

**ROLE OF PREFERRED STOCKS IN CORPORATE FINANCE: LESSONS FOR  
GEORGIA IN LIGHT OF US EXPERIENCES**

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## **ABSTRACT**

Transparent, accurate and flexible laws are one of the first steps in attracting potential investors to a country; therefore the laws governing business should be constantly modified to ensure that it reflects modern tendencies which boosts the market economy of a country to a higher level. In corporate law, one of the empirically tested modes of investment is a preferred stock, which has a long and rich history in the US, but unfortunately this is not the case in Georgia.

Thus, the purpose of this thesis is to address the role of preferred stocks in corporate finance by illustrating its importance in business reality for Georgia. This paper makes a comparative analysis of the US and Georgian legal systems and provides recommendations on how the basic concept of preferred stocks can be exported from the US to Georgia and what are the benefits that Georgia can enjoy in light of US experience.

This thesis suggests, that even though preferred stocks in Georgia are regulated and known, they are rarely used. Further, it shows that the law governing preferred stock concept in Georgia lacks transparency and needs comprehensive revision. Thus this paper provides valuable guidance concerning the issuance of preferred stocks and their importance for prospective investors and stresses why Georgia should make use of this type of equity security and how the country's economic growth will benefit from utilization of this well established investment vehicle of corporate law.

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## LIST OF ABBREVIATIONS

DGCL	Delaware General Corporation Law
Corp	Corporation
US	United States of America
Vol.	Volume
Del.Ch.	Delaware Court of Chancery
NYSE	New York Stock Exchange
MBCA	Model Business Corporation Act

## **CHAPTER ONE**

### **INTRODUCTION**

#### **1.1. Background**

One of the most important features of a country's economic growth is ensuring that legislative rules are drafted in a way that they can accommodate investor's needs and expectations in order to boost investments. The role of a government here is to utilize the legislative measures in order to attract investors and add more flexibility to a regulatory measures, in order for a given country to be a better place for starting business. It is in this way that corporations and a country itself benefits from the growth of a market economy. It is equally important to ensure that corporations are willing to be incorporated in an investor friendly environment and well developed business area, therefore it is vital to make sure that the corporate law is up-to-date and meets the expectations of the business world.

As the scarcity of Georgian empirical evidence shows, however, that is not always the case. Often a lack of knowledge or inexperience in using key features of corporate law, operates as an impediment to starting or doing business by creating problems for investors and stockholders. This is an especially acute problem for large corporations that are supposed to be the backbone of such new market economies, such as Georgia. Therefore, a law which lacks flexibility and does not accommodate investors' legitimate interests, undoubtedly has a negative impact, not only on certain specific sectors of the economy, but eventually on the whole country as well.

It follows that a well designed system must possess a corporate statute (company law) that provides for these features, starting from forming through governance of enterprises. It may

vary from jurisdiction to jurisdiction, but yet a meaningful portion of the pertaining provisions are default rules; rules that apply only if something is not expressly provided for otherwise in the articles of incorporation or other internal acts of the company. In a sense, they are a method to give flexibility to the participants of the market. As generally recognized, "these characteristics have strongly complementary qualities for many firms"<sup>1</sup> and "they make the corporation uniquely attractive."<sup>2</sup>

One of the key tools of corporate finance for attracting potential investors, are preferred stocks, as peculiar kinds of equity securities. While in Georgia they are still securities that exist only on paper rather than in practice, they have a long and rich history in the US dating back to the 19th century, where they are even referred to as so-called "hybrid"<sup>3</sup> securities given the wide variety of forms and features that developed over time. In fact, this contrast is what justifies this thesis, which shall see, based on US law and experiences, how could the so-called "dead clause" on preferred stock in Georgian company law be given content and made more widely exploited in practice.

## 1.2. Peculiar Nature of Preferred Stocks

Preferred stock is "an anomalous security"<sup>4</sup> as professor Richard M. Buxbaum rightly points out in his seminal article written in 1954. What make its nature unique as opposed to common stock are the myriad methods whereby the parties can vary its features. This, at least in

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<sup>1</sup> Reinier Kraakman, Henry Hansmann, *What is Corporate Law?*, *The Anatomy of Corporate Law: A Comparative and Functional Approach*, Yale Law School, Center for Law, Economics and Public Policy, Research Paper No.300. Oxford University Press. 1, 5 (2004).

<sup>2</sup> *Id.* at 5.

<sup>3</sup> S.H. Ballam Jr. *Preferred Stocks: They Can be Attractive Investments*, 11, No.5 *The Analysts Journal*, Published by: CFA Institute, 53, 53 (1955).

<sup>4</sup> Richard M. Buxbaum, *Preferred Stock. Law and Draftsmanship*, 42, No.2 *California Law Review*, 243, 243 (1954).

the practice of the United States, may amount even to a hybrid security having the characteristics of both equity and debt.

The word "preferred" itself should draw attention to the fact that this class of shares should have at least one or more privileges in addition to those attached to common stocks and this is what makes the preferred stock unique. The features that may be attached to preferred stock can be viewed as having the preference starting with the option of cumulative dividends, as well as the convertible feature into common stock.<sup>5</sup> Additionally, in its nature there are more of the combination of several rights, such as the right to receive dividends with a fixed rate and having superiority over common stockholders to receive reimbursement and any distribution of assets after corporation's liquidations.<sup>6</sup> Following liquidation of a company, preferred stockholders are second in line to receive the remaining assets from the corporation after creditors are fully paid.<sup>7</sup> All the above mentioned features constitute the advantages of the preferred stock which adds a so called "sweetener"<sup>8</sup> and adds additional attractiveness to them.

Hence the brief illustration of the key principles and inherent features of the preferred stocks, constitute a full and flexible package for each investor. Drawing lessons from a developed country, such as the US, is vital and its rich history of corporate finance structure adds advance and flexible regulatory measures for economic growth of the market and provides appropriate protections for both corporations and investors.

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<sup>5</sup> Ballam, *supra* note 3, at 53.

<sup>6</sup> Buxbaum, *supra* note 4, at 243.

<sup>7</sup> [www.smallbusiness.chron.com - Patrick Gleeson, Ph. D., Registered Investment Adv, Demand Media, When Should a Company Fund with Preferred Stock Instead of Common Stock or Debt?](http://smallbusiness.chron.com/should-company-fund-preferred-stock-instead-common-stock-debt-70042.html) (Available at: <http://smallbusiness.chron.com/should-company-fund-preferred-stock-instead-common-stock-debt-70042.html> - last visited March 22, 2016).

<sup>8</sup> ROBERT W. HAMILTON, RICHARD BOOTH, CORPORATION FINANCE, CASES AND MATERIALS, p. 313, (American Casebook Series, West Group, 3rd ed.2001).

As we can see, although the preferred stocks have relatively key advantages in comparison to the common stocks, it is rarely used in certain countries, such as Georgia. The vast majority of evidence of use of preferred stocks in the US, has proved that "preferred shares may constitute attractive investments under the right circumstances and with appropriate protections."<sup>9</sup> Therefore this thesis will focus on key elements developed in the US legal system and shall examine how it is delivered in practice and what is the best way that Georgia could use in its own jurisdiction. Such a change in practice could be a lesson for other developing countries.

### 1.3. Thesis Objective

Preferred stocks are known and regulated in almost all countries having modern company (corporate) law, including the two jurisdictions targeted in this thesis. There is, however, an important difference between the US and Georgia: while in the former, preferred stocks have been widely used since 19<sup>th</sup> century, that is not seem to be the case in the latter, even today – more than twenty years after the country began to build a market economy. At any event, empirical evidence is lacking. In many developed systems, as in the US, it is not the common stock, but preferred stocks that matter more and are used to achieve specific goals.

In light of this gap, this comparative analysis will try to not only see how the regulatory environment could be ameliorated but also what practical, empirically tested "formulas" could Georgian businesses and their lawyers transplant from the long and rich history of the US. The thesis will be focused on examining and evaluating the key principles and practices developed in the US in the realm of preferred stock, how it is used and how are they regulated, and what makes preferred stocks better and more valuable equity security as opposed to common stocks.

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<sup>9</sup> *Id.* at 313.

The purpose of the thesis is to understand and identify principles or formulas developed by the US legal system, by overview of statutory law and legal environment in order to identify what can be learned from the US experience and how it can be exported to Georgia's legal system in order for it to lead to an improvement of the country's economy.

#### **1.4. Methodology and Structure**

This thesis, by evaluating both Georgian and the US legal systems, shall describe the elements of corporate law of the US by highlighting the characteristics of preferred stocks and shall provide recommendations of how Georgia can benefit from their intense exploitation.

The thesis will be divided into four chapters starting with the introduction, addressing the subject matter of the research. The introduction will outline general information and shall give a brief overview of the concept of preferred stock itself, as well as the methodology and the objective of the research. The second chapter provides a historical background of the evolution of the preferred stock concept in the US, and examines and compares the statutory law of Georgia and the US, mainly focusing on Delaware General Corporation Law, known for its "pro-business"<sup>10</sup> character which will assist to draw the most important differences and similarities between two legal systems.

The third chapter, the centerpiece of the thesis, will focus on a comparison of preferred stock-related practices in Georgia and the US. It will provide discussion and analysis of relevant information regarding mechanism and the approach of both legal systems. Finally, the last chapter will be devoted to recommending, which regulatory (if any) approaches and practical practices could be transplanted to Georgia and at the end shall come up with possible solutions.

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<sup>10</sup> Lewis S. Black, Jr. *Why Corporations Choose Delaware*, Delaware Department of State Division of Corporations, 1,1 (2007).

## CHAPTER TWO

### 2.1. History of Evolution of Preferred Stocks in the United States

Before turning into a detailed description of the peculiar character of preferred stocks in more detail, it is of high importance to make a brief overview of history of evolution of preferred stock concept in the US for the readers. At the very beginning in the US, corporations used to issue common stocks rather than other classes of shares and it was only in the 19th century, which happened to be one of the important periods in the United States in terms of developing a concept of preferred stock, where the very first use of this hybrid class of stock, was basically aimed to increase capital of the corporation.<sup>11</sup>

In the United States, shares with preferential rights had been successfully used in the area of transportation industry, specifically by railroad companies as well as in relation to canals.<sup>12</sup> One of the distinguishing examples for issuing preferred stocks at early stage of the business, is the Pennsylvania Railroad Company, which in 1871 formed a subsidiary, Pennsylvania Company, "with four million common stock and eight million preferred"<sup>13</sup> in order to gain control over its business in its western subsidiaries.<sup>14</sup> "The entire amount of the preferred was turned over to the railroad by its newly created subsidiary in return for the securities of the western roads."<sup>15</sup> It is important to note that, Pennsylvania Railroad Company is an example, representing a first corporation issuing preferred stocks at the beginning of its business

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<sup>11</sup> George Heberton Evans, Jr., *Preferred Stock in the United States 1850-1878*, 21, No.1 The American Economic Review, Published by American Economic Association, 56, 56 (1931).

<sup>12</sup> George Heberton Evans, Jr., *The Early History of Preferred Stock in the United States*, 19, No.1 The American Economic Review, Published by American Economic Association, 43, 43 (1929).

<sup>13</sup> Heberton, *supra* note 11, at 58.

<sup>14</sup> *Id.*

<sup>15</sup> *Id.*

activities.<sup>16</sup> Hence, the first use of the preferred stocks in the US was basically aimed for financing the railroad industry, since some corporations were in financial need to complete several projects and this was the time when preferred stocks "received its most widespread use."<sup>17</sup>

In order to give a full picture of the birth of the preferred stock and its further development, the following historical facts will be much of an interest. In 1836, several railroad enterprises, which represented less than profitable undertakings by that time, were in need of additional funding for their business.<sup>18</sup> One of the projects, Baltimore and Ohio Railroad, as well as the Chesapeake and Ohio Canal project were among those who required financial assistance in order to finalize the construction of the railroad.<sup>19</sup> Therefore, the management of this company requested Maryland legislature for a financial aid to complete the project and build additional miles for the canal to Cumberland.<sup>20</sup> In response Maryland Assembly introduced a bill which emphasized that, the state, in order to provide additional funding for the respective project, should be in a position to subscribe to the capital stock of the companies requesting for an aid.<sup>21</sup> "The opponents of the bill forced its rejection, and later to the stocks of two railroad and three canal companies subscriptions were authorized and all of these were to yield a preferential dividend of six percent to commence on each subscription three years after it was made."<sup>22</sup>

Consequently, the terms and conditions for both companies were the following: in Baltimore and Ohio subscription, the state would have received dividend for six percent per

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<sup>16</sup> *Id.*

<sup>17</sup> George Herberton Evans, Jr., *Early Industrial Preferred Stocks in the United States*, 40, No. 2, *Journal of Political Economy*, Published by University of Chicago Press, 227, 227 (1932).

<sup>18</sup> Heberton, *supra* note 12, at 43.

<sup>19</sup> *Id.* at 44.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.* at 45.

<sup>22</sup> *Id.* at 45-46.

annum right after the company declared its profit, and in addition to that state would have been given the authority to appoint a director in the company to have a controlling mechanism , while in case of Chesapeake and Ohio, preferred stocks would have been converted into common stock "after the profits of the canal had reached a certain point"<sup>23</sup> and hence all this was done only in order to grant the state the authority over the corporation in receiving dividends in return to the funds lent to the enterprise.<sup>24</sup> Meaning that, the preferred shares were used to grant the states privileges concerning dividend distribution in return to receive financial aid<sup>25</sup> so that both of the counterparts would have benefited from the transaction and the peculiar tool, such as preferred stock, made it all possible to happen.

It is further worth of note that, the preferred stocks were not sold only to the corporations, but rather to individuals as well. The history and practice of individual and enterprise relationship in acquiring the new class of shares, continues with the history of railroad as we have already briefly discussed above.<sup>26</sup> Large enterprises issued these new classes of stocks in order to acquire financial aid either from state or from an investor, however, it was hard to attract individuals who might have been willing to make an investment and become shareholders of the corporation who was suffering financially.<sup>27</sup> A prospective investor would have thought twice before engaging in a transaction similar to this, however management of the corporation soon found out a solution and came up with an alternative vehicle for acquiring financial aid and thus decided to make a formal promise to the potential investors to pay respective interest on each

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<sup>23</sup> *Id.* at 47.

<sup>24</sup> *Id.*

<sup>25</sup> *Id.* at 50.

<sup>26</sup> *Id.*

<sup>27</sup> *Id.*

subscribed shares.<sup>28</sup> This burdensome condition of the corporations was a huge obstacle for potential investors to accept the proposal and compromise that the corporation would be in a position to pay back all the funds acquired through the investors.<sup>29</sup> Therefore, in response corporations developed a practice of issuing two classes of shares, one which was old stock for which the corporation would not pay dividends, as opposed to the newly issued shares, known as preferred stocks, when the enterprise would normally make the promise that it would pay an investor dividend on subscribed shares.<sup>30</sup> This practice soon became highly successful and attractive, it could have been identified in several of published materials and reports from those days, where "newspaper advertisements and stock exchange quotations, testify to the increasing normality of preferred stock in the early railroad construction period."<sup>31</sup> Therefore we now have a clear picture of the path of developing the preferred stock concept and the practice of payment of dividends on these "hybrid" type of stocks.

However, one important thing was actually missing for declaring preferred stock as a successful step forward in market economy and this was reflected in a lack of regulatory measure. Soon, after increased use of preferred stocks, implementation of an important regulatory measure was at last put on the agenda. Successful and continuous use of this class of stocks was soon regulated and "general acts rather than special legislation became authority for its issue."<sup>32</sup> It is also important to stress, that at the early stage the relevant acts and statutes did not actually referred to the term of "preferred stock", rather they were known as new stocks,<sup>33</sup> however later the term "preferred stock" appeared in two of the statutes: "an act of the

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<sup>28</sup> *Id.*

<sup>29</sup> *Id.* 51.

<sup>30</sup> *Id.*

<sup>31</sup> *Id.*

<sup>32</sup> Heberton, *supra* note 11, at 62.

<sup>33</sup> Heberton, *supra* note 12, at 52.

Pennsylvania legislature which permitted Philadelphia and Reading Railroad to issue preferred stock, and an act of the New York legislature which granted to the New York and Harlem Railroad the same privilege."<sup>34</sup> Similarly, General Railroad Law on Indiana which was enacted in 1852, made it possible for the corporations to issue preferred stocks in order to cover the existing debts, however it contained a requirement that the issuance of the preferred stock should have been approved by the "majority of the stockholders who give approval and that the amount should not have exceeded one-half of the capital of the company."<sup>35</sup>

At this point, we can conclude that the importance of the new type of stock was derived from a financial need of the corporations and it was mainly used by companies operating in a railroad business.<sup>36</sup> The attractiveness of the newly established form of stock essentially was essential the following: first that it would have been automatically converted into common stock, the requirement which was later changed and it ceased its existence,<sup>37</sup> and the promise of receiving dividend after certain period of time.<sup>38</sup> Taking into account these privileges, the individuals, as well as corporations were tempted to subscribe to the preferred stocks and "when this state of affairs had been reached, they expected to become common stockholders and thus share in the hoped-for large dividends of the enterprise which they had assisted."<sup>39</sup>

During the years, this new class of stocks gained its place in the business, and nowadays represent one of the important tools of corporate law and its development in the area of transportation industry, <sup>40</sup> have gained its additional attributes which nowadays makes it so

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<sup>34</sup> *Id.*

<sup>35</sup> Heberton, *supra* note, 11 at 59.

<sup>36</sup> *Id.* at 62.

<sup>37</sup> *Id.*

<sup>38</sup> *Id.* at 59.

<sup>39</sup> Heberton, *supra* note 12, at 58.

<sup>40</sup> Heberton, *supra* note 11, at 62.

attractive investment vehicle. From time to time, major changes have been made in the concept of the preferred stocks, such as automatic conversion into common stock has been disappeared and substituted by the voluntary wish of the owner to convert it into common stock.<sup>41</sup> Veto voting powers were also attributed to this class of stocks, however the voting feature deferred on case by case basis.<sup>42</sup>

In sum within the years, characteristics of preferred stocks have been relatively changed. Companies started to issue shares with different preferential rights, among those features the voting right was occasionally granted to the preferred stockholders and the feature of cumulative dividends became clearer and concrete,<sup>43</sup> thus "the simple instrument of the earlier days was developing into a stock with many special rights and privileges."<sup>44</sup> Nowadays, preferred stocks have advanced its features over the years and have been designed to represent one of the important investment vehicles in business life with its relatively impressive features which will be addressed in more detail below in the following subchapter.

## **2.2. Statutory Law of the United States**

### **2.2.1 Introduction: Corporate Law of the United States**

For the purpose of this thesis and this subchapter, it is essential to briefly familiarize the prospective readers with the corporate law of the US. Hence, the United States gives freedom of choice of place of incorporation to the enterprises on its territory.<sup>45</sup> More precisely, as corporate law is the law of the various States, it is the various State laws that regulate this area.

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<sup>41</sup> *Id.*

<sup>42</sup> *Id.*

<sup>43</sup> *Id.*

<sup>44</sup> *Id.*

<sup>45</sup> United States Corporate Law - (available at: [https://en.wikipedia.org/wiki/United\\_States\\_corporate\\_law](https://en.wikipedia.org/wiki/United_States_corporate_law)) (last visited March 11, 2016).

Consequently, every state in the US has its set of rules governing corporate issues such as main principles of corporate governance and rights and obligations of the corporations, known as corporate code.<sup>46</sup>

Speaking of a corporate law, it is of high importance to mention a state of Delaware, which happens to be the best place for incorporation of the companies and representing as a "brand name for the business of serving as the official home for corporations".<sup>47</sup> The majority of corporations have been incorporated in Delaware under Delaware General Corporation Law (DGCL), attracting the small as well as large corporations with relatively small taxes.<sup>48</sup> What makes Delaware so prestigious is that, it offers flexibility to legal entities, such as offering its DGCL, constituting "one of the most advanced and flexible corporation statutes in the nation."<sup>49</sup> Apart from the well-tuned DGCL, it includes Delaware Court of Chancery and legislature mechanisms, which makes sure that the law governing business and corporate law itself are up-to date and it meets the needs of the corporations and its shareholders.<sup>50</sup> While mainly focusing on DGCL, thesis will also briefly examine Model Business Corporation Act (MBCA), equally popular and successful model law in the US, which happens to be used by twenty-four states.<sup>51</sup>

Thus, the following subchapter will mainly focus on Delaware General Corporation Law and its interaction with the features of preferred stocks, explaining how these tools and the concept of preferred stocks itself are regulated in the US.

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<sup>46</sup> *Id.*

<sup>47</sup> Black, *supra* note 10, at 1.

<sup>48</sup> *Supra* note 45.

<sup>49</sup> Black, *supra* note 10, at 1.

<sup>50</sup> *Id.*

<sup>51</sup> *Supra* note 45.

### 2.2.2. Contractual Nature of the Preferred Stock

As we have already discussed in previous chapter, the concept of preferred stock itself and its practice starts from an early industrial stage in the US capital markets. The underline question is the main purpose and intention of companies issuing preferred stocks, rather than other equity securities, was justified by an intention to offer an attractive investment vehicle to the market, which would then have met the intentions and expectations of this investors.<sup>52</sup>

Speaking of preferred stocks, we must streamline that the relationship between corporation and the preferred stockholder is contractual in nature. The preferred stock represents "both, corporate and contractual - neither all one nor all the other".<sup>53</sup> Moreover, according to rich history of the Delaware courts, shows that, the shared characteristics between common and preferred stocks constitute corporate in nature, as opposed to the basic features of preferred shares which makes them unique, are in fact contractual in its sense.<sup>54</sup> This concept has been well illustrated in the case of *Marilyn Jedwab v. MGM Grand Hotels, Inc.*,<sup>55</sup> where Chancellor Allen stated the following:

"With respect to matters relating to preferences or limitations that distinguish preferred stock from common, the duty of the corporation and its directors is essentially contractual and the scope of the duty is appropriately defined by reference to the specific words evidencing that contract; where however the right asserted is not to a preference as against the common stock but rather a right shared equally with the common, the existence of such a right and the scope of the correlative duty may be measured by equitable as well as legal standards." <sup>56</sup>

<sup>52</sup> *Preferred Stock: CNBC Explains*, Mark Koba - available at <http://www.cnbc.com/id/44517614>, (last visited on Feb 12, 2016).

<sup>53</sup> William W. Bratton, Michael L. Wachter, *A Theory of Preferred Stock*, 161, Institute for Law and Economics, University of Pennsylvania Law Review, ECGI - Law Working Paper No.201, U of Penn, Inst. for Law & Econ Research Paper. 13-3, 1815, 1815 (2013).

<sup>54</sup> Charles R. Korsmo, *Venture Capital and Preferred Stock*, 78, Issue 4, Brooklyn Law Review, 1163, 1181 (2013).

<sup>55</sup> *Jedwab v. MGM Grand Hotels, Inc.*, Del. Ch., 509 A.2d 584 (1986) (see also Korsmo, *supra* note 54, at 1181).

<sup>56</sup> *Id.* at 594.

Hence, the preferred stock is between contract and corporate law, therefore the one's value maximizes managing to the common stock and contractual risk as well.<sup>57</sup> "Preferred stockholders are the only corporate constituents who straddle the line - their participation being both corporate and contractual"<sup>58</sup> and due to its features, which makes it so idiosyncratic and moreover, "because of preferred stock's hybrid character, legal treatment of preferred stockholders has long straddled the dividing line between corporate law and contract law."<sup>59</sup>

### 2.3. Preferred Stock and Its Key Features

What makes the preferred stock preferable as a valuable equity security, are its unique features which grant to it superiority over the common stockholders, in terms of asset distribution after liquidation and the dividend payments.<sup>60</sup>

Thus, this part of the thesis will examine key and most relevant features of the preferred stock, which mainly and foremost consists of the following:

- Preference in receiving dividends
- Preference in assets when liquidation, and
- Convertible option into common stock;

In subsection below I will describe these characteristics in more detail giving the full picture of their unique character and will show how these privileges make the "hybrid" stock so idiosyncratic.

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<sup>57</sup> Bratton, Wachter, *supra* note 53 at 1815.

<sup>58</sup> *Id.* at 1819.

<sup>59</sup> Korsmo, *supra* note 54 at 1165 (see also - William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, U. Penn. L. Sch. Instit. for. L. & Econ. Research Paper No. 13-3, 2013. at 4.)

<sup>60</sup> RICHARD T. MCDERMOTT, *LEGAL ASPECTS OF CORPORATE FINANCE*, 333, (Lexis Publishing, 3rd ed. 2000).

### 2.3.1. Preference in Dividend Distribution

Normally corporation pays dividends to its shareholders out of its earnings. The enterprise can actually deliver the dividends to the stockholders by way of cash, property or in any other form which has been explicitly agreed between the shareholders.<sup>61</sup> However, one might bear in mind the fact that, if the dividend to the shareholders are payable in cash, the shareholder is therefore authorized to require payment the way it has been agreed beforehand.<sup>62</sup> The solution for avoidance the ambiguity is to make sure that the articles of the association is drafted in a clear and transparent manner.

First and the foremost, the obligation of the corporation to issue dividends is a contractual obligation.<sup>63</sup> Most common practice is to determine terms and conditions of issuance of the preferred in the articles of incorporation as already mentioned above.

At the outset, preferred stock can be cumulative and noncumulative. Cumulative feature of the preferred stock is linked to receiving dividends,<sup>64</sup> meaning that if a shareholder owns a cumulative preferred stock and the corporation refuses to distribute dividend for a particular period, the corporation still owes to the preferred stockholders, so that it will repay all omitted dividends to the preferred stockholders before it delivers any funds to the holders of the common stock, as opposed to noncumulative stockholders, when the corporation owes nothing to the preferred stockholders even if it was unable to deliver dividends in a timely manner.<sup>65</sup> At the

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<sup>61</sup> Buxbaum, *supra* note 4 at 252.

<sup>62</sup> *Id.*

<sup>63</sup> *Id.* at 243.

<sup>64</sup> *Id.*

<sup>65</sup> EDWARD P. WELCH, ANDREW J. TUREZYN, ROBERT S. SAUNDERS, *FOLK OF DELAWARE GENERAL CORPORATION LAW*, p.354 (Aspen Publishers, Fundamentals 2011 edition) (see also William W. Bratton & Michael L. Wachter, *A Theory of Preferred Stock*, Vol. 161, Institute for Law and Economics, University of

outset, the board of directors may cancel the distribution of dividends, and the unpaid dividends most of the time are cumulative in nature, therefore the omitted dividends should be paid to the preferred shareholders before they are distributed to the common stockholders.<sup>66</sup> Thus, it justifies the fact of preference of cumulative as opposed to the non-cumulative stock. However, as professor Buxbaum points out in his article, frequently the feature of the cumulative preferred stock is assigned under articles of association, however "phrasing may lead to conflicting decisions as to the existence of the cumulative feature but the conflict is over construction of a contract".<sup>67</sup>

Additional "sweetener" to the feature of dividend distribution, is that the agreed amount of the dividend payable to the preferred stockholder is fixed and the corporation must repay dividends first to the preferred stockholders before the common shareholders are paid.<sup>68</sup> The idea of receiving the fixed dividend makes the preferred stocks more attractive to the potential investors and thus having a privilege over other shareholders is the reason why an investor would want to invest in this class of stocks.

Peculiarity of "hybrid" stock is also reflected in its resemblance with debt, a debt which must be repaid with a predetermined interest rate, and is "thus sensitive to changes in market interest rates."<sup>69</sup> Which once again is seen as a tempting tool and the fact of being an owner of

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Pennsylvania Law Review, ECGI - Law Working Paper No.201, U of Penn, Inst. for Law & Econ Research Paper. 13-3, 1815, 1825 (2013).

<sup>66</sup> Korsmo, *supra* note 54 at 1171.

<sup>67</sup> Buxbaum, *supra* note 4 at 244.

<sup>68</sup> HAMILTON, BOOTH, *supra* note 8, at 314.

<sup>69</sup> Josefine Bonnevier, Linn Naerup Borke, *A Preference for Preferred, A case study of Ratios' Preferred Stock Issue*, Stockholm School of Economics, Department of Finance, Master Thesis, 1, 5 (2014).

the preferred stocks, means to have a guarantee to receive a dividend as opposed to the holder of the common stock,<sup>70</sup> and thus makes them beneficial investment vehicle for potential investors.

Another aspect of dividend distribution nature as opposed to the common stock, is that the owners of the preferred shares usually receive higher dividend amount.<sup>71</sup> As we know, preferred stocks are not pampered with having voting rights,<sup>72</sup> therefore they have no say in appointing the management members in the corporation, which would have been seen as disadvantage of preferred stocks. But, how does the company balance this disadvantage? The businessman investing solid amount of money, would most likely wish to have a some kind of guarantee or an opportunity in taking part in the company's major decision making process. What actually matters in this case, is that in large corporations, and especially in joint stock companies, board of directors is a decision making body, therefore unless otherwise stated in the articles of incorporation, shareholders normally do not interfere in the decision making process, hence bearing in mind this somewhat of a disadvantage, investors can be easily attracted by the fact that owing a preferred stock, although with no voting right, but with high dividend rate, might add the attractiveness to this investment vehicle. Thus, it is up to the management and their intentions to what extent they are negotiable with giving up particular rights or privileges to the potential investors and how they are going to balance them. Additionally, having a higher dividend rate for the preferred stock as opposed to the common stocks, is considered as a fixed income security which carries low risk, as the corporation has the obligation towards preferred stockholders to repay the dividend to them prior to the holders of the common stock.<sup>73</sup>

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<sup>70</sup> *Supra* note 7.

<sup>71</sup> *Supra* note 52.

<sup>72</sup> *Id.*

<sup>73</sup> *Id.*

Last, but not the least point I would like to make in terms of dividends, is the fact that offering additional "sweetener" in return to the capital increase of the corporation is so-called "guaranteed payments"<sup>74</sup> which makes preferred stocks more desirable. More precisely, the advantage of issuing this particular class of stocks corresponds to the guaranteed dividend payments, meaning that once stocks are distributed, the dividend is already guaranteed and it makes its market value stable, and the moment stocks are issued, the dividend amount cannot be changed.<sup>75</sup>

### 2.3.2. Liquidation Preference

Second important feature of the preferred stock among other characteristics, is known as liquidation preference, when the owner of the preferred stocks has a privilege in asset distribution over the holders of the common stocks in case of liquidation of the corporation. Thus, preferred stockholders "having senior claim on assets in the event of liquidation, makes preferred shares senior to common equity in the capital structure".<sup>76</sup>

Liquidation preference has been assigned to the preferred stock from the very beginning of its existence and constitutes the well examined tool for reimbursement of an amount assigned to shareholders.<sup>77</sup> However, an important question which might be raised by an investor, corresponds to the amount that preferred stockholder receives after liquidation, and the answer is that it "may be based on the par value of the preferred shares, the original issue price, or some stated amount, and it usually includes a modest premium over the par value or issue price."<sup>78</sup>

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<sup>74</sup> *Supra* note 7.

<sup>75</sup> *Id.*

<sup>76</sup> Bonnevier, Borke, *supra* note 69, at 5.

<sup>77</sup> HAMILTON, BOOTH, *supra* note 8, at 314.

<sup>78</sup> *Id.*

Thus, corporation will try to satisfy the needs of the stockholders with preferential rights first, unless it faces an obstacle when there is not enough funds to cover all financial needs of the stockholders, as even though with privileges, but preferred stockholders stand second in line after the creditors.

### 2.3.3. Convertible Option into Common Stock

Apart from the listed attributes, preferred stock has also a convertible option, meaning that the preferred stock can be converted into common stock, which makes the preferred stockholder in an advantageous position having the right to convert at a "prearranged price"<sup>79</sup> and it is "attractive to preferred stock holders because they are entitled to the steady stream of dividends, plus they can enjoy appreciation in value if the company's common stock rises, hence this fixed-income characteristic makes preferred stock a good choice for a long-term retirement investments".<sup>80</sup>

In addition to a convertible feature, shareholders agreement contains the terms and conditions which basically provides the protective mechanism for the investor. As long as relationship between corporation and the shareholder is contractual in nature, frequently contract contains a provision protecting from a share dilution, which by issuing additional shares, results in a reduction of the percentage of equity ownership of the corporation.<sup>81</sup>

Additionally, one of the advantages of the preferred stocks over the debt, from the corporation's point of view, is that in any event if the corporation fails to pay dividends to the

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<sup>79</sup> *Supra* note 52.

<sup>80</sup> *Id.*

<sup>81</sup> HAMILTON, BOOTH, *supra* note 8, at 315.

stockholders, it might not necessarily lead to the company's bankruptcy,<sup>82</sup> and more importantly, the vast majority of companies tend to make a payment to the owners of the stocks in a fixed amount of return but, do not provide any remedy if there is a failure in complying with payment.<sup>83</sup> In sum, contractual nature of the relationship gives broad discretion to streamline rights and obligations of the shareholders in order to avoid complexity.

At the outset, preferred stock may also behave like bonds if payments are guaranteed to investors, more precisely, bonds have a guaranteed interest payment, in comparison to bonds, preferred stock is paid a guaranteed dividend.<sup>84</sup> What matters in this particular case is that, company issuing bonds faces the problem in terms of company's balance sheet, reflecting company's high "indebtedness",<sup>85</sup> which might have a negative impact on the share price of common stock as opposed to issuing preferred stocks, when bearing in mind this disadvantage, a company may decide to issue preferred stocks rather than bonds.<sup>86</sup> In addition to this point, issuing preferred stock has another benefit in comparison to bonds. What matters is that a corporation may delay dividend payments, without automatically making default, as opposed to bonds, when a company simply cannot skip paying money back for bonds.<sup>87</sup> "One more selling point for preferred stock, is that they can be redeemed by the issuing firm before they are scheduled to mature like a bond - and this gives the company the ability to use preferred shares of stock for a specific funding purpose."<sup>88</sup> Additional flexibility can also be seen from the

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<sup>82</sup> Ballam, *supra* note 3, at 53.

<sup>83</sup> *Id.*

<sup>84</sup> *Supra* note 7.

<sup>85</sup> *Id.*

<sup>86</sup> *Id.*

<sup>87</sup> *Does issuing preferred shares offer a tax advantage for corporations?* Chad Langager (available at: <http://www.investopedia.com/ask/answers/06/preferredsharestaxbenefit.asp>) (last visited Feb 12, 2016).

<sup>88</sup> *Supra* note 52.

dividend payments function, which is somewhat similar to interest payments on bonds and creates a guarantee of dividend distribution.<sup>89</sup>

I will close at this point, stating that preferred stocks known as "hybrid" stocks, as already highlighted in previous chapter, encompasses characteristics of stocks and bonds,<sup>90</sup> therefore "some of these rights are inherent, others are granted by statute."<sup>91</sup> Hence, rights delegated by the statute, must be flexible, advance and drafted in a manner to make conducting business activities easier and more importantly, keep the law up-to-date in order to meet the needs of the investors. Therefore, subsequent part of the thesis will examine statutory law of the US, with introduction to Delaware General Corporation Law and shall examine the rules under which preferred stocks are regulated, following with brief overview of MBCA.

## **2.4. Delaware General Corporation Law**

### **2.4.1. General Overview**

"Delaware has been preeminent as the place for business to incorporate since the early 1900s,"<sup>92</sup> and nowadays most of small or large corporations in the US are established in a state of Delaware. Why would they choose Delaware? The answer to this question is its flexible and advance corporate law.<sup>93</sup> Hence, the reason why this thesis is mainly focusing on DGCL is derived from the flexible rules that it offers to all companies incorporated under DGCL and assists them to operate on the market effectively, it constitutes a best example I would like to draw a parallel with and show what are the advantages other legal systems would want to

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<sup>89</sup> *Supra* note 7.

<sup>90</sup> *Supra* note 52.

<sup>91</sup> Buxbaum, *supra* note 4, at 243.

<sup>92</sup> Black, *supra* note 10, at 1.

<sup>93</sup> *Id.*

transpose into the jurisdiction. Thus, using it as a model makes clear picture how business activities can be carried out, what corresponds as preferable statutory regulations, most importantly, what are the key points to address in order to make market economy appealing for future potential investors and thus attracting them to invest in small or large corporations, operating on an emerging market.

The first and the most important point, is that the law governing business should offer as much flexibility as possible to the corporations as well as to its current and potential shareholders. The flexible and transparent the statute is, the better business planning is available for the investors.

At the outset, "Delaware's General Corporation law, like most general laws of incorporation in the United States, is enabling statute, with underlying philosophy that public good is advanced by provision of inexpensive mechanism that allows all individuals to achieve benefits that corporate form provides through establishing management and governance terms that appear advantageous to those designing organization."<sup>94</sup>

For better illustration how DGCL as well as MBCA deals with stocks with preferential rights, we should familiarize ourselves with statutory regulations, starting with Section 101 of DGCL<sup>95</sup> which authorizes a corporation to conduct its business lawfully and serves as a guideline for business or nonprofit corporations.<sup>96</sup> What matters in this particular wording is that, "the Delaware General Corporation Law permits the broad discretion to establish, in the

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<sup>94</sup>*Delaware Corporations Law Annotated*, 2011 edition, West, A Thompson Reuters Business, at p. 195

<sup>95</sup> DGCL §101 - Delaware General Corporation Law (Available at - <http://delcode.delaware.gov/title8/c001/>).

<sup>96</sup> Welch, Saunders, *supra* note 65 at 5.

certificate of incorporation, the terms that will govern the finance of the corporation as well as the economic and voting rights of the stockholders."<sup>97</sup>

Interestingly, "Delaware's market share seems to be growing, as eighty-one percent of corporations that went public between 2003 and 2007 were Delaware corporations"<sup>98</sup> and "these figures corroborate the value of Delaware corporation brand as a signaling device to public investors."<sup>99</sup> Therefore, we can conclude that Delaware is achieving its goal by adding flexibility to DGCL and representing the best example the developing countries might want to use the experience and transfer the key features or formulas of success, which makes it so advantageous for the business society. Thus, the new emerging corporations in developing countries shall also benefit and country shall create more attractive investment vehicle for future investors to make sure that both, corporations and the potential shareholders can actually benefit from.

Having knowledge of the fact that a certain corporation is incorporated under DGCL, gives some of the guarantees to the investors that their future business will run smoothly.<sup>100</sup> Hence flexibly tuned rules of DGCL shall thus be addressed below in more detail.

## **2.5. Preferred Stocks under Delaware General Corporation Law**

Having briefly overviewed the "pro business"<sup>101</sup> character of Delaware, it is now important to address the rules governing business under DGCL. According to Delaware General Corporation Law, preferred stock is the class of stock which may enjoy certain type of privileges

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<sup>97</sup> Edward P. Welch, Robert S. Saunders, *Freedom and its Limits in the Delaware General Corporation Law*, 33, No.3, Delaware Journal of Corporate Law (DJCL), 845, 852 (2008).

<sup>98</sup> *Id.* at 866.

<sup>99</sup> *Id.*

<sup>100</sup> *Id.* at 865-866.

<sup>101</sup> Black, *supra* note 10, at 1.

by addressing its peculiar features in respective manner, however at the outset, these features and preferences must be clearly stated in a certificate of incorporation. More precisely, let us take a look at the respective articles of DGCL authorizing stockholder to exercise their preferential rights. According to section §121 (a) of DGCL<sup>102</sup> "every corporation, its officers, directors and **stockholders** shall possess and may exercise all the powers and privileges granted by this chapter,... or by its certificate of incorporation."<sup>103</sup> Additionally, section §151 (c) and (d) speak of the opportunities, when exactly the holders of the preferred stocks can enjoy their right, which basically is dividend distribution and transfer of assets in case of dissolution, however this can be achieved under one condition that, the prerequisite of having relevant terms and conditions clearly stated in the articles of incorporations, is a must.<sup>104</sup> Thus, we can sum up that, certainly, preferred stockholders may enjoy privileges assigned to them; at least the corporation has the opportunity to benefit from the broad and general wording of the DGCL and stipulate the terms and conditions accordingly at its discretion, which will serve its business purpose at its best possible way.

Further, in order to meet specific market expectations and economic conditions, section §151 of DGCL sets number of restrictions on the corporations, more precisely, the types of stocks a company may issue.<sup>105</sup> Thus, under section 151 of the Delaware General Corporation Law<sup>106</sup> unless otherwise stated in a certificate of incorporation, a corporation is authorized to issue different classes of shares with certain privileges assigned to them, in addition subsection to article 151 makes it possible for the corporation to divide special rights and elements to the

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<sup>102</sup> DGCL §121 (a).

<sup>103</sup> *Id.*

<sup>104</sup> DGCL §151 (c) and (d).

<sup>105</sup> Welch, Saunders, *supra* note 65, at 345.

<sup>106</sup> DGCL §151

specific classes of shares, such as payments of dividends, distribution of assets while liquidation, etc.<sup>107</sup> In order to give full picture how it is exercised in practice, let me bring an example of the case *Lacos Land Co. v, Arden Group, Inc.*,<sup>108</sup> which makes a clear illustration of how the DGCL accommodates needs of shareholders as well as management and "provides great flexibility to shareholders in creating the capital structure of their firm."<sup>109</sup> More precisely, "in the case *Lehrman v. Cohen*"<sup>110</sup> it is specifically stated that the statute permits the creation of stock having voting rights only, as well as stock having property rights only"<sup>111</sup>, hence "stock can be created with voting rights but no economic rights, or with economic rights but no voting rights."<sup>112</sup>

### 2.5.1. Distribution of Dividends

Delaware General Corporation Law, eliminates vague wording and avoids brainstorming whether the preferred stocks dividends are cumulative or not, and provides in section 151 (c) the following interpretation that, "the holders of preferred or special stock of any class or of any series thereof shall be entitled to receive dividends at such rates, on such conditions and at such times as shall be stated in the certificate of incorporation".<sup>113</sup> Therefore the section 151 (c) of DGCL makes it far more flexible for the corporation to design bylaws upon its discretion, especially provide specific terms and conditions concerning dividend distribution and allows corporations to tune their internal documents, such as articles of incorporation, in order to reflect their business needs.

<sup>107</sup> Welch, Saunders, *supra* note 97, at 852.

<sup>108</sup> *Lacos Land Co. v, Arden Group, Inc.*, 517 A.2d 271(Del. Ch. 1986).

<sup>109</sup> *Id.* at 275. (see also Welch, Saunders, *supra* note 97, at 852).

<sup>110</sup> *Lehrman v. Cohen*, 222 A.2d 800, (Del. 1966).

<sup>111</sup> *Id.* at 807.

<sup>112</sup> Welch, Saunders, *supra* note 97, at 852.

<sup>113</sup> DGCL §151 (c)

The dividends can be distributed either in cash or in any other form, such as property or stocks, as professor Buxbaum mentions in his seminal article.<sup>114</sup> If a corporation and a holder of the cumulative preferred stock, agree on dividend distribution and any other funds in arrears to be carried out in cash rather than in any other form, this means that dividend should be repaid in a predetermined manner.<sup>115</sup> It is interesting to draw a parallel to DGCL to section §173 of DGCL<sup>116</sup>, which similarly gives an opportunity to a corporation to distribute dividends either in "cash, in property, or in shares of the corporation's capital stock."<sup>117</sup> Additionally, according to section §151(c) of DGCL<sup>118</sup>, the holders of both special or preferred stocks of any class are given freedom to receive dividends at predetermined rates and conditions as it will be stipulated in the documents of incorporation.<sup>119</sup> In sum, we can conclude at this point, and agree with Prof. Buxbaum's approach that since the relationship between preferred stockholders and the corporation is contractual in its sense, it is upon the parties to agree on the terms and conditions of the dividend distribution, especially when it comes to dividend payments to preferred stockholders, since it seems to be feasible under DGCL, as section §173 and §151 (c) collectively offer us a broader language and allows parties to tune the charter at their discretion and in a more sophisticated manner taking into account modern business tendencies and its expectations.

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<sup>114</sup> Buxbaum, *supra* note 4, at 252.

<sup>115</sup> *Id.*

<sup>116</sup> DGCL §173 on Declaration and Payment of Dividends.

<sup>117</sup> *Id.*

<sup>118</sup> DGCL §151 (c)

<sup>119</sup> *Id.*

### 2.5.2. Preference Right in Terms of Dissolution

Speaking of dissolution or liquidation, it is important to identify what shall be considered as liquidation or dissolution?<sup>120</sup> Drawing the line between these two, shall give us a clear picture, especially when it comes to asset distribution in either of the circumstances. As for the meaning of dissolution, Black's Law Dictionary offers an accurate clarity and states, that the dissolution in its nature means "the termination of a corporation's legal existence by expiration of its charter, by legislative act, by bankruptcy, or by other means; the event immediately preceding the liquidation or winding-up process"<sup>121</sup> and in addition it can be either voluntary or involuntary, meaning that in case of voluntary dissolution in majority of situations it "is initiated by the board of directors, while involuntary dissolution can be judicially, administrative, such as default in paying taxes or filing reports, or through involuntary bankruptcy."<sup>122</sup> As for the liquidation, Black's law dictionary gives us a following definition: "liquidation is an event that usually occurs when a company is insolvent, meaning, it cannot pay its obligations as and when they come due."<sup>123</sup> Meaning that, in the event of liquidation, assets are being distributed between shareholders and the creditors, depending on the "priority of their claims",<sup>124</sup> where these procedures are being regulated and governed by the US Bankruptcy Code.<sup>125</sup> In addition to that, the state of reorganization brings an interesting question, whether it anyhow is related to the preferred stockholders. Surprisingly, when it comes to the preferred stock, the reorganization of the corporation can also be regarded as liquidation.<sup>126</sup> More precisely, to give a full picture I

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<sup>120</sup> Buxbaum, *supra* note 4, at 260.

<sup>121</sup> Black's Law Dictionary (10th ed. 2014).

<sup>122</sup> *Id.*

<sup>123</sup> <http://www.investopedia.com/terms/l/liquidation.asp> (Last visited: March 27, 2016).

<sup>124</sup> *Id.*

<sup>125</sup> *Id.*

<sup>126</sup> Buxbaum, *supra* note 4, at 261.( see also *Central States Elec. Corp. v. Austrian*, 183 F.2d 879. 4th Cir. 1950).

would like to draw your attention to a case *Central States Elec. Corp. v. Austrian*,<sup>127</sup> in order to show that, when the corporation is being dissolved or wind up and consequently new enterprise is being formed as a result of reorganization, the preferred stockholders of the old corporation are "entitled to the liquidation preference for which their stock provides",<sup>128</sup> and in addition the court in the case at hand stated that "denying the preferred stockholders the equitable equivalent of their liquidation preference in the instant reorganization would, subvert the basic doctrine of absolute priority among competing interests and would render somewhat illusory the charter provisions for a preference to these stockholders."<sup>129</sup> Although we might be cautious in relation to the reorganization concept in realm of preferred stock, however the given example above shows that it all depends on its interpretation and surely on the facts of the case as well.

Normally, articles of incorporation contain specific wording which gives preferred shareholders a preference in asset distribution in terms of dissolution of the corporation. Interesting question arises concerning calculation of omitted amount and what is the solution to that and how can the omitted amount actually be calculated during liquidation of the enterprise?<sup>130</sup> The majority of the case law shows the approach of the courts, stating that when there is a liquidation at hand, the corporation is obliged to pay out both par and dividend arrears to the preferred shareholders, in order to "permit the full preference, although there were no profits, since dividends accrue on cumulative stock even if not earned"<sup>131</sup> as professor Buxbaum states in his seminal article.

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<sup>127</sup> *Central States Elec. Corp. v. Austrian*, 183 F.2d 879 (4th Cir. 1950).

<sup>128</sup> See *id.* at 885.

<sup>129</sup> See *id.* at 888.

<sup>130</sup> Buxbaum, *supra* note 4, at 258.

<sup>131</sup> *Id.*

Historically, and as the broad experience shows, provision concerning liquidation preference is typically contained in the contract, which additionally constitutes another "sweetener" for potential investors.<sup>132</sup> Usually, unless otherwise stated and agreed between shareholder and a corporation, the owner of the preferred stocks often receives an additional sum apart from dividends, which was omitted by the enterprise in previous year, so that the corporation is now obliged to pay back all and every amount due, and furthermore if a dissolution or liquidation is voluntary, corporation generally pays additional premium to the preferred stockholders.<sup>133</sup>

### 2.5.3. Convertible Option into Common Stock

Another feature dealing with preferred stock is a convertible option into common stock. Convertible preferred stock as defined, constitutes a "fixed-income security that investor can choose to turn into a certain number of shares of the company's common stock after a predetermined time or on a specific date."<sup>134</sup> Having this feature, investor can benefit in several ways, such as having a convertible preferred shares, the preferred shareholders are privileged in receiving dividends before they are distributed to other shareholders. However, underline questions is, how do the preferred stockholders benefit from the conversion feature? The answer is that, when a corporation makes profit and therefore the share price is rising, the investor can "profit from that rise by turning their fixed income investment into equity."<sup>135</sup>

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<sup>132</sup> *Id.* at 261.

<sup>133</sup> *Id.*

<sup>134</sup> Introduction to Convertible Preferred Shares, Ben McClure, (available at: <http://www.investopedia.com/articles/stocks/05/052705.asp> last visited March 22, 2016).

<sup>135</sup> *Id.*

Delaware General Corporation law gives flexibility to the corporations to formulate and make an accurate wording of the articles of association, which shall be suitable for each corporation. This variety of flexibility also contains the definition feature of conversion tool in the articles of the corporation. Under DGCL section 151 (e)<sup>136</sup> "any stock of any class or of any series therefore may be made convertible into, or exchangeable for at the option of either the holder or the corporation .... at such price or prices... as shall be stated in the certificate of incorporation or in the resolution adopted by the board of directors."<sup>137</sup>

While Delaware is a leader, Delaware courts try to "synchronize" law with the practice of preferred stocks, and therefore it led to the increasing tendency of preferred stocks "economic salience in recent years".<sup>138</sup> The number of use of preferred stocks relatively "outstrip both of initial public offerings of common stock and of new public common offerings."<sup>139</sup> Additionally, the popularity of preferred stock concept, as a mode of investment can be found in venture capital investment area<sup>140</sup> which will be discussed in more detail in chapter three.

In conclusion, features and information provided, illustrate practical and empirically tested "formulas" of preferred stocks in the US, and the way they are dealt under DGCL. It is equally of high importance to see how it is dealt under MBCA, thus addressed in the upcoming subchapter.

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<sup>136</sup> DGCL §151 (e)

<sup>137</sup> *Id.*

<sup>138</sup> Bratton, Wachter, *supra* note 53, at 1817.

<sup>139</sup> *Id.* at 1818.

<sup>140</sup> *Id.*

## 2.6. Preferred Stock under Model Business Corporation Act

Before addressing rules governing preferred stock features under MBCA, it is important to briefly review the aspect of MBCA for the prospective readers. Model Business Corporation Act was drafted by the Committee of Corporate Laws of the American Bar Association and has been enacted by majority of states in the US. In addition, MBCA represents a model law, which can be implemented by any state in its own legislation.

For the purpose of this thesis, it is essential to take a look at chapter six of the MBCA which deals with shares and distribution related matters. Unlike DGCL, MBCA gives us a definition of the preferred stocks under definition section; and thus defines "preferred shares" as follows: "Preferred shares means a class or series of shares whose holders have preference over any other class or series with respect to distributions."<sup>141</sup> Meaning that, preferred stocks shall have superior right over other series of shares when it comes to distributions either when declaring dividends or assets distribution in terms of liquidation.

Section § 6.01 of the MBCA suggests to the corporations broader definition of shares by providing flexible wording of classifying different classes of shares, thus shall be briefly addressed below.<sup>142</sup> In sum, MBCA adopts accurate and advanced terminology omitting classification of "common" and "preferred" shares, giving corporations freedom of choice to assign special kind of preferences to each class of shares upon its discretion and the respective language must be incorporated in the articles of incorporation.<sup>143</sup>

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<sup>141</sup> Model Business Corporation Act §13.01 (6) (hereinafter M.B.C.A - available at <https://apps.americanbar.org/dch/committee.cfm?com=CL270000>).

<sup>142</sup> HAMITLON, BOOTH, *supra* note 8, at 316.

<sup>143</sup> *Id.*

Furthermore, section 6.01 (a) of MBCA states that "articles of incorporation must set forth "any classes of shares" and the series of shares within a class ....that the corporation is authorized to issue. If more than one class or series of shares is authorized, the articles of incorporation must describe ... the terms, including the preference, rights and limitations, of that class of series."<sup>144</sup> By this illustration MBCA suggests more "general language to reflect the actual flexibility in the creation of classes of shares."<sup>145</sup>

Moreover, MBCA adopts language to allow corporations conversion right of shares. Section 6.01(c) (2) addresses the convertibility of shares and outlines that, any class of any shares can be converted into any other class of shares.<sup>146</sup> Hence, one or more classes of shares can be convertible for "cash, indebtedness, securities, or other property."<sup>147</sup>

It is of high importance to note, that section six of MBCA enables to create new classes of shares without any restriction allowing corporations to create "innovative"<sup>148</sup> series of shares which might be of relevance for business needs.<sup>149</sup> Thus, the new shares with preferential rights are created for raising capital and in order to "meet perceived corporate needs in specific circumstances or because of financial problems generated by market conditions for capital."<sup>150</sup>

In sum, both DGCL and MBCA, by offering corporations accurate language governing corporate finance, create flexibly functioning system, which once again shows that exporting

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<sup>144</sup> MBCA § 6.01 (a)

<sup>145</sup> HAMILTON, BOOTH, *supra* note 8, at 316.

<sup>146</sup> *Id.* at 318.

<sup>147</sup> M.B.C.A § 6.01 (c) (2) (ii)

<sup>148</sup> HAMILTON, BOOTH, *supra* note 8, at 318.

<sup>149</sup> *Id.*

<sup>150</sup> *Id.* at 319.

already tested rules and well crafted features, will benefit business and shall boost the market economy to a higher level.

## **2.7. Preferred Stock under Georgian law**

The Law of Georgia on Entrepreneurs belongs to civil law legal system adopted in 1994. The law of Georgia on the entrepreneurs now tries to meet the expectations of the investors, of course with few exceptions which thus justifies this thesis.

At the outset, Georgian law on entrepreneurs does not specifically grant privileges but in some circumstances neither does it contain respective wording which would be seen as an advantage for the business itself, and therefore makes me obliged to emphasize the issue which I personally think needs revision. Additionally, some of its rules are basically lacking empirical evidence of their use in practice, which again leads us to think that there is a lack of knowledge in terms of their exploitation and even less familiarity whether it can somehow positively influence a market. Therefore, continuous attempt to advance and keep the law up-to-date in order to meet the expectations of local as well as foreign investors is of importance. More precisely, inexperience of use of investment vehicle such as preferred stock, which is the case in Georgia at hand, negatively affects business environment as well as market economy.

Further, for better understanding and highlighting the issue, it is of importance to examine rules governing stock distribution in more detail. Georgian law on entrepreneurs deals with majority topics related to corporate law, it also briefly addresses the topic of shares in article 52<sup>151</sup> which basically represents a centerpiece of this thesis, dealing with types of shares

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<sup>151</sup> Law of Georgia on Entrepreneurs, §52

as well as their rights of conversion. The very first part of article 52 (1) allows companies to issue either common or preferred stocks, common with voting right at the shareholders meeting, while preferred stocks are not authorized with such right,<sup>152</sup> meaning that common stockholders, as opposed to the holders of preferred stocks are granted a controlling power in decision making process. In comparison to common stocks, preferred stocks are deprived of voting rights, however the law allows to distribute dividends to the preferred stockholders at a fixed rate.<sup>153</sup>

According to article 52 (1<sup>1</sup>), along with the common and preferred shares, the corporation is entitled to issue additional class of stocks on the shareholders general meeting and the type, quantity and additional rights assigned to the newly issued shares must be stipulated in the articles of corporation.<sup>154</sup>

Additionally it is worth mentioning, that the Law of Georgia on Entrepreneurs does not actually mention anything about liquidation preferences. Neither does it emphasize whether the preferred stockholders can enjoy any preference in terms of company's dissolution or liquidation. Furthermore, it is also silent on conversion preference, rather it makes a remark in section 52 (3) that a "joint stock company may issue other securities convertible into shares",<sup>155</sup> which again represents a general language saying nothing about conversion feature into common stock.<sup>156</sup>

As for the dividend distribution, Georgian law on Entrepreneurs, section 52 (1) includes following language, that: "any promise that future dividends will be paid in any event, such

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<sup>152</sup> Law of Georgia on Entrepreneurs, §52 (1)

<sup>153</sup> *Id.*

<sup>154</sup> *Id.* §52 (1<sup>1</sup>)

<sup>155</sup> *Id.* §52 (3)

<sup>156</sup> *Id.*

promise shall be deemed as void."<sup>157</sup> What is interesting in this part, is that law does not actually refers to dividend distribution preference for preferred stockholders, but rather makes a remark that promise for issuing dividend to the shareholders shall be regarded as void.<sup>158</sup>

Hence, to conclude, as we have seen, although preferred stocks are regulated under Georgian law, the wording itself provides neither flexibility nor does it contain provision which could have met the expectation and needs of local or foreign investors, to run their business smoothly and avoid any complications which might hinder their business activity. Therefore it is important to make sure that the law is flexible enough and reflects modern tendencies which will add attractiveness to it. Unless law governing preferred stocks is current, there is a little chance investor would prefer to use this mode of investment and neither he will be interested to invest in that particular market. Furthermore, it is not about giving all privileges to the foreign investors, but to the locals as well, therefore wording of the law is of the importance to attract serious and long term investments in the country, while the market economy of the country can only function smoothly if the relevant regulations are kept flexible and advance.

The rules governing issuance of preferred stocks have been rarely used. Moreover, preferred stocks under the Law of Georgia on Entrepreneurs, represent the type of securities which exists only on the paper rather than in practice. Even if the concept of preferred stocks tends to be new for Georgian reality, it is never too late to suggest the improvements, especially when the development of market economy is of high importance. Thus, the duty of draftsman corresponds one of the important obligations to amend law governing business in light of experience of developed systems, such as the US.

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<sup>157</sup> *Id.* §52 (1)

<sup>158</sup> *Id.*

Hence subsequent chapter will be dealing with the evidences of intense exploitation of preferred stocks in practice and shall streamline the option how and where can it be used at its best and what is the beneficial outcome, if any.

## CHAPTER THREE

### EMPIRICAL EVIDENCE OF USE OF PREFERRED STOCKS

#### 3.1. Evidence of Use of Preferred Stocks in the United States

Having briefly discussed peculiar features of preferred stocks and their importance in corporate law under US and Georgian legal systems, it is now time to review practice, if any, of exploitation of preferred stock as an investment tool in both countries, starting with the US case law, following with brief overview of the practices developed in venture capital financing.

##### 3.1.1. Landmark Cases

In order to illustrate the utilization of the "hybrid" stock in the US market, a brief overview of landmark cases is of high importance, therefore for the purpose of this thesis, I have chosen three important cases highlighting the fact that the use of preferred stocks in the US has a way long history. The cases at hand, will show the evidence of their use and the approach of the courts toward the issue. Let us start with the case *Arizona Western Insurance Company v. L.L. Constantin & Co.*<sup>159</sup>, where the plaintiff initiated a lawsuit against a defendant in order to receive dividends for the preferred stocks, being authorized by the newly adjusted certificate of incorporation granting the preferred shareholders right to receive dividends and hence corporation undertaking an obligation to distribute such dividends to them.<sup>160</sup> The issue was raised due to the default in payment of the dividends by Constantin to Arizona, under a resolution where preferred stockholders, including Arizona, were also entitled to receive dividend, however respective payments were not made on Arizona's shares.<sup>161</sup> One of the

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<sup>159</sup> *Arizona Western Insurance Company v. L.L. Constantin & Co.*, 247 F.2d 388 (3d Cir. 1957).

<sup>160</sup> *Id.* at 388.

<sup>161</sup> *Id.* at 389.

arguments Constantin brought before the court was that, if the court would have instructed Constantin to pay dividends to Arizona, such decision would have served as interference from court's end into Board of Directors competence and its activities in the corporation.<sup>162</sup> It is of high importance to note, that "Constantin was contractually bound by the provisions of its amended certificate to pay dividend, net profits being available,"<sup>163</sup> and in response to Constantin's cited case laws, court stated the following:

"We appreciate the reluctance of courts to construe provisions relative to the declaration of dividends in such a way as to hold that the directors are bound in certain circumstances to declare dividends. But the shareholder has the right to have his contract enforced, and, if the contract as expressed in the certificate of incorporation and the stock certificate, require the construction that dividends are mandatory under specified circumstances the courts can adopt no other construction of the contract between the corporation and the stockholder."<sup>164</sup>

In sum, according to a revised certificate of incorporation a company was bound to pay fixed dividend from net profits and the holders of the preferred stocks were authorized to receive these dividends, thus it was obvious that Constantin was contractually bound to repay dividends to the preferred stockholders out of net profits.<sup>165</sup>

A following case, *Guttman v. Illinois Central R.Co.*<sup>166</sup>, is dealing with the distribution of cumulative dividends. More precisely, plaintiff, the owner of the non-cumulative dividends, instituted a lawsuit against defendant, claiming that the dividends that they were assigned for in the year of 1937-1947, should have been declared by the board of directors.<sup>167</sup> The plaintiff was claiming that the board of directors have "abused their discretion in withholding dividends from

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<sup>162</sup> *Id.* at 390.

<sup>163</sup> *Id.*

<sup>164</sup> *Id.* at 391.

<sup>165</sup> *Id.*

<sup>166</sup> *Guttman v. Illinois Central R. Co.*, 189 F.2d 927 (2d Cir.1951)

<sup>167</sup> *Id.* at 927.

non-cumulative preferred stock for any of the past years."<sup>168</sup> Thus the court had to decide whether the board had the authority in declaring the dividends on arrears to the preferred stockholders, and whether they have abused their discretion in declaring dividend distribution only to the common stocks rather than on both classes of stocks.<sup>169</sup> The court held that the directors have not abused their discretion in refraining from declaring arrears on dividends to the non-cumulative preferred stockholders, thus the board of directors have no discretion in declaring dividends thereon.<sup>170</sup> Moreover, court admitted that "nothing in the wording of that contract would suggest to an ordinary wayfaring person that existence of a contingent or inchoate right to arrears of dividends and as courts on occasions have quoted or paraphrased ancient poets, it may not be inappropriate to paraphrase a modern poet and to say that '**contract is a contract is a contract.**'"<sup>171</sup>

Hence the doctrinal practice derived from this case and can be regarded as a lesson which corresponds that "the bargain made by preferred stockholders may well be of a most undesirable kind. Perhaps the making of such bargains should be prevented, but if so, the way to prevent them is by legislation."<sup>172</sup>

Lastly, a case *Schreiber v. Carney*<sup>173</sup> demonstrates veto power issue where a preferred stocks play an important role. Dispute arose after a reorganization plan made by the management of the Texas International and the restructuring was based on share to share merger into a newly formed corporation for the purpose of the reorganization plan.<sup>174</sup> The aim of the merger was to

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<sup>168</sup> *Id.*

<sup>169</sup> *Id.* at 928.

<sup>170</sup> *Id.* at 931.

<sup>171</sup> *Id.* at 930.

<sup>172</sup> *Id.* at 931.

<sup>173</sup> *Schreiber v. Carney*, 447 A.2d 17 (Del. Ch. 1982).

<sup>174</sup> *Id.* at 18.

strengthen Texas International financially.<sup>175</sup> However, in the meantime one of the shareholders, Jet Capital, who was a holder of the majority shares of the preferred stocks, claimed that it would have used its power and authority assigned to it by the certificate of incorporation and would have blocked the merger resolution, as "the merger, if approved, would impose an intolerable income tax burden on it."<sup>176</sup> Jet Capital had several alternatives, and the possibilities were either to participate in voting in favor of merger, but with tax related consequences constituting \$800,000 or it could have "exercise the warrants prematurely, then the merger would then be tax free to it as it would be to the other shareholders,"<sup>177</sup> but "it would needed additional funds in order to exercise the warrants."<sup>178</sup> In sum, Texas International and Jet Capital agreed that Texas International would have made available a loan to Jet Capital.<sup>179</sup> Thus, the plaintiff was claiming the decision to loan transaction was void because of "vote-buying"<sup>180</sup> and that the transaction was constituted as a "corporate waste."<sup>181</sup> In sum, the court held that, despite the fact that the decision on loan transaction in return for voting in favor of reorganization merger could have been a "vote-buying", however was not illegal as the detailed information was disclosed to the other shareholders and stressed that this decision could have been in the best interest of the corporation.<sup>182</sup> Thus, the court denied plaintiff's motion on claiming a loan transaction decision as a "vote-buying" from the shareholders end.<sup>183</sup>

In sum, a bottom line of the cases illustrated above, was to show, the court practice in relation to the interpreting the rights assigned to preferred stockholders. These three cases serve

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<sup>175</sup> *Id.* at 19.

<sup>176</sup> *Id.* at 19.

<sup>177</sup> *Id.* at 19.

<sup>178</sup> *Id.*

<sup>179</sup> *Id.* at 20.

<sup>180</sup> *Id.*

<sup>181</sup> *Id.*

<sup>182</sup> *Id.* at 17.

<sup>183</sup> *Id.* at 27.

the purpose to illustrate the practice linked to the preferred stock concept in various issues at hand such illustrated in the above mentioned cases. Furthermore, the use of preferred stocks as an investment vehicle in venture capital financing is also of high importance, which will be dealt in the following subchapter.

### 3.1.2. Venture Capital Financing

The notion of venture capital industry is highly important for emerging economy and this is the area where preferred stock is assumed as one of the best financing instrument in the world of corporate finance, and for venture capital companies it is quite attractive and much of promising.<sup>184</sup> At the outset, investments in venture capital has been increased significantly since "1991 from 1.69 billion US dollars to \$67.7 billion in 2000,"<sup>185</sup> thus, we can be confident that preferred stocks represent one of the best investment opportunities, especially to the newly established "high-risk, cutting-edge startup companies."<sup>186</sup>

It is worth to note, that venture capital financing has been used by many of the large corporations at the very beginning of their existence on the market.<sup>187</sup> One of the motivation for a startup companies might be the fact that, those enterprises, using venture capital financing in their startup stage include Google, Amazon, Facebook, Starbucks and Apple.<sup>188</sup> How does it

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<sup>184</sup> William W. Bratton, *Venture Capital on the Downside: Preferred Stock and Corporate Control*, 100, issue 5, Michigan Law Review, The George Washington University Law School, Public Law and Legal Theory Working Paper No. 033, 2001. 1, 3 (2002).

<sup>185</sup> *Id.* see also Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. Econ. Persp. 145, 151, Table 1 & n. a (2001).

<sup>186</sup> Korsmo, *supra* note 54, at 1164. (see also - William W. Bratton, *Venture Capital on the Downside: Preferred Stock and corporate Control*, 100 Mich. L. Rev. 891 (2002) at 892).

<sup>187</sup> *Id.* at 1164-65 (see also - National venture Capital Association, *Venture Impact: The Economic Importance of Venture Capital-Backed Companies to the US Economy* 2 (6th ed. 2011)).

<sup>188</sup> *Id.* at 1165 (see also - National venture Capital Association, *Venture Impact: The Economic Importance of Venture Capital-Backed Companies to the US Economy* 2 (6th ed. 2011) at 10).

actually work in venture capital industry is that, most of the venture capital companies make contributions in a newly established corporations and receive preferred stocks in return.<sup>189</sup>

And finally, among the features of preferreds we have already discussed in previous chapters, it seems to be that convertible preferred stocks have been widely used by the investors as a mode of investment in the area of venture financing, for the purpose of future profit the preferred stock with convertible feature could bring to them.<sup>190</sup> More precisely during an initial public offerings, preferred stock shall be converted into common stock, which in this case might bring to the investor better conditions acquiring common stock instead of preferred stocks.<sup>191</sup> Moreover, by now we already know that the preferred stocks have set of privileges over the common stock, however preferred stock when converting into a common stock, basically loses all the sweeteners and attributes assigned to them, however despite this in venture capital financing, an investor might choose to convert preferred stock into common stock to acquire more favorable dealing, such as in the case of the acquisition a businessman who invested in a startup company, might receive favorable deal if he converts preferred stock into common stock.<sup>192</sup> Thus to conclude, preferred stocks have been used not only by large corporations but by the startup companies, who either need to raise capital or need additional funding for their business. Thus the peculiar and unique features of preferred stocks assists small and large corporations to achieve their long business goals.

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<sup>189</sup> *Id.* at 1173.

<sup>190</sup> Timothy J. Harris, *Modeling the Conversion Decisions of Preferred Stock*, 58, No.2, *The Business Lawyer*, published: American Bar Association, 587, 587 (2003).

<sup>191</sup> *Id.*

<sup>192</sup> *Id.* at 587-588.

### 3.2. Lack of Evidence in Georgian Reality

As we have seen throughout this thesis, the US has a rich history of exploitation of preferred stocks, however as opposed to the developed country such as the US at hand, the empirical evidence of the use of preferred stocks is lacking in Georgia.

It is interesting that, the first step towards utilization of this hybrid stock has been made, which is justified by the fact that the concept of preferred stocks is being regulated, however there is not enough evidence of their use in practice. It is difficult to find a corporation, which could have used this hybrid stock throughout its existence on the market. We even, rarely come across with the certificate of incorporation which actually includes at least a wording that a corporation "may" issue preferred stocks, and if they anyhow emphasize whether the preferred stockholders are granted of any privileges. There is also a doubt whether a corporation who incorporated this language in its bylaws, actually has knowledge what are the benefits if they are used in practice as an investment vehicle, but it rather seems to me that the language is simply copied from the law with no actual knowledge of its use.

However, at the outset there are some exceptions as well, but unfortunately these exceptions are relatively few. It will be difficult to try and find a proper wording of preferred stock in a certificate of incorporation of a company registered in the company registry database. Thus, this actually leads us to think that there is a lack of experience which is derived from lack of knowledge of their exploitation.

Furthermore, for full picture let me briefly illustrate an example of one of the biggest securities registrars in Georgia, United Securities Registrar of Georgia JSC ("Georgian

Registrar")<sup>193</sup> corresponding one of the leading independent companies, which provides services concerning securities registrations of large corporations operating on Georgian market. Surprisingly, according to their database, there is only one company as of now registered in Georgian Registrar, which actually currently issued preferred stocks. Thus, this argument once again convincingly shows that there is not much evidence of their use.

In sum, at least in my opinion, the most straightforward problem at hand is that, merely having a provision governing preferred stock, is not enough to boost country's market economy to the next level of development. The rules governing business, existing only on paper, does not say much unless they are drafted in a manner to assist corporations to achieve their business needs. Therefore revision of respective rules are recommended, which will at the end of the day provide clear and advance guidance for prospective investors as well as current shareholders of the corporations and shall give an opportunity to utilize one of the important investment vehicles, such as preferred stock.

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<sup>193</sup> Georgian Registrar - licensed independent registrar, authorized to provide registration services for joint stock companies - (see [http://www.usr.ge/#\\_eng\\_mtavari\\_2](http://www.usr.ge/#_eng_mtavari_2)).

## **CHAPTER FOUR**

### **RECOMMENDATIONS AND CONCLUSIONS**

This thesis, by making a comparative analysis between Georgia and the US legal systems, provided basic information concerning the main features of the "hybrid" equity security such as preferred stocks and its unique value in the area of corporate law. By evaluation of these two jurisdictions targeted in this thesis, I gave a clear picture of the drawbacks and gaps which need to be filled in Georgia's corporate law.

As already mentioned at the beginning of my thesis, the concept of preferred stocks are being regulated in Georgia, but with not solid information and thus due to the lack of knowledge market is lacking potential investors who might be willing to use this investment vehicle for their future business needs. Therefore it is of high importance to accommodate foreign and local investors with an advanced and flexible law which will help their activities on the market and will not hinder their business operations. Thus it is vital to take an example of developed systems, such as the one existing in the US, and use their approach and experience in crafting flexible and transparent laws.

As already emphasized above, preferred stock represents one of the most valuable equity securities having a far rich history and use in the corporate finance. What actually matters in this particular case, is that the comparison of Georgian law to the Delaware General Corporation Law, is important, while Delaware known as the most attractive place of incorporation of the companies, it offers modern and up-to date corporate law, thus making the business attractive for both foreign and local investors as well as current shareholders. Therefore taking an example of a well developed system can be beneficial for business and country as well.

The purpose of this thesis was to show what can be achieved through intense use of preferred stocks in the Georgian reality and what are the mechanisms to achieve particular goals. Apart from the importance of intense utilization of this mode of investment, another reason for writing this thesis was to test whether it is the right decision to follow the path developed by the systems such as in the US and what can be done in order to achieve the goals set in this thesis. Starting with the revision of the law, since the wording itself regulating law on preferred stocks in Georgian reality does not say much about their use, which makes even more confusion for potential investors, and hence the lack of knowledge will never make their exploitation possible in the corporate finance which will once again, will negatively affect country's market economy.

This thesis has illustrated that one of the most important modes of investment in fact represents the concept of preferred stocks as one of the equity securities. Its unique characteristics giving the potential investors several privileges in addition to those attached to the common stocks adds to it additional attractiveness. It is essential to make sure that regulatory environment is ameliorated by offering the market economy a law which is flexible enough and reflects modern tendencies, hence assisting investors in their business planning. Thus applying the rules and empirically tested "formulas" developed through long and rich history of the US will lead Georgia's market economy to a higher level. Therefore, this thesis recommends to carefully examine the experiences developed in the US system through tailoring the current corporate law of Georgia in light of US experiences. This can be achieved by incorporating a clear and advanced rules which will avoid complexity and shall straightforward the meaning and the rules of how the preferred stocks can be used and what are its benefits. This can be achieved by adding so-called "sweeteners" and features that have been developed over times and empirical practice shows their beneficial effect. Even through the concept itself is regulated in Georgia,

however the impression remains that it basically exists only on a paper and there is a little evidence of their use in reality. Thus adding key features to the law and making the wording transparent is recommended.

The law must be revised in order to meet the expectations of the players on the market; this will be beneficial not only for the corporations actively engaged in business, but for the country's economy as well. Creating a package of attributes which will make the market for investment attractive is of high importance for Georgia, through adding maximum flexibility and simple drafting, as well as adding combination of features such as dividend distribution preference, privilege in receiving the assets after liquidation and the preference in conversion preferred stocks into common stock once again creates additional attractiveness for each prospective investor. Otherwise, the existing wording of laws governing preferred stocks gives nothing but confusion, especially in light of the lack of experience, and the lack of knowledge reduces the intention from the very first moment businessman shows its willingness to invest.

In sum, appropriate legislative action is needed by incorporating already tested elements in light of the US experience which will make a better use of them. Ultimately, this thesis argued for the intense exploitation of preferred stocks, and it showed that they can play a vital part in improving the governance of business with better ways of attracting prospective investors, both foreign and domestic and motivating startup companies by way of boosting venture capital financing which will add more economic value generated through that for the countries development.

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