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Some Current Thoughts on Corporate Capitalization

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SOME CURRENT THOUGHTS ON CORPORATE CAPITALIZATION *

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There is nothing new in the basic legal problems connected with the need of each new business to somehow or other raise the necessary funds with which to launch the enterprise. It is primarily because of the flexibility which the corporate form of doing business affords in pooling together for a common business purpose the funds of many persons with diverse financial needs and objectives, that the corporation has achieved the pre-eminent position which it occupies. But while the fundamental questions are old, new times, new decisions and new statutes serve to emphasize different phases and different facets of the more permanent problems.[1] It is the purpose of the writer here to direct attention to a few considerations that are of current importance in determining the capitalization [2] of a corporation.

Although, in investment theory, there may be an "optimum capitaliza-

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1. This element of flux in corporate finance may not be attributed to the "New Deal," although some of its legislative manifestations have had, as other articles in this symposium show, a significant impact on corporation law and practice; see also, Rohrlich, *The New Deal in Corporation Law*, 35 COL. L. REV. 1167 (1935). In 1910, it was said, "Methods of corporate finance are continually changing and, as new questions are decided by the courts, they must necessarily change." Masslich, *Financing a New Corporate Enterprise*, 5 ILL. L. REV. 70, 86 (1910). And in 1916, Lyon, in introducing the second volume of his CORPORATION FINANCE, wrote, "The passage of a few years with the varying economic, social and personal winds, make the facts presented in an old corporation manual resemble the snows of yesterday."

2. "Capitalization," as we here use the word, is an accounting rather than a legal term, meaning "the total permanent liabilities of a business, including outstanding stock." WEBSTER'S NEW INTERNATIONAL DICTIONARY (2d ed. 1947). See also, DEWING, THE FINANCIAL POLICY OF CORPORATIONS 58 (4th ed. 1947); GERSTENBERG, FINANCIAL ORGANIZATION AND MANAGEMENT 126 (2d rev. ed. 1945); LINCOLN, APPLIED BUSINESS FINANCE 96 (5th ed. 1941). ". . . in common financial parlance the long term funded debt of a corporation is usually regarded as forming part of its capital structure." Comm'r v. Neustadt's Trust, 131 F. 2d 528, 530 (C.C.A. 2d 1942); *cf.* Anhalt v. Stein, 223 App. Div. 767, 227 N.Y. Supp. 606 (1928). The word is preferable for the purposes of this article because it is broader than the lawyer's "capital," which correctly used does not include debt, but it must also be noted that it is not broad enough to encompass the corporate surplus which in a very real sense is also part of the owners' investment in the business. The Tennessee Code definition (§ 3735) is very adequately illustrative of the correct legal meaning of "capital": "The capital of every corporation shall be defined as the sum of the aggregate par value of all shares of stock having par value issued by the corporation and/or the aggregate amount of consideration received by the corporation for the issuance of shares without par value, together with such additional amounts, if any, as from time to time by resolution of the board of directors may be transferred to capital; provided, however, that any corporation may, by resolution of its board of directors, allocate to surplus, in lieu of capital, the amount or value of any part of the consideration received for the issuance of shares without par value." *Cf.* N.Y. STOCK CORP. LAW, §§ 12, 13 (1940).

tion" for each corporation,[3] the law allows a very high degree of freedom of choice,[4] and even as a matter of economics there are many possible "bases" from which to choose[5] and after one (or more) has been selected its translation into an actual balance sheet invariably involves the application of many subjective judgments as to present values and future prospects. However, in finance, no less than in dress, fashion has always played its influential part. It is difficult to imagine the creation today of corporate structures comparable to those of the "twenties."[6] What is currently significant is that it is no longer necessary to rely upon rumors as to what "everybody," "they," or "Wall Street" are doing to find objective standards. A few federal enactments, the pronouncements of the Securities and Exchange Commission,[7] and certain requirements of the New York Stock Exchange have all combined to make available a body of criteria by which to judge any particular capital structure. It is suggested that the tendency to the voluntary acceptance of such standards by persons not subject to their mandate is not only psychologically "natural," but is also, in the opinion of the writer, prudent. Adherence to such standards makes for readier acceptance in the market and may well prove worthwhile foresight should the corporation at a later date find itself before some administrative or judicial body.

"How much" is no new question. "The Securities and Exchange Commission has always founded its conclusions as to value primarily on the premise that 'value' represents a capitalization of prospective earning power at an appropriate rate which recognizes the risks inherent in the industry and in the particular enterprise."[8] The courts have very emphatically accorded

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3. GRAHAM AND DODD, SECURITY ANALYSIS c. XL (1934).

4. State requirements for industrial corporations (as distinguished from banks, insurance companies and the like) are not significant. Typical are requirements of a minimum authorized or paid-in capital as a condition precedent to doing business; these minima range from $500 (OHIO GEN. CODE ANN. § 8623-37; OKLA. BUSINESS CORPORATION ACT OF 1947, § 15) through $1,000 (DEL. REV. CODE c. 65, § 5) (1935); KY. REV. STAT. § 271.085 (1943); MASS. GEN. LAWS, c. 156, § 6(e); TENN. CODE ANN. § 3714 (Williams, 1934), to $2,000 (N.J. REV. STAT. § 14:2-3(e) (1936). Very few states have debt restrictions; but see, Arizona (CODE, § 53-301) limiting debt to two-thirds of capital stock and Tennessee (CODE, § 7304) limiting *minimum* amount of long-term secured bonds or notes.

5. LINCOLN, *op. cit. supra* note 2, at 149 *et seq.*

6. See, *A Study of the Promotion and Expansion of "The United Corporation" under the Laws of Delaware and what would have been the effect thereon of the Federal Securities Laws had they been in force at the time*, 37 COL. L. REV. 785, 936, 1137 (1937).

7. Within their limited areas the Interstate Commerce Commission [see, SHARFMAN, THE INTERSTATE COMMERCE COMMISSION, (1931)] and local public service or utility commissions have, of course, for years controlled or regulated the capitalization of corporations subject to their jurisdiction. See, Heilman, *The Development by Commissions of the Principles of Public Utility Capitalization*, 23 J. POL. ECON. 888 (1915).

8. Frank, *Epithetical Jurisprudence and the Work of the Securities and Exchange Commission in the Administration of Chapter X of the Bankruptcy Act*, 18 N.Y.U.L.Q. REV. 317, 341 (1941). See also, Gardner, *The S.E.C. and Valuation Under Chapter X*, 91 U. OF PA. L. REV. 440, 454 (1943); Comment, *Distribution of Securities in Corporate Reorganization*, 51 YALE L.J. 85, 88 (1941); Note, *Valuation by the S.E.C. in Reorganizations*, 55 HARV. L. REV. 125, 127 (1941).

primacy to prospective earnings as the base upon which to evaluate an enterprise.[9] When the question as to the "appropriate rate" of capitalization is reached, general principles are not very helpful,[10] even apart from the influence of ever present "human" factors, from which, it has been suggested, not even the Securities and Exchange Commission can wholly escape.[11] It has applied rates varying from about 8% to about 20%, with a predilection for the 10% figure.[12] The courts have applied the same range of rates in cases involving the valuation of intangibles, more particularly "good will," for tax purposes.[13]

Consistent with the historic attitude of regulatory commissions,[14] the Securities and Exchange Commission has worked in the direction of less debt and more equity capital.[15]

With the possible loss of "insulation from liability"[16] as a penalty for inadequate equity capital and excessive debt inherent in the "Deep Rock Doctrine,"[17] there should, it might appear, now be at work the powerful influence

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9. Consolidated Rock Products Co. v. Du Bois, 312 U.S. 510 (1941); Group of Institutional Investors v. Chicago, M., St. P.&P.R.Co., 318 U.S. 523 (1943); Dudley v. Mealey, 147 F. 2d 268 (C.C.A. 2d 1945), *cert. denied*, 325 U.S. 873 (1945).

10. See DEWING, *op. cit. supra* note 2, at 335-6, where considerations justifying rates varying from 10% to 100% are set forth.

11. See Gardner, *supra* note 8, at 454; also 55 HARV. L. REV. 132-4 (1941).

12. Calkins, *Valuation in Corporate Reorganization*, 16 NOTRE DAME LAW. 18, 27 (1940); 51 YALE L.J. at 90 (1941); 55 HARV. L. REV. 132-4 (1941); Gardner, *supra* note 8, at 456.

13. 10 MERTENS, LAW OF FEDERAL INCOME TAXATION § 59.42 (1943). In a very recent case (decided Feb. 18, 1948) involving a retail drug-store (owned by a partnership), the Tax Court arrived at the value of its goodwill by taking the average of its earnings for ten years (1933-1943), allowing a 10% return on tangibles and then capitalizing the remainder at 20%. The Commissioner had taken a five year period (1939-1943), allowed 8% on tangibles and used a capitalization rate of 15%. Watson v. Comm'r, T.C.M., Docket No. 10406; ¶ 48.019 P-H MEMO TC (1948). See also, Shunk v. Comm'r, 10 TC No. 36, Feb. 17, 1948, ¶ 10.36 P-H TC 1948.

14. *Supra* note 7.

15. *E.g.*, In the Matter of New England Gas and Electric Ass'n., SEC Holding Company Act Release No. 6822, Aug. 2, 1946; The Commonwealth & Southern Corporation, 11 S.E.C. 138, *aff'd.*, 134 F. 2d 747 (C.C.A. 3d 1943). See, 10 SEC ANN. REP. 99 (1944).

16. Douglas and Shanks, *Insulation from Liability through Subsidiary Corporations*, 39 YALE L.J. 193 (1929).

17. So called from the name of the subsidiary involved in Taylor v. Standard Gas & Elec. Co., 306 U.S. 307 (1939). Comment, *Right of Parent or Subsidiary to Share with Other Creditors in Assets of Associated Corporation on the Latter's Insolvency*, 37 MICH. L. REV. 440 (1939); Israels, *The Implications and Limitations of the "Deep Rock" Doctrine*, 42 COL. L. REV. 376 (1942); Krotinger, *The "Deep Rock" Doctrine: A Realistic Approach to Parent-Subsidiary Law*, 42 COL. L. REV. 1124 (1942); Sprecher, *The Conflict of Equities Under the "Deep Rock" Doctrine*, 43 COL. L. REV. 336 (1943); Hornstein, *A New Forum for Stockholders*, 45 COL. L. REV. 35 (1945); Note, *The Deep Rock Doctrine; Inexorable Command or Equitable Remedy?* 47 COL. L. REV. 800 (1947). *Cf.* In re Madelaine, Inc., 164 F. 2d 419 (C.C.A. 2d 1947); Hanson v. Bradley, 298 Mass. 371, 10 N.E. 2d 259 (1937). The doctrine narrowly stated "is at least this: Where a showing can be made that a subsidiary corporation having public preferred stockholders [or creditors] was inadequately capitalized from the outset, and was managed substantially in the interest of its parent, rather than in its own interest, the parent will not, in a bankruptcy or reorganization proceeding affecting the subsidiary, be permitted to assert a claim as a creditor, except in subordination to the claims of preferred stockholders [and creditors of the subsidiary]." Israels, *supra* at 379.

of self-interest in support of a conservative balance between debt and equity in the corporate balance sheet.[18]

But personal interest is not so easily served in this day of many laws. *The influence of the tax laws is strongly in the direction of the smallest possible equity and the largest part of the total capitalization in the form of debt.*[19] Three aspects of the federal income tax laws suggest this.

Interest paid by a corporation on its outstanding debt is deductible [20] but not so with respect to dividends paid.[21] Hence, the obvious tax minimization possibilities in more debt and less equity in the capitalization. Under the temptation of this tax saving, there has been a reluctance to use stocks even though otherwise indicated. Such other factors have, however, in many instances prevented the use of the ordinary forms of debt obligations. The result has been myriad variations with many overlapping characteristics so that it is not always easy to draw the line between the proprietary interest known as a stock and the security representing a corporate debt.[22] The decisions by the Supreme Court [23] in the *Kelley* [24] and *Talbot* [25] cases are not very helpful because without "a substantial differentiating factor," [26] it sustained diverse holdings by the Tax Court.[27] Two later decisions of the Tax Court may therefore be noteworthy.

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18. Although the "Deep Rock Doctrine" has thus far been most commonly applied in the corporate parent-subsidiary relationship and there are good reasons of policy for distinguishing between a corporate parent and individual stockholders [see LATTY, SUBSIDIARIES AND AFFILIATED CORPORATIONS 196 (1936)], it may not be safely assumed that the underlying principle is not also applicable to individual stockholders in one-man or in close corporations. *Cf.* Pepper v. Litton, 308 U.S. 295 (1939). See also Mosher v. Salt River Valley Water Users' Ass'n, 39 Ariz. 567, 8 P. 2d 1077 (1932); Dixie Coal Mining & Mfg. Co. v. Williams, 221 Ala. 331, 128 So. 799 (1930).

There is an extensive non-legal literature on the subject of what constitutes an appropriate capitalization. One of the latest discussions is in GUTHMANN AND DOUGALL, CORPORATE FINANCIAL POLICY c. 11 (2d ed. 1948).

19. See generally, Schlesinger, *"Thin" Incorporations: Income Tax Advantages and Pitfalls,* 61 HARV. L. REV. 50 (1947); Semmel, *Tax Consequences of Inadequate Capitalization,* 48 COL. L. REV. 202 (1948).

20. INT. REV. CODE, 52 STAT. 460 (1938); 26 U.S.C.A. § 236 (1940).

21. See generally, 4 MERTENS, LAW OF FEDERAL INCOME TAXATION § 26.10 (1942).

22. Comm'r v. H. P. Hood & Sons, 141 F. 2d 467, 469 (C.C.A. 1st 1944). See also, Northern Fire Apparatus Co. v. Comm'r, 11 B.T.A. 355 (1928). For general discussions of hybrid securities, see Berle, *The Vanishing Distinction Between Creditors and Stockholders,* 76 U. OF PA. L. REV. 814 (1928); Hansen, *Hybrid Securities: A Study of Securities which Combine Characteristics of Both Stocks and Bonds,* 13 N.Y.U.L.Q. REV. 407 (1936); Comment, *Status of Holders of Hybrid Securities: Stockholders or Creditors?* 45 YALE L.J. 907 (1936); Uhlman, *The Law of Hybrid Securities,* 28 WASH. U.L.Q. 182 (1938).

23. 326 U.S. 521 (1946); Comment, 44 MICH. L. REV. 827 (1946). Historically, the greatest significance in these opinions may well lie in the cautionary dictum of Mr. Justice Reed: "As material amounts of capital were invested in stock, we need not consider the effect of extreme situations such as nominal stock investments and an obviously excessvie debt structure." 326 U.S. 521, 526 (1946).

24. John Kelley Co. v. Comm'r, 1 TC 457, *rev'd,* 146 F. 2d 466 (C.C.A. 7th 1944), *rev'd, supra* note 23.

25. Talbot Mills Co. v. Comm'r, 3 TC 95, *aff'd,* 146 F. 2d 809 (C.C.A. 1st 1944), *aff'd, supra* note 23.

26. Mr. Justice Rutledge, 326 U.S. at 533 (1946).

27. Any discussion of the *Dobson* rule (320 U.S. 489) is outside the scope of this

In the first of these two recent cases,[28] the deduction was sustained. The taxpayer-corporation owned real estate which was under long-term lease, the lease containing a renewal option. The debentures in question stipulated for their maturity some two weeks following the expiration date of the original lease but contained a proviso for their extension for an equivalent term in the event of the renewal of the lease. Because of this provision, the Commissioner argued that the maturity date of the debentures was uncertain and that they did not therefore constitute debt obligations. The Tax Court rejected this contention, and distinguished the case before it from its earlier decision in *1432 Broadway Corporation*[29] wherein it had held the payments non-deductible, on the following factors, *inter alia,* which were there present:

(1) "Interest" was payable only (a) at the uncontrolled discretion of the voting trustees of the capital stock, (b) out of "surplus income," and (c) provided that cash or liquid investments were not less than $75,000.00.

(2) The outstanding "debentures" represented 124.5% of the net value of the corporation's assets and had been authorized to the extent of 160% thereof.

(3) "Debenture principal and interest" were subject and subordinate to the claims of all contract creditors.

The Court stressed that in the case before it, *per contra,* "the interest was payable monthly at all events."[30]

In the latter of these two cases,[31] the deduction was disallowed. In that case the sole security holder received in exchange for property having a value of "at least" $250,200.00 the total initial capitalization of the corporation consisting of a 99-year "income debenture" in the amount of $250,000.00 and bearing interest at the rate of 8% per annum, and 200 shares of the par value of $1.00 each. The "debenture," both as to principal and interest, was subordinate to all other debts of the corporation, and the "interest," although cumulative (without interest on accumulations), was payable only "if and to the extent there are 'net earnings' available." In determining the availability of "net earnings," the corporation was authorized to deduct from gross income "all such reserves as the board of directors of the company, in their absolute discretion, may determine to be necessary or advisable to provide for the future operations of the Company." In concluding that the "debenture" was "in all but name redeemable preferred stock," the Tax Court relied on the

article; see, Paul, *Dobson v. Commissioner: The Strange Ways of Law and Fact,* 57 HARV. L. REV. 753 (1944).

28. Cleveland Adolph Mayer Realty Corp. v. Comm'r, 6 TC 730 (1946), *rev'd on other grounds,* 160 F. 2d 1012 (C.C.A. 6th 1947).

29. 4 TC 1158 (1945), *aff'd,* 160 F. 2d 885 (C.C.A. 2d 1947).

30. 6 TC at 740 (1946).

31. Swoby Corp. v. Comm'r, 9 TC 887, No. 118 (1947).

facts and provisions which have been mentioned and additionally stressed the fact that no *loan* had been made to the corporation. Pursuing a lead suggested by the Supreme Court,[32] the Tax Court refused to find that, under the circumstances, the debenture had "a definite maturity date in the *reasonable* future."

The second tax incentive towards undercapitalization [33] lies in the threat of Section 102 of the Internal Revenue Code.[34] Since, basically, imposition of the Section 102 penalty [35] necessitates a finding that there has been an unreasonable accumulation of profits, it is clear that this point is not as quickly reached in the case of a "poor" corporation as it is in the case of a corporation fully capitalized to meet all its present and anticipated financial requirements.[36] Whether the practice of deliberately organizing initially with a low equity and a large debt to accomplish this very end of retaining earnings undistributed will not invoke a judicial reaction remains to be seen.[37]

The third tax consideration which suggests the desirability of a small capital and a large debt is present only in the case of a closely-held corporation.[38] In the absence of a ready market for his stock, the prudent investor in a close corporation not infrequently looks forward to the withdrawal of his investment, in whole or in part, without liquidation of the business, and, if possible, without the payment of ordinary income taxes involved in the receipt of dividends.[39] The statutory hurdle is Section 115(g) of the Internal Revenue

32. John Kelley Co. v. Comm'r, *supra* note 23 at 526.

33. Both as defined in note 2, *supra*, and also in the sense of "capital."

34. See, Reg. 111, § 29.102; Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code*, 49 YALE L.J. 171 (1939); "70% Distribution of Profits: Section 102 under Post-War Conditions" (C.C.H., 2d ed. 1946); Lasser and Holzman, *The "102" Cases*, 3 TAX L. REV. 119 (1947); Cary, *Accumulations Beyond the Reasonable Needs of the Business: The Dilemma of Section 102 (c)*, 60 HARV. L. REV. 1282 (1947); Landman, *Concepts of Section 102*, 26 TAXES 19 (1948). See also three lectures by Schorr, Miller and George, 6 N.Y.U. INST. FED. TAX. (1948).

35. 27½% on the first $100,000 and 38½% on the excess.

36. *E.g.*, De Mille Productions, 30 B.T.A. 826 (1934); Wean Eng. Co., 2 T.C.M. 510 (1943); Coca Cola Bottling Works v. United States, 53 F. Supp. 992 (M.D. Tenn. 1944); Lane Drug Co., 3 T.C.M. 394 (1944); General Smelting Co., 4 TC 313 (1944); Syracuse Stamping Co., 4 T.C.M. 371 (1945); Universal Steel Co., 5 TC 627 (1945). It may also be observed that a conservative dividend policy will find greater tolerance in the case of a new corporation than in the case of an established corporation having a background of actual experience upon which to forecast the future; *e.g.*, Lane Drug Co., *supra*.

37. Cary, *supra* note 34, at 1303. *Cf.* caveat by Mr. Justice Reed, in another connection, 326 U.S. at 526 (1946), *supra*, note 23; also see, Lion Clothing Co., 8 TC 1181 (1947).

38. To a lesser, but nevertheless very substantial extent, this is also true of the other two tax considerations which we have here discussed. "It is submitted that the time is ripe for a sharper division of corporation law into two parts, one dealing with the large publicly owned corporations and the other with close corporations." ROHRLICH, LAW AND PRACTICE IN CORPORATE CONTROL 215 (1933); also 35 COL. L. REV. at 1174 (1935). In addition to the material there cited, see, Winer, *Proposing a New York "Close Corporation Law,"* 28 CORN. L.Q. 313 (1943).

39. The importance of this factor is measured, of course, by the difference between the investor's income tax bracket and the 25% current maximum rate applicable to long-term capital gains. For collection of cases, see Note, 170 A.L.R. 1392 (1947).

Code.[40] The use of "bonds" or "debentures" instead of "stock" affords a *literal* escape from the impact of that provision, but *query* whether debt obligations which do not meet the test of Section 23(b) [41] might not also be held to be "stock" within the meaning of 115(g).[42]

An economic condition which in recent years has, in many instances, made undercapitalization feasible has been the large reservoir of funds in the hands of insurance companies, universities, and similar institutions, seeking profitable investments. The use of long-term leases, with ownership of the real estate in such institutional investor and the operating business as tenant, rather than direct fee ownership by the business entity and the investor as mortgagee, is one method whereby this condition has been availed of to keep not only the capitalization down but even the balance sheet liabilities low, because future rent obligations are not ordinarily shown as liabilities on the balance sheet.[43]

It will be remembered that an *appropriate function of corporate capitalization is the distribution of the "control"* of the corporation as well as of its property and profits and losses. Although state statutes quite freely grant the right to issue non-voting stocks,[44] pressure against their use is substantial.[45]

Several of the newer federal statutes restrict the use of non-voting stocks. Under the Reorganization Act, the reorganized corporation is prohibited from issuing non-voting stock.[46] The Public Utility Holding Company Act points in the same direction.[47] And the Investment Company Act requires that, with

40. "If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

41. *Supra*, notes 20-31.

42. See, Emil Stein, 46 B.T.A. 135 (1942); Bertram Meyer, 5 TC 165 (1945).

43. The form of the transaction may to some extent be influenced by the investment powers of the institution. Although in a few states insurance companies were free to engage in such transactions because of the absence of statutory restrictions, in the majority of the states enabling legislation was required. Virginia was the first to enact it in 1942 (VA. CODE ANN. § 4258a (1942), added by Laws of 1942, Ch. 91) and many states have since done so. For a good discussion of this practice, see, Levy, *The Trend of Corporations to sell their Real Estate to Institutional Investors*, 8 MORTGAGE BANKERS, No. 2, p. 11, No. 3, p. 2 (1947). See also, GUTHMANN AND DOUGALL, CORPORATE FINANCIAL POLICY 571-2 (1940).

44. Illinois is an outstanding exception; see, People *ex rel.* Watseka Telephone Co. v. Emmerson, 302 Ill. 300, 134 N.E. 707 (1922). A few states insist upon minimum voting rights in respect of fundamental corporate changes.

45. For earlier studies of "the separation of ownership from control," see BERLE AND MEANS, THE MODERN CORPORATIONS AND PRIVATE PROPERTY (1932); ROHRLICH, LAW AND PRACTICE IN CORPORATE CONTROL (1933).

46. § 216 (12); 11 U.S.C.A. § 616 (12) (a). It has been held that a voting trust is not precluded. *In re* Quaker City Cold Storage Co., 71 F. Supp. 124 (E.D. Pa. 1947). See generally, Krotinger, *Management and Allocation of Voting Power in Corporate Reorganizations*, 41 COL. L. REV. 646 (1941).

47. 15 U.S.C.A. §§ 79g.(c), 79k(a). See Meck and Cary, *Regulation of Corporate Finance and Management Under the Public Utility Holding Company Act of 1935*, 52 HARV. L. REV. 216, 224 (1938).

stated exceptions, all newly issued stock be voting stock.[48] Since 1926, the New York Stock Exchange has refused to list non-voting common stock.[49]

The same opposition to the denial of voting rights has carried over to preferred shares, but, in view of the more ancient tradition involved, has been effective to a far lesser degree. The Securities and Exchange Commission generally requires (e.g., under the Public Utility Holding Company Act) [50] that preferred stock have "the right to elect a majority of the board of directors in the event of default in the payment of four quarterly preferred stock dividends and certain voting rights in connection with the following matters: the issuance of short-term debt in excess of prescribed amounts, mergers and consolidations, the authorization of any class of stock ranking prior to or on a parity with the outstanding preferred stock, the amendments of the charter to change the express terms of the preferred stock in any substantially prejudicial manner, the issuance of authorized but unissued preferred stock." [51]

The New York Stock Exchange has not as yet gone quite as far as the Commission but it will not list new preferred stocks which do not provide at least the following minimum voting rights:

1. The right of the preferred stock, voting as a class, to elect not less than two directors after default of the equivalent of six quarterly dividends.
2. The affirmative approval of at least two-thirds of the preferred stock, voting as a class, as a prerequisite to any charter or by-law amendments altering materially any existing provision of such preferred stock.[52]

The various federal statutes which have already been referred to aim to set up an "ideal" capital stock structure to consist of one class of voting stock. This results in a presumption against, where no absolute prohibition

48. § 18 (i)(j); 15 U.S.C.A. § 80a-18(i). See Note, *The Investment Company Act of 1940*, 41 COL. L. REV. 269, 284 (1941).

49. Quoted from May 4, 1940, Statement of Listing Requirements as to Preferred Stock Voting Rights. "In broad principle," the New York Curb Exchange also, but less inflexibly, adheres to a similar policy (see statement of Policy of Committee on Listing re Voting Rights, as modified November 12, 1946). Examples could be cited to illustrate that it is evidently still possible by the skillful use of the device of classifying stocks to deprive listed voting stock of effective control. *Cf.* PUBLIC UTILITY HOLDING COMPANY ACT (*supra*, note 47), § 1 (b) (3), 49 STAT. 804 (1935). Nor does the election of directors by preferred and common stockholders voting separately as classes necessarily violate The Investment Company Act requirement of "equal voting rights." *In re* The Solvay American Corporation, S.E.C., Investment Company Act, Release No. 1165, April 13, 1948. For discussions of the rights and obligations of "management stock," see Berle, *Non-Voting Stock and "Bankers' Control,"* 39 HARV. L. REV. 673 (1926); Wood, *The Status of Management Stockholders*, 38 YALE L.J. 57 (1928).

50. *Supra*, note 47.

51. 10 S.E.C. ANN. REP. 103 (1944). See also, Note, *Voting Rights of Preferred Stockholders Under the Public Utility Holding Company Act of 1935*, 51 YALE L.J. 138 (1941). *In re* The Solvay American Corporation, *supra* note 49.

52. Statement of May 4, 1940, *supra* note 49.

exists, the use of preferred shares.[53] It is not the purpose here to prolong the debate as to the justification for using a security which "is neither fish, fowl, nor good red herring"[54] nor to examine the truth of the conclusion that "Heads, the common stockholder wins; tails, the preferred stockholder loses."[55] The writer does, however, want to direct attention to one current aspect of preferred stock, namely, *the vanishing distinction between cumulative and non-cumulative stocks.*

Until recent years, the right of holders of cumulative preferred stock to receive all dividend arrears was regarded, legally,[56] as a vested right not easily dislodged. A good expression of this attitude is to be found in *Keller v. Wilson & Co.*[57] The Delaware Chancellor there said:

> The State is concerned also with the welfare of those who invest their money, the very essence of generation, in corporate enterprises. Some measure of protection should be accorded them. While many interrelations of the State, the corporation and the shareholders may be changed, there is a limit beyond which the State may not go. Property rights may not be destroyed; and when the nature and character of the right of a holder of cumulative preferred stock to unpaid dividends, which have accrued thereon through passage of time, is examined in a case where that right was accorded protection when the corporation was formed and the stock was issued, a just public policy, which seeks the equal and impartial protection of the interests of all, demands that the right be regarded as a vested right of property secured against destruction by the Federal and State Constitutions.

However, this seemingly impregnable property—"inviolable"[58]—right was finally breached with full legal sanction in a number of states as the result of a combination of legal ingenuity, judicial tolerance and legislative encouragement. This result was first accomplished by the creation of a new senior security and the "voluntary" exchange of the old preferred stock.[59]

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53. The desire of the common stock for "leverage" is no sufficient justification for the use of preferred stock. The Commonwealth & Southern Corp., 11 S.E.C. 44, *aff'd sub. nom.* Commonwealth & Southern Corp. v. S.E.C. 134 F. 2d 747 (C.C.A. 3d 1943). When allowed, preferred stock should—from the point of view of the corporation—be callable. Matter of the United Light and Railways Co., S.E.C., Holding Company Act Release No. 7951, 1947; and must have various protective provisions. 10 S.E.C. ANN. REP. 99, 1944.

54. HOAGLAND, CORPORATION FINANCE 83 (2d ed. 1938).

55. GRAHAM AND DODD, *op. cit. supra* note 3 at 163.

56. "In practice, the chance of collecting, in cash, accumulated dividends [has always been] inversely proportional to the size of the accumulation." HOAGLAND, *op. cit. supra* note 54, at 57.

57. 21 Del. Ch. 391, 412, 190 Atl. 115, 125 (1936). See also Consolidated Film Industries, Inc. v. Johnson, 22 Del. Ch. 407, 197 Atl. 489 (1937); Buckley v. Cuban American Sugar Co., 129 N.J. Eq. 322, 19 A. 2d 820 (1940); Roberts v. Roberts-Wicks Co., 184 N.Y. 257, 263, 77 N.E. 13 (1906); Patterson v. Durham Hosiery Mills, 214 N.C. 806, 200 S.E. 906 (1939). *Cf.* Davison v. Parke, Austin & Lipscomb, Inc., 285 N.Y. 500, 35 N.E. 2d 618 (1941), noted 19 N.Y.U.L.Q. REV. 196 (1942).

58. Roberts v. Roberts-Wicks Co., *supra* note 57.

59. See, Shanik v. White Sewing Machine Corp., 15 A. 2d 169 (Del. Ch., 1940); Johnson v. Fuller, 121 F. 2d 618 (C.C.A. 3d 1941); Note, *Corporate Recapitalization by Charter Amendment,* 46 YALE L.J. 985 (1937); Peters, *The Effect of New Prior Preference Stocks Upon the Right to Accrued Cumulative Dividends,* 12 U. OF CIN. L. REV. 576

"The apple that cannot be picked can, nevertheless, be shaken down." [60] The only restraint upon this form of recapitalization, absent controlling contractual restrictions, is seemingly the requirement that it must be "fair"—but, in Delaware, at any rate, "to be held unfair it must amount to at least constructive fraud." [61] Then came the ingenious device of complete elimination of the accumulation by means of a consolidation or merger—valid even if with a wholly owned subsidiary especially created for the purpose.[62] And finally, the constitutionality of a direct elimination of the accumulation by a recapitalization under an appropriately phrased enabling act has been sustained.[63] Thus, in a substantial number of leading jurisdictions, the shift "from vested right to mirage" is now complete in so far as cumulative preferred stocks are concerned.[64]

Operating in the opposite direction, but far less successfully, has been an attempt to improve the legal status of non-cumulative preferred stock. The inherent weakness of this type of stock is obvious and has long been the subject of comment,[65] but nothing was done about it until the New Jersey

(1938); Note, *Elimination of Accrued Preferred Dividends by Charter Amendment*, 26 MINN. L. REV. 387 (1942); Note, *Intraclass Discrimination in the Elimination of Accrued Dividends*, 55 HARV. L. REV. 1196 (1942). Also articles cited *infra* notes 60-64.

60. Becht, *The Power to Remove Accrued Dividends by Charter Amendment*, 40 COL. L. REV. 633, 639 (1940).

61. Barrett v. Denver Tramway Corp., 146 F. 2d 701 (C.C.A. 3d 1944). *Cf.* Kamena v. Janssen Dairy Corp., 133 N.J. Eq. 214, 31 A. 2d 200 (1943), *aff'd*, 134 N.J. Eq. 359, 35 A. 2d 894 (1944). See Note, *The Burden Placed on Minority Stockholders by the Delaware "Gross Unfairness" Rule Applied in Corporate Reorganizations*, 20 TEMP. L.Q. 123 (1946); Comment, *The Fair and Equitable Test in Recapitalizations*, 45 MICH L. REV. 183 (1946).

62. Hubbard, Jones & Laughlin Steel Corp., 42 F. Supp. 432 (W.D. Pa. 1941); Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A. 2d 331 (1940); Hottenstein v. York Ice Mach. Corp., 136 F. 2d 944 (C.C.A. 3d 1943); Zobel v. American Loco. Co., 182 Misc. 323, 44 N.Y.S. 2d 33 (1943); Anderson v. Int. Min. & Chem. Corp., 295 N.Y. 343, 67 N.E. 2d 573 (1946); Langfelder v. Universal Laboratories, 163 F. 2d 804 (C.C.A. 3d 1947). See Note, *Scaling-Down of Arrearages on Cumulative Preferred Stock*, 4 U. OF CHI. L. REV. 645 (1937); Note, *Elimination of Accrued Dividends in Corporate Reconstruction*, 89 U. OF PA. L. REV. 789 (1941); Comment, *Abrogation of Preferred Dividend Arrearages by Charter Amendment, Merger, or Consolidation*, 39 MICH. L. REV. 1201 (1941).

63. McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N.Y.S. 2d 253 (1945); *cf.* Davison v. Parke Austin & Lipscomb, Inc., *supra* note 57. As to retroactive validity of such enabling legislation, *compare*, Wheatley v. A. I. Root Co., 147 Ohio St. 127, 69 N.E. 2d 187 (1946). For typical enabling legislation, in addition to New Jersey (Kamena v. Janssen Dairy Corp., *supra* note 61), New York (McNulty v. W. & J. Sloane, *supra*) and Ohio (Wheatley v. A. I. Root Co., *supra*) see as to Virginia [VA. CODE ANN., § 3780 (1942)], and Wisconsin [Johnson v. Bradley Knitting Co., 228 Wis. 566, 280 N.W. 688 (1938), noted 6 U. OF CHI. L. REV. 104 (1938)].

The status of accrued dividends in reorganizations under the Bankruptcy Act is beyond the scope of this article; see 6 COLLIER, BANKRUPTCY §§ 2.05, 11.06 (1947).

64. Dodd, *Accrued Dividends in Delaware Corporations—From Vested Right to Mirage*, 57 HARV. L. REV. 894 (1944). See also, Meck, *Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine*, 55 HARV. L. REV. 71 (1941).

65. *E.g.*, Berle, *Non-Cumulative Preferred Stock*, 23 COL. L. REV. 358 (1923). In sympathizing with the lot of the non-cumulative preferred stockholder, it must however not be overlooked that there is evidence to support the conclusion that in the large majority of instances they have not been discriminated against; see, Spal, *The Treatment of Noncumulative Preferred Shareholders with regard to Dividends*, 15 JOUR. OF BUS. OF U. OF CHI. 248 (1942).

courts, seizing upon helpful statutory language,[66] developed what has come to be known as the "Dividend Credit Theory." [67] Most succinctly stated, this theory requires that if in any year in respect of which full dividends were not paid on the non-cumulative preferred stock, the net earnings of that year were in excess of the dividend paid, such excess of earnings must, to the extent legally available for the payment of dividends,[68] be used to pay preferred dividends before a dividend may be paid on the common stock even though full dividends have been paid on the preferred for the subsequent year in which it is proposed to pay dividends on the common stock.[69]

Some writers seem to have accepted the view that the decision of the United States Supreme Court in *Wabash Railway Co. v. Barclay*,[70] has completely forestalled the further development and application of the dividend credit theory.[71] This is not necessarily so. The Supreme Court did say:

> We believe that it has been the common understanding of lawyers and business men that in the case of non-cumulative stock entitled only to a dividend if declared out of annual profits, if those profits are justifiably applied by the directors to capital improvements and no dividend is declared within the year, the claim for that year is gone and cannot be asserted at a later date[72]

But this view has been sharply criticized [73] and the decision of a court

66. We do not regard that particular statutory provision as of the essence but prefer to regard the decisions as evidencing a generally applicable principle. See Comment, *The Rights of Non-Cumulative Preferred Stockholders in Undivided Profits,* 34 YALE L.J. 657 (1925).

67. A broad and categorical statement of the theory may be found in Berle, *supra* note 65, and more limited statements in the opinion of Circuit Judge Manton in Barclay v. Wabash Ry. Co., 30 F. 2d 260, 262 (1929) (*rev'd, infra* note 70) and in the casenote in 14 MINN. L. REV. at 418-419. Without so denominating it, Kehl states the theory as follows: "When the corporation has earnings in any one year adequate to meet non-cumulative dividends, but decides to pass the same, the non-cumulative holders should be recognized as having an equity in the surplus thus retained, entitling them to payment of such dividends ahead of common when dividends are proposed to be paid out of accumulated surplus in later years." KEHL, CORPORATE DIVIDENDS 198-9 (1941).

68. Lich v. United States Rubber Co., 39 F. Supp. 675 (D.N.J. 1941); *aff'd,* 123 F. 2d 145 (C.C.A. 3d 1941); Comments, 26 MINN. L. REV. 117 (1941), 55 HARV. L. REV. 678 (1942). Non-cumulative preferred dividends are not deemed earned so long as there remains a deficit from losses sustained in prior years. National Newark & Essex Co. v. Durant Motor Co., 124 N.J. Eq. 213, 1 A. 2d 316 (1938), *aff'd,* 125 N.J. Eq. 435, 5 A. 2d 767 (1939). Earnings of subsidiary not declared and paid as dividends will not be deemed earnings of parent. Cintas v. American Car & Foundry Co., 131 N.J. Eq. 419, 25 A. 2d 418 (1942), *aff'd,* 132 N.J. Eq. 460, 28 A. 2d 531 (1942).

69. Day v. United States Cast Iron Pipe & Foundry Co., 95 N.J. Eq. 389, 123 Atl. 546 (1924), *aff'd,* 96 N.J. Eq. 736, 126 Atl. 302 (1924). See also, Bassett v. United States Cast Iron Pipe & Foundry Co., 75 N.J. Eq. 539, 73 Atl. 514 (1909); Morgan v. United States Cast Iron Pipe & Foundry Co., 95 N.J. Eq. 389, 123 Atl. 54 (1924), *aff'd,* 96 N.J. Eq. 698, 126 Atl. 329 (1924); Diamond v. Davis, 38 N.Y.S. 2d 103 (Sup. Ct. 1942), *aff'd,* 265 App. Div. 919, 39 N.Y.S. 2d 412, *aff'd,* 292 N.Y. 552, 54 N.E. 2d 683 (1944).

70. 280 U.S. 197 (1930).

71. *E.g.,* DEWING, *op. cit. supra* note 2, at 149.

72. *Supra,* note 70 at 203.

73. Hicks, *The Rights of Non-Cumulative Preferred Stock—A Doubtful Decision by the United States Supreme Court,* 5 TEMP. L.Q. 538 (1931); Lattin, *Is Non-Cumulative Preferred Stock in Fact Preferred?* 25 ILL. L. REV. 148 (1930). See also casenote, 14 MINN. L. REV. 417 (1930).

below has left a mark which has not been entirely obliterated.[74] With the passing of *Swift v. Tyson,*[75] the state courts may feel freer to re-examine the question on its merits.[76]

Even if the "dividend credit theory" remains a minority view, the renewed consideration of the plight of the non-cumulative preferred stockholder engendered by its formulation has suggested another possible line of relief.

While it is generally stated that the rule that the matter of the declaration of dividends is within the discretion of the board of directors applies to preferred dividends, non-cumulative and cumulative, as well as to common dividends,[77] a refinement of the analysis upon which these principles are grounded may well lead to a judicial acceptance of the view that the bona-fide discretion of directors in the payment of non-cumulative preferred dividends is limited to questions of time—when should a dividend be declared—but does not carry with it the same freedom to divert to junior securities surplus profits which in equity should have reasonably gone to the non-cumulative preferred stockholders.[78]

It is hardly necessary to recall expressly that subject only to a very few statutory requirements, the rights of security holders are matters of contract and the judicial questions therefore ones of construction. It lies accordingly with the skilled draftsman, using "the utmost precision available to legal language"[79] to abrogate or invoke the preferred stock theories to which we have called attention. But in doing so, it must not be forgotten that "while an unreasonable contract is a legal possibility, courts will normally struggle against construction leading to such a result."[80]

There remains to mention but one more topic seemingly of current interest in the matter of corporate capitalization. That is as to the *use of no-par value stock.*

When New York, in 1912, led the way in legalizing no-par stock,[81] it was seized upon as affording the only safe way of accomplishing certain of

74. 30 F. 2d 260 (C.C.A. 2d 1929).

75. 16 Pet. 1 (U.S. 1842), overruled by Erie Railroad Company v. Tompkins, 304 U.S. 64 (1938).

76. *Cf.* Joselin v. Boston & M.R. Co., 274 Mass. 551, 175 N.E. 156 (1931).

77. New York, Lake Erie and Western Railroad v. Nickals, 119 U.S. 296 (1886); Morse v. Boston and M.R.R. Co., 263 Mass. 308, 160 N.E. 894 (1928). See generally Stevens, *The Discretion of Directors in the Distribution of Non-Cumulative Preferred Dividends,* 24 Geo. L.J. 371 (1936); Stevens, *Rights of Non-Cumulative Preferred Stockholders,* 34 Col. L. Rev. 1439 (1934).

78. See Kehl, *op. cit. supra* note 67, § 66. Also dicta in Titus v. Piggly Wiggly Corp., 2 Tenn. App. 184, 204 (1925).

79. Dewing, *op. cit. supra* note 2 at 151.

80. Berle, *supra* note 65 at 359.

81. Nebraska has not followed. Its Constitution (Art. XII, Sec. 6) requires that "all stock shall have a face par value; and all stock in the same corporation shall be of equal par value." A few states (*e.g.,* Wisconsin—Stat. § 182.14) deny the privilege to preferred stock.

the objectives of corporate promoters,[82] primarily immunity against shareholders' liability on watered stock.[83] However, it is now quite clear that this is not necessarily so and that low par value shares serve many of the same purposes as well.[84] Coupled with wider recognition of this fact and of the necessity, even apart from statutory requirements,[85] for dollar values being attributed to assets and shares for balance sheet purposes,[86] certain other circumstances have served to minimize the use of no-par shares.

One hundred dollar par is no longer traditional and shares with a very low or even nominal par value are not only legal but respectable.[87] These low par value shares effectively serve the same purposes as no-par shares and, in addition, under many tax statutes result in savings. These statutes not infrequently attribute to no-par shares, for purposes of computing organization, original issue, and transfer taxes, an arbitrary value and without regard to the fact that some of the consideration may represent paid-in surplus and not

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82. The term is not used with any odious overtones. "The promoter performs a public service whenever he produces a successful concern [without abusing the interests of investors, consumers or of the general public]. . . . he either creates a new demand that helps us do our business more readily, or to live more comfortably, or he supplies older utilities in a cheaper way, or he saves the ruining wastes of competition with its long trail of duplications, unnecessary advertising, and similar extravagances. The promoter has been much maligned. He is not a prestidigitator. Rufus Wallingford no more represents the real type of promoter than Sherlock Holmes represents the true type of detective. The true promoter may have his moments of elegant ease, but he knows what real work is . . . the promoter's work of discovery, assembling, and financing is a matter of close attention to details." GERSTENBERG, *op. cit. supra* note 2 at 4.

83. See generally, Cook, *"Watered Stock"—Commissions—"Blue Sky Laws"—Stocks Without Par Value*, 19 MICH L. REV. 583, 7 A.B.A.J. 534 (1921); Pierson, *Stock Having No Par Value*, 17 ILL. L. REV. 173 (1922); Ballantine, *Nonpar Stock—Its Use and Abuse*, 57 AM. L. REV. 233 (1923); Bonbright, *The Dangers of Shares Without Par Value*, 24 COL. L. REV. 449 (1924); Berle, *Problems of Non-par Stock*, 25 COL. L. REV. 43 (1925); Clay, *Shares Without Par Value*, 13 KY. L.J. 275 (1925); Mitchell, *Capitalization of Corporations Issuing Shares Without Par Value*, 11 A.B.A.J. 377 (1925); Masterson, *Consideration for Non-Par Shares and Liability of Subscribers and Stockholders*, 17 TEX. L. REV. 247 (1939). ROBBINS, NO PAR STOCK (1927); WICKERSHAM, STOCK WITHOUT PAR VALUE (1927); WILDMAN AND POWELL, CAPITAL STOCK WITHOUT PAR VALUE (1928).

84. See Israels, *Problems of Par and No-Par Shares: A Reappraisal*, 47 COL. L. REV. 1279 (1947).

85. *E.g.*, CAL. CORP. CODE § 1900, DEL. REV. CODE c. 65 (Corp. Law), § 14 (1935); FLA. STAT. § 612.21 (1941); ILL. BUS. CORP. ACT § 19 as amended (1935); MASS. ANN. LAWS, c. 158, § 33 (1933); MICH. GEN. CORP. ACT § 20 as amended (1937); N.Y. STOCK CORP. LAW §§ 12, 13 (1940); TENN. CODE ANN. § 3725 (Williams, 1934); WIS. STAT. § 182.14 as amended (1945).

86. "Unless it proves feasible to adopt a non-par balance sheet, as well as a non-par stock certificate, that is, unless a form of financial statement can be devised which does away with pecuniary valuations of the fixed assets by interested parties, we are still faced with the same problem [of deception], though in a somewhat different form, that presents itself in the case of an overissue of par-value shares." DODD, STOCK WATERING 304 (1930). *Cf.* Item 2 (i) of Instructions as to Financial Statements issued by Securities and Exchange Commission with respect to Forms S-2 and S-3 under the Securities Act.

87. BERLE AND WARREN, CASES AND MATERIALS ON THE LAW OF BUSINESS ORGANIZATIONS—CORPORATIONS 313 (1948).

capital.[88] The impact of these taxes can generally be substantially reduced by the use of a lower "valued" par stock.

And moreover, some of the federal legislation which we have already mentioned as designed to bring about "ideal" corporate capital structures, restrict, within their purview, the use of no-par shares.[89] The Securities and Exchange Commission has said that "as a general rule common stock should be of par value," [90] but it has from time to time exercised its discretion to permit the use of no-par shares.[91]

In presenting the foregoing aspects presently germane on the subject of corporate capitalization, no attempt has been made to be exhaustive. The purpose of the writer has been merely to suggest some factors which should not be overlooked.

88. *E.g.*, INT. REV. CODE, § 1802 (a); Calif. Gov. Code § 122.1 as amended; CONN. GEN. STATS. § 3481; DEL. FRANCHISE TAX LAW c. 6, § 64; N.Y. TAX LAW, § 180. *Cf.* TENN. CODE ANN. § 1248.143 (Williams, 1934).

89. *E.g.*, PUBLIC UTILITY HOLDING COMPANY ACT, § 7 (c).

90. In the Matter of Northern States Power Company, S.E.C. Holding Company Act Release No. 5745, C.C.H.—Dec. ¶ 75,538 (1945).

91. In the Matter of Northern States Power Company, *supra* note 90; Meck and Cary, *supra* note 7, at 221-224.