

# Washington University Law Review

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Volume 23 | Issue 2

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January 1938

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### Recommended Citation

Rudolf E. Uhlman, *Law of Hybrid Securities*, 23 WASH. U. L. Q. 182 (1938).

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## THE LAW OF HYBRID SECURITIES

RUDOLF E. UHLMAN†

The distinction between corporate creditors and stockholders is as old as the law of corporations itself. Although the principle of the limited liability of stockholders is of comparatively recent origin,<sup>1</sup> it has been recognized at all times that stockholders are members of the corporation, while corporate creditors are strangers to the corporate entity.<sup>2</sup> This is also true as to those creditors of the company who belong to the class of bondholders. They are investors in the corporate business like the stockholders, but their status is fundamentally different from that of members of the company. They do not share in the profits or losses of the company and have no part in the control or management of the corporation. Because of this difference in the status of bondholders and stockholders, certificates evidencing contributions to the corporate capital are of an essentially different nature depending on whether they constitute bond or stock certificates. If the certificate is a bond certificate, it represents an obligation of the corporation to pay a fixed sum with stated interest. If it is a stock certificate, it confers upon the holder a part ownership of the corporate assets and a right to participate in the surplus profits of the corporation and, on its dissolution, in the assets remaining after payment of the creditors.<sup>3</sup>

This distinction between stockholders and bondholders, simple and clear-cut as it was originally, has been obscured by virtue of the expansion of corporate financing during the last half century. The dispersion of stock ownership in the large corporations which was followed by the concentration of corporate control in the hands of minority groups has changed the position of the small stockholders in such corporations. Although remaining stockholders in name, they have surrendered many of their prerogatives as members of the corporation and have nearly ap-

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1. Williston, *History of the Law of Business Corporations Before 1800* (1888) 2 Harv. L. Rev. 149, 160.

2. Berl, *The Vanishing Distinction Between Creditors and Stockholders* (1928) 76 U. Pa. L. Rev. 814, 815.

3. Stevens, *Corporations* (1936) 362.

proached the status of mere lenders of money. On the other hand, investors who purchase long-term bonds are just as intimately connected with the corporate business as the stockholders. "Interest return and ultimate payment of their money turn just as surely on the fidelity and business integrity of the management as do dividends and ultimate liquidation for stockholders."<sup>4</sup> Thus, the distinction between stockholders and bondholders, important as it is in theory, has lost much of its economical significance.

In legal theory the bondholder lends money to an enterprise in which he is not a participant. Whatever interest in property or control is given him is mere security for a loan. He is to be contrasted as sharply as possible with a stockholder. He is not an investor, not an owner. He is distinctly an outsider. At one time in the history of business such may have been the true situation of the bondholder, but it is not today. He is distinctly an investor. The great investment bankers when they take up the problem of financing an enterprise, decide between financing through stocks and financing through bonds on the basis of a very technical study of the conditions before them. But after they have made their decision, they sell the stock or bonds equally as investments to the public. The legal difference between stocks and bonds plays only an indirect and perhaps a minor part.<sup>5</sup>

The evolution of corporate financing has rendered it difficult also to determine often whether a given security is a bond or a stock certificate. This is particularly true in cases where the corporation has vested its securities with both bond and stock features in the hope of enhancing the attractiveness of the issue. The result of such methods is a group of securities which do not fall within the category of one of the orthodox instruments of corporate financing.

It is in the intermediate zone between stocks and bonds that the "Hybrid Security" is found—a security which represents an attempt to encompass the advantages of both classifications. To this hybrid the corporation has attempted to

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4. Berle, *Studies in the Law of Corporation Finance* (1928) 156. See also Berle & Means, *The Modern Corporation & Private Property* (1934) 279. "Though the law still maintains the conception of a sharp dividing line recognizing the bondholder as a lender of capital and the stockholder as a quasi-partner in the enterprise, economically the positions of the two have been drawn together. Consequently, security holders may be regarded as a hierarchy of individuals all of whom have supplied capital to the enterprise, and all of whom expect a return from it."

5. Isaacs, *Business Security and Legal Security* (1923) 37 *Harv. L. Rev.* 201, 210.

give the security which lies behind a bond while at the same time allowing an opportunity for increased income such as might be returned upon a stock.<sup>6</sup>

While the parties sometimes thus create securities which might be called bonds as well as shares of stock, it is the province of the courts to draw the line of demarcation between creditor and enterpriser securities. Although in a given case the bond and stock features of an instrument seem to be hopelessly interwoven, the courts are called upon to untangle them and decide whether in the last analysis the bond or the stock character of the instrument prevails. For in the eyes of the law there are no "hybrid securities." In the law a person is either a creditor or a stockholder; he cannot be both.<sup>7</sup>

In determining whether a given instrument is a stock certificate or an evidence of indebtedness, the courts will apply the traditional canons of interpretation. The courts will, therefore, disregard mere nomenclature and look to the substance of the instrument, since "to call a thing by a wrong name does not change its nature."<sup>8</sup> And they will not be guided by abstract rules, but will examine the incidents of the factual relationship which the instrument purports to establish in recognition of the principle that "the question as to whether the holder of a certificate issued by a corporation is a member of such corporation, or whether the certificate is simply evidence of a debt due by the corporation to the holder, is one that depends upon the peculiar facts of each case."<sup>9</sup>

In this article the attempt will be made to consider some classes of typical "hybrid securities" and to analyze the rules which the courts have developed in determining their nature. Excluded from this discussion will be those compromise securities the nature of which has not been disputed either in theory or in practice.<sup>10</sup>

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6. Hansen, *Hybrid Securities: A Study of Securities Which Combine Characteristics of Both Stocks and Bonds* (1936) 13 N. Y. U. L. Q. Rev. 407.

7. *Warren v. King* (1883) 108 U. S. 389, 2 S. Ct. 789, 27 L. ed. 769; *Miller v. Ratterman* (1890) 47 Ohio St. 141, 24 N. E. 496; *Cass v. Realty Security Co.* (1911) 132 N. Y. S. 1074.

8. *Burt v. Rattle* (1876) 31 Ohio St. 116; *In re Fehheimer Fishel Co.* (C. C. A. 2, 1914) 212 Fed. 357.

9. *Savannah Real Estate Loan & Building Co. v. Silverberg* (1899) 108 Ga. 281, 288, 33 So. 908.

10. The discussion of convertible bonds will, therefore, be beyond the scope of the paper, since the holders of those bonds are clearly either bond-

*Participating Operation Certificates.* The legal character of so-called participating operation certificates was discussed for the first time in *United States & Mexican Oil Co. v. Keystone Auto Gas & Oil Service Co.*<sup>11</sup> In this case, the defendant company operated service stations for the retail sale of gasoline and other merchandise. In order to raise money, certificates were issued, under the terms of which the company for a consideration of \$250 agreed to create funds by setting aside from the receipts of specified stations one cent on each gallon of gasoline and five percent on all other merchandise sold. The funds thus created were to be distributed at stated periods among the holders of certificates, until each received the sum of \$500. In accordance with this stipulation, the Keystone Co. had deposited with several banks funds amounting to about \$15,000, designated as "bond funds" or "sinking funds," when a receiver was appointed for the company. The certificate holders then brought suit against the company claiming that they had an equitable lien upon these funds. The court dismissed the suit holding that the plaintiffs were not even general creditors.

On general principles of public policy, we believe that this contract is void as against the claims of general creditors. To permit corporations, by means of certificates of this kind, to appropriate corporate assets to certain classes of creditors or shareholders, whatever they may be, would be an absolute fraud upon the general creditors of the corporation concerned, and would permit the creation of a special type of preferred creditors not contemplated by law. If enforceable at all, this contract should only be enforced as against the stockholders of the company, and not against the rights of creditors who have dealt with the corporation in the ordinary way. To give validity to such a contract would be to establish a legal vehicle for corporation fraud and illegal preference of creditors.<sup>12</sup>

The next reported case<sup>13</sup> dealing with participating operation certificates is *In re Hawkeye Oil Co.*<sup>14</sup> The facts of this case were

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holders or stockholders depending upon whether they have exercised their option to convert or not. Dewing, *Financial Policy of Corporations* (1930) 166.

11. (D. C. W. D. Pa. 1924) 19 F. (2d) 624.

12. *Id.* at 626.

13. Prior to that the District Court of Delaware followed the Keystone case without opinion in *Cities Service Refining Co. v. Go-Gas Co.* (unreported).

14. (D. C. Del. 1927) 19 F. (2d) 151.

similar to those of the *Keystone* case, *supra*, except that here the certificates were expressly secured by mortgages on the corporate property. The certificate holders petitioned for review of an order of the referee adjudging the mortgages to be null and void. The court, however, relying on the *Keystone* case affirmed the order. The opinion in reaching this result stressed the fact that the certificates in question had none of the characteristics of an indebtedness. Thus, it was held that the certificate holders did not receive interest on their claims but simply double the amount which was paid in, "regardless of the period of time, whether long or short, required to obtain it under the contract."<sup>15</sup> Moreover, it was pointed out that no definite time was fixed by the contract within which the stipulated amount had to be paid to the plaintiffs. After having made those findings, the court limited itself to the statement that the plaintiffs did not come within the class of general creditors, but the question as to which status the certificate holders actually had was not decided:

Whether the holders of such contracts are more analogous to stockholders, than to sleeping partners is not of such vital importance as the fact that they are not creditors but are co-adventurers with the stockholders, hazarding their investment upon the continued operation, and hence upon the success of the company.<sup>16</sup>

In *Massachusetts Gasoline & Oil Co. v. Go-Gas Co.*,<sup>17</sup> the court was presented solely with the question whether a lien given to the certificate holders would attach to after-acquired property of the company. The court found that the parties had made no stipulation to this end and decided, therefore, the question in the negative, without defining the legal nature of the certificates.<sup>18</sup>

The most recent case on the problem is *Stephenson v. Go-Gas Co.*, decided by the New York Court of Appeals in 1935.<sup>19</sup> In this case the stipulated funds had not been set aside as it was provided in the certificates. When the company went into receivership the certificate holders claimed that the participation certificates embodied an equitable assignment of the stipulated portion

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15. *Id.* at 152.

16. *Ibid.*

17. (1927) 259 Mass. 585, 156 N. E. 871.

18. The decision was affirmed on rehearing in (1929) 267 Mass. 122, 160 N. E. 563 and the writ of certiorari was denied in (1929) 280 U. S. 604, 50 S. Ct. 86, 74 L. ed. 648.

19. (1935) 268 N. Y. 372, 197 N. E. 317.

of the future proceeds of the gas stations. The court in dismissing the suit emphasized that nothing in the language of the certificates amounted to an assignment of the future proceeds: "Those who contributed the funds expected, not reimbursement to be secured by an assignment of a portion of the proceeds of sales made by the corporation, but a profit of one hundred percent to be created from the proceeds of the sale."<sup>20</sup> Relying on the *Keystone* and *Hawkeye* cases, *supra*, the opinion also points out that a different construction of the certificates would not only be inconsistent with the plain meaning of the actual agreement, but would also work injustice to the general creditors. Moreover, the court strongly intimated that the certificate holders were subordinate even to the stockholders of the company.<sup>21</sup> The New York case, thus, goes beyond the dicta of the *Keystone* and *Hawkeye* cases which give force to the idea that the claims of the certificate holders might be enforced against the stockholders of the company.<sup>22</sup>

*Trade Certificates.* In *Re Spot Cash Hooper Co.*,<sup>23</sup> the corporation had issued so-called trade certificates which, for a consideration of \$100, entitled the holders thereof to purchase goods from the corporation at a profit not to exceed ten percent and in addition contained the guaranty of an annual dividend of at least eight percent. On the petition of one of the certificate holders, the court declared that the certificate embodied an indebtedness which was provable under Section 63 of the Bankruptcy Act.<sup>24</sup> This result seems to be squarely in conflict with the attitude which the courts have taken in the cases dealing with the financing of gasoline chain stores by means of participating operation certificates. The *Hooper* case, accordingly, has met with much adverse criticism.<sup>25</sup>

*Tontine Insurance Policies.* The so-called Tontine Insurance policies which flourished toward the end of the last century, present another type of hybrid securities. Under the Tontine

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20. See 268 N. Y. at 380. For a detailed discussion of the case see Note (1936) 21 Cornell L. Q. 299.

21. *Stephenson v. Go-Gas Co.* (1935) 268 N. Y. 372, 381, 197 N. E. 317.

22. *U. S. & Mexican Oil Co. v. Keystone Auto Gas & Oil Service Co.* (D. C. Del. 1927) 19 F. (2d) 151, 152.

23. (*D. C. W. D. Texas* 1911) 188 Fed. 861.

24. *Id.* at 863.

25. Berl, *The Vanishing Distinction Between Creditors and Stockholders* (1928) 76 U. Pa. L. Rev. 814, 822.

Insurance plan, the insured was the holder of an endowment policy which was to run for a stated period. If the insured died during this period his beneficiary could collect the face amount of the policy. But if he survived the endowment period, he was entitled to the face amount of the policy and all the profits which might have accrued to the policy. The legal nature of those policies was the subject of numerous controversies. While the holders of death claims were considered as creditors, the character of the claims brought by the holders of unmatured policies was more dubious.

In *People v. Security Life Insurance Co.*,<sup>26</sup> suit was brought by the holders of unmatured life policies against the receiver of an insolvent insurance company for the face amount of their policies and profits accrued. The receiver claimed that the holders of running policies were not creditors and, therefore, not entitled to share in the corporate assets until after payment of the death claim and of other creditors. The court, however, relying on an earlier New York case,<sup>27</sup> held that the relationship of the company and the holders of unmatured policies was that of debtor and creditor. The court, therefore, refused to accept the theory of the receiver that the plaintiffs were merely "partners" of the company. "They who pay their money for insurances are no more jointly interested, or in any sense partners, than the depositors in a bank."<sup>28</sup>

In *Pierce v. Equitable Life Assur. Society*,<sup>29</sup> the facts were similar to those in the *Security Life Insurance Co.* case. Like the New York court there, the Massachusetts court here held that the holder of a running Tontine Insurance policy was to be regarded as a creditor and not as a member of the corporation.<sup>30</sup>

"Bonds" as Preferred Stock. In a series of cases the courts have construed securities, which were denominated as "bonds," as a species of preferred stock, if those securities had stock rather than debt features. The first in this line of cases is *Cass*

26. (1879) 78 N. Y. 114.

27. *Cohen v. New York Mutual Life Insurance Co.* (1872) 50 N. Y. 110.

28. *People v. Security Life Ins. Co.* (1879) 78 N. Y. 114, 123. *Accord*, *Uhlman v. New York Life Insurance Co.* (1888) 109 N. Y. 421.

29. (1887) 145 Mass. 56, 61, 12 N. E. 858.

30. See 145 Mass. at 61. *Accord*, *Peters v. Equitable Life Assurance Co.* (1907) 196 Mass. 143, 81 N. E. 964. An analogy to the Tontine Insurance cases is furnished by the case of *Flaherty v. Mfg. Club of Philadelphia* (1932) 104 Pa. Super. Ct. 546, 159 Atl. 209.



*v. Realty Securities Co.*<sup>31</sup> In this case instruments which were designated as "bonds" and were secured by a junior lien upon certain corporate property were held actually to represent nothing more than preferred stock. The instruments contained a promise to pay a certain sum of money at a fixed time, and to pay, meanwhile, a stated rate of interest, but it was also provided that upon liquidation of the company the holders of the instruments were entitled to a proportionate share in the surplus income, after payment of certain fixed dividends on the common and preferred stock had been made. Moreover, it was stipulated that the "bonds" should be satisfied, not only upon payment of their face value, but also upon payment of a rateable proportion of the assets, whether more or less than the face value. Considering those features of the instruments, the court concluded

The attempt seems to have been to devise a form of security which should possess all the attributes of stock, including a right to share ratably in the profits and increase in value, and at the same time to preserve a specific lien upon the company's assets which should be superior to the claims of creditors. This cannot be lawfully done for the two things are inherently inconsistent. It is said that we can sever the good from the bad, and disregard the features which assimilate these securities to stock, retaining and affirming their validity as bonds. This, as it seems to me, would be to make a new contract for the parties.<sup>32</sup>

Similarly, in *Hilson Co. v. State Board*,<sup>33</sup> the court held so-called debenture certificates with stock features to be corporate stock. The court reached this conclusion after it had found "that these debenture certificates, although they recite that the corporation is indebted to the holders thereof in the amount of their face value, disclose on their face that their holders are clothed with rights and privileges which our Corporation Act permits stockholders only to enjoy."<sup>34</sup>

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31. (1911) 132 N. Y. S. 1074, aff'd in (1912) 206 N. Y. 649, 99 N. E. 1105.

32. See 132 N. Y. S. at 1078. Accord, *Matter of Collier* (1920) 132 N. Y. S. 93. But cf. the dissenting opinion in the Cass case: "There has been an attempt to give the bondholders *certain* rights of stockholders in given contingencies which have not transpired; but a marked distinction is made between the bonds and stock and the rights of the holders of each. If it had been supposed or intended that the effect of each was the same, both would not have been provided for. Where the provisions of a contract, some of which are valid and some void, are severable, the valid provisions may be sustained and enforced." See 132 N. Y. S. at 1083.

33. (1911) 82 N. J. L. 2, 80 Atl. 929.

34. See 82 N. J. L. at 3.

Another instance of this type of compromise securities are the "debenture bonds" which came before the court in *In re Fehheimer Fishel Co.*<sup>35</sup> These securities provided that they should be subordinate to the claims of the general creditors and that, upon liquidation or dissolution of the company, the general creditors should be entitled to priority of payment in full. Another provision was that the instruments should be entitled to receive, out of the *earnings* of the company, interest at the rate of eight percent per annum before any dividend should be set apart or paid on the stock of the company, and that such interest should be cumulative. Furthermore, upon liquidation or dissolution of the company, the "debenture bonds" were entitled to the entire residue of the company's assets after the corporate debts had been paid. After having reviewed these stipulations of the instruments in suit, the court concluded

All these features are quite characteristic of stock. They are not at all characteristic of bonds. And we are satisfied that no error was committed by the court below in holding that these so-called "bonds" were in effect preferred stock.<sup>36</sup>

*Preferred Stock with Bond Features.* In another line of cases the courts had to consider the legal nature of securities which had been designated as "preferred stock," although they were vested with certain features resembling bonds. The leading case in this connection is *Warren v. King*,<sup>37</sup> decided by the Supreme Court in 1883. In this case one King who was the holder of second mortgage bonds filed a bill to foreclose two mortgages on the property of the company. Warren, who was the owner of preferred stock in the company, having been made a defendant to the suit, filed a cross-bill claiming a lien on the corporate property next to the first mortgage. He referred to the stock certificates which provided that "the preferred stock is to be and remain a first claim upon the property of the corporation after its indebtedness, and the holder thereof shall be entitled to receive from the net earnings of the company seven percent per annum, payable semi-annually, and to have such interest paid in full, for each and every year, before any payment of dividend

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35. (C. C. A. 2, 1914) 212 Fed. 357.

36. *Id.* at 360. In reaching this conclusion the court relied on *Cass v. Realty Securities Co.* (1911) 132 N. Y. S. 1074, and *Hilson Co. v. State Board* (1911) 82 N. J. L. 2, 80 Atl. 929.

37. (1883) 108 U. S. 389, 2 S. Ct. 789, 27 L. ed. 769.

upon the common stock.”<sup>38</sup> He then claimed that, by reason of the lien clause in the certificates, the preferred stockholders had the preference of a specific and continuing lien and security upon the property of the company, next after the existing mortgage indebtedness. The court, however, sustained the demurrer of the plaintiff, holding that the preferred stockholders had no preference over the junior mortgages.

The provision as to the rights of the preferred stock in the net earnings of the company leaves no doubt as to the meaning of the whole \* \* \*. The holders of preferred stock have the same relation, by virtue of the certificate, to the corpus of the property, which they have to its net earnings. Their position in regard to both is one inferior to that of all creditors.<sup>39</sup>

A closely analogous situation was before a federal court in *Hamlin v. Toledo, St. L. & K. C. R. Co.*<sup>40</sup> In that case, preferred stockholders, who originally had been senior bondholders and in the course of the reorganization of the company were given preferred non-voting stock, claimed that their certificates constituted money obligations secured by a lien next after the existing first mortgage bonds of the company. The certificates in question stipulated for the payment of annual “interests” of four percent out of the net earnings of the company and provided that “this stock constitutes a lien upon the property and net earnings of the company next after the company’s existing first mortgage” and that “the company will create no mortgage of its main line, other than its first mortgage, nor of any part thereof, except expressly subject to the prior lien of this certificate, without the consent of the holders of at least two-thirds of this stock.”<sup>41</sup> In spite of this language, the court held that the plaintiffs were not creditors of the company and were entitled only to a preference over the common stockholders. Judge Lurton, who delivered the opinion of the court, cited the *Warren* case, and pointed out that “the agreement that the ‘company will create no mortgage \* \* \* other than its first mortgage \* \* \* except subject to the prior lien, without the consent of the holders of at least two-thirds of this stock,’ is entirely consistent with an intent to give to these pre-

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38. See 108 U. S. at 393.

39. *Id.* at 399.

40. (C. C. A. 6, 1897) 78 Fed. 664.

41. *Id.* at 668.

ferred stockholders a preference over the common stockholders, not only in relation to dividends, but a preference over them in the ultimate distribution of the capital stock."<sup>42</sup> As to the other language contained in the certificate, Judge Lurton said: "By calling a dividend 'interest,' the essential nature of the thing is not changed. We must look deeper. When we do so, we find that this 'interest' is to be paid only out of 'the net earnings' after paying interest upon the first mortgage bonds, and the cost of maintenance and operation."<sup>43</sup> And it sounds like a warning against such methods of financing as those applied here, when Judge Lurton concludes: "If the purpose in providing for these peculiar shares was to arrange matters so that, under any circumstances, a part of the principal of the stock might be withdrawn before the full discharge of all corporate debts, the device would be contrary to the nature of capital stock, opposed to public policy, and void as to creditors affected thereby."<sup>44</sup>

The significance of an optional redemption date in a security otherwise a share of stock was discussed in *Cogeshall v. Georgia Land & Investment Co.*<sup>45</sup> In this case the plaintiff sought to recover the face value of several shares of preferred stock, the certificates of which provided that "this stock may be retired on or after December 31, 1912, by payment in full of the face value thereof, together with all dividends then due." The court dismissed the suit holding that the said provision did not amount to anything more than a mere option of the company to redeem the stock if it deemed it wise to do so.<sup>46</sup>

Another instance of the tendency of the courts not to consider such provisions for optional redemption as changing the actual character of preferred stock, is *Owatonna Metal Product Co. v. Hudson Mfg. Co.*<sup>47</sup> The plaintiff brought action for the recovery of the par value of two certificates of preferred stock which provided that "this preferred stock shall, at the option of the corporation, be subject to redemption on the first day of May, 1932,

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42. *Id.* at 669.

43. *Ibid.*

44. *Id.* at 671. The case is followed in *Spencer v. Smith* (C. C. A. 8, 1912) 207 Fed. 647, and in *Armstrong v. Union Trust & Savings Bank* (C. C. A. 6, 1918) 248 Fed. 268.

45. (1914) 14 Ga. App. 637.

46. *Id.* at 642. See also *Vanden Bosch v. Michigan Trust Co.* (C. C. A. 6, 1929) 35 F. (2d) 643.

47. (1935) 283 Ill. App. 199.

or if not so redeemed its time of redemption may be extended on the same terms, from year to year until all the attached coupons shall have fallen due and been paid." The court refused to follow the theory of the plaintiff that he was a creditor and said

We find no language in plaintiff's certificates that could possibly lead to an interpretation that they were other than certificates of preferred shares of stock. They contain no evidence of a promise or obligation to pay plaintiff money, but do contain merely an option to redeem, which defendant may or may not exercise.<sup>48</sup>

In another class of cases preferred stockholders who claimed to be creditors attempted to avail themselves of clauses in the certificates depriving them of their voting rights. Thus, in *Miller v. Ratterman*,<sup>49</sup> where the preferred stock had been issued under a resolution of the company "that the holders of the certificates of said preferred stock, shall not have or exercise the right to vote the same \* \* \* at any meeting of the holders of the capital stock of said company," the claim was made that this stipulation raised the preferred stockholders to the status of creditors. But the court held that the surrender of the right to vote by the preferred stockholders did not make them corporate creditors. The court emphasized that the resolution of the company divesting the preferred stockholders of their voting rights clearly showed that it was the intention of the corporation to authorize an issue of preferred stock, "for the inhibition against voting would be wholly useless had it been intended that the holders should become creditors."<sup>50</sup> The court's conclusion that the instruments in question constituted genuine preferred stock was also supported by the "absence of any provision fixing a definite time when the debt would mature" and by the provision that dividends had to be paid only out of surplus profits.

The rule laid down by the *Ratterman* case, that the surrender of the right to vote by a preferred stockholder does not make him a creditor, has been repeatedly followed by the courts,<sup>51</sup> and

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48. *Id.* at 206. For other cases see 11 Fletcher, *Cyclopedia Corporations* (Perm. ed.) 756 ff.

49. (1890) 47 Ohio St. 141, 24 N. E. 496.

50. But cf. *Best v. Oklahoma Mill Co.* (1926) 124 Okl. 135, 253 Pac. 1005, where the surrender of the voting right by a preferred stockholder gave rise to a presumption that he was an actual creditor.

51. For a collection of cases, see 11 Fletcher, *Cyclopedia Corporations* (Perm. ed.) 741 ff.

was expressed with force by the Second Circuit in *Hazen Atlas Glass Co. v. Van Dyk & Reeves* as follows<sup>52</sup>

The rights which the holder of preferred stock has depend upon his contract with the corporation. The rule is that preferred stockholders are entitled to vote the same as common stockholders, unless by the terms of its issue the voting power has been expressly withheld. But the fact that Van Dyk, as the holder of the preferred stock, was to have no right to vote it, except in the event that three dividends should remain unpaid, and thereupon should have equal voting rights with the holders of the common stock until all dividends on the preferred stock were paid, is a matter of no consequence, so far as the legal question herein involved is concerned. It does not change Van Dyk's status from that of a preferred stockholder into that of a creditor.

Finally, the contention has frequently been made by preferred stockholders that stock certificates containing a promise of guaranteed dividends are actually evidences of indebtedness. But the tendency of the courts, generally, has been to give to such stipulations a construction in accord with the stock character of the instrument. An important case in this connection is *Lockhart v. Van Alstyne*,<sup>53</sup> in which case a corporation had issued certificates of preferred stock under a resolution of the directors that a semi-annual dividend of five percent shall be guaranteed by the company. The plaintiff, who claimed to be a creditor, argued that the guaranty contained a promise in perpetuity to pay a semi-annual dividend of five percent to the preference stockholders, profits or no profits. The court, however, refused to follow the plaintiff's theory.

We think the guaranty here in question will bear the construction that the preference stockholders shall be entitled to five percent semi-annual dividends when there are profits to pay them, and not otherwise. Probably if profits were not realized to the necessary amount in any one year, they would be entitled, when they were realized, to have all arrears made up \* \* \*. This, we think, is what would be the general understanding of such a guaranty, and this is as far as the law would permit a corporation to go in guaranteeing divi-

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52. (C. C. A. 2, 1925) 8 F. (2d) 716, 722. See also *Owatonna Metal Product Co. v. Hudson Mfg. Co.* (1935) 283 Ill. App. 199, 206, quoting from the *Atlas Glass Co.* case extensively.

53. (1875) 31 Mich. 76.

dends to its own members; and to this extent no rule of good faith or of public policy is in the way.<sup>54</sup>

A similar case was brought before the Massachusetts court in *Field v. Lamson & Goodnow Mfg. Co.*<sup>55</sup> The plaintiff brought an action to recover dividends alleged due to him as the owner of preferred stock in the defendant corporation. The stock in question had been issued under a special act of 1885, which provided that "the holders of said preferred stock shall be entitled to dividends on the same annually, out of the net profits, in preference and priority to the holders of any other stock of said corporation, to the amount of such rate percent thereon, not exceeding seven percent, as may be determined by the vote of said corporation" and that dividends to the holders of such preferred stock \* \* \* may be guaranteed by said corporation." The court emphasized that under this act the payment of dividends on the preferred stock was limited to the net profits of the corporation and that, therefore, the guaranty promise contained in the stock certificates had to be construed in the light of this provision.<sup>56</sup>

In *Cratty v. Peoria Law Library Association*,<sup>57</sup> a library association had issued preferred stock on which an annual dividend of eight percent was payable. Under a by-law of the association these dividends had to be paid before corporate funds were available for the payment of necessary expenses or upkeep of the library. Upon the suit of a preferred stockholder for payment of dividends in the order mentioned, the court declared that the provision to pay dividends before the payment of necessary expenses and keeping capital intact was in violation of law and not enforceable. But the court went on,

We see no reason why the contract should not be enforced by applying to the payment of dividends the net income after deducting the expenses for conducting the library, and for losses and deterioration of books, so as to keep the capital intact and unimpaired.<sup>58</sup>

The general principle underlying all those cases of guaranteed

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54. *Id.* at 85.

55. (1894) 162 Mass. 388, 38 N. E. 1126.

56. See 162 Mass. at 392. Accord *Miller v. Ratterman* (1890) 47 Ohio St. 141, 24 N. E. 496. But see *Burt v. Rattle* (1876) 31 Ohio St. 116; *Cotting v. N. Y. & N. Eng. Ry. Co.* (1886) 54 Conn. 156, 5 Atl. 851; *Williams v. Parker* (1884) 136 Mass. 204.

57. (1906) 219 Ill. 516, 76 N. E. 707.

58. See 219 Ill. at 524.

dividends is perhaps most clearly stated in *Hazel Atlas Glass Co. v. Van Dyk & Reeves*,<sup>59</sup> where, after review of all the cases on the subject, it is said

The general rule is that a holder of preferred stock, even though the preferred dividend is guaranteed, is not regarded as a creditor of the corporation, and entitled as such to share with the other creditors in the distribution of the assets. He is, like the holders of the common stock, merely a stockholder, but with this difference, that he is entitled to priority of payment out of the assets which remain after all debts are paid; the holders of the common stock sharing in such assets as are left.<sup>60</sup>

*“Preferred Stock” as Corporate Indebtedness.* In the cases treated thus far the courts have held that preferred stock did not lose its character as such because of certain anomalous features with which it had been vested by the parties. The following cases show, however, that the courts will declare a security to be a bond or an indebtedness if it partakes of a debt character, even though the parties have called it “preferred stock.”

Such construction by the courts has been frequent in cases of certificates of “preferred stock” which had been issued under unusual or anomalous statutes. The leading case in this respect is *Burt v. Rattle*.<sup>61</sup> An Ohio statute of 1870 provided that manufacturing corporations might issue and dispose of preferred stock to any amount not exceeding one-half of the cash capital paid in by the stockholders. The holders of the preferred stock so issued were to have no voting rights and were not to be liable for the debts of the company, although the Ohio Constitution imposed liability upon stockholders in favor of the corporate creditors. The statute also provided that it should be lawful for such corporations to guaranty to the holders of preferred stock semi-annual dividends and the final payment of the stock at such time as shall be specified in the certificate. In accordance with this statute, the corporation involved issued so-called certificates of preferred stock, certifying that the corporation guaranteed to the holders the payment of four percent semi-annual dividends, and the final payment of the entire amount at a specified

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59. (C. C. A. 2, 1925) 8 F. (2d) 716.

60. *Id.* at 719. For other cases of guaranty of dividends on preferred stock, see 2 Dodd & Baker, *Cases on Business Organization* (1934) 363n.

61. (1876) 31 Ohio St. 116.



time, with the right to convert the preferred stock into common stock; and the corporation at the same time executed and delivered to a trustee its bond and mortgage to secure the holders of such certificates. When the company failed, the plaintiff, holder of such a certificate, filed a bill asking to have the mortgaged property sold for the satisfaction of the certificate holders. The court giving judgment for the plaintiff held that the transaction between the parties was actually a loaning of money upon mortgage security, and not the creation of additional members of the corporation. In reaching this result the court stressed the point that a different holding would render the Ohio statute unconstitutional.<sup>62</sup>

A situation analogous to that in the *Burt* case was before the court in *Cotting v. New York & New England Railroad Co.*,<sup>63</sup> in which case a financially embarrassed corporation, which had been placed into the hands of a receiver, was authorized, by an act of the Connecticut Legislature of 1884, to issue either second mortgage bonds or preferred shares of stock. The company adopted the second alternative and provided that on the preferred stock an annual dividend of seven percent was to be paid, commencing October 1, 1885. Since the balance sheet of the corporation of that year showed a deficiency in its earnings as compared with its operating expenses and fixed charges, the question arose whether any dividend could be lawfully declared in face of the provision of the general corporation act of Connecticut that "no corporation shall declare any dividend while its capital is impaired." The court, construing the act of 1884, gave it a liberal interpretation. Thus, speaking of the alternative way of financing to which the company was authorized by the act, the court said

It was immaterial to the state whether the money was raised in the one form or the other. The important thing to be done, in the interest of all concerned, was to raise money upon adequate security \* \* \*. There is, therefore, some reason for believing that it was the will of the legislature that the holders of the preferred stock should have the same security that the holders of the second mortgage bonds would have had if such bonds had been issued under the act;

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62. *Id.* at 129.

63. (1886) 54 Conn. 156, 5 Atl. 851.

and they certainly would not have been affected by the deficiency in the accounts.<sup>64</sup>

The court, therefore, concluded that dividends on the preferred stock lawfully might be declared and paid.<sup>65</sup> This being the holding in the case, the court did not attempt expressly to define the status of the certificate holders, although the opinion intimated that they had a creditor-like position.<sup>66</sup>

A similar suit for the recovery of dividends was the subject of a litigation in *W. C. & Phila. Ry. Co. v. Jackson*.<sup>67</sup> A special act of 1855 authorized the West Chester & Philadelphia Railroad Company to create an issue of preferred stock. With regard to this preferred stock it was provided in the act "that at any time after one year from the acceptance of this act, the president and the managers should have the right, and when the profits of the road should justify it and one-fourth of the unpreferred stock should require it, it should be their duty, to redeem all the preferred stock." The court gave judgment for the plaintiff and indicated that the "preferred stock" actually constituted an issue of bonds.<sup>68</sup>

The same problem also arose in Massachusetts under a statute of 1853 which had authorized a certain corporation to issue preferred stock not to exceed 250 shares, "the said company to give its guaranty that each share of said stock shall receive semi-annually dividends of four dollars on each share." The act found its judicial construction by the Massachusetts court in *Williams v. Parker*.<sup>69</sup> This was an action by the receiver of the corporation who sought to recover from the stockholders the dividends which had been paid them during successive years, although the liabilities of the corporation always exceeded its assets. The court sustained the demurrer of the defendants, holding that they lawfully received the dividends paid to them by the corporation.

The question which underlies all others in this case is whether the guaranty that each share of the preferred stock

64. See 54 Conn. at 166-167.

65. It must be noted that there were no creditors who could claim the corporate assets. But query, whether the decision would have been different if the company had had outstanding debts and liabilities?

66. (1886) 54 Conn. 156, 170.

67. (1875) 77 Pa. 321.

68. *Id.* at 327. See also *Totten v. Tison* (1875) 54 Ga. 139.

69. (1884) 136 Mass. 204.

'shall receive semi-annual dividends of four dollars on each share' is an absolute guaranty, or is conditional upon the earning of sufficient profits by the corporation. \* \* \* The general legislative policy of the Commonwealth \* \* \* appears to be that holders of special stock shall be regarded as creditors of the corporation for the dividends guaranteed, which have become payable. \* \* \* The defendants, so far as appears by the bill, rightfully received the dividends paid them.<sup>70</sup>

Finally, a situation which arose in Maryland should be mentioned. There, a statute of 1868 provided that a corporation in need of money may obtain the same either on bonds secured by mortgage or upon issue of preferred stock. In the latter case, the corporation was authorized to guarantee dividends of six percent out of the profits. In 1880, an amendment to the statute of 1868 was passed, which provided that "the said preferred stock shall be and constitute a lien on the franchises and property of such corporation, and have priority over any subsequently created mortgage, or other incumbrance."<sup>71</sup> The statute thus amended came before the Maryland court in *Heller v. National Marine Bank*,<sup>72</sup> in which case preferred stock had been issued by a corporation and, when the company became insolvent, the preferred stockholders claimed that under the amended statute they were preferred creditors and entitled to have their shares paid back in full. The court gave judgment for the plaintiffs and held that the so-called preferred stock constituted a lien on the company's franchises and property owned at the time the stock was issued. In the opinion of the court this holding was the necessary result of the amendment of 1880. With regard to this amendment it was said that "the last clause, giving the shareholder a lien and declaring a preference in his favor, altered the *nature* of the preferred stock and made it something that it had not been under the Act of 1868."<sup>73</sup> \* \* \* The *substance* of the thing was changed, the *name* was retained."<sup>74</sup>

While in the cases just discussed the terms of special acts of the Legislature have led the courts to construe certificates of

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70. Id. at 206.

71. Md. Civil Code (1880) art. 23, sec. 294.

72. (1899) 89 Ind. 602, 43 Atl. 800.

73. See 89 Md. 614.

74. Id. at 617. The case is followed in *Rogers, Brown & Co. v. Citizens National Bank* (1901) 93 Md. 613, 49 Atl. 843.

“preferred stock” as bonds or evidences of indebtedness, there is still another class of cases where independent of any legislative authorization so-called preferred stock was issued in such a way and under such terms as to make the transaction actually a borrowing of money. Particularly, where a fixed and absolute maturity date had been inserted into the “preferred stock” certificates, the courts have declared that the certificates were evidences of indebtedness and the holders of them bondholders or creditors of the corporation.<sup>75</sup>

An early case of this kind is *Cook v. Equitable Building & Loan Association*.<sup>76</sup> A building and loan association had issued “coupon stock” which was sold at its full face value of \$100 per share and was to bear six percent annual interest payable semi-annually. The holders of this stock were granted the privilege of withdrawing the stock upon ninety days’ notice in writing, whereupon they were to receive one hundred dollars per share for each share surrendered, together with accrued interest. The association reserved the right to call in and cancel this stock, giving the holders thereof six months’ notice in writing. The court construing the stock certificates held that the holders of the “coupon stock” were actually creditors.

The holder of this stock has really no interest in the profits or losses of the business of the association. \* \* \* We cannot possibly distinguish this from any other case of borrowing and lending money. It is just as if the association had obtained money on its note or bond upon 90 days after demand, with interest.<sup>77</sup>

The *Cook* case was relied on as authority in a subsequent Georgia decision dealing with a similar situation. In *Savannah Real Estate, Loan & Building Co. v. Silverberg*,<sup>78</sup> certificates of “preferred stock” had been issued, which deprived their holders of the right to vote and provided that “the entire issue of this preferred stock shall be retired by the company on January 1, 1897, at its face value.” Upon the suit of a certificate holder for the face value of the certificate, the court held that the so-called

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75. The tendency of the courts seems to be to disregard *optional* redemption dates as changing the legal character of preferred stock. See the discussion of *Cogeshall v. Ga. Land & Investment Co.*, and *Owatonna Metal Product Co. v. Hudson Mfg. Co.* in the text.

76. (1898) 104 Ga. 814, 30 S. E. 911.

77. See 104 Ga. at 829.

78. (1899) 108 Ga. 281, 33 S. E. 908.

preferred stock was actually a certificate of indebtedness which had to be repaid by the company as stipulated. The opinion, after having stated that the mere surrender of the right to vote by the stockholder would not make him lose this status,<sup>79</sup> made the existence of the absolute promise of the corporation to pay the face value of the certificate on a definite maturity date the *ratio decidendi*.<sup>80</sup>

In *Wright v. Johnston*,<sup>81</sup> it was not difficult for the Iowa court to uncover the bond nature of certificates of so-called preferred stock. Since this case involves a very obvious example of bonds in the disguise of "preferred stock" certificates, the amendment to the articles of the corporation authorizing these certificates in its appurtenant parts is set out in full.

Said preferred stock shall receive cumulative dividends at the rate of 8% per fiscal year, paid semi-annually out of the net profits, but shall be entitled to no dividends after the 8% cumulative dividends shall have been paid. All unpaid dividends on the preferred stock shall be paid before unpaid dividends are paid on the common stock. In the event of the dissolution or liquidation of the corporation, the holders of the preferred stock shall receive the par value of their preferred stock, plus unpaid dividends thereon, out of the assets of the corporation, before the holders of the common stock receive any of the said assets. Any surplus assets shall go to the holders of the common stock \* \* \*. The corporation may purchase the preferred stock or any portion thereof, at par, plus unpaid dividends thereon, at any time, upon giving three months' notice by mail to the holder or owner of said stock, as shown by the books of the company, and the corporation shall purchase said preferred stock, or any portion thereof, at par, plus unpaid dividends, upon six months' notice given the company by mail \* \* \*. No mortgage of any of the corporate assets shall be executed without the written consent of the holders of the preferred stock then outstanding. The word "stockholder," as used herein, shall refer to the holders of common stock only, and the holders of the preferred stock shall not be entitled to vote.

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79. For other authorities sustaining the proposition that the surrender of voting rights does not render preferred stockholders creditors, see *Miller v. Ratterman* (1890) 47 Ohio St. 141, 24 N. E. 496, and *Hazel Atlas Glass Co. v. Van Dyk & Reeves* (C. C. A. 2, 1925) 8 F. (2d) 716, discussed in text.

80. *Building Co. v. Silverberg* (1899) 108 Ga. 281, 287, 33 S. E. 908 Cf. *Cogeshall v. Ga. Land & Investment Co.* (1914) 14 Ga. App. 637.

81. (1918) 183 Iowa 807, 167 N. W. 680.

Considering those provisions, the court concluded that the "preferred stock" certificates partook of all the elements peculiar to bonds and none of those characteristics to shares of stock.

It is largely a matter of contract, and, in the absence of statutory limitations, it seems that any condition may be included in one class of stock which does not tend to impair the corporate capital available for the satisfaction of creditors. \* \* \* The attitude of the preferred shareholder on these conditions is that of creditor. He invests his money, is assured a fixed rate of interest, and may enforce repayment of the money, with interest, on specified notice. The only possible gain is the rate, definitely fixed. The only risk is possibility of a shareholder's liability in event of insolvency before he is repaid voluntarily or according to the terms of the amendment to the articles.<sup>82</sup>

Two years later, similar certificates came before the Iowa court in *Allen v. Northwestern Mfg. Co.*<sup>83</sup> The certificate of preferred stock provided that "it shall bear interest at eight percent per annum, payable annually, on the 28th day of October of each year, out of the net profits of the business of the company, and before any dividends or surplus are declared or paid on the common stock" and that "this certificate, with interest, shall be paid in full, to the lawful holder thereof, at the expiration of two years from date, upon demand therefor, and surrender of this certificate." The *Wright* case was not cited by the court, but it was followed in substance when the court declared "that the transaction was a loan by plaintiff to the defendant, by which defendant agreed to pay, with interest, at the end of two years, and that he was not, strictly speaking, a stockholder."<sup>84</sup>

The Georgia and Iowa cases just mentioned were cited with approval by the Supreme Court of Oklahoma in *Best v. Oklahoma Mill Co.*<sup>85</sup> A so-called preferred stock certificate was to be construed by the court. Plaintiff, claiming to be a creditor of the corporation, referred to the third paragraph of the certificate which provided that "this certificate of preferred stock matures

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82. See 183 Iowa at 812.

83. (1920) 189 Iowa 731, 179 N. W. 130. See also *Booth v. Union Fibre Co.* (1917) 137 Minn. 7, 162 N. W. 677, where in the absence of claims by creditors the court upheld a stipulation to redeem the preferred stock of the company without determining, however, whether the transaction was a loan resulting in a debt.

84. See 189 Iowa at 737.

85. (1926) 124 Okl. 135, 253 Pac. 1005.

on February 1, 1925, and will be redeemed or retired by the Oklahoma Mill Company on that date by the full payment of the par value thereof, together with any cumulative dividends." The court followed the plaintiff's theory stressing the compulsory character of the redemption clause in the certificate.<sup>86</sup>

The problem was presented differently in *Arthur R. Jones Syndicate v. Commissioner of Internal Revenue*,<sup>87</sup> where the parties to the transaction originally contemplated the making of a loan, at the rate of fourteen percent, but in order to avoid a conflict with the usury laws of Illinois, the corporation issued preferred stock which was to be redeemed "on July 1, 1922, by payment of the par value thereof plus a dividend at the rate of 14 percent per annum from the date hereof to the date of such payment." The court held that the transaction was actually a loan.

Aside from the form of the instrument which the parties adopted to embody their contracts, there is no evidence to contradict the asserted relationship of debtor and creditor. Not only does all the oral testimony confirm this conclusion, but the payments and other written evidence strongly confirm the words of the witnesses.<sup>88</sup>

The court concluded that the facts evidenced a loan, "the true character of which was concealed to cover the usury feature."<sup>89</sup>

*Taxation of Hybrid Securities.* "Hybrid securities" have also been the frequent subjects of tax litigations. An early case of this kind was *Miller v. Ratterman*,<sup>90</sup> in which a credit tax had been levied on certificates of preferred stock the holders of which

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86. See 124 Okl. at 137. In deciding that plaintiff was a corporate creditor, the court also emphasized the fact that he had surrendered his right to vote. However, the majority of the courts have not regarded the absence of voting power as evidence of the debt character of hybrid securities. Some cases have even gone so far as to hold that the surrender of the right to vote constitutes a presumption of the stock nature of the security. See *Miller v. Ratterman* (1890) 47 Ohio St. 141, 157, 24 N. E. 496, where it is said that "the inhibition against voting would be wholly useless had it been intended that the holders should become creditors."

87. (C. C. A. 7, 1927) 23 F. (2d) 833.

88. *Id.* at 834. As to the testimony of the witnesses the court said: "All the witnesses who testified before the Board of Tax Appeals described the transaction as a loan and stated that the parties made use of the so-called first preferred stock as a mere expedient to circumvent the force and effect of the usury laws."

89. *Id.* at 834. See also *People ex rel. Cohn v. Miller* (1904) 180 N. Y. 16, 72 N. E. 525.

90. (1890) 47 Ohio St. 141, 24 N. E. 494.

were guaranteed annual dividends and were deprived of their voting rights. The tax collector claimed that those stipulations designated the securities as certificates of indebtedness and made them, therefore, subject to a tax on credits under the law of Ohio. On the suit of a taxpayer to enjoin the collection of this tax the court held that the certificates constituted genuine preferred stock and that the tax was, therefore, unlawful. The court declared that the guaranty of dividends and the non-voting feature were not inconsistent with the character of the certificate as preferred stock and that "the absence of any provision fixing a definite time when the debt would mature" was fatal to the tax collector's contention.<sup>91</sup>

In *Hilson Co. v. State Board of Assessors*,<sup>92</sup> the question was whether the state taxing board properly considered the issue by the company of three thousand "debenture certificates" as outstanding stock for the purpose of determining the franchise tax of the corporation. The court upheld the tax stating

These debenture certificates, although they recite that the corporation is indebted to the holders thereof in the amount of their face value, disclose on their face that their holders are clothed with rights and privileges which our Corporation Act permits stockholders only to enjoy.<sup>93</sup>

The court was supported in its conclusion by the certificate of organization of the company which set out that the total amount of the authorized capital stock of the corporation was \$1,000,000 of which \$400,000 was to consist of "debenture stock."

The case of *People ex rel. Cohn & Co. v. Miller*,<sup>94</sup> involved the right of a corporation to deduct the sum of \$100,000, the total amount of its preferred stock, as a debt, in the assessment of a franchise tax. The certificates issued by the corporation were called "preferred debenture shares" and provided that, in case of liquidation of the company, the holders were to be paid in full and that the company was not to create any lien superior to the lien of the certificates. Moreover, it was provided that on a certain date the company was to pay to the registered holders of the certificates the face value thereof. Considering these provisions, the court strongly intimated that the securities were actu-

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91. See 47 Ohio St. at 159.

92. (1911) 82 N. J. L. 2, 80 Atl. 929.

93. See 82 N. J. L. at 3.

94. (1904) 180 N. Y. 16, 72 N. E. 525.



ally certificates of indebtedness and that in the case of a suit by one of the certificate holders for the face amount, judgment might be given for him.<sup>95</sup> But in its relation to the taxing state, the company could not advance the contention that the preferred stock was in reality a corporate indebtedness, since the articles of the company listed it as part of the capital stock.<sup>96</sup>

Finally, the federal courts have had to deal with "hybrid securities" in the light of federal income tax regulations. The cases arising in this connection were usually founded on the provision of the Federal Revenue Act that to determine the net income of a corporation there may be deducted from the gross income all interest paid on indebtedness,<sup>97</sup> a provision which is modified by the Treasury Regulation that "so-called interest on preferred stock, which is in reality a dividend thereon, cannot be deducted in computing net income."<sup>98</sup>

Thus, in *Arthur R. Jones Syndicate v. Commissioner of Internal Revenue*,<sup>99</sup> the corporation claimed that a certain payment constituted interest charges which were deductible from its income. The Commissioner of Internal Revenue, who was defendant in the suit, alleged that the payment represented dividends which could not be deducted. It was found that the corporation had originally intended to contract a loan at the rate of fourteen percent, but on the advice of counsel abandoned this plan and issued preferred stock which was to be redeemed at a certain date by payment of the par value thereof plus a dividend of fourteen percent per annum. The court found that the transaction was actually a loan disguised as an issue of preferred stock in order to conceal its usury features. The question then was whether the corporation should be allowed to show the true character of the transaction in order to avoid the tax. The court admitting that there was some force in the argument of the commissioner that the corporation should be estopped from denying the words of the certificates, went on to say

We conclude that a taxpayer who borrows money at a usurious rate of interest and who, to conceal the usury, is

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95. See 180 N. Y. at 24.

96. *Ibid.*

97. (1936) 49 Stat. 1659, 26 U. S. C. A. sec. 23(b).

98. Article 564 of Treasury Regulations 65, promulgated under the Revenue Act of 1924.

99. (C. C. A. 7, 1927) 23 F. (2d) 833.

compelled to execute a document which does not correctly describe the relationship of the parties, may, as against the government, disclose the true relationship of debtor and creditor. Sums by it paid as interest, regardless of the name by which it is called, may be deducted by the taxpayer from its income.<sup>100</sup>

In *Elko Lamoille Power Co. v. Commissioner of Internal Revenue*,<sup>101</sup> the company issued preferred stock in 1925 which was callable after three years at 110. In 1928 the directors of the company resolved "that such certificates of preferred stock be deemed and are hereby declared to be certificates of indebtedness of this corporation." Furthermore, on the books of the company, the preferred stock was carried as "preferred stockholders' interest account." The court held that the preferred stockholders could not be treated as creditors and that the company was, therefore, not entitled to deduct the dividends from its return as interest. The opinion pointed out that the case was clearly distinguishable from the *Arthur R. Jones Syndicate* case.

In the instant case the preferred stock could, *at the option of the corporation*, be redeemed within three years at 110. There was, however, no obligation to redeem. In the *Jones Syndicate* there was an express provision to pay at five years. It was in effect a bond payable in five years.<sup>102</sup>

Since the certificates thus embodied genuine preferred stock, the court declared that "neither the resolution passed long after the sale of the preferred stock nor the method of bookkeeping have any probative value."<sup>103</sup>

In *Commissioner of Internal Revenue v. O. P. P. Holding Corporation*,<sup>104</sup> the corporation had issued debenture bonds which were subordinated, both as to principal and interest, to the claims of all other creditors. It was also provided that the company might at its option suspend or defer the payment of interest "but such suspension of payment shall in no wise relieve the Corporation of the obligation to pay the same at some future time." The bonds had a definite maturity date. On the theory that it

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100. *Id.* at 834.

101. (C. C. A. 9, 1931) 50 F. (2d) 595.

102. *Id.* at 597.

103. *Ibid.* Accord, *Finance & Investment Corporation v. Burnet* (App. D. C. 1932) 57 F. (2d) 444; *Commissioner of Internal Revenue v. Proctor Shop* (C. C. A. 9, 1936) 82 F. (2d) 792.

104. (C. C. A. 2, 1935) 76 F. (2d) 11.

represented a dividend payment, the Commissioner disallowed a deduction of \$20,000 from gross income, which the corporation claimed to be a payment of interest on the debenture bonds. A Federal Court of Appeals affirmed a decision of the Board of Tax Appeals reversing the determination of the Commissioner. Judge Swan delivering the opinion of the court declared that the securities in question were genuine bonds, the interest on which might be properly deducted from the corporate gross income.

We do not think it fatal to the debenture holder's status as a creditor that his claim is subordinated to those of general creditors. The fact that ultimately he must be paid a definite sum at a fixed time marks his relationship to the corporation as that of creditor rather than shareholder. The final criterion between creditor and shareholder we believe to be the contingency of payment. The shareholder is entitled to nothing, prior to liquidation, except out of earnings. Even on liquidation, at least in New York, arrears of cumulative dividends are confined to earnings. \* \* \* These debenture bondholders were not so limited. The interest could be deferred, but it was not lost, though the company had no earnings; it could be collected, together with the principal, in 1954 regardless of whether there should be a surplus.<sup>105</sup>

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105. *Id.* at 12.