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CORPORATE FINANCIAL STRUCTURE

GENERALLY

Corporate capital is obtained principally from investors, creditors, and shareholders, who exchange money, property, or services for securities issued by the corporation. The attractiveness of shares as an investment is an important advantage to the corporate form of business enterprise. In addition to corporate equity securities, or shares, a corporation may contract for various types of debt financing, transactions whereby the corporation borrows money from outsiders who are willing to lend funds to the corporation. Unlike shareholders, these creditors are not owners of the company, but their loans are generally considered to be a more conservative investment than an investment in shares. The corporation is obligated to repay a loan from a debt investor, but there is no obligation to repay the funds invested by shareholders, who risk the loss of some or all of their funds.

The corporate financial structure has great flexibility, and corporate securities may have a number of features that increase the quality and attractiveness of the investment. The capitalization may be limited only to common stock, or may be some combination of equity securities, including separate classes and series, and debt securities.

TYPES OF CORPORATE SECURITIES

The term **securities** has a special meaning in the law. It generally refers to a contractual-ownership obligation that exists between a business enterprise and an investor. For purposes of the federal and state securities acts, the term may include any one of several different forms of investment obligations. In the corporate sense, securities fall into two classes:

1. *debt securities*, which evidence a corporate obligation to repay money borrowed from a creditor and are also typically called *bonds*; and
2. *equity securities*, which evidence a shareholder's ownership interest in the corporation and are usually referred to as *shares*.

When a corporation borrows money, it executes a document or bond that represents the obligation of the corporation to repay the borrowed funds. Bonds may be unsecured or secured for payment with property of the corporation. An

unsecured obligation, the corporate equivalent of a personal signature loan, is called a **debenture**. Secured bonds may be called **mortgage bonds**.

Bonds always state a principal amount owed by the corporation, a date when repayment of the principal amount is due, and a provision for interest, which is usually paid periodically. Debt securities may be marketed at a higher price than the principal amount if the attractiveness of the investment creates a demand, in which case it is said that they are sold at a **premium**, or if the investment is not all that attractive, at a lower price than the principal amount, in which case they are sold at a **discount**. Debt securities usually do not have voting rights in the corporate affairs. Instead, they represent a loan obligation in the strict business sense and the holders are merely creditors. As a practical matter, debt securities are often issued under an agreement executed by the corporation, the outside lender, and a trustee who is usually a financial institution. The agreement is called an **indenture**, and it includes the terms of the obligation, the rights of the security holders and the trustee, and any conditions upon which the bonds are issued. Debt securities issued by large corporations are freely sold on an open market, and the price of a bond depends upon the quality of the investment. Bonds frequently have several advantageous features that make them a desirable investment, such as a high interest rate, a provision allowing conversion into common shares at a specified price, and redemption features.

Equity securities are distinguished from debt securities by the relationship between the investor and the corporation. A purchaser of equity securities, a shareholder, becomes a part owner of the corporation. The proportion that the shareholder's shares bear to the total number of shares outstanding represents the shareholder's fractional ownership interest. When shares are issued, the corporation, instead of creating a liability, creates a capital account, which represents the equity of the corporation. Unlike a debt security, the corporation is under no obligation to repay a shareholder, and the return of the investment is usually strictly dependent upon the shareholder's ability to sell his or her shares to another investor. The income paid on equity securities is usually a distribution of the profit of the corporation and is called a *dividend*. The frequency and amount of these distributions are determined within the discretion of the board of directors. An equity investment is attractive if it appears that the corporation's business will expand and be profitable, thereby increasing the value of the equity security and likely resulting in dividend distributions to the shareholders. Shareholders also have the right to a proportionate distribution of corporate assets upon dissolution of the corporation.

Imaginative entrepreneurs have developed all sorts of variations on the two basic types of corporate securities, and most state corporation statutes encourage inspired financial configurations by imposing very few restrictions upon the corporate financial structure. However, since some unscrupulous entrepreneurs have duped investors with worthless securities, it should be noted that the issuance and sale of corporate securities is strictly regulated by federal and state securities laws. Any public sale of corporate shares or bonds is subject to the disclosure requirements of the **Securities Act of 1933**¹ or the applicable state blue-sky laws. These acts and the **Securities Exchange Act of 1934**² are generally designed to fully inform a potential investor of the character and quality of the investment, and to avoid untrue statements and misleading omissions about the security that may affect a decision to purchase or sell. The requirements of the securities acts are discussed in Chapter 7.³

EQUITY SECURITIES

Equity securities grant the shareholder a three-pronged ownership interest in the corporation. A shareholder is entitled to a proportionate share of earnings, distributed as dividends at the discretion of the board of directors; a proportionate share of assets in corporate dissolution; and a vote on all shareholder matters, which gives indirect control over management activities. Ignoring special classes of equity securities for a moment, a common stock shareholder is entitled to share in the earnings and assets of the corporation in the proportion of the number of shares owned compared against the total number of shares outstanding. Each common share-

holder is also entitled to one vote for each share. Every state authorizes by statute the issuance of a certain number of shares, and the division of those shares into classes, allowing preferences, limitations, and other special rights as specified in the articles of incorporation. The Model Business Corporation Act grants this general authority in section 6.01.

STAGES OF EQUITY SECURITIES

The articles of incorporation must state the number of shares the corporation will have the authority to issue.⁴ This number will be determined by the incorporators and counsel, considering the anticipated capital requirements of the corporation. Having established the authority, the corporation may issue up to the specified number of shares without any requirement for an amendment to the articles of incorporation. Thus, the first step in the issuance of corporate equity securities is the creation of the authority to issue them by describing the characteristics of the securities and specifying the number of shares in the articles of incorporation. The shares described in the articles of incorporation are the **authorized shares** of the corporation.

It is not necessary to issue all of the authorized shares of the corporation, and it is sometimes undesirable to do so. It is necessary to issue the number of shares required for the minimum paid-in capital, if that is a requirement under the applicable state statute,⁵ and to issue enough shares for sufficient capital to commence business even if no minimum capital requirements exist. Other authorized shares should be saved to allow for additional capital financing in future corporate operations. Shares that have been authorized and sold are issued to the holders and are described as **issued** and **outstanding shares**. Thus, a shareholder holds authorized, issued, and outstanding shares of the company.

Shares that have been sold to investors may be reacquired by the corporation by one of several methods. The shareholder may donate or resell them to the company, or the corporation may, if so authorized in the articles of incorporation, redeem the shares or convert them to other shares. When shares are reacquired by the corporation, they are called treasury shares.⁶ Treasury shares are authorized and issued but are not outstanding, since they are held by the corporation and not by investors.

The issuance and sale of shares is initiated by the decision of the board of directors to obtain additional capital for the corporation. The board of directors may not issue more shares than have been authorized in the articles of incorporation. It also must observe the present shareholders' preemptive rights, if they exist, by offering newly issued shares to existing shareholders in their respective proportions of share ownership before selling the shares to other investors.⁷ In addition, there may be other statutory limitations on the authority of the board of directors to issue shares. For example, section 6.21 of the Model Business Corporation Act requires a shareholder vote to approve any issuance of shares that comprises more than 20% of the voting power of the corporation and also allows all decisions concerning the consideration for the issuance of shares to be reserved to the shareholders in the articles of incorporation.

The distinction between the stages of equity securities is important for several reasons. For equity securities to be fully active (including entitlement to vote, receipt of a proportionate share of earnings, and receipt of a proportionate share of assets upon dissolution), shares must be authorized, issued, and outstanding. Treasury shares are usually not counted for determining a quorum and are not entitled to a vote.⁸ They also may not be entitled to any dividend distributions.⁹

Another distinguishing feature involves the consideration for shares. If shares are authorized and are being issued and sold, they usually must be sold for an amount no less than the par value if they have par value, or for the stated value if they are no par value shares. Thus, if shares bear a \$10 par value, the corporation may not sell them for less than \$10 per share. If the corporation sells shares for less than that amount, the consideration is inadequate and the shares become **watered**, or **discount**, **shares**. Shareholders who purchase watered shares can be assessed for the full amount of unpaid consideration. On the other hand, shares that are authorized, issued, and outstanding and are reacquired and held by the corporation as treasury

shares may be sold again for any consideration fixed by the board of directors, whether or not the consideration is equal to or less than par value. For example, if a shareholder agreed with the corporation to purchase 1,000 shares of stock with a \$10 par value for a price of \$7,000, the shares would be “watered” stock if the corporation is issuing them from the authorized but unissued shares available under the authorized capital in the articles of incorporation. The shareholder is liable to pay the additional \$3,000 to the corporation because the shares were sold for less than the par value. On the other hand, if the corporation had repurchased the 1,000 shares from a former shareholder and held the shares in the corporate treasury, the corporation could sell the shares for any agreed amount, and the shareholder is not required to pay any more than \$7,000.

PAR VALUE OR NO PAR VALUE

Several jurisdictions still require a statement in the articles of incorporation indicating whether shares are to be issued for a stated par value or for no par value. The Model Business Corporation Act and many states are now taking the position first propounded by California that it is not necessary to state whether shares have a par value.¹⁰ The corporation always has a choice between no par or par value shares, except in Nebraska, where all shares must have a par value.¹¹ The distinction between these provisions relates to the value required to be given for the purchase of shares and to the rates of capital franchise fees that must be paid in some states upon incorporation. In addition, shares with no par value permit greater flexibility in allocating the amount received in exchange for the shares to certain surplus accounts in the corporate books.

Shares with a par value may be issued only for such consideration expressed in dollars, not less than the par value, as may be fixed from time to time by the board of directors. This provision is common in most state statutes. It means that shares with a \$10 par value may be issued for \$20 if someone is willing to pay that amount, but in no case may they be issued for less than \$10. A handful of states make exceptions to this rule if the board of directors can justify the reason for selling below par value.

Shares without par value may be issued for whatever consideration may be fixed from time to time by the board of directors,¹² although many states provide that the articles of incorporation may reserve the right to fix the consideration for no par value shares to the shareholders.¹³ A few jurisdictions reverse this authority—they grant it to the shareholders unless it is reserved to the directors in the articles of incorporation. Thus, shares without par value may be issued for any amount set by the board of directors or shareholders in their good judgment. The only limitation on this authority to fix the amount of no par value shares is that the shares must be issued for approximately the same amount of consideration at approximately the same time.

Major variations in prices of no par value shares within a short time period raise a question of breach of the director’s duty of due care in dealing with shareholders. For example, suppose a corporation intended to sell no par value shares to three investors: Burn, Bush, and Bradford. In private discussions with the three investors, it was determined that Burn and Bush would pay approximately \$10 per share, but Bradford could be persuaded to pay \$15 per share. If 100 shares were simultaneously issued to each investor at those prices, Bradford would have immediate grounds for complaint. Bradford’s shares were immediately “**diluted**” with the sales to the other two investors because the board of directors effectively reduced the stated value by \$5 per share. However, if Burn and Bush purchased their shares in January, and Bradford’s purchase at \$15 per share occurred in September, it may be said that the shares increased in value enough to warrant the increase in price. The dilution problem results when no par value shares are sold at substantially lower prices at about the same time as other no par value shares, to undercut the contribution of an investor. Notwithstanding the foregoing, if the board of directors can establish that the varying prices were set for a good business reason, the board will be permitted to rapidly adjust the prices on shares without par value.

The par value-no par value distinction has other ramifications in states that exact annual **franchise fees** based upon the aggregate authorized capital of the corporation. In some states, the franchise fee is computed upon the amount stated in the articles of incorporation as the total aggregate value of authorized shares. To compute this fee, shares without par value are assigned an arbitrary value. For example, if an arbitrary value of \$1 per share were placed on each no par share to compute the franchise fee for a state, the franchise fee would be the same for a corporation authorized to issue 10,000 shares at \$5 par value as it would be for a corporation authorized to issue 50,000 shares at no par value in that state. States that discourage the use of no par value shares impose a high statutory valuation on those shares to compute the fee. It then becomes more advantageous to set a lower par value and to authorize more shares.¹⁴

Certain accounting classifications also depend upon the distinction between par value and no par value shares. In some cases it may be desirable to create a capital surplus account for the corporation in the early stages of corporate existence—assuming, for example, that the incorporators predict the desirability of repurchasing some of the shares issued by the corporation. Many statutes, and formerly the Model Business Corporation Act, permit the corporation to repurchase its own shares only if it has a surplus account from which it may make the purchase.¹⁵

The creation of a surplus account occurs in different ways. The typical surplus accounts are **earned surplus** and **capital surplus**. Earned surplus is created when the corporation accumulates profits from operations. Capital surplus is an account created for surplus funds received from the sale of stock. If the corporation issues \$10 par value stock for \$30 per share, \$10 must be placed in stated capital, and \$20 may be placed in capital surplus. Any consideration in excess of par value may be placed in capital surplus, and with no par stock, any part of the consideration may be placed in capital surplus.¹⁶

If there is a need for a surplus account in the early stages of the corporate operations, the par value or no par value characteristic of the stock is important. For example, if a corporation has issued shares with \$10 par value, and those shares are sold for exactly \$10 each, that amount of money must be placed in an account called **stated capital**. There would be no capital surplus, and if the corporation had not yet earned profits to hold as retained earnings, there would be no earned surplus. In such a case, the corporation would not be able to repurchase its own shares, since there would be no surplus account. On the other hand, if a corporation has sold shares with no par value for \$10 a share, it can divert any portion of that consideration to a capital surplus account. The board of directors may allocate, usually within sixty days after no par value shares have been issued, a portion of the consideration to capital surplus. Capital surplus could receive \$9 per share, for example, and stated capital the other \$1 per share. The corporation could then use the amount of capital surplus to repurchase its own shares, provided the articles of incorporation authorize the use of capital surplus for this purpose.

Dividends and other distributions to shareholders are subject to similar rules. Most states limit the payment of distributions to funds available from earned surplus, with a few exceptions. The corporation is permitted to distribute cash or property to its shareholders out of capital surplus under certain circumstances.¹⁷ If management intends to make a distribution to shareholders before there is sufficient earned surplus to declare a dividend, the creation of a capital surplus account is essential. No par value stock will ensure that the board of directors will be able to create the account immediately upon issuance of the first shares.

CERTIFICATES FOR SHARES

The shares of the corporation are generally represented by **certificates** (see Exhibit 9–1, share certificate). Share certificates are **negotiable**, meaning that they are like a form of currency. If a person possesses a share certificate with an appropriate endorsement—the signature of the owner of the certificate transferring the shares—that person is entitled to enforce the rights to the shares even if the transfer of the certificate was wrongful, such as by theft




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or other fraud. Thus, shareholders of corporations are wise to keep their share certificates in a secure place. The Model Act and the Uniform Commercial Code permit a corporation to provide by resolution that some or all of the classes and series of shares shall be *uncertificated*, which means that the ownership of the shares is recorded in the corporate records, but the shares are not represented by a certificate. The rights and obligations of the holders of uncertificated shares and the rights and obligations of the holders of certificates representing shares of the same class and series are identical under corporate law. The primary purposes of the uncertificated provision is to accommodate the modern trend of transferring share ownership by computer communications and to avoid the paper crunch anticipated as more and more corporations issue certificates for shares and those certificates are rapidly traded on over-the-counter and national stock exchanges. The uncertificated system is intended to simplify the transfer of ownership in a corporation by eliminating the need for transfer of a piece of negotiable paper as part of that transaction. It is also intended to guard against the loss or theft of the negotiable piece of paper (the certificate) representing ownership in the corporation.

When certificates are used, all states prescribe the content of the certificate representing shares, and the requirements of the Model Business Corporation Act are typical:

Each share certificate (1) must be signed (either manually or in facsimile) by two officers designated in the bylaws or by the board of directors and (2) may bear the corporate seal or its facsimile.¹⁸

The statute further provides that the signature of any person who was an officer and ceased to be such before the certificate is issued will have the same effect as if that person were still




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an officer as of the date of the issuance.¹⁹ Each certificate representing shares must state upon its face

1. the name of the corporation and that the corporation is organized under the laws of the particular state;
2. the name of the person to whom the shares are issued; and
3. the number and class of shares and the designation of the series, if any, represented by the certificate.

The major variations among the state statutes with respect to requirements for share certificates are what officers are required to sign the certificates, the circumstances under which facsimile signatures may be used, the need for a corporate seal, and whether the certificate must state that the shares are fully paid. In all states, if the shares have a par value, the amount of the par value must be stated on the certificate.

If the corporation is authorized to issue only one class of stock, its share certificates need contain only the bare statutory requirements. A corporation may adopt a more complex financial structure and choose to issue shares in various classes or in series; in such a case, each certificate must describe the particular elements of each class or series. Section 6.25 of the Model Business Corporation Act requires that every share certificate of a corporation authorized to issue shares of more than one class shall set forth a full statement of the designations, preferences, limitations, and relative rights of the shares of each class authorized to be issued (or, as is more common, state conspicuously that the corporation will furnish to any shareholder upon request and without charge). Further, if the corporation is authorized to issue preferred or special classes in series, the variations between the shares so far as they have been determined and the authority of the board of directors to fix the relative rights of the shares must be stated on the certificate (see Exhibit 9–2, Preferred Stock Certificate). If the latter procedure is used, it is not necessary to amend or otherwise modify the certificates representing shares whenever the corporate financial structure is changed. The classes and series of shares are explored in detail in the next section of this chapter.

CLASSIFICATIONS OF SHARES

The articles of incorporation may authorize the issuance of only one class of shares (i.e., common stock), in which case the shareholders of the common stock are entitled to all of the voting rights, all of the dividends, and all of the net assets in a dissolution distribution. In a Subchapter S corporation, it is possible to have another class of shares with different voting rights but no other differences. However, other corporate financial structures may be more complicated.

Classes of Shares

The equity securities of the corporation may be divided into several classes of shares. Common stock is the basic class, and additional classes may be authorized to grant certain shareholders a preferred right to dividends or a preferred right to assets in case of corporate dissolution. Various classes of securities may also have different voting rights, such as no vote, or two votes per share, or any other formula. When more than one class is to be authorized, the articles of incorporation must set forth the designations, preferences, limitations, and relative rights of each class.

EXAMPLE

Classes of Stock

The total number of shares of all classes of stock which the Corporation shall have authority to issue is 500,000, of which 100,000 shares shall be Class A common stock without par value and 400,000 shares shall be Class B common stock without par value. There shall be no distinction between the two classes, except that the holders of the Class B common stock shall have no voting power for any purpose whatsoever and the holders of the Class A common stock shall, to the exclusion of the holders of the Class B common stock, have full voting power for all purposes.

The share certificate must either contain this information or contain a conspicuous statement that the corporation will provide this information without charge to any shareholder requesting it.

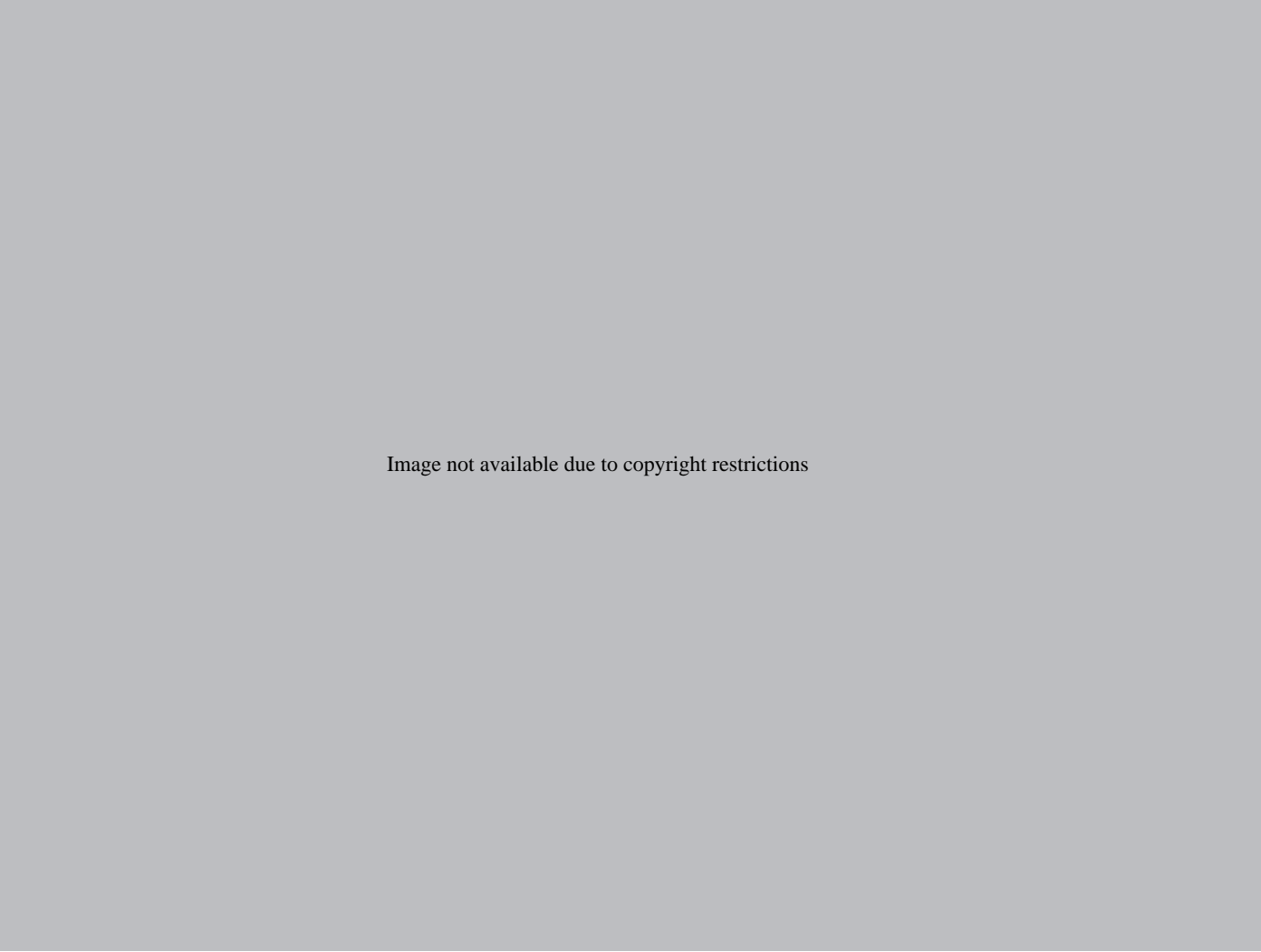


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It may be helpful to consider the circumstances under which authority to issue preferred shares is used. The general principle is that certain investors may insist upon a superior ownership position in the corporation, and in order to obtain necessary financing, it may be necessary to *prefer* those investors over others. For example, suppose Hopkins and Conner plan to form a corporation for the operation of a restaurant. Hopkins intends to run the business and to invest his available personal capital of \$25,000, and Conner is capable of investing \$100,000. Assume further that no other shareholders are contemplated at this point. Conner may be willing to take a greater proportion of common stock for his \$100,000 investment, but that will give him 80% of the common stock to Hopkins, 20%. Conner clearly would have shareholder control in such a case, and Hopkins' may be thereby hampered in his efforts to run the business. Hopkins will be aware of Conner's potential control, and may object to this posture.

It is possible, however, to issue each investor \$25,000 in common stock (with voting rights) and to issue nonvoting preferred shares, with dividend and liquidation preferences, to Conner for his \$75,000 excess investment. With this arrangement, Conner and Hopkins have equal voting rights and an equal investment in the basic equity of the corporation. Conner's excess investment is protected by his preferred status, ensuring that Conner will receive the first distributions of profit through his dividend preference, and the first distribution of assets in

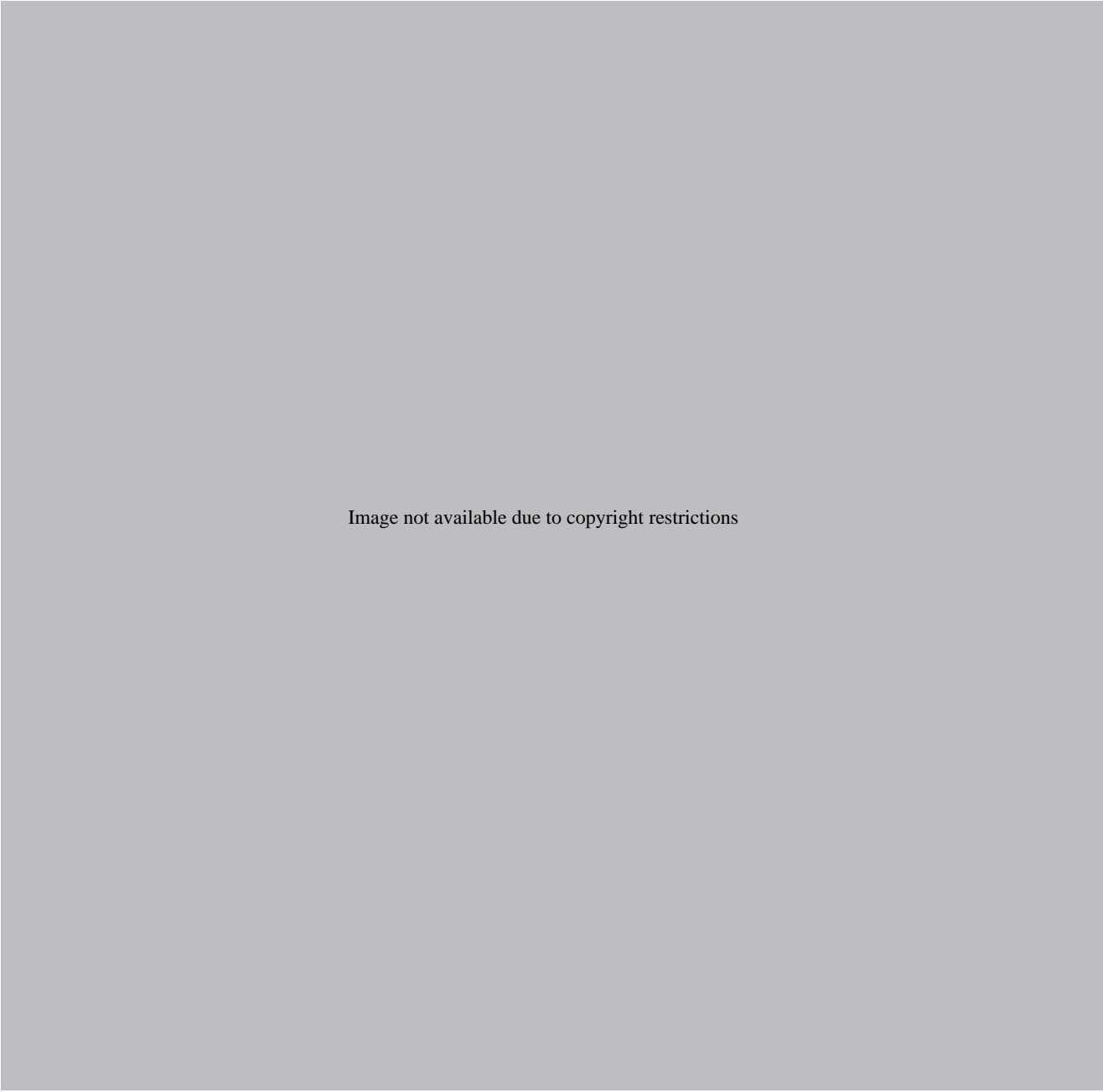


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dissolution through the liquidation preference. Thereafter, Conner and Hopkins share equally, just as though each had invested only \$25,000.

Similar problems arise when a third investor is considered. Suppose Carver has offered to invest \$50,000, but has no expertise in the restaurant business, and no interest in management and control. However, Carver is concerned about two things: a high return on his investment and a right to assert a vote if the business is being managed improperly. A separate class of securities can be created for Carver's investment. He may receive first dividend preference, even over Conner's preferred status, and his preference may be at a higher rate and may be cumulative to ensure an accumulated high return on his investment every year. His securities would have no voting rights until the happening of a contingent event,

such as when the gross receipts from the business drop below a certain amount for several consecutive months.

The possibilities for variations in preferred shares are endless, and each class can be structured to fit the peculiar needs of the investors.

The statutory authority for issuance of shares in classes usually specifies the manner in which those shares may differ from common shares. For example, section 6.01 of the Model Business Corporation Act provides that a corporation may issue shares of preferred or special classes that

1. have special, conditional, or limited voting rights, or no right to vote, except to the extent provided by the statute;
2. are redeemable or convertible as specified in the articles of incorporation at the option of either the shareholder, the corporation, or other persons, or on the occurrence of a designated event; for cash, indebtedness, securities, or other property; in a designated amount or in any amount determined in accordance with a designated formula or by reference to other events;
3. entitle the holders to distributions calculated in any manner, including dividends that may be cumulative, noncumulative, or partially cumulative; and
4. have preference over any other class of shares with respect to distributions, including dividends and distributions upon the dissolution of the corporation.

These variations among the shares are not considered to be exhaustive; the Model Business Corporation Act permits additional variations as long as they do not conflict with other statutory rules.²⁰ In any case, one or more classes of shares must have unlimited voting rights, and one or more classes of shares must be entitled to receive the net assets of the corporation upon dissolution. These rules are designed to ensure that someone will be entitled to exercise the shareholders' voting rights (even if that entitlement shifts among classes from time to time or on certain events) and that someone will be entitled to receive the assets of the corporation if the corporation is dissolved and liquidated.²¹ However, the articles of incorporation may limit or deny the voting rights or provide special voting rights for certain classes under the authority of section 7.21. The individual variations in these rights are explored in detail in "Preferred Stock Rights" later in this chapter.

Shares in Series

The articles of incorporation may authorize the division and issuance of any class of shares in series.²² The principle behind **series shares** is a refinement of the theory behind preferred shares. Classes of preferred shares meet the particular needs and demands of certain investors, and series shares do the same thing. However, all authority to issue shares comes from the articles of incorporation. Thus, for a special class of shares to be issued, the articles of incorporation must authorize that class and define its designations, preferences, limitations, and relative rights. If the articles of incorporation do not specifically authorize the issuance of a particular class of shares, the articles must be amended to grant this authority, and an amendment requires a board of directors' resolution, the approval of the shareholders, and the appropriate filing with the secretary of state.²³ The corporate officials attempting to raise capital may thus be hindered by a cumbersome, time-consuming amendment procedure in tailoring the corporate securities to the requirements of potential investors. This procedure may be particularly frustrating when prompt action is essential, such as when the corporation is negotiating to acquire desirable property in exchange for its preferred shares.

Series shares are designed to avoid this problem. The board of directors may be authorized (by the articles of incorporation) to fix the terms of a series of preferred shares, without requiring a formal amendment to the articles or shareholder approval. This board authority to vary the terms of the stock is the source of the common name, **blank stock**, for series shares. With this authority, the Model Business Corporation Act permits directors to

issue shares that vary from other shares of the same class as long as the board of directors determines the preferences, limitations, and relative rights before the issuance of any shares of that class. The board of directors may thus set any rights for any series of shares within the boundaries of the various rights provided by the statute.²⁴ For example, the articles of incorporation could authorize the creation of an additional class of shares at the discretion of the board of directors, stating that the shares may have a preferential dividend over all other shares and all other rights would be the same as the common shares. The board could then issue these series shares by resolution, providing that the first series will have a \$2.00 per share dividend preference and the second series will have a \$4.00 per share dividend preference, and so on. The board is allowed to set the preference for dividends as the board deems appropriate, since the articles authorize any variation with respect to dividends for shares issued from the series.

Most states permit the creation of series shares, but are more specific than the Model Business Corporation Act in identifying the types of rights that may be granted within the series. In most states, the series shares may differ from other shares of the same series in the following particulars: (1) the rate of dividend; (2) the price at and the terms and conditions upon which shares may be redeemed; (3) the amount payable upon shares in the event of voluntary or involuntary liquidation; (4) **sinking fund** provisions, if any, for the redemption or purchase of shares; (5) the terms and conditions upon which shares may be **converted**; and (6) voting rights. In all other respects, the shares of the series must be the same as other shares of the same class.

The scope of the directors' authority to establish series shares is defined by the articles of incorporation. The articles may state that the board of directors has full authority to divide classes of shares into series and to determine the variations in the relative rights.

EXAMPLE

Shares in Series

The preferred stock of the Corporation shall be issued in one or more series as may be determined from time to time by the Board of Directors. In establishing a series the Board of Directors shall give to it a distinctive designation so as to distinguish it from the shares of all other series and classes, shall fix the number of shares in such series, and the preferences, rights, and restrictions thereof. All shares of any one series shall be alike in every particular. All series shares shall be alike except that there may be variation as to the following: (1) the rate of dividend, (2) the price at and the terms and conditions on which shares shall be redeemed, (3) the amount payable upon shares in the event of involuntary liquidation, (4) the amount payable upon shares in the event of voluntary liquidation, (5) sinking fund provisions for the redemption of shares, and (6) the terms and conditions on which shares may be converted if the shares of any series are issued with the privilege of conversion.

The articles also may limit the authority to vary series shares to certain characteristics, such as conversion privileges or dividend preferences.

The procedure for establishing a series is considerably less formal than that for establishing a formal amendment to the articles of incorporation. The directors adopt a resolution stating the designation of the series and fixing the rights of the series shares. A statement, which the Model Act refers to as the articles of amendment,²⁵ is filed with the secretary of state or other authorized public filing office (see Exhibit 9-3, Statement with Respect to Shares). This statement is effective without shareholder action. It quotes the resolution and acknowledges that the resolution was adopted by the board of directors on a certain date. In some states, franchise taxes and fees will be due upon the establishment

of the series shares. The amendment to the articles, as filed, should contain the following information:

1. the name of the corporation;
2. the text of the resolution determining the terms of the class or series of shares;
3. the date the resolution was adopted; and
4. a statement that the amendment was officially adopted by the board of directors.

Exhibit 9-3.

Statement with Respect to Shares (Pennsylvania)

**PENNSYLVANIA DEPARTMENT OF STATE
CORPORATION BUREAU**

Entity Number

**Statement with Respect to Shares
Domestic Business Corporation**
(15 Pa.C.S. § 1522)

Name	<p>Document will be returned to the name and address you enter to the left.</p>
Address	
City State Zip Code	

Fee: \$52

Filed in the Department of State on _____

Secretary of the Commonwealth

In compliance with the requirements of 15 Pa.C.S. § 1522(b) (relating to statement with respect to shares), the undersigned corporation, desiring to state the designation and voting rights, preferences, limitations, and special rights, if any, of a class or series of its shares, hereby states that:

1. The name of the corporation is:

2. Check and complete one of the following:

___ The resolution amending the Articles under 15 Pa.C.S. § 1522(b) (relating to divisions and determinations by the board), set forth in full, is as follows:

___ The resolution amending the Articles under 15 Pa.C.S. § 1522(b) is set forth in full in Exhibit A attached hereto and made a part hereof.

3. The aggregate number of shares of such class or series established and designated by (a) such resolution, (b) all prior statements, if any, filed under 15 Pa.C.S. § 1522 or corresponding provisions of prior law with respect thereto, and (c) any other provision of the Articles is _____ shares.

Exhibit 9-3.*(continued)*

DSCB:15-1522-2

4. The resolution was adopted by the Board of Directors or an authorized committee thereon on:

5. Check, and if appropriate complete, one of the following:

The resolution shall be effective upon the filing of this statement with respect to shares in the Department of State.

The resolution shall be effective on: _____ at _____.
Date Hour

IN TESTIMONY WHEREOF, the undersigned corporation has caused this statement to be signed by a duly authorized officer thereof this

_____ day of _____.

Name of Corporation

Signature

Title



**Department of State
Corporation Bureau
P.O. Box 8722
Harrisburg, PA 17105-8722
(717) 787-1057
web site: www.dos.state.pa.us/corp.htm**

Instructions for Completion of Form:

- A. Typewritten is preferred. If not, the form shall be completed in black or blue-black ink in order to permit reproduction. The filing fee for this form is \$52 made payable to the Department of State.
- B. A separate form shall be submitted for each class or series of shares affected. If a number of classes or series of shares are affected at the same time, consideration should be given to filing form DSCB:15-1915/5915 (Articles of Amendment-Domestic Corporation).
- C. The effective date in Paragraph 5 may not be prior to the filing date, but the resolution may state a prior effective date "for accounting purposes only."
- D. If the corporation was incorporated on or after October 1, 1989, the words "or corresponding provisions of prior law" may be omitted from Paragraph 3.
- E. This form and all accompanying documents shall be mailed to the address stated above.
- F. To receive confirmation of the file date prior to receiving the microfilmed original, send either a self-addressed, stamped postcard with the filing information noted or a self-addressed, stamped envelope with a copy of the filing document.

FRACTIONS OF SHARES AND SCRIP

In some cases the corporation may need to issue fractions of shares of stock, and the authority for the issuance of a **fractional share** must come from the appropriate state statute. For example, fractional shares may be required when a corporation has declared a stock dividend entitling the holders of 100 shares of stock to receive one additional share as a dividend. In that case, the holder of 150 shares of stock would be entitled to one and one-half shares. If the state statute permits fractional shares, the corporation may issue a certificate for a one-half share. Many statutes authorize the issuance of scrip in lieu of fractional shares. *Scrip* is a separate certificate representing a percentage of a full share. It entitles a shareholder to receive a certificate for one full share when the shareholder has accumulated scrip aggregating a full share.

The Model Business Corporation Act provides that a corporation may, but is not obligated to, issue a certificate for fractional share or scrip in lieu thereof. Other alternatives include disposition of fractional interests, as by finding two shareholders who are each entitled to one-half share and arranging for a sale from one to the other so a whole share will be issued, or payment to the shareholder of cash equal to the fair value of the fractional interest.²⁶ If a certificate for a fractional share is issued, the holder is entitled to exercise a fractional voting right, to receive a fractional share of dividends, and to participate accordingly in the corporate assets in the event of liquidation.²⁷ Unless otherwise provided by the board of directors, a holder of scrip is usually not entitled to these rights. The board of directors may provide that scrip will become void if not exchanged for full certificates before a specified date.

State statutes take divergent positions with respect to fractional shares and scrip, and the individual statutes should be consulted. Most states authorize one or more of the options specified in the Model Business Corporation Act.

CONSIDERATION FOR SHARES

The consideration required for shares depends in part upon whether the shares have a par value or are without par value.²⁸ Shares with a par value usually may be issued for no less than the par value, and shares with no par value receive a stated value as fixed from time to time by the board of directors or the shareholders, as provided by statute and the articles of incorporation. Thus, in the quantitative sense, the consideration given in exchange for shares must at least equal the par value or the stated value for no par shares, whichever the case may be.

When the consideration for shares is cash, the quantity valuation is obvious. When property is transferred or services are performed in exchange for shares, the law has developed at least three rules for appraising the consideration. The first rule, the **true value rule**, requires that the property or services have, at the time of the issuance of shares, an actual value that is no less than par value or no less than the stated value for no par shares. This means that the property or services must be appraised and the actual value compared with the minimum requirements for the particular type of stock. Most jurisdictions follow the second rule, the **absence of fraud rule**, which requires that the property or services be evaluated and deemed adequate by the board of directors, who must determine in good faith that the consideration received has a value at least equal to the minimum requirements and whose determination of value will be conclusive in the absence of fraud. The third, and most flexible, rule is contained in the Model Business Corporation Act, and simply provides that “the board of directors must determine that the consideration received or to be received for shares to be issued is adequate.”²⁹ The determination by the board of directors will be conclusive in determining the adequacy of the consideration. When the second or third rule is used, the board of directors, in determining the value of the offered consideration, should carefully document and support its evaluation. These rules are used to determine whether the amount of consideration received for shares is legally adequate.

Statutes also dictate the types of consideration that may be given in exchange for stock in terms of quality. Historically, the permissible consideration was limited to money; other property, tangible or intangible; or labor or services actually performed for the corporation.³⁰ Many states prohibited the issuance of stock for promissory notes.³¹ There is some authority to the effect that preincorporation services—the services performed by the promoters and

incorporators are not really performed for the corporation because the corporation does not yet exist. Consequently preincorporation services are not generally considered adequate consideration for stock.³²

The Model Business Corporation Act developed a trend toward greater permissiveness in the financial provisions for the issuance of shares. Acceptable consideration for shares now includes any tangible or intangible property (including benefits the corporation may receive from a contract or other instrument), cash, promissory notes, services already performed for the corporation and contracts for services to be performed, and other securities of the corporation that may be exchanged for newly issued shares.³³

These rules give the board of directors great flexibility in accepting items of value in exchange for shares, and place the corporation on a more equal footing with the limited partnership and limited liability company in accepting almost anything that is offered by an investor in exchange for ownership interest. However, to protect the interests of the existing shareholders, section 6.21 of the Model Business Corporation Act provides two important limitations on the board of director's discretion to accept non-cash consideration for shares: (1) if the shares are issued for consideration other than cash or cash equivalents, the shareholders must approve the transaction by a majority vote; and (2) the determination of adequacy of the consideration that is normally decided by the board of directors, may be reserved to the shareholders by the articles of incorporation.

Notice that a potential shareholder may not be obligated to give any current value in exchange for shares. The promise to pay money in the future through a promissory note or the promise to perform services at a later time under a contract are both recognized as valuable consideration, and a shareholder may receive shares immediately upon the issuance of the note or the execution of the contract. To be certain the shareholder will perform these promises, the corporation may place the issued shares in possession of an escrow agent or independent third party to deliver to the shareholder when the services are performed or the money has been contributed. If the promises are never performed, the shares that are escrowed or restricted may be canceled.³⁴

When the corporation receives the consideration for which the board of directors has authorized the issuance of shares, the shares are considered fully paid and **nonassessable**. If shares that are not fully paid are issued, the shareholders may be liable to the creditors of the corporation for the deficiency, and the shares are **assessable**. In such a case, the directors who vote to issue shares that are not fully paid and fail to place those shares in escrow or to restrict their transfer have probably violated their fiduciary duty to the corporation and other shareholders, and may be personally liable.

COMMON STOCK RIGHTS

The corporation organized with only one class of stock has only common stock, which is best described as shares of the corporation without any special features. To authorize the issuance of common stock, the articles of incorporation need only describe the number of shares authorized and, if desired or required by statute, their par value, or contain a statement that the shares have no par value. Common stock has the following rights under most state statutes.

Distribution Rights

Distributions may be declared from time to time at the discretion of the board of directors, and may be paid in cash, property, or other shares of the corporation, provided the corporation is solvent. Common stockholders receive distributions in the same proportion that their individual shares bear to the total number of common shares outstanding. The common stockholder's right to declared distributions is limited only by the solvency of the corporation (so creditors cannot be harmed by a distribution of assets as a dividend from an insolvent corporation) and by preferred stockholders' rights to distributions, which must be paid before the common shares are entitled to distributions. The rules relating to these distributions are discussed in detail in a later chapter.³⁵

Voting Rights

The one-vote-per-share rule is codified in section 7.21 of the Model Business Corporation Act. At a meeting of the shareholders, each outstanding share regardless of class is entitled to one vote, and each fractional share is entitled to a corresponding fractional vote on each matter submitted to a vote. The statute further provides, however, that the voting rights of any class may be limited or denied by the articles of incorporation. These voting rules are common to most jurisdictions. If the corporation has only one class of stock, which is not divided into series, the single class must have full voting rights. If the corporation's financial structure includes several classes or series of securities, one or more of those classes or series may have limited or expanded voting rights.

The voting right of a shareholder may be the most important right in the corporation, since it permits the shareholder to express his or her views concerning the performance of management. If several corporations have **circular holdings**, where one corporation owns a majority of the stock in a subsidiary, and the subsidiary also owns a majority of the stock in the parent, the minority stockholders of both corporations would always be outvoted, since the same board of directors may be voting the majority shares in both corporations. For example, if X Corporation owns 60% of the stock of Y Corporation, and thereby elects all of the members of Y Corporation's board, and if Y Corporation also owns 60% of the stock of X Corporation, and thereby elects all of the members of X Corporation's board, the minority stockholders of both corporations will have nothing to say in the election of directors. To counter that problem, the Model Business Corporation Act provides that unless there are "special circumstances," the shares of a corporation may not be entitled to vote if they are owned by a second corporation and the first corporation owns a majority of the shares entitled to vote for the directors of the second corporation. If a court decided that there was no abuse as a result of this circular ownership, it could allow the shares owned by the respective corporations to be voted for the election of directors. Otherwise, those shares must be silent and the minority stockholders will be entitled to control the vote for the respective corporations.³⁶

Depending upon the statutory requirements and the provisions in the articles of incorporation, cumulative voting may be authorized for shares of common stock.³⁷

Liquidation Rights

After a decision has been made to dissolve the corporation, corporate officials are required by law to collect and dispose of the assets, and to satisfy all liabilities and obligations. Thereafter, the remaining assets in cash or property are distributed to the shareholders according to their respective interests. If the corporation has a single class of common stock, those shareholders will receive a proportionate interest in all of the net assets following dissolution and liquidation. The liquidation rights of common stock may be subordinated by the issuance of additional classes of securities that have a preference to the assets in dissolution. For example, if a corporation is being liquidated and has \$1,000,000 in cash available to distribute to the shareholders after all creditors and obligations have been paid, the common shareholders with 1,000 shares will be entitled to receive \$100 per share in liquidation. If this corporation has 100 shares of a preferred class that are entitled to a liquidation preference of \$2,500 per share, this preferred class would receive \$250,000, the preference amount, and the common shareholders would receive only \$75 per share in liquidation.

Preemptive Rights

Depending upon the state statute, preemptive rights may exist unless denied, or may not exist unless granted, in the articles of incorporation. The Model Business Corporation Act uses the latter approach in section 6.30. The preemptive right of a shareholder is the right to purchase a pro rata share of newly issued stock before that share may be offered to outsiders.³⁸

PREFERRED STOCK RIGHTS

Preferred stock is a class of stock that has been granted a preference to one or more of the normal shareholder rights; that is, preferred stock usually has a preference to distributions, to assets in liquidation, or to both. Issuance of preferred stock must be authorized by the articles of incorporation, and the terms of the articles must contain the designation of each class and a statement of the preferences, limitations, and relative rights of the shares issued in each class. Moreover, if management intends to issue the shares of a preferred class in series, the designation of each series and a statement of the variations in the rights and preferences between series must be contained in the articles of incorporation. The articles also must describe any authority to be vested in the board of directors to establish the series and to determine the variations in the relative rights of the series.

Preferred stock is customarily preferred in the following ways.

Distribution Preference

A common attraction to preferred stock is a distribution preference, if and when the board of directors declares a distribution. Preferred shareholders may have a mandatory priority to distributions, in a predetermined amount, before the corporation may pay any distributions to the holders of any other class of stock. A distribution preference may be cumulative, noncumulative, or a compromise of the two, and may also include a participation provision.

Cumulative A **cumulative distribution preference** means that preferred stockholders will accrue an entitlement to distributions each year, whether or not the distributions are declared and paid. If the distributions are not paid during a certain year, they accumulate in the prescribed amount, and when the board of directors finally declares a distribution, all accumulated distributions on the preferred stock must be paid before distributions may be paid on any other stock. For example, suppose preferred stock is entitled to a cumulative distribution of \$4 per share and Alexis Levine owns 100 shares. In the first and second years the corporation pays no distributions, so Alexis's stock accumulates distributions of \$400 per year to a total amount of \$800. In the third year management declares a distribution on all classes of stock. The corporation must first pay Alexis \$1200 on her shares (\$800 accumulated plus \$400 for the present year) before it may pay any distributions to other classes of stock.

A statement of a cumulative distribution preference follows.

EXAMPLE

Cumulative Preferred Distributions

The holders of the preferred stock shall be entitled to receive, when and as declared by the Board of Directors, out of the assets of the Corporation legally available therefor, cash distributions at the rate of \$8.40 per share per year, and no more, payable quarterly on the first days of January, April, July, and October in each year, prior to the payment of any distributions of the common stock. Such distributions shall be cumulative from the date of original issue.

Noncumulative Noncumulative preferred stock is entitled to receive a distribution preference in any given year, but if distributions are not paid during the year, the preferred shareholders lose their right to those distributions (just as common shareholders have no right to undeclared distributions). Using the same example of Alexis, if the preferred stock is entitled to a \$4 per share **noncumulative distribution**, when the corporation fails to pay in the first and second year, Alexis loses the right to the \$400 preference she would have had during each of those years. In the third year, if management decides to pay distributions, it must pay her \$400 (that year's preferred amount) before it can pay other shareholders.

Noncumulative Preferred Distributions

EXAMPLE

The holders of the preferred stock shall be entitled to receive out of the surplus or net profits of the Corporation, in each fiscal year, distributions at such rate or rates, not exceeding 8.4 percent per annum, as shall be determined by the Board of Directors in connection with the issue of the respective series of said stock and expressed in the stock certificates therefor, before any distributions shall be paid upon the common stock, but such distributions shall be noncumulative. No distributions shall be paid, declared, or set apart for payment on the common stock of the Corporation, in any fiscal year, unless the full distribution on the preferred stock for such year shall have been paid or provided for. However, if the Directors in the exercise of their discretion fail to declare distributions on the preferred stock in a particular fiscal year, the right of such stock to distributions for that year shall be lost even though there was available surplus or net profits out of which distributions might have been lawfully declared.

Other Provisions for Distribution Preferences Preferred stock may have a “**cumulative to the extent earned**” preference to distributions, permitting distributions to accumulate on preferred stock if the corporation earned money and could have declared distributions in a given year, but the board of directors decided not to declare distributions that year. On the other hand, if the corporation did not earn or accumulate enough profit to declare a distribution that year, the distribution would be lost and would not carry forward.

Another common provision is the right of the preferred stockholder to **participate** in other distributions declared, in addition to the preference. For example, if Alexis’s stock provided for a \$4 per year preference, noncumulative but participating, then in the third year when the corporation determined to pay distributions, Alexis would be entitled to \$400 as a preference, and she also would be entitled to share on a pro rata basis with all other securities in the remaining distributions that were to be declared and paid.

Liquidation Preference

Holders of preferred stock are frequently granted a preference upon dissolution and liquidation of the corporation. The terms of the stock usually recite the right for the preferred stockholder to be paid a specified amount, plus any accrued distributions that have not been paid, before any other equity security holder is entitled to share in the assets upon liquidation. The preferred shareholder is thus placed in a position analogous to that of a priority creditor. A liquidation preference is the best guarantee that can be arranged to ensure that shareholders will recoup their investment in case of liquidation. Although the preferred shareholders are subordinate to corporate creditors, they are paid before any other investor, and are entitled to be fully satisfied before any other shareholder receives a distribution in liquidation.

Liquidation preferences may be determined at a fixed percentage of par value.

Liquidation Preference at a Fixed Percentage of Par Value

EXAMPLE

In the event of any liquidation, dissolution, or winding up of the Corporation, either voluntary or involuntary, or in the event of any reduction of capital of the Corporation resulting in a distribution of assets to its stockholders, the holders of preferred shares shall be entitled to receive out of the assets of the Corporation, without regard to capital or the existence of a surplus of any nature, an amount equal to one hundred percent (100%) of the par value of such preferred shares, and, in addition to such amount, a further amount equal to the distributions unpaid and accumulated thereon to the date of such distribution, whether or not earned or declared, and more, before any payment shall be made or any assets distributed to the holders of the common shares. After the making of such payments to the holders of the preferred stock, the remaining assets of the Corporation shall be distributed among the holders of the common stock alone, according to the number of shares held by each. If the assets of the Corporation distributable as aforesaid among the holders of the preferred stock shall be insufficient to permit of the payment to them of said amounts, the entire assets shall be distributed ratably among the holders of the preferred stock.

Liquidation rights also may be based on a fixed sum, with participation rights.

EXAMPLE

Liquidation Preference Based on a Fixed Sum, with Participation Rights

In the event of any liquidation, dissolution, or winding up of the corporation, whether voluntary or involuntary, the holders of the preferred stock of the Corporation shall be entitled, before any assets of the Corporation shall be distributed among or paid over to the holders of the common stock, to be paid in full \$100.00 per share of preferred stock, together with all accrued and unpaid distributions and with interest on said distributions at the rate of fifteen percent (15%) per annum. After payment in full of the above preferential rights of the holders of the preferred stock, the holders of the preferred stock and common stock shall participate equally in the division of the remaining assets of the Corporation, so that from such remaining assets the amount per share of preferred stock distributed to the holders of the preferred stock shall equal the amount per share of common stock distributed to the holders of the common stock.

Voting Rights

Each corporation must have one or more classes of shares that have full voting rights, so at least some shareholder will be entitled to vote on all matters submitted to the shareholders.³⁹ A corporation with multiple classes of stock may have one class with full voting rights in shareholder matters, and another class with no voting rights at all. It is also permissible to grant more than one vote per share to one class while retaining the single vote per share for another class. These provisions are designed to establish voting control in one of the classes of securities. A typical application of these rules may involve shareholders of a corporation who wish to retain their control, but need to issue additional shares to secure new capital. With the establishment of a new class of nonvoting shares, the issuance of new shares will not dilute present voting control.

Modifications to voting rights are described in the articles of incorporation, and they may be expanded, denied, or granted subject to a contingency. For example, preferred shares may have no voting rights unless they have not received distributions for a specified period of time, in which case they will be entitled to vote.

EXAMPLE

Modifications to Voting Rights

The holders of the preferred stock shall not have any voting power whatsoever, except upon the question of selling, conveying, transferring, or otherwise disposing of the property and assets of the Corporation as an entirety, provided, however:

In the event that the Corporation shall fail to pay any distribution upon the preferred stock when it regularly becomes due, and such distribution shall remain in arrears for a period of six (6) months, the holders of the preferred stock shall have the right to vote on all matters in like manner as the holders of the common stock, during the year next ensuing, and during each year thereafter during the continuance of said default until the Corporation shall have paid all accrued distributions upon the preferred stock. The holders of the common stock shall have the right to vote on all questions to the exclusion of all other stockholders, except as herein otherwise provided.

If no modifications of voting rights appear in the articles, the Model Business Corporation Act and most states grant each outstanding share (including preferred shares) one vote on each matter submitted to a vote at the meeting of the shareholders.⁴⁰ The articles of incorporation may reconfirm the statutory voting scheme.

Reconfirmation of Statutory Voting Rights

EXAMPLE

The preferred stock and common stock shall have equal voting powers and the holders thereof shall be entitled to one vote in person or by proxy for each share of stock held. The common stock, however, to the exclusion of the preferred stock, shall have the sole voting power with respect to the determination of whether the preferred stock shall be redeemed, as hereinafter provided

If voting rights are denied to a particular class of shares, the holders of shares in that class are not entitled to vote on typical shareholder business. A potential problem lurks in this rule. Consider that the structure (including distribution and liquidation entitlements) of the nonvoting securities is specified in the articles of incorporation and that this structure may be changed by an amendment to the articles that is approved by the shareholders. If the holders of the nonvoting classes were never entitled to vote, even on such matters, they would be at the mercy of the voting shareholders, who could vote to amend away the advantageous features of their stock. Consequently, corporate statutes uniformly provide for class voting on matters that may affect the rights of the class.

Section 7.25 of the Model Business Corporation Act permits shares to vote as a **separate voting group** and to take action in a meeting when a quorum of the separate voting group is present. The separate voting group may be one or more classes of stock that are entitled to vote on certain matters, either because the articles of incorporation provide for a vote of the separate group, or the statute requires such a vote.

Section 10.04 of the act provides that a class will be entitled to vote as a separate voting group on any proposed amendment that would affect the rights of that class.⁴¹

Redemption Rights

The terms of preferred stock may include provisions for the **redemption** of the shares. A corporation may have the right to redeem or reacquire its shares if redemption terms are included in the description of the class. The redemption feature is a greater advantage to the corporation than to the shareholders. For example, suppose the corporation issued 20% cumulative redeemable preferred stock to acquire needed capital. The distribution percentage would make this stock very attractive, but management would prefer not to continue paying a high cumulative distribution any longer than necessary. The redemption feature would permit the corporation to retire the securities when it had generated enough capital from operations to do so.

A proper redemption provision should spell out the terms of the “forced” sale from the preferred shareholders to the corporation and the procedure that must be followed to accomplish the sale. A redemption clause must appear on the articles of incorporation and on the share certificate; it typically includes

1. a date upon which the stock will be redeemable by the corporation;
2. a price at which the stock is redeemable, usually with a provision to the effect that an amount equal to accrued and unpaid distributions will be added to the price;
3. a period of notice preceding the date of redemption and the persons to whom notice must be given;
4. a place at which payment is to be made, and the person who will make payment;
5. a time at which payment is to be made and whether the board of directors has a right to accelerate the payment date;
6. provisions regarding the surrender of share certificates and the cancellation of all rights of the shareholder upon redemption; and
7. provisions covering the possibility that a shareholder will not surrender shares for cancellation in accordance with the redemption right.

EXAMPLE**Redemption of Shares**

The preferred stock may be redeemed in whole or in part on any quarterly dividend payment date, at the option of the Board of Directors, upon not less than sixty (60) days' prior notice to the holders of record of the preferred stock, published, mailed, and given in such manner and form and on such other terms and conditions as may be prescribed by the bylaws or by resolution of the Board of Directors by payment in cash for each share of the preferred stock to be redeemed of one hundred two percent (102%) of the par amount thereof and in addition thereto all unpaid dividends accrued on such share.

From and after May 1, 1995, the Board of Directors shall retire not less than 1,000 shares of preferred stock per annum; but the Board of Directors shall first set aside a reserve to provide full dividends for the current year on all preferred stock that shall be outstanding after such purchase or retirement, and provided further that no such purchase or retirement shall be made if the capital of the Corporation would thereby be impaired.

If less than all the outstanding shares are to be redeemed, such redemption may be made by a lot or pro rata as may be prescribed by resolution of the Board of Directors; provided, however, that the Board of Directors may alternatively invite from shareholders offers to the Corporation of preferred stock at less than One hundred two dollars (\$102.00), and when such offers are invited, the Board of Directors shall then be required to buy at the lowest price or prices offered, up to the amount to be purchased.

From and after the date fixed in any such notice as the date of redemption (unless default shall be made by the Corporation in the payment of the redemption price), all dividends on the preferred stock thereby called for redemption shall cease to accrue and all rights of the holders hereof as stockholders of the Corporation, except the right to receive the redemption price, shall cease and determine.

Any purchase by the corporation of shares of its preferred stock shall not be made at prices in excess of said redemption price.

[or]

By a unanimous vote of a full board of directors of the number fixed by the stockholders at their last annual meeting, all or any shares of common stock of the Corporation held by such holder or holders as may be designated in such vote may be called at any time for purchase, or for retirement or cancellation in connection with any reduction of capital stock, at the book value of such shares as determined by the Board of Directors as of the close of the month next preceding such vote. Such determination, including the method thereof and the matters considered therein, shall be final and conclusive.

Not less than 30 days prior to the day for which a call of common stock for purchase or for retirement or cancellation is made, notice of the call shall be mailed to each holder of shares of stock called at his or her address as it appears upon the books of the Corporation. The Corporation shall, not later than said day, deposit with a bank to be designated in such notice, for the account of such holder, the amount of the purchase price of the shares so called. After such notice and deposit, all shares so called shall be deemed to have been transferred to the Corporation, or retired or canceled as the case may be, and the holder shall cease to have, in respect thereof, any claim to future dividends or other rights as stockholder, and shall be entitled only to the sums so deposited for his or her account. Any shares so acquired by the Corporation may be held and may be disposed of at such times, in such manner, and for such consideration as the Board of Directors shall determine.

The redemption of corporate securities requires large disbursements of cash and may be impossible to absorb in normal corporate operations. To plan for eventual redemption, therefore, management should consider a sinking fund for the payment of the purchase price. The objective of the sinking fund is the same as that of a holiday savings plan. By faithfully depositing a certain amount at periodic intervals, depositors can ensure that a lump sum will be available at the projected date of need. A clause establishing redemption of preferred stock with a sinking fund might look like this.

The Model Business Corporation Act repealed its statutory restrictions on redemption of shares several years ago. Many state statutes are still based on the former act provisions, however, and continue to restrict the redemption right in two important areas: (1) redemption or purchase of shares is prohibited when the corporation is insolvent or would be rendered insolvent by the redemption; and (2) redemption is forbidden if the transaction would reduce the net assets below the aggregate amount payable to the holders of shares having prior or equal rights to the assets of the corporation upon involuntary dissolution.

Sinking Fund

EXAMPLE

a) There shall be a sinking fund for the benefit of the shares of the preferred stock. As long as there shall remain outstanding any preferred stock, the Corporation shall set aside annually, on or before October 15, 1995, and on or before October 15th in each year thereafter, as and for such sinking fund for the then current year, an amount in cash equal to the lesser of either \$25,000 or 2.7% of the Consolidated Net Earnings of the Corporation and its subsidiaries for the preceding calendar year (computed as hereinafter provided). As long as dividends on the preferred stock for any past quarterly dividend payment date shall not have been fully paid or declared and a sum sufficient for the payment thereof set apart, the date for the setting aside of any amounts for the sinking fund shall be postponed until all such dividends in arrears shall have been paid or declared and a sum sufficient for the payment thereof set aside, and no amounts shall be set aside for the sinking fund while such arrears shall exist. In addition to the aforesaid sinking fund payments, the Corporation shall pay out of its general funds all amounts paid in excess of \$103 per share (for commissions or as, or based upon, accrued dividends) upon any purchase or redemption of preferred stock through the sinking fund, as hereinafter provided.

b) The moneys set aside for any annual installment for the sinking fund (with any amounts remaining unexpended from previous sinking fund installments), may, at the option of the Corporation, be immediately applied (but not earlier than the October 15th on or before which such installment is required to be set aside), as nearly as possible, to the redemption of shares of preferred stock at the redemption price of \$103 per share plus dividends accrued thereon to the date of redemption, in the manner provided herein for the redemption of preferred stock; provided, however, that if at the time any such annual installment is set aside (but not earlier than the October 15th on or before which such installment is required to be set aside), any holder of preferred stock shall hold 5% or more of the then outstanding shares of preferred stock, then there shall promptly be redeemed from such holder the number of whole shares of preferred stock (and no more) that shall bear, as nearly as practicable, the same ratio to the total number of shares which could be redeemed pursuant to this subdivision with such moneys, as the number of shares of preferred stock then owned by such holder shall bear to the total number of shares of preferred stock then outstanding.

c) Any moneys set aside for the sinking fund, as hereinabove required, and not applied to the redemption of preferred stock as provided in the preceding clause (b) (with any amounts remaining unexpended from previous sinking fund payments) shall be applied from time to time by the Corporation to the purchase, directly or through agents, of preferred stock in the open market or at public or private sale, with or without advertisement or notice, as the Board of Directors shall in its discretion determine, at prices not exceeding \$103 per share plus accrued dividends and plus the usual customary brokerage commissions payable in connection with such purchases. If at the expiration of a full period of 90 days following the date each such amount is set apart during which the Corporation shall have been entitled hereunder to purchase shares of preferred stock with such funds, there shall remain in the sinking fund amounts exceeding \$5,000 in the aggregate which shall not have been expended during such periods, then the Corporation shall promptly select and call for redemption at \$103 per share plus dividends accrued thereon to the date of redemption, in the manner herein provided for the redemption of preferred stock such number of shares of preferred stock as is necessary to exhaust as nearly as may be all of said moneys, except that no shares shall then be allocated for redemption from any holder if the pro rata share of the then current sinking fund payment shall have been applied to the redemption of shares of such holder as hereinabove in paragraph (b) of this subdivision provided. Anything herein to the contrary notwithstanding, no purchase or redemption of shares of preferred stock with any moneys set aside for the sinking fund shall be made or ordered unless full cumulative dividends for all past quarterly dividend payment dates have been paid or declared and a sum sufficient for the payment thereof set aside upon all shares of preferred stock then outstanding. When no shares of preferred stock shall remain outstanding, any balance remaining in the sinking fund shall become part of the general funds of the Corporation.

The last provision deserves an illustration. Suppose the corporation has \$1,000,000 in assets, \$700,000 in liabilities, and three classes of stock outstanding (1,000 shares of 8% noncumulative preferred stock with a \$105 liquidation preference; 2,000 shares of 10% noncumulative preferred stock redeemable at \$100 per share; and 100,000 shares of common stock). The net assets of the corporation (assets minus liabilities) total \$300,000. The corporation could not redeem all 2,000 shares of the 10% preferred stock, since that would require \$200,000 and payment of that amount would reduce net assets to \$100,000. The remainder would be insufficient to pay the 8% preferred shareholders' liquidation preference of \$105,000.

Exhibit 9-4.

Cancellation of Redeemable Shares

Form BCA-9.05 (Rev. Jan. 2003)	STATEMENT OF CANCELLATION of NON-REISSUABLE SHARES	File # _____																																								
Jesse White Secretary of State Department of Business Services Springfield, IL 62756 Telephone (217) 782-1831 http://www.cyberdriveillinois.com	<div style="border: 1px solid black; padding: 5px; display: inline-block;">Submit in Duplicate</div>	This space for use by Secretary of State Date _____ Filing Fee \$ 5.00 Approved: _____																																								
<i>Remit payment in check or money order, payable to "Secretary of State."</i>																																										
1. CORPORATE NAME: _____																																										
2. The corporation has acquired and cancelled its own shares, and the articles of incorporation prohibit the re-issuance of such shares.																																										
3. Number of shares cancelled and redemption or purchase price:																																										
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7. The undersigned corporation has caused this statement to be signed by a duly authorized officer who affirms, under penalties of perjury, that the facts stated herein are true. (All signatures must be in BLACK INK .)																																										
Dated _____, _____, _____ <div style="display: flex; justify-content: space-between;"> <i>(Month & Day)</i> <i>(Year)</i> <i>(Exact Name of Corporation)</i> </div> <hr style="width: 100%;"/> <div style="display: flex; justify-content: center; margin-bottom: 5px;"> <i>(Any Authorized Officer's Signature)</i> </div> <hr style="width: 100%;"/> <div style="display: flex; justify-content: center;"> <i>(Type or Print Name and Title)</i> </div>																																										

Redeemed shares are usually canceled and restored to authorized status, just as if they have never been issued. Under the current Model Business Corporation Act, the restoration of the shares to this status is automatic unless the articles of incorporation provide that the shares shall not be reissued, in which case the redeemed shares are eradicated by reducing the total authorized shares.⁴² A statement of **cancellation** must be filed upon redemption, describing the name of the corporation; the reduction in the number of authorized shares, itemized by class and series; and the total number of authorized shares remaining after the reduction (see Exhibit 9-4, Cancellation of Redeemable Shares). The act regards this statement as an amendment to the articles of incorporation without shareholder action.

Conversion Privileges

Certain classes of stock may be entitled to a **conversion** privilege whereby a holder of those shares may convert the shares of one class for shares of another class at a specified rate and

time. A conversion feature enhances the marketability of conservative classes of stock, because the holder has the best of both worlds. A holder of preferred shares with a conversion privilege, for example, enjoys the preferences and conservative investment protection of the preferred stock while maintaining the option to convert to common stock if its growth rate is attractive. The shareholder who owns convertible preferred stock, therefore, receives the security of preferred shares plus the right to elect an interest in the basic equity growth of the company.

A conversion clause should appear in the articles of incorporation and on the share certificates. A conversion privilege provision should include

1. a conversion rate specifying the number of shares of common stock (or another class) into which each share of preferred stock is convertible;
2. provisions respecting the issuance of fractional shares, since the conversion may result in a fractional share problem;⁴³
3. a procedure for the method of conversion, detailing the written notice required to convert the shares and a period of time following the election that the conversion will become effective;
4. provisions for the adjustment of conversion rates in case a stock dividend, stock split, or other corporate action changes the character of the shares into which the preferred stock can be converted;
5. requirement of notice to preferred shareholders when the conversion rate is adjusted; and
6. reservation of an adequate number of shares of common stock, in case all conversion privileges are exercised.

Remember that a corporation must have authority to issue common stock in its articles of incorporation, and enough common shares must be reserved to allow the preferred shareholders to exercise their conversion privilege.

Conversion of Shares

EXAMPLE

The preferred stock of this Corporation of \$100 par value may, at the option of the holder thereof, at any time on or before January 10, 2005, be converted into common stock of this Corporation of \$100 par value upon the following terms:

- a) Any holder of such preferred stock desiring to avail himself or herself of the option for conversion of that stock shall, on or before January 10, 2005, deliver, duly endorsed in blank, the certificates representing the stock to be converted to the Secretary of the Corporation at its office, and at the same time notify the Secretary in writing over the holder's signature that the holder desires to convert his or her stock into common stock of \$100 par value pursuant to these provisions.
- b) Upon receipt by the Secretary of a certificate or certificates representing such preferred stock and a notice that the holder desires to convert the same, the Corporation shall forthwith cause to be issued to the holder one share of common stock for each share of preferred stock surrendered, and shall deliver to such holder a certificate in due form for such common stock.
- c) One hundred thousand shares of common stock of this Corporation shall be set aside and such shares shall be issued only in conversion of preferred stock as herein provided.
- d) Shares of preferred stock that have been converted shall revert to the status of unissued shares and shall not be reissued. Such shares may be eliminated as provided by law.
- e) If, at any time the convertible preferred stock of this Corporation is outstanding, the Corporation increases the number of common shares outstanding without adjusting the stated capital of the corporation, the conversion rate shall be adjusted accordingly, so as to make each share of preferred stock convertible into the same proportionate amount of common stock into which it would have been convertible without such adjustment to the common stock. Each preferred shareholder shall be notified in writing of the adjusted conversion rate within thirty (30) days of such action by the Corporation.
- f) These provisions for conversion of preferred stock of this Corporation shall be subject to the limitations and restrictions contained in the Business Corporation Law.

TRANSFER AGENTS

Many public corporations employ **transfer agents** and **registrars** to keep track of the record holders of corporate securities. In a close corporation, where share certificates are exchanged only rarely, corporate officers or counsel usually serve this function. By statute, a stock transfer ledger must be maintained either at the place of business of the corporation or at the office of its transfer agent or registrar,⁴⁴ which is normally a bank or other financial institution that has a separate division for the explicit purpose of maintaining such records for corporations. The transfer agent is responsible for issuing new stock certificates. Blank certificates are usually kept in bulk at the agent's office; the statutory signatures are usually printed on the certificates, since the Model Business Corporation Act permits a **facsimile signature** of the officers.⁴⁵ If a registrar as well as a transfer agent is used, the transfer agent delivers newly prepared certificates to the registrar for registration and countersignature. The registrar returns the registered and signed certificates to the transfer agent, who then issues them. The registrar's responsibilities include recording all certificates representing shares of stock in the corporation. If the transfer agent and registrar are separate individuals, all entries made in the stock transfer ledger are made by the registrar, and the ledger is kept at the registrar's office. Transfer agents and registrars receive corporate authority by resolution of the board of directors (see Exhibit 9-5, Appointment of Transfer Agent and Registrar).

In addition to a specification of authority to act as transfer agent or registrar, such a resolution may also include a statement that the officers of the company are authorized and empowered to give instructions to the transfer agent and to the registrar and to take any other action they deem necessary to effect the issuance of the common stock.

DEBT SECURITIES (BONDS)

Every state empowers a corporation to borrow funds for corporate purposes. Debt securities represent loans to the corporation, and a debt security holder is a creditor of the corporation. A debt holder usually enjoys no right to participate in management and also has no right to receive profits. A debt security holder is, however, entitled to the repayment of the loan with the prescribed interest, and if the debt remains unpaid at the time of dissolution, repayment of the debt may be obtained from the available assets. Furthermore, debt security holders enjoy greater security for their investment than do equity security holders, since debt holders are creditors and thus are entitled to be satisfied from the available assets before equity holders are paid.

Debt securities state a principal amount, a maturity date, and a periodic interest rate. The interest is the return on the investment, and usually determines the attractiveness of a debt security. State statutes do not strictly regulate debt obligations, and as a matter of law these securities are considered to be individual agreements between the debt security holder and the corporation, containing negotiated terms. The terms of debt securities (bonds) issued by public corporations are fixed and are not subject to negotiation or modification. For example, Peoples Energy Corporation may issue bonds in the amount of \$25,000,000, with interest set at 5.34% per year and a maturity date of 2020. Investors who wish to purchase these bonds simply buy them from a broker on those terms. However, in closely held corporations, debt securities may contain a variety of terms that are negotiated between the creditor-investor and the corporation. When Local Pharmacy, Inc., decides to raise money by borrowing funds, it may negotiate with various investors in the community to reach acceptable terms for their investment. It may issue a bond to one investor for \$10,000 with interest at 8% per year to be paid in 3 years and another bond to a different investor for \$25,000 with interest at 12% per year to be paid in 2 years, and so on. Nevertheless, it is possible to generalize about the typical features of debt securities.

Exhibit 9-5.

Appointment of Transfer Agent and Registrar

Appointment of TRANSFER AGENT
REGISTRAR

(Name of Corporation)

Resolved, that The _____ Bank _____ is hereby appointed [sole] [Transfer Agent] [Registrar] for all of the shares of the _____ Preferred stock, and [_____ shares] [all of the shares]

_____ of the _____ Common stock of this Company, to act in accordance with its general practice and with the regulations set forth in the pamphlet submitted to this meeting entitled "Regulations of The _____ Bank _____ for the Transfer and Registration of Stock," which pamphlet the Secretary is directed to mark for identification and file with the records of the Company.

I, the undersigned, Secretary of the above-named Corporation, do hereby certify that the foregoing is a true and correct copy of a resolution duly adopted by the Board of Directors of said Corporation at a meeting thereof duly called and held on _____, 20____, at which a quorum were present, and that said resolution has not been in any wise rescinded, annulled, or revoked but the same is still in full force.

And I do further certify to the following facts:

The authorized and outstanding stock of the Corporation is as follows:

<i>Class</i>	<i>Par Value</i>	<i>Authorized</i>	<i>Outstanding</i>
_____	_____	_____	_____
_____	_____	_____	_____

The address of the Corporation to which notices may be sent is _____

The below-named persons have been duly elected and qualified as, and this day are, officers of the Corporation, holding the respective offices set opposite their names, and the signatures set opposite their names are their genuine signatures.

- _____ *President* _____
- _____ *Vice-President* _____
- _____ *Vice-President* _____
- _____ *Treasurer* _____
- _____ *Assistant Treasurer* _____
- _____ *Secretary* _____
- _____ *Assistant Secretary* _____

The name and address of legal counsel for the Corporation is _____

The names and addresses of all of the Transfer Agents and Registrars of the stock of the Corporation are as follows:

<i>Class of Stock</i>	<i>Transfer Agent(s)</i>	<i>Registrar(s)</i>
_____	_____	_____
_____	_____	_____

Witness my hand and the seal of the Corporation this _____ day of, 20_____.

Secretary

[Corporate Seal]

TYPES OF CORPORATE DEBT SECURITIES

Unsecured Debt

A corporate debt obligation may be set out in a simple **promissory note**, the terms of which include the amount of the debt, a promise to pay the principal at a certain time, and a promise to pay interest.

EXAMPLE

Promissory Note

\$50,000.00

November 1, 2006

One year after date, for value received, Happiness, Inc., promises to pay to Jeb P. Owen or order, payable at 1216 Charlotte Avenue, Austin, Texas, the sum of Fifty thousand DOLLARS, with interest thereon at the rate of 15 percent, per annum from date, payable monthly until paid.

Failure to pay any installment of principal or interest when due shall cause the whole note to become due and payable at once, or the interest to be counted as principal, at the option of the holder of this note, and it shall not be necessary for the holder to declare the same due, but he may proceed to collect the same as if the whole was due and payable by its terms.

Presentment for payment, notice of dishonor, and protest are hereby waived by the maker or makers, and endorser or endorsers, and each endorser for himself or herself guarantees the payment of this note according to its terms. No extension of payment shall release any signer or be paid by the parties liable for the payment of this note.

Happiness, Inc., By: Susan Powers President

Alternatively, it may be a lengthy, complex debenture obligation:

EXAMPLE

18% Twenty-Year Debenture Due August 1, 2025

\$1,000

No. _____

Trouble, Inc., a Colorado corporation (hereinafter called the "Company," which term includes any successor corporation under the Indenture hereinafter referred to), for value received, hereby promises to pay to the bearer, or, if this Debenture be registered as to principal, to the registered holder hereof, on August 1, 2025, the sum of One Thousand Dollars and to pay interest thereon, from the date hereof, semi-annually on June 1 and December 1 in each year, at the rate of Eighteen (18) percent per annum. Payment of the principal of (and premium, if any) and interest on this Debenture will be made at the office or agency of the Company maintained for that purpose in Denver, Colorado, in such coin or currency of the United States of America as at the time of payment is legal tender for payment of public and private debts.

This Debenture is one of a duly authorized issue of Debentures of the Company designated as its 18% Twenty-Year Debentures Due August 1, 2025 (hereinafter called the "Debentures"), limited in aggregate principal amount to \$1,500,000.00, issued and to be issued under an indenture dated August 1, 2005 (hereinafter called the "Indenture"), between the Company and Glorious Trust Company as Trustee (hereinafter called the "Trustee," which term includes any successor trustee under the Indenture), to which Indenture and all indentures supplemental thereto reference is hereby made for a statement of the respective rights thereunder of the Company, the Trustee and the holders of the Debentures and coupons, and the terms upon which the Debentures are, and are to be, authenticated and delivered.

If an Event of Default, as defined in the Indenture, shall occur, the principal of all the Debentures may be declared due and payable in the manner and with the effect provided in the Indenture.

The Indenture permits, with certain exceptions as therein provided, the amendment thereof and the modification of the rights and obligations of the Company and the rights of the holders of the

EXAMPLE*(continued)*

Debentures under the Indenture at any time by the Company with the consent of the holders of 66⅔% in aggregate principal amount of the Debentures at the time outstanding, as defined in the Indenture. The Indenture also contains provisions permitting the holders of specified percentages in aggregate principal amount of the Debentures at the time outstanding, as defined in the Indenture, on behalf of the holders of all the Debentures, by written consent to waive compliance by the Company with certain provisions of the Indenture and certain past defaults under the Indenture and their consequences. Any such consent or waiver by the holder of this Debenture shall be conclusive and binding upon such holder and upon all future holders of this Debenture and of any Debenture issued in exchange herefor or in lieu hereof whether or not notation of such consent or waiver is made upon this Debenture.

No reference herein to the Indenture and no provision of this Debenture or of the Indenture shall alter or impair the obligation of the Company, which is absolute and unconditional, to pay the principal of (and premium, if any) and interest on this Debenture at the times, place, and rate, and in the coin or currency, herein prescribed.

This Debenture is transferable by delivery, unless registered as to principal in the name of the holder in the Debenture Register of the Company. This Debenture may be so registered upon presentation hereof at the office or agency of the Company in any place where the principal hereof and interest hereon are payable, such registration being noted hereon. While registered as aforesaid, this Debenture shall be transferable on the Debenture Register of the Company by the registered holder hereof, upon like presentation of this Debenture for notation of such transfer hereon, accompanied by a written instrument of transfer in form satisfactory to the Company and the Debenture Registrar duly executed by the registered holder hereof or his or her attorney duly authorized in writing, all as provided in the Indenture and subject to certain limitations therein set forth; but this Debenture may be discharged from registration by being in like manner transferred to bearer, and thereupon transferability by delivery shall be restored. This Debenture shall continue to be subject to successive registrations and transfers to bearer at the option of the bearer or registered holder, as the case may be. Such registration, however, shall not affect the transferability by delivery of the coupons appertaining hereto, which shall continue to be payable to bearer and transferable by delivery. No service charge shall be made for any such registration, transfer, or discharge from registration, but the Company may require payment of a sum sufficient to cover any tax or other governmental charge payable in connection therewith.

The Company, the Trustee, and any agent of the Company may treat the bearer of this Debenture, or, if this Debenture is registered as herein authorized, the person in whose name the same is registered, and the bearer of any coupon appertaining hereto, as the absolute owner hereof for all purposes, whether or not this Debenture or such coupon be overdue, and neither the Company, the Trustee, nor any such agent shall be affected by notice to the contrary.

The Debentures are issuable as coupon Debentures, registrable as to principal, in the denomination of \$1,000 and as registered Debentures without coupons in denominations of \$1,000 and any multiple thereof. As provided in the Indenture and subject to certain limitations therein set forth, Debentures are exchangeable for a like aggregate principal amount of Debentures of a different authorized kind or denomination, as requested by the holder surrendering the same, upon payment of taxes and other governmental charges.

Unless the certificate of authentication hereon has been executed by the Trustee by the manual signature of one of its authorized officers, neither this Debenture, nor any coupon appertaining hereto, shall be entitled to any benefit under the Indenture, or be valid or obligatory for any purpose.

In witness whereof, the Company has caused this Debenture to be duly executed under its corporate seal, and coupons bearing the facsimile signature of its Treasurer to be hereto annexed. Date: December 15, 2005

Trouble, Inc.
By: Teresa Thrailkill
President

Attest:
Jerrold Glick
Secretary

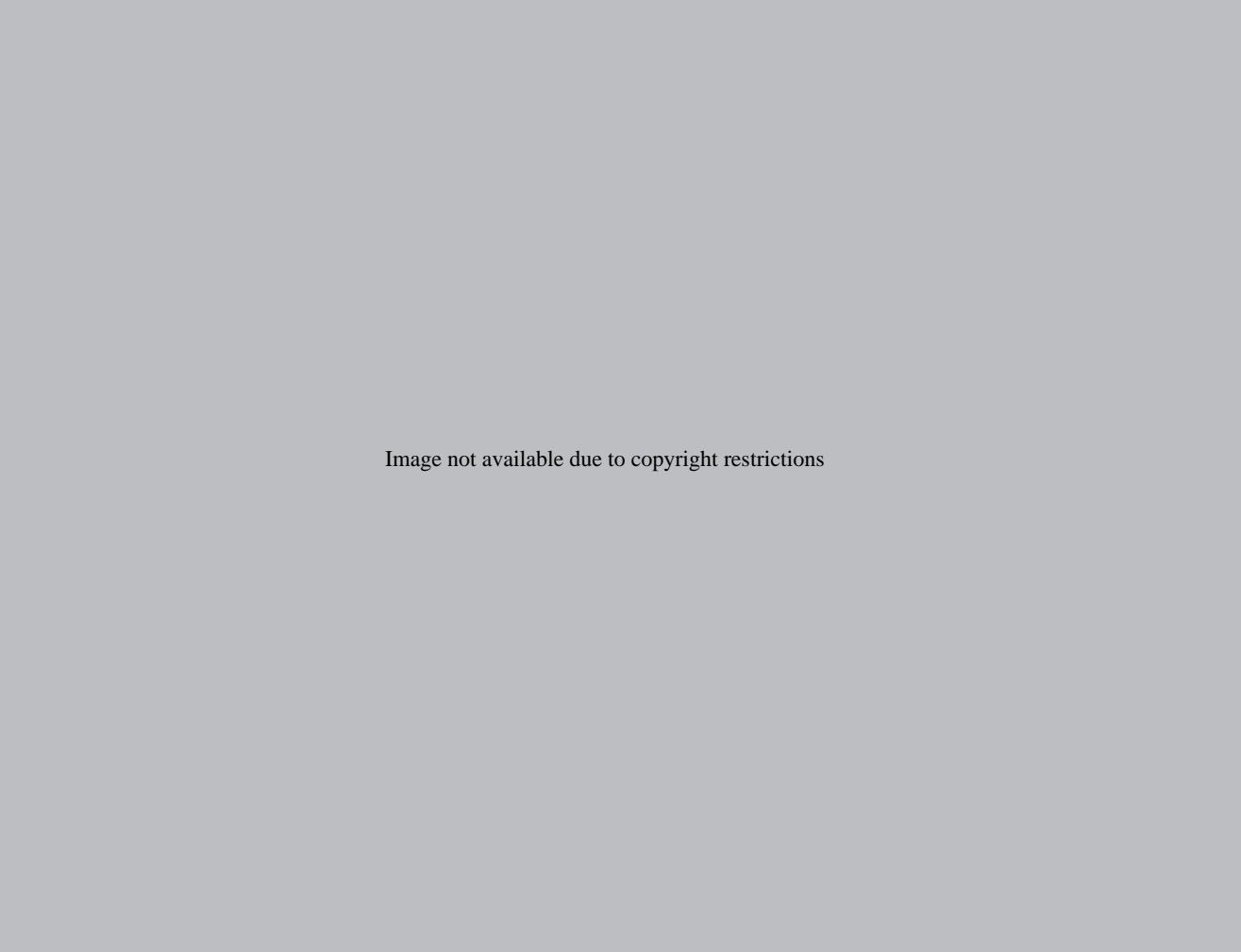


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(See Exhibit 9–6, Debenture Certificate, and Exhibit 9–7, Debenture Certificate with Coupons on page 324.)

In any case, these are unsecured obligations, meaning that the corporation simply borrows money on the strength of its own ability to repay. The characteristic common to the simple promissory note and the debenture bond is that there is no specific corporate property to which the creditor will be entitled if the corporation defaults.

Secured Debt

The unsecured debenture or promissory note should be contrasted with a mortgage bond or **secured** note in which the corporation pledges certain property as collateral to secure repayment of the obligation. If there is a default, the creditor may reach the collateral to satisfy the debt. Mortgage bonds usually have corporate land as collateral. The obligation between the creditor and the corporation is represented by a mortgage bond, or note, and a mortgage agreement, which specifies the terms under which the property will be held for the benefit of the creditor. A mortgage agreement usually requires the mortgagor (corporation) to insure the property, maintain it in good order, and keep it free from other liens or obligations so that the creditor will have its full benefit, if necessary. Secured debt obligations may also involve personal property collateral, including equipment, inventory, accounts, and so on. Personal property security interests are governed by the Uniform Commercial Code, which has been adopted in every state. The code requires a security agreement between the debtor and cred-

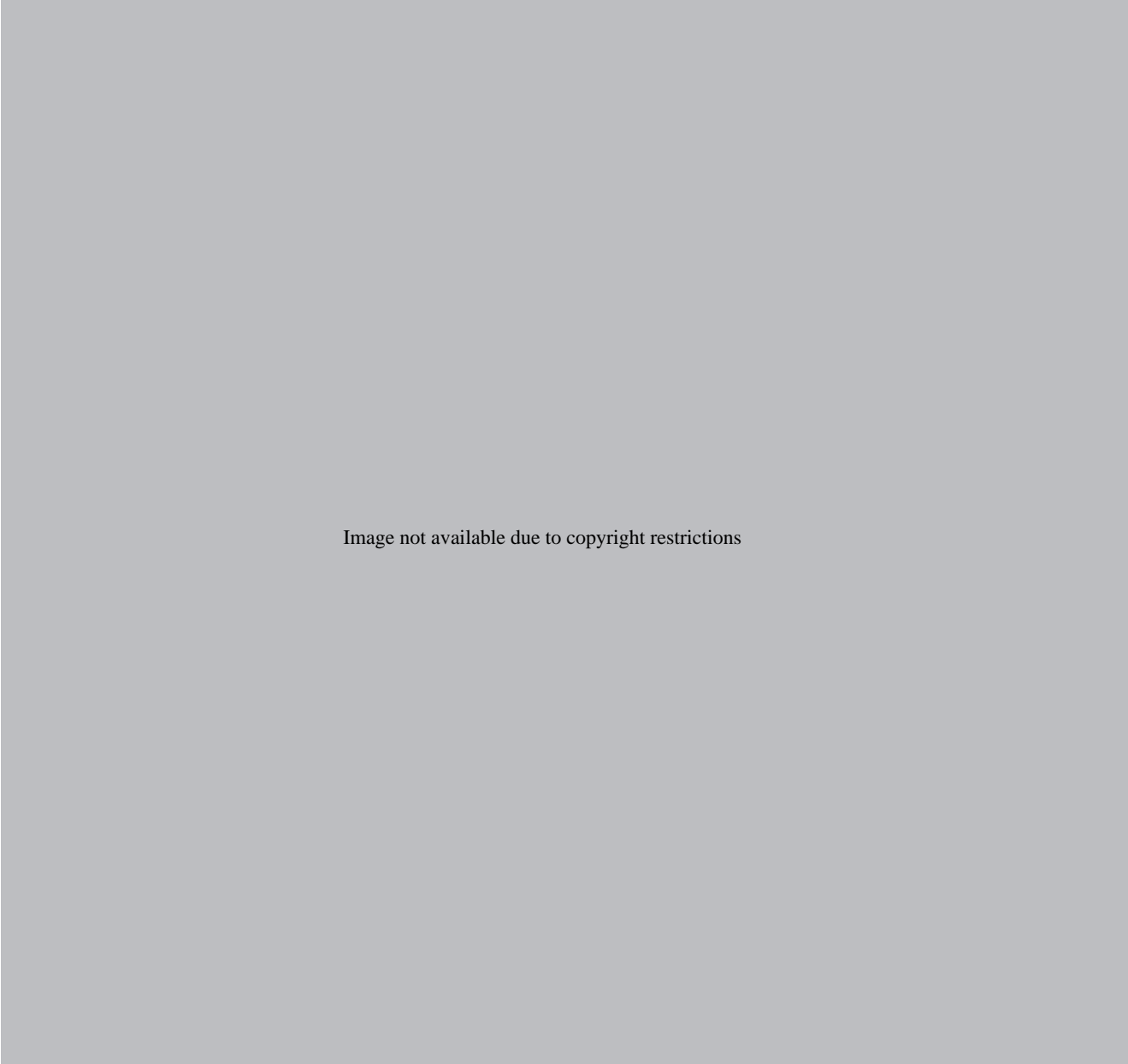


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itor (see Exhibit 9–8, Security Agreement under the Uniform Commercial Code on page 326).⁴⁶ Further, a financing statement that meets the statutory requirements⁴⁷ must be recorded in the appropriate state or county offices (see Exhibit 9–9, Uniform Commercial Code—Financing Statement on page 328).⁴⁸

TRUST INDENTURE

When numerous bonds are issued at once, a trustee is usually appointed to act on behalf of the holders of the security in case of default by the corporation. The appointment of a trustee is particularly desirable for secured debt obligations because it will be necessary for someone to take the necessary action to recover the collateral pledged to secure the bond and distribute the proceeds of its sale to the bondholders. If the corporation defaults, the trustee will act on behalf




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of the creditors to recover the property securing the obligations. The trustee is usually a financial institution, and is appointed by the execution of a **trust indenture**, an agreement that specifies the rights and responsibilities of the corporation, the rights and responsibilities of the trustee, and the rights of the security holders. If the bonds are to be sold to the public, the indenture must comply with the requirements of the **Trust Indenture Act of 1939**, the federal Securities Act of 1933,⁴⁹ and perhaps state securities statutes. The document that evidences the obligation, the bond itself, merely refers to the trust indenture for all details of the obligation. Trust indentures are unconscionably lengthy documents, and most experienced financial institutions have standard indentures for the use of their corporate customers.⁵⁰

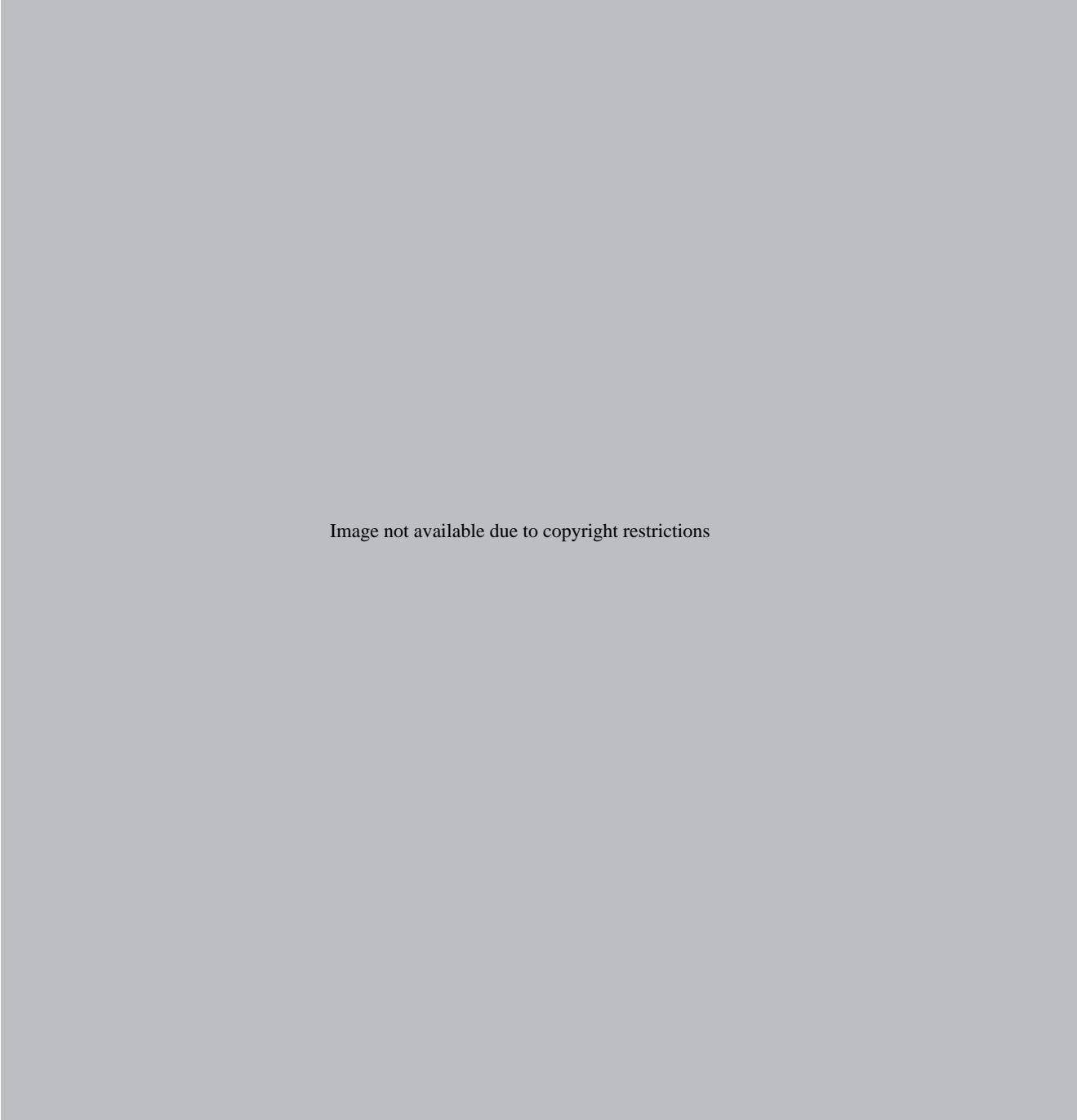


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COMMON PROVISIONS IN DEBT SECURITIES

As with stock, it is possible to introduce into debt securities various privileges that make the investment more attractive. Debt securities may also have redemption or conversion provisions, and the terms of the obligation may contain a subordination feature, which establishes a priority of one debt security over another. The investment objectives of a debt security holder are twofold: repayment of the principal and receipt of the periodic interest. The security may become more or less attractive depending upon the circumstances under which it may be redeemed (terminating the interest), converted (altering the character of the investment), or subordinated (endangering repayment of the principal).

Exhibit 9–8.**Security Agreement under
the Uniform Commercial
Code**

SECURITY AGREEMENT	
Debtor:	
Name: _____	(Exact Legal Name Required)
Address:	
Residence: _____	(Street, City, State, Zip)
Business: _____	(Street, City, State, Zip)
Secured Party:	
Name: _____	
Address: _____	(Street, City, State, Zip)
<p>Debtor, for consideration, hereby grants to Secured Party a security interest in the following property, and any and all property of like type now owned or hereafter acquired by Debtor, together with all additions, accessions, substitutions, proceeds and products therefrom, including natural increase of livestock, all herein called the "Collateral":</p>	
<p>To secure payment of the indebtedness evidenced by _____ certain promissory note _____ of even date herewith, payable to the Secured Party, or order, as follows:</p>	
<p>and all other liabilities of Debtor to Secured Party, absolute or contingent, due or to become due, now existing or hereafter arising, including liabilities arising because of funds advanced in the future at the option of Secured Party, all herein called the "OBLIGATIONS."</p>	
DEBTOR EXPRESSLY WARRANTS AND COVENANTS:	
The Collateral is used or bought primarily for:	
<input type="checkbox"/> Personal, family or household purposes;	
<input type="checkbox"/> Use in farming operations;	
<input type="checkbox"/> Use in business.	
That Debtor's residence, state of organization or chief executive office is as stated herein, and the Collateral will be kept at	
Location _____ County _____ State _____	
If any of the Collateral is oil, gas, or minerals to be extracted or timber to be cut, or goods which are or are to become fixtures, said Collateral concerns the following described real estate situate in the _____ County of _____ and State of Colorado, to-wit:	
The undersigned acknowledge receipt of a copy of this Security Agreement on date hereof, and agree that it includes and is subject to the ADDITIONAL PROVISIONS on the reverse side hereof, the same being incorporated herein by reference.	
Debtor:	_____
	Debtor's state of organization, or if not a registered organization, chief executive officer
_____	Debtor's State Identification No.
_____	Dated this _____ day of _____, 20_____.
No. 651. Rev. 8-01. SECURITY AGREEMENT (Page 1 of 2)	

Redemption

Bonds may be redeemable at the option of the board of directors at a specified time and a specified price. Redemption provisions are usually included in bonds that have very high interest rates (making them attractive to investors) but the corporation does not want to pay such high interest rates any longer than necessary. Consequently, bonds have a redemption provision allowing the corporation to buy them from the investor before maturity and eliminate the remaining interest payments. The redemption price for bonds is usually stated in terms of a

Exhibit 9-8.

(continued)

ADDITIONAL PROVISIONS

FURTHER WARRANTIES AND COVENANTS OF THE DEBTOR. The Debtor hereby warrants and covenants that:

1. Except for the security interest granted hereby, the Debtor is, to the extent that this agreement states that the Collateral is to be acquired after the date hereof, will be, the owner of the Collateral free from any prior lien, security interest or encumbrance; and the Debtor will defend the Collateral against all claims and demands of all persons at any time claiming the same or any interest therein.
2. Irrespective of whether the Secured Party claims a security interest in proceeds hereunder, the Debtor will not sell or offer to sell or otherwise transfer or encumber the Collateral or any interest therein without the prior written consent of the Secured Party. The Collateral will be located at and kept at the location shown on the reverse side hereof and shall not be removed without the prior written consent of the Secured Party.
3. The Debtor will pay all taxes and assessments of every nature which may be levied or assessed against the Collateral.
4. The Debtor will keep the Collateral at all times insured against risks of loss or damage by fire (including so-called extended coverage), theft and such other casualties as the Secured Party may reasonably require, including collision in the case of any motor vehicle, all in such amounts, under such forms of policies, upon such terms, for such periods, and written by such companies or underwriters as the Secured Party may approve, losses in all cases to be payable to the Secured Party and the Debtor as their interest may appear. All policies of insurance shall provide for at least ten days' prior written notice of cancellation to the Secured Party; and the Debtor shall furnish the Secured Party with certificates of such insurance or other evidence satisfactory to the Secured Party as to compliance with the provisions of this paragraph. The Secured Party may act as attorney for the Debtor in making, adjusting and settling claims under or cancelling such insurance and endorsing the Debtor's name in any drafts drawn by insurers of the Collateral.
5. The Debtor will not permit or allow any adverse lien, security interest or encumbrance whatsoever upon the Collateral, and will not permit the same to be attached or replevined.
6. The Collateral is in good condition, and the Debtor will, at the Debtor's own expense, keep the same in good condition and from time to time, forthwith, replace and repair all such parts of the Collateral as may be broken, worn out, or damaged without allowing any lien to be created upon the Collateral on account of such replacement or repairs, and the Secured Party may examine and inspect the Collateral at any time, wherever located.
7. The Debtor will not use the Collateral in violation of any applicable statutes, regulations or ordinances.

ADDITIONAL RIGHTS OF PARTIES. At its option, but without obligation to the Debtor, the Secured Party may discharge taxes, liens, or security interests in other encumbrances at any time levied or placed on the Collateral, may place and pay for insurance thereon, may order and pay for the repair, maintenance and preservation thereof and may pay any necessary filing or recording fees. The Debtor agrees to reimburse the Secured Party on demand for any payment made or any expense incurred by the Secured Party pursuant to the foregoing authorization. In the event of default the Debtor may lose possession of the Collateral and use it in any lawful manner, and upon default the Secured Party shall have the immediate right to the possession of the Collateral.

Debtor hereby waives all right of homestead exemption in the Collateral, including that granted by §38-41-201.6, C.R.S. and waives any other statutory exemptions, including those granted by §13-54-102, C.R.S., insofar as such exemptions pertain to the Collateral described in this Security Agreement.

THE DEBTOR SHALL BE IN DEFAULT under this agreement upon the happening of any of the following events or conditions:

- (a) default in the payment or performance of any obligation, covenant or liability contained or referred to herein or in any note evidencing the same;
- (b) the making or furnishing of any warranty, representation or statement to the Secured Party by or on behalf of the Debtor which proves to have been false in any material respect when made or furnished;
- (c) loss, theft, damage, destruction, sale in encumbrance to or of any of the Collateral, or the making of any levy, seizure or attachment thereof or thereon;
- (d) death, change of name, dissolution, merger, termination of existence, insolvency, business failure, appointment of a receiver of any part of the property of, assignment for the benefit of creditors by, or the commencement of any proceeding under any bankruptcy or insolvency laws of, by or against the Debtor or any guarantor or surety for the Debtor.

UPON SUCH DEFAULT and at any time thereafter, or if it deems itself insecure, the Secured Party may declare all Obligations secured hereby immediately due and payable subject to any notice required by law or agreement, and shall have the remedies of a secured party under Article 9 of the Colorado Uniform Commercial Code. The Secured Party may require the Debtor to assemble the Collateral and deliver or make it available to the Secured Party at a place to be designated by the Secured Party which is reasonably convenient to both parties. Expenses of retaking, holding, preparing for sale, selling or the like shall, subject to any applicable limits set forth in the Colorado Uniform Consumer Credit Code, include the Secured Party's reasonable attorneys' fees and legal expenses (including the allocated fees and expenses of in-house counsel) and such portion of the Secured Party's overhead as it may in its reasonable judgment deem allocable to and includable in such expenses. Unless the Collateral is perishable or the Secured Party in good faith believes that the Collateral threatens to decline speedily in value or is of a type customarily sold on a recognized market, the Secured Party will give the Debtor reasonable notice of the time and place of any public sale thereof or of the time after which any private sale or any other intended disposition thereof is to be made. The requirements of reasonable notice shall be met if such notice is mailed, postage prepaid, to the address of the Debtor shown at the beginning of this Agreement at least ten days before the time of the sale or disposition. As respects crops covered by this Security Agreement, upon such default, it is agreed by the parties hereto that said crops are perishable or may decline speedily in value, and that the Secured Party may protect, cultivate, care for, harvest, or process said crops at the expense of the Debtor and may sell and dispose of said crops at private or public sale as the same mature or are harvested, at the price then available. [Where the Collateral is livestock, it is agreed that a commercially reasonable means of disposing of the Collateral shall include sale of such Collateral in the customary manner on the Denver, Colorado, livestock market or through a licensed livestock sales ring in Colorado. Sale of such livestock may be otherwise as permitted by law. It is expressly agreed also that it will not be necessary, after default and before the sale of any livestock Collateral, to collect said livestock to have the same present at the place of sale.] In the event the Secured Party institutes legal proceedings to regain possession of the Collateral, Debtor knowingly and voluntarily waives his or her right to a hearing prior to losing possession of the Collateral by means of a court order, and agrees that the Secured Party may obtain an order for possession prior to hearing as provided in C.R.C.P. 104(d)(4).

No waiver by the Secured Party or any default shall operate as a waiver of any other default or of the same default on a future occasion. The taking of this security agreement shall not waive or impair any other security the Secured Party may have or hereafter acquire for the payment of the Obligations, nor shall the taking of any such additional security waive or impair this security agreement, but the Secured Party may resort to any security it may have in the order it may deem proper, and notwithstanding any Collateral Security, the Secured Party shall retain its rights of setoff against the Debtor.

All rights of the Secured Party hereunder shall inure to the benefit of the Secured Party's heirs, personal representatives, successors or assigns; and all promises and duties of the Debtor shall bind the Debtor's heirs, personal representatives, successors or assigns. If there be more than one Debtor, then liabilities hereunder shall be joint and several.

Should any provision of this Security Agreement violate any federal, state or local law or ordinance, that provision shall be deemed amended to so comply with such law or ordinance, and shall be construed in a manner so as to comply.

percentage of the principal amount, and it may be determined by a declining percentage from the date of issue to maturity or a fixed percentage figure throughout. For example, a bond may be redeemable during the first year at 110% of the principal amount, during the second year at 109.5%, during the third year at 109%, and so forth. As the bond nears maturity, the redemption price will approach 100%. The declining percentage is designed to protect the bondholder's expectation of high interest payments by discouraging early redemption by the corporation.

Instructions for UCC Financing Statement-Colorado (Form UCC1)

Please type or laser-print this form. Be sure it is completely legible. Read all Instructions, especially Instruction 7; correct Debtor name is crucial. Follow Instructions completely.

Fill in form very carefully; mistakes may have important legal consequences. If you have questions, consult your attorney. Filing office cannot give legal advice. Do not insert anything in the open space to the upper portion of this form; it is reserved for filing office use.

When properly completed, send Filing Office Copy, with required fee, to filing office. If you want an acknowledgment, complete item B and send Acknowledgment Copy; otherwise detach. If you want to make a search request, complete item 7 (after reading Instruction 7 below) and send Search Report Copy; otherwise detach. Always detach Debtor and Secured Party Copies.

If you need to use attachments, use 8-1/2 X 11 inch sheets and put at the top of each sheet the name of the first Debtor, formatted exactly as it appears in item 1 of this form; you are encouraged to use Addendums (Form UCC1Ad).

A. To assist filing offices that might wish to communicate with filer, filer may provide information in item A. This item is optional.

B. Complete item B if you want an acknowledgment sent to you. If filing in a filing office that returns an acknowledgment copy furnished by filer, prevent simultaneously with this form a carbon or other copy of this form for use as an acknowledgment copy.

1. **Debtor name:** Enter only one Debtor name in item 1, an organization's name (1a) or an individual's name (1b). Enter Debtor's exact full legal name. Don't abbreviate.
 - 1a. **Organization Debtor.** "Organization" means an entity having a legal identity separate from its owner. A partnership is an organization; a sole proprietorship is not an organization, even if it does business under a trade name. If Debtor is a partnership, enter exact full legal name of partnership; you need not enter names of partners as additional Debtors. If Debtor is a registered organization (e.g., corporation, limited partnership, limited liability company), it is advisable to examine Debtor's current filed charter documents to determine Debtor's correct name, organization type, and jurisdiction of organization.
 - 1b. **Individual Debtor.** "Individual" means a natural person; this includes a sole proprietorship, whether or not operating under a trade name. Don't use prefixes (Mr., Mrs., Ms.). Use suffix box only for titles of lineage (Jr., Sr., III) and not for other suffixes or titles (e.g., M.D.). Use married woman's personal name (Mary Smith, not Mrs. John Smith). Enter individual Debtor's family name (surname) in Last Name box, first given name in First Name box, and all additional given names in Middle Name box.
For both organization and individual Debtors: Don't use Debtor's trade name, DBA, AKA, FKA, Division name, etc. in place of or combined with Debtor's legal name; you may add such other names as additional Debtors if you wish (but this is neither required nor recommended).
 - 1c. An address is always required for the Debtor named in 1a or 1b.
 - 1d. Debtor's taxpayer identification number (tax ID # — social security number or employer identification number — this item is optional and is only required for EFS filings).
 - 1e.f.g. "Additional information re organization Debtor" is always required. Type of organization and jurisdiction of organization as well as Debtor's exact legal name can be determined from Debtor's current filed charter document. Organizational ID #, if any, is assigned by the agency where the charter document was filed; this is different from tax ID #; this should be entered preceded by the 2-character U.S. Postal identification of state of organization if one of the United States (e.g., CA12345, for a California corporation whose organizational ID # is 12345); if agency does not assign organizational ID #, check box in item 1g, indicating "none."
- Note:* If Debtor is a trust or a trustee acting with respect to property held in trust, enter Debtor's name in item 1 and attach Addendum (Form UCC1Ad) and check appropriate box in item 17. If Debtor is a decedent's estate, enter name of deceased individual in item 1b and attach Addendum (Form UCC1Ad) and check appropriate box in item 17. If Debtor is a transmitting utility or this Financing Statement is filed in connection with a Manufactured-Home Transaction or a Public-Finance Transaction as defined in applicable Commercial Code, attach Addendum (Form UCC1Ad) and check appropriate box in item 18.

No. 602, Rev. 7-01, UCC FINANCING STATEMENT (UCC1) - COLORADO

Exhibit 9-9.

(continued)

2. If an additional Debtor is included, complete item 2, determined and formatted per Instruction 1. To include further additional Debtors, or one or more additional Secured Parties, attach either Addendum (Form UCC1Ad) or other additional page(s), using correct name format. Follow Instruction 1 for determining and formatting additional names.
3. Enter information for Secured Party or Total Assignee, determined and formatted per Instruction 1. If there is more than one Secured Party, see Instruction 2. If there has been a total assignment of the Secured Party's interest prior to filing this form, you may either (1) enter Assignor S/P's name and address in item 3 and file an Amendment (Form UCC3) [see item 5 of that form]; or (2) enter Total Assignee's name and address in item 3 and, if you wish, also attaching Addendum (Form UCC1Ad) giving Assignor S/P's name and address in item 12.
4. Use item 4 to indicate the collateral covered by this Financing Statement. If space in item 4 is insufficient, put the entire collateral description or continuation of the collateral description on either Addendum (Form UCC1Ad) or other attached additional page(s).
5. If filer desires (at filer's option) to use titles of lessee and lessor, or consignee and consignor, or seller and buyer (in the case of accounts or chattel paper), or bailee and bailor instead of Debtor and Secured Party, check the appropriate box in item 5. If this is an agricultural lien (as defined in applicable Commercial Code) filing or is otherwise not a UCC security interest filing (e.g., a tax lien, judgment lien, etc.), check the appropriate box in item 5, complete items 1-7 as applicable and attach any other items required under other law.
6. If this Financing Statement is filed as a fixture filing or if the collateral consists of timber to be cut or as-extracted enflateral, complete items 1-5, check the box in item 6, and complete the required information (items 13, 14 and/or 15) on Addendum (Form UCC1Ad).
7. This item is optional. Check appropriate box in item 7 to request Search Report(s) on all or some of the Debtors named in this Financing Statement. The Report will list all Financing Statements on file against the designated Debtor on the date of the Report, including this Financing Statement. There is an additional fee for each Report. If you have checked a box in item 7, file Search Report Copy together with Filing Office Copy (and Acknowledgment Copy).
8. This item is optional and is for filer's use only. For filer's convenience of reference, filer may enter in item 8 any identifying information (e.g., Secured Party's loan number, law firm file number, Debtor's name or other identification, state in which form is being filed, etc.) that filer may find useful.

weeks prior to the redemption date in a daily newspaper of general circulation published in Cook County, Illinois. Thereupon this debenture shall become due and payable at the time and place designated for redemption in such notice, and payment of the redemption price shall be paid to the bearer of this debenture upon presentation and surrender thereof and of all unpaid interest coupons annexed hereto. Unless default shall be made in the redemption of this debenture upon such presentation, interest on this debenture shall cease from and after the date of redemption so designated. If the amount necessary to redeem this debenture shall have been deposited with the Abraham Lincoln Trust Company and if the notice of redemption shall have been duly published as aforesaid, this debenture shall be conclusively deemed to have been redeemed on the date specified for redemption, and all liability of the Company hereon shall cease on such date and all rights of the holder of this debenture, except the right to receive the redemption price out of the moneys so deposited, shall cease and terminate on such date.

EXAMPLE

The notice required by the redemption provision could be worded as follows:

EXAMPLE**Notice of Redemption**

Notice is hereby given that the Ten-Year Convertible Income Debentures due November 30, 2010, of the Nobles Corporation have been called for redemption at 110% of the principal amount thereof and will be redeemed at the office of the Abraham Lincoln Trust Company, 1198 West Adams Street, Chicago, Illinois, on May 15, 2005. From and after May 15, 2005, the holders of said Debentures will have no conversion rights or any other rights, except to receive the redemption price.

Conversion

Debt securities may be convertible into equity securities, and this convertibility further enhances the value of a bond. The bond conversion feature will specify the number of shares of stock into which the bond is convertible, the procedure for conversion, a reservation of an appropriate number of common shares, and adjustments and other matters that concern the conversion privilege.

EXAMPLE**Conversion Provisions**

As provided in the indenture with Abraham Lincoln Trust Company, this bond is convertible at the option of the holder thereof, at any time prior to maturity (or, if this bond is at any time called for redemption, then at any time before the date fixed for redemption), upon surrender of this bond for that purpose at the office of the Nobles Corporation, Chicago, Illinois. Conversion shall be made into common shares of the Nobles Corporation upon the basis of one common share for each \$100 of principal sum of this bond, subject to the provision of the indenture as to interest on bonds converted and dividends on shares received therefor, and as to change in the conversion basis or substitution of other shares, securities, or property in the event of consolidation, merger, conveyance of assets, recapitalization, or the issuance of additional shares.

Priority and Subordination

Management of the corporation may desire to **subordinate** the existing debt securities in order to secure additional financing at a later time. If the bondholders agree to accept second or third place to other creditors for certain purposes, the subordination of their debt should assist in obtaining the maximum borrowing capacity for the corporation. The subordination feature would apply only if the bonds were not paid. If the corporation defaults on the obligation, the subordination clause will determine which creditors have prior rights to corporate assets to enforce their respective rights against the corporation.

When a bond issue is already outstanding and management is attempting to obtain additional financing, subordination may be an afterthought. Corporate officials may approach existing bondholders and solicit their agreement to subordinate their debt. On the other hand, subordination may be a condition precedent to the bond obligation. For example, an investor may be willing to invest in the corporation and purchase a bond, or lend the money, provided the corporation will subordinate any future borrowing to this debt security. Subordination provisions always include the amounts that will be subordinated (principal only, principal and interest, interest only, etc.), and they always describe the senior obligations to which the bond is subordinated.

EXAMPLE**Subordination Provisions**

The rights of the holder hereof to the principal sum or any part thereof, and the interest due thereon, are and shall remain subject and subordinate to the claims as to principal and interest of the holders of 7³/₄% First Mortgage Bonds of the corporation, and upon dissolution or liquidation of the corporation no payment shall be due or payable upon this debenture until all claims of the holders of said bonds shall have been paid in full.

Voting Rights

A rare privilege accorded to bondholders in only a few jurisdictions is the right to vote on corporate matters, if so authorized in the articles of incorporation.⁵¹ If holders of debt securities are permitted to vote in corporate elections, they are treated like a separate class of voting shareholders.

IMPORTANT CONSIDERATIONS REGARDING DEBT AND EQUITY

In planning the capitalization of the corporation, the drafter has tremendous flexibility. The necessary capital may be raised in any number of ways and represented by any of the myriad debt or equity securities, depending upon the expectations of the investors and the selected corporate capitalization structure. However, certain practical matters should be considered in choosing between debt and various classes of equity securities.

Anticipation of Later Financing

If the capital structure of the corporation is simple in the beginning, management will have greater flexibility in the raising of money in the future. If the initial corporate structure has several classes of stock and various debt securities, it will be considerably more difficult to create new classes of stock later, since new classes will probably affect the rights of the existing shareholders, whose approval must be acquired for any such amendments to the articles of incorporation. It is important, therefore, to consider the future capital needs of the business at the outset, and to plan the initial capital structure with those predictions in mind.

Advantages to Common Shareholders through the Use of Senior Securities

Preferred stock and bonds are commonly called **senior securities** because of their special preferential rights. Preferred shareholders are usually entitled to a dividend preference and liquidation preference, ensuring a return on and a return of their investment. Similarly, holders of debt securities have a right to interest and a right to repayment of their obligation upon maturity. Recall that the common shareholders have no special rights to distributions, and they are entitled to share in the assets in liquidation only after the holders of debt securities and the holders of preferred stock have been satisfied. However, the common shareholders may gain an advantage through the use of senior securities when the expected profit return on capital each year exceeds the payments that must be made, either in distributions or in interest, to the holders of senior securities. The converse is also true. If the expected profit return on capital each year is less than the payments that must be made to the holders of senior securities, the common shareholders are at a disadvantage.

These principles are illustrated in the following example. Suppose Trouble, Inc., needs \$100,000 capital for the operation of its business and can reasonably predict profits after taxes of \$20,000 or more each year. Assuming a hypothetical federal income tax rate of 30%, the profit before taxes must be \$28,572 or more. The securities that will be issued in exchange for the \$100,000 capital may be any combination of common stock, preferred stock, and debt. The profit return on capital after taxes is now estimated to be 20% or more each year. If 1,000 shares of common stock are issued to raise the \$100,000 capital, the earnings per share are computed as follows, assuming the estimated profit is realized.

Profit before taxes	\$28,572
Federal income tax (30%)	<u>8,572</u>
Profit after taxes	<u>\$20,000</u>
Earnings per share of common stock (1,000 shares)	<u>\$20.00</u>

Now assume that investors are found who are willing to take preferred stock with \$100 par value and a preferred dividend rate of 16%. The \$100,000 capital may be raised by issuing 500

shares of 16% preferred stock for \$50,000, and 500 shares of common stock for \$50,000. The common stock earnings per share are computed as follows:

Profit before taxes	\$28,572
Federal income tax (30%)	<u>8,572</u>
Profit after taxes	\$20,000
Preferred dividends (16% of \$50,000)	<u>8,000</u>
Profit after preferred dividends	<u>\$12,000</u>
Earnings per share of common stock (500 shares)	<u>\$ 24.00</u>

Next assume that instead of preferred stock, debt securities with the same interest rate (16%) are issued for the \$50,000 capital. The interest paid on debt securities is deductible as an expense before taxes, which further improves the common shareholders' earnings. The statement looks like this:

Profit before interest	\$28,572
Interest (16% of \$50,000)	<u>8,000</u>
Profit before taxes	\$20,572
Federal income tax (30%)	<u>6,172</u>
Profit after taxes	<u>\$14,400</u>
Earnings per share of common stock (500 shares)	<u>\$28.80</u>

A combination of all three securities will be even better for the common shareholders. Suppose \$40,000 capital is raised by the sale of 400 common shares, \$30,000 by the sale of 300 shares of 16% preferred stock, and \$30,000 by 16% debt securities. The result is as follows:

Profit before interest	\$28,572
Interest (16% of \$30,000)	<u>4,800</u>
Profit before taxes	23,772
Federal income tax (30%)	<u>7,132</u>
Profit after taxes	\$16,640
Dividends for preferred stock (16% of \$30,000)	<u>\$4,800</u>
Profit after preferred dividends	<u>\$11,840</u>
Earnings per share of common stock (400 shares)	<u>\$29.60</u>

The common stock takes the full risk that profits will reach or exceed expectations. The illustrated advantage depends upon the profits after taxes being a greater percentage of capital than the percentage return required to be paid to the senior securities. Watch what happens to the last example if profits dip to \$15,000 (before deducting interest) rather than the predicted \$28,572 or more. The statement looks like this:

Profit before interest	\$15,000
Interest (16% of \$30,000)	<u>4,800</u>
Profit before taxes	\$11,200
Federal income tax (30%)	<u>3,360</u>
Profit after taxes	\$7,840
Dividends on preferred stock (16% of \$30,000)	<u>4,800</u>
	<u>\$3,040</u>
Earnings per share of common stock (400 shares)	<u>\$7.60</u>

Contrast this earnings figure with the one in the following statement based on the original capital structure by which the whole amount of \$100,000 is raised by the sale of \$1,000 shares of common stock.

Profit before taxes	\$15,000
Federal income tax (30%)	<u>4,500</u>
Profit after taxes	<u>\$11,500</u>
Earnings per share of common stock (1000 shares)	<u>\$11.50</u>

In the last situation, the common shareholders would benefit more from complete common stock capitalization than from combinations of common stock, preferred stock, and debt.

Taxes

The concept of double taxation and its erosion of corporate profits is discussed in “Taxation of a Corporation” in Chapter 6. Debt securities avoid double taxation, since the interest paid on the debt is deductible as an expense to the corporation, rather than being taxed as corporate profit. In this respect, debt securities enjoy a tax advantage over equity securities, since distributions to shareholders in the form of dividends are taxed first as corporate profit and again as individual income.

The solution, you might propose, would be to issue as many debt securities and as few equity securities as possible. The tax authorities of the federal government have thought of this. A disproportionate debt-to-equity ratio is called **thin incorporation**. When thin incorporation exists, the tax authorities may characterize interest payments on debt securities as dividends on equity securities for tax purposes, disallowing the interest expense deduction and requiring tax to be paid on the resulting increased profits. This restructuring has been upheld in severe cases, such as where the majority shareholder loaned considerable sums to a corporation in return for separate debt securities, and where all shareholders loaned disproportionately large amounts to a corporation with very little investment represented in common stock. A good debt-to-equity ratio should not exceed 4:1 to avoid problems of thin incorporation.

KEY TERMS

securities	certificates	participation
debenture	negotiable	separate voting group
mortgage bonds	series of shares	redemption of shares
premium	blank stock	cancellation of redeemable shares
discount	sinking fund	conversion of stock
indenture	conversion of stock	transfer agent
Securities Act of 1933	fractional share	registrar
Securities Exchange Act of 1934	true value rule	facsimile signature
authorized shares	absence of fraud rule	unsecured debt
issued shares	nonassessable	promissory note
outstanding shares	assessable	secured debt
watered, or discount, shares	circular holdings	trust indenture
diluted shares	cumulative distribution preference	Trust Indenture Act of 1939
franchise fee	noncumulative distribution	subordination of bonds
earned surplus	preference	senior securities
capital surplus	“cumulative to the extent earned”	thin incorporation
stated capital	distribution preference	

WEB RESOURCES

Access to state laws regarding issuance of stock and bonds, creation and perfection of security interests, and the other local issues related to stockholder and bondholder rights may be obtained through the Legal Information Institute maintained at Cornell Law School:

<<http://www.law.cornell.edu>>

The National Association of Secretaries of State maintains links directly to the offices of the Secretaries of State in all states. Forms for each state’s filing requirements with respect to the corporate financial structure are available from that state’s Web site in most cases:

<<http://www.nass.org>>

The specific sections of a state's corporate law may be located by a search site that directly links to the corporate laws of the state. The search may be accessed at

<<http://www.megalaw.com>>

Access to the filings with the Securities and Exchange Commission on line is available through the EDGAR system on the following sites:

<<http://www.freedgar.com>>
<<http://www.edgar-online.com>>
<<http://www.pwcglobal.com>>

The text of the federal and state securities laws may be reviewed at the following sites:

<<http://www.seclaw.com>>
<<http://www.law.cornell.edu>>

Information about the operation of stock exchanges for a public corporation's shares can be accessed through the exchange Web sites:

<<http://www.nyse.com>>
<<http://www.amex.com>>
<<http://www.nasdaq.com>>

Forms for promissory notes and debentures are available from

<<http://www.sbaonline.sba.gov>>
<<http://www.ilrg.com>>

Forms for stock certificates are available from

<<http://www.corpkit.com>>
<<http://www.uslegalforms.com>>
<<http://www.goesstockcertificates.com>>
<<http://www.stocktransfer.com>>

An explanation of generally accepted accounting principles (GAAP) in the United States and the financial accounting standards bulletins (FASBs) may be accessed at

<<http://www.cpaclass.com/gaap/>>

Information on stock transfer agents, including comparison reports and surveys, is at

<<http://www.stockholderconsulting.com>>
<<http://www.stocktransfer.com>>

Application for a CUSIP number (Standard and Poors' identification number for issuers of publicly held securities) can be submitted at

<<http://www.stocktransfer.com>>



CASES

STROH v. BLACKHAWK HOLDING CORPORATION

48 Ill. 2d 471, 272 N.E.2d 1 (1971)

DAVIS, JUSTICE

[Blackhawk Holding Corporation was organized under Illinois law in November 1963. The articles of incorporation authorized the issuance of 3,000,000 shares of Class A stock with a par value of \$1, and 500,000 shares of Class B stock without par value. The articles of incorporation provided that Class B stock was not entitled to any dividends.]

* * *

The only issue before this court is the validity of the 500,000 shares of Class B stock, which by the articles of incorporation of Blackhawk were limited in their rights by

the provision "none of the shares of Class B stock shall be entitled to dividends either upon voluntary or involuntary liquidation or otherwise." It is the plaintiffs' contention that because of the foregoing limitation—depriving the Class B shares of the "economic" incidents of shares of stock, or of the proportionate interest in the corporate assets—the Class B shares do not in fact constitute shares of stock.

* * *

A corporation is a creature of statute. (Craig v. Sullivan Machinery Co., 344 Ill. 334, 336, 176 N.E. 353.) It is a legal entity which owes its existence to the fiat of law. Its being and powers are from the sovereign State as its will is expressed through legislative enactment. (Chicago Title and Trust Co. v. Central Republic Trust Co., 299 Ill. App. 483, 492, 20 N.E.2d 351.) The articles of incorporation of an Illinois corporation constitute a contract, threefold in nature. It is a contract between the corporation and the State and it creates powers and limitations, rights and duties as between the corporation and its shareholders, as well as between the shareholders themselves. The powers and limitations of a corporation are found in its articles of incorporation, the provisions of its stock certificates, its by-laws, and in the constitutional and statutory provisions

in force when the articles of incorporation were adopted. [Citations omitted] The articles of incorporation of Blackhawk purport to create a Class B stock that possesses no rights in the assets or in the earnings of the corporation. Whether this can be done, and whether such shares have the requisite attributes of a valid share of stock, must be determined in accordance with the constitution of the State, the provision of the Business Corporation Act, and the common law of the State.

Under the Illinois constitution of 1870, a stockholder in an Illinois corporation is guaranteed the right to vote based upon the number of shares owned by him. (Ill. Const. art. XI, sec. 3, S.H.A.) Section 14 of the Business Corporation Act (Ill.Rev.Stat.1969, ch. 32, par. 157.14) provides that shares of stock in an Illinois corporation may be divided into classes,

“with such designations, preferences, qualifications, limitations, restrictions and such special or relative rights as shall be stated in the articles of incorporation. The articles of incorporation shall not limit or deny the voting power of the shares of any class.

Without limiting the authority herein contained, a corporation when so provided in its articles of incorporation, may issue shares of preferred or special classes:

* * * * *

(c) Having preference over any other class or classes of shares as to the payment of dividends.

(d) Having preference as to the assets of the corporation over any other class or classes of shares upon the voluntary or involuntary liquidation of the corporation.”

Section 41 of the Act, relating to the power of the board of directors to declare dividends, provides that no dividends may be declared or paid contrary to any restrictions in the articles of incorporation. Ill. Rev.Stat.1969, ch. 32, par. 157.41(h).

Section 2.6 of the Act, in defining “shares” states, “Shares’ means the units into which the proprietary interests in a corporation are divided.” (Ill.Rev.Stat.1969, ch. 32, par. 157.2-6.)

* * *

To the plaintiffs, “proprietary,” as used in the definition of shares, means a property right, and shares must then represent some economic interest, or interest in the property or assets of the corporation. However, the word “proprietary” does not necessarily denote economic or asset rights, although it has been defined as synonymous with ownership or to denote legal title (Evans v. United States, D.C., 251 F. Supp. 296, 300; Asch v. First National Bank in Dallas, Tex.Civ.App., 304 S.W.2d 179, 183; The American Heritage Dictionary of the English Language (1969)), and “proprietary rights” have been defined as those conferred by virtue of ownership of a thing (Colten v. Jacques Marchais, Inc., Mun.Ct., 61 N.Y.S.2d 269, 271; Black’s Law Dictionary, 4th Ed.Rev., 1968). In *Colten*, the court

defined “proprietary” as meaning ownership, exclusive title or dominion, and implying possession and physical control of a thing.

In *Millar v. Mountcastle*, 161 Ohio St. 409, 119 N.E.2d 626, 632, the Supreme Court of the State of Ohio discussed the meaning of ownership as represented by holding shares of stock. The court said that by reason of ownership of a share of corporate stock, one becomes the owner of intangible property comprised of various relationships which are determined by the terms of the stock certificate, the articles of incorporation, and the internal regulations of the corporation, and the statutes and common law of the State of incorporation. The court stated that the ownership comprising the relationship might include “one or more” of several specified rights, including the right to vote.

The meaning of ownership may vary depending upon the subject matter of the ownership, the place of the ownership, and any particular restraints placed thereon by contract or law. Both the plaintiffs and the defendants stress that section 2.6 of the Business Corporation Act, in defining shares in terms of a proprietary interest, did not change the prior statutory definition of shares as the “right to participate in the control of the corporation, in its surplus or profits, or in the distribution of its assets.” Both parties find comfort in the grammatical construction of the prior definition.

We agree with the defendants’ construction. We interpret this statutory definition to mean that the proprietary rights conferred by the ownership of stock may consist of one or more of the rights to participate “in the control of the corporation, in its surplus or profits, *or* in the distribution of its assets.” The use of the disjunctive conjunction “*or*,” indicates that one or more of the three named rights may inure to a stockholder by virtue of his stock ownership. A series of phrases in the disjunctive does not require that each phrase be separated by the word “*or*,” as the plaintiffs suggest; more commonly and correctly each phrase except the last is preceded only by a comma, and the last is preceded by the word “*or*.” The absence of the disjunctive “*or*” preceding the phrase “in its surplus or profit,” is too thin a reed to support the construction urged by the plaintiffs. The phrases in the series represent alternatives (*People v. Vraniak*, 5 Ill.2d 384, 389, 125 N.E.2d 513; *Central Standard Life Insurance Co. v. Davis*, 10 Ill.App.2d 245, 254, 255, 134 N.E.2d 653), and we so construe them. This conclusion, however, is not dispositive of this litigation.

We must here decide the extent to which economic attributes of shares of stock may be eliminated. This must be determined from the intent of the legislature which, in no small part, can be gathered from the language and words it chose to express that intent. The statutory definition of “shares” is of particular importance in that it governs the meaning of the word as used throughout the Business Corporation Act and controls in its construction. The legislature has the power to make any reasonable definition of the

terms in a statute and such definition for the purposes of the Act, will be sustained. *Modern Dairy Co. v. Department of Revenue*, 413 Ill.55, 66, 108 N.E.2d 8.

Section 14 of the Act clearly expresses the intent of the legislature to be that parties to a corporate entity may create whatever restrictions and limitations they may want with regard to their corporate stock by expressing such restrictions and limitations in the articles of incorporation. These rights and powers granted by the legislature to the corporation to make the terms of its contract with its shareholders are limited only by the proviso that the articles may not limit or deny the voting power of any share. This section of the Act expressly confers the right to prefer a class of shares over another with regard to dividends and assets. Section 2.6 defines shares as “The units into which the proprietary interests in a corporation are divided.”

In seeking the intent of the legislature, a statute should be construed as a whole and its separate parts considered together. Our present constitution requires only that a shareholder not be deprived of his voice in management. It does not require that a shareholder, in addition to the management aspect of ownership, must also have an economic interest.

Thus, section 14, like the constitution, limits the power of a corporation only as to the voting aspect of ownership. It confers upon the corporation the “power to create and is-

sue the number of shares stated in its article of incorporation;” it expressly permits the shares to be subject to “such designations, preferences, qualifications, limitations, restrictions, and such special or relative rights as shall be stated in the articles of incorporation;” it also suggests that “Without limiting the authority herein contained, a corporation, when so provided in its articles of incorporation, may issue shares of preferred or special classes,” which classes are delineated therein.

Section 41 of the Act recognizes that while the power to declare dividends with respect to shares is in the board of directors, this power is limited, among other things, by any restrictions in the articles of incorporation.

When the relevant sections of the Act are read together with the constitution, it seems apparent that it was the intent of the legislature that the proprietary interests represented by the shares of stock consist of management or control rights, rights to earnings, and rights to assets. There are other rights which are incidental to these. Under our laws, the rights to earnings and the rights to assets—the “economic” rights—may be removed and eliminated from the other attributes of a share of stock. Only the management incident of ownership may not be removed.

* * *

[The Class B stock was held to be valid under the statute.]

STAAR SURGICAL COMPANY v. WAGGONER

588 A.2d 1130 (*Del.* 1991)

MOORE, JUSTICE

In this latest dispute between the parties we determine the validity of two million shares of STAAR Surgical Company (“STAAR”) common stock issued to STAAR’s former President and CEO, Thomas R. Waggoner and his wife, Patricia Waggoner “Waggoner” or “Waggoners”).

* * *

STAAR was facing severe financial difficulties in 1987. At that time, STAAR had an open line of credit with the Bank of New York (“BONY”) secured by certain of STAAR’s account receivables and inventory. In September, 1987, STAAR’s accountants caused the company to write-down its accounts receivables. The write-down left the BONY line of credit undercollateralized by almost two million dollars.

At approximately the same time, certain STAAR shareholders were concerned about the financial performance of the company. The stockholders conferred in November 1987, and later that month discussed their concerns directly

with Waggoner. On December 13, 1987, the shareholders met with the STAAR directors in New York City. STAAR’s outside counsel, Elliot Lutzker, informed the shareholders at the meeting that among other things, STAAR was overdrawn on its BONY line of credit and that BONY had “demanded” Waggoner’s personal guarantee to secure all of STAAR’s debt to the bank. The shareholders were outraged and demanded Waggoner’s immediate resignation. The STAAR board and the shareholders reached a compromise providing for the election of two new outside directors.

The STAAR board then formally convened after the meeting on December 13, 1987. Waggoner told the board that BONY had demanded his personal guarantee of STAAR’s debts. Waggoner advised the board that he would guarantee the debts only if he was given voting control of the company while the guarantees were outstanding. Waggoner and the board generally concluded at the end of the meeting that STAAR would issue some type of convertible securities to Waggoner in exchange for his guarantee. The two sides did not formally adopt or memorialize their understanding.

BONY then sent a formal letter to Waggoner three days later, on December 16, 1987, requesting his “immediate attention” to the matter of a personal guarantee. The letter re-

quired Waggoner to respond no later than noon on December 18, 1987. Lutzker informed both Waggoner and Lamar T. Laster, STAAR's Chief Financial Officer, that BONY could shut STAAR down if it did not receive Waggoner's personal guarantee.

Waggoner then called a special board meeting for December 17, 1987 to consider BONY's "demand." The meeting was hastily summoned and poorly organized. We previously described the meeting in *Waggoner I*, quoting the trial court's finding that:

The December 17 meeting was conducted by telephone with little or no advance notice, and lasted for approximately 25 minutes. Dr. Utrata, a Board member of only four days' standing, participated between performing surgical operations. Mr. Ford, a trial attorney, participated while speaking from his car phone and while traveling between court appearances. According to the minutes, Mr. Silverman was absent for a portion of the discussion, and Mr. Sodero, a fourth director, intended to (and did) resign at the conclusion of that meeting, to be replaced by Dr. Brown.

[citation omitted]

* * *

The minutes of the December 17, 1987 STAAR Board meeting also state that the board formally adopted the following resolution:

RESOLVED, that pursuant to the authority granted to the Board of Directors in the Certificate of Incorporation, as amended, the Board hereby authorizes the creation of a series of Convertible Preferred Stock, all of which shall be held by Tom Waggoner, or his designees, which shall be converted into two million shares of Common Stock after January 16, 1988, unless all of the personal guarantees and stock pledges of Common Stock by Tom Waggoner now or hereafter in effect are removed, or a binding agreement to such effect is in place by January 16, 1988. In the event that all of the Waggoner guarantees are removed by January 16, 1988, all of the shares of Convertible Preferred Stock shall be redeemed by the Company at \$.01 per share. In the event that the two million shares of Common Stock are issued to Tom Waggoner, all of the remaining Convertible Preferred and stock pledges are removed. Holders of the Convertible Preferred Stock shall be entitled to elect a majority of the Company's directors and to otherwise vote a majority of the Shares of Common Stock outstanding at any time. The shares of Convertible Preferred Stock, in accordance with the provision of the SEC's safe-harbor rule, shall have a liquidation preference however, [sic] not entitle the holder to any dividends.

[Citation omitted]

In fact, the trial court found, and we affirmed in *Waggoner I*, that the board *never formally adopted* the resolution and only Waggoner signed the minutes.

After the board meeting, Lutzker prepared a certificate of designation pursuant to 8 *Del.C.* § 151(g), at some time between December 18, 1987 and December 24, 1987. The

certificate allegedly established the rights, powers and preferences of the convertible preferred shares pursuant to the December 17, 1987 "resolution." The certificate also recited that it included the December 17, 1987 board resolution. The certificate was six pages long and contained detailed, comprehensive language regarding the voting, conversion and redemption rights of the preferred shares not mentioned in the December 17 resolution. [Citation omitted] Furthermore, like the December 17 "resolution," the STAAR board never *formally adopted the certificate of designation*. STAAR actually issued the preferred shares to Waggoner on December 18, 1987.

Some STAAR board members were dissatisfied with the terms of the preferred stock transaction and called a board meeting for January 11, 1988. At that meeting, the board attempted to delay the conversion feature of the preferred stock. On January 19, 1988, however, Waggoner exercised his conversion option and received two million shares of STAAR common stock. Allegedly, Waggoner's action was authorized pursuant to the resolution and the certificate of designation because STAAR failed to replace Waggoner's guarantee within the prescribed time limits.

In August, 1989, the Waggoners attempted to exercise the voting provisions of the remainder of their preferred shares by removing STAAR's board. The directors, aided by two shareholders, contested the election under 8 *Del.C.* § 225. On October 24, 1989, the Court of Chancery ruled that the super voting provisions of the preferred shares were invalid. *See Laster*, slip op. at 39-40. We affirmed that decision. *See Waggoner I*, 581 A.2d at 1137-38.

The Waggoners then filed an action pursuant to 8 *Del.C.* § 211 to compel STAAR to convene a shareholders meeting. STAAR answered the Waggoners' § 211 claim denying that the Waggoners even owned the two million STAAR shares. The Waggoners then moved pursuant to 8 *Del.C.* § 227(a) for an order determining their right to vote the disputed shares. On March 15, 1990, the Court of Chancery ruled that even though the Waggoners' preferred shares were invalid, they were entitled as a matter of equity to own and vote the disputed two million common shares which were derived from the invalid preferred stock. *See Waggoner II*, slip op. at 15-16.

* * *

We start with basic and clearly applicable provisions of the Delaware General Corporation Law. A corporation can issue more than one class of stock, including preferred shares with a conversion feature. *See, e.g.*, 8 *Del.C.* §§ 151(a), (e) & (g). The powers, preferences, rights and other characteristics of such shares must be fixed in either the certificate of incorporation or through a board resolution adopted pursuant to an explicit grant of authority in the certificate of incorporation. *See* 8 *Del.C.* §§ 102(a)(4), 151(a). There is no dispute that the STAAR certificate of in-

corporation authorized the board to issue, by resolution, “blank check” preferred stock with such terms and conditions, including:

[T]he rights, if any, of holders of the shares of the particular series to convert the same into shares of any other series or class or other securities of the corporation. . . .

The Delaware General Corporation Law mandates adoption of a board resolution, when such new shares of so-called “blank check” preferred, are issued. Section 151(a) of the General Corporation Law requires, in part, that all new stock voting powers, designations, preferences and other special rights must either be in the certificate of incorporation or:

[I]n 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. 8 *Del.C.* § 151(a) (emphasis added).

Section 151(e), which specifically authorizes a company to issue convertible securities, requires, in part, that the corporation issue the new shares:

[A]t such price or prices or at such rate or rates of exchange and with such adjustments as shall be stated in the certificate of incorporation or in the resolution or resolutions providing for the issue of such stock *adopted by the board of directors as hereinabove provided*. 8 *Del.C.* § 151(e) (emphasis added).

Finally, Section 151(g) requires a corporation to file a certificate of designation when the certificate of incorporation permits the board to issue new securities through a resolution “adopted by the board.” The statute provides:

When any corporation desires to issue any shares of stock of any class or of any series of any class of which the powers, designations, preferences and relative, participating, optional or other rights, if any, or the qualifications, limitations or restrictions thereof, if any, shall not have been set forth in the certificate of incorporation or in any amendment thereto but shall be provided for in a *resolution or resolutions adopted by the board* of directors pursuant to authority expressly vested in it by the certificate of incorporation or any amendment thereto, a *certificate of designations setting forth a copy of such resolution or resolutions* and the number of shares of stock of such class or series as to which the resolution or resolutions apply shall be executed, acknowledged, filed, recorded and shall become effective, in accordance with § 103 of this title. . . . 8 *Del.C.* § 151(g) (emphasis added).

Waggoner concedes that the STAAR board never formally adopted either the board resolution on December 17, 1987, or the certificate of designation. Finally, the trial court found in *Laster* that the certificate of designation did not “set forth” a copy of the December 17, 1987 resolution. Slip op. at 11-12. Indeed, the court ruled that the certificate of designation contained materially different language from that in the resolution. *Id.* at 11 n. 5.

The parties’ arguments seem to pass like two ships in the night. STAAR contends that the board’s failure to adopt the resolution or the certificate of designation rendered the preferred shares void, thus invalidating the common stock. STAAR relies on *Triplex Shoe Co. v. Rice Hutchins, Inc.*, Del.Supr., 152 A. 342 (1930), for the proposition that illegally issued stock is void and, regardless of the equities, cannot be transferred or voted. The Waggoners, in contrast, focus on the common stock and not the preferred shares. They assert that even if the board failed to technically conform to the clear corporate law, the STAAR directors all agreed at the December 1, 1987 board meeting to issue Waggoner two million shares of common stock as compensation for his guarantee of the BONY loans. Therefore, Waggoner claims, it was clear to all of the parties that he would eventually receive the two million shares if STAAR could not find alternate financing for the loan.

The Waggoners also contest STAAR’s interpretation of *Triplex*, claiming that it is distinguishable on its facts. The Waggoners argue that the certificate of incorporation in *Triplex*, and the then current corporate law, did not authorize the board to issue new shares of a certain type of stock. Therefore, they contend, the stock in *Triplex* was void and subsequent board action could not have validated those shares. In contrast, the Waggoners argue that the STAAR certificate of incorporation at all times authorized the board to issue new shares of common stock and thus *Triplex* is not dispositive.

We must reject the Waggoners’ attempt to separate the common shares from the preferred stock. We also reject their very limited interpretation of *Triplex*. Stock issued without authority of law is void and a nullity.

It is undisputed that Waggoner could not receive his common stock without exercising the conversion option of at least one preferred share. The December 17, 1987 resolution and the certificate of designation purportedly authorized the issuance of the preferred shares. Without validly issued preferred stock, there was simply no other legal mechanism by which the common shares could be issued. Simply stated, if the preferred shares were void, as the Court of Chancery assumed, then the common stock could not be created out of whole cloth.

Based on the trial court’s findings, it is clear that the preferred convertible shares originally issued to the Waggoners were invalid and void under Delaware law. There was no compliance with the terms of 8 *Del.C.* § 151. The directors never formally adopted either the December 17, 1987 resolution or the certificate of designation.

The Waggoners’ attempt to trivialize the unassailable facts of this case as mere “technicalities” is wholly unpersuasive. The issuance of corporate stock is an act of fundamental legal significance having a direct bearing upon questions of corporate governance, control and the capital

structure of the enterprise. The law properly requires certainty in such matters.

There are many interacting principles of established law at play here. First, it is a basic concept that the General Corporation Law is a part of the certificate of incorporation of every Delaware company. *See* 8 *Del.C.* § 394. Second, a corporate charter is both a contract between the State and the corporation, and the corporation and its shareholders. *See Lawson v. Household Finance Corp.* Del.Supr., 152 A. 723, 727 (1930). The charter is also a contract among the shareholders themselves. *See Morris v. American Public Utilities Co.*, Del.Ch., 122 A. 696, 700 (1923). When a corporation files a certificate of designation under § 151(g), it amends the certificate of incorporation and fundamentally alters the contract between all of the parties. *See* 8 *Del.C.* §§ 104, 151(g). A party affecting these interrelated, fundamental interests, through an amendments to the corporate charter, must scrupulously observe the law.

Finally, it is a basic concept of our corporation law that in the absence of a clear agreement to the contrary, pre-

ferred stock rights are in derogation of the common law and must be strictly construed. [Citations omitted]

This principle of “strict construction” applies with equal force to the creation of preferred stock and its attendant rights, powers, designations and preferences. Accordingly, a board’s failure to adopt a resolution and certificate of designation, amending the fundamental document which imbues a corporation with its life and powers, and defines the contract with its shareholders, cannot be deemed a mere “technical” error.

Thus, we must reject the trial court’s authorization of the two million shares of common stock on equitable grounds. Stock issued in violation of 8 *Del.C.* § 151 is void and not merely voidable.

* * *

The judgment of the Court of Chancer is
REVERSED.

PROBLEMS

1. The 3N Corporation has developed its financial structure during the past decade by issuing and selling the following securities: (1) 500 bonds, with a principal amount of \$1,000 each, interest at 6% plus .0025% of profit per year, without security, each exchangeable for 200 shares of common stock at the holder’s option. The money received from the bonds has been used exclusively to purchase equipment for the corporation; (2) 500 shares of preferred stock, \$1 par value, with a 5% dividend preference and no voting rights; and (3) 1,000 shares of common stock, \$5 par value. Answer the following questions concerning this financial structure:
 - a. Are the bonds best described as
 - (1) 6% convertible equipment bonds;
 - (2) income bearer equipment bonds;
 - (3) registered participating redeemable debentures; or
 - (4) participating convertible debentures?
 - b. What is the minimum amount required for the corporation’s stated capital account?
 - c. What additional rights would be given to the preferred stock under the corporation statute in your state?
 - d. Would the bonds have any preemptive rights to buy additional shares of common stock under the corporation statute in your state?
 - e. Would the preferred stock have any preemptive rights to buy additional shares of preferred stock under the corporation statute in your state?
 - f. If the corporation issues 5,000 additional shares of common stock, what adjustments will be required to the terms of the bonds or the preferred stock, if any, to keep the bondholders and preferred stockholders in the same positions they now occupy?
2. Review the corporation statute in your state and answer the following questions:
 - a. What are the rights of each holder of the common stock?
 - b. What variations are permitted for classes of stock?
 - c. Do redeemed shares have to be canceled?
 - d. May bondholders vote?
3. What is the difference between repurchased and redeemed shares? What funds may be used for each purpose under the corporation statute in your state?
4. If you had your choice among a debenture, a share of preferred stock, or a share of common stock from the largest corporation in your city, which would you select and why?

PRACTICE ASSIGNMENTS

1. Write to a publicly traded corporation of your choice. Request a statement of preferences and rights associated with that company's various shares of stock and bonds. Write a report concerning the policy considerations used in developing the equity and debt structure, and analyze the advantages and disadvantages of "senior securities."
2. Draft a capital stock structure that will meet the following client needs:
 - a. Three director-shareholders want to maintain complete control over the corporation. They will contribute capital in the amount of \$50,000 each.
 - b. Two outside investors are willing to contribute \$50,000 each and are primarily interested in capital appreciation and return on investment (10% minimum is required). They are willing to leave control to the director-shareholders, but insist upon some right of contingent control if business is not prospering (for example, if it is unable to pay any dividends).
 - c. An outside investor is willing to contribute \$75,000 to the business and requires a minimum of 15% return on invested capital. She is not interested in capital appreciation and does not want to be bothered with any control.
 - d. The director-shareholders anticipate finding additional investors and want to be able to tailor the securities to be issued to each investor as necessary to attract the investor without having to consult anyone. They also want to be able to retire any corporate obligations that might make subsequent investment by others unattractive.
3. Review section 6.21 of the Model Act. Assume a corporation has 25,000 shares of common stock with a par value of \$5 per share. Is there any legal way that the corporation could sell these shares at \$4 per share? Prepare a memorandum.
4. The Nobles Company has raised capital in the following amounts with the following securities: (1) \$50,000 by issuing 5,000 shares of common stock at \$10 per share; and (2) \$50,000 by issuing 1,000 shares of 6% cumulative preferred stock at \$50 per share. Prepare a memorandum for management that answers the following questions:
 - a. Why is it more beneficial to the common shareholders to have the senior (preferred) securities if the business is successful?
 - b. What is the approximate profit-point at which it would cease to be beneficial to the common shareholders to have senior securities?
 - c. Why would the common shareholders be in a better position if 6% debt securities had been issued instead of the preferred stock?

ENDNOTES

1. Securities Act of 1933, 15 U.S.C.A. §§ 77a–77aa.
2. Securities Exchange Act of 1934, 15 U.S.C.A. §§ 78a–78m.
3. See "Public Corporations" in Chapter 7 and see J. Seligman and L. Loss, *Fundamentals of Securities Regulation*, 4th Edition (2002).
4. See Model Business Corporation Act (hereafter M.B.C.A.) § 6.01; "The Articles of Incorporation" in Chapter 8.
5. See "Filing and Other Formalities" in Chapter 8.
6. See Del. Code Ann. tit. 8, § 160.
7. See "Ownership and Management of a Corporation" in Chapter 6.
8. See, e.g., Ill. Compiled Statutes § 5/7.40.
9. E.g., New York, N.Y. Bus. Corp. Law § 510 (McKinney).
10. See M.B.C.A. § 2.02 (b); also see "The Articles of Incorporation" in Chapter 8.
11. Neb. Rev. Stat. § 21-2018.
12. See M.B.C.A. § 6.21 (b).
13. E.g., Arkansas, Ark. Bus. Corp. Act § 4-27-601.
14. "The Articles of Incorporation" in Chapter 8.
15. E.g., Idaho, Idaho Code § 30-1-6.
16. See, e.g., New York, N.Y. Bus. Corp. Law § 506 (McKinney).
17. Dividends and other distributions are discussed in detail in Chapter 11.
18. M.B.C.A. § 6.25 (d).
19. M.B.C.A. § 6.25 (e).
20. M.B.C.A. § 6.01.
21. M.B.C.A. § 6.01 (b).
22. See M.B.C.A. § 6.02.
23. See "Amendment of the Articles of Incorporation" in Chapter 15.
24. M.B.C.A. § 6.02.
25. M.B.C.A. § 6.02 (c).
26. M.B.C.A. § 6.04 (a).
27. M.B.C.A. § 6.04 (c).
28. See "Par Value or No Par Value" earlier in this chapter.
29. M.B.C.A. § 6.21.
30. E.g., Missouri, Mo. Ann. Stat. § 351.160 (Vernon).
31. E.g., Colorado Const. Article XV, § 9.
32. However, the corporation could ratify the obligation to pay for services performed by promoters, and thereby cause such services to be valid consideration for stock. See "Agency Authority—Ratified Authority" in Chapter 1.
33. M.B.C.A. § 6.21.
34. M.B.C.A. § 6.21 (e).
35. See Chapter 11.
36. M.B.C.A. § 7.21(b).
37. See "The Articles of Incorporation" in Chapter 8.

38. See “Ownership and Management of a Corporation” in Chapter 6; “The Articles of Incorporation” in Chapter 8.

39. M.B.C.A. § 6.01 (b).

40. M.B.C.A. § 7.21 (a).

41. M.B.C.A. § 10.04 provides that class voting is required for any amendment that would:

1. effect an exchange or reclassification of all or part of the shares of the class into shares of another class;
2. effect an exchange, or create a right of exchange, of all or any part of the shares of another class into the shares of the class;
3. change the preferences, limitations, or relative rights of the shares of the class;

4. change the shares of the class into a different number of shares of the same class;

5. create a new class of shares having rights and preferences prior or superior to the shares of the class;

6. increase the rights and preferences or the number of authorized shares of any class having rights and preferences prior or superior to the shares of the class;

7. limit or deny any existing preemptive rights of the shares of the class; or

8. cancel or otherwise affect distributions or dividends on the shares of the class that have accumulated but have not been declared.

42. M.B.C.A. § 6.31.

43. See “Fractions of Shares and Scrip” earlier in this chapter.

44. See M.B.C.A. § 16.01.

45. See M.B.C.A. § 6.25 (d).

46. Uniform Commercial Code (hereafter U.C.C.) § 9-201-9-206.

47. U.C.C. § 9-502.

48. U.C.C. § 9-501.

49. Securities Act of 1933, 15 U.S.C.A. §§ 77a–77aa; Trust Indenture Act of 1939, 15 U.S.C.A. §§ 77aaa–77bbbb.

50. A skeletal trust indenture, including articles, section, and subsection headings, is Exhibit I–11 in Appendix I.

51. E.g., Delaware, Del. Code Ann. tit. 8, § 221.