock" have been allowed as "interest" deductions.[61]

Another tax factor which in the close corporation suggests the desirability of debt rather than stock is the fact that the former may be repaid without tax consequences such as attach to the payments of dividends and without liquidation of the business. A redemption of stock must safely vault section 302, Internal Revenue Code,[62] if the recipient is not to be taxed as on the receipt of a dividend.[63] The use of "bonds" or "debentures" instead of "stock" affords a literal escape from the impact of that provision, but, *query* whether debt obligations in form which do not in substance meet the tests laid down under the cases under former section 23(b), now section 163, Internal Revenue Code, noted above, may not also be held to be "stock" within the meaning of section 302 of the Code.[64]

The third tax incentive towards undercapitalization[65] lies in the threat of section 531 of the Code which aims to prevent the "improper" accumulation of surplus.[66] Since, basically, imposition of the section 531 penalty[67] necessitates a finding that there has been an unreasonable accumulation of earnings, it is clear that this point is not as quickly reached in the case of a "poor" corporation as it is in the case of a corporation with a capital adequate to meet all its present and anticipated financial requirements.[68] Whether the practice of de-

60. Sam Schnitzer, 13 T.C. 43 (1949), *aff'd,* 183 F.2d 70 (9th Cir. 1950), *cert. denied,* 340 U.S. 911 (1951).

61. Bowersock Mills & Power Co. v. Commissioner, *supra* note 41. But see Mullin Bldg. Corp., 9 T.C. 350 (1947), *aff'd,* 167 F.2d 1001 (3d Cir. 1948); Jordan Co. v. Allen, 85 F. Supp. 437 (M.D. Ga. 1949).

62. If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings and profits accumulated after February 28, 1913, or represents a distribution of earnings and profits of the taxable year, shall be treated as a taxable dividend.

63. Annot., 170 A.L.R. 1392 (1947).

64. See Bertram Meyer, 5 T.C. 165 (1945), *on remand,* 7 T.C. 1381 (1946); Emil Stein, 46 B.T.A. 135 (1942).

65. Both as defined in note 2 *supra,* and also in the sense of "capital."

66. See HALL, THE TAXATION OF CORPORATE SURPLUS ACCUMULATIONS (1952); HOLZMAN, TAX ON ACCUMULATED EARNINGS (1956); Altman, *Corporate Accumulation of Earnings,* 36 TAXES 933 (1958); Kendall, *Business Factors in Justifying Accumulation of Earnings Under Section 531,* 1959 So. CALIF. TAX. INST. 225; Wallick, *The § 531 Penalty Tax: What is an Unreasonable Accumulation?,* Prac. Law. Nov., 1958, p. 31; Weithorn, *What Constitutes a "Reasonable" Corporate Accumulation?,* N.Y.U. 17TH INST. ON FED. TAX. 299 (1959).

67. 27½% on the first $100,000, and 38½% on the excess over $100,000.

68. *E.g.,* De Mille Productions, 30 B.T.A. 826 (1934); Wean Eng. Co., 2 CCH Tax Ct. Mem. 510 (1943); Coca Cola Bottling Works v. United States, 53 F. Supp. 992 (M.D. Tenn. 1944); Lane Drug Co., 3 CCH Tax Ct. Mem. 394 (1944); General Smelting Co., 4 T.C. 313 (1944); Syracuse Stamping Co., 4 CCH Tax Ct. Mem. 371 (1945); Universal Steel Co., 5 T.C. 627 (1945). It may

liberately organizing initially with a low equity and a large debt to accomplish this very end of retaining earnings undistributed will not invoke a judicial reaction remains to be seen,[69] especially in view of the statutory reference to corporations "formed" for the purpose of preventing the imposition of the surtax on shareholders.[70]

Finally, even when there is anticipation of loss rather than profit, the tax law suggests debt rather than stock as the preferred investment medium. A loss sustained on a stock investment is usually subject to the capital loss limitations of the Code.[71] On the other hand, a bad debt may be fully deductible (if incurred in the taxpayer's trade or business)[72] or treated as a short-term capital loss[73] which is still an advantage to the creditor over the shareholder who holds his stock more than six months. It is in this area that there may be found some of the most direct instances of judicial penalization of obvious inadequate capitalization.[74] When it is apparent that the corporation was never intended to stand on its own feet financially or to operate without funds "loaned" by the shareholders, their advances run substantial risk of being treated as contributions to capital and denied "bad debt" treatment.[75]

The importance of this one consideration has been materially lessened by the enactment of section 1244 which now permits the taking as an ordinary loss of losses sustained "on section 1244 stock."[76]

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also be observed that a conservative dividend policy will find greater tolerance in the case of a new corporation than in the case of an established corporation having a background of actual experience upon which to forecast the future, *e.g.*, Lane Drug Co., *supra*.

69. Cary, *Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102(c)*, 60 HARV. L. REV. 1282 (1947). *Cf.* caveat by Mr. Justice Reed, in another connection, 326 U.S. at 526, *supra* note 43; also see Lion Clothing Co., 8 T.C. 1181 (1947).

70. INT. REV. CODE OF 1954, § 532.

71. INT. REV. CODE OF 1954, § 165. But see note 74 *infra*.

72. INT. REV. CODE OF 1954, § 166.

73. *Ibid.*

74. It is virtually impossible to generalize as to what constitutes an appropriate capitalization; there is an extensive non-legal literature on the subject. One of the late discussions is in GUTHMANN & DOUGALL, *op. cit. supra* note 2, ch. 12.

See generally, Brown, *Payment on Indebtedness to Stockholders—Interest or Dividends?*, N.Y.U. 7TH INST. ON FED. TAX. 615, 617-18 (1949); Kumler, *Capital Structure*, 1950 So. CALIF. TAX. INST. 181. The writer of this article appreciates the appeal of symmetry ("They do things better with logarithms." CARDOZO, PARADOXES OF LEGAL SCIENCE 1 (1928)) but believes that any attempt at specifying a fixed ratio, as suggested in the last cited article, faces an insurmountable obstacle in the vast variety of particular circumstances confronting different corporations at different time.

75. Erard A. Matthiessen, 16 T.C. 781 (1951), *aff'd*, 194 F.2d 659 (2d Cir. 1952); Isidor Dobkin, 15 T.C. 31 (1950), *aff'd*, 192 F.2d 392 (2d Cir. 1951); Sam Schnitzer, *supra* note 60; Joseph H. Hubbard, 11 CCH Tax Ct. Mem. 958 (1952).

76. See Caplin, *Subchapter S and Its Effect on the Capitalization of Corporations*, 13 VAND. L. REV. 185 (1959). This discussion is in the main also applicable to the comparable business forms such as the Massachusetts Trust and the Joint Stock Company.

The prime division between equity and debt having been made, it remains to determine whether the equity should be divided between common and preferred stock. The question does not arise if the corporation is to be eligible to elect to be treated as a "small business corporation" under Subchapter S, Internal Revenue Code, for such corporations may have only one class of stock.[77]

It is not our purpose here to prolong the debate as to the justification for using a security which "is neither fish, fowl, nor good red herring,"[78] nor to examine the truth of the conclusion that "heads, the common stockholder wins; tails, the preferred stockholder loses."[79] But attention must be called to the fact that certain of the newer federal statutes are slanted in the direction of an "ideal" capital stock structure consisting of one class of stock.[80] Within the limited purview of these statutes, this attitude finds expression, even where no absolute prohibition is applicable, in a presumption against the use of preferred shares. For example, in a discretionary situation, the Securities and Exchange Commission held that the desire of the common stock for "leverage" is no sufficient justification for the use of preferred stock.[81]

Voting and Non-Voting Securities

It will be remembered that an appropriate function of corporate capitalization is the distribution of the "control" of the corporation as well as of its property and profits and losses. Although state statutes quite freely grant the right to issue non-voting stock,[82] pressure against their use is substantial.[83]

Several of the newer federal statutes restrict the use of nonvoting stock. Subchapter S of the Internal Revenue Code enacted in 1958

77. See Caplin, *supra* note 76.
78. HOAGLAND, CORPORATION FINANCE 83 (2d ed. 1938).
79. GRAHAM & DODD, *supra* note 21, at 355.
80. See Investment Co. Act of 1940, § 18, 54 Stat. 817, 15 U.S.C. § 80a-18 (1952); Public Utility Holding Company Act of 1935, §§ 7, 11, 49 Stat. 815, 820, 15 U.S.C. §§ 79(g), (k) (1958); Central & South West Utilities Co. v. SEC, 136 F.2d 273 (D.C. Cir. 1943); *In re* Electric Bond & Share Co., 73 F. Supp. 426 (S.D. N.Y. 1946); SEC Holding Company Act Releases 4501, 4559, 4716, 5062, 5114, 5238, 6458, 6797.
81. Commonwealth & Southern Corp., 11 S.E.C. 369 (1942), *aff'd*, 134 F.2d 747 (3d Cir. 1943). For discussion of preferred stock see text supporting note 139 *infra*.
82. Illinois is an outstanding exception, see People *ex rel.* Watseka Telephone Co. v. Emmerson, 302 Ill. 300, 134 N.E. 707 (1922). A few states insist upon minimum voting rights in respect of fundamental corporate changes. See generally, ROHRLICH, LAW AND PRACTICE IN CORPORATE CONTROL ch. III (1933); Stevens, *Voting Rights of Capital Stock and Shareholders*, 11 J. BUS. U. CHI. 311 (1938). A corporation may not issue all of its stock without voting powers. Rohrlich, *op. cit. supra*, at 30.
83. For earlier studies of "the separation of ownership from control," see BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); Rohrlich, *op. cit. supra* note 82, at 41.

does this by denying the privilege of election thereunder to corporations having more than one class of stock.[84] In a reorganization under the Bankruptcy Act, the reorganized corporation is prohibited from issuing non-voting stock.[85] The Public Utility Holding Company Act points in the same direction.[86] And the Investment Company Act requires that, with stated exceptions, all newly issued stock be voting stock.[87] Since 1926, the New York Stock Exchange has refused to list non-voting common stock.[88]

The same opposition to the denial of voting rights to common stock has carried over to preferred shares, but, in view of the more ancient non-voting tradition involved, has been effective to a lesser degree. The Securities and Exchange Commission, within its limited jurisdiction (*e.g.*, under the Public Utility Holding Company Act),[89] generally requires that preferred stock have

> the right to elect a majority of the board of directors in the event of default in the payment of four quarterly preferred stock dividends and certain voting rights in connection with the following matters: the issuance of short-term debt in excess of prescribed amounts, mergers and consolidations, the authorization of any class of stock ranking prior to or on a parity with the outstanding preferred stock, the amendments of the charter to change the express terms of the preferred stock in any substantially prejudicial manner, the issuance of authorized but unissued preferred stock.[90]

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84. See Caplin, *supra* note 76.

85. § 216(12), 11 U.S.C. § 616(12). It has been held that a voting trust is not precluded. *In re* Quaker City Storage Co., 71 F. Supp. 124 (D.C. Pa. 1947). See generally, Krotinger, *Management and Allocation of Voting Power in Corporate Reorganizations*, 41 COLUM. L. REV. 646 (1941); MOORE & OGLEBAY, 2 CORPORATE REORGANIZATIONS § 10.21 (1948).

86. 49 Stat. 815, 820 (1935), 15 U.S.C. §§ 79(g)(c), 79(k)(a) (1958). See Meck & Cary, *Regulation of Corporate Finance and Management Under the Public Utility Holding Company Act of 1935*, 52 HARV. L. REV. 216, 224 (1938).

87. 54 Stat. 821 (1940), §§ 18(i), (j), 15 U.S.C. § 80(a)(18)(i), (j) (1958). See Note, *The Investment Company Act of 1940*, 41 COLUM. L. REV. 269, 284 (1941). The election of directors by preferred and common stockholders voting separately as classes does not necessarily violate the Investment Company Act requirement of "equal voting rights." *In re* Solvay American Corp., SEC Investment Company Act Release No. 1165 (April 13, 1948). For discussions of the rights and obligations of "management stock," see Berle, *Non-Voting Stock and "Bankers" Control*, 39 HARV. L. REV. 673 (1926); Wood, *The Status of Management Stockholders*, 38 YALE L.J. 57 (1928).

88. NYSE Company Manual, § A15. "In broad principle," the American Stock Exchange also, but less inflexibly, adheres to a similar policy (see *Statement of Policy of Committee on Listing re Voting Rights*, as modified November 12, 1946). These rules were provoked by the emergence of the so-called "Class A" stocks, see text supporting note 149 *infra*. Thereafter, in November 1947, a corporation, with listed stock, created a new class of stock, to be issued for a comparatively nominal amount, entitled to elect five directors out of a board of twelve, without being delisted; but see Kahn v. Schiff, 105 F. Supp. 973 (D.C. Ohio 1952).

89. *Supra* note 86.

90. 10 SEC Ann. Rep. 103 (1944). See also In re Solvay American Corp., *supra* note 87; Statement of Policy, Pub. Util. Holding Co. Act Release No. 13,106 (1956); Leary, *Voting Rights in Preferred Stock Issues under the Public*

The New York Stock Exchange has not as yet gone quite as far as the Commission, but it will not list new preferred stocks which do not provide at least the following minimum voting rights:

1. The right of the preferred stock, voting as a class, to elect at least two directors upon default of the equivalent of six quarterly dividends;
2. The affirmative approval of at least two-thirds of the preferred stock as a prerequisite to any charter or by-law amendment altering materially any existing provision of such preferred stock.[91]

It should be remembered at the time of initial capitalization that a subsequent grant or extension of voting rights by charter amendment to preferred shares originally issued without such rights may give rise to appraisal rights in favor of dissenting common stockholders.[92]

In allocating voting rights in the election of directors,[93] consideration must be given to the question of "cumulative voting."[94] This is permissible in most states[95] and in many states cumulative voting is mandatory.[96] It would seem that even in such states a valid stockholders' agreement may be made even though its effect is to deprive the parties of the right to elect directors by the exercise of cumulative voting.[97] In the publicly held corporation, many policy questions are involved;[98] in the close corporation, however, the decision must turn, where there is free choice, on the question as to how cumulative

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Utility Holding Company Act of 1935, 27 TEXAS L. REV. 749 (1949); Note, *Voting Rights of Preferred Stockholders Under the Public Utility Holding Company Act of 1935*, 51 YALE L.J. 138 (1941).

91. *Supra* note 88. See also Bankruptcy Act, *supra* note 85, which requires comparable voting rights in preferred stock.

92. See Marcus v. R. H. Macy & Co., 297 N.Y. 38, 74 N.E.2d 228 (1947).

93. Cumulative voting has no relation to stockholders' voting on matters other than the election of directors.

94. A system of voting designed to give a minority representation on the board of directors by permitting the stockholders to multiply the number of voting shares by the number of directors to be elected and then to vote such resulting number of votes for one or more candidates. See Cole, *Legal and Mathematical Aspects of Cumulative Voting*, 2 S.C.L.Q. 225 (1950); Gerstenberg, *The Mathematics of Cumulative Voting*, 9 J. ACCOUNTANCY 177 (1910). For further reading references, see *Bibliography on Cumulative Voting*, 5 FLETCHER, PRIVATE CORPORATIONS § 2048 (Cum. Supp. 1959).

95. By charter provision under permissive statute. In the absence of any constitutional or statutory provision, *query* as to the authority to provide for cumulative voting by charter. See Note, *Cumulative Voting for Corporate Directors*, 33 CHI.-KENT L. REV. 333, 334 n. 6 (1955).

96. See, Annot., 43 A.L.R.2d 1322 (1955); Steadman & Gibson, *Should Cumulative Voting for Directors Be Mandatory?—A Debate*, Bus. Law. Nov. 1955, p. 9. The California Commissioner of Corporations has ruled that in foreign as well as domestic corporations, the absence of cumulative voting is a "negative factor."

97. Sensabaugh v. Polson Plywood Co., 28 U.S. L. WEEK 2059 (Mont. July 30, 1959); E. K. Buck Retail Stores v. Harkert, 157 Neb. 867, 62 N.W.2d 288 (1954), 45 A.L.R.2d 774 (1956).

98. See, Axley, *The Case Against Cumulative Voting*, 1950 WIS. L. REV. 278; Young, *The Case for Cumulative Voting*, 1950 WIS. L. REV. 49.

voting fits into the entire scheme devised for the allocation of voting rights to achieve the agreement and intent of the stockholders.[99]

Occasionally, it is desired to give voting rights to bond-holders, either permanently so as to give them representation on the board of directors, or only after the happening of an event of default or other stipulated contingency such as a diminution of earnings or working capital below a stated point so as to enable them in such circumstances to take over the management by electing either a new board or a majority thereof, either permanently or at least so long as the condition continues.[100] It may be said as a general rule that such voting rights may not be accorded to creditors in the absence of statutory authority.[101] However, the statutes of several states now expressly permit the granting of voting rights to bondholders.[102]

Par and No-Par Stock

Since New York, in 1912, led the way in legalizing no-par stock,[103] virtually every state has done so.[104] The primary objectives of no-par shares were to permit the issuance of bonus shares and to give promoters immunity against shareholders' liability on watered stock.[105] It was also said that no-par value shares are less likely to mislead naive investors who may take the par value printed on the certificate as a representation of present value. We shall not rehearse either the merits or the dangers of no-par stock.[106] Today, it seems more important to call attention to the similarities between the two types of stock rather than to emphasize their differences.

99. For possible conflict between cumulative voting and classification of directors, see Bohannon v. Corporation Comm., 82 Ariz. 299, 313 P.2d 379 (1957); Wolfson v. Avery, 6 Ill.2d 78, 126 N.E.2d 701 (1955); Humphrys v. Winous Co., 165 Ohio St. 45, 133 N.E.2d 780 (1956); Janney v. Philadelphia Trans. Co., 387 Pa. St. 282, 128 A.2d 76 (1956); State v. McCune, 101 S.E.2d 834 (W. Va. 1958).

100. Since voting bonds or debentures are infrequent it would be more fruitful to seek forms for adaptation among voting preferred stocks where comparable provisions are much more readily to be found. See ENCYCLOPEDIA OF INCORPORATING FORMS, ch. 4, § 6 (Prentice-Hall 1948).

101. Tracy, *The Problem of Granting Voting Rights to Bondholders*, 2 U. CHI. L. REV. 208 (1935). For a discussion of "the legal rights, if any there be, of creditors who hold unmatured obligations to control the management of the debtor corporation while it continues a solvent, going concern," see Rohrlich, *supra*, note 82, at 169.

102. DEL. CODE ANN. tit. 8, § 221 (1953); LA. REV. STAT. § 12:32(H) (1950); MD. ANN. CODE art. 23, § 18(a)(8) (1951); OKLA. STAT. ANN. tit. 18 § 1.67 (1951); VA. CODE ANN. § 13.1-32 (1950).

103. Now N.Y. STOCK CORP. LAW § 12.

104. Nebraska is an exception. Its Constitution (Art. XII, § 6) requires that "all stock shall have a face par value; and all stock in the same corporation shall be of equal par value."

105. See ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 8.03 (3d ed., 1958).

106. See generally, ROBBINS, NO-PAR STOCK (1927); WICKERSHAM, STOCK WITHOUT PAR VALUE (1927); WILDMAN & POWELL, CAPITAL STOCK WITHOUT PAR VALUE (1928); Ballantine, *Nonpar Stock—Its Use and Abuse*, 57 AM. L.

With unimportant differences in phraseology, the statutes prohibit the original issue of shares "except for money, labor done or property actually received."[107] These requirements as to the *kind* of consideration apply to no-par stock as well as to par stock.[108]

Treasury stock, whether with or without par value, previously validly issued and fully paid, may be disposed of by the corporation in the same manner as any other property owned by it.[109]

A debt due from the corporation is valid "property,"[110] but not the promissory note of the subscriber.[111] A leasehold is "property,"[112] but an agreement to render services is not.[113] A going business and

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REV. 233 (1923); Berle, *Problems of Non-Par Stock*, 25 COLUM. L. REV. 43 (1925); Bonbright, *The Dangers of Shares Without Par Value*, 24 COLUM. L. REV. 449 (1924); Cook, *"Watered Stock"—Commissions—Blue Sky Laws—Stocks Without Par Value*, 19 MICH. L. REV. 583 (1921); Israels, *Problems of Par and No-Par Shares: A Reappraisal*, 47 COLUM. L. REV. 1279 (1947); Goodbar, *No-Par Stock—Its Nature and Use*, 3 MIAMI L.Q. 1 (1948); Masterson, *Consideration for Corporate Shares, With Special Reference to Shares Without Par Value*, 2 IDAHO L.J. 75 (1932); Masterson, *Consideration for Non-Par Shares and Liability of Subscribers and Stockholders*, 17 TEXAS L. REV. 247 (1939); Mitchell, *Capitalization of Corporations Issuing Shares Without Par Value*, 11 A.B.A.J. 377 (1925); Pierson, *Stock Having No Par Value*, 17 ILL. L. REV. 173 (1922).

107. N.Y. STOCK CORP. LAW § 69. MODEL BUS. CORP. ACT § 15 requires "cash, other property, tangible or intangible, or . . . necessary services actually rendered." "Even under the broadest powers in the directors as to the consideration for which they may issue stock, a court of equity will intervene when the consideration fixed is unfair to existing stockholders," Rohrlich, *supra* note 82, at 122. See also Note, *Judicial Control over the Fairness of the Issue Price of New Stock*, 71 HARV. L. REV. 1133 (1958).

Reasonable charges for underwriting, etc., may be allowed out of the consideration received in payment for shares without thereby rendering such shares not full paid and non-assessable. See N.Y. STOCK CORP. LAW § 69; Note, *Compensation for Services Rendered in Financing a Corporation: Payment by the Issue of Stock*, 55 HARV. L. REV. 1365 (1942).

We omit from our discussion the very limited principle which sustains the issuance by a going-concern of securities below par, *ex necessitate*. Handley v. Stutz, 139 U.S. 417 (1891). *Contra*, Kraft v. Giffon Co., 82 App. Div. 29, 81 N.Y.S. 438 (1903). Thoms & Brenneman v. Goodman, 254 Fed. 39 (6th Cir. 1918) lists cases following *Handley v. Stutz*.

108. Triplex Shoe Co. v. Rice & Hutchins, 17 Del. Ch. 356, 152 Atl. 342 (1930); Bodell v. General Gas & Elec. Co., 15 Del. Ch. 119, 132 Atl. 442, *aff'd*, 15 Del. Ch. 420, 140 Atl. 264 (1927); Stone v. Young, 210 App. Div. 303, 206 N.Y.S. 95 (1924). *Cf.* Steuerwald v. Warrior Cement Co., 17 Del. Ch. 44, 141 Atl. 54 (1928); Community Hotel Corp. v. Gilbert, 135 Misc. 676, 241 N.Y.S. 352 (1930). See also Shapiro, *Validity of Issuance of No-Par Stock for Property and Services*, 5 ST. JOHN'S L. REV. 95 (1930); Note cited in note 107 *supra*.

109. Clinton Mining & Mineral Co. v. Jamison, 256 Fed. 577 (3d Cir. 1919); Furlong v. Johnston, 209 App. Div. 198, 204 N.Y.S. 710, *aff'd*, 239 N.Y. 141, 145 N.E. 910 (1924); Crawford v. Erbsloh, 137 Misc. 790, 795, 244 N.Y.S. 502 (1930). For a criticism of this "fiction," see BALLANTINE, CORPORATIONS § 261 (rev. ed. 1956); Ballantine, *The Curious Fiction of Treasury Shares*, 34 CALIF. L. REV. 536 (1946).

110. Veeder v. Mudgett, 95 N.Y. 295 (1884).

111. TEX. BUS. CORP. ACT, art. 2.16(B) (1956); First Nat'l Bank v. Cornell, 8 App. Div. 427, 40 N.Y.S. 850 (1896).

112. Close v. Noye, 147 N.Y. 597, 41 N.E. 570 (1895).

113. Steuerwald v. Warrior Cement Co., *supra* note 108; Brown v. Watson, 285 App. Div. 587, 139 N.Y.S.2d 628 (1955); Morgan v. Bon Bon Co., 222 N.Y.

its good-will are "property,"[114] but restraint must be exercised in evaluating, for stock purposes, the prospective earnings of a new business, especially when it constitutes a write-up over the actual cost to the promoters.[115]

The "work done" requirement has been construed to mean work actually done for the corporation. This excludes, therefore, promoters' services which are rendered prior to its incorporation.[116] And "services to be rendered cannot be a valid consideration for the issuance of full-paid, non-assessable shares of stock, for these can be issued only for 'labor done,' *i.e.*, after it has been done."[117]

No-par stock has not abolished the dollar sign. The minimum consideration for which no-par stock may be issued must be stated in the certificate of incorporation or fixed by directors or stockholders.[118] Where the statute requires a minimum amount of capital as a condition to doing business, this requirement must still be met even if the entire capitalization consists of no-par stock.[119] And, apart from statutory requirements, it is a practical necessity that dollar values be attributed to the assets and shares for balance sheet purposes.

> Unless it proves feasible to adopt a non-par balance sheet, as well as a non-par stock certificate, that is, unless a form of financial statement can be devised which does away with pecuniary valuations of the fixed assets by interested parties, we are still faced with the same problem [of deception], though in a somewhat different form, that presents itself in the case of an overissue of par-value shares.[120]

22, 118 N.E. 205 (1917); B & C Elec. Const. Co. v. Owen, 176 App. Div. 399, 163 N.Y.S. 31, *aff'd* 227 N.Y. 569, 126 N.E. 927 (1919); Stevens v. Episcopal Church History Co., 140 App. Div. 570, 125 N.Y.S. 573 (1910).

114. Thomas v. Sutherland, 52 F.2d 592 (3d Cir. 1931), 30 MICH. L. REV. 971 (1932); Washburn v. National Wall-Paper Co., 81 Fed. 17 (2d Cir. 1897); Brown v. Weeks, 195 Mich. 27, 161 N.W. 945 (1917); Randall v. Bailey, 23 N.Y.S.2d 173, *aff'd*, 262 App. Div. 844, 29 N.Y.S.2d 512, *aff'd*, 288 N.Y. 280, 43 N.E.2d 43 (1942); White Corbin & Co. v. Jones, 79 App. Div. 373, 79 N.Y.S. 583 (1903); Bryan v. Northwest Beverages, 69 N.D. 274, 285 N.W. 689 (1939). See also Annot., 24 A.L.R. 1273 (1923); Annot., 37 A.L.R.2d 913 (1954).

115. See v. Heppenheimer, 69 N.J. Eq. 36, 61 Atl. 843 (1905). The sweeping dicta in the opinion to the effect that prospective earnings are not "property" need not be accepted at face value. See the exhaustive discussion of the cited case in DODD, STOCK WATERING: THE JUDICIAL VALUATION OF PROPERTY FOR STOCK ISSUE PURPOSES chs. 6, 7 (1930). It must be recognized however that courts are properly skeptical of high values attributed by interested directors to unproven, and especially inchoate, intangibles. Consider in this connection the judicial rule (*e.g.*, in Texas) that in order to constitute "property" for stock use purposes it must be readily capable of being applied to the payment of the debts of the corporation; see Woodson v. McAllister, 119 F.2d 924, *rehearing denied*, 121 F.2d 126 (5th Cir. 1941).

116. Cooney Co. v. Arlington Hotel Co., 11 Del. Ch. 286, 101 Atl. 879 (1917); Herbert v. Duryea, 34 App. Div. 478, 54 N.Y.S. 311, *aff'd*, 164 N.Y. 596, 58 N.E. 1088 (1900).

117. Scully v. Automobile Finance Co., 12 Del. Ch. 174, 109 Atl. 49 (1920); see also TEX. BUS. CORP. ACT, art. 2.16(B) (1956).

118. See MODEL BUS. CORP. ACT §§ 17, 19.

119. See *supra* note 108.

120. DODD, *op. cit. supra*, note 115, at 304.

When the required consideration is stated either in terms of par value or as "stated value" for no-par shares, the stipulated amount must be received by the corporation if the shares are to be treated as full-paid and non-assessable. "A subscription to original stock at a definite par value and a subscription to an issue of no-par value stock at a fixed and definite price seem to depend upon the same principles."[121] And this is true whether the required amount, in the case of no-par stock, is fixed by statute, the certificate of incorporation, or by the directors. A case which illustrates this principle as well as the care which must be exercised in the preparation of corporation minutes[122] is *G. Loewus & Co. v. Highland Queen Packing Co.*[123] In that case, the corporation was organized under the New Jersey statute which authorized the issuance of no-par shares "for such consideration as may be prescribed in the certificate of incorporation, or, if so provided in the certificate of incorporation, as . . . may be fixed by the board of directors . . . ."[124] The certificate of incorporation did authorize the board to fix the price at which the shares might be issued. The board accepted an offer to acquire a going business in consideration of the assumption by the corporation of certain liabilities and the issuance of 300 of its no-par value shares. The property received was worth less than $6,000. Because the minutes of the directors' meeting included the statement "that the said shares shall be issued at the price of $20 per share," it was contended that the stock was not full-paid and the stockholders assessable despite the fact that the corporation had received everything it bargained for. The court recognized the rule to be that "when stock without par value is issued for less than the prescribed consideration, it is outside the plan of the statute, and the holder thereof, with notice, is liable for the balance of the consideration, or so much thereof as may satisfy creditors." However, after struggling with the "not clear" language of the minutes which we have quoted, the court finally held the stock not assessable because the corporation had in fact received all the property which the directors had intended that it should receive. Prudence dictates the avoidance of such litigation inevitably provoked by ambiguities.

On the subject of the valuation of the property received,[125] it is

121. Smith v. General Motors Corp., 289 Fed. 205, 207 (6th Cir. 1923).

122. "It is a truism that words are the tools with which a lawyer works, and that if these are inaccurate then his work will be inaccurate also," Goodhart, *English Contributions to the Philosophy of Law*, 48 COLUM. L. REV. 685 (1948). See also Mr. Justice Frankfurter, *Some Reflections on the Reading of Statutes*, 47 COLUM. L. REV. 527 at 528 (1947).

123. 125 N.J. Eq. 534, 6 A.2d 545 (1939).

124. N.J. STAT. ANN. § 14:8-6 (1937).

125. See generally, BONBRIGHT, VALUATION OF PROPERTY ch. xxiii (1937); Berle, *Valuation of Property, Labor or Services Taken in Payment for*

necessary, in view of accumulated learning on the subject, to note the existence of divergent judicial attitudes, although the writer is disposed to agree that "the distinctions are largely verbal."[126] The courts of certain states follow what is described as the "true value" rule.[127] Under this rule "payment for capital stock with property is no payment except to the extent of the true value of the property."[128] The other broad and currently prevailing principle is the "good-faith" rule under which "there must be actual fraud in the transaction to enable creditors of the corporation to call the stockholders to account."[129] Some states have changed over, either judicially or as the result of legislation.[130] Some decisions do not fit entirely into either niche but seem to take an intermediate position.[131] Here, "a deliberate and advised overvaluation of property . . . is a fraud."[132]

In view of these substantial similarities between par and no-par stock and because it has become feasible to achieve the intended objectives without the use of no-par stock,[133] it should not be surprising that comparatively minor influences have served to bring about a lessening use of no-par stock.

One hundred dollar par is no longer traditional and shares with a very low or even nominal par value are not only legal but respectable.[134] These low par value shares effectively serve the same purposes as no-par shares and, in addition, under some tax statutes result in savings. These statutes not infrequently attribute to no-par shares, for purposes of computing organization, original issue, and transfer taxes, an arbitrary value and without regard to the fact

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Stock, 3 MARQ. L. REV. 195 (1919); PRIME, INVESTMENT ANALYSIS 417-18, 373 (2d ed. 1952).

126. DODD, *op. cit. supra*, note 115, at 92.

127. *E.g.*, State Trust Co. v. Turner, 111 Iowa 664, 82 N.W. 1029, 53 L.R.A. 136 (1900). See also Holcombe v. Trenton White City Co., 80 N.J. Eq. 122, 82 Atl. 618 (1912).

128. Ballantine, *Stockholders' Liability in Minnesota*, 7 MINN. L. REV. 79, 93 (1923).

129. Coit v. Gold Amalgamating Co., 119 U.S. 343 (1886). See also Bonbright *Shareholders' Defenses against Liability to Creditors on Watered Stock*, 25 COLUM. L. REV. 408 (1925); Wickersham, *The Capital of a Corporation*, 22 HARV. L. REV. 319 (1909).

130. See Strickland v. Washington Bldg. Corp., 287 Ill. App. 340, 4 N.E.2d 973 (1936); Note, *The Establishment of Liability on Watered Stock in Missouri*, 1952 WASH. U.L.Q. 559; *Compare* Hastings v. Scott, 248 S.W. 973 (Mo. 1923) *with* MO. ANN. STAT. § 351.185(3) (1949).

131. National Tube-Works v. Gilfillan, 124 N.Y. 302, 26 N.E. 538 (1891); Gamble v. Queens County Water Co., 123 N.Y. 91, 25 N.E. 201 (1890); Douglas v. Ireland, 73 N.Y. 100 (1878). *Cf.* H. B. Humphrey Co. v. Pollack Roller Runner Sled Co., 278 Mass. 350, 180 N.E. 164 (1932).

132. Douglas v. Ireland, *supra* note 131, at 104. *Cf.* N.Y. STOCK CORP. LAW § 69.

133. See ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 8.03 (3d ed. 1949).

134. BERLE & WARREN, CASES ON THE LAW OF BUSINESS ORGANIZATIONS—CORPORATIONS 313 (1958).

that some of the consideration may represent paid-in surplus and not capital.[135] The impact of these taxes can generally be substantially reduced by the use of a lower "valued" par stock.

Some of the federal legislation which we have already mentioned as designed to bring about "ideal" corporate structures, restrict, within their purview, the use of no-par shares.[136] The Securities and Exchange Commission has said that "as a general rule common stock should be of par value,"[137] but it has from time to time exercised its discretion to permit the use of no-par shares.[138]

Preferred Stocks[139]

We have already suggested that preferred stock is viewed with a certain amount of skepticism,[140] but there are entirely valid and persuasive reasons for using this type of security as part of the capitalization of a corporation under certain circumstances.[141] From the point of view of the corporation, it enables it to raise money from a wider circle—such as institutions and trustees who are not permitted to purchase common stock but who may buy preferred stock, and investors generally too conservative to buy common stocks but who desire a higher yield than is ordinarily afforded by bonds. More important, however, is the fact that the use of preferred stock, rather than debt, obviates the risks of insolvency inherent in fixed maturity obligations. It also makes for a stronger balance sheet and leaves greater leeway for future borrowing. In order to strengthen the investment position of preferred stock, many attempts have been made at suggesting "safe" ratios for its use.[142] The measure of advantage or disadvantage to the preferred stockholders depends upon the terms

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135. *E.g.*, CAL. GOV'T CODE ANN. § 12201 (Deering 1951); R.I. GEN. LAWS ANN. § 7-1-9 (1957); Vt. Stat. Ann. tit. 32 § 8004 (1959).

136. *E.g.*, Public Utility Company Act § 7(c), 49 Stat. 815 (1935), 15 U.S.C. § 79g(c) (1952).

137 In the Matter of Northern States Power Company, 18 S.E.C. 814, 849 (1945).

138. In the Matter of Northern States Power Co., *supra* note 137; Meck & Cary, *supra* note 86, at 221-24.

139. See generally, PRIME, INVESTMENT ANALYSIS 34-41 (2d ed. 1952); Buxbaum, *Preferred Stock—Law and Draftsmanship*, 42 CALIF. L. REV. 243 (1954); Grossman, *Corporate Securities—Especially Common and Preferred Stocks*, 17 A.B.A.J. 123 (1931); Note, *Cumulative and Non-Cumulative Preferred Shares*, 22 MINN. L. REV. 676 (1938).

140. See notes 78, 79 *supra*. See also Sullivan, *Preferred Stock as an Investment Security*, 28 GEO. L.J. 232 (1939).

141. For an indication of the extent to which it is actually used by the larger corporations, see GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 213-15, 242, 271 (3d ed. 1955).

142. GUTHMANN & DOUGALL, *op. cit. supra* note 141, at 227-28, suggests as "maximum limits"—(a) asset coverage, not in excess of the value of tangible assets less all debt; (b) earning coverage, preferred dividend and interest requirements should be earned at least twice over in a representative number of years.

of the stock. Several protective devices have been suggested for the benefit of the preferred stockholder, among the more significant available to corporate action being: "(i) devices to insure payments of dividends; (ii) devices to secure redemption, and the closely allied device to assure priority in the distributions of assets upon dissolution; (iii) devices for protection against future incumbrances; (iv) devices to assure a share in the management of the corporation."[143]

The extent to which any particular provision should be adopted involves, of course, a balancing of the relative advantages and disadvantages as between the corporation and the shareholder. For example, callable preferred stock is eminently desirable from the corporate standpoint,[144] but the one-sided option is obviously disadvantageous to the holder of a high-yield preferred stock, unless the premium customarily paid on redemption is sufficient to compensate for any resulting loss in current yield.

With very few limitations, the state statutes permit the use of preferred stock,[145] but note should be taken of the general tendency mentioned earlier in the direction of a simplified capital structure of one class of voting stock fostered by certain federal statutes of limited mandatory application. Even when permissible at its discretion, the Securities and Exchange Commission will not permit the use of preferred stock by companies within its jurisdiction without certain protective provisions.[146]

Once the decision to issue preferred stock is made, the lawyer should be alert to the fact that the term "preferred stock" is, by itself, quite meaningless; it raises more questions than it answers.

> The question as to the relative rights of these two classes of stock cannot be answered by regarding only the characterization of one of them as "preferred," because of the fact that this term, standing alone, means only a stock that differs from other stock in having a preference of some sort attached to it, without expressing the special nature of the preference . . . . [T]o determine in each case the special properties and qualities it possesses, resort must be had to the statute or contract under which it was issued. "Preferred stock takes a multiplicity of forms

143. Note, *Protective Devices Available to the Preferred Shockholder*, 27 COLUM. L. REV. 587 (1927). As for statutory protection see Note, *Statutory Protection of Preferred Stockholders*, 43 YALE L.J. 1196 (1934). But see Conard, *Manipulation of Share Priorities*, 8 VAND. L. REV. 55 (1954).

144. See Matter of the United Light and Railways Co., SEC Holding Company Act Release No. 7951 (1947).

145. A late statutory revision is that of WIS. STAT. ANN. § 180.12 (1957).

146. Nor merely to satisfy the desire of the common stock for "leverage." In the Matter of Commonwealth & Southern Corp., 11 SEC 369, *aff'd*, 134 F.2d 747 (3d Cir. 1943). See authorities *supra* note 90.

> according to the desire and ingenuity of the stockholders and necessities of the corporation itself." It is a matter of contract . . . or depends upon statute.[147]

The shadowy line which divides certain debt obligations from preferred stock has already been suggested by our discussion of the deductibility of "interest" for tax purposes.[148] At the other extreme, nothing but the name distinguishes "preferred" stock from so-called "Class A" common stock.[149]

> After 1917 there came into prominence a form of preference stock usually known as Class A common stock to distinguish it from the ordinary residual common stock, known as Class B common stock. . . . Three main reasons account for the sudden coming into prominence of the classified common stock. During the period of the First World War, investor-speculators became prevalent who demanded a share of the bounteous profits then being reaped by those engaged in industry, but who also wanted some appearance of security greater than that offered by the common shares. . . . A second reason was the desire of the management to sell, when the selling was easy, a common stock that had no special lien on property or earnings, yet allowed the management to retain full administrative control. . . . A third reason . . . was the desire of bankers and investors alike to have something new.[150]

We shall therefore discuss the various points which must be clarified before a "preferred" stock takes on body and content. "Preferred stock issued by a corporation may grant to the stockholders a variety of rights."[151]

Is the preferred dividend to be cumulative or noncumulative?[152] By the general weight of authority, in the absence of any contrary indication, a preferred dividend will be construed, by implication, to be cumulative.[153] The fundamental characteristic of cumulative

147. Scott v. Baltimore & Ohio R.R., 93 Md. 475, 479, 49 Atl. 327 (1901). "The term 'preferred stock' is not a term of art," *In re* Louisville Gas & Electric Co., 77 F. Supp. 176 (Del. 1948), 47 MICH. L. REV. 121.

148. See also Aikman, *A Comparative Analysis of Income Bonds and Preferred Stock,* 1 TEXAS LAW & LEG. 175 (1947); Gilliom, *Unorthodox Preferred Stock Provisions in Priority Litigation,* 36 MICH. L. REV. 96 (1937).

149. "Very often an examination of Class A and Class B shares will show them to be merely the old-time preferred and common stocks with new names." GUTHMANN & DOUGALL, CORPORATE FINANCIAL POLICY 91 (3d ed. 1955).

150. DEWING, FINANCIAL POLICY OF CORPORATIONS 165-66 (4th ed. 1941).

151. Strout v. Cross, Austin & Ireland Lumber Co., 283 N.Y. 406, 28 N.E.2d 890 (1940).

152. See Annot., 6 A.L.R. 802 (1920); 67 A.L.R. 765 (1930); 98 A.L.R. 1526 (1935).

153. Hazel Atlas Glass Co. v. Van Dyk & Reeves, Inc., 8 F.2d 716 (2d Cir. 1925), *cert. denied,* 269 U.S. 570 (1925); Garrett v. Edge Moor Iron Co., 22 Del. Ch. 142, 194 Atl. 15, *aff'd,* 23 Del. Ch. 193, 199 Atl. 671 (1938); Powers Foundry Co. v. Miller, 166 Md. 590, 171 Atl. 842 (1934); Lockwood v. General Abrasive Co., 210 App. Div. 141, 205 N.Y.S. 511, *aff'd,* 240 N.Y. 592, 148 N.E. 719 (1925); Fidelity Trust Co. v. Lehigh Valley R. Co., 215 Pa. 610, 64 Atl. 829 (1906); Shults, *Corporations: Preferred Stock: Cumulative Dividends,* 11 CORNELL L.Q. 230 (1926).

stock is that if the preferred dividend is not paid in full in any year, whether or not earned, the deficiency must be made up before any dividend can be paid on the common stock.[154] In the case of non-cumulative stock, if in any year there is no net income applicable to the payment of the dividend or if whatever profits there may be are applied by the directors to other purposes, or possibly (depending upon the language of the provision) merely withheld and not declared, "the claim for that year is gone and cannot be asserted at a later date."[155]

Subject to very few statutory requirements, the rights of security holders are matters of private contract and it lies therefore with the skilled draftsman, using "the utmost precision available to legal language"[156] to invoke or abrogate any of the preferred stock theories to which we call attention.[157]

Is the preferred stock to participate, with the common stock, in any dividend distribution in excess of the preferred rate? On this point, the courts, in the absence of a controlling provision, are in sharp disagreement. Some take the view that "in the absence of such limitation the general rule is that [the preferred] stockholders are entitled to share with the holders of the common stock all profits distributed after the latter have received in any year an amount equal to the dividend on the preferred stock."[158] Others take the view "that in receiving the greater security of his preferential rights, the preferred stockholder impliedly agrees to accept such rights in lieu of equal participation."[159] In some states, the question is an open

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154. Bank of America Nat'l Trust & Sav. Ass'n v. West End Chemical Co., 37 Cal. App. 2d 685, 100 P.2d 318 (1940); Penington v. Commonwealth Hotel Const. Corp., 17 Del. Ch. 394, 155 Atl. 514 (1931), 75 A.L.R. 1136 (1931); Spear v. Rockland-Rockport Lime Co., 133 Me. 285, 93 Atl. 754 (1915), 6 A.L.R. 793 (1920).

155. Wabash Ry. Co. v. Barclay, 280 U.S. 197 (1930), 67 A.L.R. 762 (1930). See Annot., 21 A.L.R.2d 1073 (1953).

We omit from this article discussion of the "dividend credit theory." On this point, see ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES 352-55 (3d ed. 1958).

156. DEWING, FINANCIAL POLICY OF CORPORATIONS 151 (4th ed. 1941).

157. Berle expresses the caution that "while an unreasonable contract is a legal possibility, courts will normally struggle against construction leading to such a result." Berle, *Non-Cumulative Preferred Stock*, 23 COLUM. L. REV. 358, 359 (1923).

158. Englander v. Osborne, 261 Pa. 366, 368-69, 194 Atl. 614 (1918), 6 A.L.R. 800 (1920).

159. St. Louis Southwestern Ry. Co. v. Loeb, 318 S.W.2d 246 (Mo. 1958); Mohawk Carpet Mills v. Delaware Rayon Co., 110 A.2d 305 (Del. 1954), 53 MICH. L. REV. 887 (1955); Stone v. United States Envelope Co., 119 Me. 394, 111 Atl. 536 (1920), 13 A.L.R. 422 (1921). See Youngman, *Corporations: Right of Preferred Shareholders to Participate in Distribution of a Cash Surplus After Receipt of Their Stipulated Dividend*, 11 CORNELL L.Q. 234 (1926).

one.[160] It is probably incorrect to attempt to deal with the matter on the basis of any general rule or principle.

> I do not think that either rule can be gathered from the decisions of the courts as a maxim of the law applicable to all cases. It may be that in some cases the failure to make any provision as to participating in excess dividends would naturally be construed as granting such participation, while in other cases the failure to make such provisions would be held as a denial of participation. That question must be decided in the light of all the language of the contract, giving effect to every provision in it, and construing it in the light of the circumstances in which the parties stood.[161]

One thing only is clear; if the preferred stock is intended to participate, the right should be expressly granted; if it is not to have such participation, its dividend should be expressly limited to the stipulated rate "and no more."

Similarly, the matter of pre-emptive rights should be expressly covered.[162]

The question of the extent to which preferred stock must or should be accorded voting rights has already been discussed. It should here however be noted that, apart from its right to vote for directors or on other corporate questions, the matter of putting other securities ahead of it requires special consideration.[163]

One of the marked differences between preferred stock and debt is the absence of a fixed maturity date in the former. It is however customary to provide for the redemption of preferred stock and occasionally for sinking funds to effectuate redemption.[164]

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160. See Niles v. Ludlow Valve Mfg. Co., 202 Fed. 141 (2d Cir. 1913), *cert. denied*, 231 U.S. 748 (1913); Lockwood v. General Abrasive Co., 210 App. Div. 141, 205 N.Y.S. 511, *aff'd*, 240 N.Y. 592, 148 N.E. 719 (1925). See Levine, *Rights of Holders of Preferred Stock to Dividends in Conjunction with Distribution of Surplus to Common Stockholders*, 12 ST. JOHN'S L. REV. 108, 114-15 (1937).

161. Lyman v. Southern Ry. Co., 149 Va. 274, 141 S.E. 240 (1928). For further discussions, see Rowell, *Rights of Preferred Shareholders in Excess of Preference*, 19 MINN. L. REV. 406 (1935). For annotated cases, see Annot., 6 A.L.R. 802 (1920).

162. As to pre-emptive rights of preferred stock, see Yoakum v. Providence Biltmore Hotel, 34 F.2d 533 (D.C.R.I. 1929); Tennant v. Epstein, 356 Ill. 26, 189 N.E. 864 (1934); Thomas Branch & Co. v. Riverside & Dan River Cotton Mills, 139 Va. 291, 123 S.E. 542 (1924); General Inv. Co. v. Bethlehem Steel Corp., 88 N.J. Ch. 237, 102 Atl. 252 (1917); Russell v. American Gas & Elec. Co., 152 App. Div. 136, 136 N.Y.S. 602 (1912); Hills, *Pre-emptive Right of Preferred Stockholders to Subscribe to New Stock*, 5 N.Y.L. REV. 207 (1927); Barrett, *Corporations: Right of Preferred Stock to Share in Stock Dividends*, 16 B.U.L. REV. 189 (1936).

163. *E.g.*, Hamlin v. Toledo, St. L. & K. C. R.R., 78 Fed. 664 (6th Cir. 1897).

164. See generally, Dodd, *Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law*, 89 U. PA. L. REV. 697 (1941); Note, *Redemption of Preferred Shares*, 83 U. PA. L. REV. 888 (1935). As to the dangers inherent in INT. REV. CODE, § 302 (1954), see Comment, *Tax Warning: Beware of Preferred Stock in Closed Corporations*, 2 MIAMI L.Q. 228 (1948).

Usually the redemption provisions merely accord to the corporation the option to call in the stock, either in whole or in part. When an attempt is made to make the redemption mandatory, either at the election of the shareholder, by action of the directors exercising the right to redeem, or by an obligatory sinking fund, several principles of law must not be forgotten. A provision compelling the corporation to redeem either at a fixed date or upon certain conditions such as the demand of the holder is virtually an agreement on the part of the corporation to purchase its own stock and therefore subject to the legal limitations thereon.[165] The most general limitation is that which permits such purchases out of surplus only and not out of capital.[166] Several states have adopted statutes providing a procedure for the redemption and retirement of preferred stock out of capital.[167]

The line of demarcation to be observed in the purchase, or agreement to purchase, of preferred stock has been stated as follows:

> [A]n arrangement between the corporation and its preferred stockholders, by which a preference is given to the preferred stockholder over the other stockholders, either as regards the surplus or the capital of the corporation, where such agreement is not prohibited by the law nor the articles of incorporation, the contract is valid and enforceable, as between the stockholders and the corporation and between themselves.[168]

and,

> [A] corporation cannot give holders of preferred stock any preference, either in respect of payment of principal or dividends which will be superior to the rights of creditors .... such provisions are void as against public policy if construed as giving to the holder of preferred stock right of recovery in preference to creditors; but the provisions are

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165. See generally, Blackstock, *A Corporation's Power to Purchase Its Own Stock and Some Related Problems*, 13 TEXAS L. REV. 442 (1935); Nussbaum, *Acquisition by a Corporation of Its Own Stock*, 35 COLUM. L. REV. 971 (1935); Pollis, *The Purchase by a Corporation of Its Own Stock—A Suggested Legislative Approach*, 4 U. NEWARK L. REV. 418 (1939); Wormser, *The Power of a Corporation to Acquire Its Own Stock*, 24 YALE L.J. 177 (1915); Note, *Reacquisition of Shares Under the New York Stock Corp. Law*, 28 ST. JOHN'S L. REV. 323 (1954). Also Rankin, *Income Tax Aspects of a Corporation's Dealings in Its Own Shares*, 89 U. PA. L. REV. 934 (1941).

166. See Norwalk v. Marcus, 235 App. Div. 211, 256 N.Y.S. 697, *aff'd* 261 N.Y. 513, 185 N.E. 761 (1933); Cross v. Beguelin, 252 N.Y. 262, 169 N.E. 378 (1929); Topken, Loring & Schwartz, Inc., v. Schwartz, 249 N.Y. 206, 163 N.E. 735 (1928), 66 A.L.R. 1179 (1930); Note, *Illusory Aspect of Corporate Contract to Repurchase Stock*, 12 ST. JOHN'S L. REV. 115 (1937); Note, *Corporation Stock Repurchase Agreements; Mutuality of Obligation and Illusory Promises*, 15 ST. JOHN'S L. REV. 253 (1941).

167. *E.g.*, DEL. CODE ANN. tit. 8, § 243 (1953); ILL. ANN. STAT. c. 32, § 157.58 (Smith-Hurd 1954); N.Y. STOCK CORP. LAW § 28; PA. STAT. ANN. tit. 15, § 2852-705 (1958). *Cf.* Scovill, *Treasury Stock in its Relation to Earned Surplus*, 21 CHI.-KENT L. REV. 328 (1943).

168. Westerfield-Bonte Co. v. Burnett, 176 Ky. 188, 194, 195 S.W. 477, 480 (1917).

> generally construed as subject to the implied reservation that redemption may be made only in case the rights of creditors are not thereby prejudiced . . . .[169]

Speculative appeal can sometimes be added to preferred stock by making the issue convertible into common stock at the option of the holder; these matters are discussed later in this article.

As the precise limits and extent of the preferred's participation in earnings should be stipulated, so should its rights in the assets upon liquidation.[170]

> [T]he general common-law rule [is] that stockholders common and preferred share alike in the assets of a liquidating corporation, if the preference is only as to dividends. . . . The cases in which a different conclusion has been reached are where the contract or law determining the rights of the preferred stockholders has an express or implied restriction as to the share which they may take in the assets on liquidation.[171]

The provision may not only limit the preferred stock but may fix its preference in the assets at an amount in excess of its par or stated value by the inclusion of arrears of cumulative dividends or a premium. General language such as entitling the preferred stock to "payment in full" is not sufficiently meaningful.[172]

Provisions for a premium on liquidation are by weight of authority considered valid as against the common stock, even in the absence of an available surplus at the time of dissolution.[173]

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169. Koeppler v. Crocker Chair Co., 200 Wis. 476, 481, 228 N.W. 130, 132 (1929).

170. "Liquidation" should be carefully defined—does it include "merger or consolidation"? See Windhurst v. Central Leather Co., 105 N.J. Eq. 621, 149 Atl. 36, *aff'd*, 107 N.J. Eq. 528, 153 Atl. 402 (1931), 30 MICH. L. REV. 1074, 1078 (1932); Petry v. Harwood Elec. Co., 280 Pa. 142, 124 Atl. 302 (1924), 33 A.L.R. 1249 (1924); Simms, *An Application of the Doctrine that Consolidation Effects Dissolution*, 15 VA. L. REV. 757 (1929).

As to applicability of charter preferences on liquidation in a simplification under Public Utility Holding Company Act of 1935, 49 Stat. 838, 15 U.S.C. § 79 (1952), see SEC v. Central-Illinois Securities Corp., 338 U.S. 96 (1949); Schwabacher v. United States, 334 U.S. 182 (1948); Otis & Co. v. Securities & Exchange Comm., 323 U.S. 624 (1945).

171. Continental Ins. Co. v. United States, 259 U.S. 156, 181 (1922); Lloyd v. Pennsylvania Elec. Vehicle Co., 75 N.J. Eq. 263, 72 Atl. 16 (1909). For a review of the English cases, see *Preference Shares with Preferential Rights as to Capital*, 93 SOL. J. 571, 582 (1949).

172. Powell v. Craddock-Terry Co., 175 Va. 146, 7 S.E.2d 143 (1940).

173. Fawkes v. Farm Lands Inv. Co., 112 Cal. App. 374, 297 Pac. 47 (1931); Penington v. Commonwealth Hotel Const. Corp., *supra* note 154; Johnson v. Johnson & Briggs, 138 Va. 487, 122 S.E. 100 (1924). *Cf.* Michael v. Cayey-Caguas Tobacco Co., 190 App. Div. 618, 180 N.Y.S. 532 (1920). Note, *Dissolution: Dividends in Arrears May Be Paid from Capital*, 19 CALIF. L. REV. 450 (1931); Note, *Rights of Preferred Cumulative Shareholders on Dissolution*, 31 COLUM. L. REV. 163 (1931); Note, *Rights of Holders of Preferred Stock*, 34 HARV. L. REV. 303 (1921); Comment, *Dissolution: Distribution of Assets Between Preferred and Common Stockholders*, 30 MICH. L. REV. 281 (1931); Note, *Do Shares Preferred as to Assets and Unpaid Dividends on*

In preparing the certificate of incorporation, consideration should be given as to whether the board of directors should be given power, broadly or within stated limitations, to issue preferred stock in series, if this is permissible under the statute.

Power to issue preferred shares in series is frequently desirable because it enables the directors from time to time to fix dividend rates and other terms in the light of current conditions, without the necessity of calling a shareholders' meeting. But, this power in blank vested in the directors has been characterized as "perhaps [the] high-water mark in giving to managements unrestricted power over the position of the stockholders."[174] The authority to do this is expressly granted by the statutes of several states.[175] When exercised, meticulous care must be taken to define with precision not only the respective rights of the preferred and common stock but also as between the several series of preferred stock, having in mind any statutory requirements.[176]

Bonds and Debentures

Bonds and debentures are commonly referred to as "funded debt," especially if they have a maturity of more than one year.[177]

Incidental to the corporate power to borrow is the power to evidence and secure the debt.[178] Corporate obligations may take a large variety of forms,[179] but they commonly fall into two major categories: the independent promissory note, complete in itself, which is ordinarily used for short-term loans, and, sometimes for long-term loans made by banks or insurance companies and intended to be held to

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Dissolution Have a Right on Dissolution to Dividends for Years in Which There Were No Profits, 22 MINN. L. REV. 689 (1938); Note, *Right of Preferred Shareholders to Dividends on Dissolution,* 40 YALE L.J. 828 (1931); Annot., 133 A.L.R. 653, 666 (1941); Annot., 33 A.L.R. 1257 (1924).

174. BERLE & WARREN, CASES ON BUSINESS ORGANIZATION: CORPORATIONS 636 (1948).

175. *E.g.,* CAL. CORP. CODE ANN. § 1100 (Deering 1953); DEL. CODE ANN. tit. 8, § 151 (1953); ILL. ANN. STAT. c. 32, § 157.15 (Smith-Hurd 1954); IND. ANN. STAT. § 25-205 (Supp. 1959); MD. ANN. CODE art. 23, § 18 (1957); MICH. STAT. ANN. § 21.17 (Supp. 1957); N.J. STAT. ANN. § 14:8-2 (1939); N.Y. STOCK CORP. LAW § 11; OHIO REV. CODE ANN. § 1701.06 (1958); PA. STAT. ANN. tit. 15, § 2852-602 (1958).

176. For possible difficulties, see Vanden Bosch v. Michigan Trust Co., 35 F.2d 643 (6th Cir. 1929); Miller v. M.E. Smith Bldg. Co., 118 Neb. 5, 223 N.W. 277 (1929).

Some statutes limit the permissible differences between series and endeavor to obviate conflicts. See statutes cited note 175 *supra.*

177. MCLAREN, ANNUAL REPORTS TO STOCKHOLDERS 355 (1947).

178. Statutory debt restrictions are rare.

179. The reader interested in "hybrids" may refer to Hansen, *Hybrid Securities: A Study of Securities Which Combine Characteristics of Both Stocks and Bonds,* 13 N.Y.U.L.Q. 407 (1936); Uhlman, *Law of Hybrid Securities,* 23 WASH. U.L.Q. 182 (1938); Comment, *Status of Holders of Hybrid Securities: Stockholders or Creditors?* 45 YALE L.J. 907 (1936). See, in addition, the authorities cited in note 148 *supra.*

maturity by the original payee; and the bond or debenture.[180] The latter are customarily issued as a series under a single instrument known as a "trust indenture," which basically is the standard mortgage or pledge agreement[181] except that it runs to a trustee (or trustees) for the benefit of the bondholders rather than directly to the creditor.[182] If the bonds or debentures are to be offered for sale to the public, it may be necessary to qualify the indenture under the Trust Indenture Act of 1939.[183]

In the event of the insolvency of the debtor corporation, it is today much more likely that the rights of the creditors, including the security-holders, will be worked out in reorganization rather than in strict foreclosure and therefore the provisions of the Federal Bankruptcy Act must be kept in mind in drafting the corporate obligation.[184]

Convertible Securities

Since both bonds and preferred shares have, characteristically, only limited participation in the profits of the enterprise, speculative attraction is frequently added to such securities by the grant of conversion rights. To accomplish this purpose, the conversion privilege must be accorded to the security holder, but it is also possible for the issuing corporation to reserve a "conversion" privilege (in reality, the right to purchase or redeem with the price payable in another security rather than in cash).[185] There is ample statutory and judicial

180. "Debentures" are unsecured: Mercantile Properties, Inc. v. State Tax Comm'n, 278 N.Y. 325, 16 N.E.2d 352 (1938). "Bonds" are secured—either by tangible real and personal property ("mortgage bonds") or by the pledge of securities ("collateral trust bonds"). See Note, 27 COLUM. L. REV. 443, 579 (1927).

181. Southern Pac. R. v. Doyle, 11 Fed. 253 (D.C. Cal. 1882); Shuey v. Mulcrevy, 34 Cal. App. 218, 166 Pac. 1019 (1917); Coe v. Johnson, 18 Ind. 218 (1862); Wisconsin Cent. R.R. v. Wisconsin River Land Co., 71 Wis. 94, 36 N.W. 837 (1888).

For distinction between mortgage and deed of trust, see *In re* Bondholders of York & C. R.R., 50 Me. 552 (1861); First Fed. Trust Co. v. Sanders, 192 Cal. 194, 219 Pac. 440 (1923), noted 12 CALIF. L. REV. 307 (1924).

182. See Welch v. Northern Bank & Trust Co., 100 Wash. 349, 170 Pac. 1029 (1918); Smith, *A Forgotten Chapter in the Early History of the Corporate Trust Deed*, 61 AM. L. REV. 900 (1927). For more extended treatment of "Bonds and Debentures," see ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES § 10.07 (3d ed. 1958).

183. See, Sullivan, *Trust Indenture Act of 1939*, 28 GEO. L.J. 1084 (1940).

184. For the law and practice under Chap. X, see MOORE & OGLEBAY, CORPORATE REORGANIZATION (1948); NADLER, THE LAW OF DEBTOR RELIEF, Chaps. XXVI-XXX (1954). More generally, but antedating Chapter X, see QUINDRY, BONDS AND BONDHOLDERS: RIGHTS AND REMEDIES (1934). See also ROHRLICH, LAW AND PRACTICE IN CORPORATE CONTROL, Chaps. V, VII (1933).

185. Thus, the Associated Gas and Electric Company 6% Convertible Obligation, Series A, issued March 1, 1932, was convertible into preferred stock (a) at the option of the holder before a specified date, or (b) at the option of the Corporation at any time, the mailing of notice by the Corporation to the registered holder of the Obligation "ipso facto" operating as the conversion. See also Elias v. Clarke, 143 F.2d 640 (2d Cir. 1944), *cert. denied*, 323

authority to support the issuance of convertible securities.[186] Such securities—debentures or preferred stock—are almost always convertible into a junior security, preferred or common stock in the case of a convertible bond, or common stock in the case of convertible preferred. Although of questionable policy, it is also possible, within limits necessary for the protection of creditors, to provide for the conversion of stock into bonds.[187]

Any "practical necessity" which may exist for not requiring the recognition of pre-emptive rights in respect of shares issued in exchange for property or services[188] does not apply to convertible securities receivable in exchange for stock,[189] and when shareholders have pre-emptive rights, such rights attach to securities which may at the option of the holder be converted into stock.[190] The holder of a convertible security does not, however, have any pre-emptive rights in respect of additional issues of the class of stock into which his security may be converted.[191]

U.S. 778 (1944); *In re* Associated Gas & Elec. Co., 53 F. Supp. 107 (D.C.N.Y., 1943). Comparable speculative attraction may be afforded by "bonus" common stock issued to the purchasers of senior securities, but this procedure may raise questions as to the sufficiency of the consideration received by the corporation.

186. *E.g.*, CAL. CORP. CODE ANN. § 1103(a) (Deering 1953); DEL. CODE ANN. tit. 8, § 151 (1953); MD. ANN. CODE art. 23, §§ 18(a)(8), 20 (1957); N.Y. STOCK CORP. LAW §§ 16 (bonds into stock), § 27 (convertible shares); OHIO REV. CODE ANN. §§ 1701.21, 22 (Baldwin 1958); PA. STAT. ANN. tit. 15, § 2852-601 (1958). Even in the absence of any express statutory authority to issue convertible securities, the right to do so has been judicially recognized both as to bonds, see P.W. Brooks & Co. v. North Carolina Pub. Serv. Co., 32 F.2d 800, 802 (D.C.N.C. 1929), *aff'd*, 37 F.2d 220 (4th Cir. 1930), *cert. denied*, 281 U.S. 741 (1930); and as to stock, General Inv. Co. v. Bethlehem Steel Corp., 88 N.J. Eq. 237, 240, 102 Atl. 252, 254 (1917).

But regulatory bodies are not receptive to their use. See Bulkeley v. New York, N.H. & H.R.R., 216 Mass. 432, 103 N.E. 1033 (1914); *In re* Wisconsin Elec. Power Co., 7 S.E.C. 138, 140, note 1 (1940). See generally, Berle, *Convertible Bonds and Stock Purchase Warrants*, 36 YALE L.J. 649 (1927); Hills, *Convertible Securities—Legal Aspects and Draftsmanship*, 19 CALIF. L. REV. 1 (1930); Keith, *Convertible Securities and Stock Purchase Warrants*, 2 ROCKY MT. L. REV. 16 (1929).

187. See *In re* Phoenix Hotel Co., 83 F.2d 724 (6th Cir. 1936), *cert. denied*, 299 U.S. 568 (1936), 37 COLUM. L. REV. 128 (1937), 34 MICH. L. REV. 1041 (1936). See also Augusta Trust Co. v. Augusta, H. & G. R.R. Co., 134 Me. 314, 187 Atl. 1 (1936), 36 MICH. L. REV. 97 (1937).

Indeed, the "conversion" need not necessarily be from one security to another. The bond involved in Howard Estates Dev. Co. v. Metropolitan Trust Co., 208 App. Div. 138, 203 N.Y.S. 97 (1924) was "convertible" into (*i.e.*, acceptable as payment for) land.

188. Drinker, *The Pre-emptive Right of Shareholders to Subscribe to New Shares*, 43 HARV. L. REV. 586, 607 (1930).

189. *Id.* at 606.

190. See Wall v. Utah Copper Co., 70 N.J. Eq. 17, 62 Atl. 533 (1905). Also N.Y. STOCK CORP. § 39.

191. See Van Slyke v. Norris, 159 Minn. 63, 198 N.W. 409 (1924); Miller v. Illinois Central R.R. 24 Barb. 312 (N.Y. 1857). Comparable rights are, however, frequently granted by contract to protect against such dilution of the privilege; see ensuing discussion. See also Guthmann, *Measuring the Dilution Effect of Convertible Securities*, 11 J. BUS. 44 (1938).

Having issued a convertible security, the corporation is under the continuing obligation to have the necessary new securities available to satisfy a conversion demand in accordance with the privilege and to comply with all legal conditions precedent, such as obtaining regulatory commission approval necessary to permit it lawfully to complete the conversion.[192]

Precision must be the keyword in drafting conversion provisions. The duration of the privilege should be expressly stated. If no period is stipulated in a convertible security the privilege remains during the life of the obligation.[193] This time period should be meticulously correlated with any redemption privilege which the corporation may have in respect of the convertible security, covering specifically the period between the giving of the notice of redemption and the actual consummation of the redemption.[194] It is customary to provide that in the event of redemption the right to convert shall continue until "the close of business on the day prior to the date fixed for the redemption in the call therefor."

It is important, if the integrity of the conversion privilege is to be preserved against dilution, that provision be made for the consequences of the many capital changes which the corporation may be in a position to effectuate without the consent of the holder of the convertible security.[195] One such change is the payment of stock dividends. If the exercise of conversion is not limited to dividend dates, it may also be desirable to provide for adjustments in respect of cash dividends or expressly to provide that there is to be no adjustment. Split-up of stock,[196] reduction of the par value,[197] or the

192. Cheatham v. Wheeling & L. E. Ry., 37 F.2d 593 (D.C.N.Y. 1930), Note, 39 YALE L.J. 1209, (1930); Marony v. Wheeling & L. E. Ry., 33 F.2d 916 (D.C. N.Y. 1929); Bratten v. Catawissa R.R., 211 Pa. 21, 60 Atl. 319 (1905).

193. Loomis v. Chicago M. & St. P. Ry., 102 Fed. 233 (2d Cir. 1900); Chaffee v. Middlesex R.R., 146 Mass. 224, 16 N.E. 34 (1888); Carpenter v. Chicago, M. & St. P. Ry., 119 App. Div. 169, 104 N.Y.S. 152, *aff'd*, 192 N.Y. 586, 85 N.E. 1107 (1907). For a case considering what is a "reasonable time" within which to exercise a conversion privilege, no express time limit having been stipulated, see Larsen v. The Lilly Estate, 34 Wash. 2d. 39, 208 P.2d 150 (1949), 10 A.L.R.2d 580 (1950).

194. See P. W. Brooks & Co. v. North Carolina Pub. Serv. Co., *supra* note 186, where it was held that the conversion privilege was terminated upon the giving of the notice of redemption at a future date in accordance with the redemption provisions. But see MCCLELLAND & FISHER, CORPORATE MORTGAGE BOND ISSUES 556 (1937).

195. See Irvine, *Some Comments Regarding "Anti-Dilution" Provisions Applicable to Convertible Securities*, 13 BUS. LAW. 729 (1958).

196. The distinction between a "stock dividend" and a "split-up" is that the former involves "the permanent retention of earnings in the business through formal transfers of earned surplus, legally available for dividends, to capital account," *In re* Lissberger's Estate, 189 Misc. 277, 278, 71 N.Y.S.2d 585, 586-87, *aff'd*, 273 App. Div. 881, 78 N.Y.S.2d 199, *leave to appeal denied*, 298 N.Y. 934, 81 N.E.2d 336 (1948), quoting PATON, ACCOUNTANT'S HANDBOOK 1016 (3d ed. 1947).

197. See North Butte Min. Co. v. Tripp, 117 F.2d 304 (8th Cir. 1941); Tripp v. North Butte Min. Co., 100 F.2d 188 (8th Cir. 1938).

sale of additional shares at less than the conversion price[198] are other capital changes to be covered. It would seem that except for such contract provisions, the holder of the convertible security is without substantial protection against such dilution of the privilege by capital changes.[199]

It is also necessary to provide for the consequences of a merger or consolidation of the issuing corporation because, in the absence of express stipulations, the holder of a conversion privilege has no rights as against any "new" corporation resulting from such merger or consolidation or which may acquire all the assets of the issuing corporation,[200] unless it be found that such new corporation is merely a continuation of the old.[201] The holder is frequently protected in one of two alternative ways. The company covenants either to give him advance notice during which period he may exercise the conversion privilege or it undertakes to make appropriate provision in any such merger, sale or consolidation to assure to him a fair recognition of his privilege.[202]

Stock Purchase Options and Warrants

There is legal authority for the issuance of stock purchase options, whether embodied in another agreement, in a security, or in a separable "warrant."[203]

> A stock purchase warrant may be defined as a corporate instrument by whose provisions the corporation binds itself to deliver shares of its stock to the holder at his election upon payment to it by the holder of a specified sum of money per share, at or within a time and on conditions set forth in the instrument. . . .

198. A most extended discussion of these questions with suggestions as to covering clauses may be found in Hills, *supra* note 186. See also Berle, *Corporate Devices for Diluting Stock Participations,* 31 COLUM. L. REV. 1239 (1931). And for additional protective clauses, see Ch. IV § 7E in *Encyclopedia of Incorporating Forms* (1948).

199. See Parkinson v. West End St. Ry., 173 Mass. 446, 53 N.E. 891 (1899); Pratt v. American Bell Tel. Co., 141 Mass. 225, 5 N.E. 307 (1886); Jones v. Terre Haute & R. R. R., 57 N.Y. 196 (1874); Miller v. Illinois Central R.R., *supra* note 191; Sutliff v. Cleveland & M. R.R., 24 Ohio St. 147 (1873); Gay v. Burgess Mills, 30 R.I. 231, 74 Atl. 714 (1909).

200. See Lisman v. Milwaukee L. S. & W. Ry, 161 Fed. 472 (E. D. Wis. 1908), *aff'd,* 170 Fed. 1020 (7th Cir. 1909), *cert. denied,* 214 U.S. 520 (1909); Welles v. Chicago & N.W. Ry., 163 Fed. 330 (C.C.N.Y. 1908); Rosenkrans v. Lafayette B & M. Ry., 18 Fed. 513 (C.C. Ind. 1883); Wood v. Whelen, 93 Ill. 153 (1879); Tagart v. Northern Cent. Ry., 29 Md. 557 (1868); Chaffee v Middlesex R.R., supra note 193; Parkinson v. West End St. Ry., *supra* note 199.

201. See ROHRLICH, ORGANIZING CORPORATE AND OTHER BUSINESS ENTERPRISES §§ 9.03, 9.04 (3d ed. 1958).

202. See also Hills, *supra* note 186.

203. *E.g.,* CAL. CORP. CODE ANN. § 1103 (Deering 1953); DEL. CODE ANN. tit. 8, § 157 (1953); MD. ANN. CODE art. 23, § 20 (1957); Neb. Rev. Stat. § 21-132 (1954); NEV. REV. STAT. § 78.200 (1957); N.J. REV. STAT. § 14:8-4 (Supp. 1958); Ohio REV. CODE ANN. § 1701.16 (Baldwin 1958); PA. STAT. ANN. tit. 15, § 2852-611 (1958).

See generally BERLE & WARREN, CASES ON BUSINESS ORGANIZATION: CORPORATIONS 380 (1948); Berg, *Long-Term Options and the Rule Against Per-*

. . . . .

> Their only invariable features are convenants on the part of the issuing corporation to deliver stock upon payment of a stated price . . . and covenants defining and limiting the time or times, or period of time . . . at or within which the privilege may be exercised.[204]

Since one of the varied uses to which stock purchase options may be put is as a means of raising, or facilitating the raising, of capital, we deem it appropriate to direct attention to them.[205] Like so many instrumentalities, they are subject to abuse and raise some difficulties,[206] but used honestly and with discretion, they do represent a means (a) of compensating promoters and underwriters and retaining their continuing interest in the financial success of the corporation, (b) of adding speculative attraction to the security with which it is issued, or, less frequently, (c) of raising funds by direct and independent sale of the warrant.[207] More commonly, warrants are issued to existing shareholders to evidence their right to subscribe to an additional issue of stock. The usual distinction between a "stock *purchase*" warrant or option and a "stock *subscription* warrant" or "right" is that the latter runs for a very short period measured in days whereas the former is ordinarily for long terms measured in years, possibly even "perpetual."[208] Currently, the most prevalent use of the stock purchase option is by way of "incentive compensation" to "key employees."[209]

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petuities, 37 CALIF. L. REV. 1, 24-29 (1949); Berle, *Corporate Devices for Diluting Stock Participations*, 31 COLUM. L. REV. 1239 (1931); Berle, *Convertible Bonds and Stock Purchase Warrants*, 36 YALE L.J. 649 (1927); Garner & Forsythe, *Stock Purchase Warrants and "Rights,"* 4 So. CALIF. L. REV. 269, 375 (1931); Keith, *Convertible Securities and Stock Purchase Warrants*, 2 ROCKY MT. L. REV. 16 (1929); Note, *The Legality of Stock Option Grants to Corporate Officers*, 49 COLUM. L. REV. 232 (1949).

204. Berle, *Convertible Bonds and Stock Purchase Warrants*, *supra* note 203, at 649-50.

205. See also Haakh, *Rights Offerings to Shareholders*, 2 PRAC. LAW. 74 (April, 1956); Whiteside, *Income Tax Consequences of Distributions of Stock Rights to Stockholders*, 66 YALE L.J. 1016 (1957).

206. See especially, Berle, *Corporate Devices for Diluting Stock Participations*, 31 COLUM. L. REV. 1239 (1931). Among the difficulties there mentioned (at 1262-63) is the inability at the time of issuance to fix a fair price for the exercise of the option. See sections entitled "Practical Effect of Rights on Price of Stock" and "Formula for Finding the Theoretical Value of a Right" in GERSTENBERG, FINANCIAL ORGANIZATION AND MANAGEMENT OF BUSINESS 300-01 (3d ed. 1941).

207. See HOAGLAND, CORPORATION FINANCE ch. XIV (2d ed. 1938).

208. See DEL. CODE ANN. tit. 8, § 157 (1953). "Subscriptions" apply only to newly issued stock; "purchase" applies to outstanding stock as well.

209. See Steadman, *Stock Options and Other Executive Incentive Arrangements*, 13 VAND. L. REV. 311 (1959); Alexander, *Employee Stock Options and the 1950 Revenue Act*, 6 TAX L. REV. 165 (1951); Lyon, *Employee Stock Options under the Revenue Act of 1950*, 51 COLUM. L. REV. 1 (1951).

For an analysis of stock option plans established by 87 companies listed on the New York Stock Exchange after the enactment of the 1950 Revenue Act, see STOCK OPTION PLANS (Pension Planning Co., 1951); Wall Street Journal, September 17, 1951, p. 9, col. 2.