PART III

# FINANCING WITH HYBRID SECURITIES

## INTRODUCTION

Hybrid securities combine attributes of debt and equity. Preferred stock does this by starting with an equity interest and building on financial rights and preferences. Convertible bonds do this by starting with a debt contract and incorporating a privilege to reconstitute the contract rights as an equity interest. Both types give rise to conflicts of interest with the common stockholders and present special problems for the drafter. Section A presents preferred stock and the corporate law that governs preferred stockholders' rights. Section B takes up convertibles. Section C turns to venture capital finance, a form of relational equity investment that utilizes convertible preferred stock as its vehicle of choice.

## SECTION A. PREFERRED STOCK FINANCING

### 1. RIGHTS AND PREFERENCES

#### (A) PREFERRED STOCK DEFINED

Preferred stock is described as a senior security offering the holder a constant payment stream resembling a bond's while simultaneously holding out to the issuer the flexibility respecting periodic payments characteristic of common stock. This description prompts a question: How can an investment simultaneously perform as a fixed income security and, short of insolvency, leave management with the discretion to withhold payments? The answer is that an investment cannot do both at once, at least in an absolute sense. Where a debt security is absolute respecting its promised payment stream (outside of severe financial distress), preferred stock is contingent and not necessarily a "fixed income" security at all. To understand preferred stock's risk and return characteristics is to grasp the difference between a contract right that is fully enforceable (outside of bankruptcy) and a contract preference that yields different monetary results across the range of different business contingencies (outside of bankruptcy).

Let us begin a more particular description of preferred stock with the authorizing language of the Delaware Corporation Law (DCL), in section 151(a):

> Every corporation may issue one or more classes of stock * * * any or all of which classes * * * may have such voting powers, full or limited, or no voting powers, and such designations, preferences and relative, participating, optional or other special rights, and qualifications, limitations or restrictions thereof, as shall be stated and expressed in the certificate of incorporation or of any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the board of directors pursuant to authority expressly vested in it by provisions of its certificate of incorporation. * * *

See also Revised Model Business Corporation Act (RMBCA) § 6.01; New York Business Corporation Law (NYBCL) § 501.

Delaware § 151(a) hands the drafter of the corporate charter a blank slate on which to fill in the rights of different classes of equity participants—rights which by definition concern periodic returns, capital payouts on (or prior to) liquidation, and voting. On the blank slate the drafter may parse those rights among multiple classes of stock as he or she sees fit. To be "preferred" stock is to be a class of stock with a "preference" or "special right" as against another class of stock, with the preference or right going to periodic returns, capital payouts, or both.

The statute offers no further instructions as to the nature or form of preferred stock's rights. It instead remits us to the particular terms of a given firm's charter, an amendment thereto, or a board resolution pursuant to an authorization in the charter or an amendment, there to ascertain the particular package of rights attending a given class of stock. Section 151(a) does not even require such a class to be designated as "preferred." It could be, and often is, called Common A or Common B, as the drafter chooses.

Preferred stock, however vaguely defined in the foregoing, can be clearly distinguished from a junior debt security like a subordinated debenture. Whatever economic similarities the two may have, the preferred is *stock*. It traditionally has been booked with the common on the balance sheet in the shareholders' equity section, while the debenture shows up as a liability. Dividends on preferred are treated for tax purposes as a distribution of net profits to shareholders rather than as a deductible cost of doing business, as occurs with interest payments on the debentures. Furthermore, because the preferred is stock, payment of a dividend or redemption could run afoul of legal capital rules. In many states dividends may not be paid unless the enterprise has some form of surplus or earnings available therefor. And no return of capital may be made on dissolution unless assets are available after all debts have been satisfied. In addition, even though no law *per se* prohibits a payment of interest or repayment of principal on a debenture in a distress situation, fraudulent conveyance law may prevent the same payment being made respecting preferred. Finally, under 1129(b) of the Bankruptcy Code a class of subordinated debentures can claim absolute priority over a class of preferred.

## (B) THE PREFERRED STOCK CONTRACT

Any meaningful and more detailed profile of rights attending classes of preferred stock, in particular rights held relative to other classes of stock, follows not from corporate law but from drafting practice. As with debt securities, with preferred stock the contract defines rights in the first instance. Note that DCL § 151(a) also permits a corporate charter to authorize new classes of preferred, and hence new preferred stock contracts, on an open-ended basis. Under such a "blank check," the terms of a given issue are fixed by subsequent resolution of the board of directors without requiring a shareholder vote. See Siegman v. Palomar Medical Technologies, 1998 WL 118201 (Del.Ch.) (interpreting a blank stock charter provision providing for the issuance of preferred stock in "classes" not to authorize several "series" of preferred thereafter issued by the board). A preferred stock financing thereby can go forward as expeditiously as a debt financing. (The blank check authorization figures critically in the creation of "poison pills," where the Board unilaterally creates preferred stock and issues rights to purchase it on terms contrived to impede or effectively preclude a takeover.)

**Certificate of Incorporation of General Technology, Inc.**

**Board Resolution providing for Series A Preferred**

**Appendix A, Form 5**

### *(1) Financial Terms*

For purposes of exposition, consider the package of rights and privileges characteristic of the preferred issued in public trading markets by large firms a half century ago (and prominently featured in caselaw through the 1980s). These issues tended to be nonparticipating (or "straight") cumulative preferred stock, redeemable only at the issuer's option. More particularly, given this package of rights and preferences:

- Upon liquidation, after payment in full to all creditors, the preferred has a priority payout over the common capped at the amount paid in per share at original issue.
- From period to period, the preferred has a priority over the common with respect to the payment of dividends, the priority being stated either as a fixed percentage of the amount originally paid in or as a fixed number of dollars per share per period. This priority embodies only a contingent and negative right—so long as the full preferred dividend is not paid, the issuer may not pay a dividend on the common; so long as the common receives no dividend, no contractual default occurs respecting the preferred.
- The "cumulative" feature of the dividend imports additional (but still negative) teeth to the priority—no common dividends may be paid until all preferred dividends skipped in past periods have been paid.

- The limitation of redemption rights to the issuer means that the holders' original capital investment, like that of the common stockholders, could stay with the firm indefinitely to be returned as a practical matter only on liquidation.

The package of rights thus described is representative only. Nothing in corporate law requires that an issue of preferred be nonparticipating, cumulative, and redeemable only by the issuer.

Preferred stock contracts vary in the force of their compulsion to make dividend payments. At one extreme, they can provide for a mandatory and fully cumulative dividend. In such a case, the issuer makes a promise to pay in addition to a priority, intensifying the preferred's resemblance to debt. At the other extreme lies preferred with a discretionary and wholly noncumulative dividend. Here the preferred's payment stream takes on a contingent, speculative quality.

There is less variance in practice respecting liquidation rights. Preferred stock contracts generally provide, in the event of dissolution of the enterprise, for the payment to the preferred prior to any distribution to the common stockholders of a specified sum plus an amount equal to all dividends in arrears, and if dissolution is voluntary, often a premium. As to redemption, preferred contracts usually provide for redemption at the issuer's option at a specific price plus an amount equal to all dividends in arrears and a premium. Mandatory sinking fund payments which retire the issue on a set schedule became common in the wake of the high inflation of the late 1970s and early 1980s. Such a redemption schedule makes a class of preferred more closely resemble debt. Preferred stock contracts may contain additional protective provisions designed to minimize risk of nonpayment, such as business covenants and the protective voting provisions described below.

Preferred stock rights and preferences thus described serve the purpose of protecting the preferred holders' prior claims to dividends and principal should the enterprise lose value. But the preferred stock contract also may embody an opportunity to share in growth. Indeed, in an expanding economy, preferred stock lacking such a feature is not likely to offer a particularly attractive investment. The usual device for offering such an opportunity, while preserving priority in the event of contraction, is the conversion privilege—the right of the stockholder to convert the preferred stock into common stock by exchanging a share of preferred for a specified number of shares of common, or at a designated value for as many shares of common as may be purchased at specified prices. See Part III, Section B, infra. Alternatively, the charter can provide that the preferred "participate," that is, it shares (perhaps on a pro rata basis) in any dividends paid to the common after payment of the preferred's fixed priority. The charter also could provide for participation with the common in liquidation after repayment of the preferred's fixed liquidation preference. Such additional rights make the preferred more closely resemble equity. On the terms of preferred stock generally, see Buxbaum, Preferred Stock—Law and Draftsmanship, 42 Calif.L.Rev. 243 (1954).

### *(2) Voting Rights*

Formally the preferred stockholder is an ''owner'' with an ''equity'' interest, like a common stockholder. In some states, if the charter says nothing respecting voting rights the preferred may be entitled to vote like a holder of common stock. Return to DCL section 151(a), quoted above, and note that it accords the drafter of the charter complete discretion respecting the assignment of voting rights among classes of stock, so long of course, as the drafter in the end vests complete voting rights in one class or across the classes. ''Preferred'' stock, then, may or may not be voting stock as the charter provides. See also RMBCA § 6.01(c); NYBCL §§ 501, 613.

Where preferred serves as a means of external finance for a seasoned company, it generally is not given significant voting power. Thus the issue of publicly traded, nonparticipating cumulative preferred hypothesized above plausibly could be nonvoting. Since the stock is issued and held as a fixed income security, a given holder's interest in directing the affairs of the enterprise is not significantly different from that of a bondholder. This preferred stockholder, like a bondholder, has a prior and limited claim on earnings of the going concern and on assets in liquidation. Like a bondholder, its participation generally may be terminated by redemption at the option of the common. Like a bondholder, its interest in the enterprise differs materially from that of the common stock, which is the residual claimant of the benefits of operations and the first to sustain the burdens of loss.

#### *(a) voting and contingent voting preferred*

Many corporate charters provide the preferred full voting rights on a share by share basis. But significant voting power does not necessarily follow from the grant. If, for example, there are 1,000,000 common shares outstanding and 100,000 shares in the preferred class, control effectively lies with the common interest. Although sharing full voting rights, the preferred would not necessarily even have a representative on the board of directors. (A different alignment of interests obtains when preferred is issued in close corporation capital structures and in venture capital financing. In these situations, preferred classes often hold voting control.)

Many corporate charters ameliorate the problem of preferred board representation by providing the preferred with a class vote for the election of a specified number of directors (and possibly on other matters) upon the occurrence of failure to pay a specified number of preferred dividends. The operative notion is that interruption of the payment stream substantially increases the interest of the preferred respecting governance of the firm. Voting power is bestowed upon the preferred by class, rather than by share, in recognition of the likelihood that the number of common shares exceeds the number of preferred. The magnitude of the voting power thus contingently accorded also depends on the number of board seats. A majority of board seats shifts control to the preferred. In the alternative, and more commonly, the charter provides voice in the boardroom short of control by according a class vote for one or two seats on the board.

Corporate codes do not require these contingent voting rights. But mandates can be found in stock exchange rules. For example, the New York Stock Exchange requires corporations whose preferred stock is listed on the Exchange to accord preferred classes the power to elect ''at least two directors upon default of the equivalent of six quarterly dividends''—NYSE Listed Company Manual, § 313.00. Default is defined as the failure to pay an aggregate (rather than a consecutive) number of quarterly dividends. The American Stock Exchange makes a similar requirement ''no later than two years after an incurred default in the payment of fixed dividends.'' AMEX Listing Standards, Policies and Requirements, § 124.

Default in the payment of dividends is not the only contingency upon which voting rights might be predicated. Violation of other protective provisions in the preferred stock contract, such as minimum sinking fund requirements, limitations on dividends payable to junior securities, prohibitions against creating senior securities, or business covenants may provide the occasion for class voting rights in the preferred. (In theory, bondholders also could be accorded such rights in the charter. See DCL § 221; NYBCL § 518(c).)

Charter provisions extending particularized voting rights to preferred holders give rise to questions of interpretation. As an example, consider **FGC Holdings Ltd. v. Teltronics, Inc.**, 2005 WL 2334357 (Del.Ch.), which concerned Series B preferred stock of Teltronics issued pursuant to a Certificate of Designation (CD) that provided the holders the right to elect one member of a five-seat board as follows:

> 4(b) The holders of the Series B Preferred Stock, voting separately as one class, shall have the exclusive and special right at all times to elect one (1) director (''[the Series B director]'') to the Board of Directors of the Corporation provided, however, that so long as any shares of Series B Preferred Stock are outstanding, the Board of Directors shall not consist of more than five (5) members. * * * Upon the written request of the holders of record of at least a majority of the Series B Preferred Stock then outstanding, the Secretary of the Corporation shall call a special meeting of the holders of Series B Preferred Stock for the purpose of (i) removing any [Series B director] elected pursuant to this Section 4(b) and/or (ii) electing a director to fill a vacancy of the directorship authorized to be filled by the holders of Series B Preferred Stock pursuant to this Section 4(b). Such meeting shall be held at the earliest practicable date. A vacancy in the directorship to be elected by the holders of Series B Preferred Stock pursuant to this Section 4(b) may be filled only by vote or written consent in lieu of a meeting of the holders of a majority of the shares of Series B Preferred Stock then outstanding and may not be filled by the remaining directors.

The Series B originally had been issued to an institutional investor that made use of the right to vote a representative onto the fifth board seat. It later transferred the Series B to a second investor that chose not to take the board seat owing to a conflict of interest arising from a simultaneous interest in Teltronics debt securities. The second investor then transferred the Series B to the plaintiff venture capitalist, who claimed an immediate right to take a board seat, taking the position that CD § 4(b) accorded a right to elect the fifth director at any time. Teltronics resisted, contending the board was full after a recent annual meeting at which the common had filled all five board seats. The Series B holder responded that the CD implicitly limited the common to a maximum of four seats and that the fifth seat never should have been filled. The Chancery Court split the difference, holding the CD to "(i) limit the total size of the board to five directors; (ii) create one Series B directorship along with four common directorships; and (iii) allow the common stockholders to elect a provisional fifth common director in the event the Series B stockholders choose not to elect a Series B director, subject to the Series B stockholders' right to elect a Series B director at any time." It followed that one of the five directors would have to go. The identification of that director was up to the issuer, which should have noted the limiting contingency respecting the tenure of one member of its slate before the fact. In addition, the Series B was found not to have knowingly or intentionally waived its right to elect the fifth director.

***(b) Voting on Amendments***

The preferred stock contract is located in the corporate charter. Statutory provisions governing corporate charters accordingly are incorporated in the preferred stock contract. The results are a little surprising. If, as usually is the case, the common stockholders have most of the votes, the statute gives them (and their management representatives) the power to amend the charter to restructure the preferred stock contract's allocation of risks and returns to the disadvantage of the preferred. The asset priority embodied in the liquidation preference of preferred stock accordingly is subject to amendment (RMBCA §§ 10.03, 10.04; DCL § 242; NYBCL §§ 801–804). Similarly amendable is the income priority embodied in the preferential claim to dividends (see e.g., Johnson v. Bradley Knitting Co., 228 Wis. 566, 280 N.W. 688 (1938); Blumenthal v. Di Giorgio Fruit Corp., 30 Cal.App.2d 11, 85 P.2d 580 (1938); Western Foundry Co. v. Wicker, 403 Ill. 260, 85 N.E.2d 722 (1949)). So too is the amendment process available to modify protective features of the preferred stock contract which are designed to increase the likelihood of the payment of dividends and of the liquidation or redemption priority (such as a sinking fund provision or a special provision restricting the payment of dividends to common stock), and other features which affect its investment value, such as a noncallable feature, the redemption price, or the conversion rights or voting rights. See e.g. Morris v. American Pub. Util. Co., 14 Del.Ch. 136, 122 A. 696 (1923); compare Breslav v. New York & Queens Elec. Light & P. Co., 249 App.Div. 181, 291 N.Y.S. 932 (1936), aff'd without opinion, 273 N.Y. 593, 7 N.E.2d 708 (1937) with Beloff v. Consolidated Ed. Co., 300 N.Y. 11, 87 N.E.2d 561 (1949) and N.Y. § 801(b)(12).

A considerable body of case law addresses efforts to amend or alter preferred stock contracts. Typically, in these cases, the downside risks against which the preferred purchased its priorities and protections will have materialized to the disadvantage of the common. For example, inadequate earnings over many years will have caused successive preferred dividends to have been skipped. With no curative business upturn in sight, the cumulated dividends in arrears depress the value of the common. The common then seeks to amend the charter (1) to acquire a larger share of future returns by eliminating the preferreds' right to arrears and reducing their promised or expected future returns, and (2) to increase the preferreds' risks for the future by modifying or eliminating the protective features of the investment contract. Alternatively, an opportunity may have arisen to merge or sell all the firm's assets at a price or on terms relatively favorable to the common, with the rights of the preferred respecting dividends or redemption interfering with the transaction's consummation. Here again elimination of preferred rights benefits the common, whether in connection with the distribution of the assets of the enterprise on liquidation following an asset sale, or with the distribution of new participations in a substantially changed enterprise following a merger. In all of these cases management will contend (perhaps accurately) that the proposed transaction is necessary or appropriate for the enhancement of the firm's value. The question then arises whether concomitant alteration of the preferred stock contract is equally necessary and appropriate. Many of the cases in this Section pose this question in one form or another. Results vary.

Meanwhile, it follows that a class of preferred with no voting rights whatsoever is the rough equivalent of an issue of bonds under a contract providing for amendment at the issuer's option without the bondholders' consent. Indeed, an issue of preferred with full voting rights is not much better off so long as the preferred can cast only a minority of the votes and charter amendments are approved by the stockholder group as whole.

Corporate codes address this problem by granting preferred stockholders the right to vote as a class on charter amendments which adversely affect their interests. This statutory class voting right in effect grants the preferred a veto and appears to be mandatory. Occasions for it are specified in some detail in RMBCA § 10.04, and include increase in the par value or number of outstanding shares or the issue of prior preferred stock. The matters for a class vote appear in a more generalized statement in DCL § 242(b)(2), which prescribes class voting on those charter amendments which would increase or decrease the par value or aggregate number of authorized shares, or "alter or change the powers, preferences or special rights of the shares of such class so as to affect them adversely." See also NYBCL § 804.

Some statutes add an express provision for a class vote where stockholder approval is sought for a merger or consolidation which adversely affects the rights of the preferred. See RMBCA § 11.04(f); NYBCL § 903(a)(2). We will see in this part that where the statute does not make such provision, as in the case of Delaware's merger statute, the question arises whether a class vote can be implied from the right to vote as a class on charter amendments.

Finally, note that under DCL § 151(a), read together with §§ 242 and 251, preferred holders need not rely on the state statute to provide for protective class vote respecting a charter amendment or merger. Preferred class votes protecting rights and preferences can be directly inserted into the charter.

### *(3) Standing to Sue*

Does a preferred shareholder have standing to bring a derivative suit and, if so, are there any limitations on the type of preferred shareholder who may bring a derivative suit? Chancellor Chandler addressed this question in **MCG Capital Corp. v. Maginn**, 2010 WL 1782271 (Del.Ch.) as follows:

''[The plaintiff] MCG argues that, by default, preferred shareholders have the same standing as common shareholders to bring derivative actions. MCG premises its argument on the notion that preferred shareholders enjoy the same rights and remedies as common shareholders unless those rights and remedies are modified by contract. MCG also notes that the standing requirements for derivative actions in 8 Del. C. § 327 and Rule 23.1 do not expressly proscribe preferred shareholders from bringing a derivative action. Further, MCG argues that while 8 Del. C. § 151 gives corporations the ability to adjust the preferences of and place limitations on different classes of stock, Section 151 also requires that any preferences or limitations be expressly written in the articles of incorporation or preferred stock designations.

''Defendants concede that in some instances preferred shareholders have standing to pursue derivative claims but argue that limits should be placed on the type of preferred shareholder that is given standing. Specifically, defendants assert that preferred shareholders should have standing to pursue derivative litigation only if (1) the preferred shares' terms are such that preferred shareholders enjoy a proportionate economic interest with common shareholders in the appreciation or depreciation in corporate value that could result from the derivative litigation *or* (2) the preferred shareholders have 'taken the place' of the common shareholders as the 'residual beneficiaries of any increase in value.' Based on this theory, defendants posit that there are two scenarios in which a preferred shareholder might have standing to bring a derivative suit. The first scenario is where the preferred shares' terms provide that preferred stock will participate proportionally with the common stock in dividends or upon liquidation once the preference amount has been paid. The second scenario is where the economic condition of the corporation is such that preferred shareholders, like creditors of an insolvent corporation, have taken the place of common shareholders as the residual beneficiaries of any increase in value.

''After thorough consideration of this issue, I believe MCG has correctly argued that preferred shareholders have standing to bring a derivative claim absent some express restriction or limitation in the articles of incorporation, the preferred share designations, or some other appropriate document. I begin with the proposition that all stock is created equal. By this I mean that all classes of stock enjoy the same rights and privileges unless an affirmative expression alters those rights. Where there is an affirmative expression altering the rights of a class of stock, only those specific rights are altered, other default rights remain unaltered. The ability to bring a derivative action has been a right enjoyed by common shareholders for some time. To exercise this right, common shareholders have been required to own stock at certain critical points in the dispute. They have also been required to demonstrate that the board either wrongly refused to pursue the action or was disqualified from considering whether to pursue the action. Independent of these requirements, the law does not appear to place a limit on the type or class of shareholder who may bring a derivative claim. Nothing in the statutes, rules of procedure, or case law of this state expressly prevents preferred shareholders, as opposed to common shareholders, from pursuing a derivative action. For example, Section 327 simply states that '[i]n any derivative suit instituted by a stockholder of a corporation, it shall be averred in the complaint that plaintiff was a *stockholder* of the corporation at the time of the transaction of which such stockholder complains....' The statute does not bar certain classes of shareholders from bringing a derivative suit.

''Moreover, Section 151 suggests that any limitation on a preferred shareholder's ability to bring a derivative suit would have to be expressly stated in the articles or some other appropriate document. And the Supreme Court has made clear that '[a]ny rights, preferences and limitations of preferred stock that distinguish that stock from common stock must be expressly and clearly stated, as provided by statute. Therefore, these rights, preferences and limitations will not be presumed or implied.' Accordingly, I conclude that preferred shareholders have standing to bring derivative claims unless the ability to bring a derivative claim has been expressly limited in the articles, preferred stock designations, or some other appropriate document. As a preferred shareholder, MCG has standing to bring its derivative claims, provided it complied with the ownership and demand requirements in Section 327 and Rule 23.1.''

### *(4) Accounting Treatment*

For balance sheet reporting purposes, preferred stock may or may not be classified below the debt-equity line on the right hand page. Since 2003, under Statement of Financial Accounting Standards No. 150, the Financial Accounting Standards Board has required that mandatorily redeemable stock be treated as long-term debt for financial statement purposes.

SFAS No. 150 extends this reclassification to three broad types of obligations:

(1) A financial instrument issued in the form of shares that is mandatorily redeemable—that is, embodies an unconditional obligation requiring the issuer to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur.

(2) A financial instrument, other than an outstanding share, that, at inception, embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require the issuer to settle the obligation by transferring assets (for example, a forward purchase contract or written put option on the issuer's equity shares that is to be physically settled or net cash settled).

(3) A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares, if, at inception, the monetary value of the obligation is based solely or predominantly on any of the following: (a) a fixed monetary amount known at inception, for example, a payable settleable with a variable number of the issuer's equity shares; (b) variations in something other than the fair value of the issuer's equity shares, for example, a financial instrument indexed to the S & P 500 and settleable with a variable number of the issuer's equity shares; or (c) variations inversely related to changes in the fair value of the issuer's equity shares, for example, a written put option that could be net share settled.

The change in treatment does not cover conversion features, conditional redemption features, or other features embedded in financial instruments that are not derivatives in their entirety. It also does not affect the classification or measurement of convertible bonds, puttable stock, or other outstanding shares that are conditionally redeemable.

Does the change in the accounting treatment of mandatorily redeemable preferred hold out implications for the treatment of preferred under corporate law? **Harbinger Capital Partners Master Fund I Ltd. v. Granite Broadcasting Corp.**, 906 A.2d 218 (Del. Ch. 2006), considered a claim that it does. The plaintiff, a holder of mandatorily redeemable preferred stock, objected to the terms of a sale of assets on the ground that it constituted a fraudulent conveyance, claiming standing as a creditor and citing SFAS No. 150 as a primary justification. According to the plaintiff, even though FASB regulations do not control corporate law results, the factors that led to FASB's change of treatment at least raised a fact question as to whether the preferred shares should be treated as debt or equity. The Delaware Chancery did consider the question of fact, treating it largely as a matter of contractual intent, and ruled that the plaintiff had no standing, 906 A.2d, 230–31:

"Examining the Granite preferred shares * * * leads clearly to the conclusion that these shares should be treated as equity for standing purposes. The defendants have conceded that these securities are classified as debt by Granite under FAS150. But, as this court noted above, that is not determinative. * * * Rather, the terms of the certificate of designation are clear and unambiguous and the question of whether the preferred shares are debt turns on an examination of those terms. What that analysis reveals is a hybrid security which falls decisively on the side of equity as a matter of law. Of course, the certificate of designation here calls the securities at issue 'shares.' But the fundamental reason that the preferred shares are equity is that they provide no guaranteed right of payment. As Harbinger has discovered, should Granite fail to perform, it has no financial rights other than a claim against the residual value of the corporation. In that sense, the fate of Harbinger's stock is tied directly to Granite's business fortunes, in a way that all the courts cited herein have held is peculiar to equity.

"Moreover, under the certificate of designation, the shares at issue provide Harbinger no right to redeem, no current dividend payments, and no right to have a dividend declared. * * * Further, as the certificate of designation makes clear, the preferred stockholders here do have a range of contractual rights against certain kinds of transactions. Although Harbinger is thus powerless in the sense that it has no vote in the corporation's management until a vote-triggering event, it is bound contractually to Granite in the very way that our courts have held characterizes preferred stock. And, * * * the liquidation preference in this case is tied directly to those assets of the corporation available for distribution to its stockholders. That fact demonstrates convincingly that, before the investment at issue here went poorly, the unambiguous intent of the parties was to create an equity instrument."

### (C) ISSUER MOTIVATIONS AND HOLDER EXPECTATIONS

Return to the nonparticipating cumulative preferred stock hypothesized above. Why would a fixed income investor purchase such a security in a world offering a menu of bonds, debentures, and notes? And why would an issuer finance with straight preferred instead of an issue of subordinated debentures? Hunt, Williams and Donaldson, Basic Business Finance 360–361 (5th ed. 1974), offers the classic advice:

"The impression created is that of a limited commitment on dividends coupled with considerable freedom in the timing of such payments. In reality, experience with preferred stocks indicates that the flexibility in dividend payments is more apparent than real. The management of a business which is experiencing normal profitability and growth desires to pay a regular dividend on both common and preferred stock because of a sense of responsibility to the corporate owners and/or because of the necessity of having to solicit further equity capital in the future. The pressure for a regular common dividend in many cases assures the holder of a preferred stock that his regular dividend will not be interrupted, even in years when profits are insufficient to give common shareholders a comparable return, for it is very damaging to the reputation of a common stock (and therefore its price) if preferred dividend arrearages stand before it. The fact that most preferred issues are substantially smaller in total amount than the related common issue means that the cash drain of a preferred dividend is often less significant than the preservation of the status of the common stock.

"The result is that management comes to view the preferred issue much as it would a bond, establishing the policy that the full preferred dividend must be paid as a matter of course. The option of passing the dividend still exists, but it is seen as a step to be taken only in case of unusual financial difficulty. * * * The primary advantage of the preferred stock becomes identical with that of a bond, namely, the opportunity to raise funds at a fixed return which is less than that realized when the funds are invested. On the other hand, the dividend rate on preferred stock is typically above the interest rate on a comparable bond and may have the additional disadvantage of not developing a tax shield. Of course, the bond

[has] a sinking fund [where the preferred redeemable only at the issuer's option does not], so that the *burden* of bond and preferred stock may not be greatly different.

''The differential in cost between a preferred stock and an alternative debt issue may be considered a premium paid for the option of postponing the fixed payments. If management is reluctant to exercise this option, it is likely that the premium will be considered excessive. However, the closer a company gets to its recognized debt limits, the more management is likely to appreciate the option to defer the dividend on a preferred stock issue and be willing to pay a premium for this potential defense against a tight cash position.''

Would you recommend a nonparticipating preferred to a senior member of your own family with fixed income investment objectives? Cottle, Murray and Block, Graham and Dodd's Security Analysis 470–474 (5th ed. 1988), repeats the cautionary advice of the classic Graham and Dodd text. For Graham and Dodd, the preferred stock contract is ''fundamentally unsatisfactory'' for the fixed income investor. Accordingly, preferred makes an appropriate fixed income investment only if contractual weakness is offset by strength in the issuing company. They recommend that a preferred issuer have all the properties of an issuer of an investment grade bond, ''with an added margin of safety to offset the discretionary feature in the payment of dividends * * * so large that the directors will be expected to declare the dividend as a matter of course.'' Preferred of less than investment grade quality should be accompanied by some form of participation in periodic return in addition to the conventional fixed dividend preference.

Shifting back to the point of view of the security's issuer, the deductibility of interest payments gives debt a relative cost advantage over preferred. The tax differential has contributed to a relative decline in the use of preferred as a financing vehicle. Its issuance by large and mid-sized firms accordingly tends to be related to constrained debt capacity—by adding preferred to their balance sheets highly levered issuers increase the size of the equity cushion. This can improve the issuer's base for future debt financing, satisfy a regulator, or do both. More particularly, preferred stock financing tends to be employed by firms, such as public utilities and banks, the capital structures of which are subject to government regulation. They issue preferred to satisfy legally mandated debt equity ratios. For example, banks and bank holding companies, pressed by regulatory agencies to expand equity their capital base, issue large quantities of preferred, both short-and long-term. Preferred also tends to be issued to bolster the equity capital of firms near distress. It was, for example, widely employed in the recapitalization programs of firms having difficulty meeting the obligations assumed in high leverage restructurings undertaken during the 1980s. As with the banks, the objective is to increase the firm's equity cushion with the minimum possible dilution of the upside potential of the common stock.

Heinkel and Zechner, The Role of Debt and Preferred Stock as a Solution to Adverse Investment Incentives, 25 J. Fin. & Quant. Anal. 1

(1990), offer theoretical confirmation of these observations with an agency model. This shows that preferred creates incentives for the firm's common holders to invest, and thus ameliorates the underinvestment problem that follows from the issuance of debt. A new issue of preferred counters the agency costs of debt, and thereby not only enhances the firm's debt capacity but increases the overall value of the firm.

In some cases a tax advantage figures into preferred stock financing. This can offset the advantages of the lack an issuer deduction for dividend payments. Under the intercorporate dividend exclusion, I.R.C. §§ 243, 244, corporate taxpayers pay tax on only 30 percent of dividends received, meaning an effective marginal rate of .3 x .35 or 10.5 percent. Preferred stock accordingly can offer a more attractive investment opportunity than unsecured bonds to insurance companies and other institutional investors that are subject to federal corporate income tax. Such a corporate preferred issue could sell at a lower yield than the same company's bonds. Short-term floating rate preferred with dividend rates tied to short-term interest rates also make use of the intercorporate dividend exclusion. This paper is often issued by banks and sold to corporations with excess cash available for short term investment, for which it makes an attractive alternative to short term debt instruments.

Note that investment bankers have put the corporate trust device to use to create tax deductible preferred. Here the corporation raising the capital issues bonds to a special purpose trust. The trust in turn raises the capital to pay for the bonds by issuing preferred stock to corporate taxpayers. The ultimate credit on the deal takes an interest deduction while the ultimate sources of capital get the intercorporate dividend exclusion. See Khanna and McConnell, MIPS, QUIPS AND TOPrS: Old Wine in New Bottles, 11 J. Applied Corp. Fin. 39 (1998).

## 2. CLAIMS TO DIVIDENDS

**Appendix A, Form 5, General Technology Certificate Article 4 (d)(2),(4), (7), (12)**

### (A) PREFERRED STOCK DIVIDEND PROVISIONS

A great variety of delineations of dividend priority occurs in preferred stock contracts. At one extreme, the contract can make a promise to pay, providing that dividends shall be paid if appropriate surplus exists (Arizona Western Ins. Co. v. L.L. Constantin & Co., 247 F.2d 388 (3d Cir.1957); cf. L.L. Constantin & Co. v. R.P. Holding Corp., 56 N.J.Super. 411, 153 A.2d 378 (Ch.Div.1959) (interpreting the same charter language to be insufficiently explicit to overcome the directorial discretion that the statute authorizes)). At the opposite extreme lies preferred with a noncumulative priority (i.e., a priority that only blocks dividends to common during the current payment period and does not call for cumulation of past skipped dividends even if the enterprise was profitable). Intermediate forms most frequently encountered are fully cumulative preferred (i.e., the failure to pay dividends in any period, whether or not the enterprise had earnings