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Manipulation of Share Priorities

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MANIPULATION OF SHARE PRIORITIES

—The Record of 79 Listed Securities

BY ALFRED F. CONARD*

> "This stock is prior to all others, bears 7% cumulative dividends, has a liquidation preference of $110 and accrued dividends, and is entitled to a sinking fund of $50,000 a year, unless a majority of the class which you, as purchaser, have joined, should change its collective mind, in which case this stock is no better than second preferred and perhaps worse, bears 1% dividends which are non-cumulative, has no liquidation or sinking fund rights, and will lose all dividends that shall have been passed before the majority has made up its mind to terminate your rights."

This inscription, suggests Mr. Arno Becht, should be placed on each preferred share certificate by a candid issuer.[1] Other scholars have been similarly critical of preferred share manipulation.[2]

Investors, who seldom read law reviews, continue to put their

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*Professor of Law, University of Michigan. The author acknowledges the contribution of the following members of the Illinois Bar who, as senior students at the University of Illinois College of Law, gathered much of the data on which the study is based:

Edward J. Connor, Chicago	William L. Randolph, Macomb
Robert B. Karkow, Wilmette	Herbert B. Schuh, Bement

The author has verified only a fraction of the data, and submits this study in the belief that the inferences drawn are generally correct, although some minor errors in the basic data are probable.

1. Becht, *Alteration of Accrued Dividends*, 49 MICH. L. REV. 363, 565, 583 (1951). Mr. Becht has rounded out a complete coverage of preferred share rights with two other articles: *Corporate Charter Amendments: Issues of Prior Stock and the Alteration of Dividend Rates*, 50 COL. L. REV. 900 (1950); *Changes in Interests of Classes of Stockholders by Corporate Charter Amendments Reducing Capital, and Altering Redemption, Liquidation and Sinking Fund Provisions*, 36 CORN. L.Q. 1 (1950). This triad of monographs appears to supersede Mr. Becht's earlier study, *The Power to Remove Accrued Dividends by Charter Amendment*, 40 COL. L. REV. 633 (1940).

2. Primary credit for stimulating analytic thought on the preferred share manipulation belongs to the late E. Merrick Dodd of Harvard Law School, by reason of the following articles and books: *Purchase and Redemption by a Corporation of its Own Shares*, 89 U. OF PA. L. REV. 697, 725-726 (1941); *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780 (1942); *The Relative Rights of Preferred and Common Shareholders in Recapitalization Plans under Public Utility Holding Company Act*, 57 HARV. L. REV. 295 (1944); *Accrued Dividends in Delaware—from Vested Right to Mirage*, 57 HARV. L. REV. 894 (1944); CASES AND MATERIALS ON CORPORATE REORGANIZATION (with De Forest Billyou, 1950); CASES ON CORPORATIONS 1294-1378 (with Ralph J. Baker, 1951).

Other outstanding contributions to the subject are: Billyou, *Priority Rights of Preferred and Common Shares in Bankruptcy Reorganization*, 65 HARV. L. REV. 93 (1951), 26 J.N.A. REF. BANKR. 67 (1952); Lattin, *A Primer on Fundamental Corporate Changes*, 1 WEST. RES. L. REV. 3 (1949); Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 1 (1942); Latty, *Exploration of Legislative Remedy for Prejudicial Changes in Senior Shares*, 19 U. of CHI. L. REV. 759 (1952); Walter, *Fairness—A Disappearing Doctrine*, 29 B. U. L. REV. 453 (1949).

money into preferred stocks. In the last five reported years, approximately 3 billion of dollars worth of preferred shares have been offered to the public, or more than a third of the value of all stock offered.[3] Can Mr. Becht and the investors both be right?

Presumably the investors are directing their attention to different aspects of preferred stock than is Mr. Becht. Like other lawyers, he is considering what managements *can* do to preferred shareholders if they do their worst. His conclusions are based on the records of cases which have been fought through to judicial decision.

The investors, if they consider anything at all, would properly direct their attention to what is *likely* to happen, or what has happened most frequently in the past. On this point there is little information in the law reviews or, so far as we have discovered, in financial literature. This paper reports on an attempt to find out how frequently the investor in preferred stocks is subjected to the manipulations which legal analysts have described. It is based on the record made from 1932 through 1951 by 79 preferred stocks which were listed on the New York Stock Exchange.[4]

ABSTINENCE FROM MANIPULATION

As we surveyed the practices of the market place, we were struck by the variety of maneuvers taking place. Which should we call manipulation?

As usual, it is easier to define what is not manipulation. Of course, if shares were paid their dividends through the twenty years, and no changes were made in capital structure, there was no manipulation. Neither did we find manipulation if the shares were called in for redemption in accordance with their terms. We concluded also that there was no manipulation if the shares went into default, so long as nothing was done to alter their priorities. The charter did not promise that dividends would be paid, but only that they would have *priority* of payment. Likewise, we felt there was no manipulation even if the company failed and was liquidated, so long as the common shares received no benefit or prospect of it, without prior satisfaction of the claims of preferred.

3. SEC, Statistical Bulletin (monthly) presents the following totals of offerings for cash of new corporate securities (in millions of dollars):

	1952	1951	1950	1949	1948
Total corporate	9,852	7,741	6,361	6,052	7,078
Bonds	7,649	5,691	4,920	4,890	5,973
Preferred stock	564	838	631	425	492
Common stock	1,369	1,212	811	736	614

4. The issues were chosen from the New York Stock Exchange market report for 1932 as printed in 136 COMMERCIAL & FINANCIAL CHRONICLE 101-102 (1933). Selections were made at random from the Railroads list, and from the Industrials list, but the distribution between lists was not random, and is probably weighted in favor of the Railroads list.

A tabulation of the securities studied is furnished at the end of this article. They will henceforth be cited by an abbreviation of the issuer's name.

By these tests we found that 45 of the 79 issues studied escaped manipulation. The 45 classified themselves as follows:

Never passed a year's common dividends	13[5]
Passed common, but never passed preferred	7[6]
Passed preferred, but made up all arrears	14[7]
Liquidated or reorganized, without violation of priorities	7[8]
Passed preferred, and still in arrears without alteration of rights on December 31, 1951	4[9]

Analyzed in this way, the Abstinence Roll of Honor shrinks considerably. A cynic might say it consists largely of those who never had a chance (where neither junior nor senior shares obtained any benefits), and those who were never thirsty (arrears on preferred never accrued). The cynic will take pleasure in noting that in at least two of the companies which were still in arrears at the end of the observed period, subsequent proceedings indicate the probability of manipulation of preferred priorities.[10]

Some credit must be given, however, to the companies which never passed preferred dividends, despite the passing of common for periods from 1 to 5 years. There are others which stopped preferred dividends much more promptly and followed with manipulation of preferred rights.

Most interesting are the 14 companies which paid up their preferred arrears in full. While some had arrearages of less than a year, six of them had back dividends of five years or more, and three had arrearages of 13, 14, and 15 years, respectively.[11] In most cases, we

5. Abraham & Straus
American Tobacco
Bangor & Aroostook
City Ice & Fuel
Commercial Investment Trust
Duplan Silk
General Cigar
General Motors
Liggett & Myers
Loew's
National Biscuit
Pacific Tel. & Tel.
South Porto Rico Sugar

6. Beatrice Creamery
Bloomingdale Bros.
Century Ribbon Mills
Consolidated Oil
Crown Cork & Seal
General Railway Signal
International Printing Ink

7. Associated Dry Goods
American Smelting
Brooklyn & Queens Transit
Budd Manufacturing
Byers (A.M.) Co.
Gotham Hosiery
Guantanamo Sugar
Houdaille-Hershey
Interstate Dept. Stores
N. Y., C. & St. L. R. R.
Norwalk Tire & Rubber
Tidewater Oil
U. S. Steel
Virginia-Carolina Chemical

8. Chicago Great Western
Chicago Rock Island
Havana Electric
Mallinson (H.R.) Corp.
Market St. Ry.
Pierce Oil
Producers & Refiners

9. American & Foreign Power
International Railways
Missouri-Kansas-Texas
Western Pacific

10. American & Foreign Power; Western Pacific.

11. Budd Manufacturing (13), N. Y., C. & St. L. (14), Guantanamo Sugar (15).

have no clue as to what induced the management to pay up, while other managements were blithely funding or writing off preferred shareholders' claims. In the 13-year case, however, we know that the management first offered shareholders an exchange of prior preferred, which no shareholder accepted. After this rebuff, the directors came through with $97 in back dividends per share.[12]

In the 15-year case, a proposed amendment was adopted to give the preferred shareholders a small bond and several shares of common, but was enjoined by the New Jersey Court of Chancery.[13] Two years later, the company offered preferred holders a voluntary choice between full payment of arrearages and call price, or an exchange for new preferred stock. About a third of the shares elected payment, amounting to $227 per share.

The Gambits of Manipulation

Manipulation, as we decided to use the term, means any device for evading the priorities promised to a preferred shareholder. To evade a priority is to pay a junior shareholder before the senior shareholder has had all the dividends or liquidation values, or both, which were specified as prior to junior share payments. It will be easier to illustrate than to particularize further. We found 34 cases of manipulation, as compared with the 45 cases, already described, of "abstinence."

The most direct manipulative device is amendment. But by changing the terms of the charter, the clause providing for cumulative priority may be rewritten to provide for less priority, or none. The same thing may be done in a slightly more plausible form by "reclassifying" the outstanding shares—that is, changing from the kind of shares they were to a new kind, with different (and lesser) rights.

A slightly more sophisticated device for escaping the shackles of priority is merger or consolidation. By this means, a corporation with dividend arrearages combines with another corporation, creating what is (in substance, if not in theory) a new corporation with new charter provisions. In this metamorphosis, the scaly skin of arrearages is always left behind.

Amendment and merger are accomplished by authority of corporation laws, always requiring some sort of formal adoption by a vote of shareholders, but not incurring official supervision unless an aggrieved party takes his case to court. In contrast to these procedures of majority rule stand the officially supervised procedures of "reorganization." Most of the reorganizations encountered took place in the Court of Bankruptcy. Two were effected under the Public Utility Holding

12. Budd Manufacturing. All facts, as usual, from various annual volumes of Moody's Manual of Investments.

13. Wessel v. Guantanamo Sugar Co., 134 N.J. Eq. 271, 35 A.2d 215 (Ch. 1945).

Company Act. Although the reorganizations sometimes employed the means of amendment, merger or consolidation, sale of assets, or dissolution, we have ignored those variations because the dominant note seemed to be supplied by the judicial or administrative supervision.

Amendment, reorganization, and merger or consolidation, are all "compulsory" procedures, in that they are binding on minority investors who do not consent. But manipulation can also be effected by "voluntary" measures, in which each affected shareholder's assent is obtained to the change in his rights. The principal voluntary device is the "exchange offer," in which the holder of accrued dividend rights is offered a trade for new securities, with a strong hint that dividends will be paid on the new security if the exchange is taken. Often the proffered exchange is a new preferred stock, prior to the one already held, which has the dual function of a carrot in front and a goad behind.

Most subtle of all methods of getting rid of the preferred shareholders' priorities is the purchase of their shares in the open market.[14] When dividends are current, we have not regarded purchase as a "manipulation," although something might be said on this point. But when the dividends are in arrears, the use of funds for purchase of shares automatically diminishes the possibility that dividends will ever be paid, by reducing the fund from which they would come. Conversely, the withholding of dividends helps to provide the fund for purchase at the same time that it reduces the market price of the shares.

The principal problem in analyzing the use of this manipulative method is the difficulty in detecting it. Share purchases are not reported in the usual financial records, and can only be inferred. Sometimes the evidence is found in the balance sheet statement of capital stock outstanding, or of treasury stock. If a holding company makes the purchase, the effect is similar, but the fact will not appear on the subject company's balance sheet; it may be separately reported if the holding company is subject to the Public Utility Holding Company Act. If controlling common shareholders make the purchase, the effect is again similar, but will not appear at all in the usual financial reports. If the purchasers cause the preferred shares to be called with full discharge of arrearages, the case will appear to be one of nonmanipulation, though it is actually an instance of manipulation. No such cases were detected in the present study.

The following table indicates the frequency of the various manipulation devices which we detected:

14. See Dodd, *Purchase and Redemption by a Corporation of its Own Shares*, 89 U. OF PA. L. REV. 697, 725-26 (1941).

Amendment	8[15]
Merger or consolidation	5[16]
Reorganization (Bankruptcy 7, PUHCA 2)	9[17]
Voluntary exchange (With prior preferred, 5; without, 4)	9[18]
Purchase of delinquent shares (By subject corporation, 2; by holding company, 1)	3[19]
Total	34

BENEFIT AND DETRIMENT

Manipulation, by definition, imposes some detriment on the shares manipulated. But the detriment is usually accompanied by some form of benefit, to make it more palatable. What we want to know is, what is the net effect?

The extent of benefit and detriment are matters of opinion. All who have read the recapitalization and reorganization cases are acutely aware of the infinite scope for speculation and dispute on every element of valuation. For our purposes, we have adopted a cruder and simpler test, using the aid of hind-sight.

The test is in terms of money received, or obtainable on the market. If the manipulated investor received as much income from his manipulated security as he was entitled to receive, in priority, on his original share, we say he suffered no detriment. Or if his old security was callable, and he received new securities which were worth on the market what his old share could be called for, we say he was not hurt. In each case we follow the stock to December 31, 1951, ignoring what may have happened since that date.

No net detriment—new securities worth call price. Hercules Powder Company performed an interesting manipulation which reduced the dividend of its preferred shares without working any net detriment

15. American Hide and Leather; Atlas Powder; Bucyrus-Erie; Fairbanks, Morse; Gimbel Brothers; Goodrich, B. F.; Hercules Powder; Remington Rand
The "manipulations" in Atlas Powder and Hercules Powder were found to be non-detrimental, as explained *infra*, pp. 60-61.

16. American Locomotive; Gulf, Mobile & Northern; Minneapolis-Moline; Otis Steel; Spang, Chalfant

17. American-La France (bankruptcy); American Writing Paper (bankruptcy); Colorado Fuel & Iron (bankruptcy); Electric Power & Light (PUHCA); General Gas & Electric (PUHCA); McLellan Stores (bankruptcy); Philadelphia Rapid Transit (bankruptcy); Pierce-Arrow (bankruptcy); Symington (bankruptcy)

18. American Woolen (pr. pf.); Du Pont de Nemours; International Paper & Power; Lehigh Valley Coal (pr. pf.); Mengel Co. (pr. pf.); Revere Copper & Brass; Spear & Co.; Twin City Rapid Transit (pr. pf.); White Sewing Machine (pr. pf.)
The "manipulation" in Du Pont de Nemours was found to be non-detrimental, as explained *infra*, pp. 60-61.

19. New York Steam (purchase by holding company); Skelly Oil; United Dyewood

to the holders, by our test. In 1936, the stock was fully current on its $7 dividend, and was callable at 120. By amendment, the dividend was reduced from $7 to $6, but at the same time callability was suspended for five years. During the next five years, the stock sold generally for 125 and upwards, never touching its former call price. Since the company could have called the old shares at 120, and the holder could always sell his amended shares for more than that, we find the holder suffered no net detriment. By 1945, the $6 preferred had become callable, again at 120, and again the company reduced the dividend by one dollar, suspending callability as before. As before, the amended shares never sold as low as the old call price during the non-callable period. And so, again, the holder lost nothing by manipulation which could not have been taken from him without it.

No net detriment—new dividends equal to old priorities. Fairbanks-Morse 7% preferred illustrates a manipulation which proved non-detrimental for different reasons. In 1935, each preferred shareholder had his claim to $7 a year plus $24.50 of back dividends, and was subject to call at $110. In that year he was given in exchange one new share of $6 preferred, plus one share of common, plus $2.00 in cash. Three years later, the new preferred was called at $105. At this point, the former holder of $7 preferred might be said to be $27.00 behind the priorities to which he was originally entitled.[20] But in the next 13 years he received $32.00 in dividends, and had *two* shares of common left, each worth about $25.00.[21] So he was better off than if his $7 stock had been called in 1938 (as the new stock was) without the prior exchange. The common shareholders, in their turn, were worse off, since they had to share the company's profits in perpetuity with the former preferred shareholders.

Potential future benefit from present dividend rate. In another group of cases, the preferred shareholders had suffered a net detriment at the close of 1951, but they stood to benefit eventually if the 1951 dividend rate should continue indefinitely.

One of the most cheerful examples of this category is the 7% preferred of Otis Steel Co. With $36.75 in arrears, the holders were offered 1.28 shares of new $5.50 convertible preferred. The new stock yielded just $7.04, but a chance of compensation for arrearages lay in the conversion privilege. A few years later, the company merged with Jones & Laughlin Steel Co. The former holders of 7% preferred in Otis now found themselves holding various fractions of three

20. If the original shares had been called when the new shares were, the holder would have been additionally entitled to the $24.50 arrearage plus the $5 difference between his old and new call prices, plus the $3.00 difference between this old and new dividend rate for 3 years. Against this, he had received $2.00 cash in the recapitalization, plus $3.50 in dividends on his share of common.

21. The common shares had been split 2 for 1 in 1951.

different classes of shares in Jones & Laughlin, the dividends from all of which had reached an annual rate of slightly over $11.00 in 1951. Obviously if this rate of earning were to continue, the holders would be better off than if they still held 7% preferred, callable at 110.

There are other instances of the same possibility, in which the former preferred shareholders have much further to go to catch up with their arrearages, and are gaining at a much slower rate.

Remote possibility of benefit, if dividends increase. In every case where a former preferred shareholder receives a participating security in exchange, there is a theoretical possibility that he will ultimately benefit. But if his best rate of income through post-war years remained below his old preferred rate, the possibility must be regarded as very remote.

A dismal instance is the 7% cumulative preferred stock of American Hide and Leather. In 1935, its arrears of dividends amounted to $217.75 per share. In this year, each holder was given one new share carrying a $3.00 preference, and four new shares of common. After eleven more years passed without common dividends, the company commenced paying 50 cents a common share. Total dividends on the one preferred share and the four common shares then totalled $5.00. At this rate, each year finds the shareholder further and further away from realizing the $7 which he had originally expected in priority to common dividends. The possibility that total dividends will exceed $7 for long enough to make up the delinquent $217.75 (to say nothing of subsequent accretions) seems remote.

Benefit impossible under new capital structure. There remains a group of cases in which not even the rosiest view of the future contains a vision of benefit resulting from the preferred share manipulation. In some of these, the preferred holders exchanged their delinquent old shares for new ones which were wholly non-participating, and which carried a lower dividend than the shares they surrendered. For example, each holder of 6% preferred stock in Spang, Chalfant & Company (with $3 in arrears) emerged from a consolidation with one share of 5½% non-participating preferred in National Supply Company.

Benefit is also impossible for holders of shares in companies which transmuted their shares and later were liquidated in insolvency.

Benefit impossible—shares purchased. Another group of manipulation victims who will never reap a benefit are those whose shares were purchased by the company (or its parent) while the dividends were in arrears.

The holders of Skelly Oil 6% preferred furnish an instance. In 1932, 1933, and 1934 the company was paying no preferred dividends, but found cash to buy in outstanding preferred shares aggregating nearly $2,000,000 in par value. The market was ranging from 12 to 68. A few years later (1937) the company resumed dividends on common, having retired the unpurchased preferred shares. Since the shares were callable at 103, the preferred shareholders might have imagined that the company could not pay its common shareholders until it first paid its preferred their prior dividends, or else paid them off at call. But the company had found a way around both arrears and call for less than $68 per share. The sellers, of course, had no prospect of making up their loss in some other way.

Summary. In terms of benefit and detriment, the following distribution appeared among the 34 manipulation cases:

Net benefit—new securities worth call price	3[22]
Net benefit—new dividends equal to old priorities	4[23]
Potential future benefit from present dividend rate	9[24]
Remote possibility of benefit, if dividends increase	10[25]
Benefit impossible under new capital structure	5[26]
Benefit impossible—shares purchased	3[27]
Total	34

The over-all picture is not too bright. By the close of the phenomenally profitable decade from 1942 through 1951, only 7 of the 34 manipulations (that it, the two "net benefit" classes listed above) had

22. Atlas Powder
Du Pont de Nemours
Hercules Powder

23. American Woolen
Bucyrus-Erie
Fairbanks, Morse
McLellan Stores

American Woolen Company falls in the class of "net benefit" only for those shareholders who made the best choices at the best times. In 1936, preferred shareholders were given an opportunity to exchange for preferred shares which were convertible to common. If they both exchanged and converted immediately, they were benefitted. But if they exchanged and delayed conversion, they missed the 1946 common dividend, and did not realize the equal of their old priorities.

24. American Locomotive
Electric Power & Light
Goodrich, B. F.
International Paper & Power
Mengel Co.
Minneapolis-Moline
Otis Steel
Twin City Rapid Transit
White Sewing Machine

25. American Hide & Leather
American-La France
American Writing Paper
Colorado Fuel & Iron
Gimbel Bros.
Gulf, Mobile & Northern
Lehigh Valley Coal & Iron
Philadelphia Rapid Transit
Remington Rand
Symington

26. General Gas & Electric
Pierce Arrow (liquidated)
Revere Copper & Brass
Spang, Chalfant
Spear & Co.

27. New York Steam (purchase by holding company)
Skelly Oil
United Dyewood

proved non-detrimental. A more impressive total of 18 (the last three classes) had brought nothing but detriment in an era of prosperity whose repetition cannot be foreseen.

OCCASIONS FOR MANIPULATION

With the facts in, what clues can we give an investor as to when manipulation is to be expected?

Of course, if the common shareholders suffer no distress, the preferred are likely to be spared as well. We found 16 companies in which common dividends were paid every year. Curiously enough, two of the companies did manipulate preferred rights even under these circumstances. But these manipulations were not detrimental. They consisted of reductions of dividend rate, fully compensated for by suspensions of callability.

There were 63 cases in which common dividends were passed for a year or more. In only 8 of these did preferred escape passing. In only one of the eight did the preferred undergo a manipulation, and it was a harmless one.

So we may say that if preferred dividends are never passed, the investor is in no real danger from manipulation. Unfortunately, we have no way of predicting corporate action on preferred dividends. In 7 of the 8 cases where common were passed while preferred were paid, the common passed only one or two years.[28] It appears that when common shareholders wait more than 2 years, preferred are likely to share their misery.

When the preferred do pass, the fat is in the fire. In our sample of 56 defaulted preferred shares, only 14 were fully paid up, while 31 were manipulated. The remaining 11 are cases of wiping out preferred without manipulation, or of unfinished histories. And in the 13 "honor roll" cases, the failure to manipulate was blocked by shareholder stubbornness in at least two cases.

There is a slight correlation between the magnitude of arrearages and the disposition to manipulate. Make-ups of arrearages under two years were more common than manipulations of such arrearages. But manipulations of arrearages over ten years were more common than make-ups; and at least two of the three make-ups of over 10 years were forced by shareholder resistance.[29]

We may summarize the dividend background of the cases as follows:

Common dividends never passed for whole year	
Non-manipulated	13[30]

28. The exception was Century Ribbon Mills, which passed common dividends for 5 years while paying preferred.
29. Budd Manufacturing and Guantanamo Sugar, discussed *supra*, pp. 57-58.
30. Abraham and Straus General Cigar

Manipulated (but not detrimentally)	2[31]
Common dividends passed, but preferred never passed	
Non-manipulated	7[32]
Manipulated (but not detrimentally)	1[33]
Common and preferred dividends passed	
Dividends made up	14[34]
Manipulated	31[35]
Other (stock wiped out, or still in arrears)	11[36]

DEFENSES AGAINST MANIPULATION

Restrictions on organic change. The chief bulwark which state courts have thrown up against preferred share manipulation is made of rules against divesting vested rights, especially if the amendment method is chosen. The history of these restrictions is well-known.[37]

American Smelting
American Tobacco
Bangor & Aroostook
City Ice & Fuel
Commercial Investment Trust
Duplan Silk
General Motors
Liggett & Myers
Loew's
National Biscuit
Pacific Tel. & Tel.
Southern Porto Rico Sugar

31. Du Pont de Nemours
Hercules Powder

32. Beatrice Creamery
Bloomingdale Bros.
Century Ribbon Mills
Consolidated Oil
Crown Cork & Seal
General Railway Signal
International Printing Ink

33. Atlas Powder

34. Associated Dry Goods
American Smelting
Brooklyn-Queens Rapid Transit
Budd Manufacturing
Byers (A.M.)
Gotham Silk
Guantanamo Sugar
Houdaille-Hershey
Interstate Department Stores
N. Y., C. & St. L. R. R.
Norwalk Tire & Rubber
Tidewater Oil
U. S. Steel
Virginia-Carolina Chemical

35. American Hide & Leather
American-La France
American Locomotive
American Woolen
American Writing Paper
Bucyrus-Erie
Colorado Fuel & Iron
Electric Power & Light
Fairbanks, Morse
General Gas & Electric
Gimbel Bros.
Goodrich, B. F.
Gulf, Mobile & Northern
International Paper & Power
LeHigh Valley Coal & Iron
McLellan Stores
Mengel Co.
Minneapolis-Moline
New York Steam
Otis Steel
Philadelphia Rapid Transit
Pierce-Arrow
Remington-Rand
Revere Copper & Brass
Skelly Oil
Spang, Chalfant
Spear & Co.
Symington
Twin City Rapid Transit
United Dyewood
White Sewing Machine

36. American & Foreign Power
Chicago Great Western
Chicago Rock Island
Havana Electric
International Railways
Mallinson (H.R.)
Market Street Railway
Missouri-Kansas-Texas
Pierce Oil
Producers & Refiners
Western Pacific

37. See works of Becht and Dodd, *supra* notes 1 and 2.

Where amendment was refused, merger was allowed. Besides, legislatures moved in to authorize specifically the adoption of divesting amendments.[38]

The survey adds slightly to the history made by the cases. It shows that voluntary exchange plans can hurdle the obstacle imposed by limits on amending power, even without the aid of "prior preferred."[39]

A method still more elusive than the voluntary exchange is a policy of buying in shares on the open market, while withholding payment of dividends. If shareholders are stubborn, the management can outwait them. A striking illustration is New York Steam, which has paid neither preferred nor common dividends since 1937. In 1948, when there were earnings of $11.91 and back dividends of $66 per share, the money stayed in the till while the parent company bought in a few more shares, presumably at prices under par.[40]

The examples indicate that there is little real protection to preferred holders in forbidding manipulation by amendment. The management can find other means to reach its ends.

If amendment of priorities were impossible, it would have blocked the particular avenue chosen for some of the manipulations found in the survey. But it would also have blocked the means used for the two most beneficial manipulations found. The reclassifications of Hercules and Atlas Powder Companies, both of which appeared to benefit rather than harm preferred holders, were effected by amendment.

Official regulation. For some years, commentators on priorities manipulation have been hinting that official regulation is needed, in order to control the tyranny of majority rule. Some of the proposals involve administrative control; some, judicial. Some of them contemplate that certain defined categories of manipulation would come under review—for instance, all amendments which effect priorities, or all mergers and consolidations involving two or more classes of stock.[41]

The present study awakens serious doubts as to the effectiveness of these proposals.[42] It shows that manipulation does not depend on formal organic changes. It can be accomplished by wholly "voluntary" methods like share-exchange, or open-market purchase. If the price

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38. See statutes involved in McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945); Wheatley v. A. I. Root Co., 147 Ohio St. 127, 69 N.E.2d 187 (1946).

39. See cases cited note 18, *supra*.

40. The stock had been barred from exchange trading since 1937, when Consolidated Edison acquired 97% of it. The last over-the-counter quotation was reported for 1946, at 96. MOODY'S PUBLIC UTILITIES 957 *et. seq.* (1949).

41. The regulatory possibilities are discussed in Latty, *Exploration of Legislative Remedy for Prejudicial Changes in Senior Shares,* 19 U. OF CHI. L. REV. 759 (1952).

42. Regulation as a cure is also rejected by Becht, *Alteration of Accrued Dividends,* 49 MICH. L. REV. 565, 588-94 (1951).

of preferred is depressed by non-payment of dividends, and majority investors buy it for their personal accounts, the manipulation escapes any regulation known to legal literature.[43]

Not only is regulation (in any form yet seen) readily evaded, but it appears rather ineffective. The present study encountered 9 security issues in which the manipulation took place under the control of the Court of Bankruptcy, or the SEC. According to our crude test of benefit and detriment, the cases resulted as follows:

Net benefit	1[44]
Potential benefit	1[45]
Remote possibility of benefit	5[46]
Benefit impossible	2[47]

This is a worse record than was made by the unregulated manipulations![48]

The most effective shareholder protection which appeared in the cases studied was afforded by an individual shareholder's suit in a state which applied a strict standard of fairness. The case was *Wessel v. Guantanamo Sugar*,[49] in which the New Jersey Court of Chancery enjoined an unfavorable amendment. Shortly after, the company redeemed the preferred with all back dividends, making the biggest pay-off disclosed in our 79 cases.

The moral seems to be that shareholders can protect themselves in the courts if the courts are prepared to apply a strict standard of fairness.[50] If the courts are not so prepared, not even the mountainous

43. The most closely analogous legal remedy seems to be the claim under Rule X-10(B)5 of the Securities Exchange Commission; but cases under this section seem to depend on failure to disclose facts, rather than open abuse of power of control. See Speed v. Transamerica Corp., 99 F. Supp. 808 (D. Del. 1951).

44. McLellan Stores

45. Electric Power & Light

46. American-La France
American Writing Paper
Colorado Fuel & Iron
Philadelphia Rapid Transit
Symington

47. General Gas & Electric
Pierce-Arrow

48. Consider the following comparison

	Regulated		*Unregulated*	
	No.	*%*	*No.*	*%*
Net benefit	1	11	6	24
Potential benefit	1	11	8	32
Remote possibility of benefit	5	56	5	20
Benefit impossible	2	22	6	24
Total	9	100%	25	100%

49. Wessel v. Guantanamo Sugar Co., 134 N.J. Eq. 271, 35 A.2d 215 (Ch. 1945).

50. *Cf.* Becht, *Alteration of Accrued Dividends*, 49 MICH. L. REV. 565, 589 (1951).

heaps of paperwork which surrounded the Philadelphia Rapid Transit case will protect the investor.

A standard of objectives for directors. This study suggests that the prerequisite to control of manipulation is a standard of directors' objectives. What is needed is a pronouncement of the extent to which directors should seek the interests of preferred shareholders as against common shareholders. By this standard, courts must test directors' actions in proposing amendments, mergers, voluntary exchanges, reorganizations, their actions in purchasing shares, and their practices in declaring or withholding dividends. All these kinds of action are weapons in the war between the classes of shareholders; restrictions on one weapon are of little effect if another is left free.

This suggestion puts the emphasis on directors' action, rather than shareholders', in contrast with some suggestions that the problem should be solved by educating shareholders through the proxy statement.[51] No doubt an awake and informed body of shareholders is desirable. But there is little evidence that shareholders can be awakened, and there is certainly no way of insuring a small investor that the thousands of his co-investors will respond to alerts. Moreover, directors have means, by withholding dividends and purchasing stock for the treasury (or for their personal accounts, or for affiliated companies) to manipulate the preferred shares regardless of shareholders' consent.

When shareholders do vote, they vote on proposals made by the directors. Usually, they approve. So control is best exercised (if there is to be any) on directors' actions in making proposals.

If a standard of fairness is to be effective, courts must be willing to infer and evaluate the objectives of directors, rather than applying what Latty has so aptly called "the Solid Citizen test."[52] They must not pass every action which does not harm the corporation, on the theory that it is an exercise of "business judgment." This is like letting a fox decide, by his business judgment, how many chickens will be best for him. If "business judgment" means judgment that benefits the fund or enterprise, nearly every withholding of income and every reduction of investors' rights is good business judgment. The only limitation would be the need to make future preferred stock issues attractive to investors. But the more money a company retains, the less need it has to attract stock investors.

The picture which emerges from most of the cases is one in which shareholders of all classes accept whatever is offered them. Although some judicial decisions speak of the necessity of obtaining junior

51. See Latty, *Exploration of Legislative Remedy for Prejudicial Changes in Senior Shares,* 19 U. OF CHI. L. REV. 759 (1952).

52. *Id.* at 762.

shareholders' votes,[53] no instance was found of rejection of a plan by junior investors.

In consequence, the decision to manipulate, and the terms of manipulation, rest in the discretion of the directors. And that discretion appears to be nearly boundless. At one extreme stand the directors who seem to believe that they should honor priorities. After exercising a reasonably free judgment as to whether there are funds available for any kind of dividends, they pay these funds to the preferred shareholders. At the other extreme stand those who plainly attempt to drive the hardest bargain with preferred holders that can be driven. From one extreme to the other, the directors are likely to be successful in the course they undertake to follow.

WHAT IS FAIR?

The survey naturally could not show us what kind of treatment of priority shareholders is fair. But we had hoped it would give some clue to what managers or investors think is fair—some discernible pattern of treatment of preferred share rights.

All it showed was contrasts. One management went to one extreme, another to another. There were, for example, two department store corporations, both having 7% preferred stock outstanding; both commenced their preferred defaults early in 1932, and both resumed common dividends within a year of each other (1943-1944). Associated Dry Goods had $31.50 of arrears on its preferred dividends, but it resumed regular payments without tampering with their rights. Defaults came again in 1938 and 1939, sending arrears up to $40.25. But arrearage payments were resumed in 1940, making the preferred stock current by 1943, and common dividends were recommenced.

Gimbel Brothers, on the other hand, had only $25 in arrears in 1936 when it funded its arrears by exchanging each share of $7 preferred for 1½ shares of $6 preferred. If this situation had continued, the preferred holders would have recovered their arrearages (at 50c a year) by 1986. But in 1944, with the new preferred shares current, each $6 share was exchanged for 1 1/20 shares of $4.50 preferred. Each former $7 shareholder would now get $5.90 per share. With this saving on preferred dividends, the corporation resumed common dividends.

No other pair of companies was found which matched as closely as Associated Dry Goods and Gimble, but the same wide disparity in management objectives appeared in many company histories. It seems clear that some managements consider it their job to make the most favorable arrangement for common shareholders that the preferred holders can be persuaded to accept.

53. Barrett v. Denver Tramway Corp., 53 F. Supp. 198, 204 (D. Del. 1944).

In rare instances, the preferred shareholders reject the offer. One of two such instances discovered occurred in Budd Manufacturing. The $7 preferred was $90 in arrears, and the management offered an exchange of two new $5 shares for each old $7 share. This would have upped the current dividend priority from $7 to $10, and the liquidation priority from $110 to $200. All shareholders apparently declined the offer.

But there are many more instances where less favorable propositions were quickly snapped up by dividend-hungry preferred holders. For example, Revere Copper $7 preferred was in arrears to the extent of $38.50 per share when the holders were offered 1 1/3 shares of 5¼% preferred. This would give them an unchanged priority in current dividends, and an increase in liquidation priority of about $33—less than the arrearage. Three-fourths of them made the trade.

SUMMARY

The power to emasculate share priorities is not a rusty legal weapon. A 1932 purchaser of preferred shares on the New York Stock Exchange had a less-than-even chance of escaping manipulation of his priorities if his shares once fell into default. Most manipulations offer a theoretical opportunity of benefitting the preferred shareholder, but that opportunity seldom materialized in the unusually profitable decade ending with 1951.

The present study shows nothing about securities which are not listed on the New York Stock Exchange. An attempt to study such securities failed, for want of financial information. All the common assumptions would seem to indicate that manipulation would go to greater extremes in unlisted securities. Less information is available to shareholders; controlling blocs are more readily bought by management without disclosure; there is less chance of a professional striker interfering.

None of the legal inhibitions now existing give the preferred shareholder much protection against manipulation. Proposals for increased regulation seem to ignore the variety of devices to which managements resort. Proposals to strengthen opposition voters ignore the same point, and also ignore the impossibility of overcoming mass inertia. If control of manipulation is desirable, it must be done by defining the duties of directors, in all the many ways they have of applying pressure to shareholders. When a stricter standard of directors' conduct is adopted by the courts, a single shareholder will be able to enforce it.

APPENDIX—TABLE OF SECURITIES

Abraham & Straus, Inc. (N.Y.), 7% cum. pref.
American & Foreign Power Co., Inc. (Me.), $7 cum. 2nd pref. A
American Hide & Leather Co. (N.J.), 7% cum. pref.
American-La France & Foamite Corp. (N.Y.), 7% cum. pref.
American Locomotive Co. (N.Y.), 7% cum. pref.
American Smelting & Refining Co. (N.J.), 7% cum. pref.
American Tobacco Co. (N.J.), 6% cum. pref.
American Woolen Co. (Mass.), 7% cum. pref.
American Writing Paper Co. (Del.), $6 cum. pref.
Associated Dry Goods Corp. (Va.), 7% cum. 2nd pref.
Atlas Powder Co. (Del.), 6% cum. pref.
Bangor & Aroostook R. R. Co. (Me.), 7% cum. pref.
Beatrice Creamery Co. (Del.), 7% cum. pref.
Bloomingdale Bros. Inc., 7% cum. pref.
Brooklyn & Queens Transit Corp. (N.Y.), pref.
Bucyrus-Erie Co. (Del.), 7% cum. pref.
Budd Manufacturing Co. (Pa.), 7% cum. pref.
Byers (A.M.) Co. (Pa.), 7% cum. part. pref.
Century Ribbon Mills, Inc. (N.Y.), 7% cum. pref.
Chicago Great Western R.R. Co. (Ill.), 4% cum. pref.
Chicago, Rock Island & P. Ry. Co. (Ill. & Ia.), 7% and 6% cum. pref.
City Ice & Fuel Co. (Ohio), 6½% cum. pref.
Colorado Fuel & Iron Co. (Colo.), 8% cum. pref.
Commercial Investment Trust Corp. (Del.), 7% cum. first pref.
Consolidated Oil Corp. (N.Y.), 8% cum. pref.
Crown Cork & Seal Co., Inc. (N.Y.), $2.70 cum. pref.
Duplan Silk Corp. (Del.), 8% cum. pref.
Du Pont (E.I.) de Nemours & Co. (Del.), 6% cum. deb. stock
Electric Power & Light Corp. (Me.), $6 and $7 cum. pref.
Fairbanks, Morse & Co. (Ill.), 7% cum. pref.
General Cigar Co., Inc. (N.Y.), 7% cum. pref.
General Gas & Electric Corp. (Del.), $8, $7, and $6 pref., A & B
General Motors Corp. (Del.), $5 cum. pref.
General Railway Signal Co. (N.Y.), 6% cum. pref.
Gimbel Bros., Inc. (N.Y.), 7% cum. pref.
Goodrich (B.F.) Co. (N.Y.), 7% cum. pref.
Gotham Silk Hosiery Co. (Del.), 7% cum. pref.
Guantanamo Sugar Co. (N.J.), 8% cum. pref.
Gulf, Mobile & Northern R. R. Co. (Ala., Miss. & Tenn.), 6% cum. pref.
Havana Electric Ry. Co. (Me.), 6% pref.
Hercules Powder Co. (Del.), 7% cum. pref.
Houdaille-Hershey Corp. (Mich.), $2.50 class A conv. pref.
International Paper & Power Co. (Mass.), 7% and 6% cum. pref.
International Printing Ink Corp. (Ohio), 6% cum. pref.
International Railways of Central America (N.J.), 5% cum. part. pref.
Interstate Department Stores, Inc. (Del.), 7% cum. pref.
Lehigh Valley Coal Corp. (Del.), 6% cum. pref.
Liggett & Myers Tobacco Co. (N.J.), 7% cum. pref.
Loew's, Inc. (Del.), $6.50 cum. pref.
Mallinson (H.R.) & Company, Inc. (Del.), 7% cum. pref.
Market Street Railway Co. (Cal.), 6% cum. prior pref.
McLellan Stores Co. (Del.), 6% cum. conv. pref. ser. A
Mengel Co. (N.J.), 7% cum. pref.
Minneapolis-Moline Power Implement Co. (Del.), $6.50 cum. pref.
Missouri-Kansas-Texas R. R. Co. (Mo.), 7% cum. pref., ser. A
National Biscuit Co. (N.J.), 7% cum. pref.
New York, Chicago & St. L. R. R. Co. (Ohio, N.Y., Pa., Ind. & Ill.), 6% cum. pref., ser. A.
New York Steam Corp. (N.Y.), 6% cum. pref.
Norwalk Tire & Rubber Co. (Conn.), 7% cum. pref.
Otis Steel Co. (Ohio), 7% cum. pref.
Pacific Tel. & Tel. Co. (Cal.), 6% cum. pref.
Philadelphia Rapid Transit Co. (Pa.), 7% cum. pref.
Pierce-Arrow Motor Car Co. (N.Y.), 6% cum. pref.
Pierce Oil Corp. (Va.), 8% cum. conv. pref.
Producers & Refiners' Corp. (Wyo.), 7% cum. part. pref.

Remington Rand, Inc. (Del.), 8% cum. 2nd pref.
Revere Copper & Brass, Inc. (Md.), 7% cum. pref.
Skelly Oil Co. (Del.), 6% cum. pref.
South Porto Rico Sugar Co. (N.J.), 8% cum. pref.
Spang, Chalfant & Co. (Pa.), 6% cum. pref.
Spear & Co. (N.J.), 7% cum. pref.
Symington Company (Md.), Class A
Tide Water Association Oil Co. (Del.), 6% cum. conv. pref.
Twin City Rapid Transit Co. (N.J.), 7% cum. pref.
United Dyewood Corp. (Del.), 7% cum. pref.
United States Steel Corp. (N.J.), 7% cum. pref.
Virginia-Carolina Chemical Corp. (Va.), 7% cum. prior pref.
Western Pacific R. R. Co. (Del.), 6% pref.
White Sewing Machine Corp. (Del.), $4 cum. conv. pref.