

September 1946

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Recommended Citation

John F. Partridge, *Corporate Capital Structure under Illinois Law*, 24 Chi.-Kent L. Rev. 303 (1946).

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CHICAGO-KENT LAW REVIEW

Copyright 1946, Chicago-Kent College of Law

VOLUME 24

SEPTEMBER, 1946

NUMBER 4

CORPORATE CAPITAL STRUCTURE UNDER ILLINOIS LAW

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THE PRINCIPLES of corporation finance are a matter of concern to the lawyer, the accountant, and the business man alike. The field is a broad one, and an adequate discussion of the subject in all its ramifications would require several volumes. It is possible, however, within the space of a single article, to draw attention to some of the preliminary problems involved in designing the capital structure of a new corporation as well as to suggest certain standards and principles which should be observed. It is also possible to investigate the actual or probable status of various capital structure devices which may be adopted in relation to applicable Illinois law. One leading authority, discussing the formation of new corporations, comments that:

The principal of these preliminary questions are the situs, the name, the purposes and the financial structure of the proposed corporation. Although these are, theoretically, business questions, for decision by the client alone, yet, knowing the general aims of the client, the burden of explanation and decision will be upon the attorney, for he knows best the arguments that lie back of each decision. His will be the duty

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of advising the client, clearly and in an elementary way, what the questions are which must be decided and of leading the client's mind to a satisfactory decision on the policy involved in each particular question.¹

This article will have served its purpose, then, if it enables the lawyer to advise his clients, within the limitations of the above quotation, regarding the capital structure for a corporation to be organized in Illinois.

At the very outset, of course, the lawyer has an obligation to his clients to give proper consideration to the suitability or unsuitability of the corporate form to the undertaking in view of the more extended regulation of the corporate form of business organization in comparison to others.² Of the many special qualities conferred on corporations by law, the most important are the limited liability of the owners of the business,³ the permanence of the business organization,⁴ and the ease of transferring ownership. For many small businesses, however, the price exacted for these special favors is too high. The expense and the paper work required are not inconsiderable;⁵ registration under the so-called "Blue Sky" law may be necessary in connection with the original issuance of securities;⁶ reports must be made periodically to the

¹ Fletcher, *Cyc. Corp.*, Perm. Ed., Vol. 19, § 8862.

² The characteristics and relative advantages of the business unit employing the sole proprietorship or partnership form of organization are well known. Whenever they exist, the taxes and the legal "red tape" which attend the corporate form of organization will be sufficiently disadvantageous to bar use of the latter. See Guthmann and Dougall, "Corporate Financial Policy" (Prentice-Hall, Inc., New York, 1940), p. 25, and note in 34 *Domestic Commerce*, pp. 8-12.

³ Ill. Rev. Stat. 1945, Ch. 32, § 157.23.

⁴ *Ibid.*, § 157.5(a).

⁵ In addition to the legal, accounting, and other non-statutory expenses involved, the present law of Illinois exacts a filing fee for filing the certificate of incorporation (Ill. Rev. Stat. 1945, Ch. 32, § 157.127), an initial license fee equal to 1/20th of 1% of the initial paid capital (*Ibid.*, § 157.130), and an initial franchise tax (*Ibid.*, § 157.133).

⁶ Ill. Rev. Stat. 1945, Ch. 121½, § 99(A)(10) and § 99(B), exempt pre-incorporation stock subscriptions or sales from registration if (1) the number of such subscribers does not exceed twenty-five without regard to the amount of capital raised, or if (2) the amount of capital to be raised does not exceed \$25,000 regardless of the number of subscribers. To justify exemption, however, there must be no expense incurred in connection with the sale of the securities. The Secretary of State is empowered to require a registration in the event of fraud or unfairness in such exempt sales.

state of incorporation;⁷ formality is required in all corporate matters; special authority must be obtained before undertaking regular business in a foreign state;⁸ and the powers which may be exercised are limited to those granted by the state.⁹ Most onerous of all, special taxes are imposed which less formal business organizations escape for, in addition to the charges made by the state at the time of incorporation,¹⁰ there are many fees and taxes payable annually or upon the filing of various documents or upon other events,¹¹ and if the corporation is transacting business in another state there are additional charges payable to that state as well as additional reports to be filed.¹²

The impact of Federal income tax laws since 1936 must also be taken into consideration. Income taxed once as income to the corporation is again taxed as income to the shareholder when he receives a dividend, the shareholder being allowed to take no credit for the tax paid by the corporation.¹³ At the rates effective in 1946, a corporation which earns \$50,000 or more must pay a 38% income tax.¹⁴ If the remaining 62% of such income is then distributed as dividends, each shareholder will be taxed on his dividend just as on any other income.¹⁵ Even if the corporate net income, after taxes, is retained, the personal income tax of its shareholders as to such retained earnings is merely deferred until distribution either in the form of dividends or upon liquidation.¹⁶

⁷ See "Brief Analysis of the Administrative Provisions of the Business Corporation Act and Suggestions with Respect Thereto, 1945" compiled by Edward J. Barrett, Secretary of State, Illinois, particularly pp. 16-18.

⁸ The requirements imposed on a foreign corporation seeking to be licensed to do business in Illinois are set forth in Ill. Rev. Stat. 1945, Ch. 32, §§ 157.102 to 157.125, inclusive:

⁹ Ill. Rev. Stat. 1945, Ch. 32, § 157.5.

¹⁰ *Ibid.*, § 157.126, § 157.134, and § 157.141.

¹¹ See, for example, Ill. Rev. Stat. 1945, Ch. 32, § 157.126 to § 157.134, and also § 157.141.

¹² Requirements imposed on a foreign corporation after being licensed to do business in Illinois may be found in Ill. Rev. Stat. 1945, Ch. 32, §§ 157.102 to 157.125, and §§ 157.135 to 157.142.

¹³ See May, "Corporate Structures and Federal Income Taxation," 22 *Harv. Bus. Rev.*, pp. 10-8 (1943), for an interesting historical survey of the influence of income taxation on the capital structure of corporations both in England and in the United States.

¹⁴ 26 U. S. C. A. § 13 and § 15.

¹⁵ *Ibid.*, § 22(a).

¹⁶ *Ibid.*, § 115.

Such double taxation exacts a high premium for the benefits of the corporate form of organization, for while single proprietors or partners pay taxes on the business income at the individual rates for the year in which the income accrues to the business,¹⁷ they escape entirely the 38% tax penalty imposed on corporations.¹⁸

Despite the burdens placed upon the corporate form of business organization, it will ordinarily be found the most satisfactory form for all but the small personalized business. If the decision to incorporate has been reached, the lawyer is then faced with the problem of eliminating as many of the special corporate burdens as possible or else of reducing the impact of those that cannot be eliminated.

I. FACTORS INFLUENCING CAPITAL STRUCTURE.

A. BUSINESS FACTORS

Capital structure should never "just happen." The future success of the new corporation may be profoundly affected by the design of its capital set-up. Sound business judgment and foresight must be brought into play in order to avoid serious difficulties which may impede future operations and expansion. The lawyer cannot be expected to be an expert in all matters bearing on the design of the corporate capital structure but, when advised by the organizer as to the business purposes, by the accountant with regard to the financial needs to accomplish these purposes, and by the banker as to the economic environment in which the business will operate and the conditions then prevailing in the capital market, he should be able to show his client what types of securities permitted by the law will best overcome the special problems and attain the desired ends.

Three main factors influence the form of capitalization of new

¹⁷ *Ibid.*, § 182.

¹⁸ There has been talk recently of the alleviation or removal of this double taxation from the Federal tax system. It is probable that some relief will be provided in future years, but it is not likely that corporations will ever escape some income tax disadvantage. The provisions of the income tax law are, therefore, an important factor influencing the design of the capital structure of a corporation.

corporations. The first, and most important, is the business purpose of the organizer. The second concerns the economic environment in which the business will operate. The third calls for recognition of the limitations imposed by corporation law. Basic business purposes sought to be achieved by the design of the capital structure of a new corporation are more or less uniform in every instance. They involve (1) the retention for the organizers of as much profit as possible; (2) the securing of control in the organizer's hands; (3) the exercising of economy in acquiring the initial capital; and (4) the incorporation of flexibility into the capital structure so that additional capital may be obtained economically when needed for expansion. Since these are the ends to be attained, the question becomes one as to how they can be achieved under the law of Illinois.

B. STATUTORY FACTORS

The Business Corporation Act¹⁹ and the Securities Law²⁰ contain various provisions which, on cursory reading, appear to limit the plans for the proposed capital structure.²¹ Upon further study, however, it will be found that, in the main, these provisions go more to procedure than to substance, while those requirements which appear to express substantive limitations merely invite the lawyer to use his ingenuity.

Section 28 of the Business Corporation Act, for example, restates a provision of the Illinois Constitution to the effect that each "outstanding share, regardless of class, shall be entitled to one vote on each matter submitted to a vote at a meeting of shareholders."²² Such language would appear to prohibit the dis-

¹⁹ Ill. Rev. Stat. 1945, Ch. 32, § 157.1, et seq.

²⁰ *Ibid.*, Ch. 121½, §§ 96-137.

²¹ Thus Ill. Rev. Stat. 1945, Ch. 32, § 157.14 and § 157.28, require that all shares shall have the right to vote; § 157.17 declares that shares having a par value shall not be issued for less than par value; § 157.18 imposes the restriction that neither promissory notes nor future services may constitute payment for shares of stock; § 157.47(i) requires that the initial consideration received by the corporation for its stock before it shall commence business must be not less than \$1000; and § 157.46 insists that there be at least three subscribers to stock to act as incorporators.

²² Ill. Rev. Stat. 1945, Ch. 32, § 157.28. Compare with Ill. Const. 1870, Art. XI, § 8.

enfranchising of any class of stock. For all practical purposes, however, the same result can be achieved in this state as is accomplished elsewhere where only one class of stock must necessarily be voting stock. Nothing in the Illinois act, by express interdiction, would prevent the issuance of \$100 par value preferred stock to those who want security of income but are not interested in taking active part in the management, while no par common stock may be issued to the promoters for a consideration as small as one penny per share. Under such a capital set-up, \$100 invested in the preferred stock would buy one vote, while a like amount invested in the common stock would buy 10,000 votes.²³ In form, all stock is voting, yet the preferred stock has no real voting power in the corporate affairs. The extremes used in this illustration, perhaps, go beyond good conscience and it is possible that the Securities Department might deem such a combination to be fraudulent *per se*. Moreover, the stock transfer tax applicable to the "penny shares" would be prohibitive.²⁴ The illustration, therefore, is not intended to imply that the combination of securities described would be allowed by the administrative agencies in Illinois, but merely to point out that a reasonable combination of securities of this sort, made in good faith and with full disclosure, is not a violation of the constitutional and statutory prohibition of the issuance of non-voting stock.

Section 17 of the Business Corporation Act²⁵ requires that shares having a par value shall not be issued for less than the par value thereof. But, under Section 18, shares may be issued for services or for property, tangible or intangible, and "in the absence of actual fraud in the transaction, the judgment of the

²³ Ill. Opin. Atty. Gen., 1939, No. 81, p. 235 at 236, states, in part: "I can find nothing in section 14 of the Business Corporation Act or in section 3 of Article XI of the Constitution of 1870 which prohibits a classification of shares of stock according to the extent in which they may participate in prospective dividends. We cannot write into the Constitution or the Statute a proviso that shareholders shall have the privilege of voting according to their contribution to the common fund."

²⁴ While the federal stamp tax, 26 U. S. C. A. § 1802(a), on the penny shares would amount to only three cents on each \$20 of actual value or fraction thereof, the tax on reissues, sales or transfers of these shares, *ibid.*, § 1802(b), would be five cents per share or five times the initial consideration per share in the extreme situation used to illustrate the point made. The transfer tax in this situation would operate as a practical restraint on alienation of such shares.

²⁵ Ill. Rev. Stat. 1945, Ch. 32, § 157.17.

board of directors or the shareholders, as the case may be, as to the value of the consideration received for shares shall be conclusive.”²⁶ Thus, if the transaction is without fraud, there would appear to be nothing illegal in the issuance of a block of par value stock to an inventor-promoter in consideration for his patent, followed by a surrender to the new corporation, as a gift, of a part of the stock so received. The corporation could then sell the stock thus received as treasury stock for less than its par value.²⁷

Relative rights between the various classes of stock, such as the right to share in profits or in liquidation, to vote, providing that all shares have the right to vote, and other special contract rights, may be made the subject of almost any combination under the Illinois Business Corporation Act.²⁸ The only real limitations upon the imagination of the attorney, when fixing these relative rights, are (1) what can be sold, *i. e.* what relatively less favorable rights will be acceptable to the purchaser; (2) the promoter's and the lawyer's liability in fraud if there is less than full disclosure; and (3) the limitations which may be made by the Illinois Securities Department at its discretion if the securities must be registered under the “Blue Sky” law.

Sales of stock in a proposed corporation prior to its incorporation must be qualified under the provisions of the Illinois Securities Law unless such sales are effected without expense and without payment of commissions and unless either (1) the number of subscribers does not exceed twenty-five, or (2) the amount to be raised does not exceed \$25,000.²⁹ Pre-incorporation sale of securities when these conditions are not met, or the sale of securities after the organization of a corporation has been completed to anyone not already a shareholder, must be handled in conformity with that statute. For the small corporation, this may prove expensive and time-consuming as, in addition to audited state-

²⁶ *Ibid.*, § 157.18.

²⁷ Even before the provisions of the third paragraph of Section 17 of the present Business Corporation Act were adopted, the same rule was laid down in *Pullman v. Ry Equipment Co.*, 73 Ill. App. 313 (1898). A transaction of this sort would doubtless be examined carefully and would not be upheld unless it was free of any trace of fraud.

²⁸ Ill. Rev. Stat. 1945, Ch. 32, §§ 157.14-157.15.

²⁹ *Ibid.*, Ch. 121½, § 99(A) (10).

ments, independent appraisals, and the like required thereby, the Secretary of State has broad discretionary powers to make special investigations at the issuer's expense.³⁰ Securities to be issued for intangibles must be placed in escrow and subordinated to the interests of all other securities for at least five years,³¹ as the statute goes beyond requiring full disclosure to the prospective purchaser of the securities in seeking to protect him from his own gullibility. Failure to comply with the statute, where necessary, is not excused by either a showing of good faith on the part of the seller or that the buyer bought with full knowledge of the facts and circumstances;³² is punishable by fine and imprisonment; and the security purchaser may treat his purchase as void and recover the consideration paid.³³

If the securities to be issued exceed \$300,000 in value and are to be publicly offered outside of the state of incorporation, the issuing corporation must also comply with certain federal laws.³⁴ Such securities must be registered with the Securities and Exchange Commission, an expensive and time-consuming process, and a detailed prospectus must be prepared and delivered to each prospective purchaser of the securities.³⁵ Liability for failure to comply with the federal requirements, or for misleading statements in the prospectus, extends to the issuing corporation, to the officers and directors thereof, to the accountants, engineers, appraisers, etc., who may certify to any part of the registration statement, as well as to each participating underwriter.³⁶ In case of bond issues in excess of one million dollars,³⁷ the provisions of the Trust Indenture Act of 1939 must also be complied with.³⁸ The underlying philosophy of laws of this character may best be illus-

³⁰ *Ibid.*, Ch. 121½, §§ 99(B), 101(3), 102(b)(4), 104(16), 106, and 112, especially, and most of the other sections, give the Secretary of State a very wide discretion in administering the law.

³¹ *Ibid.*, Ch. 121½, § 107.

³² *Wehrwein v. Eastman Springs Beverage Co.*, 238 Ill. App. 443 (1925). See Watson, "The Illinois and Federal Securities Act", 29 Ill. L. Rev. 41 (1934).

³³ Ill. Rev. Stat. 1945, Ch. 121½, §§ 125 and 132.

³⁴ 15 U. S. C. A. § 77c.

³⁵ *Ibid.*, §§ 77e, 77f, 77j, and 77aa.

³⁶ *Ibid.*, §§ 77k and 77x.

³⁷ *Ibid.*, § 77ddd.

³⁸ *Ibid.*, § 77aaa et seq.

trated by a statement made by the late President Roosevelt at the time the federal legislation was under consideration. He said: "It changes the ancient doctrine of *caveat emptor* to 'let the seller beware,' and puts the burden on the seller rather than on the buyer."³⁹ It is, however, beyond the scope of this article to discuss the varied federal laws which may affect the selling of corporate securities in interstate commerce, so if the size of the issue and the manner of its distribution fall within these statutes, advice from lawyers specializing in this highly complex field is desirable.

Within the framework of these statutory limitations, it is now possible to consider how to plan a corporate capital structure so as to serve the four basic purposes of the organizer of a new corporation. As needs will vary, it is impossible to treat with a specific situation, but the following points should be kept in mind.

II. DESIGNING THE CAPITAL STRUCTURE.

A. RETENTION OF PROFIT

The organizers of a new corporation are interested in giving up as little of the prospective profits of the business as possible to outside capital and to the government in the form of taxes. Oddly enough, the present Federal income tax law provides an inducement to raise capital by borrowing, rather than by the sale of stock, thereby running counter to social policy and to sound principles of corporate finance.⁴⁰ Interest, whether on bank loans, bonds, or other debt is deductible, just as any other business expense, in determining the corporate "net income" upon which the income tax is computed.⁴¹ Dividends on preferred or common stock, on the other hand, are not so deductible.

With this fact in mind, suppose Corporation "A" will require \$1,000,000 working capital and is in a position to raise that

³⁹ "The Public Papers and Addresses of Franklin D. Roosevelt. Vol. II: The Year of Crisis, 1933," (Random House, New York, 1938), p. 94.

⁴⁰ May, "Corporate Structures and Federal Income Taxation," 22 Harv. Bus. Rev., pp. 10-8 (1943).

⁴¹ 26 U. S. C. A. § 23(a)(b).

amount either by issuing 4% bonds or by issuing 4% preferred stock. Assuming that its annual net income before servicing the bonds or the stock, as the case may be, will amount to \$200,000 and that the 38% corporate income tax rate,⁴² existing in 1946, will apply, there is an annual pecuniary advantage to the common stockholders of \$15,200 from the issuance of bonds rather than preferred stock. That advantage is calculated as follows:

	If Preferred Stock Issued		If Bonds Issued
Net Income before Interest or Dividends		\$200,000.00	\$200,000.00
Bond Interest		none	40,000.00
		<hr/>	<hr/>
Net Income Subject to Income Tax		\$200,000.00	\$160,000.00
Income Tax	\$76,000.00		\$60,800.00
Preferred Dividends	40,000.00	116,000.00	none
	<hr/>	<hr/>	<hr/>
Balance Available for Common Stockholders		\$ 84,000.00	\$ 99,200.00
		<hr/> <hr/>	<hr/> <hr/>

Looking at it from another viewpoint, the corporation would have to earn as much as \$224,516.13, or \$24,516.13 more, in order to pay preferred dividends and still have the same net amount left for common stockholders, calculated as follows:

	If Preferred Stock Issued		If Bonds Issued
Net Income before Interest or Dividends		\$224,516.13	\$200,000.00
Bond Interest		none	40,000.00
		<hr/>	<hr/>
Net Income Subject to Income Tax		\$224,516.13	\$160,000.00
Income Tax	\$85,316.13		\$60,800.00
Preferred Dividends	40,000.00	125,316.13	none
	<hr/>	<hr/>	<hr/>
Balance Available for Common Stockholders		\$ 99,200.00	\$ 99,200.00
		<hr/> <hr/>	<hr/> <hr/>

From the standpoint of the individual providing the capital, of course, the personal income tax would be the same without regard to whether he received the \$40,000 in the form of dividends or as interest,⁴³ although there would be an advantage to a corporation providing the capital to take the payment as a dividend.⁴⁴

⁴² *Ibid.*, § 13 and § 15.

⁴³ *Ibid.*, § 22 (a).

⁴⁴ *Ibid.*, § 26 (b).

Also favoring the use of borrowed capital is the increased resort to income bonds as a security device which has developed in recent years. Bonds of this type, while characteristically used in railroad reorganizations, are not limited to railroad borrowers. Interest on such bonds is payable only if earned and does not, under most of the bond contracts, accumulate as an obligation of the issuer during those years in which the interest is not earned.⁴⁵ For the issuer, this type of security has many of the favorable features of a non-cumulative preferred stock and, for a new corporation, avoids the risk of financial embarrassment and loss of credit standing because of failure to meet its contract obligations during the unprofitable developmental period. The use of the income bond device, under existing law, preserves the income tax advantage of borrowing rather than selling stock⁴⁶ while at the same time giving the corporation most of the contract advantages normally obtained only by selling stock. The same advantages may be obtained, for corporations too small to make bond financing feasible, by issuing promissory notes so worded as to make the obligation to pay interest contingent upon such interest being earned.

The encouragement given by the income tax law to debt financing is unsound in theory and undesirable in practice. It is also probable that the form of capital structure will not forever be allowed to affect taxation to the same extent as at present. Nevertheless, until the present tax procedure is changed, this anomaly in the law will continue to lend impetus to borrowing rather than to raising capital by the sale of stock.

⁴⁵ Guthmann and Dougall, *op. cit.*, pp. 171-5, 293, 681.

⁴⁶ *John Kelley Co. v. Commissioner of Internal Rev.*, — U. S. —, 66 S. Ct. 299, 90 L. Ed. (adv.) 257 (1946). See earlier reports on this and the *Talbot Mills* case in 1 T. C. 457 (1943) and 3 T. C. 95 (1944). The United States Supreme Court upheld the rulings of the Tax Court in both cases after the Circuit Court of Appeals had reversed the Tax Court in the *Kelley* case, 146 F. (2d) 466 (1944), and had affirmed it in the *Talbot Mills* case, 146 F. (2d) 809 (1944). The ultimate ruling was to the effect that whether interest on "income bonds" is a tax deduction depends upon the facts of each case and the bona fides of the transaction. Where stock was reissued as "income bonds" solely to avoid taxes and the transaction showed, as a whole, that the securities were a preferred stock in all but name, the so-called "interest" on them was held to be, in truth, a dividend and not deductible. Where the income bonds were what the name implied, the interest was held to be a tax deduction despite its non-cumulative nature.

The lawyer advising his client with regard to the capital structure of a new corporation should have some understanding of the meaning of the term "leverage," or of "trading on the equity,"⁴⁷ as it is sometimes called. "Leverage" involves no legal principles, but it is of great importance in its effect upon the retention of corporate earnings by the organizers. "Leverage" involves the obtaining of capital by the sale of senior securities having a fixed return, thereby magnifying the profits, or losses, accruing to the residual common stock held by the organizers. Such senior securities may be bonds, notes, or non-participating preferred stock. For "leverage" to operate to the advantage of the common stockholders it is essential that the capital obtained by the issuance of the senior securities can be used to produce more income than must be paid out for the use of such senior capital, and no greater amount of the senior securities should be issued in any event than can be serviced in the anticipated year of lowest earnings. If this principle is overlooked, "leverage" can wipe out all profit to the common stockholders and rapidly bring the corporation to insolvency.

To illustrate the operation of "leverage," assume the organizers of Corporation "B" are contemplating the issuance of \$100,000 in common stock to themselves and anticipate the corporation can earn \$10,000 a year with that amount of capital, or a return of 10%. The organizers are confident, however, that they can, in the poorest year, earn an additional \$10,000 if another \$100,000 capital is available to them. Assume further that they can obtain this additional capital for a fixed payment of 4%. If the organizers obtain the additional capital and their estimates are realized, the earnings on their common stock will be increased from 10% to 16%. Assuming operations in the first year are precisely as the organizers anticipated, the effect of fluctuations of earnings in subsequent years upon the rate of return on the

⁴⁷ Guthmann and Dougall, *op. cit.*, pp. 115-8; Gerstenberg, "Financial Organization and Management of Business," (Prentice-Hall, Inc., New York, 1944), pp. 187-8.

common stock because of the "leverage" provided by the senior securities can be illustrated as follows:

	1st Year	2nd Year	3rd Year	4th Year
Earnings	\$20,000.00	\$40,000.00	\$80,000.00	\$4,000.00
4% to Senior Securities.....	4,000.00	4,000.00	4,000.00	4,000.00
Balance for Common Stock.....	\$16,000.00	\$36,000.00	\$76,000.00	None
% Earned on Entire Capital....	10%	20%	40%	2%
% Earned on Common Stock....	16%	36%	76%	0%

The foregoing illustration demonstrates that the "leverage" provided by the senior fixed-return securities tends to increase substantially the fluctuation in the rate of return on the common stock. If the company is prosperous and its earnings are increasing rapidly, the common stockholders are greatly benefited by the "leverage." Thus, in the third year of the illustration, "leverage" gives them a 76% return on their investment instead of the 40% return they would have realized if additional common stock had been issued instead of the senior securities. On the other hand, the fourth year shows the common stock return reduced to nothing, while, if more common had been issued instead of the senior obligations, all common stock would have realized a 2% return even in this poor year. With the senior securities outstanding, any decline in earnings below \$4,000 would wipe out the common stockholders' equity in an amount equal to such decline.

Every corporation must have outstanding a class of stock which represents the residual ownership of the corporation, typically known as common stock.⁴⁸ It may comprise the only class of stock outstanding, but if other classes are issued they enjoy, by contract,⁴⁹ some preferential rights over the residual common stock. The common stock is generally that which the organizers of the corporation retain, in whole or in part. The profits realized by the corporation after paying interest on the corporation's debt obligations and the contract return on other

⁴⁸ *Storror v. Texas Consol. Compress & Mfg. Ass'n*, 87 F. 612 (1898). See also *Fletcher, Cyc. Corp.*, Perm. Ed., Vol. 19, § 8905.

⁴⁹ *Tennant v. Epstein*, 356 Ill. 26, 189 N. E. 864 (1934); *Roth v. Ahrensfield*, 300 Ill. App. 312, 21 N. E. (2d) 21 (1939), affirmed in 373 Ill. 550, 27 N. E. (2d) 445 (1940).

classes of stock accrue to the benefit of the common stock.⁵⁰ The converse is also true. If the corporation is unprofitable, it is the interest of the common stock which is wiped out first. Upon liquidation of the corporation, the common stockholders receive only what is left after the debts and, in most cases, the other classes of stock, have been paid in full. Common stock benefits more than the other securities when the business is prosperous and suffers the most when the business is depressed.

Next in seniority above the common stock is the preferred stock.⁵¹ There has been a tendency in recent years to drop the word "preferred" from the designation of this stock and to call it "Capital Stock, Class A" and to designate the common stock as "Capital Stock, Class B." If there are several series of shares having preferences, the common stock may be classified by a letter farther down in the alphabet, and the earlier letters may be used to identify successive series of preferred stocks. Any class of stock which enjoys special contract benefits is a preferred stock irrespective of its designation. Like common stock, preferred stock is never a debt of the corporation.⁵² It represents part of the ownership equity in the business, but its participation is defined by the contract terms of its issuance⁵³ very much in the same manner as a special partner in a partnership is a part owner but enjoys different contract rights from those enjoyed by the general partners. The special contract rights given to preferred stock issues are as varied as man's imagination. Some of the more common provisions are discussed later in this section.

The indebtedness of a corporation is senior to all classes of stock. Whether represented by bonds, by notes, or by less formal obligations, the debt of a corporation represents its obligation to pay, a credit obligation rather than an ownership.⁵⁴ The liability of the corporation to pay the principal of the obligation is abso-

⁵⁰ *General Investment Co. v. Bethlehem Steel Corp.*, 87 N. J. Eq. 234, 100 A. 347 (1917).

⁵¹ In general, see *Fletcher, Cyc. Corp.*, Perm. Ed., Vol. 11, §§ 5283-5313.

⁵² *Hamblock v. Clipper Lawn Mower Co.*, 148 Ill. App. 618 (1909).

⁵³ See cases cited in note 49, ante.

⁵⁴ In general, see *United Lines Telegraph Co. v. Boston Safe Deposit & Trust Co.*, 147 U. S. 431, 13 S. Ct. 396, 37 L. Ed. 231 (1893). See also 13 Am. Jur., Corporations, § 856.

lute and not contingent; its liability to pay interest, rather than dividends, is also absolute except when changed by contract as in the peculiar income-bond contract.

The organizers of a corporation, since they normally plan to hold all or the major part of the common stock, will seek to obtain any additional outside capital on terms which will preserve to the common stock as much of the corporate earning as possible. If the business is of a stable nature and sure to produce a certain minimum of earnings, it is possible that this outside capital can be borrowed from a bank on corporate notes. This is probably the most economical method. The interest will be at a low rate if the business is such as to assure payment of the loan. The interest paid will be a deduction in computing the corporation's income tax. The formalities involved are at a minimum. Nevertheless, bank credit is seldom a practical source of permanent capital for the new business, for the simple reason that few new enterprises are so assured of success as to satisfy the bank's loan officer. Moreover, bank loans generally are for a short period, and the new business is rare which can pay interest on the loan and also provide for the early payment of its principal.

Since new businesses generally require a few years of development during which the profits are small, or even more likely losses are incurred, it is almost an invitation to disaster for the new corporation to raise any substantial part of its capital by securities on which it has a certain and fixed obligation to pay interest. The non-cumulative income bond or income note, bearing a somewhat higher interest rate than would be paid on a fixed-interest obligation of the debtor, so as to compensate for the probable time lapse before interest will start to accrue and for the contingent nature of the interest obligation thereafter, meets this problem satisfactorily where the corporation's prospects are good enough to make this type of obligation salable.

If the organizers are themselves able to put up all the required capital, but wish to withdraw part of their contribution as soon as possible and to operate and expand the business from its own profits, they can do this to their own greatest advantage

by creating a capital structure composed of debt and common stock securities. Each subscriber, for example, might be required to subscribe \$1010.00 per unit for a "package" consisting of one no-par share of common stock and one \$1,000 interest-bearing note. If the corporation profited, the interest on the notes would constitute an income tax deduction for the corporation and, as soon as sufficient earnings had accumulated to permit the continued operation of the business after paying off the notes, the corporation could retire them. The money received by the subscribers in payment of the notes would not constitute income taxable to them, and their investment would have been reduced from \$1010.00 to \$10.00 per unit subscribed. If the business did not succeed, the subscribers would lose in proportion to their original contributions but they would probably fare better than if they had invested the same amounts in common stock for, if anything at all was left to distribute, they would be entitled to share as creditors upon the basis of the notes held.

If outside capital must be raised and the undertaking is not such as to make debt financing possible, preferred stock may be issued. The special rights and special limitations of preferred stock must be spelled out in the contract. First, the stock may be cumulative or non-cumulative.⁵⁵ If cumulative, the contract dividend rate must be paid on the stock in each year and, if not paid in any year, the amount for that year must be paid thereafter before any dividend may be paid on the common stock. The arrearage on cumulative preferred stock is not a debt of the corporation in the legal sense until declared as a dividend, but as between the preferred and the common stockholders, the arrearage must be paid to holders of the preferred shares before any dividend may be paid on the common shares. If the preferred stock is non-cumulative, the contract dividend rate must be paid on it in any year during which a dividend is paid on the common stock, but if no dividend is paid on the common shares in that year, the preferred dividend does not accumulate. Each year is considered independently of prior years. The dividend on the non-cumulative preferred shares does not have to be paid

⁵⁵ Ill. Rev. Stat. 1945, Ch. 32, § 157.14(b).

even though earned when the common stock is paid no dividend in that year, unless the failure to pay the non-cumulative preferred dividend is fraudulent or unconscionable.⁵⁶ It is obvious that, from the investor's standpoint, non-cumulative preferred stock is a very unattractive security. Consequently, it is seldom employed without other contract rights which strengthen its position. Half way between cumulative and non-cumulative preferred stock is a type of preferred stock on which dividends are cumulative if earned. If the corporate earnings are sufficient to pay the preferred dividend, such dividend must be paid in the following year or must be accumulated and paid thereafter before any dividend is paid on the common stock. New corporations occasionally issue a preferred stock with a deferred cumulative feature. This, in effect, is a preferred stock which is non-cumulative during the developmental period or until a certain date is reached or a certain condition has been met, but is cumulative thereafter.

When necessary for its sale, preferred stock is often made participating.⁵⁷ Under the usual procedure, if such stock is fully participating, it is first entitled to a certain dividend payment; next, the common shares are entitled to a like amount of dividend per share; and after these payments to shares of both classes, the balance to be declared is divided on an equal per share basis between the two classes. The preferred stock may also be issued as partially participating, or participating according to some other special contract formula.

The salability of preferred stock may also be enhanced by making it convertible at the option of the shareholder into common stock at a specified ratio.⁵⁸ From the organizers' standpoint, this feature is a dangerous one for if the business proves profitable the preferred stockholders, by converting their shares, may obtain participation in the profits in excess of the preferred dividend rate, thereby reducing the amounts accruing to the orig-

⁵⁶ See note in 27 Col. L. Rev. 53 (1927), and see also Fletcher, *Cyc. Corp.*, Perm. Ed., Vol. 12, § 5447; 13 Am. Jur., *Corporations*, §§ 689-95.

⁵⁷ Fletcher, *op. cit.*, Vol. 12, § 5448; 13 Am. Jur., *Corporations*, § 697. See also Ill. Bus. Corp. Act Anno. (Foundation Press, Inc., Chicago, 1934), p. 74.

⁵⁸ Ill. Rev. Stat. 1945, Ch. 32, § 157.14(e).

inal holders of common shares. From the investor's, the convertible feature in preferred stock gives him a priority for the preferred dividend rate plus an option on earnings in excess of that rate if the business succeeds.

It is generally to the common stockholder's benefit to make the preferred stock redeemable at the option of the corporation.⁵⁹ To improve salability, the redemption price should be a small percentage above the par value and above the original offering price for the shares. The redemption feature permits the corporation in future years either to refund the preferred at a lower rate if the financial market permits, or to retire the same outright thereby preserving to the common shares the money which would otherwise have to be paid on the preferred in the form of dividends. It also permits the return of all voting power to the common stock.

While preferred stock generally has preference over common stock in the liquidation of the corporation, such preference arises by contract only, so if not specified the preferred stock would share only proportionately with other classes of stock.⁶⁰ In that regard, it is not unusual to find that different amounts may be payable to the preferred stockholders on no-par value preferred stock in case the liquidation is voluntary in contrast to an involuntary one.

These comments by no means exhaust the special contract provisions which may be made with respect to preferred stock, but merely indicate the principal provisions in common use. Furthermore, any practical combination of these special provisions is possible, so the organizers of the new corporation may decide the issue "Cumulative, Fully Participating, Convertible and Redeemable Preferred Stock."

The Illinois Business Corporation Act permits the insertion of a provision in the articles of incorporation limiting or denying the pre-emptive rights of shareholders of any class to acquire

⁵⁹ *Ibid.*, §157.14(a).

⁶⁰ *Continental Ins. Co. v. United States*, 259 U. S. 156, 42 S. Ct. 540, 66 L. Ed. 871 (1922). See also *Fletcher, Cyc. Corp., Perm. Ed., Vol. 11, § 5303*.

additional shares of stock, if any are issued.⁶¹ If the pre-emptive rights is not restricted in the articles, or by amendment,⁶² all shareholders are entitled to an opportunity to subscribe pro rata to any new offering of stock and are thus enabled, if they so elect, to retain their proportionate interest in the business. If the organizers of a new corporation will have and retain voting control of it, the denial of the pre-emptive right can do them no harm since they can control the manner of issuance of additional securities by their votes. On the other hand, if the organizers are forced to give up the voting control to others in order to obtain additional capital, only by a preservation of the pre-emptive right can they assure that their relative interest in the business will not be reduced by subsequent issuance of additional stock and its sale to persons other than themselves. If the organizers' control of corporate affairs is secure, the denial of pre-emptive rights will make it possible to issue and sell stock in the future much more easily and with less delay than if the corporation is forced to solicit each shareholder before the additional stock can be offered generally. The decision as to the retention or denial of pre-emptive rights is thus one which touches upon profit participation, upon maintenance of the control of the corporation, and upon the acquisition of additional capital in the future.

Where the stock of the new corporation is all to be held by a few individuals, each of whom is actively employed in the corporate business, it is desirable for the corporation to pay as liberal salaries as earnings and good conscience permit to the employee-owners. The amount paid out in salaries is not subject to the corporation income tax as are earnings paid out as dividends. The salaries paid, however, must be fair. Federal income tax regulations authorize the taxing officials to determine what would be fair salaries and to allow no more than such fair salaries to be deducted as business expense.⁶³

⁶¹ Ill. Rev. Stat. 1945, Ch. 32, § 157.24.

⁶² *Ibid.*, § 157.52(o).

⁶³ Income Tax Reg. No. 111, § 29.23(a)-6.

B. RETENTION OF CONTROL

The second basic business purpose of the organizers of a new corporation is to retain in themselves a sufficient voting control of the corporation. Large corporations are frequently controlled by only a very small percentage of the total voting stock,⁶⁴ a fact made possible because the stock is usually widely distributed and there is no organized opposition. A large proportion of the thousands of owners of small lots of the stock can be counted upon not to take much interest in management so long as dividends are forthcoming, and to acquiesce in, and to consent by proxy to, the proposals of the owners of larger blocks of the stock. The inertia of the unorganized stockholders tends to perpetuate the control of those previously active in determining policies, even though the owners of the small lots of stock have, in the aggregate, substantially more than a majority of the votes. The same is not true, however, for the small new corporation. Generally the stockholders of the new corporation, whether they hold preferred or common stock, keep in close touch with developments in the business and show a keen interest in the operation of the new undertaking. For the organizers to be secure in their control of the new corporation, therefore, it is necessary, that they be able to cast more than fifty per cent. of the vote.

In an earlier section, attention was called to the effect on voting power of the issuance of stock of different par values and of the issuance of several classes of no-par stock for different amounts of consideration. One share of \$100 par value stock and an aggregate of ten shares of \$10 par value stock might have identical contract rights as to dividends, liquidation, and the like; nevertheless, the former would enjoy but one vote while the same aggregate value in the \$10 par value shares would enjoy ten votes. Since the organizers' interest is generally represented by common stock, this observation suggests that organizers' control can best be assured by issuing shares to obtain outside capital for a larger consideration per share than is paid per share for the common stock. The one vote represented by one share

⁶⁴ Gerstenberg, *op. cit.*, p. 113.

of \$100 par value preferred stock is not much threat to common stockholders who have acquired no par value common stock for a consideration of \$5 per share, giving them twenty votes for each \$100 of consideration. At first impression, the shifting of voting control in this manner appears unfair. Yet many statutes in states other than Illinois require only that at least one class of stock shall be voting, and other classes of shares may be given no voting power whatsoever.⁶⁵ Before condemning the practice of limiting the voting strength of shares issued to obtain outside capital, it must be borne in mind that the shares issued to the outsiders generally are safeguarded by privileges, priorities and peculiar rights not possessed by the common shares. Moreover, before purchasing shares which possess only limited voting power, the prudent investor will investigate the reliability of the persons who will exercise control over the affairs of the corporation. Generally such investors are less interested in having a voice in the management than in the safeguards contained in the contract under which their preferred shares are issued.

Section 146 of the Illinois Business Corporation Act⁶⁶ suggests another method whereby control may be retained by the organizers even though they have less than fifty per cent. of the voting shares. That section reads:

Whenever, with respect to any action to be taken by the shareholders of a corporation, the articles of incorporation require the vote or concurrence of the holders of a greater proportion of the shares, or of any class or series thereof, than required by this Act with respect to such action, the provisions of the articles of incorporation shall control.

Taking this language at face value, it would appear possible to provide in the articles of incorporation that a two-thirds majority shall be necessary to elect a director and that a similar majority be required to amend the articles of incorporation. Such a provision would enable the holders of anything more than one-third of the voting stock to prevent the election of new directors, thereby

⁶⁵ See, for example, Dela. Rev. Code 1935, Ch. 65, § 2045.

⁶⁶ Ill. Rev. Stat. 1945, Ch. 32, § 157.146.

causing existing directors to continue in office.⁶⁷ The existence of the right to cumulate votes for directors⁶⁸ may limit the effectiveness of this method of minority control, but does not render it impossible.

If the organizers have voting control of the corporation at the outset, the denial of the right of pre-emption⁶⁹ will also prevent a reduction of that control unless they consent thereto, since they can do whatever is necessary to assure that new stock is not issued in such manner or in such amounts as to dilute their voting strength. But there is danger, if that control may or does pass to others, that the same denial of pre-emptive rights may result in the organizers' voting strength being further reduced by the issuance of additional voting shares to others thereby preventing the organizers from maintaining their relative voting strength.

Stock purchase options, often given with preferred stock or bonds to add to their sales appeal, may sometimes be employed by the organizers of a corporation in such a manner as to permit the organizers to increase their voting power in future periods should that become desirable.⁷⁰ Under such a plan, the corporation authorizes the issuance of stock purchase warrants to the organizers either in compensation for services, or as an additional feature of the common shares purchased. These warrants may provide that the warrant holder shall have the right, at his option, to buy at a fixed or changing price a certain amount of additional stock, authorized but not issued, for each warrant held, provided the option is exercised within a stated period of time.⁷¹

⁶⁷ Although *Benintendi v. Kenton Hotel*, 294 N. Y. 112, 60 N. E. (2d) 829 (1945), a four to three decision, indicates that a by-law requiring the unanimous vote of stockholders to elect directors would be invalid under New York law, that state has no provision comparable to Ill. Rev. Stat. 1945, Ch. 32, § 157.146.

⁶⁸ Ill. Rev. Stat. 1945, Ch. 32, § 157.28.

⁶⁹ *Ibid.*, § 157.24.

⁷⁰ The Securities Commissioners of ten states, Illinois included, have adopted a statement of policy in this regard which reads, in part, as follows: "Warrants or stock purchase options to those other than the purchasers of securities will hereafter be looked upon with great disfavor and will be considered as a basis for denial of the application except in unusual instances, and the burden shall always rest upon the applicant to justify their issuance. The number of warrants sought to be issued, the exercisable price, the term in which they are exercisable and the absence or adequacy of a step-up rate in the exercisable price will all be taken into consideration." See 131 C. C. H. Stocks and Bonds Law Service ¶ 201.

⁷¹ Gerstenberg, *op. cit.*, pp. 149-54.

The option price should be above the value of the shares at the time the warrants are given. If the business prospers and the price of the stock rises above the option price, these stock purchase warrants will have considerable value since their exercise will enable the holder to acquire additional stock at very attractive terms. But, aside from the financial gain, the organizer will be in a position to acquire additional voting power when he purchases additional stock through the exercise of the option. If all of the common stock is issued with stock purchase warrants attached and all of these warrants are exercised, the value per share of all of the common stock will be diluted so that each common shareholder will have no greater proportionate interest in profits than he had before any warrants were exercised, but the result will be to add new capital to the business as well as to create greater relative voting power in the common stock as compared with other classes of stock. The use of stock purchase warrants in the financial plan must, however, be accompanied by full disclosure thereof to all persons acquiring securities of any class, and the plan must be fair and reasonable.⁷² It should also be remembered that the existence of such warrants complicates the capital structure of the corporation, ties up a substantial amount of unissued stock, and may make it more difficult to effect additional financing in the future. Because of these and other disadvantages, the issuance thereof is advisable only when other devices cannot be employed.

Even though a financial plan has been worked out which gives majority control to the organizers of the corporation, there is always the danger that one of them may sell all or part of his stock to outside interests and thereby disrupt the scheme for control. This danger may be minimized by placing restrictions upon the right of alienation. Although the law does not look with favor on such provisions,⁷³ Illinois courts have permitted reasonable restraints on alienation since the adoption of the Uni-

⁷² See note 70, ante.

⁷³ *McNulta v. Corn Belt Bank*, 63 Ill. App. 593 (1895), affirmed in 164 Ill. 427, 45 N. E. 954 (1897), and *Finch v. Macoupin Telephone and Telegraph Co.*, 146 Ill. App. 158 (1908), illustrate the older view.

form Stock Transfer Act,⁷⁴ so a charter provision might be held reasonable and legal which required that any stockholder who ceased to be an officer or employee of the corporation must first offer his stock for sale to the corporation or to the other shareholders before disposing of the same without restriction.⁷⁵

Where additional voting stock has been issued to interests friendly to the organizers, the organizers may often enlarge their voting control by obtaining proxies to vote the shares owned by such interests. Proxies must be "executed in writing by the shareholder or by his duly authorized attorney-in-fact,"⁷⁶ but any additional voting strength thus obtained represents nothing more than a temporary arrangement. The shareholder may terminate the authority of the proxy to vote his shares, unless the proxy be coupled with an interest, by express revocation, by giving a second proxy on a subsequent date, or by appearing at the shareholders' meeting and claiming the right to vote in person.⁷⁷ Moreover, unless otherwise expressly provided, the proxy becomes invalid eleven months after the date of its execution,⁷⁸ and an irrevocable proxy has been held to be against public policy and void.⁷⁹ If subsequent solicitation of proxies becomes necessary and is made by the corporation itself at a time when the

⁷⁴ *People v. Galskis*, 233 Ill. App. 414 (1924); *People ex rel. Malcolm v. Lake Sand Corp.*, 251 Ill. App. 499 (1929). Section 15 of the Uniform Stock Transfer Act, Ill. Rev. Stat. 1945, Ch. 32, § 430, declares that "there shall be no lien in favor of a corporation upon the shares represented by a certificate issued by such corporation and there shall be no restriction upon the transfer of shares so represented by virtue of any by-laws of such corporation, or otherwise, unless the right of the corporation to such lien or the restriction is stated upon the certificate."

⁷⁵ See Ill. Opin. Atty. Gen., 1935, No. 846, p. 278. That opinion was requested by the Secretary of State on a charter provision which required that any stockholder who ceased to be an officer or employee of the corporation had to offer this stock to the corporation for a period of ninety days at a price determined by a stated formula and if the corporation failed to purchase the stock, other shareholders should have the right to purchase at the same terms during an additional ninety days, and only after the two periods had elapsed could the shareholder dispose of his stock without restriction. While holding the restriction valid, the opinion pointed out that it could apply only to shares represented by certificates containing appropriate language and could not apply to shares previously issued without the restrictive language as the right of alienation could not be restricted without the shareholder's consent.

⁷⁶ Ill. Rev. Stat. 1945, Ch. 32, § 157.28.

⁷⁷ Attempts to limit the right to vote by proxy have been rejected: *People ex rel. Snapp v. Younger*, 238 Ill. App. 502 (1925). See also *Fletcher, Cyc. Corp.*, Perm. Ed., Vol. 5, § 2062.

⁷⁸ Ill. Rev. Stat. 1945, Ch. 32, § 157.28.

⁷⁹ *Laughlin v. Johnson*, 230 Ill. App. 25 (1923).

corporation's securities are registered on a securities exchange, the corporation must also send out any proxy forms which a stockholder may submit for that purpose provided he agrees to defray the expense.⁸⁰

The device of the voting trust provides still another method for protecting control. Under it, certain shareholders who own all or a majority of the common stock enter into a trust agreement pursuant to which they transfer the legal title to their shares to a trustee, or trustees, and take back voting trust certificates. Dividends received by the trust are distributed to the holders of these certificates in proportion to their contribution of stock to the trust. The trustees, generally constituting the existing management of the corporation, vote the stock held by the trust after the same has been transferred into the names of the trustees on the books of the corporation. Although the voting trust certificates are generally freely transferable, the transferee takes the certificate subject to the provisions of the trust agreement.⁸¹ This device is useful as it prevents potential change in management in the event of the transfer of voting stock to new owners while at the same time permitting the accumulation of the voting strength of scattered small holdings of stock which might not be voted at all if such holdings were not brought into the trust. There are limitations upon its use, however, for voting trust certificates are classed as "securities" in the federal Securities Act of 1933,⁸² and if either the certificates or the stock deposited in the trust is listed on a securities exchange, the certificates are also subject to the provisions of the federal Securities Exchange Act of 1934.⁸³

The Illinois Business Corporation Act has no provision limiting the use of voting trusts and voting agreements.⁸⁴ The present legal status of such arrangements is left in some doubt by the opinions of the Illinois courts, but it is quite apparent

⁸⁰ 15 U. S. C. A. § 78n; 2 C. C. H. Fed. Securities Law Service ¶ 25,606.

⁸¹ Fletcher, Cyc. Corp., Perm. Ed., Vol. 5, §§ 2075-95.

⁸² 15 U. S. C. A. § 77b(1).

⁸³ *Ibid.*, § 78c(10).

⁸⁴ Ill. Bus. Corp. Act Anno. (The Foundation Press, Inc., Chicago, 1934), pp. 125-7.

that the trend of judicial opinion in Illinois is toward a more liberal viewpoint.⁸⁵ The most strict interpretation is that given in *Luthy v. Ream*⁸⁶ where it was held that the beneficial owners in whom legal title to the shares had once become vested could not surrender their legal title to a trustee so as to give him the absolute power to vote the stock independently of any control by them, for then the trust would be invalid as amounting to an irrevocable proxy not coupled with an interest and violative of Article XI of the Illinois Constitution. There are decisions, both before⁸⁷ and after⁸⁸ the decision in *Luthy v. Ream*, which would appear to limit the application of the rule expressed in that case, and one court has even suggested⁸⁹ that the holding therein has been overruled by the decision in *Babcock v. Chicago Railways Company*.⁹⁰

One thing is evident and that is that the facts of each case will have much to do with how strictly the Illinois courts will limit the use of voting trusts. Where, because of reorganization or otherwise, the shares are issued directly to the trustee without first vesting in the persons having the beneficial interest, the voting trust may be held valid even though the trustee has absolute discretion in voting the stock without any control by the beneficial owners.⁹¹ Where the voting trust is a pooling arrangement under which the trustee must vote all of the shares as a unit as directed by a majority of the beneficial owners, the trust is not bad since the mutual promises by the beneficial owners to permit their shares to be voted according to the wishes of the

⁸⁵ See note in 3 U. of Chi. L. Rev. 640 (1936).

⁸⁶ 270 Ill. 170, 110 N. E. 373, Ann. Cas. 1917B 368 (1915).

⁸⁷ *Venner v. Chicago City Ry. Co.*, 258 Ill. 523, 101 N. E. 949 (1913); *Faulds v. Yates*, 57 Ill. 416, 11 Am. Rep. 24 (1870); *Gray v. Bloomington & Normal Ry.*, 120 Ill. App. 159 (1905).

⁸⁸ *Babcock v. Chicago Ry. Co.*, 325 Ill. 16, 155 N. E. 773 (1927); *Thompson v. J. D. Thompson Carnation Co.*, 279 Ill. 54, 116 N. E. 648, Ann. Cas. 1917E 591 (1917); *Kann v. Rosset*, 307 Ill. App. 153, 30 N. E. (2d) 204 (1940); *Boyle v. John M. Smyth Co.*, 248 Ill. App. 57 (1928); *Fitzgerald v. Christy*, 242 Ill. App. 343 (1926). *Gumbiner v. Alden Inn*, 389 Ill. 273, 59 N. E. (2d) 648 (1945), involved a voting trust of shares in a Delaware corporation.

⁸⁹ *Boyle v. John M. Smyth Co.*, 248 Ill. App. 57 (1928), at p. 82.

⁹⁰ 325 Ill. 16, 155 N. E. 773 (1927).

⁹¹ *Babcock v. Chicago Ry. Co.*, 325 Ill. 16, 155 N. E. 773 (1927).

majority constitutes sufficient consideration.⁹² For the voting trust to be irrevocable, or irrevocable for a fixed period of time, the trustee's voting right must be coupled with an interest in the stock itself.⁹³ Agreements among all stockholders of closed corporations are likely to receive more liberal recognition than those of corporations whose stock is widely held.⁹⁴ Where only a majority of the stockholders make an agreement for the election of directors, such agreements have been held enforceable.⁹⁵

The most liberal view of voting agreements in Illinois appears to be that expressed by the Appellate Court in the case of *Boyle v. John M. Smyth Company*⁹⁶ where the court held enforceable an agreement among five stockholders holding a majority of the stock under which they assigned the stock to themselves as trustees and took non-transferable receipts which could be sold only to parties to the agreement and subject to its terms. Dividends were to be paid to the receipt holders. The trust agreement was to continue in force for twenty years and was to bind the successors, heirs, and assigns of the parties. The heirs of one of the parties were denied the right to withdraw stock from the trust. If any comprehensive conclusion may be taken from the decisions on voting trusts and agreements, it is that the validity thereof largely depends upon the peculiar facts of each case and that in deciding whether a particular arrangement is valid or invalid the primary factors to be taken into account are (1) the existence

⁹² *Venner v. Chicago City Ry. Co.*, 258 Ill. 523, 101 N. E. 949 (1913); *Faulds v. Yates*, 57 Ill. 416, 11 Am. Rep. 24 (1870); *Gray v. Bloomington & Normal Ry.*, 120 Ill. App. 159 (1905). See also note in 3 U. of Chi. L. Rev. 640 (1936).

⁹³ *Babcock v. Chicago Ry. Co.*, 325 Ill. 16, 155 N. E. 773 (1927).

⁹⁴ *Hladovec v. Paul*, 222 Ill. 254, 78 N. E. 619 (1906); *People ex rel. Rudaitis v. Galskis*, 233 Ill. App. 414 (1924).

⁹⁵ *Thompson v. J. D. Thompson Carnation Co.*, 279 Ill. 54, 116 N. E. 648, Ann. Cas. 1917E 591 (1917).

⁹⁶ 248 Ill. App. 57 (1928). Cook on Corporations, 5th Ed., Vol. 2, § 622f, states: "The above decisions seem to lead to the conclusion that a deposit of certificates of stock with trustees for a specified period of time, either with or without a transfer of the same to the trustees, is legal, and is not in violation of the usual statute against restraints on the alienation of personal property; and is not opposed to public policy as a restraint upon trade; and is not an implied fraud upon stockholders who are not allowed to participate; and is not an illegal separation of the voting power from the ownership of the stock; provided always that no actual fraud is involved in the transaction. In other words, such a pooling of stock is not illegal in itself, but, like all contracts, may be illegal if actual fraud is involved."

of consideration for the surrender of the voting power; (2) the coupling of the voting power with an interest in the stock itself; and (3) the absence of fraud or of an illegal or improper purpose.

C. ECONOMY IN ACQUIRING INITIAL CAPITAL.

After an estimate has been made of the amount of initial capital which will be required by the new enterprise to cover promotion and organization expenses, the acquisition of the fixed plant and equipment, adequate working capital for inventories and receivables, and a liberal provision for contingencies,⁹⁷ a decision must be made as to how the money can be raised most economically. While this is primarily a matter of business decision rather than a legal question, there are certain matters in this connection which are the lawyer's responsibility.

If the issue offered to the public is less than \$300,000, or if the securities are to be sold only to residents of the state of incorporation and where the corporation does business, the issue need not be formally registered with the Securities and Exchange Commission.⁹⁸ If the number of persons who are to subscribe the capital does not exceed twenty-five, or if the total amount of capital to be raised does not exceed \$25,000 and the sale of the securities is to be effected without expense or the payment of commissions, compliance with the Illinois Securities Law for the pre-incorporation sale of securities will be unnecessary.⁹⁹ These registration requirements should be kept in mind by the lawyer at all times for, if it is possible to effect the financing without registering the securities, a substantial saving in the cost of acquiring the capital will usually result.¹⁰⁰

It should also be remembered that credit securities such as bonds, notes, and other debtor obligations, are less expensive to float, as a rule, than are equity securities like preferred and com-

⁹⁷ See Gerstenberg, *op. cit.*, pp. 11-41.

⁹⁸ 15 U. S. C. A. § 77c.

⁹⁹ Ill. Rev. Stat. 1945, Ch. 121½, § 99.

¹⁰⁰ See Securities and Exchange Commission, Statistical Series, Release No. 744, entitled "Cost of Floatation of Equity Securities by Small Companies."

mon stocks.¹⁰¹ This fact is due, in part, to the larger denomination and price per unit, the smaller risk to the underwriter, and the greater salability of large blocks of credit securities as compared with stocks. Consideration of the condition of the capital market at the time the securities are to be sold and the cost and manner of distribution of such securities are business matters and are not generally the responsibility of the lawyer.¹⁰² The organizers may need to be warned on these points, however, or they may defeat one of their basic purposes if the cost of acquiring capital comes too high.

D. FLEXIBILITY IN CAPITAL STRUCTURE.

One writer on the subject of the financial organization of a business has stated:

When a company is about to issue securities, it ought to consider, before it selects the form of securities to be issued, the effect of the proposed securities not only on the company and its credit at the moment of issue, but on the value of other securities, on the possibility of issuing other securities in the future, on the availability of future earnings for dividends to keep up the company's investment credit position, and on the possibility of rearranging the financial structure of the company in the future.¹⁰³

The lawyer's responsibility with respect to securing flexibility in the capital structure is, therefore, largely one of negatives.

He should discourage the placing of unnecessarily restrictive provisions in the contracts of the initial securities which may prevent subsequent issues. A provision in a bond or note indenture whereby future borrowing must be done with securities junior to those outstanding may prevent raising capital at a time when new capital is essential to save the enterprise from financial ruin.

¹⁰¹ Securities and Exchange Commission, Statistical Series, Release No. 13. A summary thereof is contained in Gerstenberg, *op. cit.*, p. 371.

¹⁰² An excellent discussion of these points is contained in Gerstenberg, *op. cit.*, Ch. XX, XXI, and XXII.

¹⁰³ Gerstenberg, *op. cit.*, p. 334.

A provision sharply restricting the payment of dividends on stock issues so long as the credit securities are outstanding may prevent the sale of new stock at a time when that would be the most beneficial method of raising capital.

He should avoid creating a complicated capital structure,¹⁰⁴ for prospective purchasers will shy away from the purchase on new securities when it is necessary to analyze in detail the rights the new securities will have in relation to several outstanding issues of securities. If the business is of a type which may have sudden need for new capital, he should negative the pre-emptive right of the initial issues of stock¹⁰⁵ so that additional stock may be sold without the delay occasioned by having first to solicit the existing stockholders. He should secure authorization in the original articles of incorporation for so much stock in addition to that which is to be sold initially as will meet the probable needs of new stock financing in the early period of operation,¹⁰⁶ or he should provide for simple and speedy authorization of additional stock by amendment of the articles.¹⁰⁷ If long term debt or preferred stock is to be issued upon organization, it is usually desirable to provide that such securities may be redeemed at the option of the corporation¹⁰⁸ so as to permit refinancing on more favorable terms, or retirement if the business experience of the company renders that expedient.

Beyond these simple observations it is scarcely necessary to go. The lawyer, like the organizer, must use his common sense to avoid creating a capital structure which, though adapted to the immediate needs, overlooks the fact that the business enterprise is not static but constantly changing. If the company encounters bad times, there must be room in the capital structure to add a new type of security which provides every safety feature which the company can marshal; if the company is successful beyond expectation, there must be room to obtain the additional

¹⁰⁴ *Ibid.*, p. 335.

¹⁰⁵ Ill. Rev. Stat. 1945, Ch. 32, § 157.24.

¹⁰⁶ *Ibid.*, Ch. 32, § 157.47, particularly subsections (f) and (i).

¹⁰⁷ *Ibid.*, § 157.52 (d).

¹⁰⁸ *Ibid.*, § 157.14 (a).

capital for its expanding business by offering such type of new securities as may be most advantageous to the company and its owners.

III. CONCLUSIONS.

The lawyer whose advice is sought as to the formation of the capital structure of a new corporation must know more than what is legal and what is not. He must also understand enough of corporate finance to advise his clients as to what is desirable among the devices legally available. He must know enough of tax law to be able to avoid undue tax burdens on the new enterprise. He must have at least an over-all understanding of the application of the federal and state securities laws. He must know how to avoid, insofar as possible, the special burdens which affect the corporate form of organization. He must know how best legally to arrange the capital structure so as to achieve the business purposes of his clients.

He should recognize that the provisions of the Illinois Business Corporation Act are more procedural than substantive and therefore see that most legitimate ends can be attained under its provisions, although the methods to be followed in attaining those results may be limited. In contrast, he should note that the provisions of the Illinois Securities Law, and of the federal laws regarding securities, are more sharply restrictive of substance as well as procedure. While the discretion given to administrative agencies under such securities legislation permits each case to be dealt with more or less individually within the framework of the legislation itself, these laws are designed primarily to prevent fraud on the security purchaser, and to shift the emphasis from *caveat emptor* to *caveat vendor*.

He should shape the corporate capital structure so as to preserve to his clients as much of the profit and control of the business as is legitimately practicable yet so arrange it that outside capital may be obtained economically in the first instance and without unnecessary difficulty if required in later phases of the corporation's existence. He should be alert to tax savings

arising from the issuance of credit securities rather than preferred or common stock, but should avoid burdening the new enterprise with heavy fixed charges in its early years of operation. Even if the organizers are to supply all of the capital, he should recognize the substantial tax savings that can be effected by issuing a combination of stock and notes in exchange for such capital. He should observe the wisdom, if outside capital is obtained, to make the securities issued redeemable at the option of the corporation or at least deny the right of pre-emption.

He should not overlook the question of voting control although, in large corporations whose shares are to be widely distributed, he may recognize the possibilities inherent in minority control by a strongly-organized minority group. Despite the fact that the Illinois law requires that all classes of stock be voting stock, he should understand how it is possible for the majority of voting strength to be held by those who have invested less than a majority of the capital. He should not be unaware of the fact that the law permits reasonable restraints on the alienation of stock and, by the judicious use of such restraints, sanctions the preservation of control against the risk of sale to an outsider. He might even toy with the thought of a voting trust or a voting agreement, for while their status, under Illinois decisions, is not clearly defined they may be used to effect voting control under certain conditions.

Above all, he should endeavor to arrange a capital structure for the new corporation that is as simple as possible, while exercising due care to save his clients from the delay and expense of registration under the state and federal securities legislation if the particular situation permits financing to be effected in such a manner as to be exempt from such requirements. Within these limits, his competent advice may well be the distinguishing factor between success and failure for the new enterprise.