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NOTES

PURCHASE BY A CORPORATION OF ITS OWN PREFERRED SHARES WITH DIVIDENDS IN ARREARS

A frequent theme in discussions of corporate finance is the weak position of the preferred shareholder in the typical corporate structure. The common shareholders, by virtue of their greater voting rights and ultimate control of management, have a position of superior power which can be exploited to enrich the common at the expense of the preferred shareholders. This power is often exercised to eliminate dividend arrearages on cumulative preferred stock by means of charter amendments, mergers, and sales of corporate assets, on terms of questionable fairness to preferred shareholders. Although such use of these devices has provoked continuing criticism,[1] another means of arrearage

[1] Scaling Down of Arrearages on Cumulative Preferred Stock, 4 Univ. Chi. L. Rev. 645 (1937); Dodd, Fair and Equitable Recapitalizations, 55 Harv. L. Rev. 780 (1942); Becht, The Power to Remove Accrued Dividends by Charter Amendment, 40 Col. L. Rev. 633 (1940); Dodd, Accrued Dividends in Delaware Corporations—From Vested Right to Mirage, 57 Harv. L. Rev. 894 (1944).

elimination—the purchase by a corporation of its own preferred shares after dividends have been passed and arrearages accumulated—has received little attention; this notwithstanding the fact that repurchase operations, unlike charter amendments, mergers, or sales of corporate assets, can be accomplished without voting or bargaining by the preferred shareholder—the class whose interests may be adversely affected.

When cumulative dividends remain unpaid over a substantial period, preferred shares usually sell on the market at prices substantially below their total liquidating preference, including arrearages.[2] Under these circumstances, the directors of the issuing corporation, allied primarily with the common stockholders,[3] find corporate purchase of the preferred stock at depressed market price attractive,[4] particularly when the prospects of a more prosperous future

[2] Curtis Publishing Company's $7 cumulative preferred stock entitled upon liquidation to $100 plus accrued and unpaid cumulative dividends sold at prices ranging from $38 to $63.50 in 1939. On July 2, 1939, unpaid cumulative dividends amounted to $16.75. Moody's Manual of Investments, Industrial Securities 2574 (1940). On December 31, 1939, dividends in arrears on National Refining Company's $6 prior preferred stock entitled to $105 plus dividends in case of liquidation amounted to $19.50. The price range in 1939 was from $28 to $48. Ibid., at 1772.

[3] See Dodd, Fair and Equitable Recapitalizations, 55 Harv. L. Rev. 780, 792 (1942).

[4] Contrary to the rule in England, American jurisdictions have permitted a corporation to repurchase its own shares under a variety of circumstances. The statutory and case law for all American jurisdictions is collected in Nemers, The Power of a Corporation to Purchase Its Own Stock, 1942 Wis. L. Rev. 161. In no jurisdiction has the existence of accrued and unpaid cumulative dividends been held to preclude the reacquisition of preferred shares by purchase.

The SEC, however, has taken a stand against such purchases in a closely analogous situation. Under Rules U-9C-3 (14) and U-12C (b), prescribed pursuant to Sections 9 (c) and 12 (c) of the Public Utility Holding Company Act, 49 Stat. 817, 823 (1935), 15 U.S.C.A. §§ 79i, l (Supp. 1945), any registered holding company wishing to purchase more than 1 per cent of the outstanding securities of its own issue or as a subsidiary must receive the prior approval of the SEC. The SEC has withheld approval when purchases of the subsidiary's stock were to be made at a time when dividends on the parent company's preferred stock were in arrears, on the ground that "the Company should not employ cash, which has accumulated because of the failure to pay preferred stock dividends, for the acquisition of securities of its subsidiaries." In the Matter of the United Light and Power Co., Holding Company Act Release No. 2348 (1940). A registered holding company was granted permission to repurchase some of its own shares in the Matter of the Commonwealth & Southern Corp., Holding Company Act Release No. 6930 (1946). Despite the existence of substantial arrearages on the stock to be repurchased the Commission granted the application because the market price was almost equal to the redemption value. The Commission's opinion implied that if there had been a large differential, approval would have been withheld.

Rule N-32C-1, prescribed by the SEC pursuant to Section 23(c)3 of the Investment Companies Act of 1940, 54 Stat. 825 (1940), 15 U.S.C.A. §80a-23 (Supp. 1945), prohibits over-the-counter repurchases by registered closed-end investment companies of their own preferred stock if cumulative dividends are in arrears. Investment Company Act of 1940, Release No. 415 (1942).

The Commission's recognition of the dangers implicit in such repurchases is also reflected in the requirement that prospectuses of securities registered under the Securities Act of 1933 disclose that the issuer has power to repurchase stock while dividends are in arrears, when such is the case. There is no specific rule or instruction imposing the requirement, which has been adopted as "an implementation of the statutory purpose that registration statements and prospectuses which form a part of such statements, contain a full and fair disclosure of the suggest that dividends will be available to the common if preferred arrearages can be eliminated.[5]

Activities of the Curtis Publishing Company afford a striking illustration of the use of the repurchase technique and its impact on the interests of the preferred and common shareholders.[6] In 1925 the capital stock of the company consisted of 900,000 shares of common stock. In that year 900,000 shares of cumulative preferred were issued, each share being entitled to a \$7 annual dividend and \$100 plus arrearages on liquidation. The shareholders' resolution authorizing the issuance of the preferred stock permitted repurchases by the company, "with or without inviting tenders at any price below \$120 a share and accumulated unpaid and accrued dividends thereon."[7] Preferred dividends were paid in full from 1926 to 1932. In 1933 preferred dividends were not fully paid, and by 1939 the arrearages amounted to \$16.87½ per share, or a total of \$12,426,000.

In the seven-year period during which the arrearages were accumulating, the company spent \$5,782,325 in the purchase of preferred stock at prices ranging from \$44 to \$116.[8] The corporation thus expended in the reacquisition of its own preferred shares funds that could have been used to pay almost half of the accumulated preferred dividends. The purchases were apparently made through stockbrokers with no general disclosure to shareholders that the corporation was the purchaser.[9] After the purchase operations were completed, \$20,000,000

character of the securities proposed to be publicly offered." Letter from Baldwin B. Bane, Director of the Corporation Finance Division, Securities and Exchange Commission, October 25, 1946.

[5] Most of the considerations discussed in this note are also applicable to repurchases of cumulative income bonds which provide for payment of "interest" at the discretion of the directors, and on which arrearages have accumulated.

[6] Johnson v. Fuller, 121 F. 2d 618 (C.C.A. 3rd, 1941).

[7] Resolution of Stockholders' Meeting of the Curtis Publishing Company. Meeting Held December 16, 1925. Stipulation Exhibit No. 1, Johnson v. Fuller, 121 F. 2d 618 (C.C.A. 3rd, 1941).

[8] The following figures, indicating sums expended in the acquisition of preferred shares, are compiled from the testimony of Cary W. Bok, Treasurer of the Curtis Publishing Co., as reported in Appellant's Appendix, pp. 66–78, containing excerpts from the transcript in Johnson v. Fuller, 121 F. 2d 618 (C.C.A. 3rd, 1941):

Year	No. of Shares Purchased	Cost	Arrearages at Year's End
1933	549	\$ 64,087	\$ 5.25
1934	1,119	128,326	8.00
1937	25,000	1,142,167	7.75
1938	53,460	2,388,173	12.25
1939	46,745	2,059,572	16.87½

During the 1933–39 period approximately \$300,000 in reacquired shares were resold leaving net purchases of \$5,471,000.

[9] Cary W. Bok, Treasurer of the Curtis Publishing Co., gave the following testimony as to his reasons for purchasing the company's preferred stock:

Q. Now can you tell us the reason for the purchase of that stock?

A. Yes, sir. If you remember, 1937 was not an easy year to invest, and my predecessor had done some very fine investing in the past and the portfolio had in it a great number of securities in earned surplus remained on the books of the company.[10] In 1940, the company adopted a plan of recapitalization involving the creation of a prior preferred stock and the elimination of the remaining arrearages by the exchange of old preferred for new prior preferred stock. The validity of the plan was upheld in *Johnson v. Fuller*.[11]

By these repurchase operations the management of the Curtis Publishing Company eliminated liquidating preferences, including arrearages, in the total sum of $14,347,366, at a cost of only $4,782,325. Perhaps more significantly, the elimination of arrearages in the sum of $1,650,066 reduced by that amount the barrier against payment of dividends to the common stock. And prospectively an annual dividend preference of $888,811 was wiped out.

The arguments used to justify repurchase operations[12] similar to those of Curtis are far from persuasive. It has been said that such repurchase operations benefit the corporation as a whole. However, the benefit which results accrues largely to the common shareholder[13] and under certain circumstances to the preferred shareholders who do not sell. In either case, the resultant benefit is

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that seemed to me to be terribly high, such as Allegheny 4's, for fifteen year maturity at 128. It was a very hard time to look around and find any good buys to put surplus money in. I do not like to have millions and millions lying loosely in the bank, and with your ultra-safe investment like Municipals and Governments, and high ground where there is more chance of their going down than up, I talked it over with various people in the company and recommended that we buy some of our own preferred stock which was selling in the forties; and if you cannot invest on the outside, it is sometimes good to invest in yourself.

Q. Better if you invest in yourself out of surplus than to pay dividends out of surplus?

A. It seemed to me a good thing to do—to buy in our own stock out of surplus.

Q. Did you consider that a question of paying dividends out of surplus instead of investing out of surplus in your own stock?

A. I approached it purely, sir, in the idea that we had all that extra money—I could not find anything else to put it into; therefore it seemed a good idea to cut down our own debts—our own obligations.

Q. You knew that in 1937 there was an arrearage of $7.75, didn't you?

A. Yes, sir.

Q. But in spite of that you thought it was best for your company to buy stock on the market, of your company, out of surplus rather than to pay dividends out of surplus, didn't you?

A. Yes, sir.

Excerpts from the transcript appearing in Appellant's Appendix, p. 71, Johnson v. Fuller, 121 F. 2d 618 (C.C.A. 3rd, 1941).

[10] Johnson v. Fuller, 121 F. 2d 618, 620 (C.C.A. 3rd, 1941).

[11] 121 F. 2d. 618 (C.C.A. 3rd, 1941).

[12] The arguments discussed herein have been gathered from correspondence with a number of lawyers and brokers in the Chicago area.

[13] The common shareholders generally have sufficient voting power to control the directorate. Thus, although the preferred shareholders in the Curtis Publishing Company were entitled to vote share for share with the common after one quarterly dividend had been passed, a two-for-one stock split in 1929 doubled the number of common shares so that there were 1,800,000 shares of common stock authorized and only 900,000 preferred shares.

generally achieved by a deliberate sacrifice of the interests of the selling preferred shareholders.[14]

The common stockholders benefit because repurchases not only eliminate at bargain rates the preferred's prior claims to assets in the form of liquidation preferences, but also reduce total arrearages and future preference claims to dividends, thereby paving the way for a resumption of dividend payments to the common stockholders. The benefit to the nonselling preferred shareholder is more doubtful. Repurchases reduce the number of equal claimants to dividend and liquidation payments, and under certain circumstances, could theoretically accelerate the full payment of arrearages on outstanding preferred stock. This acceleration might occur, for example, where the market price for the shares repurchased is not substantially above their accumulated arrearages, where earnings after purchases will be high, and where the directors will be willing to devote these earnings to the payment of arrearages. However, business uncertainties, the probable reluctance of directors to discharge substantial arrearages, and the possibility that the original repurchase operations will be followed by a recapitalization plan which will eliminate remaining arrearages[15] make the possible advantage to the nonselling shareholder remote. In any event, the nonselling preferred might well prefer that the excess funds be used to give them a small present dividend rather than the possibility of a larger one in the indefinite and speculative future.

It has also been argued that repurchases benefit the selling preferred shareholder by raising the market price. This argument is not persuasive where the market price is depressed by the very fact of arrearages, which perhaps have been deliberately permitted to pile up with a view to depressing the market. Furthermore, an announcement that excess funds would be used to discharge arrearages might have a better effect on market prices than would repurchases.[16] Such use of excess funds would seem to be required, at least by the spirit of the preferred shareholders' contract.

Repurchase operations are sometimes supported by another argument, that they permit the corporation to reduce its annual dividend claims when it is overcapitalized. This argument ignores the fact that an unequal and uncompensated sacrifice is imposed on the preferred shareholder in order to improve the capital structure. This is in direct contrast to the treatment accorded prior creditor claimants in reorganizations under the Bankruptcy Act.[17] Moreover,

[14] It should be observed, however, that there may be a tax advantage to the shareholder who sells to the corporation and realizes a capital gain instead of receiving a payment of dividend arrearages which are taxable as ordinary income.

[15] Such a recapitalization plan followed the Curtis repurchases. Johnson v. Fuller, 121 F. 2d 618 (C.C.A. 3rd, 1941).

[16] Latty, Fairness—The Focal Point in Preferred Stock Arrearages Elimination, 29 Va. L. Rev. 1, 17 (1942).

[17] Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939).

the alleged benefit from the reduction of preferred claims to future earnings, i.e., the possibility of new common stock financing, is seldom realized in practice.[18]

Despite the manifest inequities which repurchase operations often impose on preferred stockholders and the unconvincing character of the arguments advanced to justify those operations, the question of their legality has not apparently been squarely presented to the courts. It may be useful, however, to speculate on possible remedies available either under state law or under the Securities Act and the Securities Exchange Act.

Repurchase operations could be attacked under state law as a breach of the director's fiduciary obligations. Although the fiduciary relationship which exists between the directors and an individual stockholder has not been clearly defined, conventional doctrines of fiduciary responsibility afford a basis for imposing on management an obligation to deal fairly with different classes of stock,[19] to treat members of the same class equally,[20] and to make full disclosure to shareholders dealing with the corporation.[21] There would be added argument for imposing such obligations where management by virtue of large holdings of common stock derives a direct and substantial personal benefit from repurchase operations.[22]

It is clear from the analysis of the impact of repurchase operations on the preferred shareholders' rights, previously set forth, that the customary repurchase operation violates these fiduciary obligations. Accordingly, a shareholder who has not sold should be able to enjoin such repurchases; a preferred shareholder who has sold, especially if management failed to disclose that the corporation was the purchaser, might be permitted to rescind; a nonselling shareholder might also be able to require the directors to resell the treasury shares and to hold the directors liable for damages if there had been any decline in the market price. And where the funds which are to be used for purchases are available for dividends, the preferred shareholder might be able to compel the distribution as dividends of the sum set aside by the directors for repurchases. The directors' reliance on the usual defense of the sanctity of their discretion as to payment of dividends[23] would not be persuasive since the decision to repurchase implies that the funds earmarked for this purpose are not needed for operations and are, therefore, available for dividends.

[18] Dodd, Fair and Equitable Recapitalizations, 55 Harv. L. Rev. 780, 783 (1942); Scaling-Down of Arrearages on Cumulative Preferred Stock, 4 Univ. Chi. L. Rev. 645, 654 (1937).

[19] Berle and Means, The Modern Corporation and Private Property 261 (1936).

[20] Ibid., at 263.

[21] For a discussion of the fiduciary obligation of directors under these circumstances, see SEC Action against Fraudulent Purchases of Securities, 59 Harv. L. Rev. 769, 775 (1946).

[22] Berle and Means, The Modern Corporation and Private Property 263 (1936).

[23] New York, Lake Erie & Western R. Co. v. Nickals, 119 U.S. 296 (1886).

When, as in the Curtis case, a specific power to repurchase preferred shares with arrearages has been reserved by the corporation, the corporation may urge that this reservation bars relief, since the preferred shareholders have specifically agreed to these operations. However, where palpable unfairness is authorized by the terms of the reservation, it may well be invalidated as repugnant to the basic obligation of fair treatment which the directorate owes to the preferred shareholder. Moreover, such a reservation of power should not bar relief when repurchases are a part of a conscious program to depress market prices by withholding dividends since it could hardly be urged that the corporation had by contract secured this power to defraud the preferred shareholder. Finally, despite the explicit reservation, in cases where the corporation failed to disclose both that it was the purchaser and relevant facts regarding current and prospective financial conditions, the preferred shareholder could base his claim for relief on nondisclosure by the fiduciary.

When repurchase operations are carried out pursuant to a conscious plan to depress the market price of the preferred, the elements of a common-law fraud and deceit action are present, and relief on this theory might be forthcoming. The directors have implicitly misrepresented a material fact, the reason for withholding dividends. This misrepresentation was made with the intent that the shareholder should rely upon it and sell, and the shareholder who sells has relied upon the misrepresentation to his ultimate detriment.

The remedies under state law are reinforced and may be supplemented by the higher standards of conduct and disclosure which the SEC is imposing on purchasers of securities. The primary basis for the SEC's program is Rule X-10B-5, adopted under Section 10(b) of the Securities Exchange Act of 1934.[24] This rule strikes at fraudulent and deceptive purchases as well as sales of securities. An analysis of the recent SEC cases under Rule X-10B-5 reveals that the SEC has imposed strict fiduciary obligations on management and controlling shareholders purchasing stock from and engaging in related transactions with individual stockholders.[25] However, the SEC cases involved an aggregate of items, including occasionally affirmative misrepresentations and constituting in total effect flagrant nondisclosures which probably would be deemed improper in state courts. Moreover, the SEC cases have involved situations where insiders with large holdings have sought direct personal profit by instigating corporate purchases from uninformed holders at cheap prices.[26] Accordingly, it is not clear from these cases whether Rule X-10B-5 would reach the simple situation where a corporation without any disclosure purchases its own pre-

[24] 48 Stat. 891 (1934), 15 U.S.C.A. § 78j (Supp. 1945).

[25] See SEC Action against Fraudulent Purchasers of Securities, 59 Harv. L. Rev. 769, 779 (1946), for a discussion of cases under Rule X-10B-5.

[26] See Matter of Purchase and Retirement of Ward La France Truck Corp. Class "A" and Class "B" Stocks, Securities Exchange Act Release No. 3445 (1943); SEC v. Boyd Transfer & Storage Co., SEC Litigation Releases Nos. 295, 308 (1945).

ferred shares with arrearages in a depressed market under circumstances where direct financial gain to the directors is a negligible consideration. The SEC rule is, however, sufficiently elastic to require disclosure, in the foregoing situation, particularly where the repurchase operations, viewed against the background of low market price and prospective increases in earnings, erode substantial rights of the preferred shareholder. Moreover, when repurchases are preceded by a conscious program to depress the price of the preferred stock, they clearly violate Rule X-10B-5[27] and make applicable the civil and criminal penalties provided for such violations.[28] It is not certain whether individual stockholders injured by such a scheme also have a civil action under the Securities Exchange Act of 1934.[29]

It would appear desirable for the Commission to resolve existing uncertainties by promulgating a rule requiring corporations to make adequate disclosure before embarking on a repurchase program. Such a rule would benefit management by eliminating the necessity for determining whether a particular transaction would, in the absence of disclosure, be deceptive, and by affording protection against any claim by common stockholders and nonselling preferred stockholders that such disclosure was unnecessary and violated their interests by increasing the cost of repurchases. The primary benefits of such a rule would, of course, go to the preferred stockholders who would receive the information necessary for an informed judgment as to whether to sell as well as information necessary for a timely recourse to their remedies under state law. Moreover, in its practical operation, the mere requirement of disclosure would probably generate two healthy tendencies. It would eliminate repurchase operations or confine them to situations where they were not grossly unfair. It would also tend to raise the level of fiduciary responsibility, not only under federal securities legislation but also under state law.

[27] Mr. Edward H. Cashion, Counsel to the Corporation Finance Division, Securities and Exchange Commission, has said: ". . . . when such omissions of material facts are part of a plan or program of an issuer—and those in control—to repurchase its securities at prices which they have deliberately depressed by inadequate disclosure of the financial condition of the company and by withholding dividends, the retention of which could clearly serve no proper corporate purpose, at the same time using such surplus earnings to repurchase its securities to the disadvantage of the public shareholders and to the advantage of those in control, it is my opinion that a scheme to defraud has been employed within the meaning of Rule X-10B-5." Address of Edward H. Cashion before the National Association of State Securities Commissioners, St. Louis, Mo., December 13, 1945.

[28] Under Section 21(e) of the Securities Act of 1934, the SEC may seek injunctions against violations of its rules. 48 Stat. 900 (1934), 15 U.S.C.A. § 78u (Supp. 1945). Revocation of the registration of broker-dealers violating rules prescribed under Section 10 (b) is authorized by Section 15(c)1, 49 Stat. 1377 (1936), as amended, 52 Stat. 1075 (1938), 15 U.S.C.A. § 78o (Supp. 1945). Criminal penalties are provided by Section 32 (a), 48 Stat. 904 (1934), as amended, 49 Stat. 1380 (1936), 15 U.S.C.A. § 78ff (Supp. 1945).

[29] See SEC Action against Fraudulent Purchasers of Securities, 59 Harv. L. Rev. 769, 779 (1946).

While the law remains unsettled, underwriters of preferred shares might well insist upon the insertion of a charter provision restricting the repurchase of shares while cumulative dividends remain unpaid.[30]

[30] Inquiries at a dozen law firms in the Chicago area revealed that a small minority of the preferred stock certificates drafted recently by those firms had included prohibitions against the repurchase of cumulative preferred stock bearing arrearages. A considerably larger number of certificates, but still a minority, included a requirement that if arrearages exist purchases must be made "in accordance with a purchase offer made to all holders of preferred stock" or "pursuant to a call for tenders" sent to all holders of preferred stock.