RESTORATION OF PREFERRED STOCK MARGIN OF SAFETY UNDER THE HOLDING COMPANY ACT

The Securities and Exchange Commission, under powers granted by the Public Utility Holding Company Act of 1935,1 has been gradually developing standards for the protection of preferred stockholders by restricting the use of capital surplus when a capital readjustment2 is being effected. Increasing concern has

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2 The term “readjustment” is taken from Buchanan, The Economics of Corporate Enterprise 367–70 (1940), and is used to describe any process of altering the rights and interests in a corporation without court supervision. Buchanan reserves the term “reorganization” for proceedings under court supervision.
been shown over the disposition which may be made of the preferred margin of safety. When this is encroached upon for the payment of dividends or to absorb a deficit, adequate protection of the position of the preferred shareholder would seem to require that any diminution be restored out of subsequent earnings before dividends are paid to common stockholders.

One of the most common types of capital readjustments is the so-called “quasi-reorganization,”3 which affords a method sanctioned by most state laws for avoiding the effect of provisions which restrict the payment of dividends during the existence of a capital impairment. Deficits due to shrinkage in the value of assets or to operating or other losses may be written off against capital surplus, thus making subsequent earnings available for the payment of dividends. Capital surplus is created principally from a reduction of stated capital or an allocation of paid-in capital, and although state laws may require a charter amendment in order to effect a reduction of stated capital,4 they generally do not require subsequent approval by stockholders of the uses to which the capital surplus is put. As a result, the preferred shareholder may find that the contribution of junior security holders, as represented by stated capital and capital surplus, has been reduced so that the “cushion,” which served as a margin of safety to prevent injury to his dividend and liquidation rights through operating deficits or a shrinkage in the value of assets, is no longer intact. As long as the cushion remains unrestored, any subsequent payment of dividends out of earnings is, in effect, a payment out of capital. Experience has indicated that the preferred shareholder is seldom in a strategic position to protect his rights in the bargaining that accompanies a readjustment5 and he is usually powerless thereafter to force the common shareholders to consent to restoring the reduction. For that reason, it has been urged that the commission make full use of its powers under the Holding Company Act to protect preferred shareholders against the dissipation of the preferred capital cushion.6

The commission has general power under the act to control the creation and use of capital surplus.7 Its efforts to protect preferred shareholders by requiring

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3 See SEC Accounting Series Rel. Nos. 15, 16 (1940).
6 See dissenting opinion of Commissioner Frank in Matter of the North American Co., 4 S.E.C. 434, 482 (1939).
7 These powers are derived from §§ 6(a)(2) and 7(e), which prevent alteration in “the priorities, preferences, voting power, or other rights of the holders of an outstanding security” if the commission finds that such changes are detrimental to the interest of investors or consumers. By § 7(f) the commission may permit changes upon “such terms and conditions as the Commission finds necessary to assure compliance with the conditions” of the section. § 12(c) gives the commission the power to control the payment of dividends out of capital surplus.
full restoration of any reduction in the capital cushion have been limited, however, by the desire to secure a sound revaluation of the assets of the companies under its jurisdiction. The policy of adequate disclosure which is one of the underlying purposes of the Holding Company Act has imposed on the commission the duty of making every effort to bring balance sheet values into line with present realities. In Matter of Associated Gas and Electric Corp., for example, the commission refused to approve a quasi-reorganization when the company sought to set up a reserve which the commission thought insufficient to absorb a deficit which would result when assets were revalued and losses taken on the sale of certain investments. While the soundness of such accounting requirements can hardly be questioned, the deficit which emerges on the recognition of the shrinkage in asset values must be charged against earned or capital surplus if it is to be removed from the books, and where the deficit exceeds the earned surplus, the preferred capital cushion will be diminished.

The obvious way to restore the reduction and replace the preferred shareholder in his original position would be the withholding of the payment of common dividends until the cushion has been reestablished. This, however, is not always feasible in view of the need of many companies for equity financing. The cases indicate that shrinkages in asset values in the public utility industry amounted to many millions of dollars during the depression period. To restrict future dividend payments for an indefinite time while these reductions are being restored would make the sale of common stock virtually impossible. The commission has thus generally been unable to supplement its strict requirements of accurate asset revaluations with the complete safeguards needed to protect the preferred shareholder. In only one case has the commission demanded full restoration of the preferred capital cushion following a quasi-reorganization.

The argument for preserving the capital cushion is usually based on the prop-

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8 See, e.g., § 1(b).

9 6 S.E.C. 605 (1940), noted in 49 Yale L. J. 1219 (1940). Cf. Matter of Philadelphia Co., Hold. Co. Act Rel. No. 1905 (1940), where the SEC approved a "quasi-reorganization" although the revaluation reserve set up was considered inadequate to meet subsequent write-downs that would be necessary. The commission justified its ruling on the ground that the inadequacies of the reserve might be offset by the sale of certain investments held by the company, the full values of which were unrecorded.

10 See Katz, Accounting Problems in Corporate Distributions, 89 U. of Pa. L. Rev. 764, 769 (1941).

11 Douglas, Democracy and Finance c. 13, Dividends in Arrears (1940).

12 See, e.g., Matter of Associated Gas & Electric Corp., 6 S.E.C. 605 (1940) (write-down of $173,000,000); Matter of Columbia Gas & Electric Corp., 4 S.E.C. 406, 410 (1939) (write-down of approximately $71,000,000).

13 Matter of Green Mountain Power Corp., 4 S.E.C. 107 (1938). On the basis of average earnings of the company during the seven years 1931-37 as set out in the report of the case, it is estimated that it will take the company, after deducting sufficient earnings for the payment of preferred dividends, about thirteen and a half years to restore the capital surplus employed in the quasi-reorganization.
osition that the preferred shareholder relied on the existence of the contribution of junior security holders in making his investment and that any reduction would therefore alter the terms of his agreement of purchase as well as endanger his liquidation and dividend rights. One may, of course, question whether it is realistic to approach the problem in terms of the investor's reliance and, in any event, a purchaser of preferred stock can hardly say that he "relied" on securing a margin of safety which the state statutes expressly made subject to inroads by corporate action of various kinds. The efforts of the commission therefore represent an attempt to add to the preferred stock a desirable safety factor which it may not have had. It is possible to establish a minimum amount below which the capital would not be permitted to fall and yet avoid the inflexibility which results from a requirement that the cushion must be maintained at its original level. This may underlie the decision of the commission in Matter of Columbia Gas & Electric Corp., where application was made for authorization to reduce stated capital in order to create a capital surplus sufficient to absorb a deficit of approximately $71,000,000 resulting from the revaluation of assets. The commission, while it approved the reduction, ruled that the common shareholders could not thereafter obtain dividends until the board of directors had set aside out of earned surplus an amount equal to six quarterly dividends on the preferred (the equivalent of $9,763,050, an amount less than the reduction).

Restoration may also be made by the sale of new common stock which will net additional common capital sufficient to replace the reduction. Thus in Matter of Monongahela West Penn Public Service Co., the commission did not require any restoration of the preferred capital cushion when the company sought to reduce its stated capital to eliminate a deficit resulting from the establishment of a reserve for the retirement of certain obsolescent assets of the company. The commission deemed it sufficient that the company intended to compensate the preferred shareholders by the sale of common stock which would bring in new capital. With the sale of new stock an immediate prospect, it would of course be impossible to withhold dividends until the reduction had been restored. Where the preferred stockholders have preemptive rights in such new shares, however, an additional consideration may arise. To preserve his voting position, the preferred stockholder will have to contribute to the restoration of his own capital cushion.

There are several cases in which the commission permitted the use of capital surplus without restriction beyond reserving jurisdiction over any subsequent dividend payments. Where the jurisdiction reserved was merely over dividends

14 Dissenting opinion of Commissioner Franklin in Matter of the North American Co., 4 S.E.C. 434, 482 (1939).

15 4 S.E.C. 406 (1939); see 3 S.E.C. 373, 562, 986 (1938), and 4 S.E.C. 400 (1939); cf. Matter of the Int'l Paper & Power Co., 2 S.E.C. 274, 580, 792, 1004 (1937), where a reduction was permitted and no restoration required.

16 4 S.E.C. 406, 421 (1939).

17 4 S.E.C. 244 (1938).
payable from capital surplus, it is apparent that this would not protect the pre-
ferred shareholder, since this reservation does not carry with it power to re-
strict the payment of dividends out of earnings and therefore does not enable
the commission to require restoration of the reduction. But where jurisdic-
tion is reserved over the payment of subsequent dividends out of earned surplus," there will be an opportunity at a later time to consider whether dividends should
be withheld until the impairment has been restored. The decision as to what pro-
tection should be given the preferred shareholder is probably postponed in order
that the commission may observe the effects of the readjustment and appraise
thereby the further changes which should be made.

The discussion so far has been devoted to the situation where there is a re-
duction of the preferred capital cushion in order to cancel a deficit which had
prevented the payment of dividends. The cushion may also be diminished by
the direct payment of dividends from capital surplus as permitted under most
state laws. The justification for using capital surplus to cover deficits due to
asset revaluations in order that the balance sheet will reflect the present value
of the assets is not present in this situation. Some justification may be found
where capital surplus is used for the payment of preferred dividends in order to
prevent the accumulation of arrearages. There would seem to be no reason of
equal importance for paying common dividends, and the commission appears to
have limited the availability of capital surplus to the payment of preferred di-
vidends. Although the commission does not always require the reduction to
be restored, where such a payment is made, it is apparent that capital is being
returned in the form of dividends and adequate disclosure of that fact should
be made to the recipients in order to prevent any misconception as to the
source. Some indication of the amount of disclosure which the commission will
require may be found in Matter of the United Corp. There the commission ap-
proved the payment of preferred dividend arrearages out of capital surplus, and
specifically ordered that until the capital surplus used for the dividend pay-
mments had been restored out of earnings other surplus accounts shown on any
interim balance sheet which might be published should be captioned "Surplus

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18 Matter of the Cincinnati Gas & Electric Co., 3 S.E.C. 858 (1938). The commission, of

19 course, is expressly granted this jurisdiction under § 12(c) of the act.


21 § 12(c) of the act expressly provides that no registered holding company or subsidiary can
declare dividends out of capital surplus without the consent of the commission. 40 Stat. 823
and Reg. 1203 (1939).


23 Matter of the Securities Corporation General, Hold. Co. Act Rel. No. 2301 (1940); Mat-

subject to adjustment." Also, disclosure of the source of the payment of the dividend arrearages had to be made and the fact that the capital surplus was to be restored from future income. The balance sheet was to bear appropriate footnotes indicating the effect of these transactions and the terms of the commission's order of approval.

As the United Corporation case indicates, the commission may permit the use of capital surplus to pay preferred dividends, but only on condition that the diminution will be restored out of subsequent earnings. However, the commission has been reluctant to allow the payment of preferred dividends out of capital surplus where the persistence of an earned surplus deficit raises some question as to the company's ability to meet subsequent dividend payments from earnings without the necessity of making further inroads into capital surplus. In such a situation, the commission may refuse the request and precipitate a complete capital readjustment, requiring as it did in Matter of Illinois Power and Light Corp. that the readjustment plan include provisions scaling down annual preferred dividend requirements so that current earnings would be adequate for the payment of such dividends.

Thus when prospective earnings are poor, the preferred shareholder may be required to give up rights even more important than the right to an undiminished capital cushion. Complete protection of the latter has proven difficult when the company is called upon to absorb a large deficit resulting from the revaluation of assets. The Columbia Gas & Electric case suggests a device which would seem to afford adequate protection in lieu of complete restoration. An exami-

Ibid., at 6.

Payment of common dividends was prohibited until the reduction was restored.


Compare Matter of Securities Corporation General, 5 S.E.C. 89 (1939), with the United Corporation case.

28 S.E.C. 263, 266, 1001 (1937). Here the company had paid no dividends on its two classes of preferred stock since 1933 and, as of the close of 1936, had a substantial deficit in its earned surplus account. The company, realizing that the SEC would not sanction payment of accrued preferred dividends out of capital surplus except pursuant to a plan of recapitalization, submitted a plan which decreased preferred and common stock approximately one-half and scaled down annual preferred dividend requirements from $6 to $2.50 per share. The company then proposed to issue dividend arrearages certificates to the preferred stockholders and to create a reserve out of the surplus arising from the reduction of stated capital from which to pay the dividend arrearages certificates. The SEC approved the arrearages payment plan of the company without requiring restoration of the reduction surplus from subsequent earnings, although well aware that it would constitute a "return of capital" to shareholders.

It may be observed that as issues of preferred stock become smaller by reason of the application of § 7(c)(1) of the Holding Company Act, which discourages the issuance of preferred stock, this entire problem will be reduced in importance. It should be noted, however, that as preferred issues are being retired, it would seem unnecessary to retain the original cushion for the fewer remaining preferred shareholders. In this situation the holding in the Columbia case, requiring only partial restoration of the capital cushion based on the dividend requirements of the outstanding preferred shares, would seem to afford a ready solution.
nation of the prospectuses of several recent preferred issues indicates that this type of protection is being adopted by many corporations on their own initiative. Several contain provisions restricting the payment of common dividends from earnings until a reserve has been established to meet future dividend requirements for a determined period, and others contain provisions which stipulate that no common dividends can be paid if the value of the corporation's assets should fall below a certain percentage of the par or liquidating value of the preferred stock being issued. As Commissioner Frank has pointed out, however, even such desirable provisions as these are ineffective unless the preferred shareholders are given control of the management when their rights are in danger. Unless this is done, the commission is frequently powerless to extricate the preferred shareholders from their untenable position in times of financial stress.

Prospectus, June 27, 1939, American Investment Co. 5 (one year); Prospectus, July 18, 1939, Copperweld Steel Co. 14-15 (four years); Prospectus, Oct. 23, 1939, Abbott Laboratories 11 (three years); Prospectus, Dec. 12, 1939, Scott Paper Co. 8 (two years); Prospectus, March 19, 1940, Colgate-Palmolive-Peet Co. 15 (three years); Prospectus, March 25, 1940, Commonwealth Loan Co. 15 (one year).

Another provision, having a similar effect, is that no common dividends can be paid except from earned surplus arising subsequent to a certain date: Prospectus, March 25, 1940, Commonwealth Loan Co. 15; Prospectus, Oct. 29, 1940, Westvaco Chlorine Products Corp. 12; Prospectus, Nov. 30, 1940, Neiman-Marcus Co. 6; Prospectus, Oct. 30, 1940, American Airlines, Inc. 15.

Prospectus, June 27, 1939, American Investment Co. 5 (net quick assets of the company after common dividend must equal 150 per cent of the par value of all outstanding preferred stock or net assets, and 200 per cent of par value of all preferred stock); Prospectus, Oct. 23, 1939, Abbott Laboratories 11 (net tangible assets must equal at least twice the aggregate par value of preferred stock); Prospectus, Dec. 8, 1939, The Hydraulic Press Mfg. Co. 8 (capital and surplus must exceed 200 per cent or current assets be above 100 per cent of the par value of preferred stock); Prospectus, March 25, 1940, Commonwealth Loan Co. 15 (net quick assets must equal 150 per cent and net assets 200 per cent of the par or stated value of all preferred stock); Prospectus, Jan. 9, 1940, Seiberling Rubber Co. 10 (current assets must be in excess of current liabilities by one and one-half times the liquidation preferences of preferred stock); Prospectus, March 19, 1940, Colgate-Palmolive-Peet Co. 15 (capital represented by junior shares plus surplus must exceed the sum of funded debt plus preferential amount payable to preferred stock on involuntary liquidation); Prospectus, Apr. 29, 1940, Marshall Field & Co. 12 (net assets must exceed $165 for each share of both classes of preferred stock); Prospectus, July 16, 1940, Taylorcraft Aviation Corp. 10 (net assets must exceed the liquidation preferences of preferred stock); Prospectus, July 18, 1939, Thompson Products, Inc. 16 (net quick assets must exceed 125 per cent of sum arrived at by multiplying $100 by the number of shares of prior preferred stock); Prospectus, Oct. 23, 1940, Auto Finance Co. 11 (the net worth of the company must exceed 175 per cent of involuntary liquidation preferences of preferred stock exclusive of dividend arrearages).