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CORPORATIONS - UNORTHODOX PREFERRED STOCK PROVISIONS IN PRIORITY LITIGATION

Elbert R. Gilliom
University of Michigan Law School

CORPORATIONS — UNORTHODOX PREFERRED STOCK PROVISIONS IN PRIORITY LITIGATION — To one who has accumulated sufficient savings to earn the position of a prospective purchaser of corporate securities there is presented an impressive and somewhat mystifying list of interests from which he may choose, advisedly or otherwise.[1] Between orthodox common stock at one extreme and secured bonds at the other, ranges an endless variety of stocks embodying some bond characteristics,[2] bonds bearing stock attributes,[3] and a welter of certificates professing to be neither stocks nor bonds.[4] Because individual sources of funds needed for industry do differ in their convictions as to relative advantages of different characteristics of securities, issuing corporations, in an effort to attract every available dollar under every imaginable market or credit condition, over a long period of time have devised the amazing spectrum of hazily distinguishable investments currently displayed to potential purchasers.[5]

[1] The enterpriser who desires above all a high yield per dollar contributed expects to assume the risks of an owner, and is attracted by common stock, with its privileges of control and maximum participation in earnings of the business; similarly, the seeker of security of principal and freedom from care is satisfied with a lower fixed rate of income, and is lured by definitely maturing obligations which place their holder in the preferred position of creditor of the corporation and are secured by specific property. LYON, INVESTMENT 294 (1926); BADGER and GUTHMANN, INVESTMENT PRINCIPLES AND PRACTICE 132 (1936).

[2] Preferred as to dividend, redeemable preferred, redeemable secured preferred, "special" (Massachusetts), "interest-bearing," guaranteed as to principal and dividend, convertible, and "debenture stock."

[3] Debenture, income, voting, and irredeemable bonds.

[4] Participating operation certificates, trade certificates, and participation certificates. See Hansen, "Hybrid Securities," 13 N. Y. UNIV. L. Q. REV. 407 (1937) and 76 UNIV. PA. L. REV. 80 (1927).

[5] BADGER and GUTHMANN, INVESTMENT PRINCIPLES AND PRACTICE 131 (1936).

Although any attempt at rigid functional classification of these examples of legal and financial ingenuity would be futile, judicial tendency has been to tag them from the standpoint of legal theory as basically either debt obligations or stock. The occasion for such categorization by the courts is usually a bankruptcy,[6] receivership,[7] foreclosure,[8] or reorganization[9] proceeding involving a question of priority between the certificate-holder and general unsecured or subsequent secured creditors of the corporation. The "hybrids"[10] most frequently of doubtful status are "preferred stocks"[11] which are redeemable at a definite date and/or whose par value is secured by mortgage or other lien.

I.

The standard approach to the question of the place of the "compromise" security in the priority picture has commenced with the premise that an advance of funds to a business must necessarily be either a loan by a party remaining outside the enterprise, to be repaid at a definite date, or a capital commitment, giving the investor a share in the ownership of the enterprise, for better or worse.[12] All cases agree that, though significant when all other indications are equal, the name given the security is not conclusive, and the ascertainment of its essential nature involves a separation of the circumstances of issue and the individual intrinsic attributes of the security into two lists, one pointing toward proprietorship and the other indicating the creditor status, and

[6] In re Fifty Gold Mines Corp., (D. C. Colo. 1911) 190 F. 105.

[7] Vanden Bosch v. Michigan Trust Co., (C. C. A. 6th, 1929) 35 F. (2d) 643; Mathews v. Bradford, (C. C. A. 6th, 1934) 70 F. (2d) 77; Jefferson Banking Co. v. Trustees of Martin Institute, 146 Ga. 383, 91 S. E. 463 (1917).

[8] Warren v. King, 108 U. S. 389, 2 S. Ct. 789 (1882); Hewitt v. Linnhaven Orchard Co., 90 Ore. 1, 174 P. 616 (1913); Augusta Trust Co. v. Augusta, H. & G. R. R., (Me. 1936) 187 A. 1.

[9] In re Phoenix Hotel Co., (D. C. Ky. 1935) 13 F. Supp. 229.

[10] This apt designation is employed in 45 YALE L. J. 907 (1937) and Hansen, "Hybrid Securities," 13 N. Y. UNIV. L. Q. REV. 407 (1937).

[11] Securities denominated "bonds" are usually accorded full creditor status, though bearing express proprietorship privileges, but in Cass v. Realty Securities Co., 148 App. Div. 96, 132 N. Y. S. 1074 (1911), "bonds" were held a type of preferred stock, due to right of participation in surplus earnings and in excess on liquidation. See also, In re Fechheimer Fishel Co., (C. C. A. 2d, 1914) 212 F. 357 and 28 COL. L. REV. 65 at 66 (1928).

Position of holders of participating operation certificates, trade certificates, and participation certificates is a difficult question, but arises infrequently, due to rarity of such issues.

[12] Armstrong v. Union Trust & Savings Bank, (C. C. A. 9th, 1918) 248 F. 268, is typical, Wolverton, D. J., declaring, "The question presented for solution is whether these certificates constitute the holders thereof stockholders of the company or creditors."

then weighing and balancing these qualities to ascertain which class preponderates.[13]

In striking this balance, no one factor governs. Elements outside the certificates, viz., proportion of the amount of already outstanding security issues to the total amount authorized, and method in which the issue in question is carried on corporate financial statements, should be first investigated.[14] The effect of these circumstances surrounding issuance is aided or refuted by provisions written into the certificates themselves. The privilege to convert into a different designated interest at least establishes that the security in question is of a different nature than that into which it may be converted.[15] Control of management through voting privilege is usually possessed only by a proprietor, yet it is commonplace that many genuine proprietorship shares are expressly non-voting,[16] and voting bonds are not deprived of their character as debts.[17] Though rate of income return on debt obligations is traditionally low and participation in excess earnings is generally confined to stock, cases indicate that bond interest may be calculated on an income basis[18] and is frequently relatively high if the bond is

[13] Miller v. Ratterman, 47 Ohio St. 141, 24 N. E. 496 (1890); In re Fifty Gold Mines Corp., (D. C. Colo. 1911) 190 F. 105; 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 719 (1932); 5 THOMPSON, CORPORATIONS 439 (1927); 28 COL. L. REV. 65 at 66 (1928).

[14] When a certain classification would result in there being more of such security outstanding than the corporation is by charter authorized to issue, it is extremely doubtful that issuer intended to act ultra vires by promulgating securities of such class. 45 YALE L. J. 907 at 914 (1937); Wright v. Johnson, 183 Iowa 807, 167 N. W. 680 (1918). Whether the issue is designated on corporate balance sheets as a fixed liability or as a proprietorship equity seems a fair indication of the corporation's understanding of its nature. Though extrinsic facts would hardly determine the holder's rights, such circumstances indicate the issuer's intention as to the nature of the certificate, a material factor in weighing and construing provisions seemingly inconsistent with the security's general nature. Guaranty Trust Co. v. Galveston City R. R., (C. C. A. 5th, 1901) 107 F. 311; Spencer v. Smith, (C. C. A. 8th, 1912) 201 F. 647; 12 COL. L. REV. 368 (1913); 2 DETROIT L. REV. 178 (1932).

[15] An option to convert to bonds would demonstrate strongly that the investor is a shareholder with a chance to shift to the status of creditor if he desires greater security, while an election to trade for preferred stock is equally demonstrative of the contemplation that he is a creditor with an opportunity to become an owner and enjoy greater gains in the event of business improvement. The right to convert to common stock is barren of significance, since a shift thereto would be an increase in risk and in potential return over either preferred stock or bonds.

[16] 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 741 (1931).

[17] State ex rel. Attorney General v. McDaniel, 22 Ohio St. 354 (1872); Phillips v. Eastern R. R., 138 Mass. 122 (1884); New England Mutual Life Insurance Co. v. Phillips, 141 Mass. 535, 6 N. E. 534 (1886).

[18] DEWING, FINANCIAL POLICY OF CORPORATIONS 112 (1934). Of course, the usury laws constitute an upper limit to bond participation in income.

unsecured.[19] The fund from which income return is payable is some test of the security's character, "dividends payable from profits" usually indicating stock, and "interest" without mention of profits pointing toward a loan, but numerous cases hold "interest-bearing stock" and stock with "guaranteed dividends" to be true proprietorship shares.[20] The prime characteristic of a debt is that a definite sum is payable at a definite date, yet "bonds" so payable have been held stock,[21] and "preferred stock" containing an express undertaking to redeem as to principal and accrued dividends on a certain date seldom gains the exalted position of a bond.[22] Security, in the form of mortgage or pledge, is a common bond characteristic, but its presence is of itself insufficient to make a debt of a share possessing stock attributes.[23]

Writers agree, thus, that no one characteristic of the security or circumstance of its issue is ever determinative of its nature as stock or debt,[24] though some are given greater weight[25] than others. It is at this point, after designating the certificate as one or the other of these conventional forms by a balancing process, that many courts carry the dogma to the utmost extreme by categorizing each of the holder's express privileges opposing their conclusion as (1) not inconsistent with the determined status of the holder, (2) intended to signify something other than its express meaning,[26] or (3) totally void as against

[19] DEWING, FINANCIAL POLICY OF CORPORATIONS 71 (1934).

[20] Such "interest" or "guaranteed dividend" is payable only from funds legally available for dividend payment. 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 766 (1931); 5 THOMPSON, CORPORATIONS 378 (1927).

[21] Cass v. Realty Securities Co., 148 App. Div. 96, 132 N. Y. S. 1074 (1911); Hilson v. State Board of Assessors, 82 N. J. L. 2, 80 A. 929 (1911); In re Fechheimer Fishel Co., (C. C. A. 2d, 1914) 212 F. 357.

[22] 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 761 (1931); Warren v. Queen, 240 Pa. 154, 87 A. 595 (1913); In re Culbertson's, (C. C. A. 9th, 1932) 54 F. (2d) 753.

[23] Black v. Hobart Trust Co., 64 N. J. Eq. 415, 53 A. 826 (1902); Spencer v. Smith, (C. C. A. 8th, 1912) 201 F. 647; Hewitt v. Linnhaven Orchard Co., 90 Ore. 1, 174 P. 616 (1918).

[24] 45 YALE L. J. 907 at 910 (1937); 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 5294 (1931).

[25] *Fixed and absolute maturity date*: Best v. Oklahoma Mill Co., 124 Okla. 135, 253 P. 1005 (1926); Allen v. Northwestern Mfg. Co., 189 Iowa 731, 179 N. W. 130 (1920); Hansen, "Hybrid Securities," 13 N. Y. UNIV. L. Q. REV. 407 at 429 (1937). *Right to vote and share profits*: Weaver Power Co. v. Elk Mountain Mill Co., 154 N. C. 76, 69 S. E. 747 (1910); 13 COL. L. REV. 545 (1913). *Participation in excess earnings*: Mathews v. Bradford, (C. C. A. 6th, 1934) 70 F. (2d) 77. *Mortgage security*: Cass v. Realty Securities Co., 148 App. Div. 96, 132 N. Y. S. 1074 (1911).

[26] *Mortgage*: Spencer v. Smith, (C. C. A. 8th, 1912) 201 F. 647; Ellington v. Raleigh Building Supply Co., 196 N. C. 784, 147 S. E. 307 (1929). *Lien*: King v. Ohio & Mississippi R. R., (C. C. Ind. 1880) 2 F. 36; Warren v. King, 108 U. S.

public policy.[27] On which of these doorsteps the orphan is left determines whether it will thrive in full health, survive as a cripple, or perish altogether.

A recent decision employing this typical approach is *Augusta Trust Co. v. Augusta, H. & G. R. R.*,[28] in which serial coupon bonds secured by a trust mortgage on all franchises, income, and property of the corporation were convertible into preferred stock which received a four per cent semi-annual dividend, carried voting rights, was redeemable at a certain date, and by its terms was secured as to principal and dividends by the mortgage equally with any outstanding bonds. On the trustee's foreclosure of the mortgage, proceeds from sale of the property were insufficient to pay claims of both bondholders and preferred stockholders. The decree of the county court that holders of preferred stock share ratably with holders of bonds was reversed, the opinion stating that the "preferred stock" had every attribute of a stock, as against creditors it constituted a trust fund for their benefit, its holder cannot be both a debtor and a creditor, and a mortgage indenture attempting to effect this result is void as against public policy because not expressly authorized by statute. The net result is that persons formerly enjoying the position of secured creditors, and who, in spite of the attractiveness of higher income return, would in all probability not have converted to preferred stock had they suspected invalidity of either the redemption or security provisions, are subjected to a total loss of investment.

In the preferred stock cases this result is justified under the time-honored postulate that the capital stock of a corporation constitutes a "trust fund" for payment of its creditors, making the shareholder a

389, 2 S. Ct. 789 (1882); Weaver Power Co. v. Elk Mountain Mill Co., 154 N. C. 76, 69 S. E. 747 (1910); Guaranty Trust Co. v. Galveston City R. R., (C. C. A. 5th, 1901) 107 F. 311. *Redemption provision*: Vanden Bosch v. Michigan Trust Co., (C. C. A. 6th, 1929) 35 F. (2d) 643; In re Culbertson's, (C. C. A. 9th, 1932) 54 F. (2d) 753; Mathews v. Bradford, (C. C. A. 6th, 1934) 70 F. (2d) 77. *Conversion right*: In re Phoenix Hotel Co., (D. C. Ky. 1935) 13 F. Supp. 229.

[27] *Mortgage*: Hewitt v. Linnhaven Orchard Co., 90 Ore. 1, 174 P. 616 (1918); Augusta Trust Co. v. Augusta, H. & G. R. R., (Me. 1936) 187 A. 1. *Lien*: Continental Trust Co. v. Toledo, St. L. & K. C. R. R., (C. C. Ohio, 1896) 72 F. 92; Hamlin v. Toledo, St. L. & K. C. R. R., (C. C. A. 6th, 1897) 78 F. 664; Jefferson Banking Co. v. Trustees of Martin Institute, 146 Ga. 383, 91 S. E. 463 (1917); Kinston Cotton Mills v. Wachovia Trust Co., 185 N. C. 7, 115 S. E. 883 (1923). *Pledge*: Ellsworth v. Lyons, (C. C. A. 6th, 1910) 181 F. 55. *Redemption provision*: Warren v. Queen & Co., 240 Pa. 154, 87 A. 595 (1913). *"Rider" redemption agreement*: Armstrong v. Union Trust & Savings Bank, (C. C. A. 9th, 1918) 248 F. 268. *Condition to stock subscription, requiring corporation to issue bonds secured by mortgage*: Morrow v. Nashville Iron & Steel Co., 87 Tenn. 262, 10 S. W. 495 (1889).

[28] (Me. 1936) 187 A. 1.

debtor to the extent of his capital commitment or subscription, and its corollary that he can not be both a creditor and a debtor by virtue of his ownership of stock.[29] But is it inevitable that in these priority contests the certificate-holder be placed at one pole of the securities spectrum or the other? May not a security be issued consistently with legislative authority which will effectively subject him to some of the risks of a shareholder and guarantee him a few of the safeguards of a creditor?

2.

Whether a corporation has power to issue any particular security depends upon the intent of the legislature under whose sanction the artificial entity was created and chartered,[30] and that intent is best fathomed by reference to statutory utterances and significant silence. The weight of authority is that in total absence of any statutory expression a corporation by its creation is impliedly empowered by the legislature to issue stock giving its holders preferred rights over other shareholders, provided no contract rights of such shareholders are impaired,[31] or to borrow by selling bonds which insure their holders preferred rights over other creditors.[32] Frequently these powers are expressly granted in unrestricted terms.[33] Although logically authority to issue both these interests concurrently does not necessitate the conclusion that a combination of the two may be promulgated, there seems to be better reason for implying the affirmative than the negative when the issue is for legitimate corporate purposes. What intent shall be

[29] Miller v. Ratterman, 47 Ohio St. 141 at 154, 24 N. E. 496 (1890); Spencer v. Smith, (C. C. A. 8th, 1912) 201 F. 647; Warren v. Queen & Co., 240 Pa. 154, 87 A. 595 (1913); Armstrong v. Union Trust & Savings Bank, (C. C. A. 9th, 1918) 248 F. 268; Hazel Atlas Glass Co. v. Van Dyk & Reeves, Inc., (C. C. A. 2d, 1925) 8 F. (2d) 716; Augusta Trust Co. v. Augusta, H. & G. R. R., (Me. 1936) 187 A. 1.

[30] 3 THOMPSON, CORPORATIONS 829 (1927); 6 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 174 (1931).

[31] 5 THOMPSON, CORPORATIONS 422 (1927); 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 697, 703 (1931).

[32] 3 THOMPSON, CORPORATIONS 1000 (1927); 6 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 483 (1931). Though prior liens on specific property may not be impaired by an issue of secured bonds, such bonds gain preference as to the mortgaged property over all general creditors, prior or subsequent.

[33] *Preferred stock:* "The shares of the capital stock of a corporation formed or existing under this act may be divided into classes, with such rights, voting power, preferences and restrictions as may be provided for in the articles." Mich. Gen. Corp. Law, § 17, Pub. Acts 1931, No. 327.

Bonds: Corporations shall have power "To borrow money and issue, sell or pledge bonds, promissory notes, bills of exchange, debentures, and other obligations and evidences of indebtedness whether secured by mortgage, pledge, or otherwise, or unsecured." Mich. Gen. Corp. Law, § 10, Pub. Acts 1931, No. 327.

imputed to a silent legislature must depend upon the dictates of public policy, which would presumably control the legislative fiat.

A canvass of the cases in which preferred shareholders have been accorded creditors' privileges is instructive on this point of legislative intent, policy, and statutory construction. Express statutory authorization has been relied upon to give preferred stock an absolute lien on corporate property prior to subsequent creditors in Maryland,[34] and to declare the holder of "special stock" in Massachusetts[35] a creditor as to accrued dividends, regardless of earnings. In *Burt v. Rattle*,[36] "preferred stock" guaranteed as to payment at a definite date, non-participating over the "legal interest rate," convertible into common stock, and secured by bond and mortgage was held in fact a secured loan to the corporation, despite designation in the statute as "preferred stock" and absence of any authorization for the lien. Under the usual charter power to issue preferred stock and to borrow money by issuing evidences of debt, definitely maturing, non-voting, eight per cent cumulative non-participating "preferred stock" was termed simply a loan in *Savannah Real Estate, Loan & Building Co. v. Silverberg*,[37] and the holder was permitted to sue as a creditor for corporate failure to retire the shares. With a declaration that the ordinary law of corporations governed, the same court held a building and loan association's "coupon stock," which bore "6% interest" and a right to receive the face amount on ninety days notice, to be a positive obligation, with interest.[38] In *In re Fifty Gold Mines Corp.*,[39] a bankruptcy proceeding, the district court, relying on no statute whatever, weighed stock and debt characteristics of "preferred stock" which carried ten per cent cumulative dividend, dissolution preference, definite redemption date, and mortgage security, and gave the holder priority over sub-

[34] Heller v. National Marine Bank, 89 Md. 602, 43 A. 800 (1899); Rogers, Brown & Co. v. Citizens National Bank, 93 Md. 613, 49 A. 843 (1901). Md. Laws (1880), c. 474, Code (1888), art. 23, § 294, provided for the lien and its recording; this section was repealed expressly by Md. Laws (1908), c. 240, and at present "in case of insolvency, the debts and other liabilities of the corporation shall be paid before any payment or distribution is made to the holders of any class of stock." Md. Ann. Code (Bagby 1924), art. 23, § 25.

[35] Williams v. Parker, 136 Mass. 204 (1883); Mass. Stat. (1855), c. 143; Mass. Stat. (1870), c. 224, § 25.

[36] 31 Ohio St. 116 (1876).

[37] 108 Ga. 281, 33 S. E. 908 (1899). In Totten v. Tison, 54 Ga. 139 (1875), the same court said as dictum that holders of preferred stock guaranteeing 15% annual return for two years, convertible at holder's option, and secured by pledged bonds, were creditors.

[38] Cook v. Equitable Building & Loan Assn., 104 Ga. 814, 30 S. E. 911 (1898).

[39] (D. C. Colo. 1911) 190 F. 105. Although this decision was reversed in Spencer v. Smith, (C. C. A. 8th, 1912) 201 F. 647, it serves to illustrate how courts differ on identical facts in inferring intention of the same legislature.

sequent mortgage creditors. Similarly, in *Allen v. Northwestern Manufacturing Co.*,[40] without reliance on statute, "preferred stock" definitely maturing in two years and bearing "interest at eight per cent from profits" was termed a loan, entitling the holder to sue on the debt on default in retirement. No express legislative sanction was deemed necessary in *Best v. Oklahoma Mill Co.*[41] for the conclusion that definitely maturing, non-voting, seven per cent cumulative "preferred stock," containing a covenant against future encumbrances on corporate property, is an evidence of debt, giving holders priority over subsequent mortgages.

With the former Maryland and Massachusetts exceptions, the above survey indicates no express difference between the legislative policy of states in which creditors' privileges are permitted perferred stockholders and that of the forums of hostile adjudications. Decisions on both sides of the issue are found which mention no statute at all and are governed by essentially similar general legislation, and in each case there existed the universal power to issue bonds. As has been pointed out, the doctrine that the capital stock of a corporation constitutes a "trust fund" for payment of creditors has been siezed upon to impute to the legislature an intent that no corporation shall have power to issue secured and absolutely redeemable preferred stock unless expressly authorized by statute to emanate just such a share.[42] Cases giving voice to the "trust fund" doctrine lead one to the conclusion that it amounts to no more than the common sense rule of equity that when proprietors, for the purpose of doing business with limited liability, operate a corporation which incurs debt, the amount contributed by them to the business becomes impressed with a trust for payment of creditors as soon as the corporation becomes insolvent.[43] Doubtless any legislature intends that in the event of a litigated priority question *after* corporate insolvency this principle must apply, but it does not follow that there exists an intent that holders of hybrid securi-

[40] 189 Iowa 731, 179 N. W. 130 (1920).

[41] 124 Okla. 135, 253 P. 1005 (1926).

[42] Morrow v. Nashville Iron & Steel Co., 87 Tenn. 262, 10 S. W. 495 (1889); Rider v. Delker & Sons Co., 145 Ky. 634, 140 S. W. 1011 (1911); Spencer v. Smith, (C. C. A. 8th, 1912) 201 F. 647; Armstrong v. Union Trust & Savings Bank, (C. C. A. 9th, 1918) 248 F. 268; Kinston Cotton Mills v. Wachovia Trust Co., 185 N. C. 7, 115 S. E. 883 (1923); Hazel Atlas Glass Co. v. Van Dyk and Reeves, Inc., (C. C. A. 2d, 1925) 8 F. (2d) 716; Vanden Bosch v. Michigan Trust Co., (C. C. A. 6th, 1929) 35 F. (2d) 643; Ellington v. Raleigh Building Supply Co., 196 N. C. 784, 147 S. E. 307 (1929); In re Phoenix Hotel Co., (D. C. Ky. 1935) 13 F. Supp. 229; Augusta Trust Co. v. Augusta, H. & G. R. R., (Me. 1936) 187 A. 1.

[43] Miles, "Stockholders as General Creditors," 17 KY. L. REV. 3 at 4 (1928); Youngblood, "Trust Fund Doctrine," 14 DETROIT L. REV. 109 (1930).

ties promulgated under general power to issue preferred stock are necessarily "proprietors" within the rule.

It seems that hostile decisions are based not on actual legislative intent, thus, but upon a balancing of equities[44] by the court at the insolvency stage, with a tendency to favor the party who extended credit to the corporation "relying" upon assets equal to aggregate outstanding "stock" of any description. But surely, when the mortgage securing preferred stock is recorded, reliance cannot be claimed by subsequent mortgagors or lienors who were bound to search the record title before relying on specific property as security. Likewise no creditor who has taken the risk prior to issuance of the preferred stock can have actually relied on funds represented by the new securities. Thus, as a matter of analysis and justice, the only persons deserving protection from the operation of special preferred share maturity and security provisions are those extending general credit after the issue of the stock. Indeed, it is doubtful that any creditor or credit bureau in fact relies in any degree upon capital stock figures in rating the corporation a good risk, for the true index actually sought and ascertained by them is past record for prompt payment and current ratio of liquid assets to currently maturing liabilities.[45]

Opposing the apparent judicial policy of protecting subsequent general creditors in the priority contest is the interest of the investor who placed his savings in the corporation's hands believing the special recited privileges fully available to him. The effect of every decision like the *Augusta* case[46] is that the preferred shareholder when he purchased the certificate was mistaken as to his rights under it, and in most cases it is fair to say he was actively misled by express provisions purporting to afford him combined advantages of stockholder and bondholder.[47] The oft-quoted and ever-doubted doctrine that every man is

[44] In 45 YALE L. J. 907 at 913 (1937), it is suggested that inasmuch as presence or absence of individual stock and bond characteristics is inconclusive in determining the essential nature of the security, the "general equities" between litigating parties might determine priority (e.g., opportunity for abnormal profits would constitute holder a non-creditor) were it not for the difficulty of applying the test and the uncertainty of the investor's status.

[45] "The amount of actual capital invested in the business means little to the credit man. . . . It is rather the manner in which a merchant handles his capital that has the most important bearing on his financial standing. . . ." BREWSTER, LEGAL ASPECTS OF CREDIT 91 (1924). According to BENJAMIN, PRACTICAL CREDIT ANALYSIS 3 (1933), reliance is placed on the balance sheet of the prospective debtor corporation, with emphasis on current business assets and liabilities, indicating "ability of the debtor to meet his obligations as they mature out of the current assets of the business."

[46] (Me. 1936) 187 A. 1.

[47] Skiddy v. Atlantic, M. & O. R. R., 3 Hughes 320, Fed. Cas. No. 12,922 (1879). Such misleading is avoided to some extent by the Securities Exchange Com-

presumed to know the law affords no actual protection to the lay investor thus deceived, and it seems that the equities in priority litigation are in his favor in the light of the fact that in the great majority of cases there is *actual* reliance by the investor on these purported rights, as opposed to a bare non-factual *presumption* of general creditors' reliance on stated capital stock.

There is no want of analogies supporting the adjudications upholding these special preferred stock rights. In most jurisdictions there has been no hesitation in permitting a corporate shareholder to possess creditor's rights against the corporation independently of his stock certificate,[48] and a separate redemption agreement has been held an absolute obligation of the corporation, enforceable by the shareholder as a general creditor, without regard to solvency of the corporation at the time.[49] If there is evil in express provisions in the certificates themselves, public policy emasculating or voiding them should even more quickly strike down independent, covert privileges of the same character and operation, lest evil be accomplished indirectly and surreptitiously. If prospective creditors in fact rely at all upon stated capital, there is far greater probability of their being prejudicially misled when there exist unpublicized collateral obligations of the corporation.

Concern for the investor does predominate in priority decisions if reliance by creditors is precluded or unwarranted.[50] Preclusion of this reliance may be the optimum mode of preventing these priority contests in the case of future security issues. Any holding out that the hybrid is "stock" the proceeds of which will be available to satisfy creditors would be effectively forestalled by carrying the issue on corporate financial statements under a truth-disclosing name, such as "First Mortgage Redeemable Preferred Stock." It seems entirely feasible through the corporation acts to define corporate security-issuing power in a manner requiring future emanation of hybrids to be under designations revealing their special nature and to require appearance of the same designation on financial statements without straight-jacketing the future expansion of legitimate business needs. Such expression of the legislative will, plus parallel rules and regula-

mission's requirements in registration statements. 48 Stat. L. 78, 88, 15 U. S. C., § 77g, 77aa (12) (1934).

[48] Carr v. Wainwright, (C. C. A. 3d, 1930) 43 F. (2d) 507, and McDonald v. Luckenbach, (C. C. A. 3d, 1909) 170 F. 434, notes.

[49] Keyes v. Blue Bell Medicine Co., 34 S. D. 297, 148 N. W. 505 (1914); Davis v. Proprietors of Second Universalist Meeting House, 8 Metc. (49 Mass.) 321 (1844).

[50] Skiddy v. Atlantic, M. & O. R. R., 3 Hughes 320, Fed. Cas. No. 12,922 (1879), where holders of preferred stock stipulating for lien next to existing mortgage were given priority over subsequent mortgage creditors even though the preferred stock lien was not recorded, the court stressing the fact of notice through other channels.

tions of security commissions[51] would effectively and practically prevent issue or sale of securities likely to mislead prospective investors as to the extent of their rights or creditors as to their margin of safety.

In summary, it appears that in an effort to attract capital for industrial development in varying market conditions, there have been issued "preferred stocks" which on their face purport to afford the holder creditors' privileges, and the validity of these special rights as against corporate creditors has been upheld by some courts, but denied by the majority on the ground that all "stock" constitutes a "trust fund" for payment of creditors and that the latter, in extending credit, have relied upon paid-in capital as a margin of safety. In priority litigation involving such stock already issued by corporations empowered by general provisions to promulgate preferred stock or bonds, equity and policy preponderate in favor of the actually misled investor as against creditors whose "reliance" is doubtful. To prevent future misleading of either investors or creditors, legislation requiring accurate designation of such issues on corporate financial statements and on the certificates themselves seems advisable.

Elbert R. Gilliom

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[51] Suggested by the court in Koeppler v. Crocker Chair Co., 200 Wis. 476, 228 N. W. 130 (1930).