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# Fractional Corporate Shares

W. LEWIS ROBERTS\*

## INTRODUCTION

Where a stock dividend is issued or where there is a re-organization of a company, and new shares are awarded to the stockholders, some may be entitled to fractions of shares. The question as to what is to be done with these fractional shares has become more important in recent years as they have been increasingly favored by corporations.

Where the stock dividend, or the privilege of subscribing for rights to buy shares of a new issue of stock, is that for every one hundred shares of stock held the owner shall receive six shares of new stock, a person owning less than one hundred shares will receive a certain number of shares and a fraction of a share. If he owns thirty shares, for instance, he will receive two whole shares and four-fifths of another share. It is his rights in this fractional share that call for our consideration.

In the average case, the value of this fractional share is so small that resort to litigation, to determine the owner's rights in it, is infrequent. Consequently, very few cases bearing on fractional shares are to be found in the law reports. However, mention of fractional shares is found in the statutes of some states and in the Uniform Business Corporation Act, which has been adopted with modifications in several states.

### *The Shareholder's Interest*

What interest does the holder of a fractional share acquire in the corporation? How is his interest increased in the corporation? Little has been written on the subject. Over thirty-five years ago a writer considered the ways the issue of fractional shares affects the interest of the owner in the corporation.<sup>1</sup> Four

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<sup>1</sup> Waring, "Fractional Shares Under Stock Dividend Declarations," 44 Harv. L. Rev. 404 (1931).

viewpoints are set forth by the writer, namely: (1) the effect of the corporation's paying cash for the fractional interest; (2) the issue of scrip in lieu of a certificate for a fractional share; (3) allowing credits to accumulate until enough fractional shares aggregate a full share or shares; and (4) a combination of these methods.

If a corporation declares a dividend to its stockholders and makes it payable in shares of the company's stock, or if it offers a new issue of stock to its shareholders, the law requires that each shareholder of stock of the same class shall be entitled to the same return as every other shareholder. This was recognized at an early date in *State v. Baltimore & Ohio R. R.*,<sup>2</sup> where the court invalidated a dividend declaration which provided that holders of less than fifty shares should be paid in cash and holders of more than fifty shares should be paid partly in bonds and partly in cash.

In *Reynolds v. Diamond Mills Paper Co.*,<sup>3</sup> the position was taken that even though the owner of fractional rights has his proportionate say in the management of the corporation diminished by receiving cash for such rights, he suffers no great injury since he can go into the open market and acquire other fractional rights to replace them.

The method of meeting the problem by issuing scrip to those entitled to fractional shares, when the right to subscribe for an issue of new stock is offered to shareholders, has been adopted in some jurisdictions. When the scrip issued aggregates a full share or shares, the corporation gives a stock certificate for the same. Usually a time limit is set for redeeming the scrip.

Sometimes the term "fractional warrants" is used, giving the right of subscription to a fractional share. It cannot be exercised unless the combination of fractional warrants aggregates one or more full shares. These fractional warrants can be bought or sold on the market.<sup>4</sup>

The Uniform Business Corporation Act provides for the issue of certificates of stock and adds that in case of "a further allotment of shares, a corporation may issue to a shareholder full or fractional share warrants evidencing the number of shares or the

<sup>2</sup> 6 Gill 363 (Md. 1847).

<sup>3</sup> 69 N.J. Eq. 299 (Ch. Ct.), 60 Atl. 491 (1905).

<sup>4</sup> 19 Fletcher, Private Corporations § 8977 (perm. ed. rev. 1933).

fraction of a share to which the shareholder is entitled to subscribe. . . ."<sup>5</sup> Most of the jurisdictions that have followed the Uniform Act provide that a corporation "may but shall not be obliged to issue a certificate of a fractional share of stock," or allow the directors to issue scrip, or warrants, giving the holder the right to a full share or shares of stock upon his presenting scrip for fractional shares aggregating a full share of stock. It is usually stipulated that the scrip or warrant will be forfeited if not exchanged within a specified time. The scrip issued may be subject to conditions laid down by the directors of the corporation.

A third way of meeting the problem of fractional shares is to accumulate credits for the fractions and to issue certificates for full shares of stock when the accumulated credits aggregate full shares. This places the burden of keeping a record of the fractional shares on the corporation, but it is far less burdensome in the case of large corporations than would be the task of keeping the records, if certificates of fractional shares were given and the holders were entitled to vote and draw dividends on such interests. Holders in this group are allowed an option of taking cash, but the terms of the offer are usually so unattractive that "cashing in" is discouraged. It has been claimed that this scheme of dealing with fractional shares does not result in the same treatment to all holders of the same class of stock. However, the discrimination is kept to a minimum and may be justified on the ground of business convenience.<sup>6</sup>

Under some state statutes, the three methods of dealing with the problems of fractional shares have been combined to a certain extent. Fractional share owners are allowed a choice of (a) taking cash, (b) taking scrip, or (c) accumulating credits.

#### *Corporation's Right to Sell the Fractional Shares*

Many of the statutes permitting the issue of fractional shares provide that the issuing corporation may, under stipulated conditions, sell the fractional shares and pay the cash received therefrom to the shareholder entitled thereto.<sup>7</sup>

<sup>5</sup> Model Business Corporation Act § 14.

<sup>6</sup> Waring, *supra* note 1, at 421-22.

<sup>7</sup> Cal. Corp. Code Ann. § 1113 (West Supp. 1957); D. C. Code Ann. § 29-904a (Supp. 1955); Ill. Rev. Stat. c. 32, § 157.22 (1957); Md. Ann. Code art. 23, § 28 (1957); Nev. Rev. Stat. § 78.205 (1957); Ohio Rev. Code Ann.

The Connecticut statute states that no certificates for fractional shares shall be issued. It allows fractional shares to be disposed of, however. If the shareholder, who becomes entitled to a fractional share on an increase or reduction of the corporation's capital stock, fails to purchase an additional fractional share to entitle him to a certificate of a full share, the directors are empowered to sell the fractional share to the highest bidder after giving due notice to the owner.<sup>8</sup> The California statute provides that the corporation may purchase its own stock out of capital or surplus stock issued by it to eliminate fractional shares.<sup>9</sup>

The Oklahoma Act provides that a corporation may issue certificates for fractional shares, or by action of the board of directors may issue, in lieu thereof, scrip which entitles the holder to receive a certificate for a full share, upon presenting scrip aggregating a full share.<sup>10</sup> The owner of such scrip may hold it subject to the condition that the scrip shall become void if it is not exchanged for full shares before a certain date. The corporation in such case is empowered to sell the scrip and distribute the proceeds.<sup>11</sup>

#### *Voting and Dividend Rights*

One of the rights usually held by a stockholder is the right to vote for directors of the company and on other questions of the corporation's business that are submitted to shareholders for their determination. The common law favored giving the members of a corporation equal rights. It originally gave each stockholder one vote regardless of the number of shares he held. This rule was taken from the rule governing public corporations before joint stock companies were developed. The present rule of giving a vote to each share, Fletcher states, came about by statutory action or common usage, the latter being "sufficient ground for implying an intention on the part of the legislature, in the absence of express provision, to give each share a vote."<sup>12</sup>

<sup>8</sup> §1701.34 (Baldwin 1953); Okla. Stat. tit. 18, § 1.62 (1951); Ore. Rev. Stat. § 57.126 (1953); Wis. Stat. Ann. § 180.19 (1957).

<sup>9</sup> Conn. Gen. Stat. § 5174 (1949).

<sup>10</sup> Cal. Corp. Code Ann. § 1113 (Supp. 1957).

<sup>11</sup> Okla. Stat. tit. 18, § 1.62 (1951).

<sup>12</sup> *Ibid.*

<sup>13</sup> 5 Fletcher, *Private Corporations* § 2045 (perm. ed. rev. repl. 1952).

The statutes in a few states allow the holder of a fractional share to vote on the same.<sup>13</sup>

In states following the Uniform Business Corporation Act, the holder of fractional share scrip is not given the right to vote on the fractional share, nor to draw dividends on the same unless it is so provided in the articles of incorporation, by-laws or statutes.<sup>14</sup>

In the case of *Commonwealth ex rel. Cartwright v. Cartwright*,<sup>15</sup> the Pennsylvania Appellate Court ruled that the Pennsylvania Business Corporation Act does not authorize fractional shareholders to vote at stockholders' meetings. The lower court had held that since the statute authorized the issuance of certificates for fractional shares or scrip in lieu of certificates, it impliedly conferred the right to vote on a fractional share.

One jurisdiction allowing the issue of fractional shares specifically states that the holders thereof shall not have the right to vote on the same.<sup>16</sup> In Texas, whenever there is a reduction of the capital stock of a corporation and by reason thereof fractional shares are issued, "the holder of any such fractional share shall be entitled to vote the same at any meeting of the shareholders in accordance with the proportionate or ratable value of such shares."<sup>17</sup>

A proxy may be appointed to vote fractional shares under the Oklahoma law, unless it is provided in the by-laws that a holder of fractional shares shall not be entitled to vote unless they aggregate full shares.

The question naturally arises as to whether an owner of fractional rights should have the right to share in the dividends paid by a corporation to its shareholders. It is arguable that if he is not given dividends he will not receive the same return that every other holder of shares in the same class of stock receives, and that the equality rule will be violated. Some jurisdictions have statutory provisions giving the holder of a frac-

<sup>13</sup> Ore. Rev. Stat. § 57.126 (1953); Wis. Stat. Ann. § 180.19 (1957).

<sup>14</sup> Arkansas, see note 7; California, see note 7; D. C. Code Ann. § 29.908h (1951); Illinois, see note 7; Maryland, see note 7; Mo. Ann. Stat. § 351.300 (Vernon 1952); N. C. Gen. Stat. § 55-58 (1957); Ohio, see note 7; Oregon, see note 7; Pa. Stat. Ann. tit. 15, § 2852-602 (Purdon 1938); Wash. Rev. Code, § 23.16.020 (1952).

<sup>15</sup> 350 Pa. 638, 40 A. 2d 30 (1944).

<sup>16</sup> W. Va. Code Ann. § 3079 (67) (1955).

<sup>17</sup> Tex. Rev. Civ. Stat. art. 1333 (1925).

tional share or shares the right to draw dividends on the same. This group of states includes Illinois, Oregon, and Wisconsin.<sup>18</sup> These three states distinguish between a holder of a certificate of a fractional share and the holder of scrip for fractional shares in the matter of voting rights and receiving dividends. For example, the Illinois Statute reads in part as follows:

A certificate for a fractional share shall, but scrip shall not unless otherwise provided therein, entitle the holder to exercise fractional voting rights, to receive dividends thereon and to participate in any of the assets of the corporation in the event of liquidation.<sup>19</sup>

The Ohio Code allows a corporation to issue scrip instead of fractional shares and a holder is entitled to vote and to draw dividends on the same.<sup>20</sup>

Another group of states has statutes that provide that holders of fractional shares are not to share in corporate dividends unless provision is expressly made for the same. In this class are Arkansas, District of Columbia, Maryland, Missouri, Nevada, North Carolina, Ohio, Oklahoma and Wisconsin.<sup>21</sup>

In Kansas and other jurisdictions which have no statutory provisions regarding fractional shares, it is fair to infer that the articles of incorporation, the by-laws or other agreements may stipulate that owners of fractional shares shall be entitled to draw dividends on their fractional interests.

### *Taxation Aspects*

Perhaps of greatest interest to the practicing lawyer are the problems that arise relating to the taxation of fractional shares. Their liability to federal taxation especially presents many interesting questions. It is necessary to know at the outset whether the fractional share arises from the corporation's issuing a stock dividend or whether it is a case of paying a cash dividend where one holds a fractional share. It is the old question of whether the holder is receiving a return of capital or income.

In the Revenue Code of 1954 it is provided that any distribu-

<sup>18</sup> Ill. Rev. Stat. c. 32, § 157.22 (1957); Ore. Rev. Stat. § 57.126 (1953); Wis. Stat. Ann. § 180.19 (1957)

<sup>19</sup> Ill. Rev. Stat. supra note 18.

<sup>20</sup> Ohio Gen. Code Ann. § 8623-30 (Page Supp. 1952).

<sup>21</sup> Arkansas, see note 7; District of Columbia, see note 14; Maryland, see note 7; Missouri, see note 14; Nevada, see note 7; North Carolina, see note 14; Ohio, see note 20; Oklahoma, see note 7; Wisconsin, see note 7.

tion by a corporation to its shareholders of stock or stock rights is not to be included in the stockholder's gross taxable income unless the distribution is a preference dividend or is made at the election of the shareholders instead of accepting a cash payment.<sup>22</sup> The reason for not taxing the stock dividends either as income or as a capital gain is based upon the fact that the issue of a stock dividend does not add to what the shareholder had before the dividend was issued. Where he had a certificate for a certain number of shares which represent the same interest in the corporation, he has really no more than he had before the issue was made. His ownership in the corporation remains the same as it was before. His wealth has not been increased by the transaction. Of course, when he comes to sell his stock he may be subjected to a capital gains tax on the increase over his original investment.

The sale of scrip covering fractional shares presents a different problem for the tax lawyer. Where scrip certificates were issued on fractional shares arising on a stock dividend and the stockholder had the option of allowing the corporation to sell the same as his agent, it was held that the stockholder should compute his gain or loss in the same manner as if he had received and sold stock dividends.<sup>23</sup> The scrip certificate does not represent a cash dividend but a stock dividend.<sup>24</sup> Where fractional shares or certificates for fractional shares are issued and the shareholders receiving the same are given the right to redeem them in cash at specified rates for full shares, a tax would be assessed to the extent of the "cash distribution or the redemption value of the fractional shares."<sup>25</sup>

Right warrants may be issued in some jurisdictions allowing a shareholder to subscribe on a new issue of stock offered by the corporation.<sup>26</sup> Here also the stockholder may possibly acquire a right to a fractional share. He may either buy additional rights to fractional shares and secure enough to entitle him to purchase a full share or shares of stock, or he may sell his warrant. Since the right of warrants is only an option, the shareholder is not

<sup>22</sup> Int. Rev. Code of 1954 § 305.

<sup>23</sup> 2 C.C.H. 1959 Stand. Fed. Tax Rep. § 2334.115.

<sup>24</sup> O.D. 859, Cum. Bull., June 1921.

<sup>25</sup> *Supra* note 23.

<sup>26</sup> Fletcher, *supra* note 4; 1 Morowitz, *Private Corporations* § 455 (2nd. ed. 1886).

subject to a tax on its issue to him. It is not income.<sup>27</sup> A tax problem arises in such a case when the subscribing stockholder sells the shares he acquired on exercising his right to buy the stock. He will be held for capital gain on the increase of the selling price over the cost basis, or will be allowed a loss-deduction if the selling price is less than the cost basis.

<sup>27</sup> Whiteside, "Income Tax Consequences of Distributions of Stock Rights to Shareholders," 66 Yale. L. J. 1016 (1957).

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