CORPORATE POWERS AS POWERS IN TRUST

IT is the thesis of this essay that all powers granted to a corporation or to the management of a corporation, or to any group within the corporation, whether derived from statute or charter or both, are necessarily and at all times exercisable only for the ratable benefit of all the shareholders as their interest appears. That, in consequence, the use of the power is subject to equitable limitation when the power has been exercised to the detriment of such interest, however absolute the grant of power may be in terms, and however correct the technical exercise of it may have been. That many of the rules nominally regulating certain specific uses of corporate powers are only outgrowths of this fundamental equitable limitation, and are consequently subject to be modified, discarded, or strengthened, when necessary in order to achieve such benefit and protect such interest; and that entirely new remedies may be worked out in substitution for or supplemental to existing remedies. And that, in every case, corporate action must be twice tested: first, by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules somewhat analogous to those which apply in favor of a cestui que trust to the trustee's exercise of wide powers granted to him in the instrument making him a fiduciary.

The question is not academic. Its solution in the sense suggested would give greater flexibility to corporate managements in certain respects. It would permit them, when the action is actually necessary or beneficial, to do things in the doing of which

* In preparing this article, the author is indebted for assistance and suggestions to Messrs. Irving H. Dale, David H. Holzman, Wilbur Stammmer, William J. Hoff, Hugh R. Dowling, Abraham Marcus, Felix S. Cohen and David Orlikoff, all students in the Columbia Law School.

The theory herein expressed was suggested by the writer in Cases and Materials in the Law of Corporation Finance (1930) 62. The need of some synthesis to harmonize the many apparently individual rules in the law of corporations was likewise suggested by the writer in a paper, Organization of the Law of Corporation Finance, read before the National Association of American Law Schools in December, 1930, and in course of publication in the University of Tennessee Law Review for May, 1931.
they are now unduly hampered by technical rules. But where no showing of benefit can be made, and where one group within the corporation is to be sacrificed for the benefit of another, it would, equally, circumscribe the use of certain apparently absolute powers. In this latter aspect it is noteworthy that for years corporate papers and general corporation laws have multiplied powers and made them increasingly absolute; that charters have to an increasing extent included immunity clauses and waivers of "rights." It seems not to have occurred to draftsmen that, through the very nature of the corporate entity, responsibility goes with power.

Stated thus broadly, the thesis can be supported only by an examination of the law governing every corporate power. As space does not permit this, five of the principal apparently "absolute" corporate powers are here examined. Examination of all other powers would, as far as the writer's studies have gone, lead to the same result; the five chosen cover a fair cross-section of the field.

A. The power to issue stock is at all times subject to the equitable limitation that such issue must be so accomplished as to protect the ratable interest of existing and prospective shareholders.

Among the rules developed are:

(1) The rule that the incoming shareholder must make a contribution which in good conscience entitles him to participate to the extent allowed by his shares.

The requirement that stock be paid for has two distinct bases in American law. One line of thought required that stock be paid for in order to supply a fund available for the protection of creditors. With this ideology we are not at present concerned.

The second line was definitely based on the theory that every shareholder had an interest in the payment made by every other shareholder upon the issuance of his stock.¹ Mathematically

¹ The cleanest statement of this rule is found in Luther v. Luther Co., 118 Wis. 112, 123, 94 N. W. 69, 72 (1903), the court saying: "For the purposes of the present case, it is not necessary to consider the unissued stock otherwise than as mere property, over which the powers of the directors are the same as over any other
this is obvious; but it would by no means necessarily follow that the law would adopt the mathematical rule. Statutory provisions requiring payment for stock in cash or property afford no ground for an assumption as to which of the two lines of thought influenced the legislature. It was left to the courts first to interpret the statutes in this sense, and later to evolve the same result in the absence of statute and even in the face of provisions apparently granting to corporate managements wide latitude as to what and how much consideration should be required to justify the issuing of stock. As long ago as 1876 a requirement by statute that all stocks should be subscribed for "in good faith" caused an Illinois court to hold that stock issued for a nominal consideration was void; and in this case the thrust of the decision was primarily the protection of other shareholders.

Almost at once, however, the question arose in a new form. Statutory provisions generally provided for the issue of stock for "property received." "Property" is a word so broad as to include almost every definable fragment of value capable of being transferred. In its wide sense under these provisions stock could be issued for a note of the subscriber (negotiable instruments being certainly personal property), goodwill, contracts for services to be rendered, and a whole range of intangible elements of a similar sort. Commonly these provisions were accompanied by the requirement

assets of the corporation, namely, to sell to whom and at such prices as to them shall seem best for the corporation and all its stockholders, in the honest exercise of the discretion and trust vested in them. Even then, however, their duties with reference thereto are fiduciary; they are bound to act uberrima fides for all stockholders. To dispose of or manage property of the corporation to the end and for the purpose of giving to one part of their cestuis que trustent a benefit and advantage over, or at the expense of, another part, is breach of such duty, especially when the directors themselves belong to the specially benefited class." This case merely carried forward the line of thought marked out by the Massachusetts court in Hayward v. Leeson, 176 Mass. 310, 57 N. E. 656 (1900), that the fiduciary duty extends to present and prospective shareholders, a doctrine which in turn necessarily follows from the reasoning of the court in Gray v. Portland Bank, 3 Mass. 363 (1807).

2 People v. Sterling Mfg. Co., 82 Ill. 457 (1876), where the court's difficulty arose from the fact that the voting rights granted to the common stock were equal to those granted to the preferred, though the former invested only $50,000 and the latter $950,000. Of course, whenever the words "good faith" appear, the language in and of itself imports a certain fiduciary quality. In normal business transactions, the state of mind of the opposite party is not a factor; it is enough if there is actual consent without deceit.
that the par value of stock (prior to 1912 non-par stock was unknown), if not paid in cash, must be paid in by a transfer of "property." The courts were at once faced with the problem of determining whether all property could be so received; and if not, of distinguishing between types of property to be accepted and types to be rejected, and giving a reason for the distinction. Greater latitude was introduced at once because, while the measure of cash is always cash, property must be appraised, and there is great leeway for difference in valuation. The judicial reasoning on both questions is by no means clear in its groundwork; but on both issues the results, particularly in retrospect, are astonishingly plain. Thus, courts declared a note of the subscriber insufficient consideration,\(^3\) except when it was adequately secured,\(^4\) in which case the security element made the note "property" within the terms of the now judicially amended statutes. This was further defined in one case where the security was worthless stock, by throwing out even a secured note of the subscriber. What happened here was that the courts permitted the corporation to issue stock against one type of risk and declined to permit its issue against other types of risk. The obvious rationale of the decisions is that the former reasonably protected both creditors and stockholders; the latter did neither.

The question subsequently came up as to patents, obviously property, as remarked by one court, but

"There is no species of property the value of which is more uncertain than letters patent which secure to the patentee the exclusive right to manufacture the patented article. From the nature of the property,

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\(^3\) Alabama Nat. Bank v. Halsey, 109 Ala. 196, 19 So. 522 (1895); Jones Drug Co. v. Williams, 139 Miss. 170, 103 So. 810 (1925); Southwestern Tank Co. v. Morrow, 115 Okla. 97, 241 Pac. 1097 (1925); Kanaman v. Gahagan, 111 Tex. 170, 230 S. W. 141 (1921); see (1926) 10 MINN. L. REV. 536; (1930). 39 YALE L. J. 706, 712. But it does not follow that a note so taken is necessarily unenforceable as against the maker, which has given rise to confusion in the result of these cases. See Pacific Trust Co. v. Dorsey, 72 Cal. 55, 12 Pac. 49 (1887); Goodrich v. Reynolds, Wilder & Co., 31 Ill. 490 (1863); German Mercantile Co. v. Wanner, 25 N. D. 479, 142 N. W. 463 (1913); Schiller Piano Co. v. Hyde, 39 S. D. 74, 162 N. W. 937 (1917).

\(^4\) See the discussion in Sohland v. Baker, 15 Del. Ch. 431, 141 Atl. 277 (1927). For a case in which the facts and the statute forced a decision that even a secured note was not property, see Walz v. Oser, 93 N. J. Eq. 280, 116 Atl. 16 (1922).
the real value of patents can only be determined after the invention is introduced and in use." 5

Accordingly the quality of the property was referred back to the question of valuation; and in respect to patents this is generally the rule. It will be noticed that this is a less rigid rule, permitting more latitude, and permitting protection of the interests actually involved. A contract for the services of an outsider to help publish a history has been held not "property" within the meaning of these statutes. 6 Goodwill — well understood as property in other fields of law, and differing from tangible property only in that it is more difficult to reduce to definite appraisal — has been treated both ways; one case disallowed it completely; 7 others left the question open for the determination of the possibility of a demonstrable valuation. 8

Once in the valuation field, judicial modification of liberty of action becomes even more striking. Both of the principal rules on the subject — the rule that stock may be issued for property at its "absolute value," as over and against the rule that stock may be issued for property upon such valuation as reasonable business men would approve under the circumstances 9 — merely


6 Stevens v. Episcopal Church History Co., 140 App. Div. 570, 125 N. Y. Supp. 573 (1910). But see Van Cott v. Van Brunt, 82 N. Y. 535 (1880), where the work done had to be paid for in stock and such stock was issued in good faith. The issue was upheld even though the labor might not be worth the par value of the stock issued.

7 Coleman v. Booth, 268 Mo. 64, 186 S. W. 1021 (1916), a case weakened by the fact that the circumstances raised the issue of probable fraud.

8 This would seem to be the rule in New York. The case of Gamble v. Queens County Water Co., 123 N. Y. 91, 25 N. E. 201 (1890), raised the problem of validity of issue of stock for water mains and connections in adjacent territory. Concededly, the cost of the property was less than the amount of stock issued. Yet its strategic location might very well give it a value to the issuing corporation in excess of cost. The New York Court of Appeals directed a new trial, instructing that this element be taken into consideration. The prospective earning power of the development — substantially goodwill in the modern understanding of that term — would appear thus to be recognized at least in connection with tangible property.

9 See Dodd, Stock WATERING (1930) 57 et seq., 77. Dr. Dodd comes to the conclusion that there is no sharp distinction between the rules such as is commonly assumed by the bar, the fact being that courts starting from apparently opposite premises reach pretty much similar results.
give the courts the power to correct unconscionable issues of stock, whether they use the value of the consideration or the directors' morals as the primary test. The attempt to create a rule that the judgment "in good faith" of the board of directors shall be conclusive has received only minor support in the cases; but these holdings necessarily force back even further upon the board of directors the decision as to what constitutes a fair and conscionable consideration for the issue.

In determining both the nature of the property for which stock may be issued, and the valuation at which property may be taken to justify the issue of stock, courts have consistently rejected apparently absolute tests set out by statute and carried forward by corporate charters, and have substituted (as they needs must) a test for the conduct of the corporate management. In practically every case this conduct is couched in terms of "good faith," except where the situation has been carried to the point in which apparently the courts thought that no group in "good faith" could justify its action.

The moment, however, that "good faith" is introduced in the picture the fiduciary principle is raised. The phrase implies good faith towards someone, arising out of some previous relation. The argument has never been made that directors "in good faith" would believe it desirable for one group of men (not otherwise contributing) to pay one-third the contribution to the corporate capital required from everyone else. Nor would such an argu-

Among the cases in this sense are Troup v. Horbach, 53 Neb. 795, 74 N. W. 326 (1898); Holcombe v. Trenton White City Co., 80 N. J. Eq. 122, 82 Atl. 618 (1912); Van Cott v. Van Brunt, 82 N. Y. 535 (1880); American Tube & Iron Co. v. Hays, 165 Pa. 489, 30 Atl. 936 (1895); Kelley Bros. v. Fletcher, 94 Tenn. 1, 28 S. W. 1099 (1894).

The majority rule requires that a value must be set on the property taken for stock such as would be approved by prudent and sensible business men under the circumstances, exclusive of visionary or speculative hopes. See Detroit-Kentucky Coal Co. v. Bickett Coal & Coke Co., 251 Fed. 542 (C. C. A. 6th, 1910); State Trust Co. v. Turner, 111 Iowa 664, 82 N. W. 1029 (1900) (no statute involved); Ryerson & Son v. Peden, 303 Ill. 171, 135 N. E. 423 (1922); Jones v. Bowman, 181 Ky. 722, 205 S. W. 923 (1918); Van Cleve v. Berkey, 143 Mo. 109, 44 S. W. 743 (1897) (result reached without benefit of statute); Gates, Adm'r v. Tippecanoe Stone Co., 57 Ohio St. 60, 48 N. E. 285 (1897) (without statutory test); Cole v. Adams, 92 Tex. 171, 46 S. W. 790 (1898).

Conceivably, all of the parties might agree that one set of stockholders should pay less than another. See the discussion in Welton v. Saffery, [1897] A. C.
ment find much favor in any court. The "good faith" phrase is merely a shorthand way of saying that the directors must use their power to test the quality and appraise the value of the consideration offered for stock in such a manner that creditors and shareholders will not be hurt.

This is, in rough outline, the result of the cases down to the advent of non-par stock. With the appearance of this device legal concern for the protection of the creditors largely passed away. There remained the proper protection of the interests of the other shareholders; and this consideration at once became paramount. Commencing with the decision that non-par stock could not be issued for nothing, as a bonus, there ensued a decision holding that such stock must be issued at approximately equal prices at the same time to all concerned. This decision was subsequently modified by the Circuit Court of Appeals into a rule that where there is an inequality of consideration exacted, reasons must appear justifying the board of directors in making the distinction. And the test of justification was whether the amount of consideration required was or was not sufficient to operate as a protection to the remaining shareholders.

(2) The rule that after stock has been issued additional stock may be issued only (a) at a price or under circumstances which protect the equities of the existing shareholders or (b) in accordance with a scheme which permits the existing shareholders to protect their equities by subscribing for a ratable amount of the additional stock.

When the stock is without nominal or par value, there is usually direct authority, as clear as can be derived from words, permitting

299 (H. L.), in which both the majority and the dissenters agreed that there was nothing essentially impossible in such an agreement, but differed as to whether the text of the statute involved permitted it.

12 Johnson v. Louisville Trust Co., 293 Fed. 857, 862 (C. C. A. 6th, 1923), the court saying: "The generally, if not universally, accepted theory of the purpose of such statutes is that they are intended to do away with both the 'trust fund' and 'holding out' doctrines." The court approved Mr. Cook's remark that the whole theory of stock without par value is to let the buyer beware and let the creditor beware.

13 Stone v. Young, 210 App. Div. 303, 206 N. Y. Supp. 95 (1924), the court saying that the no par stock statute is "no warrant for the gratuitous distribution."


the directors of a corporation to issue stock as they see fit, when they see fit, and for any price they see fit. *Prima facie* this would appear to be an absolute power. Actually, however, courts have controlled this power almost from the time its implications became apparent. And there is manifestly no difference between the issue of non-par stock and the issue of stock having par value, except that in the latter case statutes and charters prescribe a minimum issue price (the par value) payable in a more or less restricted form (cash, property of approved quality, services actually rendered). The situation is approximately the same in both cases, however, barring only this statutory restriction.

Even statutory restrictions involving a minimum price upon the issue of par value stock have been swept away by the courts under circumstances in which it appeared that the position of the corporation did not permit the issue of par value stock for its par value, but in these cases the courts required that it should be made to appear both that the stockholders had assented or were protected under all the circumstances, and that creditors would not be prejudiced. Faced even with an apparent restriction, the courts evolved an equitable principle to the effect that under the circumstances indicated the restriction could be ignored.

Early in the history of corporation law the equitable principle was developed that *prima facie* the directors, despite their power to issue stock, must so issue it that the stockholders would be given an opportunity to protect their equities by subscribing to ratable shares of new stock. This rule, evolved in 1807 in *Gray v. Portland Bank*, probably was misunderstood by the bar and by courts generally. An examination of the facts in that case makes it plain that the court did not undertake to lay down a piece of judicial legislation requiring the management to offer stock promiscuously to all shareholders. The court did hold that in that particular situation the issue of additional shares without permitting a shareholder to subscribe impaired his equity. Judge Sewall

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17 3 Mass. 363 (1807).
18 It is noticeable that the court was preoccupied with working out a remedy. The preëmptive right was arrived at after the court had excluded the possibility of specific relief or of restoration of the stock, and had pointed out that the accumulated dividends were in the hands of third persons, and that the plaintiff had not paid for the stock anyhow. Judge Sewall thereupon came to the conclusion:
observed that an incorporation for a bank was "a trust created with certain limitations and authorities, in which the corporation is the trustee for the management of the property, and each stockholder a cestui que trust according to his interest and shares," 19 and he went on to say that the power to the corporation was "not a power granted to the trustee to create another interest for the benefit of other persons than those concerned in the original trust, or for their benefit in any other proportions than those determined by their subsisting shares." 20 It followed that the power to increase the number of shares did not "abolish the security of the members first engaging in it in the beneficial interest and property they might acquire in the institution." The conclusion was that "plaintiff's loss in this case will be compensated by allowing him the market value of the shares he was entitled to at the time when he demanded his certificates, and they were refused to him." The thrust of the case was that, relying on equitable principles to find the right, the court used equal latitude in evolving a remedy compensating the particular plaintiff.

This was the nascence of the so-called préémtive right. It would by no means follow that the préémtive right should attach in every case. But the spirit of the last century sought specific and rigid rules, and built up the doctrine here laid down into a rule that all additional shares, whenever issued and whatever the circumstances, were always subject to a préémtive right. Necessarily the very rigidity of the rule led to equally arbitrary exceptions. Some courts declined to attach the préémtive right to previously authorized but unissued stock (obviously fearing that the first subscriber to the share of stock would promptly claim a préémtive right to the entire balance of the issue); 21 courts de-

19 3 Mass. at 379.
20 Ibid.
21 Such was the law in New York under the case of Archer v. Hesse, 164 App. Div. 493, 150 N. Y. Supp. 296 (1914), but the doctrine received a rude shock in Dunlay v. Avenue M. Garage Co., 253 N. Y. 274 (1930), holding that authorized but unissued shares could be issued without préémtive right only where it is "reasonably necessary to raise money to be used in the business of the corporation
clined to extend the right to treasury stock; and the mistake of a New Jersey vice-chancellor who was pressed for a quick decision over a lunch hour led to the evolution of a third exception—the issue of stock for property. None of these exceptions, perhaps, need have been labored as the courts evolving them seemed to think necessary. It would have been simpler to observe that the circumstances in respect to these particular transactions required no preemptive right to protect adequately the interests of the existing shareholders. The case finally came up of an additional issue of preferred stock which could not by any possibility affect either the amount of the equity of existing shareholders or their proportionate voting control; the New Jersey court was forced to say that in such circumstances there was no reason for the rule and it thereupon disappeared. Commentators on this situation, with varying degrees of emphasis but with considerable unanimity, have been forced to two conclusions: first, that the preemptive right, while a rough and ready protection to common shareholders in a corporation having only a simple capital structure, did not fit many situations where there was a complex capital structure, and frequently was unnecessary even in the simpler cases; second, that the so-called preemptive right was not a right at all, but a remedy—a remedy evolved out of equitable principles—and that unless a situation appeared calling for a remedy and requiring this particular remedy the right should not necessarily be assumed to exist. 

The only conclusion that can be drawn from the tangled history rather than the expansion of such business beyond the original limits. This is the kind of distinction which satisfies a meticulous jurist and drives a business man to distraction. Must I, says he, determine at my peril whether or not the money I expect to raise by selling stock is for "the business" of my corporation or "the expansion of such business"?

of préemptive rights is that the doctrine arose from an attempt to impose an equitable limitation on an apparently absolute power of directors to issue stock; that it should never have hardened into a rigid rule of law, and that it should revert to its original status as a remedy, available in equity and possibly, by transposition, at law. But it should be considered merely as one of many possible remedies — certainly not an exclusive one and not necessarily the best one.

In cases where, by reason of the exceptions to the préemptive right doctrine, no such right existed, courts have had no difficulty in applying equitable remedies of other sorts and kinds. Thus a Wisconsin court enjoined the issue of shares where the sole motive was to permit the directors to augment a rapidly melting majority; 26 a federal court insisted that a sale of treasury shares must be made either at public auction or at a price which demonstrably would maintain the equities of the existing shareholders. 27 Non-par stock without a préemptive right was held to be of such nature that the price paid for it must adequately protect the existing equities. 28 At this point, however, courts ran into a familiar business situation. Not infrequently it is worthwhile to have a substantial shareholder even though equities are sacrificed to bring him in. Such was the case in Atlantic Refining Co. v. Hodgman, 29 and the situation being made plain, the court sanctioned a scheme by which existing equities of approximately $16 were sacrificed to permit the entrance of the Atlantic Refining Company on payment of $8 a share in view of the added strength which that company lent to the issuing corporation through its connections, its goodwill, and its business tactics. So, a Delaware court sanctioned the issue of non-par stock at $25 a share, though its market value was $40 a share, where it appeared that the stock was being offered préemptively to existing shareholders and that the offer of such stock at a low price made

26 Luther v. Luther Co., 118 Wis. 112, 94 N. W. 69 (1903).
27 Borg v. International Silver Co., 2 F.(2d) 910 (S. D. N. Y. 1924). The history of the handling of the sale of this block of treasury stock is peculiarly interesting as an exercise of the equitable power to protect shareholders in the case of stock freed from the so-called technical rule of préemptive right.
29 Supra note 28.
it possible for the corporation to obtain a higher price for shares issued to outsiders with full knowledge of the facts.

The language of the Delaware court in connection with the issue of no par stock is interesting not merely as regards the issue of such stock, but for its bearing on the general thesis of this essay. After pointing out the absolute authority which directors had to issue such stock at any price they deemed fit, the Chancellor said:

"The statute does not impose any restraint upon the apparently unbridled power of the directors. Whether equity will, in accordance with the principles which prompt it to restrain an abuse of powers granted in absolute terms, lay its restraining hand upon the directors in case of an abuse of this absolute power, is another question which will be presently considered and answered in the affirmative. . . . Notwithstanding the absolute character of the language in which the power to the directors is expressed, it cannot be that a court of equity is powerless in proper cases to circumscribe it. The section requires the directors to fix the consideration. It certainly would be out of all reason to say that no court could review their action in fixing it." 30

And the court went on to point out that directors stood in the situation of fiduciaries; and while not "trustees in the strict sense of the term, yet for convenience they have been described as such."

The foregoing is by no means a complete résumé of the limitations which courts have thrown around the issue of shares despite an apparently absolute power granted to the management. Enough has been said, however, to indicate the completeness with which the apparently absolute power has been circumscribed, and the principal lines of limitation which have been thrown around this power.

B. The power to declare or withhold dividends must be so used as to tend to the benefit not only of the corporation as a whole but also of all of its shareholders to the extent that this is possible.

Among the rules worked out are:

(1) The rule that dividends must be withheld only for a business reason: private or personal motives may not be indulged.

The statute and charter alike accord to the directors the power to declare dividends, and impose no limitation on them in so doing or declining so to do except (normally) that dividends may not be declared out of capital or (in most instances) where the capital is impaired. Beyond this their power is at least nominally absolute. Despite this, where dividends were withheld in a family corporation because the father of the family decided that the shareholders who were other members of the family needed discipline, a court directed the declaration of dividends. In another case, where the object of withholding dividends was to depress the price of stock in the market, presumably to enable the management or its friends to buy in such stock at a lower price (a process colloquially called "freezing out"), the court again intervened. Where, also, the primary object of the transaction was to accumulate a large surplus ultimately available for objects which Mr. Henry Ford believed to be to the general good of the community, an order was made requiring the declaration of dividends; and generally, where dividends are "unreasonably withheld" courts have interfered to control the use of the power.

(2) The rule that dividends may not be withheld so as to benefit one class of stock as against another class, save where there is a business situation requiring such action.

The rule stated in the caption has been the subject of controversy in recent years. Wherever the corporate charter includes in its financial structure non-cumulative stock or its equivalent (participating preferred stocks form such equivalent in a great majority of instances) it is possible, by timing the dividend declarations properly, to withhold earnings and to use these for the purpose of building up surplus which subsequently falls to junior stock. A New Jersey court and two federal courts came to the conclusion that where dividends were earned, they must be either declared or set aside as a dividend credit to the stock which would have been entitled to such dividends had they been declared an-

nually or periodically.\(^3\) This doctrine must be regarded as shaken if not completely over set by the recent Supreme Court ruling in *Barclay v. Wabash R. R.*\(^4\)

That decision does not go as far as is currently supposed, since the only *ratio deciderendi* is that although non-cumulative dividends, earned but unpaid, have not been paid out to the non-cumulative preferred shareholders, dividends may, nevertheless, be paid to the common stock provided the non-cumulative dividend for the year in question has been declared and paid. The facts are worth a glance. The Wabash Railroad had issued non-cumulative preferred stock. Over a period of years the unpaid dividends on this stock amounted to some $16,000,000. Year by year the railroad had earned sufficient profits to pay these dividends had the directors elected to declare them. The directors did not do so, but converted the earnings into surplus. Finally; having paid the dividends on the non-cumulative stock in one year, they then undertook to inaugurate dividends on the common.

A bill for an injunction was brought by a preferred shareholder; and the Supreme Court reversed a decision of the Circuit Court of Appeals granting the injunction. It is to be noticed, however, that the payment of dividends to the common stock in no way cut into the $16,000,000 accumulated by withholding dividends on the cumulative preferred; the question remains open, therefore, as to the ultimate disposition of the surplus so created. Even assuming that the *Wabash* case would permit the distribution of this surplus to the common shareholders, as by a liquidation or in subsequent dividends, the Supreme Court above and the dissenting opinion by Judge Learned Hand below both indicated that where withholding the non-cumulative dividend was unreasonable, a preferred shareholder could bring his suit to compel the declaration of the dividends; and Judge Hand intimated that a design to withhold dividends on the one class of stock so as to benefit the junior stock would in and of itself (and nothing appearing to the contrary) be evidence showing unreasonableness.


It would seem, therefore, that by way of dictum at least, even the jurisdictions following the *Wabash* case have indicated a certain measure of equitable protection where the declaration of dividends is manipulated primarily with a view toward benefiting one class of stock as against another class, leaving latitude only where a business situation exists in which it may reasonably be said that the withholding of the dividend will ultimately work for the benefit of the corporation as a whole, and that the benefit will be spread with substantial equity over the various classes.

(3) The rule that there may be no discrimination between shareholders of the same class, and no discrimination between any shareholders except as provided in the charter.

This rule, whether worked out in equity or from a "presumed interpretation" of simple contract, is fundamental. It requires no discussion here save to point out that it forms one of the standard safeguards in equity against the unreasonable manipulation of dividend policy.

C. *The power to acquire stock in other corporations must be so used as to tend to the benefit of the corporation as a whole and may not be used to forward the enterprises of the managers as individuals or to subserve special interests within or without the corporation.*

The rule above stated is probably honored more in breach than in present practice, but there seems to be no reason to doubt its existence as a matter of law. The rule has a history which may be briefly sketched here. Leaving aside special restrictive statutes of which there are many, and assuming a full kit of statutory and charter powers to purchase stock, courts have, nevertheless, limited the use of this power almost from the beginning of corporate history. Thus it has been insisted that where one cor-

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37 Cases are collected in (1919) 14 C. J. § 1236.
38 The first line of limitation was that the mere existence of a corporation implied that its powers should be exercised and its capital extended through its own officers and employees and not indirectly through another corporation operated under its control. Anglo-American Land Co. v. Lombard, 132 Fed. 721, 736 (C. C. A. 8th, 1904); see also People v. Chicago Gas Trust Co., 130 Ill. 268, 22 N. E. 798 (1889); Elkins v. Camden & Atlantic R. R., 36 N. J. Eq. 5 (1882).
poration purchases stock in another, such purchase must tend to forward the "primary" purpose of the corporation; as one court said,

"whether the purchase of stock in one corporation by another is ultra vires or not, must depend upon the purpose for which the purchase was made, and whether such purchase was, under all the circumstances, a necessary or reasonable means of carrying out the object for which the corporation was created, or one which under the statute it might accomplish." 39

This would mean little if the "object" of the corporation could be ascertained by merely reading the "object clauses" in its charter. It seems plain, however, that in ordinary circumstances the situation is more complicated than that. For instance, although the Prudential Insurance Company certainly had power to purchase stock, where it proposed to buy a majority of the stock of the Fidelity Trust Company which already owned a majority of stock in the Prudential Insurance Company, and the result of the scheme was to create a situation in which the management could maintain itself perpetually in office, the court observed that the purchase was not for the purpose of making an investment (which the insurance company could do) but for the purpose of carrying out a scheme of corporate control of advantage to the management individually. 40 Accordingly, the transaction was enjoined. One may suggest that a so-called investment trust which used its funds for the purchase of shares not primarily for investment but for the purpose of obtaining control of a corporation to the advantage of the managers of the investment trust, would come under the same condemnation. 41

39 Hill v. Nisbet, 100 Ind. 341, 349 (1884).
41 This is a problem which should be a matter of general concern. Some billions of dollars have been acquired by so-called "investment trusts." The theory is that the investment trust managers or officers can supplant the individuals in the management of funds, with advantage to the latter by reason of the peculiar experience and information which the managers have. These rapidly turn up as devices by which the investment trust managers claim actual or partial control of a series of unrelated corporations. Dillon, Read & Co. are said by this means to have obtained representation on the board of the Rock Island Railroad. It was charged that by this means Cyrus Eton sought to control the Youngstown Sheet and Tube Co. These are two of many instances.
Purchases of stock by one corporation in another commonly fall into two categories. In the one case the purchase does not involve control of the corporation whose stock is being purchased. In this situation normally the only problem is whether the purchase can fairly be treated as an investment by the purchasing corporation. The second category involves situations in which the purchasing corporation acquires control over a second corporation by buying a controlling block of its stock. Here the naked power to purchase is an insufficient justification. Transactions have been steadily enjoined unless the corporation can justify its purchase on the ground that the controlled corporation may furnish facilities or materials in carrying out its objects, or is engaged in substantially the same enterprise, or that the purchase aids a corporation usefully to the buyer’s business.\textsuperscript{42} Failing such justification, the purchase is frequently enjoined.

The ground of prohibition is commonly called “\textit{ultra vires}.” At first blush this seems to be a long way from equitable limitation. Yet on closer analysis it develops that the words, “\textit{ultra vires}” are here used in a sense quite different from that usually applied to the familiar phrase. The courts do not deny the “power” to make the purchase. What they say is that by reason of the \textit{object}, the power is not well exercised. The only conclusion which can be drawn is that the courts have weighed the power in the light of the circumstances and have in certain cases declined to sanction its \textit{use} — a position quite different from asserting that the power does not exist. The criteria adopted in cases where the purchasing corporation is buying control of another, concern management issues in practically every case — a comparison of the

\textsuperscript{42} Among the many cases may be cited: Edwards v. International Pavement Co., 227 Mass. 206, 116 N. E. 266 (1917); Fernald v. Ridlon Co., 246 Mass. 64, 140 N. E. 421 (1923); Dittman v. Distilling Co. of America, 54 Atl. 570 (N. J. Ch. 1903); State v. Missouri Pac. Ry., 237 Mo. 338, 141 S. W. 643 (1911); Ellerman v. Chicago Junction Ry., 49 N. J. Eq. 217, 23 Atl. 287 (1891). On the other hand, see: Sumner v. Marcy, Fed. Cas. No. 13,609 (D. Me. 1847); Pauly v. Coronado Beach Co., 56 Fed. 428 (S. D. Cal. 1893); Savings Bank v. Meriden Agency, 24 Conn. 159 (1855); Hunt v. Hauser Malting Co., 90 Minn. 282, 66 N. W. 85 (1903); Bank of Commerce v. Hart, 37 Neb. 197, 55 N. W. 633 (1893); Nebraska Shirt Co. v. Horton, 93 N. W. 225 (Neb. 1903). In these last cases, purchase of stock by a corporation in another corporation was enjoined, the theory being that the object of such purchase did not tend to fulfil or round out the primary objects of the buying corporation.
purposes of the two corporations, an examination of the relation between them, an assessment of the motive with which the purchase is made. Unless a reasonable connection can be found between the purposes, and an advantage to the corporation arises from linking the two concerns, and the motive has been to benefit the corporation as a whole, the purchase stands a good chance of being thrown out, although the paper authority is on its face unlimited.\footnote{The question remains open as to whether a corporation may not have as its primary purpose the use of its funds in a fashion analogous to a "blind pool." The older corporation statutes do not readily permit a corporation so to state its objects. The modern corporate form does permit precisely this. It would seem that the avowed object of the corporate management, particularly as announced to the public in the publicity surrounding the issue of its stock, might well indicate the "primary purposes" sought for in these cases.}

Manifestly, we are only on the eve of a development of law in this respect. Of recent years aggregations of capital have been collected from the public sale of stock in corporations with paper powers which are broad enough to permit them to rove the world at will. These are nominally supposed to be "investment" or "trading" corporations. Presently, however, it develops that their funds have been so invested as to give control of one or more enterprises to the bankers managing the so-called investment or trading companies. In other words, the purpose of the corporation is investment; but the power to purchase stock has been used, not for investment purposes, but to forward the control of the managing group in extraneous fields. The "investment trust" has suddenly become a holding and management company. \textit{Quaere} if this was the "object" of the corporation.

D. \textit{The reserved power of the corporation to amend its charter must be so exercised that the result will tend to benefit the corporation as a whole, and to distribute equitably the benefit or the sacrifice, as the case may be, between all groups in the corporation as their interests may appear.}
CORPORATE POWERS AS POWERS IN TRUST

Since the power to amend the charter or by-laws is normally conferred on a majority of shareholders, we are manifestly now dealing with a somewhat different group from that heretofore considered. In principle, however, this would seem to make little difference. A power in the one case exercised by the directors is here exercised by the majority. There is a difference in one respect. The vote of shareholders would at least tend to create a presumption that the action taken benefited all of such shareholders.\textsuperscript{44} The presumption is apparently subject to be rebutted either by proof that the majority is a compact group having interests adverse to the corporation as a whole or to the other classes,\textsuperscript{45} or, possibly, by the mere fact of adverse interests, though this last is not so clear. Ultimately courts may take judicial notice of the "rubber-stamp" quality of most stockholders' votes.

In general, however, power granted to a majority must be regarded as standing on the same footing with power granted to the management. While an individual shareholder normally is not required to exercise his voting rights in a fiduciary capacity,\textsuperscript{46} nevertheless the power of a majority is subject to certain equitable limitations, which appear to differ under varying states of fact. Thus, a majority composed of scattered shareholders, not actuated by a unifying interest, nevertheless must not so exercise its power

\textsuperscript{44} See Berle, Studies in the Law of Corporation Finance (1928) ("Non-voting Stock and Bankers' Control"). And the presumption would certainly not exist as regards shares which did not vote. For instance, in the case of a vote of common stockholders reducing capital and thereby reducing the "cushion" or security behind preferred shares, which did not vote on the reduction.

\textsuperscript{45} The language of the court in Davis v. Louisville Gas & Elec. Co., 142 Atl. 654 (Del. 1928), would seem to indicate this. The court, after remarking that where a large majority of stockholders have voted for the change there is a presumption of good faith, then examined where stock most hurt by the amendment was held, and pointed out that since the management itself stood to be most prejudiced by the change, the presumption of good faith would be difficult to rebut. But the implication is plain that the presumption is rebuttable. One may feel, however, that the court's examination of the facts was hardly complete. A public utility holding company (the majority holder in the Davis case) might well have an interest in sacrificing both its own and the minority interests in one company in order thereby to forward the interests of a quite different company.

\textsuperscript{46} North-West Trans. Co. v. Beatty, [1887] 12 A. C. (P. C.) 589; Camden & Atlantic R. R. v. Elkins, 37 N. J. Eq. 273 (1883) (but quaere whether this case would be decided in the same manner today).
as to "confiscate" the rights of the minority, nor so as to oppress them unreasonably.\textsuperscript{47} The mere power concentrated in the hands of, say, a parent corporation, or of the management itself, appears to be tested by rules almost exactly like those applicable to boards of directors. Where the majority power is in fact exercised by or through the management or its control, courts take cognizance of that fact.\textsuperscript{48}

To the principle of equitable control of the power to amend the certificate of incorporation, there seems to be not a single exception in any American jurisdiction. The stringency of the control varies. In substantially all states it is held that no amendment of the certificate of incorporation can interfere with certain specific rights. The principal example of this is the right of a holder of accumulative preferred stock to be protected against any amendment which disturbs accrued unpaid cumulative dividends.\textsuperscript{49} This is familiarly spoken of as a "vested right," though the phrase states a conclusion rather than an argument. As a matter of strict English, the right to have unpaid cumulative dividends charged as a preference against the net assets of the corporation seems not different in kind from the right to receive a preference on liquidation up to a stated amount. As such, the former would seem to be as subject to amendment as the latter under a reserved power to alter "preferences." Nevertheless, practically every case on the subject prohibits an amendment modifying accrued cumulative dividends, substantially on the theory that to do so is an oppression of the preferred shareholder.

\textsuperscript{47} New Haven & Derby R. R. v. Chapman, 38 Conn. 56 (1871); Perkins v. Coffin, 84 Conn. 275, 79 Atl. 1070 (1911); Lonsdale Corp. v. International Mercantile Marine Co., 101 N. J. Eq. 554, 139 Atl. 50 (1927); Kent v. Quicksilver Mining Co., 78 N. Y. 159 (1879).


\textsuperscript{49} Yoakum v. Providence Biltmore Hotel Co., 34 F.(2d) 533 (D. R. I. 1929); Morris v. American Pub. Util. Co., 14 Del. Ch. 136, 122 Atl. 696 (1923); Lonsdale v. International Mercantile Marine Co., 101 N. J. Eq. 554, 139 Atl. 50 (1927). But even this right was questioned in Windhurst v. Central Leather Co., 101 N. J. Eq. 543, 138 Atl. 772 (1927), where the corporation was in such bad condition that failure to modify such rights might have been disastrous.
Certain states, notably New Jersey, enlarge this area of "vested rights." 50 A majority of jurisdictions appear to permit the amendment upon a showing that the business interests of the corporation, including the class of stock whose preferences are affected, require the change. Even Delaware, the loosest of jurisdictions, suggests, obiter, that if a showing can be made that the majority is acting adversely to the minority, primarily to benefit itself as against the minority, without corresponding compensation through business strength or otherwise to all concerned, an injunction will issue. 51 This process of advantage to one group at the expense of another is usually described under the loose and somewhat misleading term "fraud"; but the meaning seems plain.

The majority of amendments, even those cutting down specific contract rights such as the right to a fixed dividend, the right to a fixed preference in assets, and the right to a stated participation, are commonly sustained; but no court seems to have based its decision on the naked power to amend. In every case, the equities have been examined, the business situation considered, and the reasoning upholding the amendment has been grounded on the theory that the amendment was under the peculiar circumstances equitable for all concerned. There may be dispute on the facts; there certainly is ground for believing that few dissenting stockholders are in a position to cope with the management (which commonly represents the majority) in a battle to determine where the business interests of the group as a whole really lie. But it can not be said that the results lend any color to the proposition that an absolute right to amend the charter has ever been recognized despite the plain power granted by statute and carried forward by appropriate provision in the certificate of incorporation.

E. The power to transfer the corporate enterprise to another enterprise by merger, exchange of stock, sale of assets or otherwise, may be exercised only in such a manner that the respective interests of the shareholders of all classes are respectively recognized and substantially protected.

Substantially all corporate statutes today grant to corporations created under them the power to unite with other enterprises or

to transfer their activities to other corporations. Various mechanisms are provided to this end. The old power to merge and consolidate is historic; the power to lease all of the assets followed; today, the result is more often obtained by a sale of the assets to the acquiring entity in return for an assumption of all liabilities and for a block of stock, which stock is in turn distributed to the stockholders of the transferring corporation. Another method is the individual transfer by shareholders of their stock in exchange for stock of the acquiring corporation, or in exchange for stock of a holding company, the process becoming complete when a controlling majority of the shares of stock has been so exchanged. Financial jargon lumps all these processes, as well as other more recondite methods, under the loose word "merger."

This power was not inherent in a corporation; historically, it could be exercised only by unanimous consent. Under an early decision, the power to sell the assets, for example, did not include the power to take stock of another corporation in compensation and to force this stock down the throats of the old shareholders; but the ground of the decision was lack of power, not misuse of power. The modern statute, however, contains such authority, and the modern corporate charter carries forward the authority by inserting an appropriate provision suggesting corporate action by which the authority may be exercised.

In its earlier phases, it was thought that the validity of a merger was tested by power only—a decision flatly contrary to the thesis of this essay. A federal court once remarked that where a sale of assets had taken place and the proceedings conformed to the organic law, it did not matter "that the majority were actuated by dishonorable or even corrupt motives, so long as their acts were legitimate. In equity, as at law, a fraudulent intent is not the subject of judicial cognizance unless accompanied by a wrongful act." Subsequent decisions, however, have obliterated this doctrine. Thus in Windhurst v. Central

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52 See Ballantine, Corporations (1928) 594–95.
54 Ervin v. Oregon Ry. & Nav. Co., 20 Fed. 577, 580 (C. C. S. D. N. Y. 1884), aff'd, 27 Fed. 625 (C. C. S. D. N. Y. 1886). The quotation belies the actual decision; the court ultimately held the transaction inequitable, and charged the new corporation's assets with a lien in favor of complainants.
Leather Co.,55 the court remarked: "Every case must to some extent stand on its own facts as they are affected by the principles and doctrines of equity," a decision which sets out substantially the doctrine of the modern cases. So, where a corporation owned properties leased to a public service corporation,56 the corporate income being the lease rental, and the lessee corporation acquired a majority of the stock of the lessor and then attempted to force a sale of the assets in consideration of preferred stock of the lessee corporation, the transaction was enjoined since in equity the rights of the stockholders of the lessor were being reduced from a first charge on the property of the lessee by way of rental, to a junior charge in the form of preferred dividends. The court made an added point of the fact that the preferred stock was redeemable in three years, so that the transaction amounted to an option by the lessee corporation to buy out its lessor. In that case, the court did not even require a showing of actual fraud; and, after conceding that the merger agreement was "in legal form," remarked, "The agreement calls for careful judicial scrutiny, and the burden is on the majority to show that the consideration is fair and equitable, and judgment, as to fairness, is not to be influenced by the heavy vote of approval, as it otherwise would be if the vote were independent."57 The last remark was, of course, occasioned by the fact that the majority stock voting in favor of the transaction was owned by the lessee corporation which benefited from it. An earlier case, Jones v. Missouri-Edison Elec. Co.,58 dealt with a merger, likewise carried out in scrupulous accord with the legal requirements, in which the equities of the shareholders of one of the merging corporations were tremendously diluted. Here, the merger was an accomplished fact and the eggs could not be unscrambled. The appellate court remanded the case to the court below with instructions to work out appropriate relief, and pointed out that the directors were in substance trustees for shareholders, that a majority having control was in much the same position, and that a dilution of the equity of the minority was a breach of

56 Outwater v. Public Serv. Corp. of New Jersey, 103 N. J. Eq. 461, 143 Atl. 729 (1928).
57 Id. at 464, 143 Atl. at 730.
trust. The court took occasion to say: "The fraud or breach of trust of one who occupies a fiduciary relation while in the exercise of a lawful power is as fatal in equity to the resultant act or contract as the absence of the power." 59

In a New York case, Colby v. Equitable Trust Co., 60 the court faced a situation in which there was a dilution of the stock in one of the merging corporations. On examination, however, the business situation indicated that that corporation had been running a losing race and was facing an uninviting future. The court, taking these facts into consideration, came to the conclusion that the merger was not "so unfair and unconscionable . . . that a court of equity should interfere and prevent its consummation." There are many similar cases. Though an equitable limitation was applied in favor of pro rata control when additional stock was issued, the fact that proportionate control is diluted by a process of merger seems not to be persuasive. 61 Whether this is because courts today take a more realistic view and recognize pro rata control as not being worth very much, or because its loss is not a sufficient consideration to over-balance the business interests involved, does not appear; but few students of corporate problems will quarrel with the conclusion.

Though by no means complete, the foregoing substantially summarizes the position of courts in regard to the power to consummate a merger. Save in Pennsylvania, where an archaic rule requires that no merger be consummated unless the shareholder is given an option to be paid out in cash, 62 the equitable limitation seems undisputed; and even under the Pennsylvania rule it would appear that the courts involved were struggling for an automatic right compensating the shareholder for his loss of position, much as the Massachusetts court in Gray v. Portland Bank struggled for such a right.

It is singular that no generalization has been attempted covering equitable control over situations where statute and charter have

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59 144 Fed. at 771.
granted apparently clear powers to act. Yet such a generalization is not difficult to find. By contract shareholders may distribute rights and participations *inter sese*. They may grant to one of their number a senior preferred position and to another a junior position; they may divide or limit rights in assets, or the immediate participations in earnings as they agree. These are individual agreements among themselves. But where powers are conceded to the management or to any group to act for the corporation as a whole, the obvious, if tacit, assumption is that these powers are intended to be used only on behalf of all. They are distinctly not intended to be granted for the purpose of benefiting one set of participants as against another. To do so would be to violate every intendment of the whole corporate situation. While incidental variations in individual participations, or in class participations may take place as the powers are used, the powers themselves are designed to forward the ends of all, not to forward the ends of some and defeat the ends of others.

In this respect, corporation law is substantially at the stage in which equity was when it faced the situation of a trustee who had been granted apparently absolute powers in his deed of trust. So far as the law and the language went, the power *was* absolute; the trustee could do as he pleased; could perhaps trade with himself irrespective of his adverse interests; could, perhaps, sell the trust assets at an unfairly low price. Yet to permit untrammeled exercise of these powers would be to violate the whole underlying concept of the trust institution. It was possible to argue under the old and rigid corporation laws that the statute had carefully laid down the lines of corporate action, and that wherever a power was not to be exercised, the statute had itself declined to grant the ability to act. Modern statutes and charters admit no such interpretation. The statute is in substance a permission to the trustees to claim any powers they choose, within very few limits. This very liberty negatives the assumption that the state through its statute has undertaken to say that all powers, however exercised, must be considered to be properly exercised. Courts, accordingly, have been substantially forced to the conclusion here expressed: namely, that no power, however absolute in terms, is absolute in fact; that every power is subject to the essential equitable limitations.
In this concept, corporation law becomes in substance a branch of the law of trusts. The rules of application are less rigorous, since the business situation demands greater flexibility than the trust situation. Probably the requirements as to motive and clean-mindedness on the part of the persons exercising the powers are substantially similar. The requirements of exactitude in apportioning or assessing ratable differences must yield to the necessary approximations which business entails. But the fundamental requirements follow similar lines.

As a conclusion, it necessarily follows that:

First: Whenever a corporate power is exercised, its existence must be ascertained and the technical correctness of its use must be checked; but its use must also be judged in relation to the existing facts with a view toward discovering whether under all the circumstances the result fairly protects the interests of the shareholders.

Second: Many of the apparently rigid rules protecting shareholders, as, for example, the rule creating preëmptive rights, are in reality not "rights" but equitable remedies, to be used, molded, or discarded as the equities of the case may require.

Third: New remedies may be worked out and applied by the courts in each case, depending on the circumstances. For example, to protect the rights of a non-cumulative preferred stockholder whose dividend should be withheld for business purposes but should be retained for him for purposes of equitable treatment, a court might require the declaration of the dividend in stock or scrip. The powers of courts of equity in this regard are as broad as may be necessary to adjust and maintain the relative participations of the various classes of shareholders.

Fourth: No form of words inserted in a corporate charter can deny or defeat this fundamental equitable control. To do so would be to defeat the very object and nature of the corporation itself.

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