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Not preferred

If it were up to Emmis Communications Corp. to rewrite the history of the past 15 years, there would be a couple of changes. No. 1, the Internet would never have gotten off the ground—a convenient thing, as Emmis owns radio stations whose advertising lunch the Web is devouring. No. 2, the 2,422,320 shares of Emmis 6.25% Series A cumulative convertible preferred stock that do, in fact, exist, would never have come into the world—another convenient thing, as it would save the Emmis insiders the trouble of mounting their current all-out campaign to wipe those securities from the face of the Emmis capital structure.

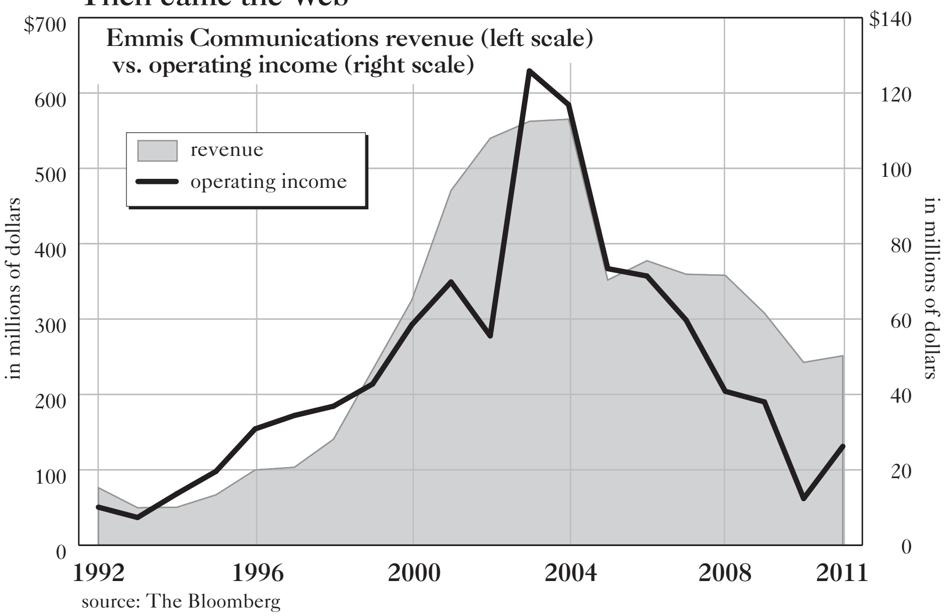
Now unfolding is a story about the sanctity of contract—or, as it appears to be in Emmis's case, the evanescence of contract. Such rights as the Emmis articles of incorporation confer on the preferred holders, the insiders now propose to extinguish, but without the customary nicety of compensating the deprived investors for their prospective losses. At stake is more than the future of a dwindling, idiosyncratically governed Indianapolis media company. Victory by Emmis over the preferred would tend to impair the standing of preferred stock as a national asset class and compromise the position of minority investors of all descriptions. More importantly, the insiders' success would shake the presumption that contract law applies even when, from the point of view of the insiders, it would be more convenient if it didn't.

Emmis traces its beginnings to 1979, when its founder, CEO and controlling shareholder, Jeffrey H. Smulyan, bought his first radio station. It was WSVL-FM in Shelbyville, Ind. Almost before you knew it, one station became many, and the entrepreneur became a corporate chieftain. Today, Emmis owns radio stations in Austin, Indianapolis, Los Angeles, New York, St. Louis and—closer to its corporate roots—Terre Haute. It also owns stations much farther removed from the corporate roots in Hungary, Slovakia and Bulgaria.

As recently as 2003, corporate revenue topped $562 million, but then came the onslaught of the digital media. Through the first nine months of the current fiscal year, revenue punched in at the annual rate of just $243 million. It is surely no sign of financial health that Emmis common is quoted at less than $1 a share (a reverse split is on the corporate agenda to forestall a delisting by Nasdaq) or that management has found it necessary to enter into an agreement with a Sam Zell-sponsored credit fund to borrow $35 million at an interest rate of 22.95% in order to implement the Emmis preferred-stock extinction plan.

Management's focus on this single security has taken on some of the characteristics of a fatwa. What does the preferred have that management so devoutly wishes it didn't? First and foremost, perhaps, is the ability "to require Emmis to repurchase all of such

Then came the Web



source: The Bloomberg

holders' preferred stock upon certain going-private transactions," to quote from the proxy material—and at a price substantially above the currently quoted $17.29 a share. Among other rights and privileges are these:

- Dividend payments will accrue at the stipulated 6.25% rate even when the company can't or won't pay them (none has been paid since October 2008).
- Arrearages in preferred dividend payments will grant to preferred holders the right to nominate directors to the Emmis board.
- Arrearages in preferred dividend payments will check the company's ability to make distributions to the common.

Smulyan, whose control of the 10-votes-per-share Class B Emmis common makes him master of all he surveys in his corporate domain, has tried to take the company private, most recently in 2010, but was thwarted by the preferred. Holders of two-thirds of these shares, the minimum required, refused to accept compensation offered at less than the contractually stipulated terms. By now, we are going to venture a guess, CEO Smulyan is heartily sick of what the *Indianapolis Business Journal*, in a March 14 report on the preferred-stock imbroglio, called Emmis's "albatross." What to do?

Management proceeded to call various preferred holders. It said it was prepared to repurchase their shares for $15 or $16 each, the then-market price. Once the company acquired the two-thirds of the stock required to form an assenting body of preferred holders, it would vote to denude the remaining one-third, said the friendly voice on the Emmis end of the phone, according to an investor who received the call and relayed its message to colleague David Peligal. This the company would do by erasing the rights previously enumerated. Uncooperative preferred holders would receive not $15 or $16 a share, but the value inherent in the consequences of the company's anti-preferred drive, i.e., $2 or $3 a share.

The preferred has a stated liquidation preference of $50 a share. It has, besides, $11 in dividend arrearages. So, as one might suppose, if the company wanted to get the preferred out of its hair—in anticipation of a new going-private initiative, for instance—it would have to stump up $61 a share.

Intending to do no such thing, Emmis rather devised a means of gathering in the votes of the preferred shares whose owners agreed to tender. As your editor, a non-lawyer, understands the federal securities law, a company may not vote its own stock. Shares retired and deposited in the corporate treasury are supposed to be voteless. In this case, however, management has entered into so-called swap arrangements with the compliant preferred holders. Emmis has bought their stock but, through swap agreements, has left voting power in the hands of the sellers—providing the sellers agree to vote "aye" to management's plan to strip the preferred of its rights and much of its value. In a statement released to *Grant's*, Emmis says that it has offered "liquidity" to all preferred holders: "While we did not have sufficient capital to tender for all shares at the maximum tender price, we did have sufficient capital to provide liquidity to all those who tendered," says an Emmis spokesperson. "No one in the tender had to sign a voting agreement; their shares were purchased outright."

One preferred holder, at least—he is the one quoted above, though not by name at his request—disputes that voluntarism was the spirit of the tender proceedings.

"I could understand the company," our informant told Peligal, "if they came to all of the preferred holders and said, 'Look, we want to get out of this, and this—these provisions of your preferred. We're going to need to offer you something for that—and they would offer it to all the preferred holders, not just two-thirds. If they got two-thirds of the preferred holders to accept that, then it's just like a bond provision when you want to change a covenant. . . . In this case, they were never offering anything to all the holders—they were just trying to creep up to get two-thirds and then they were going to vote the other one-third into oblivion. That's essentially what they set up here. They're essentially defrauding the remaining preferred holders of very valuable rights."

Do you wonder why the indignant and noncompliant minority of Emmis preferred holders don't combine to deny management the two-thirds majority of preferred votes it would need to strip the entire Emmis preferred cohort? They have, in fact, accumulated 811,000 shares, or a third of the outstanding. The company owns 61%, with a few percent unaccounted for, i.e., neither in the so-called lockup group nor bedded down with management through the voting swap agreements. It may therefore seem as if the lockup group has the whip hand. Not as far as Smulyan is concerned. On March 13, management filed a plan with the SEC to issue 400,000 new preferred shares at a nominal price to a newly created Emmis employee retirement trust. Controlling these votes, management would have the two-thirds majority required to throttle its albatross for good. (As a point of information, the fourth of the "Eleven Commandments of Emmis Communications" reads: "Never jeopardize your integrity—we win the right way or we don't win at all.")

If Emmis is weak in the radio-advertising department, it is a fount of enterprise in legal stratagems. Its lawyers contend that, under Indiana law, management may indeed vote its treasury stock and that the board of directors owe the preferred holders no fiduciary duty; what's good for the common—not least for the controlling common shareholder, a.k.a., the CEO—is good for the company. Management has called a special meeting to win approval to proceed. Certainly, the company can use the many millions it stands to save with its preferred-stock gambit, although many doubt that Emmis is anything like insolvent. An analysis prepared by BIA Capital Strategies in April 2010 represents the asset value of the company to be in excess of $600 million.

"They've tried to paint us as pigs who are looking for $60 a share," another preferred holder, who also seeks anonymity, tells Peligal. "Nothing could be further from the truth. We've offered flexibility. We're economic animals, but we value securities for a living, and $15.56 is a capitulation trade. It's not what these are worth."

If Emmis succeeds in journaling millions from the preferred holders to the common holders, the resulting ripples could be worth billions. "A corporate board with preferred outstanding might, in fact, feel they have a fiduciary duty to the common stock to attempt the same gambit," a longtime investor in preferred stock tells *Grant's* (neither does this authority want to be identified by name). "So the effect on preferred prices in the secondary market could be quite significant. Put it this way: if a second company followed up with the same scheme and got investors' attention, the preferred market would decline by 25%, which, of course, would make it even more attractive for issuers of the racket to continue."

Once upon a time, the jurist Louis D. Brandeis chose to represent a certain client for the sake of advancing the public interest. "I should say I was counsel for the situation," Brandeis said. "I was looking out for the interests of everyone."

In the matter at hand, this publication trusts that the SEC will stand up for the contractual rights of the Emmis preferred holders against the arbitrariness of a self-interested management and pliable board of directors—standing up, as Brandeis said, for "the situation."

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