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CORPORATIONS-VALIDITY OF OPTION TO CONVERT PREFERRED STOCK INTO MORTGAGE BONDS

CORPORATIONS—VALIDITY OF OPTION TO CONVERT PREFERRED STOCK INTO MORTGAGE BONDS—A corporation issued preferred stock, with a fixed dividend rate, power to elect a director voting as a class, and an option in the holder to convert, at his election, into mortgage bonds which were issued at the same time. After a substantial indebtedness had been incurred by the corporation, the stockholders exercised their option to convert into bonds. The corporation then went into bankruptcy, and in reorganization proceedings, the bondholders claim a preference over general creditors. *Held*, that the former holders of the preferred stock were stockholders and not creditors of the corporation and that, in the absence of a statute, an agreement giving stockholders a preference over general creditors is contrary to public policy and void. *In re Phoenix Hotel Co.*, (D. C. Ky. 1935) 13 F. Supp. 229.

Whether a holder of a certificate of "preferred stock" [1] is a stockholder or a creditor [2] depends upon the terms of his contract with the corporation, as evidenced by the certificate, the corporate charter, and the statutes of the jurisdiction.[3] As was held in the principal case, sharing in profits and management are

[1] The name given the instrument is not decisive of its effect. In Wright v. Johnston, 183 Iowa 807, 167 N. W. 680 (1918); Burt v. Rattle, 31 Ohio St. 116 (1876); Savannah Real Estate Co. v. Silverberg, 108 Ga. 281, 33 S. E. 908 (1899); and In re Fifty Gold Mines Corp., (D. C. Col. 1911) 190 F. 105, shares of "preferred stock" were held to be certificates of indebtedness. "Debenture bonds" have been held to be preferred stock. In re Fechheimer Fishel Co., (C. C. A. 2d, 1914) 212 F. 357.

[2] It is suggested in 76 UNIV. PA. L. REV. 80 (1927) that there might also be the third possibility that the certificate holder is neither creditor nor stockholder, but a co-adventurer with the stockholders.

[3] In re Culbertson, (C. C. A. 9th, 1932) 54 F. (2d) 753; Smith v. Southern

usually indicative of a stockholder's status,[4] although the absence of such provisions is not conclusive of the contrary.[5] Being stockholders, in the absence of a statute, they would not be entitled to share equally with the general creditors in distribution of the assets on reorganization [6] and, *a fortiori*, would not be entitled to a preference.[7] An agreement to give preferred stockholders a priority over creditors on insolvency would be contrary to public policy and void.[8]

Foundry Co., 166 Ky. 208, 179 S. W. 205 (1915); Tennant v. Epstein, 271 Ill. App. 204 (1933), reversed 356 Ill. 26, 189 N. E. 864 (1934); Miller v. Ratterman, 47 Ohio St. 141, 24 N. E. 496 (1890). See 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 718 (1932).

[4] Hamlin v. Toledo, St. L. & K. C. R. R., (C. C. A. 6th, 1897) 78 F. 664; Jefferson Banking Co. v. Trustees, 146 Ga. 383, 91 S. E. 463 (1917); Field v. Lamson & Goodnow Mfg. Co., 162 Mass. 388, 38 N. E. 1126 (1894). For tests to determine the legal effect of a security, see 28 COL. L. REV. 65 at 67 (1928).

[5] Jones, "Redeemable Corporate Securities," 5 So. CAL. L. REV. 83 at 97 (1931). Kidd v. Puritana Cereal Food Co., 145 Mo. App. 502, 122 S. W. 784 (1909); Koeppler v. Crocker Chair Co., 200 Wis. 476, 228 N. W. 130 (1929); Inscho v. Mid-Continent Development Co., 94 Kan. 370, 146 P. 1014 (1915); Hazel Atlas Glass Co. v. Van Dyk and Reeves, (C. C. A. 2d, 1925) 8 F. (2d) 716.

[6] THOMPSON CORPORATIONS, 3rd ed., 349 (1927). See Cring v. Sheller Wood Rim Mfg. Co., 98 Ind. App. 310, 183 N. E. 674 (1932); In re Howell, (D. C. Pa. 1925) 6 F. (2d) 672; Tepel v. Coleman, (D. C. Pa. 1914) 229 F. 300; Mathews v. Bradford, (C. C. A. 6th, 1934) 70 F. (2d) 77; In re Recording Devices Co., (D. C. Ohio 1924) 1 F. (2d) 474; Armstrong v. Union Trust & Savings Bank, (C. C. A. 9th, 1918) 248 F. 268; Weaver Power Co. v. Elk Mountain Mill Co., 154 N. C. 76, 69 S. E. 747 (1910). But see, Butler v. Beach, 82 Conn. 417, 74 A. 748 (1909).

[7] 15 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 715 (1932). First Trust Co. v. Crooked Creek Ry., (D. C. Iowa 1917) 243 F. 450; Spencer v. Smith, (C. C. A. 8th, 1912) 201 F. 647; Bolton v. Britton, (C. C. A. 8th, 1925) 9 F. (2d) 492; In re Marcella Cotton Mills, (D. C. Ala. 1925) 8 F. (2d) 522; Hamlin v. Toledo, St. L. & K. C. R. R., (C. C. A. 6th, 1897) 78 F. 664. Cases listed in 39 L. R. A. (N. S.) 1007 (1912); 27 L. R. A. 136 (1895); 29 A. L. R. 254 (1924); 21 L. R. A. (N. S.) 228 (1909); Ann. Cas. 1917B 558; 20 Ann. Cas. 122 (1911). But see, Fitch v. Wetherbee, 110 Ill. 475 (1884).

In some states, statutes expressly forbid a preference: N. C. Code (1931), § 1156, Ellington v. Raleigh Bldg. Supply Co., 196 N. C. 784, 147 S. E. 307 (1929); 2 Mich. Comp. Laws (1929), § 10003.

[8] 1 COOK, CORPORATIONS, 8th ed., 910 at 913 (1923). Cring v. Sheller Wood Rim Mfg. Co., 98 Ind. App. 310, 183 N. E. 674 (1932); Ellsworth v. Lyons, (C. C. A. 6th, 1910) 181 F. 55; Guaranty Trust Co. v. Galveston City R. R., (C. C. A. 5th, 1901) 107 F. 311; Hamlin v. Toledo, St. L. & K. C. R. R., (C. C. A. 6th, 1897) 78 F. 664; Continental Trust Co. v. Toledo, St. L. & K. C. R. R., (C. C. Ohio 1896) 72 F. 92; Jefferson Banking Co. v. Trustees, 146 Ga. 383, 91 S. E. 463 (1917); Sumrall v. Commercial Bldg. Trust, 106 Ky. 260, 50 S. W. 69 (1899); Kidd v. Puritana Cereal Food Co., 145 Mo. App. 502, 122 S. W. 784 (1909). But it was held in Heller v. Nat. Marine Bank, 89 Md. 602, 43 A. 800 (1899), that when a statute provides that preferred stock issued under the statute shall have a preference, no principle of public policy is violated.

By statute, the issuance of a preferred stock has been authorized, the holders of which are given a preference over general creditors. Md. Laws (1880), c. 474, repealed Md. Laws (1908), c. 240; Heller v. Nat. Marine Bank, 89 Md. 602, 43

The stockholders in the principal case have attempted to enhance their position by converting their stock into bonds, but the court holds the conversion to be ineffectual to give them a preference. Although the conversion was authorized by statute,[9] it in effect resulted in a redemption of capital stock, and the right of stockholders to compel a redemption is subordinate to the rights of creditors and must be exercised while the corporation is solvent.[10] The crucial issue to

A. 800 (1899); Leviness v. Consolidated Gas Co., 114 Md. 559, 80 A. 304 (1911); Fryer v. Wiedemann, 148 Ky. 379, 146 S. W. 752 (1912). Mass. Acts (1855), c. 143, c. 290; Williams v. Parker, 136 Mass. 204 (1884). Ohio Laws (1870), v. 67, p. 26; Burt v. Rattle, 31 Ohio St. 116 (1876). See also, Totten v. Tison, 54 Ga. 139 (1875); The Atlantic, Miss. & Ohio Ry. Case, 3 Hughes (U. S. Cir. Ct.) 320 (1877); 29 A. L. R. 254 (1924). However, it is submitted that such securities are not preferred stock, but belong in a separate category of their own. 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 711 (1932). But see Fryer v. Wiedemann, 148 Ky. 379, 146 S. W. 752 (1912), in which the holders of "preferred stock" issued under the Maryland statute are held to be stockholders with rights and liabilities as such.

[9] Ky. Stat. (Carroll 1930), § 564-1; 2 Mich. Comp. Laws (1929), § 10,000; 2 N. J. Comp. Stat. (1911), p. 1616, § 29a.

[10] Koeppler v. Crocker Chair Co., 200 Wis. 476, 228 N. W. 130 (1929); Campbell v. Grant Trust, 97 Ind. App. 169, 182 N. E. 267 (1932); Booth v. Union Fibre Co., 142 Minn. 127, 171 N. W. 307 (1919); Shaw v. Noyes, (Tex. Civ. App. 1929) 13 S. W. (2d) 433; Ellsworth v. Lyons, (C. C. A. 6th, 1910) 181 F. 55.

Redemption is generally prohibited when the corporation is already insolvent, when redemption would make it insolvent, or insolvency would be threatened in the near future: Del. Laws (1933), c. 91, § 4; La. Gen. Stat. (Dart 1932) § 1125; Me. Rev. Stat. (1930), c. 56, § 20; W. Va. Code (1931), c. 31, art. 1, § 14; Cal. Civ. Code (Deering 1931), § 347; Ill. Rev. Stat. (Smith-Hurd 1931), c. 32, § 34; Mich. Comp. Laws (1929), § 10000. See 83 UNIV. PA. L. REV. 888 at 890 (1935). But it was held in Butler v. Beach, 82 Conn. 417, 74 A. 748 (1909), that an agreement allowing preferred stockholders in a grocery company to trade out their stock in groceries could be enforced against the corporation in spite of the fact that it was insolvent and in the hands of a receiver and there was a statute which prohibited the purchase of its own stock by a corporation when insolvent. See also Allen v. Northwestern Mfg. Co., 189 Iowa 731, 179 N. W. 130 (1920).

Analogously a subscriber's right to rescission of a fraudulently induced stock subscription is generally conditioned on the solvency of the corporation, although the cases are by no means agreed upon the stage in the corporation's affairs at which the right to rescind is cut off. See 4 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., 415 et seq. (1932); Woman's Temperance Bldg. Assn. v. Devore, 160 Ill. App. 153 (1911); MacNamee v. Banker's Union, (C. C. A. 2d, 1928) 25 F. (2d) 614; Preston v. Jeffers, 179 Ky. 384, 200 S. W. 654 (1918); Earle v. Humphrey, 121 Mich. 518, 80 N. W. 370 (1899).

A redemption will be valid when no injury to creditors results. Cring v. Sheller Wood Rim Mfg. Co., 98 Ind. App. 310, 183 N. E. 674 (1932), discussed in 17 MARQ. L. REV. 229 (1933); Alabama Consol. Coal Co. v. Baltimore Trust Co., (D. C. Md. 1912) 197 F. 347; 44 A. L. R. 11 (1926). See also 29 COL. L. REV. 672 (1929).

The fact that bonds of the corporation are taken on redemption instead of cash does not injure creditors. Alabama Consol. Coal Co. v. Baltimore Trust Co., (D. C. Md. 1912) 197 F. 347 (conversion according to statute held not contrary to public

be considered should be the state of the solvency of the corporation at the time of the actual conversion.[11] The court in the principal case fails to mention the point, but since the burden of proving the improbability of injury to creditors at the conversion date is on the stockholders,[12] their apparent failure to raise the issue would justify the subordination of their claim in the reorganization proceedings.[13] However, even though a proper result was reached on these particular facts, it is unfortunate that the decision is broad enough to exclude the stockholders without consideration of the possible solvency of the corporation at the time of the conversion.

E. S. S.

policy or immoral). Jones, "Redeemable Corporate Securities," 5 So. CAL. L. REV. 83 at 102 (1931), suggests that creditors are even benefitted by such an arrangement, which enables the corporation to conserve working capital. But see, Vanden Bosch v. Michigan Trust Co., (C. C. A. 6th, 1929) 35 F. (2d) 643, criticized in 28 MICH. L. REV. 764 (1930).

[11] Corporate solvency at the redemption date was the ground for allowing enforcement of an obligation given in payment, although the corporation subsequently became insolvent, in Campbell v. Grant Trust Co., 97 Ind. App. 169, 182 N. E. 267 (1932), and Totten v. Tison, 54 Ga. 140 (1875). *Contra*, Vanden Bosch v. Michigan Trust Co., (C. C. A. 6th, 1929) 35 F. (2d) 643.

[12] Koeppler v. Crocker Chair Co., 200 Wis. 476, 228 N. W. 130 (1929). When a stockholder is suing to force the corporation to redeem according to contract, the complaint does not state a cause of action unless solvency and ability to pay without prejudice to creditors are affirmatively alleged. Smith v. Southern Foundry Co., 166 Ky. 208, 179 S. W. 205 (1915).

[13] Recovery has been denied when there was no showing of solvency at the redemption date, but insolvency was present at the enforcement date. Armstrong v. Union Trust Co., (C. C. A. 9th, 1918) 248 F. 268; Hazel Atlas Glass Co. v. Van Dyke and Reeves, (C. C. A. 2d, 1925) 8 F. (2d) 716; Bolton v. Britton, (C. C. A. 8th, 1925) 9 F. (2d) 492; Booth v. Union Fibre Co., 142 Minn. 127, 171 N. W. 307 (1919); Koeppler v. Crocker Chair Co., 200 Wis. 476, 228 N. W. 130 (1929); Hewitt v. Linnhaven Orchard Co., 90 Ore. 1, 174 P. 616 (1918).