

SHARE CHARACTERISTICS UNDER THE NEW CORPORATION STATUTES

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INTRODUCTION

Over the past thirty years, many states have substantially revised their general business corporation statutes.¹ This development has reflected a realization that previously existing statutes were unsuited to the requirements of the modern corporation and, because they were unsuitable, had induced businessmen to incorporate elsewhere and to do business as a foreign corporation in the state which, except for its obsolete laws, should have been the situs of incorporation.²

The manner in which these revisions have been effected has depended primarily upon the starting point taken by the committee assigned to the task in the particular state. All but two of the nine corporation statutes which have been revised since 1950 have been patterned after the Model Business Corporation Act prepared by the Committee on Corporate Laws of the American Bar Association.³ The Maryland revision was based upon many sources, particularly its existing corporation statutes, but also the statutes of other states and the Model Act. The Ohio revision was based primarily upon the earlier corporation statutes of that state. Other states that are considering revision of their corporation statutes, however, appear to be inclining to the Model Act.⁴

Section fourteen of the Model Act provides that authorized shares may be divided into one or more classes and permits great latitude with respect to such share characteristics as voting, par value, preferences on liquidation, dividends, redemption of shares, convertibility, and pre-emptive rights. Each of the new statutes which has

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¹ See Garrett, *Model Business Corporation Act*, 4 BAYLOR L. REV. 412, 416 (1952), for a list of the statutes revised during the years 1927-51. Since 1950, the following states have adopted revised general business corporation statutes: District of Columbia (1954), Maryland (1951), North Carolina (1955), North Dakota (1957), Ohio (1955), Oregon (1953), Texas (1955), Virginia (1956), and Wisconsin (1951).

² The North Carolina Business Corporation Act, as proposed to the Legislature, contained a provision intended to prevent avoidance of its corporation statutes by making their provisions applicable to pseudo-foreign corporations doing business in North Carolina. A pseudo-foreign corporation was defined as ". . . a foreign corporation which . . . obtains . . . a certificate of authority to transact business in this State and which engages in no substantial business activity in the state or country of its incorporation, and which, by virtue of the place and character of its business and personnel, is more closely identified with the business life of this State than with that of any other state or country. . . ." N.C. S.B. No. 49, § 55-2(11) (1955). Because of the vagueness of its language as well as its novelty, the Legislature omitted this provision in adopting the Act. See Powers, *Drafting a Corporation Code for North Carolina*, 10 ARK. L. REV. 37, 44 (1955).

³ The Model Business Corporation Act was first widely-publicized in *Business Lawyer*, Nov. 1950, No. 1. It has since been published as a handbook by the Committee on Continuing Legal Education of the American Law Institute in its 1950 form, and, with revisions, it has been republished in 1953 and 1955.

⁴ See Garrett, *supra* note 1, at 425.

followed the Model Act has directly adopted section fourteen;⁵ and those which have not, contain a comparable provision which affords similar leeway with respect to share characteristics.⁶ This article will proceed to examine the new statutory provisions relating to the more important share characteristics.

I

VOTING

A. Generally

Under the Model Act, each outstanding share of stock is entitled to one vote on each matter submitted to a vote at a meeting of the shareholders, but voting rights may be limited or denied to any class by the articles of incorporation to the extent not prohibited by the Act.⁷ Under that Act, the matters as to which voting rights cannot thus be limited or denied are mergers or consolidations;⁸ sales, leases, mortgages, and other dispositions of all or substantially all assets not in the regular course of business;⁹ voluntary dissolution;¹⁰ revocation of voluntary dissolution proceedings;¹¹ and amendments to the articles of incorporation substantially affecting the shares of any class.¹² On all of these important matters, corporate action requires a two-thirds vote of all issues and outstanding shares. And in the case of an amendment to the articles of incorporation¹³ or a merger or consolidation¹⁴ substantially affecting the shares of a class, a two-thirds vote of that class is also required.

The pattern of the Model Act with respect to voting rights has been followed in each of the jurisdictions which has based its revised corporation statute thereon, but in all cases, there has been some variation. Many of these new statutes differ from the Model Act with respect to the percentage of vote required for various corporate actions.

The Texas statute requires¹⁵ a four-fifths vote for all action requiring a two-thirds vote under the Model Act,¹⁶ except amendments to the articles of incorporation, which require a two-thirds vote,¹⁷ and mortgages and pledges of assets not in the regular course of business, which may be authorized by action of the board of directors.¹⁸ Although Texas, in adopting this requirement, has merely adhered to

⁵ D.C. CODE ANN. § 29-908 (Supp. 1956); N.C. GEN. STAT. § 55-40 (Supp. 1955); N.D. LAWS 1957, c. 102, § 12; ORE. REV. STAT. § 57.080 (Supp. 1955); TEX. BUS. CORP. ACT, art. 2.12 (1956); VA. CODE ANN. §§ 13.1-12, 13.1-13 (Supp. 1956); WIS. STAT. § 180.12 (1955).

⁶ OHIO REV. CODE ANN. § 1701.06 (Page Supp. 1956); MD. ANN. CODE art. 23, § 14 (1951).

⁷ MODEL BUSINESS CORPORATION ACT §§ 14, 31.

⁸ *Id.* § 67.

⁹ *Id.* § 73.

¹⁰ *Id.* § 77.

¹¹ *Id.* § 82.

¹² *Id.* § 53.

¹³ *Id.* § 55.

¹⁴ *Id.* § 67.

¹⁵ For the Texas provision as to voting generally, see TEX. BUS. CORP. ACT art. 2.29 (1956).

¹⁶ *Id.* art. 5.03 (as to merger or consolidation), *id.* art. 5.10 (as to sales, leases, exchanges, and other dispositions, other than mortgages and pledges, of all or substantially all assets), *id.* art. 6.03, 6.08 (as to dissolution and revocation of dissolution).

¹⁷ *Id.* arts. 4.02, 4.03.

¹⁸ *Id.* art. 5.10, as amended, Tex. Acts 1957, c. 54, § 9. As originally adopted, this provision required an eighty per cent shareholder vote for mortgages, but this was found to be too burdensome and

its prior statutory standard, such a high percentage vote would appear to be unnecessarily strict and unduly burdensome. Stockholder inertia alone in a publicly-held corporation might suffice to prevent corporate action which requires an eighty per cent affirmative vote. If it were considered desirable to retain the eighty-per-cent-approval requirement for important action, it might have been preferable to have prereduced only a two-thirds vote, while giving a veto power to votes of twenty per cent cast in opposition. At least this would have put the burden on the opposition. Since dissenters' rights are available in each case where the eighty per cent vote is required, however, even such a veto power is probably unnecessary, as the potential cash drain from dissents would in most cases serve as an effectual deterrent to an unpopular plan.

North Carolina, adhering to its pre-existing statutory standard, has reduced to a majority the vote required for a merger or consolidation¹⁹ or an amendment of the articles of incorporation.²⁰ This reduction can be justified on the theory that the availability of dissenters' rights in these situations affords adequate protection to those shareholders who may feel themselves prejudiced thereby. In any case, it would seem to make little difference whether the vote requirement is two-thirds or a majority, as experience indicates that plans seldom fail because of inability to muster the statutory minimum. The real limiting factor is rather the threat to working capital posed by dissenters' rights of appraisal.

The District of Columbia statute has departed from the Model Act provision by requiring a class vote for a merger, whether or not the merger would effect a substantial change in the securities of such class.²¹ This is the antithesis of the philosophy embodied in the New York²² and Delaware²³ statutes, which do not even require a class vote where the rights of a class of shares would be substantially affected by the merger or consolidation. These latter statutes rather rely on dissenters' rights to guarantee adequate protection against changes adversely affecting a particular class.

In certain states, the requirement that all shareholders be granted a vote on a particular action has been changed to specify that only those shareholders entitled to vote under the articles of incorporation may vote. In Wisconsin²⁴ and the District of Columbia,²⁵ this has been done with respect to sales, mortgages, and pledges of all assets in other than the regular course of business. Under the Ohio statute, only shareholders entitled to vote under the articles of incorporation may vote with regard to amendments, mergers or consolidations, sales of assets, and dissolution.²⁶ In the same vein, North Carolina, Texas, and Virginia have eliminated the require-

was changed by amendment in the 1957 legislative session to its present form. See Carrington, *Experience in Texas with the Model Business Corporation Act*, 5 UTAH L. REV. 292, 302 (1957).

¹⁹ N.C. GEN. STAT. § 55-107 (Supp. 1955).

²⁰ *Id.* § 55-101.

²¹ D.C. CODE ANN. § 29-927c (Supp. 1956).

²² N.Y. STOCK CORP. LAW §§ 51, 86.

²³ DEL. CODE ANN. tit. 8, § 251 (1953).

²⁴ WIS. STAT. § 180.71 (1955).

²⁵ D.C. CODE ANN. § 29-928 (Supp. 1956).

²⁶ OHIO REV. CODE ANN. §§ 1701.06, 1701.71, 1701.76, 1701.79, 1701.86 (Page Supp. 1956).

ment of a shareholder vote in connection with mortgages or pledges of assets.²⁷ Since the board of directors, without shareholder action, can create other indebtedness, which, upon a default and prosecution to judgment may become a lien on the corporation's assets, there would not appear to be any real reason for otherwise inhibiting the execution of a direct mortgage or pledge of assets to secure such indebtedness.²⁸

Several of the new statutes have added dissenters' rights with respect to matters where dissenters are not accorded such rights under the Model Act. The Model Act provides for the right of dissent only in connection with mergers, consolidations, and sales or exchanges of assets.²⁹ The North Carolina statute, however, has added dissenters' rights with respect to amendments to the certificate of incorporation which substantially affect a class of equity securities which is preferred as to dividends or on liquidation.³⁰ And the Ohio statute has a substantially identical provision.³¹ But in so providing, these statutes impair a corporation's ability to reclassify its shares when such action is desirable or even necessary for purposes of reorganization. Thus, if a corporation seeks to reorganize by reclassifying a preferred class of its equity securities, the availability of dissenters' rights might constitute such a cash-drain potential as to prevent, as a practical matter, the effectuation of the plan.

In eliminating the right afforded by section fifty-three of the Model Act, by amendment to the articles of incorporation to cancel or otherwise affect the right of holders of shares to receive cumulative dividends which have accrued but have not been declared, the District of Columbia statute may raise a similar problem.³² During the 1930's, many corporations sought to eliminate accrued dividend arrearages in this manner.³³ Since the existing statutes did not specifically authorize this technique, the courts held, in a number of instances, that such accrued undeclared dividends were vested rights and could not be so divested.³⁴ Consequently, they declared void reorganization plans which sought to reclassify shares to eliminate accrued dividends or to capitalize them by the issuance of shares in return therefor. To circumvent this obstacle, corporations subsequently resorted to mergers with wholly-owned subsidiaries, a technique that was sanctioned by the courts.³⁵ Statutory provisions permitting amendment of the articles of incorporation to reclassify

²⁷ N.C. GEN. STAT. § 55-112 (Supp. 1955); TEX. BUS. CORP. ACT art. 5.09 (1956); VA. CODE ANN. § 13.1-77 (Supp. 1956).

²⁸ See Carrington, *supra* note 18, at 304.

²⁹ MODEL BUSINESS CORPORATION ACT §§ 71, 74.

³⁰ N.C. GEN. STAT. § 55-101 (Supp. 1955).

³¹ OHIO REV. CODE ANN. § 1701.74 (Page Supp. 1956).

³² D.C. CODE ANN. § 29-921f (Supp. 1956).

³³ See Barnhart, *Recent Trends in Corporation Legislation*, 10 ARK. L. REV. 12, 22 (1955).

³⁴ *E.g.*, Keller v. Wilson, 21 Del. Ch. 391, 190 Atl. 115 (Sup. Ct. 1936); Film Industries v. Johnson, 22 Del. Ch. 407, 197 Atl. 489 (Sup. Ct. 1937). *Contra*, McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945).

³⁵ Havender v. Federal United Corp., 24 Del. Ch. 318, 11 A.2d 331 (Sup. Ct. 1940); Holtenstein v. York Ice Machinery Corp., 136 F.2d 944 (3d Cir. 1943).

shares in order to eliminate accrued dividend arrearages,³⁶ however, obviate this problem; but any plan of reorganization involving the elimination of such arrearages must be fair and equitable,³⁷ giving an equivalent in return therefor. Failure to adopt the portion of section fifty-three of the Model Act permitting such elimination of arrearages, will therefore, resurrect the problem which the Model Act had sought to cure.

The original draft of the Model Act, patterned after the Illinois statute,³⁸ provided that each share of stock was entitled to one vote in all matters, and the right to vote was subject to abridgment only in the case of junior stocks where preferred dividends were in arrears.³⁹ It was felt, however, that the Illinois statutory provision was unnecessarily stringent. Thus, it would have prevented the issuance of non-voting preferred stocks, a fairly traditional security, and, it would have deprived the corporation of flexibility in other situations where equity financing without disturbing control is the object. For example, in the recent trend toward restricted stock option plans, closely-held corporations have sought to grant to officers and key employees the tax benefits of restricted stock option plans, without giving them a voting security. This has been done through the issuance of options on nonvoting shares. A strict statutory provision as to voting rights, such as that of Illinois, would not have permitted this. Accordingly, the Model Act was altered to its present form in 1953.

The Model Act provision restricting mandatory voting to important matters has been a real step forward in providing both flexibility and sufficient shareholder safeguards. The new statutes patterned after the Model Act apparently have found its general provisions sufficiently palatable to warrant substantial adoption. Except for the adherence by Texas to its *sui generis* high vote requirement, the inclusion of dissenters' rights upon amendments of the articles of incorporation by North Carolina, and the omission by the District of Columbia of the right to amend the articles of incorporation by a two-thirds vote to eliminate accrued dividend arrearages, the changes imported into the Model Act by the various jurisdictions that have embraced it do not appear to have disturbed its basic philosophy.

B. Cumulative Voting

The 1953 revision of the Model Act made cumulative voting for the election of directors compulsory.⁴⁰ Among the alternative provisions introduced in the 1955 revision, however, was one making cumulative voting optional.⁴¹ The compulsory provision has not been adopted in any of the states whose new statutes are patterned after the Model Act, except North Dakota,⁴² which has a constitutional

³⁶ E.g., MD. ANN. CODE art. 23, § 10(9) (1951).

³⁷ See Barnhart, *supra* note 33, at 24.

³⁸ ILL. REV. STAT. c. 32, §§ 157.14, 157.28 (1955).

³⁹ See Harris, *The Model Business Corporation Act—Invitation to Irresponsibility?*, 50 NW. U. L. REV. 1, 12 (1955).

⁴⁰ MODEL BUSINESS CORPORATION ACT § 31.

⁴¹ Alternative provisions are set forth in COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT, REVISIONS AND OPTIONAL SECTIONS (1955).

⁴² N.D. LAWS 1957, c. 102, § 30.

provision requiring cumulative voting. Texas, Virginia, Oregon, and the District of Columbia provide that the articles of incorporation may permit cumulative voting.⁴³ In North Carolina and Ohio, cumulative voting is also permitted, but for it to apply to a particular election of directors, appropriate notice must be given by the shareholder desiring it.⁴⁴ In originally providing only the compulsory cumulative-voting provision, the draftsmen of the Act were of the opinion that minority representation should be preserved under all circumstances;⁴⁵ but after further reflection, they appear to have changed their minds and now offer the alternative provision without recommendation.⁴⁶

In thirteen states, cumulative voting is constitutionally required; it is made mandatory by statute in six other states; and twelve states have permissive provisions with respect thereto.⁴⁷ In making cumulative voting permissive rather than mandatory, the recently-adopted statutes have conformed to the majority view of states in which the matter is not regulated by a constitutional provision.

The compulsory cumulative-voting alternative provision of the Model Act is, to some extent, modified by section thirty-five, which provides that when a board of directors consists of nine or more members, it may be divided into two or three classes, each of which may be elected on a staggered basis, so that only a portion of the whole board is elected annually. In states which constitutionally require cumulative voting, a problem will be raised as to whether or not this statutory provision may be adopted. Thus, in *Wolfson v. Avery*,⁴⁸ the court held that the Illinois statutory provision permitting the classification of directors conflicted with the constitutional requirement. In other states having this constitutional requirement, however, the question is still open, and some corporations there continue to classify their boards of directors, regardless. Until a decision is rendered in the matter in these states, such boards of directors will prove to have *de facto* rather than *de jure* status if it is finally determined that such classification is invalid. The precise wording of the constitutional requirements is not the same in each of these states, however, and it may be that the courts will distinguish the *Wolfson* case and uphold classified boards. It may be significant in this connection that in spite of its constitutional requirement of cumulative voting for directors,⁴⁹ North Dakota has adopted the Model Act provision permitting classification of directors,⁵⁰ its legislature apparently recognizing no conflict.

By limiting the classifications to only two or three and by limiting the power to

⁴³ TEX. BUS. CORP. ACT art. 2.29D(2) (1956); VA. CODE ANN. § 13.1-32 (Supp. 1956); ORE. REV. STAT. § 57.170(4) (Supp. 1955); D.C. CODE ANN. § 29-911 (Supp. 1956).

⁴⁴ N.C. GEN. STAT. § 55-67 (Supp. 1955); and OHIO REV. CODE ANN. § 1701.55 (Page Supp. 1956).

⁴⁵ Preface to 1950 revision at p. vi, contained in COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT (1953).

⁴⁶ See Carrington, *A Corporation Code for Texas*, 10 ARK. L. REV. 28, 33 (1955).

⁴⁷ See Commissioners' Note following MODEL BUSINESS CORPORATION ACT OF 1928, 9 U.L.A. 108 (1951).

⁴⁸ 6 Ill.2d 78, 126 N.E.2d 701 (1955).

⁴⁹ N.D. CONST. § 135.

⁵⁰ N.D. LAWS 1957, c. 102, § 35.

classify to boards having more than nine members, the Model Act, to some extent, dampens the effect of classification. But classification, nevertheless, effectively frustrates, at least partially, the purpose of the cumulative voting requirement. For instance, if the board of directors consisted of nine and all were elected at one election, it would take ten per cent of the vote plus one vote to elect one director. If the board were classified so that only three were elected at a time, however, it would take twenty-five per cent of the vote plus one to elect one director.⁵¹

C. Miscellaneous Provisions Relating to Voting

Under section 136 of the Model Act, which has been adopted by each jurisdiction patterning its act after the Model Act, a greater vote may be required by the articles of incorporation with respect to particular action than is specified by the statute for such action. This provision was intended to overrule those cases which have, in certain instances, cast doubt on the validity of such articles.⁵² It can prove particularly useful in meeting the needs of closely-held corporations, which may be regarded as incorporated partnerships.⁵³

Section thirty-two, likewise adopted in each such jurisdiction, authorizes the creation of voting trusts limited to a ten-year period. A copy of the voting-trust agreement must be deposited with the corporation and must be open to examination by shareholders and holders of an interest in the voting-trust agreement at all times.

Certain other provisions of the Model Act, fixing the voting status of particular persons in specified instances and the manner in which voting may be conducted, have also been adopted by the jurisdictions following the Model Act.⁵⁴ These provisions make it clear that treasury shares are not entitled to vote; that voting may be accomplished by proxy, but proxies are not valid after eleven months, unless otherwise provided in the proxy; that shares held by the corporation in another corporation may be voted, specifying the person who may vote them on behalf of the corporation; and that the pledgor votes pledged shares until they are transferred into the name of the pledgee. They also cover the voting status of fiduciaries and trustees. Other provisions relate to notice requirements, record dates, closing the transfer books, quorum requirements, and taking action by unanimous written consent instead of voting at meetings. By clarifying procedures and voting status, those provisions eliminate uncertainties which experience has shown would otherwise exist.

II

PRE-EMPTIVE RIGHTS

The Model Act provides that the pre-emptive right of a shareholder to acquire unissued or treasury shares may be limited or denied to the extent provided in the

⁵¹ See Note, 50 NW. U. L. REV. 112 (1955); CHARLES M. WILLIAMS, CUMULATIVE VOTING FOR DIRECTORS 48 (1951).

⁵² Jones v. St. Louis Structural Steel Company, 267 Ill. App. 576 (1949).

⁵³ See Latty, *The Closed Corporation and the New North Carolina Business Act*, 34 N.C.L. REV. 432, 444 (1956).

⁵⁴ MODEL BUSINESS CORPORATION ACT §§ 27, 28, 30, 31, 138.

articles of incorporation. If the articles do not originally so provide, the corporation, by amendment procedures, including a class vote by the class or classes of shares having pre-emptive rights, may amend its articles of incorporation to limit, deny, or grant such pre-emptive rights.⁵⁵ Unless otherwise provided in the articles of incorporation, any corporation may sell its shares to its officers or employees or to officers or employees of any subsidiary, without first offering such shares to its shareholders, if the terms of the option are approved by the holders of two-thirds of each class of shares entitled to vote thereon or by its board of directors pursuant to like approval of shareholders. The Model Act does not define the term "pre-emptive rights," but leaves it to the common law. It does, however, specify that pre-emptive rights apply to treasury shares, although this is not true at common law.

These provisions have been adopted almost verbatim in North Dakota,⁵⁶ Oregon,⁵⁷ Texas,⁵⁸ and the District of Columbia.⁵⁹ The District of Columbia, however, has deleted the reference to treasury shares. Wisconsin did not adopt the provision for the limitation of pre-emptive rights in connection with sales of shares to employees.⁶⁰

The states of Virginia and North Carolina also have departed in a substantial way from the Model Act provisions in defining pre-emptive rights and the particular situations in which they are applicable. The Virginia statute limits these rights to unissued shares and clarifies their status in certain other contexts. Thus, pre-emptive rights do not apply to shares issued for services or property or to shares issued to officers or employees pursuant to a plan approved by the shareholders; the holders of shares preferred as to dividends and assets are not entitled to pre-emptive rights for shares of any class; the holders of common stock are not entitled to pre-emptive rights as to shares preferred and limited as to dividends or assets; and the holders of nonvoting common stock are not entitled to pre-emptive rights as to common stock. The articles of incorporation may, however, confer pre-emptive rights where not provided by the statute. And if a package is offered consisting of common stock and other securities, it is not contemplated that pre-emptive rights will apply.⁶¹

Under the North Carolina statute, pre-emptive rights apply to treasury shares, but, as is also the case under the Virginia statute, they are otherwise limited to circumstances under which they would be available at common law.⁶² The North Carolina provision relating to pre-emptive rights was based on the comparable Ohio statute⁶³ and resembles it particularly in that it provides a definition of pre-emptive rights and covers pre-emptive rights with respect to convertible securities and options.

⁵⁵ *Id.* §§ 24, 53, 55. Alternative provision is set forth in COMMITTEE ON CORPORATE LAWS, AMERICAN BAR ASSOCIATION, MODEL BUSINESS CORPORATION ACT, REVISIONS AND OPTIONAL SECTIONS (1955).

⁵⁶ N.D. LAWS 1957, c. 102, §§ 23, 54.

⁵⁷ ORE. REV. STAT. §§ 57.136, 57.355, 57.365 (Supp. 1955).

⁵⁸ TEX. BUS. CORP. ACT arts 2.22, 4.02, 4.03 (1956).

⁵⁹ D.C. CODE ANN. §§ 29-908; 29-921f, 29-922 (Supp. 1956).

⁶⁰ WIS. STAT. §§ 180.21, 180.50 (1955).

⁶¹ VA. CODE ANN. § 13.1-23 (Supp. 1956), and comment thereon of the Code Commission appointed to draft the statute.

⁶² N.C. GEN. STAT. § 55-56 (Supp. 1955).

⁶³ OHIO REV. CODE ANN. §§ 1701.15, 1701.22 (Page Supp. 1956).

Under the North Carolina and Ohio statutes, it is expressly provided that pre-emptive rights do not apply to shares issued to satisfy conversion or option rights, but the issuance of securities convertible into shares or options to purchase shares of a class which has pre-emptive rights requires approval by a two-thirds vote of that class, which vote operates as a waiver of its pre-emptive rights.⁶⁴ On the other hand, under the New York Stock Corporation Law, it is expressly provided that convertible securities and options are subject to pre-emptive rights and that these rights may be satisfied by first offering the convertible security or option to stockholders.⁶⁵ At common law in some jurisdictions, too, pre-emptive rights apply to convertible securities⁶⁶ and may be satisfied by giving existing shareholders having such rights the right of first refusal with respect thereto prior to their issuance. Apparently the Model Act leaves the resolution of these matters to the common law.

During recent years, convertible debentures have become a popular method of financing. Also, in connection with underwritings, particularly in the case of small corporations, options have been granted in lieu of cash payment to underwriters. It would seem, therefore, that to the extent that these new statutes have clarified the status of pre-emptive rights with respect to convertible securities and stock options, they have effected a significant improvement.

The North Carolina and Ohio statutes also specifically provide for the waiver of pre-emptive rights in particular cases by two-thirds vote.⁶⁷ The Model Act, by expressly referring to waiver in the case of employee stock-option plans, gives rise to the implication that waiver in other instances by a specified vote is not possible, unless otherwise authorized by the articles of incorporation. Of course, a procedure which could be followed under the Model Act would be to amend the articles of incorporation so as to provide for the limitation of pre-emptive rights in particular instances by a specified vote of shareholders, and to obtain a vote for limitation with respect to a particular issue involved.

It is understood that the draftsmen intend to revise the provisions of the Model Act with respect to pre-emptive rights. In so doing, they may follow the North Carolina statute in defining what is meant by pre-emptive rights. With respect to options and convertible securities, they may follow the North Carolina and Ohio statutory provisions, which deny pre-emptive rights in connection therewith, or the New York statutory provision, which recognizes these rights and specifies the means of satisfying them.

⁶⁴ N.C. GEN. STAT. §§ 55-44, 55-56 (Supp. 1955); OHIO REV. CODE ANN. §§ 1701.15(D) and (E), 1701.16, 1701.22 (Page Supp. 1956).

⁶⁵ N.Y. STOCK CORP. LAW § 39.

⁶⁶ See HENRY W. BALLENTINE, CORPORATIONS 491 (1946).

⁶⁷ N.C. GEN. STAT. § 55-56(c)(6) (Supp. 1955); OHIO REV. CODE ANN. § 1701.15 (Page Supp. 1956).

III

PAR VALUE

Under the Model Act, corporations have complete freedom of action in determining whether shares will have par value or not and if so, how much par value will be.⁶⁸ In addition, by amendment, which requires a class vote, there is complete freedom to increase or decrease par value, or to change from par to no par value, or vice versa.⁶⁹ The concept of par value affects the stated capital and capital surplus of the corporation, both of which are defined terms under the Model Act.⁷⁰ Shares having a par value may not be issued for a lesser consideration, which, to that extent, becomes stated capital of the corporation; the excess, if any, over par value becomes capital surplus, which the board of directors is free to transfer wholly or partially to stated capital, as it wishes. Shares without par value, on the other hand, may be issued for such consideration as the board of directors may fix, unless the articles of incorporation reserve this determination to the shareholders. The entire amount of consideration thus received becomes stated capital. Directors, however, within sixty days after the issuance of shares without par value, may allocate to capital surplus not more than twenty-five per cent of the consideration received from their sale. In the case of shares without par value having a preference in voluntary liquidation, a further limitation is imposed, in that not more than the excess over the amount of this preference may be designated as capital surplus.⁷¹

When payment of the consideration for which shares are to be issued has been received by the corporation, the shares are deemed to be fully-paid and nonassessable, and the stockholder has no obligation to the corporation or its creditors with respect thereto.⁷²

Upon the issuance of shares having par value as dividend, a transfer to stated capital of an amount equal to such par value is required. In the case of a stock dividend of shares without par value, the transfer to stated capital of an amount fixed by the board of directors is required.⁷³ A stock split-up or subdivision, on the other hand, does not require such transfer to capital. Par value also constitutes a limitation on the extent to which shares without par value may be converted into shares with par value, as the stated capital of the corporation represented by the shares without par value is required to be at least equal to the aggregate par value of the shares into which the shares are to be converted.⁷⁴

Each of the revised statutes which has been patterned after the Model Act has followed its structure with respect to provisions governing par, no par, and low par value shares, the consideration required for their issuance, and the accounting procedure to be observed.⁷⁵ Under the North Carolina and District of Columbia

⁶⁸ MODEL BUSINESS CORPORATION ACT § 14.

⁶⁹ *Id.* §§ 53, 55.

⁷⁰ *Id.* § 2(j) and (m).

⁷¹ *Id.* §§ 17, 19.

⁷² *Id.* § 40(d).

⁷³ *Id.* §§ 16, 23.

⁷⁴ *Id.* § 14(e).

⁷⁵ D.C. CODE ANN. §§ 29-908, 29-908c, 29-908d, 29-908e, 29-908f, 29-922 (Supp. 1956); ORE. REV. STAT. §§ 57.080, 57.100, 57.106, 57.111, 57.131, 57.355, 57.365 (Supp. 1955); WIS. STAT. §§ 180.12,

statutes, however, the board of directors is permitted to allocate to paid-in surplus more than twenty-five per cent of the consideration received for shares without par value.⁷⁶ The rationale of this departure is that since par value shares may have an insignificant par value, there is no reason for limiting the proportion of the consideration paid for no par value shares that may be allocated to paid-in surplus. The North Carolina statute also makes it clear that par value shares are fully-paid, although issued at a discount representing underwriting compensation.⁷⁷

A variation from the Model Act in the Virginia statute permits corporations to sell par value shares for less than par.⁷⁸ The provision was derived from Virginia's previous statute, and in line therewith, "stated capital" for par value shares is limited to the consideration received for their issuance up to par value, unless the directors dedicate any excess to stated capital.⁷⁹ Shareholder liability is limited to payment of the full consideration for which the shares were to be issued, and upon its receipt by the corporation, the shares are deemed fully-paid and nonassessable, unless there has been fraud or the stock statement filed with the State Corporation Commission of Virginia does not properly reflect valuation of any property or of services for which the stock was issued.⁸⁰

As will be discussed more fully below, application in the statutes of the defined terms "stated capital" and "capital surplus," together with the term "earned surplus" and in some cases other defined terms, affects the corporation's right to make distributions, to pay dividends, and to acquire its own shares. The concept of par value, through its effect in this connection, is, thus, an important one.

IV

PREFERENCES ON LIQUIDATION AND AS TO DIVIDENDS

Under section fourteen of the Model Act, a corporation, by so providing in its articles of incorporation, may create shares that entitle their holders to preferences over other classes in the assets of the corporation upon its voluntary or involuntary liquidation. This section also permits the establishment of both preferences as to dividends and the right to cumulative and noncumulative or partially cumulative dividends. Preferred classes or special classes of shares may be issued in series which must be identical, except for dividend rates, terms of redemption, amounts payable on voluntary and involuntary liquidation, sinking-fund provisions, and circumstances under which convertibility, if any, is authorized.⁸¹ Such terms may be fixed by the board of directors, if this is so authorized by the articles of incorporation. By amend-

180.14, 180.15, 180.16, 180.50, 180.52 (1955); N.D. LAWS 1957, c. 102, §§ 12, 15, 16, 18, 54, 56; TEX. BUS. CORP. ACT arts. 2.12, 2.15, 2.16, 2.17, 2.21, 4.01, 4.03 (1956); VA. CODE ANN. §§ 13.1-12, 13.1-17, 13.1-18, 13.1-55 (Supp. 1956); N.C. GEN. STAT. §§ 55-40, 55-46, 55-47, 55-99 (Supp. 1955).

⁷⁶ D.C. CODE ANN. § 29-908e (Supp. 1956); N.C. GEN. STAT. § 55-47(b)(2) (Supp. 1955).

⁷⁷ N.C. GEN. STAT. § 55-46(c)(2) (Supp. 1955).

⁷⁸ VA. CODE ANN. § 13.1-17 (Supp. 1956).

⁷⁹ *Id.* § 13.1-18.

⁸⁰ *Id.* § 13.1-22.

⁸¹ MODEL BUSINESS CORPORATION ACT § 15.

ment of the articles of incorporation, a corporation may create new classes of shares which may be senior or junior to existing classes and may effect reclassifications, changes, and exchanges of its shares.⁸² Where a senior class is created, however, a class vote is required.⁸³

The Model Act contains no requirement that dividends be paid. It does, however, permit payment of preferred dividends in circumstances where payment of other dividends is not permitted. Dividends, except stock dividends and dividends payable out of depletion reserves by a wasting-assets corporation, may be paid only out of the unreserved and unrestricted earned surplus of the corporation.⁸⁴ Under section forty-one, however, which covers distributions in partial liquidation, the board of directors of the corporation may distribute dividends to the holders of shares having a cumulative preferential right thereto out of the capital surplus, if the corporation has no earned surplus and is not insolvent at the time. Whenever such distribution is made, however, it must be identified as a payment out of capital surplus.

The Model Act protects liquidation preferences by preventing distributions to and acquisitions of shares which would reduce net assets below the amount of those preferences. Distributions in partial liquidation are, thus, prohibited where they would reduce the remaining net assets below the voluntary liquidation preference of any class of shares.⁸⁵ And purchases of other than redeemable shares and purchases in certain other specified circumstances may be made only out of earned surplus or, if the articles of incorporation so provide or if two-thirds of shareholders entitled to vote in the matter approve, out of capital surplus;⁸⁶ but redeemable shares may not be redeemed if this would reduce the corporation's net assets below the aggregate amount that would be payable to the holders of preferred shares upon involuntary liquidation.⁸⁷ Accordingly, the standard limiting the amounts which may be disbursed in dividends or distributed to or used for acquisitions of shares is the preferential amount to which preferred shares are entitled upon liquidation. The Model Act has been criticized, however, because this criterion permits the depletion of the stated capital of junior shares which would otherwise constitute a cushion of protection to the preferred shareholders.⁸⁸

If the par value of par value shares or the consideration received for no par value shares equals or exceeds liquidation preferences, the stated capital of junior shares, initially at least, affords added protection to the preferred stockholders' liquidation preference. There are various ways, however, in which this cushion can be depleted by corporate action, without approval of the preferred class. Thus, for example, a distribution to common stock in partial liquidation may be made under section:

⁸² *Id.* § 53.

⁸³ *Id.* § 55.

⁸⁴ *Id.* § 40.

⁸⁵ *Id.* § 41(d).

⁸⁶ Such other specified circumstances being to eliminate fractions, settle indebtedness to the corporation, or pay dissenting shareholders. MODEL BUSINESS CORPORATION ACT § 5.

⁸⁷ *Id.* § 60.

⁸⁸ Hackney, *The Financial Provisions of the Model Business Corporation Act*, 70 HARV. L. REV. 1357 (1957).

forty-one, without any vote, if the articles of incorporation so provide, to the full extent of the stated capital of the common stock in excess of liquidation preferences.

Also, by permitting acquisitions and redemptions of shares, the Model Act allows the corporation to reduce the security of preference shares by the stated capital of junior shares. Thus, if permitted by the provisions of the articles of incorporation, or with a vote of two-thirds of the shareholders entitled to vote (without any class vote) if not so permitted, junior shares may be purchased out of capital surplus from the sales of junior shares or even of the senior shares themselves.⁸⁰ Although, until the shares are canceled, use of the surplus represented by such shares is restricted with respect to any further purchases of shares, thereafter stated capital is reduced, and surplus is once again freed for further purchases. This permits the use of capital surplus as a revolving fund to reduce stated capital by director action alone, if the articles of incorporation so provide. By permitting the redemption of redeemable junior shares⁸⁰ out of stated capital or capital surplus, without any shareholder vote, so long as it does not reduce net assets below preferred share preferences, the Model Act also permits a reduction of stated capital, which affects the margin of security afforded to senior preferred shares by the stated capital of junior shares.⁸¹

The statutes patterned after the Model Act have, for the most part, also followed its structure with respect to provisions relating to authority to create classes of stock with preferences;⁸² and the North Dakota, Oregon, and Wisconsin statutes substantially follow the Model Act with respect to provisions relating to dividends, distributions, and acquisitions of shares as they relate to preferred dividends and the protection of liquidation preferences.⁸³ The District of Columbia, North Carolina, and Texas statutes, however, have departed from the Model Act with respect to these latter matters.

Under the North Carolina statute, all preferred shares are entitled to a dividend credit—the excess of earnings over dividends from the date of issuance—and until such credit is paid in full, no dividend can be paid on junior shares.⁸⁴ This constitutes a pressure on common stock to pay preferred dividends which does not exist under the Model Act, unless made a part of the share contract by the articles of incorporation. Possibly this is a desirable change, but it presupposes that in all circumstances, preferred holders desire ordinary income in the form of dividends. Under current tax laws, situations are certainly conceivable where this is not the case.

⁸⁰ MODEL BUSINESS CORPORATION ACT § 5. Capital surplus available for this purpose may be created by reduction of stated capital, either without charter amendment under section sixty-three or by charter amendment without a class vote (unless par value is affected) under section fifty-three.

⁸⁰ See *infra* 279-81 for discussion as to creation of redeemable common stocks.

⁸¹ MODEL BUSINESS CORPORATION ACT § 60.

⁸² D.C. CODE ANN. §§ 29-908, 29-908a (Supp. 1956); N.C. GEN. STAT. §§ 55-40, 55-41 (Supp. 1955); N.D. LAWS 1957, c. 102, §§ 12, 13; ORE. REV. STAT. §§ 57.080, 57.085 (Supp. 1955); TEX. BUS. CORP. ACT arts. 2.12, 2.13 (1956); VA. CODE ANN. §§ 12.1-12, 13.1-13, 13.1-14 (Supp. 1956); WIS. STAT. § 180.12 (1955).

⁸³ N.D. LAWS 1957, c. 102, §§ 5, 40, 41, 63; ORE. REV. STAT. §§ 57.035, 57.216, 57.221, 57.390 (Supp. 1955); and WIS. REV. STAT. §§ 180.38, 180.39, 180.385 (1955).

⁸⁴ N.C. GEN. STAT. § 55-40(c) (Supp. 1955).

The North Carolina statute also requires, upon demand of twenty per cent of a class of shares, payment of one-third of the corporation's net profits in a specified period as dividends in cash.⁹⁵ This provision, in addition to being subject to the above criticism, by not taking into account the corporation's working capital situation or the prevalence of covenants in debt instruments restricting dividends, may also prove to be impracticable from a business point of view.

The Oregon, Texas, District of Columbia, and North Carolina statutes have, moreover, departed from the Model Act to clarify provisions relating to dividends of corporations exploiting natural resources.⁹⁶ In each of these jurisdictions, this provision has been changed so as to emphasize that such dividends are payable out of net profits before deduction of depletion. The Texas statute, in addition, restricts the payment of dividends by wasting-assets corporations if all cumulative preferred dividends have not been fully paid or if such dividends, after provision for actual depletion fairly reflecting the decrease in value of assets from such depletion, would reduce net assets below preferential rights in voluntary liquidation. These provisions, in effect, make applicable to dividends paid by wasting-assets corporations the restrictions on distributions in partial liquidation of the Model Act relating to full payments in cumulative dividends and preservation of assets sufficient to meet liquidation preferences. Under the Model Act, this is left to the share contract of the preferred stock.

The second class of provisions introduced by the new statutes are those which have increased restrictions on distributions to and acquisitions of shares in order to protect liquidation preferences.

Under the District of Columbia statute, dividends may be paid out of paid-in or reduction surplus.⁹⁷ Distributions in partial liquidation may not be made, however, when net assets are less than stated capital and must be authorized by a two-thirds class vote.⁹⁸ Also, purchases of shares are restricted where they would reduce the net assets below the sum of stated capital plus surplus other than earned surplus. Redeemable shares, however, may be purchased at a price not exceeding the redemption price, if this would not reduce the net assets below the amount which would be payable on liquidation to holders of shares having a senior or *pari passu* position and in the cases referred to in section five of the Model Act.⁹⁹

Under the Texas statute, dividends, other than stock dividends and dividends paid by wasting-assets corporations, may only be paid out of unreserved and unrestricted earned surplus.¹⁰⁰ Distributions in partial liquidation may be made out of capital surplus or surplus created by a reduction of capital and must be approved by a two-thirds vote of each class.¹⁰¹ Without such approval, however, dividends may

⁹⁵ *Id.* § 55-50(i).

⁹⁶ D.C. CODE ANN. § 29-917 (Supp. 1956); N.C. GEN. STAT. § 55-50(d) (Supp. 1955); ORE. REV. STAT. § 57.216 (Supp. 1955); TEX. BUS. CORP. ACT art. 2.39 (1956).

⁹⁷ D.C. CODE ANN. § 29-917(b) (Supp. 1956).

⁹⁸ *Id.* § 29-917a(d).

⁹⁹ *Id.* § 29-904a.

¹⁰⁰ TEX. BUS. CORP. ACT art. 2.38 (1956).

¹⁰¹ *Id.* art. 2.40.

be paid out of this surplus on shares having a cumulative preferential right thereto.¹⁰² Only shares having a liquidation preference may be redeemable by the corporation, and if such redemption is for an amount greater than the stated capital of the shares redeemed, the excess must be paid out of surplus. Purchases of shares out of unrestricted capital surplus or unrestricted reduction surplus, except in the case of redeemable shares and in the cases specified in section five of the Model Act, may be made only upon a two-thirds class vote of all shares of each class.¹⁰³

Under the North Carolina statute, dividends may be paid out of earned surplus or net profits for the preceding or current accounting period; but on preferred shares, dividends may be paid out of capital surplus if the corporation has no earned surplus, although capital surplus paid in by a senior class may not be used to pay dividends on a junior class.¹⁰⁴ Dividends are restricted if they would result in a reduction of net assets below the aggregate of the highest liquidation preferences of preferred stocks or if the "dividend credit" of preferred stocks has not been fully paid. Distributions on partial liquidation are permitted out of capital surplus and reduction surplus, but only upon a majority class vote. Purchases or redemptions when capital is impaired may be made only of redeemable shares, at prices not exceeding the redemption price, or in the cases specified in section five of the Model Act, or to perform repurchase agreements with employees, or by an open-end investment company to purchase its shares. Junior shares may not be purchased or redeemed when a default exists in the payment of accrued dividends or of the "dividend credit" on any senior shares. Ratable purchases out of surplus may be made of all holders of a class, without any vote of shareholders, or on an organized exchange, with the approval of a majority of the holders of the shares of the class purchased, or from any shareholder, upon vote of a majority of the holders of the shares of the class purchased and of the classes otherwise entitled to vote.¹⁰⁵

The Virginia statute is less stringent as to dividends, distributions, and acquisitions. Without a vote of shareholders, dividends may be paid out of capital surplus,¹⁰⁶ and purchases and redemptions of shares may be made out of capital surplus.¹⁰⁷

The variety of the statutory provisions, intended to protect liquidation preferences against dividends, distributions, and acquisitions of shares, raises a basic question as to what the status of preferred stock should be. Should the statutes merely restrict dividends, distributions, and acquisitions so that they do not reduce net assets below liquidation preferences, the standard adopted by the Model Act; or should preferred stocks be entitled to have the cushion of the stated capital of junior

¹⁰² *Id.* art. 2.12B(1).

¹⁰³ *Id.* art. 2.03.

¹⁰⁴ N.C. GEN. STAT. § 55-40 (Supp. 1955). Permitting the payment of dividends out of net profits for the preceding or current accounting periods, while seemingly liberal, does directly what can be done indirectly by a reduction of capital. Combining this provision with the "dividend credit" and the requirement that dividends be paid if twenty per cent of a class so request, see notes 94 and 95, *supra*, gives preferred stockholders a strong position under the North Carolina statute.

¹⁰⁵ *Id.* § 55-52.

¹⁰⁶ VA. CODE ANN. § 13.1-43 (Supp. 1956).

¹⁰⁷ *Id.* § 13.1-4.

stocks and surplus other than earned surplus protected against such dividends, distributions, and acquisitions? Under prevalent concepts, there is no necessary relationship between stated capital, capital surplus, and liquidation preferences, so that it is only in the case where such capital accounts exceed liquidating preferences that the latter type of protective provisions would be effective. North Carolina, Texas, and the District of Columbia have sought to protect stated capital and capital surplus by requiring approval by a class vote of shareholders on distributions to and acquisitions of junior shares from these sources. This type of provision gives to a holder of preferred stock rights which a creditor does not have, since without any creditor action, capital can be reduced to the minimum specified in the statutes, usually \$1,000, and distributions then can be freely made to stockholders down to that amount. The position of a holder of preferred stock is more precarious than that of a creditor. At a definite date, the corporation's obligation to a creditor becomes due, at which time he can pursue his remedies. This is not true as to preferred stocks, although preferred stock provisions usually include a sinking-fund requirement which produces the same result. Also, preferred stock provisions normally contain their own limitations on dividends, distributions, and acquisitions of shares and frequently reserve to holders the right to elect part of the board of directors when things are not going well.¹⁰⁸ The Model Act type of provision leaves a wide area for bargaining in fixing the terms of a preferred stock, but at the same time, it protects the actual amounts to which preferred shareholders are entitled in liquidation. This type of provision seems preferable to the more clumsy one which becomes operative only if the capital accounts happen to exceed liquidating preferences and which may prevent distributions and acquisitions of shares by the corporation, which would be advantageous to all concerned.

V

REDEMPTION

Section fourteen of the Model Act authorizes the creation of shares redeemable by the corporation. The terms and conditions governing redemption are among the matters which the board of directors may determine for a particular series, if so authorized by the articles of incorporation.¹⁰⁹ By amendment to the articles of incorporation, redeemable classes can be authorized.¹¹⁰ A corporation may purchase its redeemable shares out of earned or capital surplus without a shareholder vote,¹¹¹ but redeemable shares may not be purchased if the corporation is insolvent or the

¹⁰⁸ For a preferred stock to be listed on the New York Stock Exchange, it must provide for the right to elect at least two directors upon default in six quarterly dividends. NEW YORK STOCK EXCHANGE, COMPANY MANUAL § A-15 (1956). See also SEC Release No. 13106, Feb. 16, 1956, requiring preferred stocks issued by companies subject to the Public Utility Holding Company Act of 1935, 49 Stat. 803, 15 U.S.C. § 79 (1952), to provide the right to elect a majority of the board if dividends are in arrears for four quarters; and section 367 of the Regulations issued under the California Corporate Securities Law, having a similar requirement.

¹⁰⁹ MODEL BUSINESS CORPORATION ACT § 15.

¹¹⁰ *Id.* § 53.

¹¹¹ *Id.* § 5.

purchase would reduce its net assets below the amount payable in involuntary liquidation to the holders of shares having prior or equal rights.¹¹² Redemption cancels redeemable shares and, unless the articles of incorporation provide that they may not be reissued, restores them to the status of authorized but unissued shares.¹¹³ This automatically reduces stated capital upon the filing of a statement of cancellation with the secretary of state.

The statutes patterned after the Model Act generally follow its provisions relating to redeemable classes of stock,¹¹⁴ with the exceptions noted above under the heading "Preferences on Liquidation and as to Dividends" relating to circumstances under which redemptions and purchases of redeemable shares may be carried out. Under the Texas statute, however, only shares having a liquidation preference can be redeemed.¹¹⁵ But in other states, the authority to create redeemable shares is not so limited. This raises the question as to whether or not redeemable common stocks may be created. In *Starring v. American Hair & Felt Co.*,¹¹⁶ it was held that the words of the Delaware statute which granted corporations authority to make "preferred and special classes" of stock redeemable, did not contemplate common stock. In *Lewis v. H. P. Hood & Sons*,¹¹⁷ however, the Supreme Court of Massachusetts construed the similar Massachusetts statute as authorizing the creation of redeemable common stock. The argument that the creation of redeemable common stock was against public policy, in that it destroys the independence of stockholders, was met with the opinion that such redemption could not be exercised oppressively or for the purpose of discriminating against minority stockholders. Also, the court rejected the argument that the inherent nature of common stock is such as to be incompatible with a call provision. While there thus seems to be a division of view as to whether redeemable common stocks can be created, since common stock is normally intended to provide the permanent capital of the corporation, there would appear to be little hardship in Delaware's construction of its statute.

The North Carolina statute provides that the right of redemption must be at the option of the corporation,¹¹⁸ which is comparable to the California provision.¹¹⁹ Underlying this type of statute is the belief that stockholders should not have the option to compel redemption of their stock by the corporation at any particular time. Such an option would, it is argued, constitute a continuing threat to working capital and the cash position of the corporation, and, as a practical matter, it would most likely be exercised when the corporation was least able to pay. This theory, however, does not seem sound. After all, management negotiates the terms of any

¹¹² *Id.* § 60.

¹¹³ *Id.* § 61.

¹¹⁴ D.C. CODE ANN. §§ 29-908, 29-921f (Supp. 1956); ORE. REV. STAT. §§ 57.080, 57.355 (Supp. 1955); WIS. STAT. §§ 180.12, 180.50 (1955); N.D. LAWS 1957, c. 102, §§ 12, 54; VA. CODE ANN. §§ 13.1-13, 13.1-55 (Supp. 1956); TEX. BUS. CORP. ACT arts. 2.12, 4.01 (1956); N.C. GEN. STAT. §§ 55-40, 55-99 (Supp. 1955).

¹¹⁵ TEX. BUS. CORP. ACT art. 2.12B(1) (1956).

¹¹⁶ 21 Del. Ch. 380, 191 Atl. 887 (Ch.), *aff'd*, 22 Del. Ch. 394, 2 A.2d 249 (Sup. Ct. 1937).

¹¹⁷ 331 Mass. 670, 121 N.E.2d 850 (1957).

¹¹⁸ N.C. GEN. STAT. § 55-40 (Supp. 1955).

¹¹⁹ CAL. CORP. CODE § 1011.

stock, and presumably it is in a position to protect itself against injurious provisions. There may, in fact, be situations in which it would be advantageous from a tax or another viewpoint to grant a put to the shareholder. It would, therefore, seem preferable to leave the question of whether preferred stocks may be redeemable at the option of their holders to negotiation by the parties.

VI

CONVERTIBILITY

Under the Model Act, corporations have the power to create and issue shares convertible into shares of any other class; but, in order to prevent dilution of senior classes, shares may not be convertible into shares of a senior class, and the stated capital represented by no par value shares must be at least equal to the aggregate par value of shares into which they are convertible.¹²⁰ If the articles of incorporation so provide, the board of directors may fix the terms on which particular series of a class of shares may be converted.¹²¹ The stated capital of shares issued on conversion is the stated capital of the shares converted, plus the surplus transferred to stated capital, and any additional consideration paid to the corporation.¹²²

For the most part, the new statutes which have been based upon the Model Act substantially follow its provisions as to convertibility.¹²³ The District of Columbia statute, however, does not contain the provision prohibiting convertibility into senior shares.¹²⁴ And the Texas statute makes specific provision for including in the terms of convertible shares appropriate antidilution provisions for the protection thereof.¹²⁵

The North Carolina statute, in addition to covering convertible equity securities, includes provisions specifically authorizing the creation of debt securities convertible into capital stock.¹²⁶ Moreover, it provides that a corporation must show on its balance sheet the current conversion ratio of outstanding convertible securities and the price at which exercisable and, at all times, must reserve sufficient shares to meet the conversion rights. If such reservation is not made, the right to claim damages exists. And as has been pointed out above, the creation of securities convertible into a class of stock which has pre-emptive rights must be approved by the vote of two-thirds of the holders of such class.

Convertible securities have been popular in recent years because of their associated tax advantages. In the case of convertible debt securities, they afford the holder a fixed income and a creditor status until conversion. If the corporation does well, a capital gain can be realized either by sale of the debt security or by conversion into common stock and the sale of the common stock. The corporation gains

¹²⁰ MODEL BUSINESS CORPORATION ACT § 14.

¹²¹ *Id.* § 15.

¹²² *Id.* § 17.

¹²³ D.C. CODE ANN. §§ 29-908, 29-908a, 29-908c (Supp. 1956); N.D. LAWS 1957, c. 102, §§ 12, 13, 15; ORE. REV. STAT. §§ 57.080, 57.085, 57.100 (Supp. 1955); VA. CODE ANN. §§ 13.1-13, 13.1-14, 13.1-19 (Supp. 1956); WIS. STAT. §§ 180.12, 180.14 (1955); TEX. BUS. CORP. ACT arts. 2.12, 2.13, 2.15 (1956); N.C. GEN. STAT. §§ 55-40, 55-41, 55-44 (Supp. 1955).

¹²⁴ D.C. CODE ANN. § 29-908 (Supp. 1956).

¹²⁵ TEX. BUS. CORP. ACT art. 2.12 (1956).

¹²⁶ N.C. GEN. STAT. § 55-44 (Supp. 1955).

an advantage, too, in that pending absorption of the capital produced by sale of the convertible security and the resultant generation of additional earnings, the corporation can deduct interest as an expense. The rate of interest is lower because of the conversion feature. Also, during the period prior to the realization of additional earnings from capital expenditures made with such proceeds, the earnings per share of common stock do not become diluted. Because of the attractiveness of conversion, from both the point of view of the investor and the corporation, it is desirable that statutory provisions relating to convertibility be clarified. The North Carolina statute, by covering these matters, has made a desirable contribution.

CONCLUSION

A good corporate statute should confer maximum flexibility with respect to each share characteristic. A corporation should be permitted to grant, limit, or deny voting powers to particular classes, to grant preferences as to dividends and in liquidation, to make shares redeemable, and to create convertible securities. It should be enabled to make changes in its capital structure to meet the needs of growth, acquire assets by merger and consolidation, and reorganize if it becomes involved in difficulties. Such flexibility should be limited only by reasonable protective provisions. In order to be effectual, a corporate statute must be competitive with the statutes of other states. Otherwise, a state defeats its own purpose in revising its corporate statute, because ambiguity or unusual and impractical provisions will drive businessmen to incorporate elsewhere. The recent statutes, except possibly the Texas statute, solely because of its eighty-per-cent-vote requirement for particular matters, and the North Carolina statute, because of numerous novel provisions, seem adequately to meet the competition. The Model Act has provided an excellent starting point in its clarity, internal consistency, and flexibility. It is, indeed, a credit to its draftsmen that so many jurisdictions have followed it so closely in framing their new corporation statutes.