

YALE LAW JOURNAL

Vol. XXXVIII

MARCH, 1929

No. 5

SHAREHOLDERS' PRE-EMPTIVE RIGHTS*

ALEXANDER HAMILTON FREY

When a corporation, acting through its board of directors, proposes to increase the number of its shares then outstanding, existing shareholders have a variety of rights with respect thereto. For instance, a shareholder has a right that statutory provisions be complied with in the matter of the creation of additional shares; he has a right that there be no "overissue" of shares; under some circumstances, he has a right that no new shares be created for less than their reasonable sale value; and under other circumstances, he has a right to have offered to him (to "subscribe" for) a proportion of the proposed shares before such opportunity is offered to others. This article is concerned exclusively with an analysis of this last-mentioned right. Herein this right is designated as a shareholder's pre-emptive right.

Orthologically, pre-emption is the right of purchasing before others, and much confusion has resulted from the common practice of textwriters and commentators of using the term pre-emptive right to include two separate and distinct rights: (1) the right of a shareholder that, *if* the corporation proposes to create new shares at less than a certain price, he be offered the first opportunity to purchase a proportion thereof at the price

* The substance of this article constituted a paper presented by the author at the Section on Business Associations of the Association of American Law Schools, December, 1927. The materials were collected largely in connection with the author's work on the American Law Institute's Restatement of Business Associations, Tentative Draft No. 1, including sections 11 to 19, dealing with pre-emptive rights, was submitted to the Council of the Institute in April, 1927.

offered; here he has no absolute right of first purchase, for his right arises only if the shares are offered, for example, at less than their reasonable sale value; and (2) the right of a shareholder, no matter at what price the corporation proposes to create the new shares, that a proportion thereof be first offered to him. Throughout this paper the term "shareholder's pre-emptive right" will be employed only with reference to this latter right.¹

In short, if a given transaction resulting, or which would result, in the creation of additional shares does not contravene the right of a shareholder to a first offering of a particular proportion of the shares, the shareholder has, under the circumstances of such transaction, no pre-emptive right, although he may have other rights which the transaction violates. This distinction is obvious in those cases in which the articles of association of a corporation expressly deny to the shareholders the right to subscribe proportionately to new shares;² here shareholders have no pre-emptive rights, although the creation of a particular block of shares may be in derogation of their rights that additional shares be not created at a price which will adversely affect their interests in net earnings or net assets.

The orthodox statement as to the pre-emptive rights of shareholders to be found in such well known treatises as those of Ballantine,³ Cook,⁴ Fletcher,⁵ Morawetz,⁶ Machen⁷ and Thompson⁸ is that "every shareholder has a right to subscribe proportionately to any increase in the capital stock of his corporation." What are the implications of such an assertion? The key word is, of course, "proportionately," but to what proportion of additional shares which his corporation is about to create has a given shareholder a claim? In the early stages of corporate finance when but one class of shares was known, such a rule was clear

¹ If it be objected that this is not the "true" meaning of "pre-emptive right" I should welcome the substitution of any term that seems more feasible as a description of the right in question; the subject matter of this article will remain unchanged whatever name may be applied to it.

² An example of this denial of pre-emptive rights is the provision in the certificate of incorporation of the General Motors Corporation that "No holder of stock of the corporation of whatever class shall have a preferential right of subscription to any shares of any class of the corporation issued or sold, or to be issued or sold, or to any obligations convertible into the stock of the corporation, nor any right of subscription to any thereof, other than such, if any, as the Board of Directors in its discretion may determine. . . ."

³ BALLANTINE, CORPORATIONS (1927) § 135.

⁴ COOK, CORPORATIONS (8th ed. 1923) § 286.

⁵ FLETCHER, CORPORATIONS (1917) § 3462.

⁶ MORAWETZ, CORPORATIONS (2d ed. 1886) § 455.

⁷ MACHEN, CORPORATIONS (1908) § 603.

⁸ THOMPSON, CORPORATIONS (3d ed. 1927) § 3668.

and easily administered and therefore adequate.⁹ But today with the complexity of the share structure of many modern corporations, with the number of varying types of shares limited only by the ingenuity of corporate mentors and their financial needs, this rule, which developed during comparatively simple conditions, cannot feasibly be applied to the prevailing situation. And why not? Apparently, in the earliest cases dealing with pre-emptive rights, the shares involved were what would now probably be called common, voting shares of a uniform par value. That is to say, there being but one class of shares, these shares were not preferred as to dividends payment and not limited to any maximum amount of dividends, and were similarly unpreferred and unlimited as to capital distributions,¹⁰ for example, upon dissolution.

Probably the need for additional capital plus a reluctance to borrow money eventually induced some corporation to create a new type of shares the holders of which were given a preference over common shareholders in the distribution of dividends of, say, six dollars per share per year. In all other respects such shares were most likely on a parity with common shares; if so, the holders of these preferred shares were not limited in the event of dividend payments to the amount of the preference, and were both unpreferred and unlimited with respect to capital distributions. With reference only to dividend payments, such shares might be described as "participating preferred."

The idea of a preference once having been established, it was but natural that before long there should be created shares the holders of which, while preferred as to dividends to a stated amount, were limited to that amount or a stated maximum in

⁹ The earliest American case recognizing the existence of shareholders' pre-emptive rights is that of *Gray v. Portland Bank*, 3 Mass. 363 (1807).

¹⁰ The term "dividend payments" as here used means distribution of net earnings or surplus by a solvent, functioning corporation (a "going concern"). The term "capital distributions" as here used means all other payments by a corporation to its shareholders; "capital distributions" in this sense may take place by a going concern, as where shares are retired or redeemed, as well as by a corporation in the process of liquidation, dissolution, or reorganization. "Capital distributions" may be more (or less) than the par value of the shares, as when holders of shares having \$100 par value are entitled to receive \$110 per share upon retirement or dissolution. "Capital distributions" may be less as well as more than the amount contributed to the corporate enterprise by shareholders, as where a portion of the amount paid to a corporation for share is immediately allocated to surplus; and an increment of "capital distributions" may even include payments on account of accrued dividends, as in the case of retirement of cumulative preferred shares. In short, "capital distributions" is a term arbitrarily selected, as there seems to be no other in current use, to indicate all payments by a corporation to its shareholders other than payments out of net earnings or surplus by a corporation not in the process of dissolution or of retirement of shares.

excess thereof. Insofar as dividend payments are concerned, such shares might be termed "non-participating preferred."

The final development has been the creation of shares the holders of which are unpreferred as to dividends yet limited to a maximum amount of the net earnings of any given year; with respect merely to dividend payments, such shares might be designated as "deferred."

Thus as to dividend payments alone, there are today four groups of shares: (1) common, *i.e.*, unpreferred and unlimited, (2) participating preferred, *i.e.*, preferred and unlimited, (3) non-participating preferred, *i.e.*, preferred and limited, and (4) deferred, *i.e.*, unpreferred and limited. Obviously, shares may be created having with respect to capital distributions any one of these four combinations of incidents, depending upon whether the share is preferred or unpreferred, limited or unlimited, as to capital distributions. And as each one of these four types as to dividend payments may be combined with any one of the four as to capital distributions, sixteen different groups of shares are possible,¹¹ taking into consideration only the presence or

¹¹ The sixteen classes are as follows:

- (1) Preferred and limited as to dividends, preferred and limited as to capital.
- (2) Preferred but unlimited as to dividends, preferred and limited as to capital.
- (3) Preferred and limited as to dividends, preferred but unlimited as to capital.
- (4) Preferred but unlimited as to dividends, preferred but unlimited as to capital.
- (5) Preferred and limited as to dividends, unpreferred and unlimited as to capital.
- (6) Preferred but unlimited as to dividends, unpreferred and unlimited as to capital.
- (7) Preferred and limited as to dividends, unpreferred but limited as to capital.
- (8) Preferred but unlimited as to dividends, unpreferred but limited as to capital.
- (9) Unpreferred but limited as to dividends, preferred and limited as to capital.
- (10) Unpreferred and unlimited as to dividends, preferred and limited as to capital.
- (11) Unpreferred but limited as to dividends, preferred but unlimited as to capital.
- (12) Unpreferred and unlimited as to dividends, preferred but unlimited as to capital.
- (13) Unpreferred but limited as to dividends, unpreferred and unlimited as to capital.
- (14) Unpreferred and unlimited as to dividends, unpreferred and unlimited as to capital.
- (15) Unpreferred but limited as to dividends, unpreferred but limited as to capital.
- (16) Unpreferred and unlimited as to dividends, unpreferred but limited as to capital.

absence of a preference or limitation, both as to dividend payments and capital distributions.¹²

When only those other share incidents thus far invented are applied to each of these groups, the number of possible classes of shares becomes staggering. For example, each group may be voting or non-voting; and even voting rights may be of a number of different classes; voting may be cumulative or non-cumulative; some shares which normally carry no voting rights may acquire voting rights upon certain conditions, such as the passing of three successive dividends, while others may lose normal voting rights upon similar conditions; some shares may entitle the holder to vote for directors but upon no other matters; others may exclude the holder from voting for directors but permit him to vote on other questions. Each group of shares may be of a par value or of no par value; the par value may be of any conceivable amount. The preference as to dividends may be cumulative or non-cumulative, and the preference both as to dividends and capital may be of various amounts. The shares may be convertible or non-convertible, redeemable or non-redeemable, and the shares may even limit the rights of the holder to dividend payments and exclude him entirely from participation in capital distributions.¹³ When confronted with such

¹² Class 1 is the ordinary form of non-participating preferred share. Examples of Class 2 are the 7% preferred shares of A. M. Byers Co. and the preferred shares of American Products Co., both of which are participating as to dividend payments, but non-participating as to capital distributions. An example of Class 3 is the preferred shares of Maple Leaf Milling Co. of Ontario, which as to dividend payments are limited to the amount of their preference, but which, while preferred, are not limited as to capital distributions in the event of dissolution. An excellent example of Class 4 is the so-called Class A common shares of the Burns Bros. coal corporation which are preferred but not limited to the amount of the preference, both as to dividend payments and capital distributions. The 7% preferred shares of the National Biscuit Co. are an illustration of Class 5, being limited to the amount of their preference as to dividends, but participating equally with the common shares in a distribution of "assets." Shares illustrating Class 6 are of increasing frequency, although they are usually called "Class A common" shares, a contradiction in terms inasmuch as they are accorded a preference over the common shares to a designated extent in dividend payments, while participating on a parity with the common as to further dividend payments or as to capital distributions; for illustrations see the "Class A common" shares of Isaac Benesch & Sons, Inc., or of the Illinois Pacific Glass Corporation. Class 14 is, of course, the case of the ordinary common share. Class 15 is well illustrated by the shares of the Citizens Gas Company of Indianapolis, which are limited to a maximum annual dividend of 10%, net earnings in excess of that amount being available for the retirement of the shares, and the property of the Company passing to the City when all the shares have been retired. Examples of the remaining classes would, in any event, be rare, and none have as yet come to my notice.

¹³ See, for example, the Dividend Participations involved in *Bodell v. General Gas & Electric Co.*, 132 Atl. 442 (Del. 1926).

a maze of possible classes of shares, how is the proportionate claim of any given shareholder to shares of a particular class to be determined in relation to shareholders of other classes? When shares have certain incidents in common but are not identical, how is the relative importance of specific incidents to be evaluated in determining the proportionate distribution of new shares to the respective existing shareholders?

These and similar queries indicate that, in the light of modern complex share structures, the orthodox pre-emptive right rule that "every shareholder has a right to subscribe proportionately to any increase in the capital stock of his corporation" is either unjustifiably arbitrary or impossible of rational application.¹⁴

¹⁴ A few examples may help to demonstrate the inadequacy of the orthodox pre-emptive right rule:

Case 1: Corporation *C* has outstanding 1000 voting, common shares (unpreferred and unlimited both as to dividend payments and capital distributions) and 1000 voting shares preferred and unlimited as to dividend payments, and preferred and limited as to capital distributions; Corporation *C* purposes creating 1000 non-voting common shares at their reasonable sale value; since both of the existing classes of shares entitle the respective holders to unlimited participation in dividend payments, why should the common shareholders be given a right to have the proposed additional common shares offered exclusively to them? Upon what basis should the additional common shares be apportioned between the existing common and preferred shareholders? Why, under the circumstances indicated, should there be any apportionment?

Case 2: Same facts as in Case 1, except that the shares Corporation *C* purposes creating at their reasonable sale value are 1000 non-voting shares on a parity with the outstanding preferred shares with respect to dividends, but unpreferred and unlimited as to capital distributions; such shares have the dividend incidents of the outstanding preferred shares and are identical with the outstanding common shares except for the preference as to dividends and the absence of voting power. What is the proportion of these new shares to which each existing shareholder is entitled? Is there any logical basis upon which these new shares can be fairly apportioned? Is there any necessity for apportionment under the circumstances outlined?

Case 3: Corporation *C* has outstanding 1000 voting common shares and 1000 non-voting common shares and purposes creating 1000 additional voting common shares at their reasonable sale value. How should these additional shares be apportioned among the outstanding shareholders? Should non-voting shareholders ever have pre-emptive rights as to voting shares?

Case 4: Corporation *C* has outstanding 1,000 voting common shares and 1000 voting shares preferred and limited both as to dividend payment and capital distributions; Corporation *C* purposes creating 1000 additional voting common shares at their reasonable sale value. How should these additional shares be apportioned among the outstanding shareholders? When additional voting shares are about to be created, should a voting shareholder always have a pre-emptive right to that proportion thereof which the number of voting shares he possesses bears to the total number of voting shares then outstanding, regardless of whether or not his shares are in other respects of the same class as the voting shares about to be created?

That there is, however, some form of pre-emptive right is settled beyond reasonable dispute, whatever one may think of the desirability of the existence of such a rule. Having thus far attempted to demonstrate what this rule of pre-emption is not, I now purpose considering what it is. The solution lies in the answer to the question, to whom and in what proportions must new shares of various classes be first offered.

At this point it might be well to recall the alleged reasons why the common law developed the orthodox pre-emptive right rule as to corporations having but one class of shares. The basis most frequently asserted for the existence in a shareholder of a right to have offered to him a proportion of additional shares about to be created is that he may thereby be enabled to maintain his proportionate interest in the voting control of the corporation, and his interest in its net assets and net earnings. It will be observed that the pre-emptive right is thus a secondary right, arising only to prevent some other or primary right from being violated. Consequently, a shareholder has no pre-emptive right with respect to the creation of new shares unless the creation of such shares will in some material way adversely affect at least one of his interests in the corporation;¹⁵ if the reason for the rule disappears, the rule itself must vanish, especially where its extension to a new field is sought.

Is the right of a shareholder that his interest in the net assets shall not be diminished by the creation of additional shares one which can or ought to be protected by pre-emption? Obviously this right concerns itself exclusively with the *price* at which such new shares shall be created and not with the persons to whom they may be sold. If additional shares are about to be created at a price which will not diminish a given shareholder's interest in the net assets, what right has he, in so far as his interest in net assets is concerned, that some proportion of such shares be offered to him? And if a corporation, having several classes of shares outstanding, is about to create additional shares at a price which will adversely affect the interests in the net assets of the shareholders of one or more of these classes, are we not back to the original problem of the impossibility of determining a rational basis upon which such additional shares can be apportioned?

For example, Corporation *C* has outstanding 1000 voting common shares, and 1000 non-voting shares, which are preferred and limited as to dividend payments, but on an equal footing with common shares as to capital distributions. Under such circumstances, the respective interests of common and preferred shareholders in net assets is not nearly so simple of solution as might

¹⁵ See *General Investment Co. v. Bethlehem Steel Corp.*, 38 N. J. Eq. 237, 102 Atl. 252 (1917).

at first appear. But assume, if you will, that owing to appreciation in the value of fixed assets both common and preferred shareholders would each receive \$150.00 were dissolution to take place at once. Corporation *C* now purposes creating an additional 1000 voting, common shares at \$100.00 per share. If these new shares be created exclusively in the old common shareholders and dissolution were to be effected immediately thereafter, obviously the preferred shareholders would then receive less than \$150.00 per share. How then should these additional shares be apportioned? Fifty-fifty among common and preferred shareholders? Are non-voting shareholders to be allotted voting shares? Are shareholders who are limited to a maximum dividend to receive shares which may participate to the hilt in the corporation's net earnings? Or are the preferred shareholders merely to be accorded a right to enjoin the creation of these additional common shares at less than their reasonable sale price, with the additional right against the corporation to compensation to the extent of their damage if the shares are created before an injunction might reasonably be obtained?

The right of a shareholder that his interest in the net assets shall not be diminished by the creation of additional shares is a very real and important right with many interesting ramifications. While a corporation may be able under certain circumstances to protect itself from violating this right by voluntarily offering a shareholder an adequate proportion of new shares, nevertheless this right of a shareholder with respect to net assets is quite distinct from a right to be offered a proportion of proposed new shares, and not until courts and writers cease jumbling it up with the pre-emptive right will it receive the detailed and separate treatment that it requires.

This leads to the question of proportionate interest in the net earnings as a possible basis for establishing a pre-emptive right rule. Has a shareholder, even where his corporation is authorized to create but one class of shares, a legal right that his present interest in the net earnings shall not be diminished by the creation of additional shares? Suppose Corporation *C* has an authorized capital stock of 2000 common shares of \$100.00 par value each, 1000 of which are outstanding, and that the annual net earnings and paid dividends of the corporation for a number of years have been \$5 per share. If the corporation now creates an additional 1000 shares at \$100.00 per share, which we shall assume is the reasonable sale value of the outstanding shares, the present interest in net earnings of the old shareholders will be diminished, even though the new shares are allotted to them, unless the corporation can utilize the additional \$100,000.00 received through the creation of the new shares at least as profitably as the \$100,000.00 already invested in the enterprise. On

the other hand, the additional capital may enable an expansion that will more than double the corporation's total net earnings. If the corporation were earning and paying \$20.00 per share on the old shares, their reasonable sale value would probably be around \$400.00 per share, and if the corporation were to issue the new shares at \$400.00 apiece, it would have to earn only about 5% and not 20% on the additional \$400,000.00 thus acquired, in order that the interest in net earnings of old shareholders would be not adversely affected. Will the law concern itself with a matter so highly speculative as the effect of the creation of additional shares upon the interest in net earnings of an existing shareholder, especially if the possible effect on this interest is his sole basis of complaint as to a proposed or accomplished share issue?

There would appear to be no case in which the effect upon a shareholder's interest in net earnings has been recognized as the basis for a pre-emptive right, even though only one class of shares was involved. As it would seem patent that, when more than one class of shares is outstanding, the same impossibility of rational apportionment based upon interest in net earnings exists as in those instances where interest in net assets is claimed as the basis of such apportionment, the rejection of a shareholder's interest in net earnings as a legal or logical reason for a pre-emptive right rule would seem justified.

Of the bases for pre-emption most commonly suggested there remains to be considered only a shareholder's proportionate interest in voting control. And here quite different problems are involved than those heretofore discussed.

A chorus of rather querulous voices has lately arisen in protest against the growing practice of creating non-voting common shares—the burden of their complaint is that this so-called divorcing of ownership from control is somehow detrimental to the best interests of society.¹⁶ With this tirade I find myself not entirely in sympathy. But it is one thing to create shares without voting rights, and quite another to deprive an existing shareholder of his proportionate interest in the voting control of his corporation. Where such voting rights exist, this interest warrants the highest degree of protection, for in these days when the courts are giving recognition to the ever-expanding province of the board of directors as managers of the corporate enterprise, their election by those shareholders who have not deliberately foregone this privilege stands out as one of the few remaining forms of shareholder control over the enterprise.

In this connection it should be observed that voting shares have a block value; for example, if Corporation *C* has 100,000 voting shares outstanding, of which shareholder *X* holds 30,000,

¹⁶ See RIPLEY, *MAIN STREET AND WALL STREET* (1927).

his block of voting shares will have a value in excess of 30,000 times the value of one voting share. Furthermore, the voting strength of shareholder *X* in relation to other shareholders is an important factor. If, for instance, the remaining 70,000 voting shares are widely scattered, *X*'s 30,000 voting shares will have a greater value than if the other 70,000 shares are held by a small group of persons, for it is well known that in the case of large corporations whose shares are not closely held, considerably less than a majority of the voting shares outstanding is normally adequate for control of shareholders' meetings.

In our search for the basis of a pre-emptive right rule, three primary distinctions may be noted between a shareholder's proportionate interest in voting control and his interests in net assets and net earnings. In the first place, there is nothing speculative about the diminution of a voting shareholder's proportionate interest in voting control if additional voting shares are created and none are offered to him. Consider a simple case: Corporation *C* has outstanding 100 voting shares of which *X* holds 45, *Y* 35, and *Z* 20; Corporation *C* is about to create 100 additional voting shares. Obviously unless *X* is offered at least that proportion of the new shares which the number of voting shares he now holds bears to the total number of voting shares outstanding, his proportionate interest in voting control will be adversely affected, and the same is equally true of *Y* and *Z*.

Secondly, the only way for a voting shareholder to maintain undiminished his proportionate interest in voting control when additional voting shares are about to be created is for him to have an opportunity to take that proportion of the new voting shares which corresponds to his present fraction of voting control. If an existing voting shareholder is offered none of the proposed new voting shares, his proportionate interest in voting control will inevitably be diminished at whatever price such shares may be created, or however great may be the opportunities for profitably employing the additional capital.

And in the third place, a pre-emptive right rule based exclusively upon proportionate voting control is feasible, regardless of how complex the share structure of a corporation may be. It is possible to determine with mathematical precision the proportion of total voting control which each existing shareholder, common or preferred, has at the time when additional voting shares are about to be created, and to allot to him that proportion of the new voting shares, regardless of what the other characteristics of the new shares may be; and as I have already endeavored to demonstrate any other basis of apportionment of new shares is either irrational or unworkable.

For these reasons, then, I would suggest that the pre-emptive rights rule is as follows: unless otherwise provided by statute

or in the articles of association, every holder of voting shares has a right that the corporation shall not create any voting shares, or other securities convertible into such shares, without first offering to him that proportion thereof which the number of votes possessed by him at a time reasonably fixed by the board of directors bears to the total number of votes then possessed by all voting shareholders.¹⁷ If it be objected that, however desirable this rule might be, it is an innovation, and not the common-law rule as to shareholders' pre-emptive rights, this I must strenuously deny.

An exhaustive search has revealed eighty-seven American cases dealing with various phases of the pre-emptive right problem; of these, all but eleven¹⁸ relate to corporations having only one class of shares outstanding at the time of the proposed creation of additional shares.¹⁹ Thus, in the overwhelming majority of existing cases, the court was not confronted with the necessity of selecting one of divers incidents of the existing shares as the basis for a right of pre-emption, inasmuch as each share involved the same interests as every other share. And this is reflected in the opinions for, as has been heretofore noted, although many of the courts advert to the importance of protecting a shareholder's interest in net earnings and net assets as well as in

¹⁷ This is substantially, although not exactly, the practically unanimous opinion of those engaged in the American Law Institute's Restatement of Business Associations as to what the pre-emptive right is. See LAW OF BUSINESS ASSOCIATIONS RESTATEMENT, Tentative Draft No. 1 (Am. L. Inst.) §§ 12 *et seq.*

¹⁸ *Stone v. U. S. Envelope Co.*, 119 Me. 394, 111 Atl. 536 (1920); *Page v. Whittenton Mfg. Co.*, 211 Mass. 424, 97 N. E. 1006 (1912); *Jones v. Concord & Montreal R. R.*, 67 N. H. 234, 30 Atl. 614 (1892); *General Investment Co. v. Bethlehem Steel Corp.*, 87 N. J. Eq. 234, 100 Atl. 347 (1917), *General Investment Co. v. Bethlehem Steel Corp.*, *supra* note 15; *Page v. American & British Mfg. Co.*, 129 App. Div. 346, 113 N. Y. Supp. 734 (1st Dep't 1908); *Russell v. American Gas & Electric Co.*, 152 App. Div. 136, 136 N. Y. Supp. 602, (1st Dep't 1912); *Branch & Co. v. Riverside Mills*, 139 Va. 291, 123 S. E. 542 (1924); *Riverside Mills v. Branch & Co.*, 147 Va. 509, 137 S. E. 620 (1927), 52 A. L. R. 220 (1928); *Weidenfeld v. Northern Pacific R. R.*, 129 Fed. 305 (C. C. A. Sth, 1904); *Borg v. International Silver Co.*, 11 F. (2d) 147 (C. C. A. 2d, 1925).

¹⁹ The reason for this paucity of such cases is probably that where corporations have a complex share structure their articles of association either negative the existence of pre-emptive rights or contain such detailed provisions with respect thereto that controversies are forestalled or, more likely still, such corporations, in creating additional shares, have thus far managed to make arrangements satisfactory to all shareholders who could not be bought off. But any day a case may arise in which the proposal for the creation of additional shares by a corporation having several classes of shares outstanding will not be satisfactory to the existing shareholders, or in which the validity of provisions in the articles of association either denying or arbitrarily regulating pre-emptive rights will be tested. Indeed, Professor Ripley has already viewed with alarm such charter provisions, and recent questionable developments in corporate financing seem to indicate that he is hardly tilting at a windmill.

voting control, no generally accepted theory as to the basis for pre-emption is to be found in the cases. Nor is this surprising, for the protection afforded to one of the interests of a shareholder by a right of pre-emption is necessarily afforded to all his interests where but one class of shares is outstanding.

But where a corporation has two or more classes of shares outstanding, the totality of the interests represented by each class differs from the totality of interests of every other class; consequently it is, under most circumstances, not possible to create more shares of one class or shares of a new class without disturbing one or more of the proportionate interests of another class or classes, no matter how the additional shares may be apportioned among the existing shareholders. The particular interests in voting control, dividend payments and capital distributions of a share of a given class can no more be added together, in an attempt to arrive at the total "interest" in the corporation represented by the share, than a doughnut can be added to the square root of two. A "weighted average" of the differing interests of shares of various classes being impossible, there can be no rational method of apportioning additional shares among holders of the shares of different classes except on the basis of an interest (or interests) prevailing in all of the existing shares.

The few cases which have thus far arisen involving the respective rights of existing shareholders of different classes to a first offering of new shares have, with one possible exception,²⁰ been cases in which all the shares participated in voting control and the courts have been most alert in protecting a shareholder's proportionate voting strength.

In *Russell v. American Gas & Electric Co.*,²¹ a holder of voting preferred shares sought to restrain a proposed creation of voting common shares at par unless both the preferred shareholders and the common shareholders were permitted upon the same terms to subscribe thereto. The market value of the common shares was then about \$30 per share above par. The injunction was denied, but only upon the condition that the preferred shareholders be allowed to subscribe for an equivalent amount of the preferred shares at par, despite the fact that the preferred shares were non-participating, both as to dividend payments and capital

²⁰ *Weidenfeld v. Northern Pacific R. R.*, *supra* note 18. This is merely a case in which a common shareholder sought to enjoin the consummation of a plan involving the creation of additional common shares on the ground that the existing holders of participating preferred shares had not been offered an opportunity to subscribe proportionately to such common shares; in dismissing the petition the court observed that the plaintiff was "not the protector or conservator of the personal rights of the preferred shareholders."

²¹ *Supra* note 18.

distributions. Since the only adverse effect upon the holders of such preferred shares by the creation of additional common shares at less than their market value would relate to their proportionate voting control, the condition upon which the injunction was granted must have been motivated by a desire to protect this voting interest.

In *Branch & Co. v. Riverside etc. Mills*,²² voting preferred shareholders sued at law to redress a violation of their alleged rights resulting from the creation of additional common shares, exclusively as to the existing common shareholders, at less than their market value. The preferred shares were non-participating as to dividend payments, but on the same basis as the common shares with respect to capital distributions. The court held that each shareholder, whether common or preferred, had a right to subscribe to that proportion of the new common shares which the number of shares held by him bore to the total number of shares of both classes then outstanding, and awarded damages measured by the difference between the market value of the common shares at the time of the increase and the price at which they were created. Here again, the court appears to be stressing the importance of the voting interest of the preferred shareholders, inasmuch as their interests in dividend payments were not adversely affected by the creation of the new common shares, and as there was nothing to indicate whether the high market value of the common shares was due to accumulated earnings or to unearned appreciation in the fixed assets of the corporation.

In *Page v. Whittenton Mfg. Co.*,²³ the court refused to enjoin the consummation of a plan, authorized by statute, whereby the 8,000 common voting shares outstanding were to be reduced to 1,000, while the 2,000 voting preferred shares were all to be permitted to remain outstanding, and common shares were thereafter to be created as to the common shareholders and preferred shareholders in the proportion obtaining after the reduction rather than before. Since the preferred shares were participating as to dividend payments, and possibly as to capital distribution (this does not clearly appear), and as the entire plan had statutory sanction, this case sheds little light upon the underlying basis for pre-emption.

A somewhat similar case, also involving the reduction of the number of common shares outstanding, is *Page v. American & British Mfg. Co.*²⁴ At a time when 80,000 voting common shares and 20,000 voting preferred shares were outstanding, the majority of the shareholders voted to reduce the authorized capital stock to 20,000 voting common shares, and 20,000 voting pre-

²² *Supra* note 18. See also *Riverside Mills v. Branch & Co.*, *supra* note 18.

²³ *Supra* note 18.

²⁴ *Supra* note 18.

ferred shares. In an action by a transferee of common shares to compel the corporation to issue a new certificate to him, the court held that this reduction was "illegal," solely on the ground that it would disturb the proportionate voting control of the common and the preferred shareholders, saying:

"The effect of the action taken is to give the holders of preferred stock, who only contribute one-fifth of the capital, an equal vote and voice in the management of the corporation with the holders of the common stock, who contributed four-fifths of the capital, and it reduces the voting power and authority of the stock owned by the plaintiff four-fifths without any reduction in the voting power or the authority of the preferred stock."

In *Stone v. U. S. Envelope Co.*,²⁵ a voting common shareholder was granted an injunction restraining the corporation from permitting voting preferred shareholders to participate in a proposed increase of voting common shares, the preferred shares being construed by the court to be non-participating both as to dividend payments and capital distributions. The injunction was granted on the ground that since the additional common shares were being offered at materially less than their market value, the preferred shares would be receiving, in effect, a dividend in excess of the amount to which they were limited, if permitted to subscribe for the new common shares at the price offered. The case contains no discussion of the proportionate voting interests of the respective classes of shares, and there is nothing to indicate that a similar injunction would not have been granted to preferred shareholders restraining the issuance of voting common shares exclusively to common shareholders, on the ground that this would reduce the voting power of the preferred shares.

In *Jones v. Concord & Montreal R. R.*,²⁶ the court refused to grant an injunction restraining the corporation from permitting all classes of shareholders to subscribe for additional common shares at par in proportion to their respective holdings. There were four classes of shares outstanding, all of which voted and participated equally as to capital distributions, but Classes 1, 2 and 3 were limited to their respective preferences as to dividend payments. The market value of the common shares was above par, but the court emphasized that "it does not appear what the new company has earned or what disposition has been made of its earnings. They may have been properly paid out in dividends, or to creditors of the Montreal, or properly expended in the maintenance or improvement of the road. The excess of value of the new stock above par may be a consequence of the union. It

²⁵ *Supra* note 18.

²⁶ *Supra* note 18.

may arise from a recent or an old and long-continued advance in the value of the corporate plant."

One of the *Bethlehem Steel*²⁷ cases merely involved a power of the corporation to create non-voting common shares and the other was principally concerned with the power of the corporation to create preferred shares taking a priority over existing preferred shares. The *Borg*²⁸ case was decided on the ground that pre-emptive rights do not apply to "treasury shares."

This review of the cases involving an apportionment of new shares between existing shareholders of different classes of shares would seem to justify the conclusion that a rule of pre-emption based upon proportionate interest in voting control is not contrary to the present state of American case law. Moreover, while it is true that today the overwhelming majority of corporations still has but one class of shares outstanding, a rule of pre-emption based upon voting rights is applicable to all such corporations as the single class of shares inevitably must include voting incidents.

The new Ohio Corporation Act limits pre-emptive rights to holders of shares of the same class as those about to be created,²⁹ and the Uniform Business Corporations Act adopted last June by the National Conference bases such provisions as to apportionment of new shares as it contains upon this Ohio rule.³⁰ Such a rule of pre-emption is unsupported by authority, illogical in its conception and fraught with possibilities of grave injustice in its application. Two principal objections to such a rule stand out: in the first place it hampers the corporation by requiring it invariably to apportion new shares of a given class among all the existing holders of shares of that class, even though such old shareholders would be in no way adversely affected by not re-

²⁷ *Supra* note 18.

²⁸ *Supra* note 18.

²⁹ Ohio Laws 1927, § 8623-35: "Except as otherwise provided in the articles, the holders of shares of any class of a corporation shall, upon the sale for cash of shares of the same class, have the right, during a reasonable time to be fixed by the board of directors, to purchase such shares in proportion to their respective holdings of shares of such class, at such price as may be fixed in the manner hereinbefore provided Shares of a class of which none are outstanding shall not be subject to pre-emptive rights."

³⁰ The tenth draft of the Uniform Business Corporation Act, tentatively approved by the National Conference in 1927, contained a section expressly limiting pre-emption to voting shares, unless otherwise provided in the articles. The Act as finally approved in 1928 appears to contain no provisions as to pre-emptive rights. Section 24, covering dividends, does, however, contain this provision: "VI (c) no dividend payable in shares of any class shall be paid to shareholders of any other class unless the articles so provide or such payment is authorized by the vote of the holders of a majority of the shares of the class in which the payment is to be made." This is an unfortunate adaptation of section 38 of the new Ohio Act.

ceiving an aliquot portion of the new shares; and, secondly, it offers no safeguard to the holders of shares of a class different from those about to be created against an unwarranted reduction of their proportionate voting control. The possibilities of legalized chicanery by those temporarily in the corporate saddle which such a rule of pre-emption presents are patent and appalling.

WHO ARE VOTING SHAREHOLDERS?

In view of the complex provisions sometimes appearing in corporate charters with respect to voting rights, an understanding of a rule of pre-emption based upon proportionate voting control requires some consideration of who may be regarded as voting shareholders at any given time. Occasionally the holders of some shares are entitled to vote only for directors but upon no other matters; and in some few instances a particular class of shareholders is accorded the right to vote on questions other than the election of directors. In the rule of pre-emption herein set forth the term "voting shares" applies to all shares the holders of which have a right to vote in the election of directors regardless of other limitations on their voting rights, and excludes all shares the owners of which are not entitled to vote for directors, even though they may have other voting rights.

It should also be noted that by express provision in the articles of association, a particular class of voting shares may be subject to either a total or a partial loss of voting rights upon the happening of a stipulated condition such as the passing of three successive dividends on preferred shares; similarly a class of shares may acquire voting rights or additional voting rights upon the happening of a condition expressed in the articles of association. The happening of the condition may be exceedingly remote, or it may be quite imminent. If a particular change in the voting rights will inevitably take place in the very near future, although the condition upon which it rests may not actually have occurred as yet, there is little doubt but that the courts would regard those about to acquire voting rights as voting shareholders, and those about to lose voting rights as non-voting shareholders, insofar as the rule of pre-emption is concerned. For example, if such shift in voting control were conditioned on the passing of three successive preferred dividends and two had already been passed, and no funds were available for the payment of the third dividend, although the date therefor was practically at hand, the preferred shareholders would, in all probability, be regarded as having exclusive voting control if the directors proposed to create an additional block of voting shares shortly before the arrival of this third dividend date.

DO PRE-EMPTIVE RIGHTS APPLY WHERE SHARES ARE CREATED FOR PROPERTY OR SERVICES?

Although the statement not infrequently appears that pre-emptive rights do not exist where shares are created in return for property or services,³¹ neither logically nor on authority can this distinction be supported. There are but five American cases³² in which the pre-emptive right where shares are created in exchange for property or services has been even discussed. Of these cases, *Meredith v. N. J. Zinc & Iron Co.*³³ is the only one which contains anything remotely resembling an authoritative holding on this point.

In that case a shareholder sought to enjoin the creation of shares in exchange for property of peculiar value and not otherwise procurable, on the ground that he had not been offered his proportion of the proposed shares. While the injunction was denied, it should be noted (1) that at the trial counsel for defendant offered to the complainant to insure to him the right to purchase at par such proportion of the proposed shares as he would be entitled to under the rule relied upon; (2) that although the court denied the injunction, it did not deny the existence of a pre-emptive right with respect to shares created for property, for Vice-Chancellor Pitney, who delivered the opinion, specifically stated, "Besides it is well held in such cases that, in case the corporation deprives a stockholder of his rights in this behalf, it is liable to an action at law for damages, and there is no suggestion that the zinc company is not of sufficient responsibility to answer to such action;"³⁴ and (3) the case of *Wall v. Utah Copper Co.*³⁵ somewhat weakens the effect of the *Meredith* decision, as Pitney in this later case deprecates his former opinion.

The *Bonnet* case³⁶ involved the creation of shares upon a consolidation; and the *Bond* case³⁷ and the *Archer* case,³⁸ as well as the *Stokes* case,³⁹ contain only dicta, unsupported by sound

³¹ See BALLANTINE, *op. cit. supra* note 3, at 423.

³² *Meredith v. N. J. Zinc & Iron Co.*, 55 N. J. Eq. 211, 37 Atl. 539 (1897), *aff'd* without opinion, 56 N. J. Eq. 454, 41 Atl. 1116 (1898); *Bonnet v. First National Bank*, 24 Tex. Civ. App. 613, 60 S. W. 325 (1900); *Bond v. Atlantic Terra Cotta Co.*, 137 App. Div. 671, 122 N. Y. Supp. 425 (1st Dep't 1910); *Archer v. Hesse*, 164 App. Div. 493, 150 N. Y. Supp. 296 (1st Dep't 1914); *Stokes v. Continental Trust Co.*, 186 N. Y. 285, 78 N. E. 1090 (1906), 12 L. R. A. (N. S.) 969 (1908), 9 ANN. CAS. 748 (1908).

³³ *Supra* note 32.

³⁴ *Ibid.* 220, 37 Atl. at 542.

³⁵ 70 N. J. Eq. 17, 62 Atl. 553 (1905).

³⁶ *Supra* note 32.

³⁷ *Supra* note 32.

³⁸ *Supra* note 32.

³⁹ *Supra* note 32.

argument or by authority, to the effect that the pre-emptive right does not apply where shares are exchanged for property.

The strongest argument against permitting pre-emptive rights where shares are created for property is that the board of directors, in the sound and honest exercise of their discretion, may have determined that a particular piece of property, which can be obtained only in exchange for shares, is practically indispensable to the corporate enterprise, and that they should not be hampered in their fair conduct of the corporation's affairs. This raises the issue whether the right of the existing shareholders not to have their voting control disturbed, or the right of the directors to be unhampered in managing the corporation, is of paramount importance. But this problem is not unique to the creations of shares for property. The same conflict may arise when the board of directors desires to create for cash certain shares in a person whom they believe it would be extremely desirable to have as a shareholder. And if the recognition of shareholders' voting control is of paramount importance when shares are created for cash, there would seem to be no justification for adopting a contrary attitude when it is sought to create shares for property or services.

If Corporation *C* has an authorized capital stock of 1300 common shares, of which 1000 are outstanding, and a majority of the board of directors holds 490 shares, surely the majority members of the board ought not to be privileged to perpetuate themselves in office by creating the remaining 300 shares in themselves in return for Blackacre, without offering an aliquot portion of these 300 shares to the holders of 51% of the shares then outstanding, even assuming that Blackacre is reasonably worth 300 shares and that its acquisition would be highly beneficial to the corporation. If it be urged that principles of equity would preclude such a transaction by the directors, this is but another method of alleging the incorrectness of the statement that pre-emptive rights do not apply when shares are created for property. And it should be noted that the cases in which the protection afforded by the pre-emptive right is of most importance usually involve just such questions of control.

It may well be that the existence of any pre-emptive right is open to attack, but that is a question beyond the scope of this paper, and in any event ought not to be raised by an illogical and back-door exception to the widely recognized general principle.

DO PRE-EMPTIVE RIGHTS APPLY TO TREASURY SHARES?

The paucity of authority concerning the applicability of the pre-emptive right to "treasury shares" is almost as complete as with respect to the creation of shares for property. One very

ancient case, *Hartridge v. Rockwell*,⁴⁰ held that the pre-emptive right did not apply to "treasury shares," that is, where the corporation was about to exercise a power to create shares which power it acquired through the previous purchase of some of its own shares, an injunction was not granted to a shareholder to whom none of such shares had been offered by the corporation; but the case does not indicate whether the shares were purchased with an intention of exercising the power thus acquired to create shares, or how long an interval elapsed between the acquisition of this power and its attempted exercise. The case of *Crosby v. Stratton*,⁴¹ which was in fact a damage action by one shareholder against another for an alleged conversion of shares, contains a dictum to the effect that no pre-emptive right attaches to a power to create shares acquired by the corporation through the transfer to it by its shareholders of over 700,000 shares; but again the evidence is unsatisfactory as to the character of this transfer or its duration, although there is nothing to indicate a lack of intention on the part of the corporation eventually to exercise the power thus acquired. The case of *State v. Smith*⁴² has been cited as authority for the proposition that pre-emptive rights do not apply to "treasury shares," but it in fact merely decides that when a corporation buys some of its own shares this does not effect a reduction in its authorized capital stock (that is, in its total power to create shares), but that following such purchase of shares the corporation has power to create new shareholdership in other persons in lieu of that which was cancelled when the corporation bought the shares.

The recent case of *Borg v. International Silver Co.*⁴³ sustains the proposition that pre-emptive rights do not apply to "treasury shares" if the corporation has consistently indicated an intention thereafter to exercise the power to create other shares in lieu of the shares cancelled; in the instant case the defendant corporation had for fifteen years described the cancelled shares in its annual balance sheets as "in treasury." On the other hand, the case of *Dunn v. Acme Auto and Garage Co.*⁴⁴ specifically supports the position that where a corporation purchases some of its own shares, and there are no attendant circumstances to indicate a future intention to exercise the power thus acquired to create shares, pre-emptive rights apply to these "treasury shares" to the same extent as to any other creation of shares by the corporation. Rosenberry says in his opinion:

⁴⁰ 2 Charlton 260 (Ga. 1828).

⁴¹ 17 Colo. App. 212, 68 Pac. 130 (1902).

⁴² 48 Vt. 266 (1876).

⁴³ 11 F. (2d) 147 (C. C. A. 2d, 1925).

⁴⁴ 168 Wis. 128, 169 N. W. 297 (1918).

"What is the effect, then, of a lawful purchase of its own capital stock by a corporation? If retired, cancelled, and placed in the treasury of the company and not reissued, manifestly its effect is to decrease the outstanding capital stock. When the capital stock of the corporation has been decreased and it is proposed to reissue the repurchased stock, every reason for making such reissue proportionate to the holdings of the then stockholders exists that would exist if such increase were of stock not theretofore issued or an increase in the authorized capital. . . . It seems fairly clear that the corporation did not treat the stock repurchases as a liability; in fact it did not appear on either side of its books. Under such circumstances, the corporation having lawfully purchased and then retired its own shares, and having statutory power to diminish its capital stock, it must be held that the outstanding capital stock is thereby diminished. . . . It further appears that the company continued after the retirement of the stock to do a profitable business, and under such circumstances the rule that the directors of a corporation cannot authorize a sale or an increase of capital stock either by formally increasing the amount originally authorized or by issuing that which had originally been withheld, without first giving to all its existing stockholders an opportunity to take their proportionate share of such increase, applies to such proposed reissue, and the attempt of the directors to reissue such stock without first offering it to the then stockholders of the company was unlawful, and such sale should not have been authorized. A different question would have been presented if the shares of its own stock purchased by the corporation had been carried on its books as a liability and they had been treated as an asset of the corporation. . . ." ⁴⁵

These cases are a far cry from the conclusion that pre-emptive rights do not apply to "treasury shares." To be sure the *Borg* case exempts from pre-emption those voting "treasury shares" which can be said to have been temporarily cancelled, but this is an illogical exception to the pre-emptive right rule and opens the door to the very abuses which the right is aimed against. This danger is exemplified by the facts in *Elliott v. Baker* ⁴⁶; in that case the court ordered the cancellation of voting "treasury shares" which had been sold by the corporation at their then market value to friends of certain directors without first being offered proportionately to the complainants who were thereby deprived of voting control. Furthermore these "treasury shares" had been merely temporarily cancelled as they had resulted from the donation to the corporation of fully paid shares with

⁴⁵ *Ibid.* 135, 169 N. W. at 300.

⁴⁶ 194 Mass. 518, 80 N. E. 450 (1907).

the understanding that they were to be resold for the benefit of the corporation at the discretion of the directors.

CONCLUSION

The *Elliott* case, and in fact most of the cases in which a particular distribution of additional shares has been held to violate rights of existing shareholders, might be regarded merely as a specific application of the single principle that directors must deal fairly with shareholders in the matter of creating new shares. Such a principle, however, is of little aid in the anticipation or solution of a controversy. It is fundamental that directors must at all times and in all matters be free from fraud in their relations with their shareholders. But fraud and fair dealing are unfortunately not self-explanatory; even sensitive consciences will vary in their reactions to a given situation. Hence specific rules are needed. Two such rules have been set forth in the foregoing pages: (1) the rule of pre-emption as to voting shares, and (2) the rule that no shares shall be created at a price which would adversely affect the interests of an existing shareholder as to net earnings or net assets, unless he is afforded an opportunity to subscribe at the price offered for a sufficient number of new shares to enable him to maintain unimpaired his existing interests.

This latter rule is infinitely the more difficult of application and, therefore, must be meticulously distinguished from the rule of pre-emption. Where a complex share structure exists there may be an impossibility of determining the proportion of new shares at the price offered which an existing shareholder would have to acquire in order to protect his interests in net earnings and net assets. Moreover, this rule and the rule of pre-emption may conflict where the rights of various classes of shareholders are involved. Under such circumstances the plan for the creation of the additional shares, as originally proposed by the directors, may have to be altered, perhaps by offering the shares at their reasonable sale value, or by permitting holders of different classes of shares to subscribe for similar proportions of shares of their respective classes.