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CORPORATIONS-PREEMPTIVE RIGHT TO SUBSCRIBE TO STOCK ISSUES- NECESSITY OF ACTION BY THE SHAREHOLDER

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CORPORATIONS—PREEMPTIVE RIGHT TO SUBSCRIBE TO STOCK ISSUES—NECESSITY OF ACTION BY THE SHAREHOLDER—In *Oppenheimer v. Wm. F. Chiniquy Co.*,[1] a stockholder sought to compel the corporation to issue to him his pro rata share of treasury stock which had been offered to the shareholders on August 6, 1945. The final date for application was September 6, but no time for payment was specified. The shareholder wrote to the company accepting the offer before the final date, but did not tender payment until October 16. The corporation had not disposed of the shares, and the court ordered the company to issue them to the shareholder, holding that the delay was of no importance.

The reasoning in this decision appears to violate the variously stated rule that the preemptive right is lost by failure to comply with the terms

[1] 335 Ill. App. 190, 81 N.E. (2d) 260 (1948).

of the offer.[2] The groundwork for this rule was laid in *Gray v. Portland Bank*, in the suggestion of Judge Sedgwick that the right would be lost by unreasonable delay.[3] In more recent cases the statement that the right is lost by failure to make demand is very common, frequently by way of introduction to matters at issue in the case. To determine the proper scope of the rule, it is proposed to classify the cases dealing with the effect of delay on the preemptive right into three groups. These are: (1) cases in which the shares were offered to the stockholder, and he delayed or rejected the offer; (2) cases in which there was a breach of duty by the directors, and (3) cases in which the shares were not offered to the stockholders.

A. Shareholder's Delay or Refusal

1. Delay

Before the stockholder can be held to have lost his preemptive right by delay in making demand, it must first be determined that he has, in fact, waited beyond the permissible period. The corporation almost always sets a final date for subscription, but it is clear that there are limits on the power of the corporation to prescribe a time. In the absence of statute, the test is stated to be whether a reasonable time has been allowed. When the time is so limited that a share holder will be unable to subscribe, this of itself is not sufficient to make the time unreasonable.[4] But when the time limit was selected with this in mind, to deprive the shareholder of his opportunity to subscribe so that the other shareholders could invade his equity in the surplus, eleven days were held clearly unreasonable.[5] In another case, a total of eleven days, five from the day of sending notice, was insufficient time though the shareholder was notified and had time to subscribe. The stock was offered at par, less than the value, but the books were so poorly kept that it was impossible to determine the value of the shares.[6] On the other hand, the Appellate Division of New York held that a seven day period, four after sending notice, was adequate,

[2] 11 FLETCHER, CYC. CORP., perm. ed. §§ 5138, 5139 (1932); 1 COOK, CORPORATIONS, 8th ed., § 286 (1923).

[3] 3 Mass. 364 at 388 (1807).

[4] Hoyt v. Great American Insurance Co., 201 App. Div. 352, 194 N.Y.S. 449 (1922); Noble v. Great American Insurance Co., 200 App. Div. 773, 194 N.Y.S. 60 (1922), affd. without opinion, 235 N.Y. 589, 139 N.E. 746 (1923).

[5] Jones v. Morrison, 31 Minn. 140, 16 N.W. 854 (1883). Mail from the shareholder took eighteen days to reach the office of the company. The value of the stockholder's shares was reduced from $153,000 to $81,600.

[6] Bennett v. Baum, 90 Neb. 320, 133 N.W. 439 (1911).

though the authorizing faction thereby acquired control of the corporation. The court felt that the complainants had not been sufficiently vigilant and were objecting because others had seized the opportunity.[7] The attitude of the court and the reason for the particular time[8] are important factors. Very short periods may be held reasonable. However, though the court may not hold that the time allowed is unreasonable, it may be an unexpressed factor in determining the effect of delay on the stockholder's right to share in a new issue.

Only four cases were found in which a shareholder, whose only fault was delay in accepting the offer, sought to compel issue of his pro rata share of an issue of stock, and in which the corporation still had the shares at the time demand was made. Of these cases, *Hart v. St. Charles Street R.R. Co.*[9] is the earliest and the only one in which the court did not decree that the shares be issued. The subscription period, including extensions, was one hundred days. On the ninety-ninth day the shareholder declared her intention to take, but did not tender payment until eight days later. The court did not consider whether delay should defeat the right, the sole issue being whether the period prescribed was for subscription only or also for payment, and on rehearing it was held to be the latter.

The next decision, in point of time, was the English case of *James v. Buena Ventura Nitrate Grounds Syndicate, Ltd.*[10] A shareholder died after an increase in the capital stock but before it was offered to the shareholders. Notice, although sent to his executors, was misdirected. One year later the pro rata share was demanded, and the court decreed that it be issued. The chief question was whether a deceased shareholder was entitled to participate in the issue, but the corporation also relied on the delay to justify its refusal to issue the shares. The defense of delay was dismissed by Lord Herschell with the statement that the company had not acted to its prejudice on the assumption that no application would be made for the shares. Though he expressly declined to consider the case in which the shareholder had received notice, Lord Herschell's statement would be equally applicable. When the question arose in New York, in *Somers v. Armor Gas & Oil Co.*,[11] his argument was

[7] Dusenberry v. Sagamore Development Co., 164 App. Div. 573, 150 N.Y.S. 229 (1914).

[8] Hoyt v. Great American Insurance Co., 201 App. Div. 352, 194 N.Y.S. 449 (1922); sale of the entire issue by the end of the year was necessary to obtain a certificate from the superintendent of insurance.

[9] 30 La. Ann. 758 (1878).

[10] [1896] 1 Ch. 456.

[11] 71 Misc. 211, 128 N.Y.S. 382 (1911), affd. 147 App. Div. 919, 131 N.Y.S. 1144 (1911), affd. 207 N.Y. 739, 101 N.E. 1122 (1913).

quoted by the court. In this case, ten days were allowed for subscribing and paying, but the shareholder, who had received notice, made no demand until thirteen days after expiration of the period. Formal tender of payment was never made, though she was prepared to pay four days after making demand. The court expressly declared that delay merely barred contesting a disposition of the stock to someone else.

In the principal case,[12] the Illinois court, though mentioning that no time for payment had been set and that the shareholder had tendered payment, based its decision squarely on the *Somers* case, stating it was in full accord with the reasoning and judgment.

Of these four cases, only the New York and Illinois decisions are clear authority for the proposition that when the corporation still has the stock, mere delay does not extinguish the preemptive right. However, the authority of the *Somers* case is questionable in view of the more recent decision in *Tarlow v. Archbell*.[13] This was not an action to compel the corporation to issue shares, but was a shareholder's derivative suit. An issue of stock was offered to the shareholders at par on July 14, 1936, application and payment to be made by August 17. McKitterick, a director and president of the corporation, died on August 15, without having exercised his right. The board extended the subscription period until August 31, so that his executrix could subscribe for the 8695 shares to which he was entitled. No notice of the extension was given, but other applications for 3242 shares, some by directors, were accepted in that period. It was alleged that the value of the shares exceeded par by $40 and that the secret extension was a breach of duty in which the estate had participated. The trial court denied a motion to dismiss for failure to state a cause of action. The decision was affirmed without opinion by the appellate division[14] and the court of appeals.[15] Relying on cases in which the stock had been sold prior to the late demand,[16] the trial court stated that failure to exercise the right was a waiver, and that as all stockholders had a right to a reasonable opportunity to share in any increase on the same terms, the extension was unlawful. The *Somers* case was not mentioned.

It is submitted that the *Hart* and *Tarlow* cases are not good law, in

[12] Oppenheimer v. Wm. F. Chiniquy Co., 335 Ill. App. 190, 81 N.E. (2d) 260 (1948).
[13] 47 N.Y.S. (2d) 3 (1943).
[14] 269 App. Div. 837, 56 N.Y.S. (2d) 363 (1945).
[15] 296 N.Y. 757, 70 N.E. (2d) 556 (1946).
[16] Noble v. Great American Insurance Co., 200 App. Div. 773, 194 N.Y.S. 60 (1922), affd. without opinion, 235 N.Y. 589, 139 N.E. 746 (1923); Hoyt v. Great American Insurance Co., 201 App. Div. 352, 194 N.Y.S. 449 (1922).

so far as they hold that the offer must be complied with within the subscription period. The reason for holding that the right is lost in this class of cases is to permit the corporation to dispose of the shares and thus enable it to obtain needed capital. When the shares are not disposed of, the reason fails. To the extent that the corporation is free to dispose of the remaining shares as it may choose, there is no unfairness to the other shareholders in holding that as long as no action has been taken respecting those shares the right still subsists in the shareholders who did not subscribe. There may be independent grounds on which the right may properly be denied,[17] but mere failure to act in the prescribed period is not such a reason.

2. *Refusal*

Where the stockholder not merely delays, but refuses to take his pro rata share or has acted so that he is held to have waived his right,[18] and the shares have been disposed of, the preemptive right is clearly extinguished.[19] However, if the corporation still has the shares and circumstances are unchanged there would be little more reason to hold that the stockholder is precluded where he refuses than there is where he merely fails to act. It is not a reason to say that his "election" is conclusive.

No case with this fact situation has been found. The closest is *Hall v. Hall.*[20] Four years after the shareholder's refusal, his shares were purchased by the plaintiff in the action. The additional shares were later sold at a directors' meeting at which the plaintiff was present and offered a lesser price. Seeking to retain control, he then claimed these shares should have been offered to all the stockholders pro rata. The court held that the company was free to deal with the shares as it chose, since

[17] In each of the following cases the shares had been sold prior to the demand, but there were other reasons for denying the right: Seaman v. Ironwood Amusement Co., 283 Mich. 220, 278 N.W. 51 (1938) (increase offered when the corporation was on the verge of failure, and the first demand was made when the corporation was in a much improved condition); Van Slyke v. Norris, 159 Minn. 63, 198 N.W. 409 (1924) (four months delay, but a clear attempt to take advantage of a requirement of a written waiver to cause trouble and make a profit by collecting "damages").

[18] In Heylandt Sales Co. v. Welding Gas Products Co., 180 Tenn. 437, 175 S.W. (2d) 557 (1943), a contract not to acquire a majority of the stock was held to be a waiver of the right to participate in an additional issue. The shareholder had violated the contract, and by not permitting him to participate in the new issue his proportionate holding was reduced to that which he had agreed not to exceed. The court also relied on the doctrine of "unclean hands."

[19] Conklin v. United Construction Supply Co., 166 App. Div. 284, 151 N.Y.S. 624 (1915), affd. 219 N.Y. 555, 114 N.E. 1063 (1916); Hoyt v. Shenango Valley Steel Co., 207 Pa. 208, 56 A. 422 (1903).

[20] 30 Ohio C. C. 826 (1908).

the preemptive right incident to the shares purchased by the plaintiff had expired prior to the plaintiff's purchase. At most this case indicates that a four year interval will bar the right.

B. Directors' Breach of Duty

The vast majority of cases do not deal with a simple failure to demand, or a refusal to take shares, but involve a failure to offer the issue to the shareholders and, frequently, an alleged breach of duty by the directors. When there is a breach of duty by the directors[21] as well as a violation of the preemptive right, only extreme delay or supervening rights defeat the action.[22] But as this would be the rule were there no violation of the preemptive right, these cases merely obscure the extent of the doctrine of preemptive rights and are of no help in determining the effect of delay or refusal.

C. Failure to Offer to the Shareholders

When the sole "wrong" is the violation of the preemptive right, the shareholder must act, and must act promptly. Failure to demand, or very slight delay, will result in loss of the right. In *Griffith v. Sprowl,*[23] the board voted to issue the stock to outsiders. Thirteen days later an injunction was sought to prevent such issue. There was no real need for cash, but the proceeds were used to pay certain debts of the corporation. The injunction was denied, the court emphasizing that sufficient stock remained for the complainants to acquire their pro rata share and that they had failed to demand such issue.

The reason for the rule in this class of cases lies in the defects inherent in the doctrine of preemptive rights. The practical difficulties in offering a new issue to the shareholders when the corporation has a complex capital structure are considerable.[24] Further, the doctrine gives an opportunity for personal advantage to a few shareholders who choose to

[21] (a) Shares in a very profitable corporation issued to the family of a director: Ross Transport, Inc. v. Crothers, 185 Md. 573, 45 A. (2d) 267 (1946). (b) Issued to gain control: Glenn v. Kittaning Brewing Co., 259 Pa. 510, 103 A. 340 (1918) (sold at $222 less than book value); Rowland v. Times Pub. Co., (Fla. 1948) 35 S. (2d) 399; Titus v. Paul State Bank, 32 Idaho 23, 179 P. 514 (1919).

[22] Strickler v. McElroy, 45 Pa. Super. 165 (1911) (six years delay held no bar to an action for damages); Keeney v. Converse, 99 Mich. 316, 58 N.W. 325 (1894) (ten years delay held a bar in an action for damages); Morris v. Stevens, 178 Pa. 563, 36 A. 151 (1897) (two years delay held no bar in an action to cancel shares).

[23] 45 Ind. App. 504, 91 N.E. 25 (1910).

[24] Frey, "Shareholders Preemptive Rights," 38 YALE L.J. 563 (1929); Drinker, "Preemptive Right of Shareholders to Subscribe to New Shares," 43 HARV. L. REV. 586 (1930).

obstruct action which is advantageous for the corporation. In *Stokes v. Continental Trust Co.*,[25] the capital stock was increased from $500,000 to $1,000,000 to take advantage of an offer to purchase the entire increase at $450 per share, which exceeded the book value by $140. One stockholder, by demanding his pro rata share of the increase at par, $100, preserved his preemptive right and was permitted to recover the difference between the sale price and the inflated market price resulting from the offer to take the increase. The possibilities in this situation are brought out in *General Investment Co. v. Bethlehem Steel Corp.*,[26] where the court found that stock was purchased for the purpose of harassing the steel corporation, in particular with respect to a contemplated scheme of refinancing.

D. Conclusion

Because of the defects inherent in the doctrine of preemptive rights, a rule that the shareholder must act promptly may be necessary, but it is submitted that it should be limited to cases in which the issue is for valid business reasons and the sole "wrong" is the failure to offer the issue to the shareholders, for it is in this class of cases that the defects inhere. It is recognized that the rule has no application where there is not merely a violation of the preemptive right, but also a breach of duty by the directors.[27] It should be recognized that it has no application when the issue is offered to the shareholders and the sole question is the effect of refusal or delay on the preemptive right.

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[25] 186 N.Y. 285, 78 N.E. 1090 (1906).

[26] 88 N.J. Eq. 237, 102 A. 252 (1917).

[27] In Upton v. Southern Produce Co., 147 Va. 937 at 948, 133 S.E. 576 (1926), certain directors fraudulently purchased shares eighteen months after they had been offered to the stockholders. A shareholder sued for the secret profits made by the directors and was permitted to recover despite the delay. The court stated, "Numerous text-writers and cases are cited in the appellants' petition for an appeal for the proposition that a stockholder may waive his right to share in the distribution of unissued or new stock, and by his conduct ratify an issue to an outsider. That principle of law is unquestionably sound, but it is applicable only in cases where the sale and purchase are untainted by fraud."