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CORPORATIONS — PRE-EMPTIVE RIGHTS OF SHAREHOLDERS IN ORIGINALLY AUTHORIZED BUT UNISSUED CAPITAL STOCK — Plaintiff, a minority stockholder, brought an action to cancel 58,400 shares of originally authorized but unissued stock which the directors had issued to defendant general manager in payment of his services. Plaintiff contended this violated his pre-emptive right to subscribe to the shares and alleged the transaction was fraudulent in that defendant and the directors conspired to gain voting control. *Held*, the issue was proper because the stock was part of the first offering of original authorized capital stock to which plaintiff's pre-emptive right did not attach, and plaintiff failed to show collusion between directors and defendant to gain voting control and therefore did not state a case of fraud. *Yasik v. Wachtel*, (Del. Ch. 1941) 17 A. (2d) 309.

Since the early decision of *Gray v. Portland Bank*,[1] the doctrine of pre-

[1] 3 Mass. 364 (1807). The pre-emptive rights doctrine has for its objective "The preservation, unimpaired and undiluted, of the old stockholder's relative and

emptive rights has been consistently applied to new issues of stock increasing the capital stock beyond the originally authorized total.[2] The result reached in the principal case seems to be in accord with the majority holding that no pre-emptive right to issues of original authorized stock vests in a shareholder.[3] There is, however, some authority to the contrary, holding that pre-emptive rights do arise with respect to unissued original stock.[4] But even where the denial of pre-emptive rights is recognized, the rule has in some jurisdictions

proportionate voting strength and control, that is, the existing ratio of his proprietary interest and voting power in the corporation. . . ." 11 FLETCHER, CYCLOPEDIA CORPORATIONS, rev. ed., § 5135 at p. 221 (1932). For a discussion of the impossibility of utilizing the pre-emptive rights approach to preserve the relative proprietary interests of the stockholders when there are several classes of stock with variant participation rights, see Frey, "Shareholders' Pre-emptive Rights," 38 YALE L. J. 563 (1929).

[2] See annotation in 52 A. L. R. 220 (1928) and cases there collected. An exception is recognized when the new stock is issued in payment of property or to effect a merger. Thom v. Baltimore Trust Co., 158 Md. 352, 148 A. 234 (1929). Also a stockholder has no pre-emptive right as to issues of treasury stock, in the sense of stock which has been reacquired after having been once issued. 1 COOK, CORPORATIONS, 8th ed., § 286 (1923); 11 FLETCHER, CYCLOPEDIA CORPORATIONS, rev. ed., § 5160 (1932); Hartridge v. Rockwell, R. M. Charlt. (Ga.) 260 (1828); Crosby v. Stratton, 17 Colo. App. 212, 68 P. 130 (1902) (dictum); Borg v. International Silver Co., (C. C. A. 2d, 1925) 11 F. (2d) 147. *Contra*: Dunn v. Acme Auto & Garage Co., 168 Wis. 128, 169 N. W. 297 (1918). Treasury stock may not be issued by directors to themselves without effecting a breach of their fiduciary obligations to stockholders, unless an offering is first made to the stockholders. Hammer v. Werner, 239 App. Div. 38, 265 N. Y. S. 172 (1933).

Depending on the circumstances, the stockholder's remedy against directors for denial of his pre-emptive right may take the form of an injunction, a writ of mandamus, or an action in assumpsit. 5 THOMPSON, CORPORATIONS, 3d ed., §§ 3674, 3675 (1927).

[3] The rule is stated most broadly in Archer v. Hesse, 164 App. Div. 493, 150 N. Y. S. 296 (1914), which held that the directors have full power to dispose of original unissued stock for legitimate purposes with no obligation to give preference to stockholders. The reason for exempting issues of untaken original stock from the pre-emptive rights rule has been held to be the fact that stockholders take with notice that their status will not be fixed until the authorized amount of stock is subscribed. Dunlay v. Avenue M Garage & Repair Co., 253 N. Y. 274, 170 N. E. 917 (1930). Curry v. Scott, 4 Smith (54 Pa. St.) 270 (1867), is also often cited to this effect but its authority is weakened because the court found plaintiff's failure to allege an offer to subscribe, a sufficient answer to the complaint. Other cases denying pre-emptive rights are: Cross v. Farmers' Elevator Co. of Dawson, 31 N. D. 116, 153 N. W. 279 (1915); Sims v. Street R. R., 37 Ohio St. 556 (1882) (holding no pre-emptive rights attach in the absence of stockholder action in closing the books); Russell v. American Gas & Electric Co., 152 App. Div. 136, 136 N. Y. S. 602 (1912) (denying pre-emptive rights of preferred shareholders to issues of untaken common exclusively to common stockholders); Shellenberger v. Patterson, 168 Pa. St. 30, 31 A. 943 (1895); Harris v. Sumner, 39 New Bruns. 204 (1909) (stating Canadian rule).

[4] Titus v. Paul State Bank, 32 Idaho 23, 179 P. 514 (1919); Jones v. Morrison, 31 Minn. 140, 16 N. W. 854 (1883), dictum; Crosby v. Stratton, 17 Colo. App. 212, 68 P. 130 (1902), dictum; Reese v. Bank of Montgomery County, 7 Casey (31 Pa. St.) 78 (1855); Snelling v. Richard, (C. C. N. Y. 1909) 166 F. 635.

been circumscribed considerably. Thus, in New York, pre-emptive rights seem to be denied in respect of issues of originally authorized stock only when such issues are "reasonably necessary" to raise funds to be used in the business, but not when they are used pursuant to expansion of the enterprise.[5] Some of the authorities suggest that pre-emptive rights attach when the originally authorized stock is issued a long time after the corporation commences to do business.[6] One writer advocates denying pre-emptive rights only as to original stock issued to raise funds with which it was contemplated to start the business.[7] The courts are uniform in holding that directors cannot issue untaken original stock to themselves or to their confederates for the purpose of perpetuating themselves in office by divesting other stockholders of voting control.[8] This disability is likewise extended over the issuance of untaken original stock to certain individual stockholders to the exclusion of the rest.[9] It is to be noted that these latter exceptions are not predicated on pre-emptive rights but deal with breaches of the fiduciary obligations of directors to stockholders, a distinction which the decisions are prone to obscure.[10] While the result seems equitable in the principal case, the court bases its denial of pre-emptive rights upon the tenuous ground that the issue to defendant was a continuation of the original offering, such

[5] Dunlay v. Avenue M Garage & Repair Co., 253 N. Y. 274, 170 N. E. 917 (1930).

[6] 1 COOK, CORPORATIONS, 8th ed., § 286 (1923); Thurmond v. Paragon Colliery Co., 82 W. Va. 49, 95 S. E. 816 (1918); Morris v. Stevens, 178 Pa. St. 563, 36 A. 151 (1897) (decision based in part on the fact that original stock was issued 15 years after incorporation). This problem is given passing notice in Kingston v. Home Life Ins. Co. of America, 11 Del. Ch. 258, 101 A. 898 (1917).

[7] Drinker, "The Preëmptive Right of Shareholders to Subscribe to New Shares," 43 HARV. L. REV. 586 at 603 (1930).

[8] Dunlay v. Avenue M Garage & Repair Co., 253 N. Y. 274, 170 N. E. 917 (1930); Luther v. C. J. Luther Co., 118 Wis. 112, 94 N. W. 69 (1903); Essex v. Essex, 141 Mich. 200, 104 N. W. 622, (1905); Trask v. Chase, 107 Me. 137, 77 A. 698 (1910); Whitaker v. Kilby, 55 Misc. 337, 106 N. Y. S. 511 (1907); Agricultural Society v. Eichholtz, 45 Kan. 164, 25 P. 613 (1891); Snelling v. Richard, (C. C. N. Y. 1909) 166 F. 635.

[9] Luther v. C. J. Luther Co., 118 Wis. 112, 94 N. W. 69 (1903); Agricultural Society v. Eichholtz, 45 Kan. 164, 25 P. 613 (1891).

The principal case conceivably might have been decided adversely to defendant because he was converted into a majority stockholder by the exclusive issue of voting shares to him. It would seem, however, that some justification is found in the fact that the issue was in payment of a debt to defendant, and, further, from the fact that plaintiff was decidedly a minority stockholder, and hence his relative position was not greatly altered in so far as he may have aspired to control the voting power.

[10] "Anyone who undertakes to read the numerous decisions which the text-writers, the digests, and the decisions cite as supporting the doctrine of preëmptive right, will be surprised, it is believed, to find how very few there are which do not involve either a deliberate attempt by the directors, for their own benefit, to wrest the control from the majority shareholders, or an attempt to deprive the complainants of a substantial interest in the surplus and potential earnings. . . ." Drinker, "The Preemptive Right of Shareholders To Subscribe To New Shares," 43 HARV. L. REV. 586 at 598-99 (1930).

finding being deduced from the fact that some shares had been sold during the life of the corporation.[11] This would seem to imply a new exception to the general rule of denial of pre-emptive rights in originally authorized but unissued stock, viz., pre-emptive rights attach after the "original offering" has come to an end. If a limitation on the denial of pre-emptive rights in originally authorized but unissued stock is desired, perhaps the best method would be to fix a period of time, beginning with the date of incorporation or the date when the corporation starts operations, beyond which the stockholder would be entitled to a pre-emptive subscription in further issuance of the original shares. This would permit the relative status of the shareholders as to voting power and their respective interests in the assets to become fixed rather than to remain in a state of flux pending total subscription to the authorized capital stock whenever that happens to be consummated. It is submitted, however, that any of the limitations set out above [12] are apt to be artificial and difficult of application. Perhaps the most salutary approach would be to deny pre-emptive rights until all of the originally authorized stock has been fully subscribed, or the issue has been formally terminated by action of the directors or the stockholders.

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[11] Such a criterion seems to work well as applied to the facts of the principal case, for the record disclosed that 15,000 shares had been issued during the four-year period since incorporation. This would seem to indicate acquiescence by the stockholders in the policy of continued issuance whenever a buyer could be found and a recognition that their proportionate status was not to be settled until the authorized capital was fully subscribed.

[12] See notes 5, 6, 7, supra.