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Chapter 15

Legal Aspects of Corporate Finance

LEARNING OBJECTIVES

After reading this chapter, you should understand the following:

1. The general sources of corporate funds
2. The basics of corporate bonds and other debt leveraging
3. What the various types of stocks are
4. Initial public offerings and consideration for stock
5. What dividends are
6. Some of the modern trends in corporate finance

A corporation requires money for many reasons. In this chapter, we look at the methods available to a corporation for raising funds, focusing on how firms generate large amounts of funds and finance large projects, such as building a new factory.

One major method of finance is the sale of stock. A corporation sells shares of stock, often in an initial public offering. In exchange for consideration—usually cash—the purchaser acquires stock in the corporation. This stock may give the owner a share in earnings, the right to transfer the stock, and, depending on the size of the corporation and the number of shares, power to exercise control. Other methods of corporate finance include bank financing and bonds. We also discuss some more modern financing methods, such as private equity and venture capital. Additional methods of corporate finance, such as commercial paper (see [Chapter 19 "Nature and Form of Commercial Paper"](#) and [Chapter 20 "Negotiation of Commercial Paper"](#)), are discussed elsewhere in this book.

15.1 General Sources of Corporate Funds

LEARNING OBJECTIVES

1. Discuss the main sources for raising corporate funds.
2. Examine the reinvestment of earnings to finance growth.
3. Review debt and equity as methods of raising funds.
4. Consider private equity and venture capital, and compare their utility to other forms of financing.

Sources

To finance growth, any ongoing business must have a source of funds. Apart from bank and trade debt, the principal sources are plowback, debt securities, equity securities, and private equity.

Plowback

A significant source of new funds that corporations spend on capital projects is earnings. Rather than paying out earnings to shareholders, the corporation plows those earnings back into the business. **Plowback**¹ is simply reinvesting earnings in the corporation. It is an attractive source of capital because it is subject to managerial control. No approval by governmental agencies is necessary for its expenditure, as it is when a company seeks to sell securities, or stocks and bonds. Furthermore, stocks and bonds have costs associated with them, such as the interest payments on bonds (discussed in [Section 15.1.3 "Debt Securities"](#)), while retaining profits avoids these costs.

Debt Securities

A second source of funds is borrowing through debt securities. A corporation may take out a debt security such as a loan, commonly evidenced by a note and providing security to the lender. This is covered in [Chapter 25 "Secured Transactions and Suretyship"](#) and [Chapter 26 "Mortgages and Nonconsensual Liens"](#). A common type of corporate debt security is a **bond**², which is a promise to repay the face value of the bond at maturity and make periodic interest payments called the coupon rate. For example, a bond may have a face value of \$1,000 (the amount to be repaid at maturity) and a coupon rate of 7 percent paid annually; the corporation pays \$70 interest on such a bond each year. Bondholders have priority

1. Reinvesting corporate earnings in the corporation as a method of raising funds.
2. A debt security to raise corporate funds where the corporation pays periodic interest (the coupon rate) and the face value at maturity.

over stockholders because a bond is a debt, and in the event of bankruptcy, creditors have priority over equity holders.

Equity Securities

The third source of new capital funds is equity securities—namely, **stock**³. **Equity**⁴ is an ownership interest in property or a business. Stock is the smallest source of new capital but is of critical importance to the corporation in launching the business and its initial operations. Stock gives the investor a bundle of legal rights—ownership, a share in earnings, transferability and, to some extent, the power to exercise control through voting. The usual way to acquire stock is by paying cash or its equivalent as consideration. Both stock and consideration are discussed in more detail in [Section 15.3.2 "Par Value and No-Par Stock"](#) and [Section 15.4 "Initial Public Offerings and Consideration for Stock"](#).

Other Forms of Finance

While stock, debt securities, and reinvested profits are the most common types of finance for major corporations (particularly publicly traded corporations), smaller corporations or start-ups cannot or do not want to avail themselves of these financing options. Instead, they seek to raise funds through **private equity**⁵, which involves private investors providing funds to a company in exchange for an interest in the company. A private equity firm is a group of investors who pool their money together for investment purposes, usually to invest in other companies. Looking to private equity firms is an option for start-ups—companies newly formed or in the process of being formed—that cannot raise funds through the bond market or that wish to avoid debt or a public stock sale. Start-ups need money to begin operations, expand, or conduct further research and development. A private equity firm might provide **venture capital**⁶ financing for these start-ups. Generally, private equity firms that provide a lot of venture capital must be extremely savvy about the start-up plans of new businesses and must ask the start-up entrepreneurs numerous challenging and pertinent questions. Such private equity firms expect a higher rate of return on their investment than would be available from established companies. Today, venture capital is often used to finance entrepreneurial start-ups in biotechnology and clean technology.

Sometimes, a private equity firm will buy all the publicly traded shares of a company—a process commonly termed “going private.” Private equity may also be involved in providing financing to established firms.

Another source of private equity is angel investors, affluent individuals who operate like venture capitalists, providing capital for a business to get started in

3. An ownership interest in a corporation (synonymous with *shares*).

4. Ownership interest, such as stock, in property or a business.

5. Finance conducted through private investors, either individuals or firms.

6. Financial capital provided to early-stage, high-potential, high-risk start-up companies by investors who often expect a return on the investment by an eventual sale of the company or by taking the firm public.

exchange for repayment with interest or an ownership interest. The main difference between an angel investor and a venture capitalist is the source of funds: an angel investor invests his or her own money, while venture capitalists use pooled funds.

Private equity firms may also use a **leveraged buyout (LBO)**⁷ to finance the acquisition of another firm. Discussed further in [Chapter 18 "Corporate Expansion, State and Federal Regulation of Foreign Corporations, and Corporate Dissolution"](#) on Corporate Expansion, in the realm of private equity, an LBO is a financing option using debt to acquire another firm. In an LBO, private equity investors use the assets of the target corporation as collateral for a loan to purchase that target corporation. Such investors may pursue an LBO as a debt acquisition option since they do not need to use much—or even any—of their own money in order to finance the acquisition.

A major drawback to private equity, whether through a firm or through venture capital, is the risk versus return trade-off. Private equity investors may demand a significant interest in the firm, or a high return, to compensate them for the riskiness of their investment. They may demand a say in how the firm is operated or a seat on the board of directors.

KEY TAKEAWAY

There are four main sources of corporate finance. The first is plowback, or reinvesting profits in the corporation. The second is borrowing, commonly through a bond issue. A corporation sells a bond, agreeing to periodic interest payments and repayment of the face value of the bond at maturity. The third source is equity, usually stock, whereby a corporation sells an ownership interest in the corporation. The fourth source is private equity and venture capital.

EXERCISES

1. What are the main sources of corporate finance?
2. What are some of the legal rights associated with stock ownership?
3. Describe private equity. What are some similarities and differences between private equity and venture capital?

7. The acquisition of another company using a significant amount of borrowed money to pay for the acquisition. Often, the assets of the company being acquired may be used as collateral for the loans.

15.2 Bonds

LEARNING OBJECTIVES

1. Discuss the basics of corporate bonds.
2. Review the advantages and disadvantages to the corporation of issuing bonds.

Basics of Corporate Bonds

Corporations often raise money through debt. This can be done through loans or bank financing but is often accomplished through the sale of bonds. Large corporations, in particular, use the bond market. Private equity is not ideal for established firms because of the high cost to them, both monetarily and in terms of the potential loss of control.

For financing, many corporations sell corporate bonds to investors. A bond is like an IOU. When a corporation sells a bond, it owes the bond purchaser periodic interest payments as well as a lump sum at the end of the life of the bond (the maturity date). A typical bond is issued with a face value, also called the par value, of \$1,000 or some multiple of \$1,000. The **face value**⁸ is the amount that the corporation must pay the purchaser at the end of the life of the bond. Interest payments, also called **coupon payments**⁹, are usually made on a biannual basis but could be of nearly any duration. There are even zero coupon bonds, which pay only the face value at maturity.

Advantages and Disadvantages of Bonds

One advantage of issuing bonds is that the corporation does not give away ownership interests. When a corporation sells stock, it changes the ownership interest in the firm, but bonds do not alter the ownership structure. Bonds provide flexibility for a corporation: it can issue bonds of varying durations, value, payment terms, convertibility, and so on. Bonds also expand the number of investors available to the corporation. From an investor standpoint, bonds are generally less risky than stock. Most corporate bonds are given ratings—a measurement of the risk associated with holding a particular bond. Therefore, risk-averse investors who would not purchase a corporation's stock could seek lower-risk returns in highly rated corporate bonds. Investors are also drawn to bonds because the bond market

8. The amount that a corporation pays a bondholder at the bond's maturity.

9. The interest payment made by a corporation to the holder of a bond.

is much larger than the stock market and bonds are highly liquid and less risky than many other types of investments.

Another advantage to the corporation is the ability to make bonds “callable”—the corporation can force the investor to sell bonds back to the corporation before the maturity date. Often, there is an additional cost to the corporation (a call premium) that must be paid to the bondholder, but the call provision provides another level of flexibility for the corporation. Bonds may also be convertible; the corporation can include a provision that permits bondholders to convert their bonds into equity shares in the firm. This would permit the corporation to decrease the cost of the bonds, because bondholders would ordinarily accept lower coupon payments in exchange for the option to convert the bonds into equity. Perhaps the most important advantage to issuing bonds is from a taxation standpoint: the interest payments made to the bondholders may be deductible from the corporation’s taxes.

A key disadvantage of bonds is that they are debt. The corporation must make its bond interest payments. If a corporation cannot make its interest payments, the bondholders can force it into bankruptcy. In bankruptcy, the bondholders have a liquidation preference over investors with ownership—that is, the shareholders. Additionally, being highly leveraged can be risky: a corporation could load itself up with too much debt and not be able to make its interest payments or face-value payments. Another major consideration is the “cost” of debt. When interest rates are high, corporations must offer higher interest rates to attract investors.

KEY TAKEAWAY

Corporations often raise capital and finance operations through debt. Bank loans are one source of debt, but large corporations often turn to bonds for financing. Bonds are an IOU, whereby the corporation sells a bond to an investor; agrees to make periodic interest payments, such as 5 percent of the face value of the bond annually; and at the maturity date, pays the face value of the bond to the investor. There are several advantages to the corporation in using bonds as a financial instrument: the corporation does not give up ownership in the firm, it attracts more investors, it increases its flexibility, and it can deduct the interest payments from corporate taxes. Bonds do have some disadvantages: they are debt and can hurt a highly leveraged company, the corporation must pay the interest and principal when they are due, and the bondholders have a preference over shareholders upon liquidation.

EXERCISES

1. Describe a bond.
2. What are some advantages to the corporation in issuing bonds?
3. What are some disadvantages to the corporation in using bonds?

15.3 Types of Stock

LEARNING OBJECTIVES

1. Understand the basic features of corporate stock.
2. Be familiar with the basic terminology of corporate stock.
3. Discuss preferred shares and the rights of preferred shareholders.
4. Compare common stock with preferred stock.
5. Describe treasury stock, and explain its function.
6. Analyze whether debt or equity is a better financing option.

Stocks¹⁰, or **shares**¹¹, represent an ownership interest in a corporation. Traditionally, stock was the original capital paid into a business by its founders. This stock was then divided into shares, or fractional ownership of the stock. In modern usage, the two terms are used interchangeably, as we will do here. Shares in closely held corporations are often identical: each share of stock in BCT Bookstore, Inc. carries with it the same right to vote, to receive dividends, and to receive a distribution of the net assets of the company upon liquidation. Many large corporations do not present so simple a picture. Large corporations may have many different types of stock: different classes of common stock, preferred stock, stock with par value and no-par stock, voting and nonvoting stock, outstanding stock, and treasury stock. To find out which types of stock a company has issued, look at the shareholders' (or stockholders') equity section of the company's balance sheet.

Authorized, Issued, and Outstanding Stock

Stocks have different designations depending on who holds them. The articles of incorporation spell out how many shares of stock the corporation may issue: these are its **authorized shares**¹². The corporation is not obliged to issue all authorized shares, but it may not issue more than the total without amending the articles of incorporation. The total of stock sold to investors is the issued stock of the corporation; the issued stock in the hands of all shareholders is called outstanding stock.

Par Value and No-Par Stock

Par value¹³ is the face value of stock. Par value, though, is not the market value; it is a value placed on the stock by the corporation but has little to do with the buying and selling value of that stock on the open market.

10. An ownership interest in a corporation (synonymous with *shares*).

11. An ownership interest in a corporation (synonymous with *stock*).

12. The maximum number of shares of stock that a company can issue, although management will typically keep the amount higher than those actually issued.

13. The face value of a stock.

When a value is specified on a stock certificate, it is said to be par value. Par value is established in the articles of incorporation and is the floor price of the stock; the corporation may not accept less than par value for the stock.

Companies in most states can also issue no-par shares. No-par stock may be sold for whatever price is set by the board of directors or by the market—unless the shareholders themselves are empowered to establish the price. But many states permit (and some states require) no-par stock to have a stated value. Corporations issue no-par stock to reduce their exposure to liability: if the par value is greater than the market value, the corporation may be liable for that difference.

Once the universal practice, issuance of par value common stock is now limited. However, preferred stock usually has a par value, which is useful in determining dividend and liquidation rights.

The term *stated capital* describes the sum of the par value of the issued par value stock and the consideration received (or stated value) for the no-par stock. The excess of net assets of a corporation over stated capital is its **surplus**¹⁴. Surplus is divided into earned surplus (essentially the company's retained earnings) and capital surplus (all surpluses other than earned surplus). We will return to these concepts in our discussion of dividends.

Preferred Stock

The term *preferred* has no set legal meaning, but shareholders of **preferred stock**¹⁵ often have different rights than shareholders of common stock. Holders of preferred stock must look to the articles of incorporation to find out what their rights are. Preferred stock has elements of both stock (equity) and bonds (debt). Thus corporations issue preferred stock to attract more conservative investors: common stock is riskier than preferred stock, so corporations can attract more investors if they have both preferred and common stock.

Preference to Dividends

A dividend is a payment made to stockholders from corporate profits. Assume that one class of preferred stock is entitled to a 7 percent dividend. The percentage applies to the par value; if par value is \$100, each share of preferred is entitled to a dividend of \$7 per year. Assuming the articles of incorporation say so, this 7 percent preferred stock has preference over other classes of shares for dividend payments.

14. The excess of net assets of a corporation over its stated capital.

15. A variety of stock that differs from common stock in provisions for dividends and/or preference upon liquidation.

Liquidation Preference

An additional right of preferred shareholders is the right to share in the distribution of assets in the event of liquidation, after having received assets under a liquidation preference—that is, a preference, according to a predetermined formula, to receive the assets of the company on liquidation ahead of other classes of shareholders.

Convertible Shares

With one exception, the articles of incorporation may grant the right to convert any class of stock into any other at the holder's option according to a fixed ratio. Alternatively, the corporation may force a conversion of a shareholder's convertible stock. Thus if permitted, a preferred shareholder may convert his or her preferred shares into common stock, or vice versa. The exception bars conversion of stock into a class with an asset liquidation preference, although some states permit even that type of so-called upstream conversion to a senior security. Convertible preferred shares can be used as a poison pill (a corporate strategy to avoid a hostile takeover): when an outsider seeks to gain control, convertible shareholders may elect to convert their preferred shares into common stock, thus increasing the number of common shares and increasing the number of shares the outsider must purchase in order to gain control.

Redeemable Shares

The articles of incorporation may provide for the redemption of shares, unless in doing so the corporation would become insolvent. Redemption may be either at an established price and time or by election of the corporation or the shareholder. Redeemed stock is called cancelled stock. Unless the articles of incorporation prohibit it, the shares are considered authorized but unissued and can be reissued as the need arises. If the articles of incorporation specifically make the cancellation permanent, then the total number of authorized shares is reduced, and new shares cannot be reissued without amending the articles of incorporation. In this case, the redeemed shares cannot be reissued and must be marked as cancelled stock.

Voting Rights

Ordinarily, the articles of incorporation provide that holders of preferred shares do not have a voting right. Or they may provide for contingent voting rights, entitling preferred shareholders to vote on the happening of a particular event—for example, the nonpayment of a certain number of dividends. The articles may allow class voting for directors, to ensure that the class of preferred stockholders has some representation on the board.

Common Stock

Common stock¹⁶ is different from preferred stock. Common stock represents an ownership interest in a corporation. Unless otherwise provided in the articles of incorporation, common stockholders have the following rights:

1. Voting rights. This is a key difference: preferred shareholders usually do not have the right to vote. Common shareholders express their ownership interest in the corporation by voting. Votes are cast at meetings, typically the annual meetings, and the shareholders can vote for directors and on other important corporate decisions (e.g., there has been a recent push to allow shareholders to vote on executive compensation).
2. The right to ratable participation in earnings (i.e., in proportion to the total shares) and/or the right to ratable participation in the distribution of net assets on liquidation. Bondholders and other creditors have seniority upon liquidation, but if they have been satisfied, or the corporation has no debt, the common shareholders may ratably recover from what is left over in liquidation.
3. Some shares may give holders preemptive rights to purchase additional shares. This right is often invoked in two instances. First, if a corporation is going to issue more shares, a shareholder may invoke this right so that his or her total percentage ownership is not diluted. Second, the right to purchase additional shares can be invoked to prevent a hostile takeover (a poison pill, discussed in [Section 15.3.3 "Preferred Stock"](#)).

Corporations may issue different classes of shares (including both common and preferred stock). This permits a corporation to provide different rights to shareholders. For example, one class of common stock may give holders more votes than another class of common stock. Stock is a riskier investment for its purchasers compared with bonds and preferred stock. In exchange for this increased risk and junior treatment, common stockholders have the rights noted here.

Treasury Shares

Treasury shares¹⁷ are those that were originally issued and then reacquired by the company (such as in a buyback, discussed next) or, alternatively, never sold to the public in the first place and simply retained by the corporation. Thus treasury shares are shares held or owned by the corporation. They are considered to be issued shares but not outstanding shares.

16. A security that represents ownership in a corporation and allows the holder to elect a board of directors.

17. Stock that was issued and then later reacquired by a company (a buyback) or that was never sold to the public in the first place and simply retained by the company.

Buyback

Corporations often reacquire their shares, for a variety of reasons, in a process sometimes called a **buyback**¹⁸. If the stock price has dropped so far that the shares are worth considerably less than book value, the corporation might wish to buy its shares to prevent another company from taking it over. The company might decide that investing in itself is a better strategic decision than making other potential expenditures or investments. And although it is essentially an accounting trick, buybacks improve a company's per-share earnings because profits need to be divided into fewer outstanding shares.

Buybacks can also be used to go private. Private equity may play a role in going-private transactions, as discussed in [Section 15.1.5 "Other Forms of Finance"](#). The corporation may not have sufficient equity to buy out all its public shareholders and thus will partner with private equity to finance the stock buyback to go private. For example, in early 2011, Playboy Enterprises, Inc., publisher of *Playboy* magazine, went private. Hugh Hefner, the founder of Playboy, teamed up with private equity firm Rizvi Traverse Management to buy back the public shares. Hefner said that the transaction "will give us the resources and flexibility to return Playboy to its unique position and to further expand our business around the world." Dawn C. Chmielewski and Robert Channick, "Hugh Hefner Reaches Deal to Take Playboy Private," *Los Angeles Times*, January 11, 2011. <http://articles.latimes.com/2011/jan/11/business/la-fi-ct-playboy-hefner-20110111>.

Corporations may go private to consolidate control, because of a belief that the shares are undervalued, to increase flexibility, or because of a tender offer or hostile takeover. Alternatively, an outside investor may think that a corporation is not being managed properly and may use a tender offer to buy all the public shares.

Stocks and Bonds and Bears, Oh My!

Suppose that BCT Bookstore, Inc. has become a large, well-established corporation after a round of private equity and bank loans (since repaid) but needs to raise capital. What is the best method? There is no one right answer. Much of the decision will depend on the financial and accounting standing of the corporation: if BCT already has a lot of debt, it might be better to issue stock rather than bring on more debt. Alternatively, BCT could wish to remain a privately held corporation, and thus a stock sale would not be considered, as it would dilute the ownership. The economy in general could impact the decision: a bear market could push BCT more toward using debt, while a bull market could push BCT more toward an initial public offering (discussed in [Section 15.4.1 "Sale of stock"](#)) or stock sale. Interest rates could be low, increasing the bang-for-the-buck factor of debt. Additionally, public stock sales can be risky for the corporation: the corporation could

18. A process whereby a corporation reacquires or repurchases its shares (the shares then become treasury shares).

undervalue its stock in the initial sale, selling the stock for less than what the marketplace thinks it is worth, missing out on additional funds because of this undervaluation. Debt may also be beneficial because of the tax treatment of interest payments—the corporation can deduct the interest payments from corporate profits. Thus there are many factors a corporation must consider when deciding whether to finance through debt or equity.

KEY TAKEAWAY

Stock, or shares (equity), express an ownership interest in a corporation. Shares have different designations, depending on who holds the shares. The two main types of stock are preferred stock and common stock, each with rights that often differ from the rights of the other. Preferred stock has elements of both debt and equity. Holders of preferred shares have a dividend preference and have a right to share in the distribution of assets in liquidation. Holders of common stock have a different set of rights, namely, the right to vote on important corporate decisions such as the election of directors. A corporation may purchase some of its shares from its shareholders in a process called a buyback. Stock in the hands of the corporation is called treasury stock. There are a variety of factors that a corporation must consider in determining whether to raise capital through bonds or through stock issuance.

EXERCISES

1. What are some key rights of holders of preferred shares?
2. What is the major difference between preferred stock and common stock?
3. Why would a corporation buy back its own shares?
4. What are some factors a corporation must consider in deciding whether to issue stock or bonds?

15.4 Initial Public Offerings and Consideration for Stock

LEARNING OBJECTIVES

1. Understand what an initial public offering is and under what circumstances one is usually done.
2. Examine the various requirements of selling stock.
3. Discuss what adequate and valid consideration is in exchange for stock.

Sale of stock

Rather than using debt to finance operations, a corporation may instead sell stock. This is most often accomplished through an **initial public offering (IPO)**¹⁹, or the first time a corporation offers stock for sale to the public. The sale of securities, such as stock, is governed by the Securities Act of 1933. In particular, Section 5 of the 1933 act governs the specifics of the sale of securities. To return to BCT Bookstore, Inc., suppose the company wishes to sell stock on the New York Stock Exchange (NYSE) for the first time. That would be an IPO. The company would partner with securities lawyers and investment banks to accomplish the sale. The banks underwrite the sale of the securities: in exchange for a fee, the bank will buy the shares from BCT and then sell them. The company and its team prepare a registration statement, which contains required information about the IPO and is submitted to the Securities and Exchange Commission (SEC). The SEC reviews the registration statement and makes the decision whether to permit or prohibit BCT's IPO. Once the SEC approves the IPO, BCT's investment banks purchase the shares in the primary market and then resell them to investors on the secondary market on the NYSE. (For a further discussion of these two markets, see [Chapter 17 "Securities Regulation"](#)). Stock sales are not limited to an IPO—publicly traded corporations may sell stock several times after going public. The requirements of the 1933 act remain but are loosened for well-known corporations (well-known seasoned issuers).

An IPO or stock sale has several advantages. A corporation may have too much debt and would prefer to raise funds through a sale of stock rather than increasing its debt. The total costs of selling stock are often lower than financing through debt: the IPO may be expensive, but debt costs can vastly exceed the IPO cost because of the interest payments on the debt. Also, IPOs are a popular method of increasing a firm's exposure, bringing the corporation many more investors and increasing its public image. Issuing stock is also beneficial for the corporation because the corporation can use shares as compensation; for example, employment

19. The first time a corporation offers stock for sale to the public.

compensation may be in the form of stock, such as in an employee stock ownership plan. Investors also seek common stock, whether in an IPO or in the secondary market. While common stock is a riskier investment than a bond, stock ownership can have tremendous upside—after all, the sky is the limit on the price of a stock. On the other hand, there is the downside: the price of the stock can plummet, causing the shareholder significant monetary loss.

Certainly, an IPO has some disadvantages. Ownership is diluted: BCT had very few owners before its IPO but may have millions of owners after the IPO. As mentioned, an IPO can be expensive. An IPO can also be undervalued: the corporation and its investment banks may undervalue the IPO stock price, causing the corporation to lose out on the difference between its determined price and the market price. Being a public corporation also places the corporation under the purview of the SEC and requires ongoing disclosures. Timing can be problematic: the registration review process can take several weeks. The stock markets can change drastically over that waiting period. Furthermore, the offering could have insufficient purchasers to raise sufficient funds; that is, the public might not have enough interest in purchasing the company's stock to bring in sufficient funds to the corporation. Finally, a firm that goes public releases information that is available to the public, which could be useful to competitors (trade secrets, innovations, new technology, etc.).

As mentioned, one of the main disadvantages of going public is the SEC review and disclosure requirements. The Securities Exchange Act of 1934 governs most secondary market transactions. The 1934 act places certain requirements on corporations that have sold securities. Both the 1933 and 1934 acts require corporations to disseminate information to the public and/or its investors. These requirements were strengthened after the collapse of Enron in 2001. The SEC realized that its disclosure requirements were not strong enough, as demonstrated by the accounting tricks and downfall of Enron and its accountant, Arthur Andersen. For a full discussion of Enron, see Bethany McLean and Peter Elkind, *Enron: The Smartest Guys in the Room* (New York: Portfolio, 2004).

As a result of Enron's accounting scandal, as well as problems with other corporations, Congress tightened the noose by passing the Sarbanes-Oxley Act of 2002. Sarbanes-Oxley Act can be viewed at University of Cincinnati, "The Sarbanes-Oxley Act of 2002," *Securities Lawyer's Deskbook*, <http://taft.law.uc.edu/CCL/SOact/toc.html>. This act increased the disclosure of financial information, increased transparency, and required the dissemination of information about what a corporation was doing. For example, Section 302 of Sarbanes-Oxley requires that a corporation's chief executive officer and chief financial officer certify annual and quarterly reports and state that the report does not contain any material falsehoods and that the financial data accurately reflect the corporation's condition.

Nature of the Consideration

Consideration²⁰ is property or services exchanged for stock. While cash is commonly used to purchase stock, a stock purchaser may pay with something other than cash, such as property, whether tangible or intangible, or services or labor performed for the corporation. In most states, promissory notes and contracts for future services are not lawful forms of consideration. The case *United Steel Industries, Inc. v. Manhart*, (see [Section 15.7.1 "Consideration in Exchange for Stock"](#)), illustrates the problems that can arise when services or promises of future delivery are intended as payment for stock.

Evaluating the Consideration: Watered Stock

In *United Steel Industries* ([Section 15.7.1 "Consideration in Exchange for Stock"](#)), assume that Griffiths's legal services had been thought by the corporation to be worth \$6,000 but in fact were worth \$1,000, and that he had received stock with par value of \$6,000 (i.e., 6,000 shares of \$1 par value stock) in exchange for his services. Would Griffiths be liable for the \$5,000 difference between the actual value of his services and the stock's par value? This is the problem of **watered stock**²¹: the inflated consideration is in fact less than par value. The term itself comes from the ancient fraud of farmers and ranchers who increased the weight of their cattle (also known as stock) by forcing them to ingest excess water.

The majority of states follow the **good-faith rule**²². As noted near the end of the *United Steel Industries* case, in the absence of fraud, "the judgment of the board of directors 'as to the value of consideration received for shares' is conclusive." In other words, if the directors or shareholders conclude in good faith that the consideration does fairly reflect par value, then the stock is not watered and the stock buyer cannot be assessed for the difference. This is in line with the business judgment rule, discussed in [Chapter 16 "Corporate Powers and Management"](#). If the directors concluded in good faith that the consideration provided by Griffiths's services accurately reflected the value of the shares, they would not be liable. The minority approach is the true value rule: the consideration must in fact equal par value by an objective standard at the time the shares are issued, regardless of the board's good-faith judgment.

A shareholder may commence a derivative lawsuit (a suit by a shareholder, on behalf of the corporation, often filed against the corporation; see [Chapter 16 "Corporate Powers and Management"](#)). In a watered stock lawsuit, the derivative suit is filed against a shareholder who has failed to pay full consideration under either rule to recover the difference between the value received by the corporation and the par value.

20. The surrender of any legal right (a detriment) in return for the promise of some benefit in return.

21. When consideration is inflated such that the property given for consideration in exchange for shares is in fact less than par value.

22. Directors' judgment as to the value of consideration received for shares is deemed conclusive.

KEY TAKEAWAY

Corporations may raise funds through the sale of stock. This can be accomplished through an initial public offering (IPO)—the first time a corporation sells stock—or through stock sales after an IPO. The SEC is the regulatory body that oversees the sale of stock. A sale of stock has several benefits for the corporation, such as avoiding the use of debt, which can be much more expensive than selling stock. Stock sales also increase the firm's exposure and attract investors who prefer more risk than bonds. On the other hand, stock sales have some disadvantages, namely, the dilution of ownership of the corporation. Also, the corporation may undervalue its shares, thus missing out on additional capital because of the undervaluation. Being a publicly traded company places the corporation under the extensive requirements of the SEC and the 1933 and 1934 securities acts, such as shareholder meetings and annual financial reports. The Sarbanes-Oxley Act adds yet more requirements that a corporation may wish to avoid.

Consideration is property or services exchanged for stock. Most investors will exchange money for stock. Certain forms of consideration are not permitted. Finally, a corporation may be liable if it sells watered stock, where consideration received by the corporation is less than the stock par value.

EXERCISES

1. Describe the process of conducting an IPO.
2. What are some advantages of selling stock?
3. What are some disadvantages of selling stock?
4. What is consideration? What are some types of consideration that may not be acceptable?

15.5 Dividends

LEARNING OBJECTIVES

1. Discuss several types of dividends.
2. Review legal limitations on distributing dividends.
3. Define the duties of directors when paying dividends.

Types of Dividends

A **dividend**²³ is a share of profits, a dividing up of the company's earnings. The law does not require a corporation to give out a specific type of dividend.

Cash Dividend

If a company's finances are such that it can declare a dividend to stockholders, a cash dividend always is permissible. It is a payment (by check, ordinarily) to the stockholders of a certain amount of money per share. Under current law, qualified dividends are taxed as a long-term capital gain (usually 15 percent, but the figure can be as low as zero percent under current law). These rules are set to expire in 2013, when dividends will be taxed as ordinary income (i.e., at the recipient's ordinary income tax rate).

Stock Dividend

Next to cash, the most frequent type of dividend is stock itself. Normally, the corporation declares a small percentage dividend (between 1 and 10 percent), so that a holder of one hundred shares would receive four new shares on a 4 percent dividend share. Although each shareholder winds up with more stock, he realizes no personal net gain at that moment, as he would with a cash dividend, because each stockholder has the same relative proportion of shares and has not sold or otherwise transferred the shares or dividend. The total outstanding stock represents no greater amount of assets than before. The corporation may issue share dividends either from treasury stock or from authorized but unissued shares.

Property Dividend

Rarely, corporations pay dividends in property rather than in cash. Armand Hammer, the legendary financier and CEO of Occidental Petroleum Corporation,

23. A share of a corporation's profits.

recounts how during World War II he founded a liquor business by buying shares of the American Distilling Company. American Distilling was giving out one barrel of whiskey per share as a dividend. Whiskey was in short supply during the war, so Hammer bought five thousand shares and took five thousand barrels of whiskey as a dividend.

Stock Split

A stock dividend should be distinguished from a stock split. In a **stock split**²⁴, one share is divided into more shares—for example, a two-for-one split means that for every one share the stockholder owned before the split, he now has two shares. In a reverse stock split, shares are absorbed into one. In a one-for-two reverse split, the stockholder will get one share in place of the two he held before the split.

The stock split has no effect on the assets of the company, nor is the interest of any shareholder diluted. No transfer from surplus into stated capital is necessary. The only necessary accounting change is the adjustment of par value and stated value. Because par value is being changed, many states require not only the board of directors but also the shareholders to approve a stock split.

Why split? The chief reason is to reduce the current market price of the stock in order to make it affordable to a much wider class of investors. For example, in 1978, IBM, whose stock was then selling for around \$284, split four for one, reducing the price to about \$70 a share. That was the lowest IBM's stock had been since 1932. Stock need not sell at stratospheric prices to be split, however; for example, American Telnet Corporation, whose stock had been selling at \$0.4375 a share, declared a five-for-one split in 1980. Apparently the company felt that the stock would be more affordable at \$0.0875 a share. At the opposite end of the spectrum are Class A shares of Warren Buffett's Berkshire Hathaway, which routinely trade for more than \$100,000 a share. Buffett has rebuffed efforts to split the Class A shares, but in 2010, shareholders approved a fifty-for-one split of Class B shares. *BusinessWeek* covers many stock splits and reverse splits in its finance section, available at <http://www.businessweek.com/finance>.

Legal Limitations on Dividends

The law imposes certain limitations on cash or property dividends a corporation may disburse. Dividends may not be paid if (1) the business is insolvent (i.e., unable to pay its debts as they become due), (2) paying dividends would make it insolvent, or (3) payment would violate a restriction in the articles of incorporation. Most states also restrict the funds available for distribution to those available in earned

24. Increasing the number of a firm's outstanding shares by issuing more shares to current shareholders, adjusting the price to keep the firm's market capitalization the same.

surplus. Under this rule, a corporation that ran a deficit in the current year could still declare a dividend as long as the total earned surplus offset the deficit.

A few states—significantly, Delaware is one of them—permit dividends to be paid out of the net of current earnings and those of the immediately preceding year, both years taken as a single period, even if the balance sheet shows a negative earned surplus. Such dividends are known as nimble dividends. See *Weinberg v. Baltimore Brick Co.* *Weinberg v. Baltimore Brick Co.*, 35 Del. Ch. 225; 114 A.2d 812 (Del. 1955).

Distribution from Capital Surplus

Assets in the form of cash or property may be distributed from capital surplus if the articles of incorporation so provide or if shareholders approve the distribution. Such distributions must be identified to the shareholders as coming from capital surplus.

Record Date, Payment Date, Rights of Stockholders

Under the securities exchange rules, the board of directors cannot simply declare a dividend payable on the date of the board meeting and instruct the treasurer to hand out cash. The board must fix two dates: a record date and a payment date. By the first, the board declares a dividend for shareholders of record as of a certain future date—perhaps ten days hence. Actual payment of the dividend is postponed until the payment date, which could be a month after the record date.

The board's action creates a debtor-creditor relationship between the corporation and its shareholders. The company may not revoke a cash dividend unless the shareholders consent. It may revoke a share dividend as long as the shares have not been issued.

Discretion of Directors to Pay Dividends When Directors Are Too Stingy

In every state, dividends are normally payable only at the discretion of the directors. Courts will order distribution only if they are expressly mandatory or if it can be shown that the directors abused their discretion by acting fraudulently or in a manner that was manifestly unreasonable. *Dodge v. Ford Motor Co.*, (see [Section 15.7.2 "Payment of Dividends"](#)), involves Henry Ford's refusal in 1916 to pay dividends in order to reinvest profits; it is often celebrated in business annals because of Ford's testimony at trial, although, as it turned out, the courts held his refusal to be an act of miserliness and an abuse of discretion. Despite this ruling,

many corporations today do not pay dividends. Corporations may decide to reinvest profits in the corporation rather than pay a dividend to its shareholders, or to just sit on the cash. For example, Apple Computer, Inc., maker of many popular computers and consumer electronics, saw its share price skyrocket in the late 2000s. Apple also became one of the most valuable corporations in the world. Despite an immense cash reserve, Apple has refused to pay a dividend, choosing instead to reinvest in the business, stating that they require a large cash reserve as a security blanket for acquisitions or to develop new products. Thus despite the ruling in *Dodge v. Ford Motor Co.*, courts will usually not intercede in a corporation's decision not to pay dividends, following the business judgment rule and the duties of directors. (For further discussion of the duties of directors, see [Chapter 16 "Corporate Powers and Management"](#)).

When Directors Are Too Generous

Directors who vote to declare and distribute dividends in excess of those allowed by law or by provisions in the articles of incorporation personally may become jointly and severally liable to the corporation (but liability may be reduced or eliminated under the business judgment rule). Shareholders who receive a dividend knowing it is unlawful must repay any directors held liable for voting the illegal dividend. The directors are said to be entitled to contribution from such shareholders. Even when directors have not been sued, some courts have held that shareholders must repay dividends received when the corporation is insolvent or when they know that the dividends are illegal.

KEY TAKEAWAY

A dividend is a payment made from the corporation to its shareholders. A corporation may pay dividends through a variety of methods, although money and additional shares are the most common. Corporations may increase or decrease the total number of shares through either a stock split or a reverse stock split. A corporation may decide to pay dividends but is not required to do so and cannot issue dividends if the corporation is insolvent. Directors may be liable to the corporation for dividend payments that violate the articles of incorporation or are illegal.

EXERCISES

1. What is a dividend, and what are the main types of dividends?
2. Is a corporation required to pay dividends? Under what circumstances is a corporation barred from paying dividends?
3. You have ten shares of BCT, valued at \$10 each. The company engages in a two-for-one stock split. How many shares do you now have? What is the value of each share, and what is the total value of all of your BCT shares?

15.6 The Winds of Change

LEARNING OBJECTIVES

1. Know the modern changes to corporate finance terminology and specific requirements imposed by states.
2. Compare the application of the Uniform Commercial Code to corporate finance with the applicability of the 1933 and 1934 federal securities acts.

Changes in the Revised Model Business Corporation Act

Perhaps the most dramatic innovations incorporated into the Revised Model Business Corporation Act (RMBCA) are the financial provisions. The revisions recommend eliminating concepts such as par value stock, no-par stock, stated capital, capital surplus, earned surplus, and treasury shares. It was felt that these concepts—notably par value and stated capital—no longer serve their original purpose of protecting creditors.

A key definition under the revisions is that of *distributions*—that is, any transfer of money or property to the shareholders. In order to make distributions, a corporation must meet the traditional insolvency test and balance sheet tests. Under the balance sheet test, corporate assets must be greater than or equal to liabilities and liquidation preferences on senior equity. The RMBCA also provides that promissory notes and contracts for future services may be used in payment for shares.

It is important to note that the RMBCA is advisory. Not every state has abandoned *par value* or the other financial terms. For example, Delaware is quite liberal with its requirements:

Every corporation may issue 1 or more classes of stock or 1 or more series of stock within any class thereof, any or all of which classes may be of stock with par value or stock without par value and which classes or series may have such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to

authority expressly vested in it by the provisions of its certificate of incorporation. Del. Code Ann. tit. 8, § 151 (2011).

Therefore, although the modern trend is to move away from *par value* as well as some other previously discussed terms—and despite the RMBCA’s abandonment of these concepts—they still, in large measure, persist.

Introduction to Article 8 of the Uniform Commercial Code

Partial ownership of a corporation would be an awkward investment if there were no ready means of transfer. The availability of paper certificates as tangible evidence of the ownership of equity securities solves the problem of what to transfer, but since a corporation must maintain records of its owners, a set of rules is necessary to spell out how transfers are to be made. That set of rules is Article 8 of the Uniform Commercial Code (UCC). Article 8 governs certificated securities, uncertificated securities, registration requirements, transfer, purchase, and other specifics of securities. Article 8 can be viewed at <http://www.law.cornell.edu/ucc/8/overview.html>.

The UCC and the 1933 and 1934 Securities Acts

The Securities Act of 1933 requires the registration of securities that are sold or offered to be sold using interstate commerce. The Securities Exchange Act of 1934 governs the secondary trading of securities, such as stock market sales. The UCC also governs securities, through Articles 8 and 9. The key difference is that the 1933 and 1934 acts are federal law, while the UCC operates at the state level. The UCC was established to standardize state laws governing sales and commercial transactions. There are some substantial differences, however, between the two acts and the UCC. Without going into exhaustive detail, it is important to note a few of them. For one, the definition of *security* in the UCC is different from the definition in the 1933 and 1934 acts. Thus a security may be governed by the securities acts but not by the UCC. The definition of a private placement of securities also differs between the UCC and the securities acts. Other differences exist. See Lynn Soukup, “Securities Law and the UCC: When Godzilla Meets Bambi,” *Uniform Commercial Code Law Journal* 38, no. 1 (Summer 2005): 3–28. The UCC, as well as state-specific laws, and the federal securities laws should all be considered in financial transactions.

KEY TAKEAWAY

The RMBCA advises doing away with financial concepts such as stock par value. Despite this suggestion, these concepts persist. Corporate finance is regulated through a variety of mechanisms, most notably Articles 8 and 9 of the Uniform Commercial Code and the 1933 and 1934 securities acts.

EXERCISES

1. What suggested changes are made by the RMBCA?
2. What does UCC Article 8 govern?

15.7 Cases

Consideration in Exchange for Stock

United Steel Industries, Inc. v. Manhart

405 S.W.2d 231 (Tex. 1966)

MCDONALD, CHIEF JUSTICE

This is an appeal by defendants, United Steel Industries, Inc., J. R. Hurt and W. B. Griffiths, from a judgment declaring void and cancelling 5000 shares of stock in United Steel Industries, Inc. issued to Hurt, and 4000 shares of stock in such corporation issued to Griffiths.

Plaintiffs Manhart filed this suit individually and as major stockholders against defendants United Steel Industries, Inc., Hurt, and Griffiths, alleging the corporation had issued Hurt 5000 shares of its stock in consideration of Hurt agreeing to perform CPA and bookkeeping services for the corporation for one year in the future; and had issued Griffiths 4000 shares of its stock in consideration for the promised conveyance of a 5 acre tract of land to the Corporation, which land was never conveyed to the Corporation. Plaintiffs assert the 9000 shares of stock were issued in violation of Article 2.16 Business Corporation Act, and prayed that such stock be declared void and cancelled.

Trial was before the Court without a jury which, after hearing, entered judgment declaring the 5000 shares of stock issued to Hurt, and the 4000 shares issued to Griffiths, issued without valid consideration, void, and decreeing such stock cancelled.

* * *

The trial court found (on ample evidence) that the incorporators of the Corporation made an agreement with Hurt to issue him 5000 shares in consideration of Hurt's agreement to perform bookkeeping and accounting services for the Corporation for the first year of its operation. The Corporation minutes reflect the 5000 shares issued to Hurt "in consideration of labor done, services in the incorporation and organization of the Corporation." The trial court found (on ample evidence) that such minutes do not reflect the true consideration agreed upon, and that Hurt

performed no services for the Corporation prior to February 1, 1965. The Articles of Incorporation were filed on January 28, 1965, and the 5000 shares were issued to Hurt on May 29, 1965. There is evidence that Hurt performed some services for the Corporation between January and May 29, 1965; but Hurt himself testified the “5000 (shares) were issued to me for services rendered or to be rendered for the first year in keeping the books....”

The situation is thus one where the stock was issued to Hurt both for services already performed and for services to be rendered in the future.

The trial court concluded the promise of future services was not a valid consideration for the issuance of stock under Article 2.16 Business Corporation Act; that the issuance was void; and that since there was no apportionment of the value of future services from the value of services already rendered, the entire 5000 shares were illegally issued and void.

Article 12, Section 6, Texas Constitution, provides: “No corporation shall issue stock...except for money paid, labor done, or property actually received....” And Article 2.16 Texas Business Corporation Act provides: “Payment for Shares.

“A. The consideration paid for the issuance of shares shall consist of money paid, labor done, or property actually received. Shares may not be issued until the full amount of the consideration, fixed as provided by law, has been paid....

“B. Neither promissory notes nor the promise of future services shall constitute payment or part payment for shares of a corporation.

“C. In the absence of fraud in the transaction, the judgment of the board of directors...as to the value of the consideration received for shares shall be conclusive.”

The Fifth Circuit in *Champion v. CIR*, 303 Fed. 2d 887 construing the foregoing constitutional provision and Article 2.16 of the Business Corporation Act, held:

Where it is provided that stock can be issued for labor done, as in Texas...the requirement is not met where the consideration for the stock is work or services to be performed in the future....The situation is not changed by reason of the provision that the stock was to be given...for services rendered as well as to be rendered, since there was no allocation or apportionment of stock between services performed and services to be performed.”

The 5000 shares were issued before the future services were rendered. Such stock was illegally issued and void.

Griffitts was issued 10,000 shares partly in consideration for legal services to the Corporation and partly in exchange for the 5 acres of land. The stock was valued at \$1 per share and the land had an agreed value of \$4000. The trial court found (upon ample evidence) that the 4000 shares of stock issued to Griffitts was in consideration of his promise to convey the land to the Corporation; that Griffitts never conveyed the land; and the issuance of the stock was illegal and void.

The judgment of the board of directors “as to the value of consideration received for shares” is conclusive, but such does not authorize the board to issue shares contrary to the Constitution, for services to be performed in the future (as in the case of Hurt), or for property not received (as in the case of Griffitts).

The judgment is correct. Defendants’ points and contentions are overruled.

AFFIRMED.

CASE QUESTIONS

1. What was wrong with the consideration in the transaction between United Steel and Hurt?
2. What if Hurt had completed one year of bookkeeping prior to receiving his shares?
3. What was wrong with the consideration Griffitts provided for the 4,000 shares he received?

Payment of Dividends

Dodge v. Ford Motor Co.

204 Mich. 459, 170 N.W. 668 (Mich. 1919)

[Action by plaintiffs John F. Dodge and Horace E. Dodge against defendant Ford Motor Company and its directors. The lower court ordered the directors to declare a dividend in the amount of \$19,275,385.96. The court also enjoined proposed expansion of the company. The defendants appealed.]

[T]he case for plaintiffs must rest upon the claim, and the proof in support of it, that the proposed expansion of the business of the corporation, involving the further use of profits as capital, ought to be enjoined because it is inimical to the best interests of the company and its shareholders, and upon the further claim that in any event the withholding of the special dividend asked for by plaintiffs is arbitrary action of the directors requiring judicial interference.

The rule which will govern courts in deciding these questions is not in dispute. It is, of course, differently phrased by judges and by authors, and, as the phrasing in a particular instance may seem to lean for or against the exercise of the right of judicial interference with the actions of corporate directors, the context, or the facts before the court, must be considered.

* * *

In 1 Morawetz on Corporations (2d Ed.), § 447, it is stated:

Profits earned by a corporation may be divided among its shareholders; but it is not a violation of the charter if they are allowed to accumulate and remain invested in the company's business. The managing agents of a corporation are impliedly invested with a discretionary power with regard to the time and manner of distributing its profits. They may apply profits in payment of floating or funded debts, or in development of the company's business; and so long as they do not abuse their discretionary powers, or violate the company's charter, the courts cannot interfere.

But it is clear that the agents of a corporation, and even the majority, cannot arbitrarily withhold profits earned by the company, or apply them to any use which is not authorized by the company's charter....

Mr. Henry Ford is the dominant force in the business of the Ford Motor Company. No plan of operations could be adopted unless he consented, and no board of directors can be elected whom he does not favor. One of the directors of the company has no stock. One share was assigned to him to qualify him for the position, but it is not claimed that he owns it. A business, one of the largest in the world, and one of the most profitable, has been built up. It employs many men, at good pay.

"My ambition," said Mr. Ford, "is to employ still more men, to spread the benefits of this industrial system to the greatest possible number, to help them build up their

lives and their homes. To do this we are putting the greatest share of our profits back in the business.”

“With regard to dividends, the company paid sixty per cent on its capitalization of two million dollars, or \$1,200,000, leaving \$58,000,000 to reinvest for the growth of the company. This is Mr. Ford’s policy at present, and it is understood that the other stockholders cheerfully accede to this plan.”

He had made up his mind in the summer of 1916 that no dividends other than the regular dividends should be paid, “for the present.”

“Q. For how long? Had you fixed in your mind any time in the future, when you were going to pay—

“A. No.

“Q. That was indefinite in the future?

“A. That was indefinite, yes, sir.”

The record, and especially the testimony of Mr. Ford, convinces that he has to some extent the attitude towards shareholders of one who has dispensed and distributed to them large gains and that they should be content to take what he chooses to give. His testimony creates the impression, also, that he thinks the Ford Motor Company has made too much money, has had too large profits, and that although large profits might be still earned, a sharing of them with the public, by reducing the price of the output of the company, ought to be undertaken. We have no doubt that certain sentiments, philanthropic and altruistic, creditable to Mr. Ford, had large influence in determining the policy to be pursued by the Ford Motor Company—the policy which has been herein referred to.

* * *

The difference between an incidental humanitarian expenditure of corporate funds for the benefit of the employees, like the building of a hospital for their use and the employment of agencies for the betterment of their condition, and a general purpose and plan to benefit mankind at the expense of others, is obvious. There should be no confusion (of which there is evidence) of the duties which Mr. Ford conceives that he and the stockholders owe to the general public and the duties which in law he and his codirectors owe to protesting, minority stockholders. A

business corporation is organized and carried on primarily for the profit of the stockholders. The powers of the directors are to be employed for that end. The discretion of directors is to be exercised in the choice of means to attain that end and does not extend to a change in the end itself, to the reduction of profits or to the nondistribution of profits among stockholders in order to devote them to other purposes.

* * *

We are not, however, persuaded that we should interfere with the proposed expansion of the business of the Ford Motor Company. In view of the fact that the selling price of products may be increased at any time, the ultimate results of the larger business cannot be certainly estimated. The judges are not business experts. It is recognized that plans must often be made for a long future, for expected competition, for a continuing as well as an immediately profitable venture. The experience of the Ford Motor Company is evidence of capable management of its affairs. It may be noticed, incidentally, that it took from the public the money required for the execution of its plan and that the very considerable salaries paid to Mr. Ford and to certain executive officers and employees were not diminished. We are not satisfied that the alleged motives of the directors, in so far as they are reflected in the conduct of the business, menace the interests of shareholders. It is enough to say, perhaps, that the court of equity is at all times open to complaining shareholders having a just grievance.

[The court affirmed the lower court's order that the company declare a dividend and reversed the lower court's decision that halted company expansion].

CASE QUESTIONS

1. What basis does the court use to order the payment of dividends?
2. Does the court have a positive view of Mr. Ford?
3. How do you reconcile 1 Morawetz on Corporations (2d Ed.), § 447 (“Profits earned by a corporation may be divided among its shareholders; but it is not a violation of the charter if they are allowed to accumulate and remain invested in the company’s business”) with the court’s decision?
4. Would the business judgment rule have changed the outcome of this case? Note: The business judgment rule, generally summarized, is that the directors are presumed to act in the best interest of the corporation and its shareholders and to fulfill their fiduciary duties of good faith, loyalty, and due care. The burden is on the plaintiff to prove that a transaction was so one sided that no business person of ordinary judgment would conclude that the transaction was proper and/or fair.

15.8 Summary and Exercises

Summary

Corporations finance through a variety of mechanisms. One method is to reinvest profits in the corporation. Another method is to use private equity. Private equity involves financing from private investors, whether individuals (angel investors) or a private equity firm. Venture capital is often used as a fundraising mechanism by businesses that are just starting operations.

A third method is to finance through debt, such as a loan or a bond. A corporation sells a bond and agrees to make interest payments over the life of the bond and to pay the face value of the bond at the bond's maturity.

The final important method of raising capital is by the sale of stock. The articles of incorporation govern the total number of shares of stock that the corporation may issue, although it need not issue the maximum. Stock in the hands of shareholders is said to be authorized, issued, and outstanding. Stock may have a par value, which is usually the floor price of the stock. No-par shares may be sold for any price set by the directors.

Preferred stock (1) may have a dividend preference, (2) takes preference upon liquidation, and (3) may be convertible. Common stock normally has the right to (1) ratable participation in earnings, (2) ratable participation in the distribution of net assets on liquidation, and (3) ratable vote.

Ordinarily, the good-faith judgment of the directors concerning the fair value of the consideration received for stock is determinative. A minority of states adhere to a true value rule that holds to an objective standard.

A corporation that sells shares for the first time engages in an initial public offering (IPO). The Securities Act of 1933 governs most IPOs and initial stock sales. A corporation that has previously issued stock may do so many times afterward, depending on the corporation's needs. The Securities Exchange Act of 1934 governs most secondary market stock sales. The Sarbanes-Oxley Act of 2002 adds another layer of regulation to the financial transactions discussed in this chapter.

A dividend is a share of a corporation's profits. Dividends may be distributed as cash, property, or stock. The law imposes certain limitations on the amount that the corporation may disburse; most states restrict the cash or property available for distribution to earned surplus. However, a few states, including Delaware, permit dividends to be paid out of the net of current earnings and those of the immediately preceding year, both years taken as a single period; these are known as nimble dividends. The directors have discretion, within broad limits, to set the level of dividends; however, they will be jointly and severally liable if they approve dividends higher than allowed by law or under the articles of incorporation.

With several options available, corporations face many factors to consider in deciding how to raise funds. Each option is not available to every corporation. Additionally, each option has advantages and disadvantages. A corporation must carefully weigh the pros and cons of each before making a decision to proceed on a particular financing path.

EXERCISES

1. Ralph and Alice have decided to incorporate their sewer cleaning business under the name R & A, Inc. Their plans call for the authorization and issuance of 5,000 shares of par value stock. Ralph argues that par value must be set at the estimated market value of the stock, while Alice feels that par value is the equivalent of book value—that is, assets divided by the number of shares. Who is correct? Why?
2. In Exercise 1, Ralph feels that R & A should have an IPO of 1 million shares of common stock, to be sold on the New York Stock Exchange (NYSE). What are the pros and cons of conducting an IPO?
3. Assume that Ralph and Alice decide to issue preferred stock. What does this entail from R & A's standpoint? From the standpoint of a preferred stock purchaser?
4. Alice changes her mind and wants to sell bonds in R & A. What are the pros and cons of selling bonds?
5. Assume that Ralph and Alice go on to consider options other than financing through an IPO or through the sale of bonds. They want to raise \$5 million to get their business up and running, to purchase a building, and to acquire machines to clean sewers. What are some other options Ralph and Alice should consider? What would you suggest they do? Would your suggestion be different if Ralph and Alice wanted to raise \$500 million? \$50,000?

SELF-TEST QUESTIONS

1. Corporate funds that come from earnings are called
 - a. equity securities
 - b. depletion
 - c. debt securities
 - d. plowback

2. When a value is specified on a stock certificate, it is said to be
 - a. par value
 - b. no-par
 - c. an authorized share
 - d. none of the above

3. Common stockholders normally
 - a. have the right to vote ratably
 - b. do not have the right to vote ratably
 - c. never have preemptive rights
 - d. hold all of the company's treasury shares

4. Preferred stock may be
 - a. entitled to cumulative dividends
 - b. convertible
 - c. redeemable
 - d. all of the above

5. When a corporation issues stock to the public for the first time, the corporation engages in
 - a. a distribution
 - b. an initial public offering
 - c. underwriting
 - d. a stock split

SELF-TEST ANSWERS

1. d
2. a
3. a
4. d
5. b