

**Boalt Hall School of Law**

**CORPORATIONS**

**Law 250.1**

**Reading Package for  
Part II: The Corporate Form**

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### A. The Corporate Form

#### 1. Corporate Attributes

The corporation is the standard form of almost all large American firms. Why? The traditional answer is that the corporation dominates the partnership as a vehicle for raising capital for large businesses. A general partnership involves personal liability, instability, illiquidity, and diffuse management. By contrast, the chief attributes of the corporate form are generally listed as:

- 1) limited liability for investors;
- 2) free transferability of investor interests;
- 3) legal personality (entity-attributable powers, indefinite life span, and purpose); and
- 4) centralized management.

Which investment contract would you prefer as a small equity participant in a large enterprise? The answer seems obvious, even though there are apparent anomalies such as large law and accounting firms that persist as general partnerships. (Large investment banks have only recently adopted the corporate form. Why the switch do you suppose?)

From a doctrinal perspective, the key attributes of corporate form all depend, directly or indirectly, on the legal identity of corporations as distinct "persons" apart from their shareholders and directors. State corporation statutes establish this identity and provide the basic rules governing relationships among corporate shareholders, directors, and managers.

#### 2. Klein & Coffee

##### **TAXONOMY: PUBLIC, CLOSELY HELD, AND OTHER TYPES OF CORPORATIONS**

The corporate form is used by firms of widely differing economic characteristics. To avoid confusion, one must maintain an awareness of this reality.

1. The Closely-Held-Versus-Public Dichotomy. Most commentators divide corporations into two categories, or ideal types: the closely held corporation and the public corporation. The closely-held-versus-public dichotomy is reflected in the laws of many states which, in recent years, have developed special rules available only to the closely held type. The closely held (or close) corporation is often referred to as an incorporated partnership, which implies that the partnership form, would be more suitable for it or, at least, that at one time most such firms would have been organized as partnerships. The principal distinguishing feature of the closely held corporation is a small number of shareholders, though in all likelihood the firm will also be one of relatively modest economic scope (whether measured by revenues, by assets, or on any other scale), and generally (though by no means always) the people owning a substantial portion of the total shares will occupy the top managerial positions or will be involved in a meaningful way in the selection and monitoring of the people who do occupy those positions as well as in the formulation of corporate strategies and policies.

2. The Public Corporation: Separation of Ownership and Control. At the other end of the spectrum is the public corporation, with many shareholders and sometimes of mind-boggling size. In 1988 the leader in sales was General Motors with \$122 Billion; in assets, Citicorp with \$208 Billion; and in profit, IBM with \$10.3 Billion. For students of business organization, perhaps the most salient characteristic of such firms is a large number of shareholders, no one of whom owns enough shares to have the incentive, or the ability, either individually, or by

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creating coalitions with other shareholders, to exercise control over the operational or strategic decisions of the firm. Control is exercised by professional managers. This phenomenon is referred to as "separation of ownership and control" or an absence of "corporate democracy." It is singularly clearcut in the extreme case of a corporation like General Motors, Exxon, or IBM whose size is such that the possibility of a take-over of control by a dissident group of shareholders or by another corporation, or both, is remote.

Although this phenomenon of the separation of ownership and control will be examined in more detail, an important point to keep in mind is that the legal and economic structure of the corporation is inherently attractive to those persons who desire to be passive investors. Shareholder passivity may then be at least as much attributable to investor preferences as to managerial domination. The corporate form induces investors to accept an inactive status for at least four primary reasons, each of which tends to distinguish the corporation from the partnership.

First, equity investors have limited liability in the corporate setting and thus need not fear exposure to liabilities greater than their investment. Of course, limited liability means only that the risks of business failure are shifted to others and not that they disappear, but this lesser exposure for shareholders implies that they need not monitor the firm's activities as closely as they would otherwise need to do and hence can remain more "passive."

Second, equity interests in the corporation are subdivided into units, called shares, which can be traded in a "secondary market" (that is, a market among investors, such as a major stock exchange). In addition, corporate law tends to assume that these shares are freely transferable unless explicit provision is made to the contrary; under most statutes, this restriction must be specifically noted on the share certificate. This norm of free transferability enhances the investor's liquidity and gives the investor the ability to exit the corporation at will. In turn, this right of exit (at least when there is a secondary market) probably makes the shareholder less interested in participating in the affairs of the corporation than the investor who is locked into an investment (as the typical partner will be).\*

Third, corporate law in effect specifies a model form contract that governs relationships among shareholders, managers, creditors, and others participating in the corporation and that, for the public corporation, is sufficiently complete so that little modification is required. As a result, shareholders of such corporations,

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\* This is an important point that distinguishes "shareholder democracy" from a political democracy. In politics, a citizen has less ability to "exit" (which requires that he or she transfer citizenship) and hence has more incentive to participate in public affairs. This trade-off between the ability to exit and the incentive to participate was first described by Professor Albert O. Hirschman of Harvard. See A.O. Hirschman, *Exit, Voice and Loyalty* (1970). Note, however, that in the case of a closely held corporation, where there is no secondary market, the incentive to participate is still strong, and shareholder passivity should therefore not be anticipated.

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unlike partners in the typical partnership, need not, at the outset of the venture, become involved in negotiation of the terms of their relationships among themselves and with other participants. They can rely on the basic corporate law to supply terms (relating to both the broad structure and to the details of what is called the organization of the corporation) that will at least adequately fulfill their needs and roughly accord with their expectations. The existence of such a body of law not only reduces the transaction cost of corporate formation, but also promotes liquidity by allowing investors who wish to buy in later to acquire shares without a close examination of the corporation's basic documents. Many economists view much of traditional corporate law as a body of "default rules," which shareholders are free to modify if they choose; that is, shareholders can take the off-the-rack legal rules that corporate law affords or they can tailor more expensive rules through special charter provisions. This generalization needs qualification, however, because some provisions of corporate law are mandatory and cannot be repealed by contrary charter provisions.

A final reason why the corporate form is associated with shareholder passivity is that it specifies a general norm of centralized management under which virtually all business decisions are controlled by the board of directors, not the shareholders. Although shareholders elect the directors and must vote on certain fundamental corporate changes, corporate law denies shareholders authority to make ordinary business decisions. In reality, the significance of this delegation of power to directors varies with the context (in the case of the closely held corporation, the shareholders may simply elect themselves to the board of directors), but it suggests the utility of the corporate form, at least as a default rule, for those investors who wish to operate the business through specialized agents (i.e., managers). This centralization of the managerial authority in the board also eliminates the risk that a lone shareholder could take action in the firm's name that would effectively bind the others (as is the case in the partnership, where each general partner possesses authority under most circumstances to bind the firm and the other general partners).

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4. The Reification Illusion: "Decomposing" the Corporation. Both lawyers and laypersons tend to speak instinctively of the corporation as an "it"-that is, as a thing that has an identity and existence of its own. While this is sometimes a helpful shorthand form of expression, a basic message of this book is that corporations should not be analyzed in this fashion, except when the complexity of the actual relationships becomes so unmanageable as to make it necessary to reify. Generally, to gain a clear understanding of how a firm behaves and why it is structured in a particular fashion, one must decompose the firm into the various categories of participants whose activities are coordinated within the firm: equity investors, creditors, managers, employees, suppliers, etc.

This statement may seem confusing, because it is clear that the law, itself, does not do this. In general, the corporation is reified. **Y** That is, the law conceives of the corporation as having an existence separate from that of its employees, customers, suppliers, and so forth -- but mainly, from its shareholders. Sometimes, to be sure, the corporation is called a "fictional" entity -- in apparent recognition of the abstract and potentially misleading nature of the concept. Still, there is the basic notion of a barrier, a psychological wall, between the shareholders (and other participants in the venture) and the corporation. Thus, for example, as a matter of law a shareholder (even the sole shareholder) of a corporation does not own the assets devoted to the business of the corporation; he or she instead owns only shares of stock of the corporation, and the corporation owns the assets. **Y** Sometimes the process goes a step further. The fictional (conceptual) entity becomes a putative person -- capable, for example, of committing a crime or of bearing the burden of a tax. In other words, reification sometimes leads to anthropomorphism -- that is, treating the corporation as if it were a human being.

### 3. Sources of Corporate Law

The primary emphasis of corporate law is on the relationship between (and among) the corporation, its shareholders, and its directors. (If you are not familiar with the terms shareholders and directors, you should think of shareholders as the "owners" of the corporation -- i.e. those who are ultimately entitled to the profits the corporation makes -- and of directors as the "managers" of the corporation -- i.e. those who decide how to run the corporation.) There are several sources that define these relationships. Some of these sources are laws (statutes or case law); other are regulations promulgated by federal (or, less commonly, state) agencies; others are contractual.

#### a. State Corporation Law

##### 1. Corporation Statutes

The most important laws on corporations are the state corporation statutes. Each corporation is (primarily) governed by the state corporation statute of the state in which the corporation is incorporated. Each corporation generally has the choice to incorporate in any one of the 50 states. Thus, when one decides to form a corporation, one basically has the choice between 50 laws to be governed by. Though these corporation statutes differ from state to state, a century of borrowing, inter-state competition for incorporation business, and reform efforts by the corporate bar have contributed to a general uniformity of structure. The task of analyzing state law is made even simpler by the fact that one state, Delaware, has emerged as the state of incorporation of choice for the majority of large U.S. corporations. In light of the special position of Delaware, we will focus chiefly on the Delaware General Corporation Law ("DGCL"), which is contained in the statutory supplement that you should have purchased. To get a sense of what a state corporation statute contains, you should leaf through the table of contents of the DGCL (in the supplement).

Before we continue with our overview of the sources of corporate law, it is important to briefly discuss the basic allocation of power laid down by the corporate statutes. (Legal terms of art are in italics. You should start getting familiar with these terms and their meaning) Basically, there are three classes of people that share power: stockholders, directors and officers.

1. *Shareholders* (a.k.a. stockholders). The main source of power for shareholders is that they elect *directors*. Generally, all directors are elected every year at an *annual meeting* of shareholders. If shareholders are dissatisfied with the directors, they can

(i) elect different directors at the next annual meeting; or

(ii) in some circumstance *remove* directors either at a *special meeting* or by *written consent* (i.e. by signing a form stating that they want to remove them).

The scope and the (legal as well as practical) limitations of shareholder voting rights will be discussed in Part V of the materials.

2. *Directors*. Directors have the legal power to manage the corporation. This means that directors decide how to run the business operations, how much salary they receive, and how much is distributed to shareholders in *dividends*. (If a corporation decides to distribute money to its shareholders, it usually pays dividends.) In managing the business, directors are generally not bound by directions given to them by the shareholders. All directors together form the *board of directors* or, in short, the *board*.

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3. *Officers*. Officers help the directors to manage day-to-day business operations. Officers have fancy titles (such as President and Chief-Executive Officers). Despite these fancy titles, they are, as a legal matter, bound by directions given to them by the board of directors.

Directors that are also officers (or otherwise employees) of the company are commonly referred to as *inside directors*. Directors that are not otherwise affiliated with the company are *outside directors*. Outside directors generally do not spend much of their time in managing the company, are often hand-picked by the inside directors, and receive, relative to inside directors, a small amount of compensation. (For example, in 1994, J.F. Smith, Jr., the Chief Executive Officer of GM, received a salary of \$1.5 million, a bonus of \$1.9 million, long-term incentive payouts of \$2.3 million, and stock options on 120,000 shares. W.E. Hogle, the Executive Vice President, received \$3.2 million in salary, bonus, and long-term incentive payouts and stock options on 70,000 shares. GM's outside directors received a retainer of \$26,000 and \$1,000 for each of the 11 board meetings they attended. If they served on a committee, they received an additional retainer of \$6,000 and \$750 for each committee meeting attended.) Directors (in particular inside directors) and/or officers are sometimes also referred to as management. (Note that, while these terms appear in case law and academic writing, they are not used in the DGCL.) Even though, as a matter of law, all directors have equal powers, the real power is often exercised by the Chairman of the Board and/or the CEO.

4. *Shareholder Management Powers*. Though directors have the general power to manage the corporations, certain extraordinary decisions require as well the approval of shareholders. These decisions include:

- (i) the dissolution of the corporation;
- (ii) a sale by the corporation of all of its assets;
- (iii) a *merger* of the corporation with another corporation (a merger of two corporation essentially means that they become one corporation that holds all the assets and owes all the liabilities previously held or owed by either one of the two corporations);
- (iv) an amendment to the *certificate of incorporation* (more on the certificate is to follow soon).

## 2. State Case Law

Not all of the state corporation law is contained in the corporation statutes. Equally important is state case law. In particular, case law (and not statutory law) defines the two important duties owed by directors and officers to the corporation and its shareholders: the duty of care (i.e. the duty not to be negligent in managing the corporation) and the duty of loyalty (i.e. the duty to manage the company for the benefit of the shareholders, and not for their own personal benefit). These duties will be further discussed in Part IV.

### b. Federal Law and Regulations

The main source of federal law for corporations is the *Securities Exchange Act of 1934* (also referred to as the 1934 Act, the Exchange Act, or the Securities Exchange Act). The Exchange Act (together with the Securities Act of 1933, which is not important for our purposes) forms the core of a complex regulatory scheme. As part of that scheme, Congress established the *Securities and Exchange Commission (SEC)* and empowered it to enforce the provision of the Exchange Act and to promulgate detailed rules and regulations in a number of areas. For our purposes, the most important of these regulations are those on insider trading (discussed in Part VII) and on acquisitions of corporations (Part VIII).

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### c. Corporate Contracts

Apart from legal rules, the relationship between shareholders, directors, officers, and the corporation is governed by two documents which are similar to contracts: the *certificate of incorporation* (a.k.a. *charter*) and the *by-laws*. The various sources of rights discussed above form a hierarchy. On top of the hierarchy are federal laws (and regulations). If state law is inconsistent with federal law, federal law governs. Next are the state corporation statutes and (below) state case law. Then comes the charter. Charter provisions are only valid if they are not inconsistent with federal or state law. Finally, there are the by-laws. By-law provisions are trumped both by federal and state law and by the charter. (Note, however, that corporation statutes will often contain "default" rules, i.e. rules that, by their terms, can be modified by charter or by-law provisions. Such rules will contain phrases such as "unless otherwise provided in the corporation's certificate of incorporation ..." See, e.g., DGCL ' 141(i).)

#### 1. The Certificate of Incorporation

Every corporation must have a charter. Indeed, a corporation is formed by filing the charter with the Secretary of State. A charter contains two kinds of provisions: mandatory and optional ones. The provisions that *must* be contained in the charter are listed in DGCL ' 102(a). The provisions that *may* be contained in it are listed in DGCL ' 102(b). Please read the Amended and Restated Certificate of Incorporation of Heartplumber, Inc. (downloadable from website) together with ' 102, skimming Article IV.

In reading the statute and the charter, pay attention to the following questions:

1. Which charter provisions are mandatory? Are all mandatory provisions contained in the charter?
2. Which charter provisions are optional? Why were these provisions included? Do they have a common theme?

You will have to make an effort in reading these texts. Reading statutes and contracts tends to be tedious. But this is what lawyers do for a living.

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### **Note on *ultra vires***

An issue of little practical relevance today (but of enough historical importance that it is often raised in older cases and that you should know what it is about) are corporate actions that are outside of the corporate purpose and therefore exceed the corporate powers (in Latin, *ultra vires*). In the dark ages of corporation law, the powers of a corporation imposed significant constraints on corporate activities and *ultra vires* was a colorable defense against third-party contract claims (i.e. the corporation could assert that it was not liable under a contract to a third party since it lacked the power to enter into the contract).

Modern statutes and charters, however, impose almost no limits on corporate purpose and powers. See DGCL ' 102(a)(3) and Article Third of the Heartplumber Charter. Thus, the issue of *ultra vires* arises infrequently.

In the rare instances in which *ultra vires* is an issue, the possible consequences are laid out in DGCL ' 124. Please read the section. Can a company assert *ultra vires* as a defense against third-party contracts? Who can make a claim of *ultra vires*? What purposes may be served today by an *ultra vires* claim?

### **2. By-Laws**

Almost all corporations also have by-laws. DGCL ' 109 specifies how by-laws are adopted or changed and what provisions may be contained in them. Many by-law provisions are technical (and boring).

If you are interested in reviewing them, you can download the bylaws of Heartplumber, Inc. from my website.

## **B. Corporate Securities and Capital Structure**

### **1. Introduction/Equity Securities**

Even if the formal legal problems associated with invoking the corporate form are minor, two aspects of the incorporation decision are critical. Small businesses must ask, first, whether to incorporate at all. This is primarily an issue of tax planning and secondarily one of the relative advantages of the corporate form over the partnership form: For example, limited liability versus personal liability, etc.

Assuming that the decision to incorporate is made, the second question at the incorporation phase is fixing the terms of the deal. The basic contours of the deal among corporate participants must be reflected in the design and distribution of corporate securities.

On the most general level, the corporation must raise capital either by obtaining equity contributions (i.e. stock) or by borrowing. Raising capital through both of these devices yields a "capital structure:" a hierarchy of claims against the revenues generated by the business. Creditors who have hard contractual rights to interest and the repayment of principal must be paid first; stockholders (i.e. corporate equity holders) may then receive distributions in the form of dividends or stock repurchases as the corporation's board of directors decides.

All of the corporation's equity -- and often much of its debt -- are raised by "issuing" (i.e. selling) securities. The notes and questions that follow examine some of the common varieties of securities that corporations issue, beginning with stocks.

### **Equity Securities**

An ownership interest in a business is conventionally said to include two formal rights: a claim on the firm's residual earnings (i.e., the earnings that remain after workers, suppliers, creditors, and taxing authorities are paid); and a right to participate in the control of the business. For corporations, these rights reside in one or more classes of tradable stocks. Separating ownership rights from the identities of individual participants in the firm allows great flexibility. It means that portions of the value of the business can be bought and sold, control over management policies can change hands, and all owners of the company can turn over without altering the legal structure of the firm or renegotiating the terms on which equity holders participate in the firm's earnings and control.

The flexibility of corporate stock is not merely a function of its tradability, however. Corporation statutes place very few restrictions on precisely how control rights and earnings claims are to be allocated among classes of stock. This means that the initial incorporators of a business are free to structure complex deals among disparate initial contributors to a corporation's assets (for example, the entrepreneurs and investors who join forces in venture capital firms) merely by distributing stocks with different control rights and claims on residual earnings.

Yet notwithstanding the infinite variety of equity securities that a corporation might issue to raise capital, most stocks fall into two generic categories: common stock and preferred stock.

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Common stock is the most basic corporate security: the stock that usually carries the voting rights to elect the corporation's board of directors and the stock that receives dividends (or liquidating distributions) after all other participants in the corporation have been paid. In small corporations, common stock is often the only class of stock. In large public corporations, common stock is stock as you know it: the stock that most analysts follow, that corporate raiders buy in takeovers, and that business reporters discuss when talking about the financial health of the corporation. The barebones rights of common stockholders are governed by the corporation statute and, more generally, applicable state and federal law. They may also be further articulated by the corporate charter. Although it is usual to have only one class of common stock with identical distribution and voting rights, the corporate charter may provide for several classes. Multiple classes of common stock might differ in control rights: for example, holders of Class A common might receive 10 votes per share in the election of directors, while holders of Class B might receive only one vote per share. It is even possible (although rare) for different classes of common stock to differ in distribution rights: for example, in the case of USX today, holders of one class of shares receive dividends keyed to the performance of the company's steel assets while holders of another class receive dividends keyed to the performance of its oil assets. Despite such differences in payout and control rights, however, multiple classes of common stock remain "common" because they hold residual claims for dividends or other distributions that can only be exercised after other claims against the firm and its earnings are satisfied.

By contrast, preferred stock is, as the name implies, stock with a claim on the company's residual earnings or assets that comes ahead of common stock. The precise rights of preferred stockholders vary from issue to issue, and are defined either in the corporate charter or, more commonly, in a separate "certificate of designation" drafted pursuant to a provision of the charter empowering the board to issue preferred stock. Generally, preferred stock pays a fixed dividend that must be paid before common stock receives any dividend payment. As with common stock, the board of directors of the corporation has the discretion to withhold dividends from holders of preferred stock (Preferred stock is still stock, so there is no hard and fast contractual obligation to pay dividends on it.) The point, however, is that if preferred must be paid before common receives anything, there is considerable pressure on the board to pay preferred dividends. This pressure may be further enhanced by giving preferred limited control rights. Generally, preferred stock does not carry the right to vote for directors, but the preferred contract may shift this right from common to preferred stock if no dividends are paid to preferred holders for an extended period such as six quarters. (If nothing is said about voting rights in the corporate charter or certificate of designation, the presumption is that preferred stock carries the same voting rights as common stock.) Finally, preferred stock may also be redeemable by the corporation for a price, or convertible by its holder into shares of common stock at a pre-set ratio.

## **Questions on New York Times Balance Sheet - Please download from website**

## 2. Forms of Debt

In addition to equity, corporations obtain capital through debt. In general, there are three main sources of debt: trade debt, bank debt, and bonds (unsecured bonds are also called debentures and bonds with a maturity of less than 10 years are also called notes). Trade debt consists mainly of debt owed to suppliers and shows up in a balance sheet as accounts payable. The terms of trade debt are mostly straightforward: payment of the amounts due within a certain (relatively short) period of time.

The terms of bank debt and bonds are more complex. Such debt can be secured or unsecured. Other corporations sometimes guarantee the payment of such debt. The interest rate on bank debt or bonds may be fixed or may fluctuate. Bank debt is sometimes issued under a revolving credit agreement -- that is, the corporation does not borrow the whole amount when the agreement is signed, but rather borrows (and repays) amounts as needed (naturally, up to a certain limit).

Just like Integrated Resources Preferred Stock was redeemable by the company, bonds are often redeemable (or callable) by the corporation -- e.g. the company may have the right to redeem ("call") a \$1,000 bond for, say, \$1,005. Other bonds contain sinking fund provisions requiring the company to redeem or repurchase a certain amount of bonds each year. Call provisions are also referred to as optional redemption, and sinking funds as mandatory redemption provisions. Some bonds are contractually subordinated to other specified debt (called senior indebtedness); in such a case, holders of subordinated debt are not paid until the holders of senior indebtedness have been paid in full. Other bonds are convertible into common stock.

Most bonds pay interest in cash at a fixed rate. Other bonds are "zero-coupon", i.e. they pay no interest, but when they become due the company must pay an amount significantly higher than the amount the company received when the bond was sold (e.g., a \$1,000 zero-coupon bond due 1995 may have been issued in 1985 for \$400). A few bonds pay interest at rates that vary over time. For example, the interest rate may be tied to the rate paid by the U.S. Government on treasury bills plus a fixed premium.

Furthermore, bank debt agreements and the "agreements" under which bonds are issued (called "indentures") generally contain limitations on what a company may do (called "covenants"). These covenants can, for instance, limit the right of the company to pay dividends, to make certain investments, or to incur additional debt.

In short, the terms of bank debt and bonds differ widely. For the moment, it is not necessary for you to memorize these differences. However, you should try to obtain some familiarity with the terms since these terms will reappear throughout the course and, more importantly, in the legal practice of those of you who will deal with corporations.

## 3. Creditor Priority

As a general rule, in a dissolution or liquidation, all debt has *equal* priority: no one debt is has the right to be paid off before any other debt. Thus, if a company's assets are not sufficient to pay all the debt in full, the debt is paid off *pro rata*. That is, each creditor receives, in payment of her claim, a fraction of the amount of the debt owed to her that equals the fraction of the total assets held by the company to the total debt owed by the company.

Assume, for example, that ABC Inc. has \$5 million in assets and owes \$2 million to Mark, \$3 million to Nora, and \$5 million to Olga. The total amount of debt owed by ABC is then \$10 million and the fraction of total assets to total debt is 1/2. Thus, each of Mark, Nora and Olga get 1/2 of the respective amount owed to them.

There are 3 important exceptions to the general rule that all debt has equal priority. First, there is secured debt. Secured debt is secured by certain assets; such assets are called "collateral." If debt is secured, the collateral is used *first* to pay off the debt secured by the collateral. If, after paying the secured debt, some collateral is left over (e.g. if the collateral was worth \$100 million and the secured debt owed was only \$60

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million), the remainder (\$40 million) is distributed *pro rata* among the unsecured debt. If the collateral is not sufficient to pay the secured debt in full (e.g. if the secured debt owed was \$100 million but the collateral was worth only \$70), the unpaid portion of the secured debt (i.e. \$30 million) is treated like another \$30 million of unsecured debt, i.e. it receives a *pro rata* portion of the assets that do not constitute collateral.

Second, there is voluntary involuntary subordination. Think of voluntary subordination as a contract between creditors in which some creditors agree that their debt is subordinated to the (senior) debt owed to certain other creditors.<sup>1</sup> (Thus, there are three kinds of debt: subordinated debt, senior debt, and debt owed to creditors which are not party to this contract and which therefore is neither subordinated nor senior.) Subordination means that, if the company that owes the debt (the debtor) does not repay the senior debt in full, the holders of subordinated debt will pay any deficiency, *but only to the extent they receive payment by the debtor on account of their subordinated debt*. That is, the holders of voluntarily subordinated debt agree to subordinate their right to be repaid to the right of the holders of senior debt to be repaid. Involuntary subordination is when the court forces a party it believes has acted wrongly to subordinate its claims to those of other creditors.

Third, the federal Bankruptcy Code establishes certain classes of unsecured debt (e.g. unpaid taxes) which have priority over other unsecured debt in a federal bankruptcy case.

Take a look at the following problems and try to figure out how much of each kind of claim is paid. (A claim, in this context, means the right to be paid on account of debt owed to the claimant.) Hints: if there is secured debt, first figure out how much of the collateral is used to pay the secured debt and then figure out how the remaining assets are distributed; if there is subordination, first figure out the *pro rata* distribution to the creditors that are neither senior nor subordinated (and are thus not affected by the subordination); then allocate the remaining assets first to the senior claims (until they are paid in full) and then to the subordinated claims; if there is both secured debt and subordination, deal first with the secured debt and then with the subordination.

### Distribution Problems

In all cases, the company has total assets of \$5 million. Amounts are stated in million of dollars.

1)

		Distrib. of Collateral	Distrib. of Other Assets	Total Distribution
Value of Collateral:	\$2			
Secured Creditors' Claim:	\$2	_____	_____	_____
Unsecured Creditors' Claims:	\$7		_____	_____

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<sup>1</sup> There is also involuntary (or equitable) subordination, in which the court forces a party it believes has acted wrongly to subordinate its claim to those of other parties.

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2)

		Distrib. of Collateral	Distrib. of Other Assets	Total Distribution
Value of Collateral:	\$1			
Secured Creditors' Claim:	\$2	_____	_____	_____
Unsecured Creditors' Claims:	\$7		_____	_____

3)

		Distrib. of Collateral	Distrib. of Other Assets	Total Distribution
Value of Collateral:	\$3			
Secured Creditors' Claim:	\$2	_____	_____	_____
Unsecured Claims:	\$7	_____	_____	_____

4)

		Pro Rata Distribution	Subordination Distribution
Senior Claims:	\$3	_____	_____
Subordinated Cl.:	\$2	_____	_____
Other Claims:	\$5	_____	_____

5)

		Pro Rata Distribution	Subordination Distribution
Senior Claims:	\$3	_____	_____
Subordinated Cl.:	\$5	_____	_____
Other Claims:	\$2	_____	_____

6)

		Pro Rata Distribution	Subordination Distribution
Senior Claims:	\$5	_____	_____
Subordinated Cl.:	\$2	_____	_____
Other Claims:	\$3	_____	_____

7)

		Distrib. of Collateral	Pro Rata of Other Assets	Subord. Distribution	Total Distrib.
Value of Collateral:	\$1				
Senior Secured Creditors' Cl.:	\$2	_____	_____	_____	_____
Subord. Unsecured Creditors' Cl.:	\$3		_____	_____	_____
Other Unsecured Creditors' Cl.:	\$4		_____	_____	_____

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8)

		Distrib. of Collateral	Pro Rata of Other Assets	Subord. Distribution	Total Distrib.
Value of Collateral:	\$1				
Secured Creditors= Cl.:	\$2	_____	_____	_____	_____
Senior Unsecured Creditors=Cl.:	\$2		_____	_____	_____
Subord. Unsecured Creditors=Cl.:	\$4		_____	_____	_____
Other Unsecured Creditors=Cl.:	\$1		_____	_____	_____

**4. Expected Return in II.A**

Class lecture. For further detail, see Klein, Coffee, Business Organization and Finance (7<sup>th</sup> ed), pp. 226-228.

**5. Agency Costs of Debt**

The possibility that creditors are not repaid in full (which is increased by limited liability) results in potential conflicts of interest between shareholders and creditors. Shareholders, and not creditors, elect the board of directors, which in turn manage the company. Creditors may thus reasonably fear that, unless restrained, companies will act in the interest of shareholders where shareholder interests conflict with those of creditors. If the agents (here the directors) do not fully take into account the interest of all their principals (here the creditors), there may be undesirable consequences. These undesirable consequences are called "agency costs of debt." (Later on, we will deal with agency costs of equity, which result from the fact that directors do not fully take into account the interests of shareholders.)

Agency costs of debt come in three basic flavors. First, actions by companies which are in the interest of shareholders, but not in the combined interest of shareholders and creditors. Second, the costs of designing contracts or laws designed to prevent managers from taking such actions. Third, the costs of monitoring compliance with such contracts or laws. The following problems illustrate the first kind of agency costs. The remainder of this section of the materials deals with the laws and contracts designed to prevent the more egregious kind of activities that harm creditors.

**Problems**

1. One year from now, Alpha Corp. has to repay \$120 million in principal and interest. Alpha Corp. is faced with two alternatives. One, declare a special dividend of \$50 million and invest the remaining assets in Project A. Project A is certain to yield one year from now \$100 million. Two, not pay any dividend and invest all assets in Project B. Project B has a 50% chance of yielding one year from now \$120 million and a 50% of yielding one year from now \$200 million.

One year from now, Alpha Corp. will pay up to \$120 million to its creditors and distribute any remaining assets to its shareholders.

(a) What is the expected value to creditors of the first alternative? What is the expected value to creditors of the second alternative?

(b) What is the expected value to shareholders of the first alternative? What is the expected value to

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shareholders of the second alternative?

(c) What would Alpha Corp. do if it tries to maximize expected shareholder value? What should it do in order to maximize the expected joint value of shareholders and creditors?

2. One year from now, Beta Corp. has to repay \$50 million in principal and interest. Beta Corp. can now invest either in Project A or Project B. Project A has a 40% chance of yielding one year from now \$70 million and a 60% chance of yielding \$50 million. Project B has a 10% chance of yielding one year from now \$200 million and a 90% of yielding one year from now \$30 million.

One year from now, Beta Corp. will pay up to \$50 million to its creditors and distribute any remaining assets to its shareholders.

(a) What is the expected value to creditors of the first alternative? What is the expected value to creditors of the second alternative?

(b) What is the expected value to shareholders of the first alternative? What is the expected value to shareholders of the second alternative?

(c) What would Beta Corp. do if it tries to maximize expected shareholder value? What should it do in order to maximize the expected joint value of shareholders and creditors?

3. Same facts as in Question 2, except that Project B has a 20% chance to yield \$200 one year from now and a 80% chance to yield \$30 million.

(a) What is the expected value to creditors of the first alternative? What is the expected value to creditors of the second alternative?

(b) What is the expected value to shareholders of the first alternative? What is the expected value to shareholders of the second alternative?

(c) What would Beta Corp. do if it tries to maximize expected shareholder value? What should it do in order to maximize the expected joint value of shareholders and creditors?

4. Are shareholders led to prefer projects that involve more risk or less risk? Are creditors led to prefer projects that involve more risk or less risk? What other actions can companies take that benefit shareholders and harm creditors?

## 6. Questions on Certificate of Designation for Preferred Stock

Below you will find a certificate of designation for the \$3.07 Cumulative Convertible Preferred Stock of Integrated Resources, Inc. (Any idea what "\$3.07" and "Cumulative" stand for?) Spend a few minutes thinking about what you would like to be protected against if you were a preferred stockholder. Then read the excerpt of the Certificate of Designation of Integrated Resources and the case dealing with the rights of Preferred Stockholders of Marriott that follows.

Note that Integrated's Preferred Stock is convertible into common stock. That is, the economic value of the Preferred Stock lies not only in the right to receive the dividends etc. to which a preferred stockholder is entitled, but also in the right to exchange the preferred stock into common stock if the value of the common stock rises high enough.

In reading the Certificate and answering the questions below, assume that Integrated Resources, Inc. ("Integrated") has 3 million shares of Common Stock and 1 million shares of Preferred Stock issued and outstanding. All the Preferred Stock is held by Tamara, a wealthy investor.

Consider the following questions. (The relevant sections are noted next to each question.)

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1. Is Tamara *entitled* to receive any dividends on her preferred stock? If not, when does Tamara receive dividends? If no dividends are paid on the Preferred Stock, may Integrated pay any dividends on its common stock? (Sections 2 and 5)

2. If dividends are paid, what amount will Tamara receive on June 1 of each year? (Section 2)

3. Assume that Integrated has paid all dividends on its preferred stock except those for March 1 and June 1, 1982. If Integrated wanted to redeem Preferred Stock on August 1, 1982, what is the price per share that Integrated would have to pay to Tamara? (Section 3)

4. Assume that Integrated will be liquidated next week and that its net assets (i.e., its assets less its liabilities) may take on any of the following values: (i) \$10 million, (ii) 25 million, (iii) \$50 million, (iv) \$100 million, (v) \$150 million or (vi) \$200 million. There are no accrued and unpaid dividends.

(a) How much will Tamara receive, in each of these cases, if (x) she holds on to the Preferred Stock or (y) she converts her Preferred Stock into Common Stock under Section 6(A)? How much will the holders of the 3 million shares of Common Stock receive? (Sections 4 and 6(A))

(b) How would you describe the "business deal" between Tamara and Integrated when Tamara bought her 1 million shares given the liquidation preference of \$25 per share and the conversion rate? (Describe the deal either verbally or graphically without the use of legal or technical terms.)

5. Assume that Integrated splits its Common Stock by replacing each (old) share of Common Stock with two (new) shares.

(a) How many shares of Common Stock will be outstanding after the stock split?

(b) If the conversion rate does not change, how much will Tamara receive if she converts her shares of Preferred Stock into Common Stock before the liquidation. (Use the net asset values from Question 4.)

(c) How is Tamara affected by the stock split? Absent 6(c)(i), is the stock split within the spirit of Tamara's business deal with Integrated?

(d) What effect does Section 6(C)(i) have on Tamara's conversion rights and on the amount Tamara would receive in a liquidation if she exercises her conversion rights?

6. Now assume that Integrated has a net asset value of \$200 million.

(a) If Tamara converts, how many shares of Common Stock with what value will she receive? What will be the per share value of the Common Stock?

(b) Assume that the "current market price" for one share of Common Stock is equal to the value calculated above. Integrated distributes to each holder of Common Stock a Warrant entitling such holder to purchase, for each share of Common Stock such holder owns, another share of Common Stock, at a price of \$5 per share. All holders of Common Stock immediately exercise this right.

(i) How many shares of Common Stock will be outstanding after the distribution and exercise of the Warrants?

(ii) Assuming no adjustment to the conversion rate, how much will Tamara receive if she converts her Preferred Stock after the distribution of the Warrants?

(iii) What adjustment in the conversion rate is required by Section 6(C)(iii)? How many shares of Common Stock, with what value, will Tamara receive upon conversion? How would you describe the effect of the adjustment on the business deal between Tamara and Integrated?

7. Why are provisions such as Sections 6(C)(i) and (iii) called anti-dilution provisions?

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**Certificate of Designation, Preferences and Rights of  
\$3.07 Cumulative Convertible Preferred Stock of  
Integrated Resources, Inc.**

2. Dividends. The dividend rate on the Preferred Stock shall be \$3.07 per annum, and no more, payable on the first days of March, June, September and December, commencing March 1, 1981. Dividends thereon shall accrue from the date of issuance thereof. Dividends shall be paid on the Preferred Stock only when, as and if declared by the Board of Directors out of funds legally available therefor. Any dividends payable to holders of Preferred Stock which are not paid shall be cumulative.

3. Redemption.

(A) The Company may, at the option of the Board of Directors, at any time or from time to time, commencing one year after the date of the issuance thereof, redeem the whole or any part of the then outstanding shares of the Preferred Stock upon notice duly given as hereinafter specified, at the following prices per share if redeemed during the twelve-month period beginning November 26 of the year indicated:

1981.....	\$28.00	1985.....	\$26.00
1982.....	\$27.50	1986.....	\$25.50
1983.....	\$27.00	1987, and	
1984.....	\$26.50	thereafter....	\$25.00

together in each case with accrued and unpaid dividends through the date of redemption. ...

4. Liquidation. Upon any liquidation, dissolution or winding up of the Company, whether voluntary or involuntary, the holders of the shares of the Preferred Stock shall be entitled, before any distribution or payment is made upon any Common Stock, and subject to the rights of holders of senior securities, to be paid, out of the assets of the Company available for distribution to its shareholders, an amount in cash equal to \$25 per share on each outstanding share of the Preferred Stock, plus accrued and unpaid dividends payable in respect of the Preferred Stock, and the holders of such shares shall not be entitled to any further payment. .

5. Priority.

(A) So long as any shares of Preferred Stock shall be outstanding, no dividends, whether in cash or property, shall be paid or declared, nor shall any other distribution be made, on the Common Stock of the Company or any other security junior to the Preferred Stock as to dividend rights, unless all dividends on the Preferred Stock for all past quarterly dividend periods and the full dividends for the then current quarterly period shall have been paid or declared and duly provided for. The provisions of this paragraph shall not, however, apply to a dividend payable in the Common Stock or any other security of the Company junior to the Preferred Stock.

...

6. Conversion Rights. The holders of shares of the Preferred Stock shall have conversion rights as follows:

(A) The shares of the Preferred Stock shall be convertible, at the option of the respective holders thereof, at any time prior to the termination of the right to convert as hereinafter set forth, at the office of any transfer agent for the Preferred Stock, or if there is no such transfer agent, at the principal executive office of the Company, into fully paid and non-assessable shares of Common Stock of the Company at the conversion rate in effect at the time of conversion, determined as hereinafter provided. Each share of the Preferred Stock shall

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initially be convertible into one share of Common Stock. Such initial conversion rate shall be subject to adjustment from time to time in certain instances, as hereinafter provided. ...

(C) The conversion rate hereinabove provided for shall be subject to the following adjustments:

(i) In case the Company shall (a) pay a dividend on its Common Stock in shares of the capital stock of the Company, (b) subdivide its outstanding Common Stock, (c) combine the outstanding Common Stock into a smaller number of shares, or (d) issue by reclassification of its Common Stock (whether pursuant to a merger or consolidation or otherwise) any shares of the capital stock of the Company, the conversion rate in effect on the record date for any stock dividend or the effective date of any such other event shall be increased (or decreased in the case of a reverse stock split) so that the holder of each share of the Preferred Stock shall thereafter be entitled to receive, upon the conversion of such share, the number of shares of Common Stock or other capital stock which he would own or be entitled to receive after the happening of any of the events mentioned above had such share of the Preferred Stock been converted immediately prior to the close of business on such record date or effective date. The adjustments herein provided for shall become effective immediately following the record date for any such stock dividend or the effective date of any such other events. ...

(iii) In case the Company shall issue rights or warrants to the holders of its Common Stock entitling them to subscribe for or purchase Common Stock at a price per share less than the current market price per share off the Common Stock on the record date for determination of shareholders entitled to receive such rights or warrants, then in each such case the number of shares of Common Stock into which each share of the Preferred Stock shall thereafter be convertible shall be determined by multiplying the number of shares of Common Stock into which such share of the Preferred Stock was theretofore convertible by a fraction, of which the numerator shall be the number of shares of Common Stock outstanding on the date of issuance of such rights or warrants plus the number of additional shares of Common Stock offered for subscription or purchase, and of which the denominator shall be the number of shares of Common Stock outstanding on the date of issuance of such rights or warrants plus the number of shares which the aggregate offering price of the total number of shares so offered would purchase at such current market price. For the purposes of this paragraph (iii), the issuance of rights or warrants to subscribe for or purchase shares of securities convertible into Common Stock shall be deemed to be the issuance of rights or warrants to purchase the shares of Common Stock into which such shares or securities are convertible at an aggregate offering price equal to the aggregate offering price of such shares or securities plus the minimum aggregate amount (if any) payable upon conversion of such shares or securities into Common Stock. ...

7. Voting Rights. The holders of the Preferred Stock shall have no right to vote for any purpose, except as specifically required by the General Corporation Law of the State of Delaware and except as follows:

(A) If at any time cumulative dividends on the shares of the Preferred Stock then outstanding aggregating an amount at least equal to six full quarterly dividends shall be in arrears and unpaid, the holders of the Preferred Stock shall have the right, voting as one class together with any other series of preferred stock then entitled to vote, regardless of series, to elect two members of the Board of Directors of the Company, in addition to the directors to be elected by all other shareholders of the Company. A meeting of the holders of the Preferred Stock and any other series of preferred stock then entitled to vote shall be held within 60 days of the non-payment of such sixth dividend. Such voting power shall terminate when all accrued dividends and the dividends for the then current quarterly dividend period on all outstanding shares of the Preferred Stock shall have been paid or declared and provided for. ...

(C) So long as any shares of the Preferred Stock remain outstanding, the Company shall not, without first obtaining the consent or affirmative vote, either expressed in writing or at a meeting called for that purpose, of the holders of at least two-thirds (2/3) of the then outstanding Preferred Stock, voting as one class together with any other series of the Company's preferred stock then entitled to vote on such matter, regardless of

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series, repeal, amend or otherwise change this Certificate of Designation, Preferences or Rights or the Certificate of Incorporation of the Company in a manner which would increase or decrease the aggregate number of authorized shares of preferred stock, increase or decrease the par value of the shares of the Preferred Stock, or alter or change the powers, preferences or rights of the Preferred Stock, so as to adversely affect them. However, in case the Preferred Stock would be affected by any action referred to in this paragraph (C) in a different manner than any other series of preferred stock then outstanding, the holders of the shares of the Preferred Stock shall be entitled to vote as a series, and the Company shall not take such action without the consent or affirmative vote, as above provided, of at least two-thirds (2/3) of the total number of shares of the Preferred Stock then outstanding, in addition to or as a specific part of the consent or affirmative vote hereinabove otherwise required. ...

(D) Each share of the Preferred Stock shall entitle the holder thereof to one vote on all matters to be voted on by the holders of the Preferred Stock, as set forth above. ...