MAINTAINING CORPORATE CONTROL: A COMMENT
(On Carlson v. Ringgold County Mutual Telephone Company)

EDWARD R. HAYES*

Recent years have seen a number of battles over corporate control, in mammoth enterprises such as Montgomery Ward and New York Central, and in small ones as well. Often these battles result in court decisions plowing virgin fields in the acres of corporate law. One such recent decision, in Iowa,[1] which has cleared some areas but perhaps created problems in others, is the basis for this comment.

The Ringgold County Mutual Telephone Company, organized in 1917 (and renewed in 1937 and 1957),[2] had successfully operated a telephone exchange in Mt. Ayr, Iowa, for a number of years. Plaintiffs, in the business of purchasing, reorganizing, combining and operating telephone exchanges in Iowa, Illinois, and Kentucky, became interested in Ringgold. They made an offer to the directors of $100 per share for its stock, which was refused; then, after further study of the situation, through letters, advertisements and other means they offered $200 per share for any outstanding shares. Soon plaintiffs acquired 203 of the 356 outstanding shares. At this point, with loss of control a possibility, the directors at a special meeting authorized the sale of up to 644 shares (1,000 were authorized for issue in the articles) to such persons as they might approve, subject to first option to the corporation, for $40 per share. At that price, before plaintiffs could obtain an injunction, 225 shares were sold to families, relatives, and friends of the directors and to company employees, with retention of control an important objective. Sixty-two of these shares may have been treasury stock. When plaintiffs learned of these sales, they notified the company that they would exercise their preemptive rights in this opportunity. The directors took the position that plaintiffs had no preemptive rights, and also refused to transfer to plaintiffs the 203 shares already purchased, on the basis of a by-law. Plaintiffs obtained a temporary injunction against further sales and brought action to enjoin the new issues without granting them preemptive rights and to compel transfer to them of the shares previously purchased by them. The trial court held for plaintiffs, and defendants, the corporation, its officers and directors, appealed.

---

*Professor of Law, Drake University Law School.

[1] Carlson v. Ringgold County Mut. Tel. Co., 108 N.W.2d 478 (Iowa 1961).

[2] Under IOWA CODE § 491.24, and its predecessors which date back to 1851, Iowa business corporations could incorporate until recently only for a period of twenty years, but could renew corporate existence for additional twenty-year periods. In 1943 it become possible to provide for perpetual existence as well, but the Ringgold Company seems not to have done this. See Hayes, *Iowa Incorporation Practices—A Study: Introduction and Part I*, 39 IOWA L. REV. 409, 425-26 (1954). Renewal usually involves the filing of articles again, often referred to as "amended and substituted articles." The Company had been intended to operate as a mutual organization, and the original articles had provided that no more than five shares could be owned or controlled by one person, but this seems to have been abandoned in later sets of articles. All three sets provided that no stockholder was to have more than one vote in corporate affairs. Appellants' Brief and Argument 7. Apparently this became interpreted as one vote per share, for nowhere in the trial court's opinion or in Appellants' Brief is the argument made that plaintiffs would be entitled to no more than one vote regardless of the number of shares they might acquire.

Defendants contended the issues were whether preemptive rights should be allowed in connection with sales of authorized but unissued stock or of treasury stock, unless required by charter; whether Ringgold's charter provided for preemptive rights only in connection with increases of authorized capital and issuing of shares from the increase; whether the directors' consent to transfer of shares was required, before plaintiffs could become shareholders, because of the corporate by-laws; and whether plaintiffs had clean hands. Plaintiffs viewed the issues somewhat differently. They argued that any time stock was issued, whether treasury stock, originally authorized but unissued, or newly authorized, Ringgold's charter required recognition of preemptive rights; that preemptive rights could be recognized in authorized unissued shares; that the particular restriction on transfer here, appearing in the by-laws, was invalid as unreasonable and because not stated on the share certificates; and that the issuing of stock by defendants to themselves and their friends was a breach of fiduciary duty. They also contended that they had acted properly, and that some of the so-called "treasury stock" was cancelled and could not be treated as such. For several of these propositions there was little if any Iowa case precedent, and little from other jurisdictions.

The Court, affirming, held plaintiffs were entitled to preemptive rights in the previously unissued stock, that part of the "treasury stock" had been retired, and that the balance could not be sold in the manner attempted here, that the articles required use of preemptive rights any time a share was sold by the company, that the by-law restricting transfer was invalid, and that plaintiffs were entitled to equitable relief. The Court's resolution of the various issues clarifies some aspects of the Iowa law on preemptive rights, but it could have settled other points of corporate law which it did not, and in some respects it may have muddied the waters.

PREEMPTIVE RIGHTS — AUTHORIZED BUT UNISSUED SHARES; TREASURY SHARES

The preemptive rights doctrine is used to protect shareholders against issuance of stock to favored persons, so as to manipulate corporate control, and also against issuance at inadequate prices to benefit favored persons. Whether the "right" is a common-law one, or simply an equitable remedy, has been the subject of some dispute;[3] in either event the ease with which it can be circumvented and the many exceptions which are applied make it frequently of little significance. Its prime value is to the shareholder in the closely held corporation.[4]

---

[3] Stating or implying that the right is a common-law one are: BALLANTINE, CORPORATIONS § 209 (Rev. ed. 1946); 1 O'NEAL, CLOSE CORPORATIONS § 3.39 (1958); and Frey, *Shareholders' Pre-emptive Rights*, 38 YALE L. J. 563 (1929). Referring to it as equitable in nature are: LATTIN, CORPORATIONS 424 (1959); and Drinker, *The Preemptive Right of Shareholders to Subscribe to New Shares*, 43 HARV. L. REV. 586 (1930). STEVENS, CORPORATIONS § 111 (2d ed. 1949), is noncommital. The Iowa Court had previously dealt with this "right" in two cases, Gord v. Iowana Farms Milk Co., 245 Iowa 1, 60 N.W.2d 820 (1953); and Schmidt v. Pritchard, 135 Iowa 240, 112 N.W. 801 (1907). The *Schmidt* case refers to the right as one allowed by law, which is protected through equitable relief, and *Gord* seems to accept this view.

The texts referred to in this footnote are cited in subsequent footnotes as BALLANTINE, LATTIN, O'NEAL and STEVENS.

[4] Courts often refer to the preemptive right as protecting a shareholder against dilution of his voting power and his dividend participation. Professor Berle once in-

Two commonly stated exceptions have been that there are no preemptive rights in connection with new issues of originally or previously authorized shares, or in connection with sales of treasury shares.[5] Appellants cited *Corpus Juris Secundum* and ten cases to the Court as supporting the first exception,[6] and eight cases including one from Iowa plus several secondary sources as supporting the second.[7] Appellees cited *Corpus Juris Secundum* and one case against application of the first exception to the facts in this case.[8]

The Court's opinion, dealing with the "originally authorized" exception, says merely:

> The cases relied upon by defendants in support of their argument that there are no preemptive rights in connection with an originally authorized issue are not factually comparable to the situation here and do not disclose any situations where additional stock is issued and sold for one-fifth of the market value of outstanding stock.[9]

Actually, most of the cases cited by appellants do not support their position that preemptive rights are inapplicable to any subsequent issue of originally authorized stock.[10] It is now well accepted that preemptive

---

dicated to a Corporation Law class at Columbia that the right's main value was to assure an investor in a corporation that he, rather than outsiders, would be allowed to make further investments therein when bargain opportunities were available. As most of the writers referred to in note 3, *supra*, indicate, the complex structures and widely spread holdings in most large corporations make use of preemptive rights by them difficult to handle. In the case of the closely held corporation, with a simple capital structure, the right's main value is its protection of shareholders against dilution of their interest.

[5] See BALLANTINE § 209; LATTIN 426; STEVENS § 111; Drinker, *op. cit. supra*, note 3, 601-09.

[6] Yasik v. Wachtel, 23 Del. Ch. 247, 17 A.2d 309, 40 MICH. L. REV. 115 (1941); Hartridge v. Rockwell, R. M. Charlton 260, 1 Ga. Rep. Anno. 209 (1828); Dunlay v. Avenue M Garage & Repair Co., 253 N.Y. 274, 170 N.E. 917 (1930); Archer v. Hesse, 164 App. Div. 493, 150 N.Y. Supp. 296 (1st Dept. 1914); Russell v. American Gas & Elec. Co., 152 App. Div. 136, 136 N.Y. Supp. 602 (1st Dept. 1912); Cross v. Farmers Elevator Co., 31 N.D. 116, 153 N.W. 279 (1915); Sims v. Street R.R. Co., 37 Ohio St. 556 (1882); Curry v. Scott, 54 Pa. 270 (1867); Bonnett v. First Nat'l Bank, 24 Tex. Civ. App. 613, 60 S.W. 325 (1900); Harris v. Sumner, 39 New Bruns. 204, 8 Can. Abridg. 918 (1909); and 18 C.J.S. *Corporations* § 268 (1939). See discussion of these cases in note 10, *infra*.

[7] State *ex rel.* Weede v. Bechtel, 244 Iowa 785, 56 N.W.2d 173 (1953); Borg v. International Silver Co., 11 F.2d 147 (2d Cir. 1925); Crosby v. Stratton, 17 Colo. App. 212, 68 Pac. 130 (1902); Hartridge v. Rockwell, *supra*, note 6; Maynard v. Doe Run Lead Co., 305 Mo. 356, 265 S.W. 94 (1924); Archer v. Hesse, *supra*, note 6; Bonnet v. First Nat'l Bank, *supra*, note 6; State *ex rel.* Page v. Smith, 48 Vt. 266 (1876); COOK, STOCK AND STOCKHOLDERS AND CORPORATION LAW 317-18 (2d ed. 1889); Morawetz, *The Preemptive Right of Shareholders*, 42 HARV. L. REV. 186, 197 (1928); 13 AM. JUR. *Corporations* § 189 (1938); 18 C.J.S. *Corporations* § 201D (1939); and 14 C.J.S. 396 § 524. The last citation seems to be a misprint, because the quotation on page 93 of Appellants' Brief and Argument which is supposed to come from that source does not do so, and there is nothing relevant to the problem on page 396 of 14 C.J.S. See discussion of cases in note 12, *infra*.

[8] Crosby v. Stratton, *supra*, note 7; 18 C.J.S. *Corporations* § 201 (1939). See discussion in note 10, *infra*.

[9] 108 N.W.2d 478, at 483 (1961).

[10] The cases referred to are cited in note 6, *supra*. The C.J.S. reference is to a section on "Power to Increase or Reduce Capital Stock", and says merely that the issuance of additional stock where the full original authorization has not been issued previously is not "an increase"—the section does not refer to preemptive rights. In appellants' argument is a reference to 18 C.J.S. *Corporations* § 201, which says that existing shareholders have been allowed preemptive rights in originally authorized shares, but the rule is not universally recognized without qualification. This supports appellees' position.

rights are applicable to subsequent issues when the original authorization was large and there was no present intent to sell all of it immediately or within a reasonable period of time after incorporation, or when conditions

---

Hartridge, the oldest case, denied preemptive rights in treasury stock and did not involve authorized unissued. The only possible relation to the latter problem is a quotation, appearing at page 43 of Appellants' Brief, which to me is taken out of context.

Curry v. Scott is the oldest case usually cited to support appellants' position, but is weak authority. There the objector, contesting an election lost by his faction because of the issue to outsiders, never demanded he be given his pro rata shares; he claimed fraud in the issuing but the court found none; it was sold for par; and the court did say untaken stock can't be disposed of unequally to the "corporators" but must be used for the benefit of all.

Sims is primarily concerned with the power of a street railroad corporation to extend its line; plaintiff, the objecting shareholder, owned a major interest in a rival road that would be adversely affected by the extension; the stock was sold, at par, when worth less on the market, to get funds for the extension; plaintiff really was trying to prevent any issue at all, and did not offer to buy a pro rata portion of the issue.

Bonnet involved an attempt to assert a preemptive right in an increase of stock, used to effect a merger. The court, 60 S.W. at 326, said the general rule was that there was a preemptive right when capital stock was increased by issue of new shares, though not so if for property, and "the general rule applies only when the capital is actually increased, and not to a *reissue* of any portion of the original stock." [Italics supplied.]

Russell, the first New York case, was brought by a preferred shareholder objecting to issue of authorized common, at par, pro rata to existing *common* shareholders. The court held he had no right in the common, and, citing *Curry*, said that it was doubtful whether absent bad faith there was any preemptive right in authorized, unissued; but it affirmed a judgment conditioned on giving plaintiff the right to acquire a comparable number of preferred shares. This case wsa followed shortly by *Archer*, which started as a shareholder's action to cancel 197 shares improperly issued. After the decree ordering cancellation was entered, these shares were surrendered to the corporation, and 55 were promptly reissued to two attorneys for defendants, in payment for their services. The plaintiff then attacked this issue as in contempt of the decree, and most of the opinion involves the "contempt" issue. The court did say preemptive rights were needed only where capital stock was increased and the new shares were issued for money, but not for property or merger; and the authorized shares here had been used for a legitimate purpose. The New York rule, based on this case, was for some time assumed to be as appellants urge; but the *Dunlay* case removed this assumption. It criticized the *Archer* statement mentioned above as "too loosely" made, and indicated that where authorized shares were reserved for future expansion rather than immediate business needs, preemptive rights would be applicable. The case sustained an issue made without preemptive rights because it was reasonably necessary to pay debts arising from the corporate business. This view of Dunlay has been generally accepted. BALLANTINE 489; LATTIN 426; STEVENS 510; 40 MICH. L. REV. 115, 117 (1941). It is the view accepted by the trial court in this case. Record 584.

Cross was an action by a promoter who, in the process of secretly acquiring control in violation of a by-law, discovered that the sale at par of authorized unissued prevented his achieving his objective. When he tried to have the newly issued shares cancelled (he did not try to buy a pro rata share), the court held that he did not have clean hands, and that state law required all authorized stock to be subscribed for. Appellants' Brief, at 44-45, quotes a portion of the opinion in which the court said that maybe there is a preemptive right in treasury stock, but it knew of no case holding that one purchasing a majority of the stock before it was fully subscribed had a vested interest in control and could prevent sale of the balance—public policy of full subscription is of considerable significance in this case.

Yasik, the most recent case, contains a comment quoted in Appellants' Brief at 40, to the effect that the preemptive right in authorized unissued does not apply until the original issue or offering has been terminated, but does apply thereafter; the court found that the corporation had been in need of capital and continually was offering its stock so that the original offering had not been terminated. Part of appellants' argument in *Ringgold* was that that corporation had never closed its

materially changed and there was a substantial lapse of time between the prior and the subsequent issues.[11] Apparently the Court will follow this approach to the "authorized-unissued" exception.

The Court neither accepted nor rejected appellants' argument that treasury shares can be sold free from preemptive rights, absent contra provisions in the articles.[12] Its agreement with the trial court that twenty-four of the sixty-two shares in question had been cancelled and were not treasury stock made the sale of treasury shares immaterial insofar as corporate control here was concerned. What the Court did hold is this. "Even treasury stock held for resale should not be sold at a price destructive of the value of other stock."[13] This may imply that the Court's only objection to sale of treasury shares to directors and friends, in order to maintain

---

books on the original offering, so that it was still open, but there was no evidence of active use of stock sales (or sales other than of treasury shares, in recent years), or of need for substantial capital increase.

The *Canadian Abridgement* reference to the *Harris* case does not make it clear whether that case turned primarily on violation of fiduciary duty arguments or on preemptive rights, although it is cited in 40 MICH. L. REV. 115 for the same point as appellants cite it. At any rate, as the theory of preemptive rights originated in the United States, it is not clear to what extent a Canadian decision would be in point.

[11] In addition to the case so indicating, referred to in note 10, *supra*, see Ross Transport, Inc. v. Crothers, 185 Md. 573, 45 A.2d 267 (1946), decided on breach of fiduciary duty grounds but suggesting that preemptive rights would be applicable to authorized unissued shares. See also: BALLANTINE 489 (listing three additional cases in which the exception was held inapplicable); LATTIN 426; STEVENS 509-10; Drinker, *op. cit., supra*, note 3, 602; and 13 AM. JUR. *Corporations* § 189 (1938), which appellants cite for its position on preemptive rights on treasury stock.

[12] The cases referred to are cited in note 7, *supra*. The *Weede* case was concerned with the fees to which plaintiffs' attorneys' were entitled as the result of their obtaining cancellation of 39,468 shares improperly issued. In considering benefit of their services to the corporation the Court asked whether treating the returned stock as treasury stock or authorized unissued made any difference, and decided it did not. In the process the Court made some comments about the status of treasury stock, but nothing is said about the applicability or nonapplicability of preemptive rights. 244 Iowa at 824, 56 N.W.2d at 194.

Most of the remaining cases and materials cited by appellants agree with their position. This clearly includes: *Borg, Crosby, Hartridge* (see note 10, *supra*), and *State* ex rel. *Page. Bonnet*, discussed in note 10, *supra*, is not on point, but does have a passing reference which can be read in appellants' favor. *Archer* agrees, but must be read in the light of *Dunlay* (see note 10, *supra*). In all these cases there seem to have been corporate needs for the funds obtained by the issue, and little indication of unfairness. *Maynard v. Doe Run Lead Co.* refused to compel the corporation to issue to petitioner the shares he sought, but these were his proportion of the treasury shares which the company retained and issued to no one—he had received a pro rata portion of those treasury shares which were issued. This case does not discuss the rule appellents contend for.

The two encyclopedias support appellants, but C.J.S. points out the route by which several courts have reached a different result—they held that the shares had been retired or so held as to lose their status as "true treasury stock". Hammer v. Werner, 239 App. Div. 38, 265 N.Y. Supp. 172 (2d Dept. 1933); Dunn v. Acme Auto & Garage Co., 168 Wis. 128, 169 N.W. 297 (1918).

Several writers doubt the desirability or correctness of the claimed exemption. BALLANTINE 491 (in any event the duty of good faith and fairness on the part of the directors applies; and "directors may not issue treasury shares to themselves whether for an adequate or for an inadequate price for the purpose of manipulating the control of the corporation."). LATTIN 426; 1 O'NEAL 120; STEVENS 511; Frey, *op. cit., supra*, note 3; Drinker, *op. cit., supra*, note 3. Morawetz, *op. cit., supra*, note 7, also says there is no preemptive right in treasury stock, but there may be circumstances where an issue of treasury shares without first offering them to existing shareholders would be a breach of duty.

[13] 108 N.W.2d 478, 485 (1961).

control, is based on inadequacy of price. Some cases support appellants' proposition by arguing that proportionate voting rights were established by the original issue, and the resale of the treasury shares does not further dilute these rights.[14] The propriety of this exception is questionable, but may not have been thoroughly tested in some cases because accompanying circumstances, such as the inadequacy of price found here, made enjoining of the sale clearly appropriate.[15]

Under the new Iowa Business Corporation Act, which was not applicable to this corporation, a shareholder has preemptive rights in unissued shares except to the extent denied or limited by the articles; he has none in treasury shares unless the articles provide for such right.[16] The Act does not, by its terms, resolve the authorized-unissued situation; in view of this decision, if the articles are silent circumstances probably will determine whether existing shareholders are entitled to preemptive rights when additional shares of the original authorization are issued.

PREEMPTIVE RIGHTS—EFFECT OF THE ARTICLES

The *Ringgold* articles contained a provision which, similar in form, is found in articles of many Iowa corporations. Article III, after providing for the amount of capital stock authorized ($10,000), par value ($10), issuance only for payment in full, and issuance for consideration other than cash only subject to approval of the Executive Council of Iowa, reads as follows:

> The capital stock may be increased by vote of sixty per cent, in interest, of all stockholders, by the adaption [sic] of amendment [sic] to these articles. When the outstanding capital is increased, additional stock shall be offered to existing stockholders in proportion to their then holdings, at not less than par, . . .[17]

Appellants interpreted this provision as eliminating preemptive rights, by necessary implication, except in connection with additional authorizations of capital stock.[18] Appellees argued that the first sentence referred to increasing authorized capital stock, and the second to increasing outstanding capital stock (shares held by the shareholders), so that the articles expressly required preemptive rights in any case of sales of newly authorized stock, issues of authorized but unissued, and treasury shares.[19] A third possible interpretation would be that the second sentence applies only to the

---

[14] Borg v. International Silver Co., 11 F.2d 147 (2d Cir. 1925); Crosby v. Stratton, 17 Colo. App. 212, 68 Pac. 130 (1902).

[15] See STEVENS 511; Drinker, *op. cit., supra,* note 3. BALLANTINE 491, and LATTIN 427, say the exception is based on supposed practical grounds, but Lattin doubts that the courts have thoroughly examined their assumptions. 1 O'NEAL 120 says preemptive rights must be made applicable to treasury shares of close corporations.

[16] Iowa Laws c. 321, § 25 (1959), IOWA CODE ANN. § 496A.25 (Supp. 1961).

[17] 108 N.W.2d 478, 482 (1961); Appellants' Brief and Argument 5-6.

[18] Appellants' Brief and Argument 47-65. Appellants substitute "authorized" for "outstanding". They support this shift, in part, by reference to a by-law that "all unsold stock shall be held by the corporation subject to disposal by the board of directors", and by evidence that the article was discussed at the time of reincorporation in 1957 and stockholders were advised at the meeting that it applied only to new authorizations. The Court applied the parol evidence rule to ignore this testimony, on the theory there was no ambiguity as to the meaning of "capital"!!! 108 N.W.2d 478, 484.

[19] Appellees' Brief and Argument 28-58.

situation involved in the first sentence, increases in authorized capital, but does not limit other situations. Reaching the result desired by appellees, the Court used still another interpretation. It reasoned that "capital" in the second sentence meant the corporate property, rather than the equivalent of "capital stock" in the first sentence, and therefore that under this provision any time the corporation acquires additional assets in exchange for stock existing shareholders have preemptive rights.

Both appellants and appellees assumed that "outstanding capital" meant "outstanding capital stock".[20] The Court's construction is based upon an unrelated comment in one Iowa case to the effect that capital may be synonymous with capital stock or may be broader,[21] and upon two citations from *Words and Phrases*.[22] One citation, to the effect that "The 'capital' of a corporation is its property, while the 'capital stock' of the corporation represents the interest of stockholders in the corporation, and is their property," is derived from *Shepard v. State*,[23] which involved the question whether Wisconsin could impose inheritance tax upon a New Jersey resident owning shares of a New York corporation simply because the company owned property in Wisconsin. On the next page in *Words and Phrases* are several references to the use of "capital" and "capital stock" as synonymous, although more frequently to mean property received by the corporation than stock issued. Indeed, many times the term "capital stock" is given the same meaning that the Iowa Court here attributed to "capital".[24] The other *Words and Phrases* citation is based upon a Texas case involving an attempt to enforce a note given to purchase shares, held invalid because of a state constitutional provision forbidding issuance of stock except for money, labor, or property.[25] The Court cites nothing to indicate why "capital", in the context used in the *Ringgold* articles, should be treated as having a meaning different from "capital stock", or different from that which both appellants and appellees assumed it should have.[26] The trial court had made no attempt to interpret this provision, and had enjoined

---

[20] "Article III instead provides that when the outstanding capital (stock) is increased . . ." *Id.* at 31.

[21] Iowa State Sav. Bank v. City Council, 98 Iowa 737, 739, 61 N.W. 851, 852 (1895). The case involved interpretation of a statute providing that "the paid up capital of all savings banks" shall be subject to taxation.

[22] 6 WORDS AND PHRASES 65, 109 (1940).

[23] 184 Wis. 88, 197 N.W. 346 (1924).

[24] Also derived from the same page in WORDS AND PHRASES is the Court's statement that " 'Capital' may be either real or personal property, but 'capital stock' is always personal." 108 N.W.2d 478, 483. This just isn't so. In Randall v. Bailey, 23 N.Y.S.2d 173 (County Ct. 1940), involving the question whether corporate dividends based primarily on appreciation in value of real estate and leasehold interests violated a statute against impairment of capital, the court assumed that capital and capital stock were synonymous and both included real property.

[25] Turner v. Cattleman's Trust Co., 215 S.W. 831 (Tex. 1919).

[26] The Court also equates "outstanding capital" with "net capital invested in the business", of $68,778. Capital, in the sense of corporate assets, can be obtained by borrowing, sale of shares, or retention of earnings. As the corporation seems to have sold no more than 440 shares, and most if not all at $10 per share, nearly all this type of capital was derived from retained earnings. But Article III says: "When the outstanding capital is increased, additional stock shall be offered to existing stockholders." This increase in capital by retaining earnings was not accompanied by offering additional stock. It seems further support for the argument that "outstanding capital" as used in Article III was intended to mean "outstanding capital stock".

the entire issue on a breach of fiduciary duty theory. While there is language in the Court's opinion suggesting it may have felt there was a breach of duty, the Court does not so hold, although logically this would be more readily supportable, and would have reached the same result.

The two sentences quoted from the Articles are derived from a commonly-used form, and I suspect have been given an interpretation different from the intent of most drafters. If this interpretation is followed, it should mean that preemptive rights apply even though unissued, authorized shares are used to acquire property, or in connection with a merger, situations in which preemptive rights usually have not been recognized.[27]

BY-LAW RESTRICTION ON TRANSFERABILITY OF SHARES

Each stock certificate in *Ringgold* had on its face a statement that the shares were "transferable only as prescribed by the By-Laws of [Ringgold]."[28] Two by-laws related to transfer, the first stating insofar as relevant "Transfers of stock shall be made only on approval of the Board of directors . . . .",[29] and the second dealing with procedure to effect an approved transfer, or to obtain replacement of lost or destroyed certificates. The Articles had no reference to any restrictions on transferability. Relying on *Mason v. Mallard Telephone Company*,[30] which upheld a comparable restriction in the articles in a similar situation, appellants argued that the by-law enabled the directors to refuse to recognize plaintiffs as shareholders.[31] Plaintiffs argued,[32] and the trial court agreed,[33] that the by-law was invalid because not set out in substance on the certificate, as they felt was required by the Uniform Stock Transfer Act.[34] In addition appellees argued that there were two exceptions to the general policy of invalidating restraints on alienation of stock, one where the restraint was not unreasonable (as in the case of the typical first option), and the other in the *Mallard Telephone* case where the restraint, in the Articles, supposedly formed part of the contract between the shareholders.[35] The Iowa Court, in that case, had stated there was a distinct difference between restrictions contained in the articles and those contained in the by-laws.[36]

The Court ignored the statutory argument, and held the by-law invalid because it was neither reasonable[37] nor authorized by the articles, citing as

---

27 BALLANTINE 490; LATTIN 426; STEVENS 512. In the case of the closely held corporation, there may be situations where these exceptions should not be applicable. 1 O'NEAL 120; STEVENS 512.

28 108 N.W.2d 478, 482 (1961), sets out the form of the certificate.

29 *Ibid.*

30 213 Iowa 1076, 240 N.W. 671 (1932), discussed in Hayes, *Corporate Cake with Partnership Frosting*, 40 IOWA L. REV. 157, 164-66 (1954).

31 Appellants' Brief and Argument 66-87.

32 Appellees' Brief and Argument 69-86.

33 Record 585.

34 IOWA CODE § 493A.15 (1958). *But see:* Allen v. Biltmore Tissue Corp., 2 N.Y.2d 534, 161 N.Y.S.2d 418, 141 N.E.2d 812 (1957).

35 Appellees' Brief and Argument 58-86.

36 Mason v. Mallard Tel. Co., 213 Iowa 1076, 1083, 240 N.W. 671, 674 (1932).

37 The Court comments, 108 N.W.2d at 484, that the directors' attempt to enforce the by-law is destructive rather than protective of the rights of shareholders and is an attempt "to deny to the majority stockholders any voice in the management . . . because the suspected purpose of the present majority is offensive to the desires and ambitions of the directors." But defendants argued that the by-laws prevented

authority *Farmers' & Merchants Savings Bank of Lineville v. Wasson*,[38] *Mallard Telephone*, and *American Jurisprudence*.[39]

There is some slight judicial support for the thought that a by-law restriction on transferability, not authorized by articles, is invalid whether reasonable or not.[40] While the *Lineville Bank* case could be treated as so holding, it may also be interpreted as based on other grounds, and subsequent Iowa cases have proceded on the assumption that reasonable restrictions are enforceable even though found only in the by-laws.[41] If the Court means to say that this restriction was invalid only because it is both unreasonable and in the by-laws, and would be valid if in the articles, its position seems unsound. Many cases indicate that only a reasonable restriction on transferability will be upheld, regardless of its location in corporate documents.[42] Several commentators have felt that in *Mallard Telephone* the Court decided, with justification, that the consent restriction was reasonable.[43] And the argument, made by both appellees and the Court, that the articles constitute a contract between shareholders while the by-laws do not, flies squarely in the face of several decisions which held a by-law restraint invalid as such but valid as part of the contract between the shareholders.[44] These by-laws seem to have been adopted shortly after the corporation was first organized, and were never changed; but there is no evidence whether adoption was unanimously approved by the shareholders at that time.[45]

The Iowa Business Corporation Act provides: "If the articles of incorporation so provide, the by-laws may contain any provisions restricting the transfer of shares."[46] [Usually this will be interpreted to permit only reasonable restrictions.] Noting that this Act was not applicable to the *Ringgold* situation, the Court thought, however, it showed "legislative thinking that restrictions on transfer of stock appearing in the by-laws are effective only when specifically authorized by the articles."[47]

---

plaintiffs from *becoming* majority shareholders. The Court's comment could lead to the implication that even a first-option restriction, usually considered reasonable, would become unenforceable if the "prospective purchaser" had managed to acquire more than 50% of the shares without regard to the option restriction. This is an undesirable result. The option restriction is intended to protect shareholders against an undesirable associate, whether he proposes to acquire a small interest or a large one. *Query*—does the public utility aspect of this particular corporation have any significance to this point, or to any other involved in this case?

38 48 Iowa 336 (1878).

39 13 AM. JUR. *Corporations* 411.

40 2 O'NEAL § 7.07; BALLANTINE 337; LATTIN 339; STEVENS 601; Hayes, *op. cit., supra*, note 30, 160.

41 Hayes, *op. cit., supra*, note 30, 160-61.

42 See cases collected in texts referred to in note 40, *supra*.

43 LATTIN 340; 2 O'NEAL §7.08; BALLANTINE 776, 778-79; STEVENS 599-600.

44 BALLANTINE 779; 2 O'NEAL § 7.07.

45 The corporation's treasurer-manager testified that the by-laws had remained unchanged since adoption and were signed by the officers and directors of the company at the time of adoption. Record 381-82. Plaintiffs claimed they tried to examine the by-laws in December, 1958, while purchasing stock, but were not able to do so until after the temporary injunction was granted in January, 1959. The manager denied refusing to supply by-laws. There were only two copies, one kept in the safe and the other hung on the wall but in such a place that it was difficult, if not impossible, for a visitor in the office to observe them and learn their contents. 108 N.W.2d 478, 481 (1961); Record 293, 309, 321, 341, 391-97, 412-13.

46 Iowa Laws c. 321, § 26 (1959); IOWA CODE ANN. § 496A.26 (Supp. 1961).

47 108 N.W.2d 478, 485 (1961).

The Court's decision, especially in view of the way the issues were framed, leaves in doubt the effect of an unreasonable restriction appearing in the articles, and also the effect of any reasonable restriction which is referred to in the stock certificates by such language as "transferable only as prescribed in the articles [or by-laws]", but is not described in substance on the certificate.

OTHER ISSUES

As noted, the Court's handling of the possible breach of fiduciary duty by appellants is rather indirect. It is clear, however, that the Court felt the issue of shares at $40, to favored purchasers, when outstanding shares were selling for $200, was not proper conduct under the circumstances involved here.[48] There is no indication whether the Court would consider that monetary relief for such conduct belongs to the corporation or to the objecting stockholders.

Appellants tried to characterize themselves as the protectors of the local corporation and residents against outside raiders who intended to take control, raise rates, subvert the purpose of the corporation as essentially a local mutual, and make profits which would be taken from Ringgold County;[49] appellees made a better showing of their intentions, here to convert to dial telephones and improve rural service, than was made in *Mallard Telephone*,[50] and prevailed. In their attack on appellees, appellants also tried to invoke the clean hands doctrine,[51] but both courts thought that nothing underhanded or legally improper had been shown, even though appellees might have been somewhat aggressive in their conduct.

---

[48] For some years the corporation had been paying 8% dividends on an assumed basic value of $25 per share. There had been a few sales of shares between 1943 and 1958, mostly to the directors and officers, at prices of $30 to $50 per share. Record 99, 164, 335, 371, 419. The directors claimed these sales were more indicative of value than plaintiffs' offer of $200 per share, and they took $40 as an average between the high and low prices. Record 371, 419. However, they had turned down appellees' $100 per share offer as too low, and had been advised from at least two other possible purchasers of the company that the stock was worth a last $200 per share; furthermore its book value was almost $200. Record, 344, 351-53.

A very interesting recent case has held that where part of the price paid for stock is for the advantage of controlling the corporation, the selling shareholder may have to regurgitate that portion of what he received and make it available to the shareholders he left behind. Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955). An interesting analysis of this case is found in Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956). However, in *Perlman* the shares involved had been held or controlled by the person who was operating the company.

[49] See "Statement of the Case" and "Statement of Facts" in Appellants' Brief and Argument 3, 6-8, 11-19.

[50] While appellants were considering improvements to the plant and conversion to dial service, there is no evidence that this had been seriously discussed or any attempts to formulate and communicate plans for this had been made until appellees announced their intention to acquire *Ringgold* plus other exchanges in the county and combine them into a county-wide system. However, a board had been installed in the *Ringgold* plant which enabled their operators to dial long-distance calls placed by local patrons, and this would be useful in any conversion of local phones to dial.

[51] Several charges were levied against appellees. They continued to make offers to the Board to buy, after being told the Board wasn't interested. They offered "excessive" prices for the stock. They attempted to take control against the wishes of the Board, which was the agent of the stockholders. They told the Board one shareholder owning a number of shares had sold to them, when he had only given them an option. A meeting of shareholders, in December, to discuss the Board's

CONCLUSION

Assuming the facts to be as the trial court found, and as the Supreme Court accepted them, both Courts reached a reasonable decision. The opinion of the Supreme Court seems, as indicated, to have resolved some aspects of law revelant to battles for corporate control, but to have left others in a somewhat uncertain stage.

The opinion should serve as a warning to counsel for close corporations, especially for those organized under the older corporation law. If the article referring to preemptive rights is similar to *Ringgold's,* it should be studied and probably rewritten to state clearly what the shareholders intend. Preemptive rights will be applicable to corporations organized under the new Business Corporation Act, unless the articles provide otherwise. If the rights are to apply to treasury stock, this should be stated specifically. And it might be advisable to indicate the circumstances under which the rights are applicable to authorized-unissued shares. If restrictions on transfer of stock are used, and are based solely on by-laws, the articles should be amended, at the least to authorize by-law restrictions. And even though the opinion failed to say so, it seems advisable to have the substance of any transfer restrictions endorsed on outstanding share certificates to which it applies.

---

plan for improving service, was disrupted when one of plaintiffs "took over the meeting" without permission from the chairman, to describe what plaintiffs intended to do. The advertisements soliciting shares were in the name of one of plaintiffs' corporations, but it never was one of the purchasers. (Plaintiffs said they had intended to use this corporation as a parent, but were revising their plans, partly as a result of the delay caused by defendants' actions.) Plaintiffs had engineers in the county planning the changes to be made, by mid-January, even though they knew the directors were refusing to recognize them as shareholders. Plaintiffs were buying other exchanges in the county, which made it difficult for defendants to undertake improvements on a county-wide basis. Plaintiffs would raise prices and run the corporation as they saw fit. Appellants' Brief and Argument 102-111.

Two other charges were of some interest but not clearly connected to plaintiffs. Someone, said the manager, told Northwestern Bell to send Ringgold's telephone toll checks to one of plaintiffs' corporations. Record 336-37. No one from Northwestern Bell testified to this. And one of the directors produced a blank check, payable to the secretary and purportedly signed by one of plaintiffs. The director testified that the secretary said he was told if he would sell his stock to plaintiffs he could fill in the amount as he saw fit. Another of plaintiffs testified that the secretary had always been offered $200 per share, and had been given a check with that amount filled in. He stated the check in evidence had not been signed by his associate. Neither the secretary nor the associate were witnesses. Record 305-08, 373-74.