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CORPORATIONS-THE FAIR AND EQUITABLE TEST IN RECAPITALIZATIONS

Robert O. Hancox
University of Michigan Law School

COMMENTS

CORPORATIONS—THE FAIR AND EQUITABLE TEST IN RECAPITALIZATIONS—Changes in capital structures of corporations which modify rights of security holders generally occur under one of two circumstances:[1] (1) reorganization of insolvent[2] corporations which affects

[1] For a description of the circumstances, see Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 at 780-784 (1942).

[2] Insolvent, in this respect, is used to include both corporations which are insolvent in the bankruptcy sense and corporations which are insolvent in the equity sense of being unable to pay debts as they mature.

the rights of creditors as well as shareholders and necessitates judicial supervision; and (2) recapitalization of solvent corporations involving only the relative rights of the different classes of shareholders. It is the author's present purpose to focus attention on the effect of the latter type of modification on the most zealously guarded right of the preferred shareholder—the right to accrued dividends on cumulative preferred stock.[3]

A. *Voluntary Recapitalization*

Basically, the reason for a voluntary recapitalization, affecting preferred shareholders' rights, is to depict a changed financial condition on the corporate balance sheet in order to attract new investment, that is, for the most part, common share financing, and to preserve the corporation as a going concern.[4] Also, recapitalizations may be occasioned by a desired merger or consolidation. To accomplish this change, the articles of incorporation, a part of the stock contract, must be amended, an act which involves two basic issues:[5] (1) Are the adjustments permissible within the terms of the preferred stock contract? (2) Are the adjustments fair and equitable? By the terms of the type of stock contract assumed here, the preferred shareholder's preference includes a right to accrued dividends.

The technical rules by which to test the validity of corporate modification of this contractual priority have undergone a series of gradual

[3] On the problem of accrued dividends, generally, see Meck, "Accrued Dividends on Cumulative Preferred Stock: the Legal Doctrime," 55 HARV. L. REV. 71 (1941). See collection of cases in 32 MICH. L. REV. 743 at 775, note 118 (1934), and 46 YALE L. J. 985 at 990 (1937), wherein it is stated, "Although courts in general have allowed amendments changing other features of a class of stock, such as its proportionate right to dividends, its redemption price, its voting powers, and the preferences to which it is entitled, no court to which the question has been presented has yet [1937] upheld a recapitalization plan which cancels accumulated arrears accrued prior to the time of cancellation." And see cases collected id. at 992, note 21.

[4] See "The Doctrine of Strict Priority in Corporate Recapitalization," 54 YALE L. J. 840, especially at 840, note 1 (1945).

[5] BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 248 (1932), "In every case, corporate action must be twice tested: first, by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules . . . ." The phrase is footnoted and reworded in the text by Meck, "Accrued Dividends on Cumulative Preferred Stock: The Legal Doctrine," 55 HARV. L. REV. 71 at 73 (1941), but at p. 97 he suggests a different framing of the dual problem, first asking if the corporation has the power, then asking if the exercise of the power is limited by equitable rules. See 77 UNIV. PA. L. REV. 256 at 257 (1928), and the suggested limitation to the decision in Davis v. Louisville Gas and Electric Co., (Del. 1928) 142 A. 654.

changes[6] since Chief Justice Marshall[7] labelled the corporate charter a contract. Although the tide has ebbed and flowed under the conflicting forces of reserved powers and contractual protections, the sands of contractual rights have been slowly, but consistently, washed away. Where a residuum of beach remains at all, there lies this right to accrued dividends on cumulative preferred stock.[8] Where the legislatures have seemed to side with the eroding elements, the courts have to some extent erected a sea-wall.[9] But although balked at this point in many jurisdictions, the tendencies would seem to indicate that at least the technical limitations on corporate modification of even this right to accrued dividends are in the process of being eliminated,[10] as they have been in states such as Delaware, New York, Ohio, and Virginia.[11]

Even though the technical limitations are being eliminated, still, an attempt is made to provide technical safeguards. Legislative requirements include an affirmative vote of some majority of the holders of the preferred class of stock whose rights are to be modified,[12] or protection is afforded dissenters by giving them the option of a fair cash value for their stock if they do not wish to participate in the corpora-

[6] One of the most succinct reviews of the development is provided by BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, c. 4 (1932). Also see Meck, "Accrued Dividends on Cumulative Preferred Stock: The Legal Doctrine," 55 HARV. L. REV. 71 (1941); Curran, "Minority Stockholders and the Amendment of Corporate Charters," 32 MICH. L. REV. 743 (1934); Dodd, "Dissenting Stockholders and the Amendment of Corporate Charters," 75 UNIV. PA. L. REV. 585, 723 (1927); Stern, "The Limitations of the Power of a State under a Reserved Right to Amend or Repeal Charters of Incorporation," 53 UNIV. PA. L. REV. 1, 73, 145 (1905).

[7] In Trustees of Dartmouth College v. Woodward, 4 Wheat. (17 U.S.) 518 (1819).

[8] See Curran, "Minority Stockholders and the Amendment of Corporate Charters," 32 MICH. L. REV. 743 (1934); Meck, "Accrued Dividends on Cumulative Preferred Stock: The Legal Doctrine," 55 HARV. L. REV. 71 (1941), 55 HARV L. REV. 780 (1942), 54 HARV. L. REV. 917 (1941), and footnote 3, supra.

[9] The significance of the decision in Keller v. Wilson and Co., 21 Del. Ch. 391, 190 A. 115 (1936), may be weakened to some extent by a decision made four years later by the same court in Havender v. Federal United Corp., (Del. 1940) 11 A. (2d) 331; but that case involved a merger with a wholly-owned subsidiary. See the excellently documented footnote 7, 54 YALE L. J. 840 at 842 (1945), that brings up to date the court's attitude as to the sanctity of accrued dividends.

[10] See Dodd's summary, "Accrued Dividends in Delaware Corporations—From Vested Right to Mirage," 57 HARV. L. REV. 894 (1944).

[11] Ohio Gen. Code Ann. (Page, 1937) §§ 8623-14, 8623-15; Va. Code Ann. (Michie, 1942) § 3780; N.Y. Stock Corp. Law (McKinney, 1940) § 36. See 54 YALE L. J. 840 at 842, 843 (1945).

[12] See Del. Rev. Code (1935) § 2058. See 55 HARV. L. REV. 780 at 787-791 (1942).

tion in its modified form.[13] However, as almost universally the method of recapitalization is an internal matter carried out by some majority vote by class of shareholders,[14] the protection of judicial proceedings is not afforded, as in the case of reorganizations.[15] Since there is no statutory provision for judicial review, a dissenter's remedy[16] is only the limited one of an equitable bill seeking relief against an amendment claimed to be invalid as to the dissenter; but the review would seem to be limited to such questions as whether the statute is constitutional,[17] whether the amendment is authorized by the statute,[18] and whether the amendment has been adopted in the proper manner and by the proper vote.[19] To invalidate the proposed plan of modification on the ground of unfairness, the Delaware Chancery stated in a recent case[20] that the ". . . unfairness must be of such character and must be so clearly demonstrated as to impel the conclusion that it emanates from acts of bad faith, or a reckless indifference to the rights of others interested, rather than from an honest error in judgment."[21]

The statutory standard, requiring reorganization programs to be fair and equitable,[22] although attended by some ambiguity in its application, especially where an effort is made to achieve plans which are "feasible" as well as "fair and equitable," has been made definite by

[13] See N.Y. Stock Corp. Law (McKinney, 1940) § 38(9).

[14] Many of the statutes provide that amendments shall be adopted by resolution of the board of directors before they are submitted to the shareholders. See e.g. Del. Rev. Code (1935) § 2058.

[15] The method adopted for reorganizations is a petition to a federal court, followed by the appointment of an independent trustee and in many cases by the active intervention of an administrative agency. The series of decisions: Northern Pacific Ry. v. Boyd, 228 U.S. 482, 33 S.Ct. 1913 (1913) (see "The Doctrine of Strict Priority," 54 YALE L. J. 840 (1945); Case v. Los Angeles Lumber Products Co., 308 U.S. 106, 60 S.Ct. 1 (1939) [see Dodd, "The Los Angeles Lumber Products Co. Case and Its Implications," 53 HARV. L. REV. 713 (1940)]; and Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510, 61 S.Ct. 675 (1941), has made it mandatory, in theory, that reorganization plans be subjected to a definite test, which permits only a limited amount of flexibility.

[16] See Lattin, "Remedies of Dissenting Stockholders," 45 HARV. L. REV. 233 (1931); 75 UNIV. PA. L. REV. 585, 723 especially at 750-752 (1927); 27 COL. L. REV. 547 (1927); 32 COL. L. REV. 60 (1932).

[17] Keller v. Wilson and Co., 21 Del. Ch. 391, 190 A. 115 (1936).

[18] Consolidated Film Industries, Inc. v. Johnson, 21 Del. Ch. 417, 197 A. 489 (1937).

[19] Hartford Accident and Indemnity Co. v. W. S. Dickey Clay Mfg. Co., (Del. Ch. 1941) 21 A. (2d) 178, aff'd (Del. 1942) 24 A. (2d) 315.

[20] Porges v. Vadsco Sales Corp., (Del. Ch. 1943) 32 A. (2d) 148. See 57 HARV. L. REV. 894 at 896 (1944).

[21] 32 A. (2d) 148 at 151 (1943).

[22] Bankruptcy Act, c. X, §§ 156, 169; 52 Stat. L. 888, 890 (1938), 11 U.S.C. (Supp. 1939) §§ 556, 569.

the courts, for no plan is fair and equitable unless senior claims in the hierarchy of corporate securities are fully compensated before junior claims participate in the reorganization.[23] This doctrine of strict priority in reorganizations was established in the *Boyd* case of 1913,[24] adopted as the legislative yardstick in the Bankruptcy Act,[25] and the concept rounded out by the decision in *Consolidated Rock Products Co. v. Du Bois* in 1941.[26] The lack of statutory standards and the limited judicial review afforded by an equitable bill in the case of recapitalization, coupled with the disadvantageous position of the typical preferred shareholder,[27] makes obvious the need for some method to assure the fairness of recapitalizations. A tendency toward the adoption of the same test of strict priority for voluntary recapitalizations,[28] as applied in reorganizations, is indicated by the statement in the *Consolidated Rock Co.* case that the rule of the *Boyd* case applies to reorganizations of solvent, as well as insolvent, companies. And in reorganizations the strict priority rule is applied between different classes of shareholders in addition to the creditor-stockholder relationship.[29] The problem seems to be more or less procedural, for the technical safeguards of majority vote and optional redemption dissuade the courts from declaring recapitalization plans unfair and inequitable; but the decisions in the *Durham Hosiery Mills* case[30] and the *Buckley* case[31] indicate an appreciation of the problem by some courts.

B. *Compulsory Recapitalization Under the Public Utility Holding Company Act*

The inequities attending voluntary recapitalizations were clearly recognized by both the courts[32] and the writers;[33] but the solution of

[23] See FINLETTER, THE LAW OF BANKRUPTCY REORGANIZATION, 427-477, passim (1939); 54 YALE L. J. 840 at 841, note 4 (1945); 55 HARV. L. REV. 780 at 786, note 19 (1942).

[24] See note 15, supra.

[25] See note 22, supra.

[26] See note 15, supra.

[27] See 55 HARV. L. REV. 780 at 790 (1942); 54 HARV. L. REV. 488 (1941).

[28] See 54 HARV. L. REV. 488 at 493-495 (1941).

[29] In re Utilities Power and Light Corp., (D.C. Ill. 1939) 29 F. Supp. 763; 54 HARV. L. REV. 488 at 493 (1941). Case v. Los Angeles Lumber Products Co., 308 U.S. 106 at 119, note 14, 60 S.Ct. 258 (1939); 33 GEO. L. J. 346 (1945).

[30] Patterson v. Durham Hosiery Mills, 214 N.C. 806, 200 S.E. 906 (1939).

[31] Buckley v. Cuban American Sugar Co., 129 N.J. Eq. 322, 19 A. (2d) 820 (1940).

[32] Willcox v. Trenton Potteries Co., 64 N.J. Eq. 173, 53 A. 474 (1902); Outwater v. Public Service Corp., 103 N.J. Eq. 461, 143 A. 729 (1928); see Meck, "Accrued Dividends on Cumulative Preferred Stock: The Legal Doctrine," 55 HARV. L. REV. 71 at 95 et seq. (1941).

[33] See 44 YALE L. J. 1025 (1935); 36 COL. L. REV. 674 (1936).

giving equity an affirmative control over all such adjustments was not feasible, for it would have imposed too great an administrative burden on judges who were not expected to be qualified as financial experts.[34] In 1935 the Securities and Exchange Commission was given the administration of the Public Utility Holding Company Act,[35] section 11(b)(2), which makes it the duty of the commission to require all registered holding companies and their subsidiaries to ". . . take such steps as the commission shall find necessary . . ." to simplify the capital structures of their holding company systems and to correct inequities in the distribution of voting power among security holders. Orders under section 11(b) are reviewable in a circuit court of appeals; and, to compel compliance with such orders, the commission is authorized by section 11(d) to resort to the district courts of the United States for enforcement thereof. Section 11(e) provides for voluntary compliance by a company whereby a plan is submitted to the commission to consider whether the plan is ". . . necessary to effectuate the provisions of [section 11] subsection (b) and fair and equitable to the persons affected by such plan. . . ." At the request of the company the commission may apply to a district court for enforcement, such court being authorized to ". . . approve such plan as fair and equitable and as appropriate to effectuate the provisions of Section 11 . . ." and is vested with jurisdiction to enforce the plan so approved. In order to be approved, a plan of recapitalization must meet the test of being "fair and equitable" applied by the commission, by the district court wherein enforcement is sought, or by the circuit court of appeals upon the hearing of an appeal, either directly from the commission, or from an enforcement order of a district court.[36]

In the exercise of its discretionary power to determine what corporate structures must be simplified, the commission has regarded the presence of large dividend arrearages on preferred shares as sufficient proof of undue complexity.[37] What has been the result of the application of the fair and equitable test to plans involving modifications of the right to accrued dividends?

The "fair and equitable" phrase, which had been previously used in that part of the Bankruptcy Act[38] governing railroad reorganization plans, was presumably an adoption of the standard that had come to be

[34] See 46 YALE L. J. 985 at 1003 (1937).

[35] 49 Stat. L. 820 (1935), 15 U.S. C. (1940) § 79.

[36] See generally 55 HARV. L. REV. 780 at 812 et seq. (1942); 57 HARV. L. REV. 295 (1944); 93 UNIV. PA. L. REV. 308 (1945).

[37] See 58 HARV. L. REV. 604 at 607 (1945).

[38] Bankruptcy Act, c. X, § 216(12) (a), 52 Stat. L. 896 (1938), 11 U.S.C. (Supp. 1939) § 616(12) (a). Chap. X superseded section 77B, but retained the words "fair and equitable."

interpreted as spelling out the strict priority rule.[39] In the *Federal Water Service* case of 1941,[40] Commissioner Healy stated: "The words 'fair and equitable' are 'words of art' and embody a 'fixed principle' which has had a well understood meaning for some time. It is the 'rigorous standard' of the Boyd case, as the Supreme Court has called it."[41] But the strict priority doctrine arose out of reorganization plans of insolvent corporations wherein the priorities have matured independently of any action taken pursuant to the statutory provisions for reorganization. To liquidate the enterprise would wipe out a large part of its value, therefore, the law permits reorganization as a substitute, and although reorganization prevents creditors from getting the cash for which they bargained, at least the strict priority doctrine gives them the nearest practicable equivalent.[42] But in the case of a recapitalization under the Holding Company Act, the preferred shareholder would not have had any matured claim but for the act; should recapitalization then be treated as the legal equivalent of liquidation? The commission and the majority of the United States Supreme Court assert that recapitalization is not "liquidation" within the meaning of the preferred stock contract,[43] thus liquidation preferences are but one factor in an over-all valuation. More important are the immediately operative rights (such as dividend rights, rather than inchoate rights of liquidation preferences)[44] whose charter preference, by the *Otis* case,[45]

[39] See 54 YALE L. J. 840 at 847-852 (1945).

[40] In the Matter of Federal Water Service Corp., 8 S.E.C. 893, 924 (1941).

[41] See Case v. Los Angeles Lumber Products Co., 308 U.S. 106 at 120, 60 S.Ct. 1 (1939).

[42] See 58 HARV. L. REV. 604 at 608 (1945).

[43] "The exercise of legislative power by Congress through § 11(b) (2) to accomplish simplification as a matter of public policy and the Commission's administration of the Act by dissolution of this particular company [Maryland's United Light and Power] results in a type of liquidation which is entirely distinct from the 'liquidation of the corporation whether voluntary or involuntary,' envisaged by the charter provisions of Power for preferences to the senior stock." Otis & Co. v. S.E.C., 323 U.S. 624 at 631, 65 S. Ct. 483 (1945), citing S.E.C. Holding Company Release No. 4215, April 6, 1943, pp. 8-9; In the Matter of Puget Sound Power & Light Co., S.E.C. Holding Company Act Release No. 4255, April 28, 1943, p. 22.

[44] In the Matter of Southern Colorado Power Co., S.E.C. Holding Company Act Release No. 4501, August 24, 1943, p. 16; In the Matter of Virginia Public Service Co., S.E.C. Holding Company Act Release No. 4618, Oct. 16, 1943, at p. 27 states that ". . . the interests of the common stock must be measured by an evaluation of senior claims as a whole, giving proper emphasis to those claims that are immediately operative (such as the claims to interest and preferred dividends), and giving less significance to those claims (such as the liquidation preference of the preferred stock) which are inchoate rights."

[45] Otis & Co. v. S.E.C., 323 U.S. 624, 65 S.Ct. 483 (1945); See 13 GEO. WASH. L. REV. 372 (1945).

was held to be inapplicable to liquidation as a result of the exercise of legislative power to accomplish simplification of the corporate structure of a continuing business.

Thus, with the virtual abandonment of the strict priority rule in the case of recapitalizations under the Holding Company Act, what is the basis of the fair and equitable test? The problem has devolved to one of anticipated earnings.[46] If anticipated earnings exceed the dividend requirements of preferred shares as they exist under the corporate structure prior to recapitalization, an amount will be left over at the end of each fiscal year to be applied to the payment of dividend arrearages. Assuming earnings will continue as anticipated, arrearages will be paid off at the end of a certain number of years. Thereafter the excess of earnings over preferred dividend requirements will be available to holders of common shares. No matter how remote the time when common would receive earnings, if it were not for the intervention of recapitalization under the Holding Company Act, the eventual possibility is said to constitute an interest vested in common which must be recognized by granting common participation in the recapitalization.[47] The real problem centers around the question as to the amount of participation to be allowed the common; therein lies the difficulty of measurement.[48] Now that Commissioner Healy's dissents from the basic premise of the majority of the commission have been silenced by the decision in the *Otis* case,[49] there still remain three vulnerable points in the commission's reasoning process:[50] (1) the estimate of

[46] See In the Matter of Community Power and Light Co., 6 S.E.C. 182, 193 (1939); 54 YALE L. J. 840 at 848 (1945).

[47] See KEHL, CORPORATE DIVIDENDS 217-218 (1941).

[48] In the Matter of American Utilities Service Corp., S.E.C. Holding Company Act Release No. 5114, June 22, 1944, the release illustrates the difficulty in measuring common's participation where corporate earning power was analyzed from the following viewpoints: (1) amount of reasonably forseeable earnings, (2) amount of such which may be prudently distributed, (3) increase resulting from the reinvestment in the business of such portion of these earnings as are not distributed, (4) the length of time probably required to pay off accrued arrearages, (5) the making of due compensation to the preferred stockholders for giving up their preferential position, (6) the possible reduction in fixed charges, (7) amounts potentially realizable if the company is liquidated.

[49] Cited supra, note 45. In the Otis case, 323 U.S. 624 at 633, 65 S.Ct. 483 (1945), the Supreme Court, through Justice Reed, said: "We reach the conclusion that the Securities and Exchange Commission applied the correct rule of law as to the rights of the stockholders inter sese. That is to say, when the Commission proceeds in the simplification of a holding company system, the rights of stockholders of a solvent company which is ordered by the Commission to distribute its assets among its stockholders may be evaluated on the basis of a going business and not as though a liquidation were taking place."

[50] See 93 UNIV. PA. L. REV. 308 at 318 (1945).

future earnings; (2) the assumption that all future net earnings will be applied to the payment of current preferred dividends and the elimination of arrearages; and (3) the lack of a predictable relation between the number of years which the common will have to wait to receive dividends and the percentage rate of participation in assets in which the common shareholders will be entitled.

In the recent *Phillips* case,[51] upon review of the commission's approval of a recapitalization plan initiated under section 11(e), Judge Clark, in an opinion concurred in by Judges Learned and Augustus Hand, affirmed an order of the commission. The case represented the reversal of the usual situation, for here the petitioner was a common shareholder, claiming that the recapitalization plan grossly overpaid the preferred shareholders. In answer to the petitioner's complaint as to the basis of earnings, the commission stated that it had never considered corporate earnings of a top holding company as an exclusive test of fairness, for its interest lies in the actual earnings of the underlying companies, undistributed as well as distributed. The average net income of the top holding company, the United Corporation, was found to be $2.91 per share, while the actual earnings of its underlying companies, undistributed as well as distributed, amounted to $4.73 per preference share. Thus, taking both of these into consideration, the exchange for a package, the earnings of which average $3.56 per share, was not an unfair one.

Again liquidation rights of shareholders alone should not be held controlling, but in this case they were obviously deserving of careful consideration upon the issue of the fair limits of an offer to retire preferred stock. In regard to the strict priority rule, the court said: "It should be noted that the issue which divided the Supreme Court in the Otis case and has since interested the commentators is whether the Commission had not violated the rule of absolute priority at the expense of the preferred shareholders. And it would be anomalous if here the commission should be held in error in allowing the corporation to offer its preferred investors somewhat nearer their full contract rights than is the current market value." Although the preferred shareholders are not afforded the complete protection of the contract preference (here there was a liquidation preference of $50.00 and a dividend arrearage of $5.25 per share) as they would be by the application of the strict priority rule, it seems that the court does appreciate the position of the disadvantageously situated preferred shareholder,[52] in this case increasing the cash payment involved in the exchange to $6.00 from the $5.00 proposed in the company's plan.

[51] Phillips v. S.E.C., (C.C.A. 2d, 1946) 153 F. (2d) 27.

[52] See 54 YALE L. J. 852 (1945); 55 HARV. L. REV. 780 (1942).

The series of decisions involving recapitalizations under the Holding Company Act have shown the liberal attitude of the courts as to modification of even the previously considered vested rights of the preferred shareholder, with only the qualification of fairness. But what would be the solution to a situation where such modification is ordered or approved under the act as meeting the test of being fair and equitable, but does not pass the technical limitations of a certain majority vote? How would the stalemate be overcome where the modification is ordered under the act, yet compliance is made impossible by statutory or judicial limitations regarding the immunity of such rights of the preferred shareholder? And lastly, if such modification can be ordered under the act, why cannot a corporation conduct such modification in its corporate structure apart from the act, subject only to the same qualification of being fair and equitable?

Robert O. Hancox