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Validity of Issuance of No Par Stock for Property and Services

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VALIDITY OF ISSUANCE OF NO PAR STOCK FOR PROPERTY AND SERVICES.

The transformation of the small, closely-held personal business into widely-held and loosely-governed corporate organizations has brought the question of corporate control into significant prominence.[1] Disregarding a varied history of public antipathy towards corporate power, the President of the United States hails the dawn of the age of legalized monopoly, seeing increased prosperity as a direct result.[2] Men of vision, however, have long ago sounded the tocsins of alarm and continue to publicize the ruthless extinction of individual rights.[3] Among the egregious devices utilized to further disfranchise the public is that of no par stock.[4] Issuing stock without par value for property or services is particularly open to abuse and the legal consequences are deservant of analysis.

That no par stock is here to stay is very evident when one examines the bankers' circular on the financial sheets of newspapers. The majority of new stock issues in recent years carries the no par stock feature.[5] Canada and nearly all of the states of the Union possess statutes permitting the use of no par stock,[6] which, of itself, is convincing of its general utilization. The no par stock provisions of these various states have been classified and seem to follow two main lines of division,[7] the majority following the liberal Delaware form

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[1] William Z. Ripley v. Main Street and Wall Street (1927).

[2] President Hoover, in an address before the American Legion Convention, 1930, stated, "that we might be better off without anti-trust laws and that we would have more prosperity under monopoly than under competition."

[3] Woodrow Wilson, American Bar Association Review (1910), p. 439, addressing the A. B. A. convention: "The present task of the law is to rehabilitate the individual. * * * I regard the corporation as indispensable to modern business enterprise. * * * My purpose is to recall you to the service of the nation as a whole. You are not the servants of the special interests, the expert counsellors of this, that, or any other group of business men, but guardians of the general place, the guide of those who seek to realize by some best accommodation the right of men. I am asking you to look again at the corporation." Also Berle, Studies in the Law of Corporation Finance (1928), ch. IV; Robbins, No Par Stock (1927), 88.

[4] *Supra* Note 1 at 46: "An egregious malversation of the rights of the stockholders and of the rights of the public generally is the device of no par stock."

[5] *Financial Chronicle* (1926) lists over 500 corporations using this novel stock device.

[6] Wildman and Powell, Capital Stock Without Par Value (1928), 70; Thompson, Corporation, sec. 3918.

[7] Bonbright, The Danger Of Shares Without Par Value (1924), 24 Col. L. Rev. 449, at 458: "* * * we may divide the laws into two types—the Delaware type, followed by the large majority of the states, and the New York type adopted by New York and California. Their chief difference is that the former makes no provision as to the stated capital with which a corporation will carry on business, whereas the latter does make such a provision.

of legislation,[8] the minority, the statutes of New York.[9] Other forms also exist.[10]

Although at first blush the differences between the Delaware and New York statutes are not of a startling nature, it is diverse enough to cause considerable variation in liabilities. The tenor of the New York law suggests that the consideration received for no par stock ought to be stated in terms of value.[11] This requirement, though said to be desirable, is ambiguous, and thus far there has been no decision in point. Bonbright points out that if the New York court decides that no value need be stated, then the effect of the New York law is identical with that of Delaware.[12]

A frequent critique leveled at this new feature in corporate finance is that it leaves the door for fraud wide open. It was early observed that little, if any, liability arises when one issues no par stock for insufficient consideration.[13] Furthermore, new stockholders

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[8] Delaware General Corp. Law (1929), sec. 4a: "For such stock (no par) may be issued from time to time for such consideration as may be fixed by the board of directors pursuant to authority conferred in the certificate of incorporation or amendment thereto or * * * by the consent of the holders of two-thirds of each class of stock outstanding, given at a meeting called for that purpose.

[9] N. Y. Stock Corp. Law, sec. 12: "A. The capital of the corporation shall be at least equal to the sum of the aggregate par value of all issued shares having par value plus * * * dollars in respect to every issued share without par value, plus such amounts as, from time to time, by resolution of the board of directors, may be transferred thereto, or, stated value of no par stock. B. The capital of the corporation shall at least be equal to the sum of the aggregate par value of all issued shares having par value, plus the aggregate amount of consideration received by the corporation for the issuance of shares without par value, plus such amounts as, from time to time, by resolution of the board of directors, may be transferred thereto." (True no par stock.)

[10] Wickersham, Stock Without Par Value (1928), 128, summarizes the statutory provisions into four categories as follows:

I. Arbitrary stated value as in Illinois.
II. Amount received for the stock (Ind., Conn., La., Ohio, Md., Minn. and Nev.).
III. Amount required to begin business:
  (a) stated capital represented by no par shares with additions or deductions (Pa., Md., N. Mex., Me., Vt.).
  (b) capitalized (Me., Vt.).
IV. Actual net assets (Idaho).

[11] N. Y. S. C. L., sec. 12: "All corporations other than moneyed corporations may issue stock without par value (a) for such consideration as may be prescribed in the charter, (b) for such consideration as shall be the fair market value of such shares * * *, (c) for such consideration as the directors may fix, (d) for such consideration as may be approved by a majority of the holders of the voting shares."

[12] *Supra op. cit.* Note 7.

[13] Cook, Stock Without Par Value (1921), 19 Mich. L. Rev. 583; see 7 Amer. B. A. Journal 534; Reed, Corporation Finance (1927), p. 8; Pierson, Shares Having No Par Value, 17 Ill. L. Rev. 179.

of a concern may obtain the same rights and privileges at a cost grossly less than that paid by existing stockholders to the latter's consequent loss.[14] Since existing stockholders are presumably acquainted with the characteristics of their holdings, to say, therefore, there is no fraud is an ingenious argument,[15] but of little succor to the inequities of the situation. Of even more potent significance is the concurrent facilitation of the control of property rights by the corporate management, when the no par stock is issued for property or services. With the advent of this device, directors and promoters are with great ease able to secure a strangle-hold on the future profits of any going concern by brazenly issuing a block of stock for imaginary services or fictitiously valued property.[16] The lack of adequate legal restraints suggests a most profitable field for nefarious directorates and simultaneously points at the helpless predicament of shareholders. In this we are not concerned with the validity of stock issued to a subscriber of stated value no par shares,[17] nor with the viewpoint of the speculator or of the perpetrator of *prima facie* fraud. The law is settled in those situations. But as concerns the validity of the issuance of no par stock for property and services, the law is still in a state of flux.

As preliminary safeguards ordinarily the good faith and true value rules have been regarded as a basis for imposing liability when stock was issued for property. But with the advent of no par stock these rules are difficult of application for it is *prima facie* issued as fully paid and non-assessable[18] and the surest way of avoiding liability is to avoid mentioning monetary value.[19] In New York the discretion of the directorate determines whether the same consideration be maintained for all no par stock issued at the same time.[20] At best this is a risky safeguard even though at all times they must act in the interests of the stockholders.[21]

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[14] Berle, Studies in the Law of Corporation Finance (1928), p. 72; Hodgman v. Atlantic Refining Co., 13 F. (2nd) 781 (C. C. A., 3rd, 1926): "Simultaneous issue at different prices is not illegal in the absence of statutes to the contrary."

[15] Cassius Clay, Shares Without Par Value (May, 1925), 13 Ky. L. Rev. 278, points out: "There can be no fraud on existing stockholders, strictly speaking, for when new shares for less than the usual considerations is issued, the existing stockholders should have known all the time that such things might happen."

[16] For a searching and analytical discussion of no par stock see Berle, Studies in the Law of Corporation Finance (1928), ch. IV.

[17] It is generally conceded that stated value no par stock will easily be governed by par stock principles.

[18] *Supra* Note 8.

[19] Bonbright, *supra* Notes 7, 11, states, "A valid agreement of stock subscription is made out by the transfer of 'x properties' or 'a dead cat and yellow dog,' for a block of no par shares." The subscriber has thus paid all he has agreed to contribute and so he has no additional liability.

[20] N. Y. S. C. L., *supra* Note 11; see Stone v. Young, 206 N. Y. Supp. 95 210 App. Div. 203, (1924), it was held that no par shares could not be issued as a pure bonus, and that in any case there must be consideration.

[21] Berle, *Supra* Note 14 at 51 *et seq.*

Being exposed to such risks, what then are the remedies that either law or equity will afford? The relief afforded the divers classes of interests involved after a violation of the stock statutes may be classified as follows: [22]

1. The corporation of itself has no remedy if the existing stockholders assented to the transaction, even though the only stockholders at that time all connived to profit at the expense of future subscribers.. Nearly all jurisdictions allow an innocent stockholder maximum protection if his consent was not obtained, by allowing a cancellation of his subscription. It has been suggested that the issue is not void but should be declared invalid only as to the over-valued shares, because to do otherwise would be unfair to an innocent stockholder who bought his shares at less than nominal value.[23]

2. The original subscriber's transferee with notice of the transaction, or having means to obtain information is in no better position than his transferor. However, it has been held that the corporation in attempting to collect an assessment from an innocent purchaser of fully paid and non-assessable stock will not be upheld for the reason that, as between both parties the innocent purchaser deserves protection since his culpability and negligence is less than that of the corporation.

3. There is also to be considered the right of the innocent creditor. His position may be summarily dismissed by noting that under the present state of the law in regard to no par stock corporations, little, if any, relief is accorded him. Actions by creditors against corporations or against promoters whose pockets are lined with corporate funds are futile.[24]

The procedure of the promoter is either to get a majority of the stock or sometimes all of the authorized issue in exchange for some property or service of doubtful value. Suits against promoters for secret profits have been the most frequent manifestation in the tribunals of the presence of this problem of the validity of issued no par stock. How far the courts will go in upholding its validity is usually seen in a suit by the corporation or by stockholders as individuals against promoters who allegedly have made big profits. True, the body of rules evolved from this litigation pertain to par stock. Yet in the light of some decisions there should be no distinction dependent upon whether no par or par stock was used, regarding the trustworthiness of organizers.[25] Because of the fiduciary relation

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[22] Ballentine, Private Corporations (1927), ch. XVI.

[23] Berle, *supra* Note 16 at 88; also Note, (1926) 39 Harv. L. Rev. 757.

[24] Robbins, No Par Stock (1927), p. 100 *et seq.;* Ballentine, *supra* Note 22 at 690; sec. 70, N. Y. Stock Corporation Law, imposes liability upon creditors but no decision as yet has held, that it applies to no par stock.

[25] Smith v. General Motor Corp., 289 Fed. 205 (C. C. A., Mich., 1923): "* * * a subscription to original stock at a definite par value and subscription to an issue of increased no par stock at a fixed price seem to depend upon the same principles"; Berle, *supra* Note 16 at 75.

that the promoter, whose position is of vital importance, nowadays, assumes toward the corporation which he is organzing, a full disclosure of his act must be made.[26] With the corporation as a plaintiff there can be no recovery if there has been full disclosure, for there then can be no corporate injury. Disclosure, therefore, is of paramount importance, especially so where the organizers take all the capital stock for property.[27]

Two extremely important cases involving millions of dollars gave new views and restated settled rules. In Old Dominion Copper Co. v. Bigelow [28] non-disclosure, even to those later original subscribers, was declared to be the basis for fraud. Its companion case, Old Dominion Copper Co. v. Lewisohn,[29] arising out of the same facts but tried in the United States Supreme Court, refused to allow recovery. Holmes, *J.*, bases the Court's conclusion on, first, the fact that there was full disclosure to all subscribers at the time of the sale, and, second, to allow recovery would lead to inequitable results. Although it has been suggested that the Lewisohn case has in effect been overruled by Davis v. Las Ovas Co., and "to have removed the ratio *decidendi* of the Lewisohn decision," [30] recent cases indicate that the latter rule is still in its pristine effect.[31]

New Jersey has been a strong adherent of the Bigelow case and, in fact stoutly maintains that it continues to be. Recently in Piggly Wiggly, Delaware v. Bartlett,[32] the Court held that there may be no recovery against a promoter who obtained the entire issue of no par value stock in exchange for an option worth $1,000. The stock was subsequently sold by him to the public without any disclosure as to how the transaction occurred. The sale netted the promoter a clean $48,000. The basis of this startling decision was that the 15,000 shares of no par common stock at the time of its issuance to the promoter was worth no more than the property he conveyed to the corporation. Hence, no over-valuation and therefore no liability. Of course, if there is no over-valuation there cannot be a profit nor a recovery. This is a frequent delimiting factor that prohibits promoters' liability. Unfortunately Piggly Wiggly, Delaware v. Bartlett indicates another loophole that would release the promoter from delivering up his lucre, since the courts refuse to allow justice when

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[26] See Berle, Bankers and Promoters Stock Profits (1929). 42 Harv. L. Rev. 751.

[27] Ballentine, *supra* Note 22 at 166 *et seq.*

[28] 188 Mass. 315, 74 N. E. 653 (1905).

[29] 210 U. S. 206, 28 Sup. Ct. 634, 52 L. ed. 1025 (1907).

[30] (1926) 26 Col. L. Rev. 447, 451; Ehrich, Promoters, sec. 140.

[31] See Henderson case, *infra* Note 36 at 217, for authorities.

[32] Piggly Wiggly, Delaware v. Bartlett, 97 N. J. Eq. 469, 129 Atl. 413 (1925).

no par stock has been the device used. This attitude of the court has been regarded as unsound and has justly been vigorously denounced.[33]

Following on its heels, came the case of Allenhurst Park Estates v. Smith [34] which reiterates the attitude of the Piggly Wiggly decision and deals a deathblow to the hopes of those who waited a change of position. The corporation sued the promoters for an injunction and for secret profits, setting up that 3,000 shares, the entire outstanding issue, was presented to defendants for insufficient consideration, in return for an option on some property. Nothing was paid on the option by the promoters out of their own money but only out of money subscribed to share capital. *Held,* relief denied, although the defendants are fiduciaries and are under the burden of proving that their dealings are fair and honest, they need not so do here. The promoters were given a clean bill of health, since, first, they had been real subscribers to all the stocks; second, secured ratification of all their acts; and, third, had disclosed all material facts to the original subscribers.

But what is of more importance, the Court refused to allow the par stock cases, involving the issuance of bonus stock, to govern on the question of consideration when no par stock was utilized. Arguing further, it asserts that giving away the entire outstanding stock for far-fetched promoters' services is merely just compensation. The decision is full of similar provoking statements and stretches several points in order to justify the conduct of the promoters without whom "much of the material success and industrial progress of this country would not have been attained." [35] The Court seems to seize upon the devices of no par stock, and word jugglery, in order to avoid what is considered a vacuous doctrine of "judge-made law wherein the promoter is restrained from enjoying his legitimate profit or reaping the honest rewards of his labor." To do that, the decision asserts, would make the courts an instrument of fraud, but it seems to forget the similarly equitable duty in maintaining the rights of innocent stockholders and to safeguard the corporation capital. Not long ago the position of the New Jersey court was strengthened by Henderson v. Plymouth Oil Co.[36] where the promoters were given even greater leeway. After a scholarly review of the authorities, the decision asserts that the Bigelow case is by far the minority. However, the strong minority opinion of Harrington, *J.,* bolsters the legal implications of the Bigelow case and points out its desirability.

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[33] *Supra* Note 24 at 88: "No par stock may have been designed originally to protect investors, but the Bartlett decision is conclusive proof that under the present laws the removal of par value denies investors an important legal protection." For an excellent discussion of the Bartlett case, see Note (1926) 26 Col. L. Rev. 447.

[34] Allenhurst Park Estates v. Smith, 101 N. J. Eq. 581, 138 Atl. 709 (1927).

[35] *Supra* Note 34 at 716.

[36] Henderson v. Plymouth Oil Co. (Del. Ch., 1928), 141 Atl. 197.

In the Allenhurst case the Court distinguishes it from the facts in the Bartlett case since there was no sale of stock in the former.[37] Yet the ratio *decidendi* of these cases would indicate that the instrument of no par stock has been used as a means of evading liability. It is hopeful to note, however, that authorities are beginning to comprehend the situation and that by a continuing attack will cause the discarding of the present view of non-imposition of any restraints in issuing no par stock for property or services.

To prevent the Bartlett case and such similar swindles, the following suggestions have been presented by a clear-thinking student of the problem: [38]

1. That the prices must be agreed upon as a means of valuation, and is really necessary to give effect to the law.
2. If no such standard is had, at least the old good faith and true value rules should apply.
3. There may be a provision that no share be issued at less than its market value. Perhaps it would be well to follow the old Massachusetts rule that the commissioner of securities must be sure that the stocks issued for property is reasonable.[39]
4. The stockholder should be given the right of independent appraisal if they are not sure directors' valuations are fair.

The same author has elsewhere [40] gone further is enunciating a theory opined by the best legal authorities by stating that no par shares cannot be issued at whatever price the directors desire but that the price of all other issues other than the first would be limited by a court of equity. This equitable minimum issue price, as he dubs it, is the lowest amount at which a share of stock may be issued without prejudice to the equality of the old shareholders and will depend upon the circumstances of the case. Then follows the Minimum Issue Price Rule stating no share of stock may be issued at less than, (a) its par value if the stock has a par value, (b) its stated value in case of a stated value no par share, (c) its equitable minimum in any case.[41] It is submitted that to extend this beneficial rule to stock originally issued would go a long way in preventing the abuses attending the no par feature.

Various proposed reforms suggested are:

1. The use of the Blue Sky Laws,[42] so that the commissions would prevent fraud in the distribution of securities. This

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[37] *Supra* Note 34 at 715.

[38] Robbins, *supra* Note 24 at 128.

[39] Mass. Stat. (1875), ch. 177, sec. 2.

[40] Montgomery, Financial Handbook (1925), 1629.

[41] Robbins, *supra* Note 40 at 1630, restates the rule: "The equitable minimum is the highest price at which the particular shares may be issued in the open market for such shares."

[42] Ballentine, *supra* Note 22 at 832 *et seq.*

unfortunately seems useless in the light of the usual ineffectiveness of these commissions.

2. That a public registry be required for all issues of stock, having a sworn statement of the amount paid for the property. This is at present done in Germany and had been followed in England since 1867.[43]

3. It has been suggested,[44] "Any share of non-par stock may be issued for payment of money or in exchange for property or rights which the company may hold or for services rendered by providing a certificate setting forth the number of shares in question, the amount paid thereon, and describing with reasonable definiteness the property, rights, or services, accepted in payment thereof, prior to the issue thereof, executed, acknowledged, and reported as part of the charter. No share of stock shall be issued until such recording and so forth is done. This original certificate may be amended by a new certificate, issued, executed, and so forth in like manner as the original certificate." This would at least put subscribers in a position to become familiar with the status of the corporation.

4. California has a unique way of dealing with the situation by penalizing the stock brokers engaged in shady transactions.[45] This, of course, also suggests the fact that the Stock Exchanges could help the situation along by supervising and making public these transgressions.

In conclusion, as soon as this means of swindling the investor is made public knowledge (and there is ample evidence to the effect that the courts and the corporation authorities are becoming wiser) a reaction will take place. The Bartlett and Allenhurst cases, instead of being taken as evidence of the fact that the courts refuse to recognize the rights of the stockholder as against the grabbing promoter, should be viewed in a more hopeful light. These cases will eventually prove to the judges the danger of the use of no par stock when issued for services and property. It should lead to, first, a series of decisions restricting the promoters in their actions, and, second, stringent laws putting the evaluation of consideration received for stock, whether par or no par, on a more substantial basis.

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[43] Meeker, Preventive and Primitive Security Laws (1926), 26 Col. L. Rev. 318 at 327.

[44] Machen, 1920 Corporation Reports 16.

[45] List v. Republic Bond & Mortgage Co., 271 Pac. 529 (1928).