Corporate Finance--Chapter 1.5--Part I--Classes and Issues of Shares

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CORPORATE FINANCE

CHAPTER 1.5, PART I

CLASSES AND ISSUES OF SHARES

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Chapter 1.5 is concerned with financing and capitalizing the corporation. The first section specifies the manner in which the corporation may create shares of stock and authorizes it to separate the shares into different classes if desired and to fix their characteristics. Thus, it permits the creation of par value or no par value shares with different designations, preferences, limitations and relative rights.

The different characteristics and combinations of characteristics which the corporation may attach to its shares under the new act are virtually unlimited. Representative of the more important possibilities are common shares with full voting rights; non-voting common stock; preferred shares with no vote or a vote conditional upon a specified number of dividend defaults; shares preferred as to dividends which may or may not be cumulative and which may or may not be participating; shares which are preferred as to assets on liquidation; redeemable shares; and shares which are convertible into other shares or into debt securities of the corporation.

This flexibility which the act permits in the terms of securities is of course important in financing the public issue corporation because it enables the management to select and offer the type security which will be most attractive to the investing public at the time of the offering. But such flexibility is also important to the closely held corporation. For example, it may be important to a parent to have absolute voting control while for tax or other legitimate business reasons it is desirable for his children to receive the bulk of the profits. Under the act this could be accomplished by issuing to the parent all of the voting common stock and to the children either non-voting common or preferred.

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The important provisions of Section 12-15.1 are adopted almost verbatim from the Model Act.[1] They are similar to, but are clearer and more comprehensive than, the provisions of the statute presently in effect. The 1952 Code section 12-211 authorizes "one or more classes of capital stock" either par or no par. But this general provision is clouded by section 12-212 which authorizes a wide variety of preferences, rights, restrictions, etc. for *no par* "preferred capital stock." Thus, by implication, it seems that under the old law preferences, rights and restrictions may not be attached to shares having a par value. The new act makes no such distinction between par and no par preferred shares.

The provision of section 12-15.1 which is expected to be most subject to controversy is that "The articles of incorporation may grant, limit or deny the voting rights of the shares of any class to the extent not inconsistent with the provisions of this Act." This is a much needed clarification of the old statute. The 1952 Code section 12-253 provides that "each stockholder shall be entitled to one vote for each share of stock held or owned." By reason of this, there is serious question as to whether any class of shares can now be denied the right to vote on any corporate matter requiring stockholder action. The new statute removes this question by making it clear that voting rights may be denied.[2]

While the new act thus clears up the voting situation which exists under the old statute, there remains an important area in which it creates rather than removes confusion. For throughout the act it is provided, or at the least assumed, that a corporation may deny specified classes of its stock the right to vote in the election of directors. It frequently refers to the "shares entitled to vote to elect directors."[3]

In this respect there would seem to be a strong argument that the act runs counter to Article 9, Section 11, of the South Carolina Constitution, which is as follows:

1. MODEL BUS. CORP. ACT §14 (1953).
2. There is the limitation that the right to vote may be denied only "to the extent not inconsistent with the provisions of this Act." This quoted phrase relates to other sections which preclude the corporation from denying the holders of shares of any class a vote on mergers, consolidations, sales of assets, dissolutions and in connection with certain amendments to the articles of incorporation.
3. See S. C. CODE §§12-16.10(a)(2) (Supp. 1962); 12-16.1(d), and (e) (Supp. 1962).

Art. 9 §11. Election of officers of corporations.

The General Assembly shall provide by law for the election of directors, trustees or managers of all corporations so that *each stockholder* shall be allowed to cast, in person or by proxy, as many votes as the number of *shares* he owns multiplied by the number of directors, trustees or managers to be elected, the same to be cast for any one candidate or to be distributed among two or more candidates. (Emphasis added.)

Under the definitions contained in the act, it can hardly be denied that preferred shares of stock and non-voting common shares of stock are "shares" or that a holder of such stock is a "stockholder."[4]

It seems to be the assumption of the drafters of the act that the courts will not give a literal construction to the Constitutional provision; that is, that it will be construed not as making voting rights mandatory for every share of stock of every class — but merely as requiring cumulative voting for shares which by the articles of incorporation are given the right to vote for directors.

The validity of the act so far as it allows the creation of shares which are not entitled to vote for directors would seem to be too important to the act in its entirety to be made to hinge on such a doubtful outcome. The question should be clarified by Constitutional amendment or otherwise prior to the effective date of the act. For if it is held that the Constitution requires that every share of every class has the right to vote in the election of directors, then every provision of the act which refers to "the shares entitled to vote to elect directors" will have an unintended meaning. Moreover, confusion might result in corporations which have issued large numbers of what were believed to be non-voting shares.

Passing this problem we come to sections 12-15.2 and 12-15.3 which elaborate on the right of the corporation to classify its stock. The preceding section specified the right to provide for different classes of stock — such as common and

4. S. C. CODE §12-11.2 (Supp. 1962). Definitions.

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(e) "Shares" means the units into which the proprietary interests in a corporation are divided.

...

(g) "Shareholder" means one who is a holder of record of shares in a corporation.

...

preferred. Section 12-15.2 carries this a step further and permits the preferred classes to be divided into series. The two or more series in the same class may differ from each other in one or more of five specified ways; i. e., as to dividend rate, redemption, preference on liquidation, sinking fund and conversion. For example, a corporation may have Series A preferred stock not subject to redemption and which carries a 6% dividend, and Series B preferred, which is entitled to a 4% dividend and is subject to redemption and contains sinking fund provisions assuring such redemption.

Except as to these five variations, the shares of different series of a single class must be the same. Therefore, shares of one series could not have voting powers different from the shares of another series of the same class. Such a variation as this would require different classes.

Moreover, all of the shares of the same series must be identical.

This section is essentially the same as the Model Act. It is an improvement over our old corporation statute. Code section 12-212(4) provides that *no par* preferred stock may be issued in different series carrying different rates of dividends. The new act extends this right to par value preferred stock and permits other variations than rates of dividends.[5]

Under section 12-15.3 the stockholders may authorize a class of preferred stock and delegate to the directors authority to divide the class into series and fix their exact rights and terms.[6]

This provision is new to our law. Under the statute now in effect the stockholders must establish the terms of the stock. While this new provision will be of little benefit to the private or closely held corporation, it should prove useful to public issue corporations, where it is desired to raise funds through the sale of stock in the securities markets. Fre-

5. It might be noted that an apparent conflict of relatively minor importance appears between the provisions of §§12-14.3 and 12-15.2 in that the former section indicates that one series within a class may have par value and another series in the same class be no par stock while §12-15.2 seems to prohibit any such variation between series of the same class.

6. The caption indicates that the provisions of this section authorize the directors to "issue" shares of preferred or special classes of stock. This would seem to be misleading. The section does not authorize the directors to *issue* any shares; rather, it authorizes them, if so stated in the articles, to establish different series of a class which have already been provided for by the stockholders.

quently, it cannot be known in advance the terms which will make stock most attractive to prospective investors. This section will make it possible for the directors to act promptly in establishing the most significant terms of the issue just before the issue is marketed, thereby eliminating the delay which would be required in calling a stockholders' meeting to fix the terms of the stock.

Safeguards are provided in sections 12-15.2 and 12-15.3 which limit the authority which may be delegated to directors to determine the rights and preferences of the stock. First, as stated earlier, there are only five ways in which series may be varied; i. e., as to conversion, redemption, sinking fund, rights on liquidation and rate of dividend. Since the directors cannot tamper with voting rights, the possibility of abuse is greatly avoided. Moreover, once the directors have fixed the terms of a series and caused the stock to be issued, they are powerless to change the terms. Any such change would require stockholder action.[7]

Section 12-15.4 sets forth rules for determining various rights of preferred stockholders where the preferred certificate or contract is silent. If nothing more were known than that the stock is entitled to a preference for the payment of a dividend of a certain percentage of the par value, all of the other important characteristics would be automatically suppied by this section. That is, the dividends would be cumulative, the shares would not participate in profits beyond the amount of the fixed dividends, the shares would be preferred on liquidation to the extent of the par value plus accrued but unpaid dividends and no more, and the shares would not be entitled to vote except in specific instances, such as on mergers, sales of assets, etc.[8]

Neither the Model Act nor the statute now in effect contains any provision comparable to this. It is an innovation

7. As will be seen later in this discussion, §§12-19.1-19.9 authorize almost any conceivable change to be made in the terms of outstanding as well as unissued stock if desired by the holders of two-thirds of all outstanding shares and of the shares affected acting separately. Whatever may be said for or against thus permitting shares to be divested of some right to which they were entitled at the time they were issued without the unanimous consent of the shareholders affected, there can be little argument as to the wisdom of §12-15.3 which prohibits the directors from making any changes in shares after their issuance.

8. See note 2 with respect to the limitation set forth in the act on denying the right to vote and the discussion beginning on page 3 as to the possible effect of S. C. CONST. art. 9, §11, on denying the right to vote in the election of directors.

which should prove most helpful to our practicing bar. It sets forth in summary form the result of a substantial amount of American law on the subject. Moreover, the rules seem to reflect accurately what corporations normally intend to give in a preferred share and what investors normally expect to receive.

It should be emphasized that the statute does not require the preferred share contract to contain these provisions. Every one of the rules is expressly subject to variation by the terms of the contract; hence, the statute does not impose a straight jacket on, or inhibit originality in, preferred shares. Rather, it might be said to operate as a checklist of some of the more important features of the preferred share contract. It comes into play only if the contract is silent as to one or more of the five matters usually inserted in the contract.

Without this statutory guidepost it would be necessary to search a large body of case law in other jurisdictions — some of which is conflicting and much of which turns upon the precise language of the preferred shares involved in the case. It is hoped that this provision will achieve a degree of certainty not otherwise available. Finally, it should be helpful in foreclosing litigation on at least many typical questions (judging from reported cases from other jurisdictions) although, needless to say, no statutory provision can ever be litigation proof.

We come next to the subject of subscriptions,[9] which, although still important, has lost a good deal of its significance by reason of the omission from the new act of the requirement of mandatory pre-incorporation subscriptions.[10]

As in the 1952 Code section 12-55, the new act leaves it to the board of directors to determine whether subscriptions shall be paid in full or in installments, although calls must be uniform and non-preferential.

And the new act contains provisions similar to the old law with respect to the enforcement of subscriptions. The cor-

9. S. C. CODE §12-15.5 (Supp. 1962).

10. It may be of interest to note that there is disharmony between the 1952 Code, §12-58, which requires money, etc., to be paid in on subscriptions as a condition to acquiring a charter and §402(b) (10) of the South Carolina Uniform Securities Act which exempts pre-incorporation subscriptions from the registration requirements of the act *only if no payment is made.* The new corporation act removes this disharmony by not requiring pre-incorporation subscriptions and if there are any, not requiring payment thereon prior to the time the charter is issued.

poration may sue for the unpaid amount and effect collection by exercising its lien on the shares represented by the subscriptions.[11] This is in accord with the 1952 Code sections 12-101 and 12-102. And as under the old law, if the by-laws so provide, the corporation may have other remedies upon failure of the subscriber to pay a call when due, such as the right after specified notice to call for a forfeiture of the subscription and of all amounts previously paid.[12]

Neither the old statute nor the Model Act contains any requirement that subscriptions be in writing. Presumably they could be oral.[13] In this respect the new act departs from the old law and very wisely requires subscriptions to be in writing and signed by the subscribers. This should provide a degree of certainty not present in oral subscriptions and it is in consonance with the Federal and our State Securities Acts which by definition characterize subscriptions as securities.

What was initially declared to be the most important feature of section 12-15.5 and of the comparable Model Act section is the declaration that share subscriptions are to be irrevocable for a period of six months unless otherwise provided by the subscription agreement or unless all of the subscribers consent to the revocation of the subscription. For, in the absence of statute, a subscription is generally considered to be merely an offer to the corporation which can be revoked until accepted. Thus, such a provision as this in the old law would most certainly have gone a long way toward preventing some of the unfortunate situations which came about as a consequence of the requirement that fifty per cent of the authorized capital be subscribed before incorporation. Many times pre-organization subscriptions amounted to little more than options whereby the promoters

11. Apparently, in order for the corporation to have a lien on its shares, such lien must be stated on the certificate. For although §12-15.5 (d) expressly provides that "the corporation shall have a lien on the subscribed shares" for the unpaid amount of the subscriptions, §12-17.18 just as specifically provides that "There shall be no lien in favor of a corporation upon the shares represented by a certificate issued by such corporation unless the right of the corporation to such lien . . . is stated upon the certificate."

12. While subscription agreements providing for forfeiture in the event of default are permissible so far as the act is concerned, the South Carolina Securities Commissioner has refused on one occasion known to the writer to permit the *public* sale of stock on such basis.

13. See *Baker v. Mutual Loan and Inv. Co.*, 218 S. C. 47, 61 S. E. 2d 387 (1950), which assumed the validity of oral subscriptions.

acquired large blocks of stock representing the controlling interest in the corporation for a nominal consideration. However, with the abandonment of the requirement for pre-incorporation subscriptions, the irrevocability of subscriptions loses much of its significance. The new emphasis which has recently been given to enforcement of the securities laws has also done much to correct the unhealthy situation which existed formerly.[14]

Section 12-15.6 deals with the consideration, expressed in dollars, for which the corporation may dispose of its stock.[15] While it adds clarity and certainty, it departs in no material way from present law and practice.

Shares may be sold for whatever amount the directors (or the stockholders if they reserve the right to fix the consideration) determine to be appropriate, subject only to the requirement that par value shares not be sold initially at less than par. In consonance with the statute presently in effect[16] this limitation does not apply to treasury shares. That is, par value treasury shares may be disposed of at less than par if desired.[17]

Carefully worded provisions are given with respect to the accounting treatment to be accorded the issuance of shares as share dividends and on conversion. These are tied in with and elaborated on in later sections of the act.

The amount of the consideration fixed by the directors (or stockholders as the case may be) must be paid in one or a

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14. In this connection Rule 6b under the South Carolina Uniform Securities Act provides as follows:

> Applications to register securities by qualification or coordination will be in general regarded with disfavor and subject to denial where pre-incorporation stock subscriptions under South Carolina law remain unpaid, and have not been released by the subscribers to form part of the public offering. Consideration will be given to such applications if unpaid and unreleased subscriptions
> (a) do not exceed 20% of the currently outstanding shares;
> (b) are due no longer than 9 months from date of application for registration;
> (c) are a firm commitment to purchase for cash.
> On subscriptions released to form a part of the public offering, the liability of the original subscribers remains until the shares are sold.

15. The last sentence of subsection (b) is a repetition of the provisions of subsection (d) and should be deleted.

16. S. C. CODE §12-218 (1952).

17. Treasury shares are the corporation's issued shares which it has subsequently re-acquired but has not cancelled. (§12-11.2.) Although they are, figuratively speaking, held in the corporate "treasury," they are not assets. They are useful in a variety of corporate transactions, including purchases with shares, meeting option requirements and share distributions.

combination of money, property and services.[18] The money or property must have been actually received by the corporation and the services must have been performed. One of the most important provisions of the new act is the negative declaration that promises or obligations to pay money or deliver property or perform services in the future do not constitute payment for stock.[19]

Currently, shares may be paid for by means of promissory notes.[20] This undercuts the requirement that funds and property be actually gathered into the corporate fold. It is not uncommon for notes to be held for extended periods without any effort to enforce them either as to principal or interest. A corporation whose shares have been paid for only or mostly by notes may have an apparently healthy balance sheet but, unknown to prospective creditors and stockholders, actually be in a precarious position. The new act should strengthen our corporate setup materially in this respect.

Section 12-15.8 has to do with the granting of rights and options to purchase shares of the corporation's stock in the future. This relates principally to the granting of warrants to underwriters as added incentive for their undertaking to purchase or distribute an issue of the corporation's securities, and to the granting of options to directors, officers and employees as an incentive for their services.

Grants of stock options to directors and officers by way of incentive and reward were given impetus by high income tax rates during the war years coupled with limitations then prevailing on corporate salaries. Such grants came into increasing use by reason of the provisions of the Internal Revenue Code enacted in 1950 (and continued in the 1954 Code) according capital gains treatment to profits on sales of shares acquired under "restricted stock options."[21]

Both options and warrants have been issued for many years in South Carolina without benefit of statutory authority, under a corporation's general powers to contract and to

18. See S. C. CODE §12-15.7 (Supp. 1962).
19. The comparable provisions governing payment for debtor securities are contained in §12-15.23. The provisions are not identical. For example, while §12-15.7 contains a flat prohibition against paying for stock with promissory notes or other obligations, the similar prohibition in §12-15.23 is against paying for bonds with promissory notes or other obligations "of a purchaser."
20. Glenn v. Rosborough, 48 S. C. 272, 26 S. E. 611 (1897).
21. INT. REV. CODE OF 1954, §421.

provide for the issuance of its shares. Reflecting the increasing use of such securities, the new act in section 12-15.8 provides the previously absent statutory authority.[22] It provides that for a corporation to be able to issue warrants or options the authority to do so must be contained in the charter and, moreover, if they are to be issued to officers, directors or employees, stockholder approval must first be obtained. This is a restrictive departure from present practice which requires stockholder approval only in granting options to directors. Otherwise, it is generally thought to be the sole province of the directors to determine when, to whom and at what price disposition shall be made of shares of authorized but unissued stock. This restriction will reduce the opportunity for abuse of options.

This section (12-15.8) ties in with other sections of the act.[23] The only such section calling for special consideration is section 12-16.21. It provides in effect that where the charter is silent with respect to pre-emptive rights, all options and rights and all shares issued on exercise of options and rights, except only "shares issued or optioned to employees," are subject to pre-emptive rights. The desirability of this provision is not apparent. At the very least it would seem that the exception should be extended to shares covered by officers' and directors' options.[24]

In section 12-15.9 the new act states the universally recognized principle that shares are fully paid and non-assessable when the amount and character of the consideration set by the directors has been received. And also in accordance with the general law the fully paid and non-assessable character

22. It is interesting to note that at the very time we receive this expression of public policy sanctioning warrants and options they are in fact losing favor. Indicative of this is the following rule recently promulgated by the South Carolina Securities Commissioner: Rule 4b — Options or warrants issued to persons other than the purchasers of securities will be regarded in general with disfavor and will be considered as grounds for the denial of an application (for registration) unless fully justified. . . .

23. See S. C. CODE §§12-12.2(10), 12-16.21 and 12-18.16(c) (Supp. 1962).

24. This is not the only criticism to which §12-16.21 would seem to be subject. As will be seen below, it deals with the problem of pre-emptive rights with long, cumbersome and complicated provisions. The writer believes strongly that it should be replaced by the alternative Model Act provision; i.e.:

> The shareholders of a corporation shall have no pre-emptive right to acquire unissued or treasury shares of the corporation, or obligations of the corporation convertible into such shares, except to the extent, if any, that such right is provided in the articles of incorporation.

of the shares is not impaired as a result of deduction of organization and underwriting expenses from the selling price.

In line with the over-all purpose of strengthening the corporate setup against manipulation is the prohibition in section 12-15.10 that "No certificate shall be issued for any share until such share is fully paid." From a casual reading it would seem that this, coupled with the prohibition in section 12-15.7 against paying for stock with promissory notes, etc., would foreclose the possibility of having shares outstanding for which the corporation has not received full payment.

This may very well not be correct, however. The statute does not say that no *shares* shall be issued until fully paid but only that until such payment the certificate representing the shares shall not be issued. Since the certificate is nothing more than evidence of the shares, it would seem to follow that we still do not have any statutory prohibition against having shares outstanding for which the corporation has not been paid. Perhaps this view is too narrow, but it would seem to be consistent with a literal construction of the wording and to be strengthened by other provisions of the act, such as the provisions of sections 12-15.5 and 12-16.23. The former gives the corporation a lien on shares for the unpaid part of the subscription price while the other limits the liability of the holder of shares to the "amount remaining due to the corporation upon such shares." Neither of these provisions would seem to be meaningful if shares cannot be outstanding until paid for.

Consideration should be given to plugging this apparent loophole. For it does not seem to be consistent to take such pains to assure that insiders and others do not gain control by giving notes and yet let them do so by making a nominal payment on the total purchase price.

In addition to prohibiting premature issuance of certificates, section 12-15.10 contains the obviously sound requirement that certificates either set forth the relative terms, rights and preferences of each class and series of shares or else state that this information will be furnished on request and without charge. This is in line with the current emphasis in the new Securities Act and this act on informing stockholders of the character of what they own.

Presumably, corporations will almost invariably follow the alternative of stating on the certificates that the required information will be supplied on request. Otherwise, all certificates would have to be called in and new ones issued each time a change occurred in any of the classes or series.[25]

Section 12-15.11 sets forth the procedures which the corporation may follow with respect to fractions of shares. While it probably adds little to present practice, having a statutory guide on the subject is of growing importance due to the increasing popularity of stock dividends and stock splits. Since fractional shares are not traded in the securities market, it is necessary that there be some convenient means of disposing of them.

The first and obvious procedure which the act authorizes is the issuance of certificates representing fractions of shares just like the certificates representing whole shares. It is specifically provided that such certificates "shall entitle the holder, in proportion to his fractional holdings, to exercise voting rights and receive dividends and other distributions." Because of the inconvenient marketability of fractional shares and the complicated computations which they create with respect to dividends, voting rights, etc., they are not often encountered. However, a corporation — particularly a closely held corporation — might have good occasion to issue them.

One alternative procedure permitted by the act, and the one typically used by publicly owned corporations, is the issuance of scrip for the fractions of shares which, if surrendered to the corporation within a stated time with sufficient other scrip certificates, will be exchanged for a regular stock certificate. The scrip itself is not the stock and is entitled to no voting or other rights of stock and usually becomes void if not exchanged for stock within a stated time. For convenience the corporation usually — and is expressly permitted by the act — to provide reasonable opportunity for the purchase and sale of the scrip.

Finally, for the corporation which wishes to avoid the complications involved in the issuance of certificates for fractional shares or scrip, the act provides the simple procedure of paying cash for the fractional interests.

25. Reference should be made to §§12-16.14 and 12-17.18 which contain other requirements with respect to the contents of stock certificates.

One of these three alternatives must be followed by a corporation when fractions of shares arise. It is believed to be the occasional practice in this State at present to deal with fractions by simply providing that they will not be recognized and that certificates will be issued for full shares only. This is not permitted under the act.

As in the statute presently in effect, the new act provides two procedures for obtaining a new certificate in place of one which has been lost or destroyed. One procedure is set forth in the Uniform Stock Transfer Act which is retained verbatim.[26] This provides for a judicial proceeding to command the issuance of a duplicate certificate for one which has been lost or destroyed. It is seldom used because it is somewhat complicated and does not relieve the corporation from liability to good faith transferees who may subsequently turn up with the certificate believed to have been lost or destroyed.

Section 12-15.12 of the new act sets forth the other procedure for obtaining a new certificate. It is the same as that presently contained in Code sections 12-142, et seq., with language changes to harmonize with the rest of the new act. It affords a nearly *in rem* action against the old certificate. After newspaper notice of the holder's application for a new certificate and the filing of an affidavit, and the filing of a bond if the corporation requires,[27] the new certificate is issued. The original certificate and the interest it represents become void after two years and in the absence of actual fraud, the corporation is thereafter relieved of liability with respect to it.

26. S. C. Code §12-17.21 (Supp. 1962).

27. The 1952 Code, §12-243, makes the filing of a bond an absolute condition precedent to the issuance of the new certificate. Under the new act the corporation may or may not require a bond.