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REMOVING THE LIMITS ON AUTHORIZED STOCK

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One of the benefits of developing alternative ways of doing things is that it often leads to reexamination and improvement of existing practices. So we are finding with the fast-expanding number of forms of business associations.

From S corporations to C corporations and from LLCs to LPs and LLPs—not to mention REITs, REMICs and UPREITs—the explosion of forms of doing business threatens to drown us all in a rich alphabet soup not seen since the days of the New Deal. The freedom and flexibility of the limited liability company (LLC) statutes, in particular, are likely to lead to rethinking many of the conventions of other forms of doing business, including the federal income tax requirements for S corporations and state law requirements for corporations. Moreover, the LLC statutes offer the bright prospect of encouraging reexamination of some of the most basic principles of state corporation statutes. Nowhere is this movement more evident than in the provisions of LLC statutes dealing with entity finance. The typical state corporation statute's financial provisions are founded on the artificial concepts of par value and authorized stock.[1] In many states, par value and its inevitable companion, stated capital (par value multiplied by the number of shares of issued and outstanding stock), continue to govern both contributions to the corporation by its stockholders and distributions by the corporation to its stockholders.[2] In all states, however, the concept of a limit on the number of shares of stock that the corporation has authority to issue continues to survive without serious challenge or

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1. *See, e.g.*, DEL. CODE ANN. tit 8, § 151 (1991 & Supp. 1994) (stating that every corporation may issue stock with or without par value); N.Y. BUS. CORP. LAW § 501 (McKinney 1986 & Supp. 1994) (providing for authorized shares and for shares with or without par value); *see also* HARRY G. HENN & JOHN R. ALEXANDER, LAWS OF CORPORATIONS §§ 123, 159 (3d ed. 1983) (discussing authorized shares and par value).

2. *See, e.g.*, DEL. CODE ANN. tit. 8, §§ 153, 154 (1991); N.Y. BUS. CORP. LAW §§ 504(c), 506(a), 511(a)(1) (McKinney 1986).

question.[3]

In 1980, the Committee on Corporate Laws of the Section of Business Law of the American Bar Association, the authors and continuous revisers of the Model Business Corporation Act, amended the Act to eliminate both par value and stated capital.[4] As to contributions to the corporation by the stockholders for their shares, section 6.21(b) of the Revised Model Business Corporation Act (RMBCA) now permits the board of directors to "authorize shares to be issued for consideration consisting of any tangible or intangible property or benefit to the corporation, including cash, promissory notes, services performed, contracts for services to be performed, or other securities of the corporation."[5] There is no requirement that shares must be issued for a minimum consideration consisting of the par value of the shares. Instead, under section 6.21(c) of the Act, "[b]efore the corporation issues shares, the board of directors must determine that the consideration received or to be received for shares to be issued is adequate."[6] Section 6.21(d) further provides: "When the corporation receives the consideration for which the board of directors authorized the issuance of shares, the shares issued therefor are fully paid and nonassessable."[7]

On the distribution side, the RMBCA drafters severed the standards governing the corporation's legal ability to make distributions (dividends, redemptions, share repurchases or partial liquidations) from the artificial standards of par value and stated capital. Instead, section 6.40 of the RMBCA wisely substituted two tests based on the current economic condition of the corporation: the "equity solvency" test and the "balance sheet solvency" test. Under the former, section 6.40(c)(1) provides that no distribution may be made if, after giving effect to the distribution, "the corporation would not be able to pay its debts as they become due in the usual course of business."[8] Under the latter, section 6.40(c)(2) provides that no distribution may be made unless, after the distribution, assets will exceed the sum of liabilities plus senior dissolution (liquidation) preferenc-

3. *See* HENN & ALEXANDER, *supra* note 1, § 123.

4. COMMITTEE ON CORP. LAWS, AMERICAN BAR ASS'N, 1 MODEL BUSINESS CORP. ACT ANNOTATED, intro. at xxxi (3d ed. 1994) [hereinafter MBCA ANNOTATED].

5. REVISED MODEL BUSINESS CORP. ACT § 6.21(b) (1984) [hereinafter RMBCA].

6. *Id.* § 6.21(c).

7. *Id.* § 6.21(d).

8. *Id.* § 6.40(c)(1); *see also id.* § 6.40 cmt. 2 (discussing the equity insolvency test).

es.[9] In effect, section 6.40(c)(2) treats senior liquidation preferences as liabilities for purposes of determining the corporation's legal ability to pay dividends to holders of junior classes of stock.[10]

Seventeen states have enacted corporation statutes that follow the RMBCA closely enough to be said to have adopted it.[11] These statutes all include provisions substantially similar to section 6.40.[12] In addition, other states, such as Hawaii and Maryland, have adopted distribution provisions substantially similar to section 6.40.[13]

Nevertheless, most states, including the still important chartering state of

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9. Specifically, § 6.40(c)(2) prohibits distributions if, following the distribution,

> the corporation's total assets would be less than the sum of its total liabilities plus (unless the articles of incorporation permit otherwise) the amount that would be needed, if the corporation were to be dissolved at the time of the distribution, to satisfy the preferential rights upon dissolution of shareholders whose preferential rights are superior to those receiving the distribution.

Id. § 6.40(c)(2); *see also id.* § 6.40 cmt. 4.

10. Note, however, that if the charter so provides, senior liquidation preferences will not be treated as liabilities. RMBCA § 6.40(c)(2) (1984). Thus, the drafter of preferred stock provisions in a Model Act state should always consult with the client to determine whether the client wants maximum flexibility in making distributions to its stockholders, including junior classes of stockholders. If so, under § 6.40(c)(2), the charter must affirmatively provide that senior liquidation preferences shall not be added to liabilities in determining compliance with the balance sheet solvency test. *Id.* The real economic contest, of course, is between the senior stockholders and the junior stockholders. The former will want liquidation preferences to be added to liabilities because doing so will always decrease any excess of assets over the sum of liabilities and liquidation preferences, thus reducing the amount of assets of the corporation available for distribution to holders of junior classes of stock. The latter, however, will generally prefer for the corporation to have the greater flexibility of a larger amount of assets available for the payment of distributions to the junior stockholders.

Resolution of this issue, therefore, is likely to depend upon the relative economic strength and bargaining power of the senior and junior stockholders. If the corporation badly needs additional capital, then the junior stockholders may have no choice but to accede to the insistence of the prospective purchasers of the senior stock (or their representatives, typically the underwriters) and forgo inclusion of a provision excepting senior liquidation preferences from § 6.40(c)(2). On the other hand, the corporation, acting through its board of directors (which is typically elected by the junior stockholders), may conclude that it is in a strong enough position economically or can offer other inducements (such as a higher dividend rate) to the prospective senior stockholders so that it can insist upon inclusion of an opt-out provision from § 6.40(c)(2).

The most important point for the drafter, however, is to be aware of the existence of § 6.40(c)(2) and the possibility for adjusting its impact by opting out of it—in whole or in part—in the charter. The trap for the unwary is ignorance of § 6.40(c)(2) and the opt-in option, with the result that the corporation's ability to make distributions to its junior stockholders will be automatically reduced by the amount of any senior liquidation preferences.

11. MBCA ANNOTATED, *supra* note 4, intro. at xli. The adopting states are Arkansas, Florida, Georgia, Indiana, Iowa, Kentucky, Mississippi, Montana, New Hampshire, North Carolina, Oregon, South Carolina, Tennessee, Utah, Virginia, Wisconsin, and Wyoming. *Id.*

12. *Id.* at xliii - xliv.

13. *Id.*

Delaware, retain statutory contribution and distribution provisions based on par value and stated capital. Section 170(a) of the Delaware General Corporation Law (DGCL) permits the board of directors of a Delaware corporation to "declare and pay dividends upon the shares of its capital stock . . . either (1) out of its surplus . . . or (2) in case there shall be no such surplus, out of its net profits for the fiscal year in which the dividend is declared and/or the preceding fiscal year."[14] Section 154 of the DGCL provides: "The excess, if any, at any given time, of the net assets of the corporation over the amount . . . determined to be capital shall be surplus. Net assets means the amount by which total assets exceed total liabilities."[15] Thus, in Delaware, a dividend may be paid only out of the excess ("surplus") of total assets over the sum of total liabilities plus "capital," defined in section 154 of the DGCL as being not less than the aggregate par value of shares with par value.

Par value has always been a totally arbitrary number. Par value may have been invented as a means to promote "equitable contribution" among shareholders, i.e., the concept that the amount contributed by each stockholder to the corporation should bear the same proportion to the total contributions by all stockholders to the corporation as the number of shares received by that stockholder bears to the total number of shares issued by the corporation to all stockholders.[16] It may also be easily imagined that par value and stated capital, together with laws prohibiting dividends or other payments to stockholders that "impair" capital (i.e., result in a decrease in the assets of a corporation to a number less than the sum of its liabilities plus stated capital), were a convenient means of assuring creditors that some irreducible core of assets would remain in the corporation as a cushion to insure that the creditors were paid.[17] In short order, the management and directors of corporations found that they could skirt the legal capital requirements by issuing stock with low par value or even no par value. In many states, this development required amendment of the applicable corporation statutes, many of which prescribed a minimum par value per share.

By the time corporations and state legislatures arrived at the idea of low

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14. DEL. CODE ANN. tit. 8, § 170(a) (Supp. 1994). For some of the many interpretive problems arising out of this language, see BAYLESS MANNING & JAMES J. HANKS, JR., LEGAL CAPITAL 84 n.34 (3d ed. 1990).

15. For treatment of senior liquidation preferences in Delaware, see DEL. CODE ANN. tit. 8, § 170(a) (Supp. 1994). The relevant discussion is located in the next-to-last sentence.

16. *See* MANNING & HANKS, *supra* note 14, at 17, 22-24.

17. *Id.* at 24-25.

par or no par stock, creditors realized—if they had not realized it already—that there were more effective ways of protecting their interests—e.g., covenants and default provisions in the loan documents, adequate collateral—than par value and stated capital. At about the same time, it became clear to most observers that the concept of equitable contribution among stockholders did not make much sense either. Equitable contribution worked fairly well so long as all stockholders were investing in the corporation at about the same time. Once the corporation had been in existence for a little while, however, par value—the amount that the original stockholders had invested—might be more than the amount at which new stockholders would be willing to buy a new share of stock or less than the amount at which the corporation would be willing to sell a new share of stock.

Indeed, in the well-known case of *Handley v. Stutz*,[18] the Supreme Court faced the question whether an economically distressed corporation may issue new stock at less than its par value. The Court, in an opinion by Justice Brown, responded with the entirely sensible conclusion, anticipating later law-and-economics theory, that the corporation is entitled to sell its stock for whatever price it can negotiate:

> The wholesome doctrine, so many times enforced by this court, that the capital stock of an insolvent corporation is a trust fund for the payment of its debts, rests upon the idea that the creditors have a right to rely upon the fact that the subscribers to such stock have put into the treasury of the corporation, in some form, the amount represented by it; but it does not follow that every creditor has a right to trace each share of stock issued by such corporation, and inquire whether its holder, or the person of whom he purchased, has paid its par value for it. It frequently happens that corporations, as well as individuals, find it necessary to increase their capital in order to raise money to prosecute their business successfully, and one of the most frequent methods resorted to is that of issuing new shares of stock and putting them upon the market for the best price that can be obtained; and so long as the transaction is *bona fide*, and not a mere cover for "watering" the stock, and the consideration obtained represents the actual value of such stock, the courts have shown no disposition to disturb it. Of course no one would take stock so issued at a greater price than the original stock could be purchased for, and hence the ability to negotiate the stock and to raise the money must depend upon the fact whether the purchaser shall or shall not be called upon to respond for its par value.[19]

18. 139 U.S. 417, 429 (1890).
19. *Id.* at 430.

In other words, the Court concluded that it is preferable for a corporation to be able to sell its stock for something—even a price lower than par value—than to fail for lack of funds to the detriment of stockholders and creditors alike.[20] With that realization, par value was effectively decoupled from the contribution by a stockholder to the corporation for her stock.

Most LLC statutes have followed, intentionally or not, the RMBCA in jettisoning both par value and stated capital. For example, the Maryland LLC statute sensibly provides that a member of an LLC is obligated to do whatever he agrees to do in the articles of organization or the operating agreement with respect to contributing cash or property or performing services, even if the member dies or becomes disabled.[21] The LLC's remedies against a defaulting member may be set forth in the operating agreement and may include reduction of the member's interest in the LLC, subordination of his interest to those of the nondefaulting members or forfeiture of his interest.[22] As for distributions, the Maryland LLC statute adopts the "equity solvency" and "balance sheet solvency" tests of RMBCA section 6.40(c).[23]

The Maryland LLC statute defines "capital contribution" as "anything of value that a person contributes as capital to the limited liability company in that person's capacity as a member, including cash, property, services rendered or a promissory note or other binding obligation to contribute cash or property or to perform services."[24] However, with some sensible, flexible provisions permitting the parties to tailor their own arrangements for contributions to the LLC and distributions by it, this definition is almost irrelevant. Indeed, the word "capital," which is part of the definition of "capital contribution," is not itself defined.

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20. For further discussion of this case, including its role in the eventual marginalization of par value, see MANNING & HANKS, *supra* note 14, at 27, 49-50.

21. MD. CODE ANN., CORPS. & ASS'NS § 4A-502(a)(1) (1993).

22. *Id.* § 4A-502(c).

23. Specifically, the Maryland statute provides:

> A distribution may not be made if, after giving effect to the distribution:
>
> (1) The limited liability company would not be able to pay its debts as they become due in the usual course of business; or
>
> (2) The limited liability company's total assets would be less than the sum of its total liabilities plus, unless the operating agreement permits otherwise, the amount that would be needed, if the affairs of the limited liability company were to be wound up at the time of the distribution, to satisfy any preferential rights which are superior to the rights of members receiving the distribution.

Id. § 4A-503(a).

24. *Id.* § 4A-101(f).

Although par value and stated capital are gradually receding both as statutory and economically relevant concepts, limits on authorized stock remain not only significant but central to corporation law. So far as is known, every state corporation statute requires some limit on the number of shares of stock that a corporation may issue and requires that this limit be set forth in the corporation's charter.[25] Even the RMBCA has not abandoned authorized stock limits. Section 6.01(a) of the RMBCA requires the articles of incorporation to "prescribe the classes of shares and the number of shares of each class that the corporation is authorized to issue."[26]

From the earliest days of corporations in this country, there has been some prescription of the number of shares of stock that a corporation could issue. In 1783, when The Proprietors of the Susquehanna Canal were incorporated by special act, as was typical until the early 19th century, the General Assembly of Maryland provided that the 20,000 pounds "current money of Maryland . . . shall be divided into twenty shares . . . but no person shall be allowed to subscribe to more than one share, nor less than one fifth of a share."[27] Surveying the special acts of incorporation, one commentator observed:

> In almost all of the special acts of incorporation, the State specified the amount of capital stock which had to be subscribed before the company should be incorporated and could function. Sometimes the minimum capital was also the maximum, but very frequently a larger sum could be raised by the sale of shares. When an increase in the capital stock was permitted, the State specified the maximum capital and generally prescribed the method by which the additional stock should be issued. A reduction in capital stock or an alteration in the par value of the shares required an amendment to the charter.[28]

It is easy to imagine that in the early days of corporations Parliament and the state legislatures desired some limit on the amount of funds that could be raised by the incorporators. Most early corporations were formed for

25. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(a)(4) (1991); N.Y. BUS. CORP. LAW § 402(a)(4) (McKinney 1986).

26 RMBCA § 6.01(a) (1984).

27. 1783 Md. Laws ch. XXIII, §V.

28 JOSEPH G. BLANDI, MARYLAND BUSINESS CORPORATIONS 1783-1852, at 33 (1934) (footnotes omitted). One of the omitted footnotes states: "The American Telegraph Company seems to be the only concern which had no limit placed upon its total capital stock. Laws of Maryland, 1847, ch. 28." *Id.* at 33 n.9.

singular purposes and not for the general conduct of business.[29] It is logical that legislators, in England and in the young United States, should have preferred some limit on the amount of money eligible to benefit from the rights conferred on the incorporators and the entity. That does not explain, however, the need for a limit on the number of shares into which the aggregate authorized capital could be divided. Perhaps the legislators were seeking to be sure that only a relatively wealthy person would be able to purchase a single share—possibly a reaction to the South Sea bubble of the early eighteenth century[30] and other financial disasters. Or perhaps because monopolies and exclusive licenses were often granted to early corporations,[31] the legislators did not want them to become too strong. As Professor Berle once observed, "our great grandfathers had not the slightest intention of allowing these fictitious collective persons to roam the world, possessing indefinite wealth, or to dominate the commercial industrial scene."[32]

It is easy in the late twentieth century to forget that the corporation was not always as common and widely accepted as it is today. In *Louis K. Liggett Co. v. Lee*,[33] Justice Brandeis reflected on the early perception of corporations:

> The prevalence of the corporation in America has led men of this generation to act, at times, as if the privilege of doing business in corporate form were inherent in the citizen; and has led them to accept the evils attendant upon the free and unrestricted use of the corporate mechanism as if these evils were the inescapable price of civilized life and, hence, to be borne with resignation. Throughout the greater part of our history a different view prevailed. Although the value of this instrumentality in commerce and industry was fully recognized, incorporation for business was commonly denied long after it had been freely granted for religious, educational and charitable purposes. It was denied because of fear. Fear of encroachment upon the liberties and opportunities of the individual. Fear of the subjection of labor to capital. Fear

29. Adolph A. Berle, Jr., *Historical Inheritance of American Corporations*, 3 SOCIAL MEANING OF LEGAL CONCEPTS 189, 191-99 (1950) (discussing the origins of the American corporation).

30. The "South Sea bubble" refers to a period of enormous speculative inflation during the 1730s brought on by the actions of the South Sea Corporation. *Id.* at 194.

31. "A second objective in securing a franchise was, in the case of turnpikes, and later canals and railroads, to enable a group of entrepreneurs to share in the state's power to take land for public purposes, although as the growing separation between public and private enterprises became clearer, this power was challenged at every step of the way." MORTON J. HORWITZ, THE TRANSFORMATION OF AMERICAN LAW 1780-1860, at 116 (1977).

32. Berle, *supra* note 29, at 196.

33. 288 U.S. 517 (1933).

> of monopoly. Fear that the absorption of capital by corporations, and their perpetual life, might bring evils similar to those which attended mortmain. There was a sense of some insidious menace inherent in large aggregations of capital, particularly when held by corporations. So, at first, the corporate privilege was granted sparingly; and only when the grant seemed necessary in order to procure for the community some specific benefit otherwise unattainable. The later enactment of general incorporation laws does not signify that the apprehension of corporate domination had been overcome. The desire for business expansion created an irresistible demand for more charters; and it was believed that under general laws embodying safeguards of universal application the scandals and favoritism incident to special incorporation could be avoided. The general laws, which long embodied severe restrictions upon size and upon the scope of corporate activity, were, in part, an expression of the desire for equality of opportunity.[34]

Nineteenth century judicial opinions reflected some of these concerns about unrestricted freedom for corporations to issue shares of stock. In *Mechanics' Bank v. New York & New Haven Railroad Co.*,[35] the capital stock of the defendant railroad "was limited to $3,000,000, to be divided into shares of $100 each."[36] In the opinion by Judge Comstock, the court held that the plain meaning of the charter language restricted the number of shares that could be issued.[37] Rather than just resting on the plain meaning of the language of the charter, however, Judge Comstock explained that:

> The owner of each share was entitled to a fixed and unalterable proportion of that capital. And from this it follows, that any attempt to create a greater number of shares, by the issue of additional certificates, is not only a violation of the organic law of the corporation, but a direct invasion of the contract between it and each holder of its stock. Now, while it cannot be denied that the value of every share may be reduced by misfortune or accident in the management of the business of the corporation, or by the

34. *Id.* at 548-49 (Brandeis, J., dissenting) (footnotes omitted).

35. 13 N.Y. (3 Kernan) 599 (1856).

36. *Id.* at 617.

37. *Id.* Judge Comstock explained the limitation as follows:

> Now, if it is plain, as all concede, that the capital could not be increased beyond the $3,000,000, it seems to me equally plain that no more than thirty thousand shares could be created. Both are unalterably fixed by the charter; the capital by expressing the aggregate amount, and the number of shares by expressing the amount of each. The whole capital is divided into shares of $100 each, and the mathematical result is thirty thousand in all.

Id The court refused to recognize any "more capacity to increase the nominal capital by multiplying the shares to an indefinite extent." *Id.*

neglect and misconduct of its agents acting within their acknowledged powers, it is equally plain that this result cannot be effected by a change in the fixed proportion which each share bears to the aggregate number.[38]

In other words, according to Judge Comstock, the purpose of the authorized stock limit was to protect stockholders against dilution—a concern that had given rise to the judicial invention of preemptive rights in 1807 in *Gray v. Portland Bank*.[39] In that case, Judge Sewall wrote:

> In viewing a corporation of this kind as a co-partnership, a power of increasing their stock, reserved in the original agreement [act of incorporation], is a beneficial interest vested in each partner, to which no stranger can be made a party, but by the consent of each subsisting partner; and it is a power which the subsisting partners must exercise proportionately, and according to their interest in the original stock.[40]

Judge Sewall then went on to state an alternative ground for his holding: the corporation is a trust in which the corporation is the trustee and each stockholder a beneficiary, in which the trustee has no power "to create another interest for the benefit of other persons than those concerned in the original trust, or for their benefit in any other proportions than those determined by their subsisting shares."[41] Nevertheless, Judge Sewall specifically recognized that: "It is clear that a power of that kind might be given, but not by the limitation supposed, which plainly relates to one and the same stock."[42] For the purpose of deciding the case before him, however, Judge Sewall held: "A share in the stock or trust . . . is a share in the power of increasing it . . . ."[43] Thus, the number of authorized shares fixed in the charter was a limit for the protection of the stockholders and only they could increase it.[44]

38. *Id.* at 617-18.

39. 3 Mass. 364 (1807).

40. *Id.* at 378.

41. *Id.* at 379. The judicially created doctrine of preemptive rights has gradually been overturned by statutes in many states providing that stockholders do not have preemptive rights unless the articles of incorporation specifically so provide. *E.g.*, DEL. CODE ANN. tit. 8, § 102(b)(3) (1974 & Supp. 1994); General Assembly of Maryland, House Bill 748 (1995 Session) (amending MD. CODE ANN., CORPS. & ASS'NS §§ 2-205(a), 2-105(a)(10) (effective Oct. 1, 1995)).

42. *Gray*, 3 Mass. at 379.

43. *Id.*

44. Viewing the corporation as a trust, however, ignores the role of the board of directors as overseers of the business of the corporatiion with duties running to the corporation that ultimately benefit the stockholders. Judge Sewall failed to make clear why a decision to issue shares of stock is different from any other decision entrusted to directors.

At one time, corporation statutes limited the dollar amount of capital that could be raised by corporations. Justice Brandeis noted: "Limitation upon the amount of the authorized capital of business corporations was long universal. The maximum limit frequently varied with the kinds of business to be carried on, being dependent apparently upon the supposed requirements of the efficient unit."[45] Gradually, these statutory restrictions disappeared but, unaccountably, the requirements for limitations on authorized stock remained.

The survival of limits on the number of authorized shares appears to be a historical anomaly. The persistence of these limits apparently derives from the fact that the number of authorized shares, along with the par value per share, which together yielded the maximum aggregate capital of the early corporations,[46] was almost invariably one of the terms of a charter granted by Parliament or the early state legislatures. Therefore, the number of authorized shares could not be varied except by amending the legislative act.[47]

As the general acts of incorporation began to replace the practice of forming corporations by special legislative acts, the new corporation statutes, like the special acts of incorporation, required that a maximum number of shares and a specified par value per share be stated in each corporation's articles of incorporation. As the power to amend charters passed from the legislatures to the stockholders, it is easy to see how the power to change the number of authorized shares of stock and the par value per share passed with it. It is likely that no one thought that these terms should be treated differently from any other terms required or permitted to be included in the corporation's charter. For example, in *Railway Co. v. Allerton*,[48] the charter provided for capital stock of $100,000, which "may be increased from time to time, at the pleasure of the said corporation."[49] The directors claimed the right, without stockholder approval, to increase the capital stock on the ground that it was within the powers of the

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45. Louis K. Liggett v. Lee, 288 U.S. 517, 550 (1933) (Brandeis, J., dissenting).

46. Low par stock and capital surplus had not yet been developed.

47. See New York & New Haven R.R. Co. v. Schuyler, 34 N.Y. (Tiffany VII) 30, 49 (1865), in which the court states:

> A corporation with a fixed capital divided into a fixed number of shares can have no power of its own volition, or by any act of its officers and agents, to enlarge its capital or increase the number of shares into which it is divided. The supreme legislative power of the State can alone confer that authority . . . and hence every attempt of the corporation to exert such a power, before it is conferred, by any direct and express action of its officers is void . . . .

48. 85 U.S. (18 Wall.) 233 (1873).

49. *Id.* at 234.

corporation and that they were charged with the exercise of those powers. Faithfully reflecting the stolid jurisprudence of the mid-nineteenth century, Justice Bradley held for the Supreme Court that:

> [A] change so organic and fundamental as that of increasing the capital stock of a corporation beyond the limit fixed by the charter cannot be made by the directors alone, unless expressly authorized thereto. The general power to perform all corporate acts refers to the ordinary business transactions of the corporation, and does not extend . . . to an enlargement of its capital stock.[50]

By 1881, the Supreme Court, in an opinion by Justice Woods citing the *Mechanics' Bank*, *Schuyler*, and *Allerton* cases, declared that "it is well settled that a corporation has no implied power to change the amount of its capital as prescribed in its charter, and that all attempts to do so are void."[51]

Thus, for over a hundred years, it has been well accepted that a change in the number of authorized shares of stock must be approved not only by the directors but also by the stockholders. So far as is known, the general corporation statute of every state codifies this principle by requiring that the number of authorized shares be stated in the charter and by requiring stockholder approval of charter amendments.[52] As we have seen, these requirements apparently grew out of provisions contained in the early special acts of incorporation.[53] Very little attention has been given to the wisdom of continuing to require the charter to specify a maximum number of authorized shares that may be changed only with stockholder approval.

In fact, there are good reasons to abandon this hoary descendant of the special acts of incorporation. First, a limit on the number of authorized shares of stock serves no useful purpose that is not already served more effectively through other means. The only arguable reason for a ceiling on the number of shares of stock that may be issued by a corporation is to protect the existing shareholders against dilution of their percentage of outstanding stock. However, control of the power to issue shares is typically vested in the board of directors. For example, section 6.21(b) of the RMBCA provides that "[t]he board of directors may authorize shares to be issued for consideration consisting of any tangible or intangible

50. *Id.* at 234-35.

51. Scovill v. Thayer, 105 U.S. 143, 148 (1881); *see also* Cass v. Manchester Iron & Steel Co., 9 F. 640, 642 (W.D. Pa. 1881).

52. *See, e.g.*, DEL. CODE ANN. tit. 8, § 102(a)(4) (1991); N.Y. BUS. CORP. LAW § 402(a)(4) (McKinney 1986).

53. *See supra* notes 46-47 and accompanying text.

property or benefit to the corporation . . . ."[54] Thus, the directors have plenary power to determine the price and other terms and conditions of the issuance of shares of the corporation's stock. It is the potential for *economic* dilution—issuance of shares for less than fair value (or other acts or omissions that result in decreasing the value of the corporation's equity)—that is typically of greater concern to the stockholders than the possibility that a rogue board of directors may issue shares of stock in excess of some arbitrary number. As the Official Comment to section 6.21 of the RMBCA sensibly observes:

> The price at which shares are issued is primarily a matter of concern to other shareholders whose interest may be diluted if shares are issued at unreasonably low prices or for overvalued property. This problem of equality of treatment essentially involves honest and fair judgments by directors and cannot be effectively addressed by an arbitrary doctrine establishing a minimum price for shares such as "par value" provided under older statutes.[55]

Likewise, the problem of protecting stockholders against the dilution of the value of their economic interest in the corporation will not be adequately solved by limiting the number of shares of stock that the corporation may issue.[56] The issuance of stock is but one of many corporate functions under the control of the directors. The hiring of the chief executive officer, the introduction of a new product line, or the closing of a plant are just a few of the risks that are within the power of directors.[57] In fact, misuse by directors of powers already long conferred on them can have far greater impact on the value of the stockholders' investment than the effect of dilution arising from an increased number of issued shares. If these decisions turn out badly, they may erode the value of the stockholders' investment. If directors are trusted with these types of major decisions, as they routinely are, it is not necessary to place some limit on the number of shares they may authorize to be issued.

54. RMBCA § 6.21(b) (1984).

55. *Id.* § 6.21(b) cmt.

56. The limit on authorized stock has been viewed by one court as sufficiently inconsequential that a provision in a corporate charter authorizing an indefinite number of shares, while not "exactly conform[ing] to law," was held not to be "a condition precedent to the existence of the corporation itself." Lord v. Essex Bldg. Ass'n, 37 Md. 320, 326-27 (1873).

57. *See* RMBCA § 8.01(b) (1984) (stating that "[a]ll corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation or in" an authorized shareholder agreement).

The best protection for maintenance and enhancement of stockholders' investment is the board of directors. The power to elect good directors and remove bad ones belongs to the stockholders.[58] This imposes a significant limitation on any inclination of the directors to issue stock on terms and conditions not likely to be viewed favorably by the stockholders. Moreover, directors are subject to various statutory and judicial standards of conduct, the violation of which may expose them to personal liability.[59]

Second, limits on the number of authorized shares of stock impose excessive burdens and costs. With the typical publicly traded corporation, the process of amending its charter is long and costly and, therefore, is not undertaken lightly. The board of directors must approve the charter amendment and submit the matter to a meeting of stockholders.[60] If the annual stockholders' meeting is not due to be held within the succeeding few months, a special meeting must be called.[61] A proxy statement must typically be drafted, reviewed, submitted to the Securities and Exchange Commission (SEC), reviewed by the SEC staff, revised, resubmitted, and mailed to stockholders.[62] This part of the process alone can easily consume several weeks. Often a proxy solicitation firm must be retained to beat the bushes for stockholder votes. Typically, the vote requirement for a charter amendment will be two-thirds of the votes entitled to be cast, which will generally amount to a much larger percentage of the votes actually cast. The stockholders meeting itself must then be held.[63] If the meeting is a special rather than an annual meeting, additional costs will be incurred for this purpose. Finally, articles of amendment must be executed and filed.[64] This laborious process is then periodically repeated as the corporation issues shares over time and gradually depletes its reserve of unissued stock. As a result, many corporations, confronted with having to

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58. *Id.* §§ 8.04, 8.08; DEL. CODE ANN. tit. 8, § 211(b) (1991).

59. For example, section 8.30(a) of the RMBCA requires each director to act:

(1) In good faith;
(2) with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
(3) in a manner he reasonably believes to be in the best interests of the corporation.

RMBCA § 8.30(a) (1984).

60. *Id.* § 10.03(b)(1).

61. *Id.* § 7.02(a)(1) (discussing special meetings).

62. *See* HENN & ALEXANDER, *supra* note 1, § 196 (discussing proxies and the costs involved in proxy fights); *id.* § 297 (discussing SEC regulation of proxies); *see also* RMBCA § 7.22 (1984) (dealing with proxy regulations).

63. *See generally* RMBCA §§ 7.01, 7.07 (1984) (discussing shareholders meetings).

64. *Id.* § 10.06.

set some limit on their authorized stock, pick an extremely high number of authorized shares, e.g., one billion or more, in order to avoid having to come back to the stockholders again and again.[65]

In the case of a privately held corporation, the charter amendment process is, of course, much simpler. Often, the directors and stockholders are able to act by written consent and file the charter amendment the same day or in a very short period of time.[66] However, in privately held corporations, where the need for protection against dilution may be greatest, it is also possible, as discussed below, to protect stockholders against dilution in ways other than relying on ceilings on authorized stock.

When a corporation has an insufficient number of authorized but unissued shares of stock, it bears an additional burden beyond the actual costs of the charter amendment process. The corporation may be foreclosed from pursuing an advantageous business opportunity—e.g., a stock-for-stock acquisition or merger—if the time requirements for negotiating and consummating the transaction do not allow for the extended process of charter amendment.

Third, there are other more effective and less costly means of protecting stockholders against dilution than arbitrarily limiting the number of shares that the corporation may issue. As noted above, the desire to protect stockholders against dilution of their percentage of stock ownership is most likely to be present and significant in a closely held corporation. There, the burdens of amending the charter are far less onerous than in the case of a publicly held corporation. Thus, a limit on the number of shares of authorized stock may serve as a relatively effective means of preserving the economic relationship among stockholders.

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65. Thus, it is common for the number of issued and outstanding shares of stock to be a low percentage, often under 50%, of the number of authorized shares of stock. For example, according to their latest Forms 10-Q filed with the Securities and Exchange Commission, the following Fortune 50 corporations had the following numbers of authorized shares and issued and outstanding common shares of stock:

Corporation	Authorized Shares	Issued and Outstanding Shares
Chrysler Corporation	1,000,000,000	364,100,000
ConAgra, Inc.	1,200,000,000	252,828,935
Hewlett-Packard Company	600,000,000	254,229,000
Digital Equipment Corporation	450,000,000	142,746,524
Bristol-Myers Squibb Company	1,500,000,000	532,711,881

This being the case, it is difficult to see how a limit on authorized stock provides much protection against dilution.

66. RMBCA § 7.04 (1984) (allowing shareholders to act by written consent providing that all decisions are unanimous).

There are, however, other techniques that also offer protection to stockholders against dilution. These include preemptive rights, a unanimity requirement for action by the board of directors to issue new shares, and an agreement among stockholders on economic and corporate governance issues, including future stock issuances. Each of these techniques is likely to be more effective in preventing dilution than a limit on authorized stock, unless that limit is also the same number as the number of issued and outstanding shares, in which case the corporation is foreclosed from other possibly beneficial moves such as granting incentive stock options to employees.

Fourth, a growing number of noncorporate forms of business association have refrained—perhaps because they are descended from different historical antecedents than corporations[67]—from requiring any limitation on the number of shares or units of equity that may be issued by the entity. As noted earlier, the LLC statute in Maryland contains no limit on the aggregate capital contributions that may be made to the LLC by its members or on the number of units of interest that may be issued by the entity.[68] Other states' LLC statutes are similar in this regard.[69] Likewise, neither the Revised Uniform Partnership Act nor the Revised Uniform Limited Partnership Act requires a general partnership or a limited partnership, respectively, to limit the amount of capital or the number of partnership units.[70] Business trust statutes, which have been enacted by several states in the past decade, typically do not limit the number of shares or units of beneficial interest that may be issued by the trust.[71] Section 2-105(c) of the Maryland General Corporation Law permits the board of directors of a Maryland corporation "that is registered or intends to register as an open-end company under the Investment Company Act of 1940 . . . to increase or decrease the aggregate number of shares of stock or the number of shares of stock of any class that the corporation has authority to

67. *See supra* notes 27-53 and accompanying text.

68. *See supra* notes 21-24 and accompanying text.

69. *See, e.g.*, DEL. CODE ANN. tit. 6, § 18-201 (Supp. 1994).

70. *See* REVISED UNIF. PARTNERSHIP ACT § 202 (1993); REVISED UNIF. LTD. PARTNERSHIP ACT § 201 (1985).

71. *See* DEL. CODE ANN. tit. 12, § 3801(a) (Supp. 1994) (defining "business trust" but not specifying the number of shares that must be issued); N.Y. GEN. ASS'NS LAW § 2(2) (McKinney 1942) (defining "business trust" and requiring that beneficial interests be divided into shares represented by certificates, but not limiting the number of shares issued); *see also* HENN & ALEXANDER, *supra* note 1, §§ 58-67 (discussing business trusts generally).

issue," unless the charter provides otherwise.[72]

Finally, abandoning limits on authorized stock would avoid the possibility of an overissuance of stock and all of the many consequent problems of overissuances, including invalidly issued shares and possibly invalid actions by stockholders. Thus, the conventional state law requirement that a corporation specify in its charter a limit on the number of shares of stock that it may issue is a historical anomaly in the development of forms of business association. State legislatures should follow the wise example of LLC, limited partnership, and business trust statutes, among others, and abandon the unnecessary and often burdensome requirements that limit the number of shares of stock that corporations may issue.[73] Even in the absence of such a requirement, nothing would prevent a corporation from adopting such a limit if its stockholders wished. As an intermediate step, a legislature could amend its existing authorized stock requirement to provide that a corporation may include in its charter—either in the original articles or by amendment—a provision that the board of directors may increase the number of authorized shares of stock, without a vote of the stockholders, by filing supplementary articles with the secretary of state or other appropriate state official.[74]

Either type of statute would free corporations from a requirement that has long since lost any useful purpose that cannot be served by other more targeted means and, for many corporations, has become a needlessly time-consuming and costly obstacle to financing and expanding the enterprise.

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72. MD. CODE ANN., CORPS. & ASS'NS § 2-105(c) (1993).

73. For states, like Delaware, that base their franchise tax on authorized capital, some other tax basis, e.g., issued capital, would have to be found. For states, like Maryland, that have no franchise tax, this would not be a problem.

74. The General Assembly of Maryland recently enacted legislation permitting the declaration of trust of a real estate investment trust formed in Maryland to authorize its board of trustees to increase or decrease the number of authorized shares of beneficial interest (without a vote of shareholders). General Assembly of Maryland, House Bill 749 (1995 session) (amending MD. CODE ANN., CORPS. & ASS'NS § 8-202(b)(2) (effective Oct. 1, 1995)).