is compensated by a stipulated fee, is not an increase of his salary in the constitutional sense.

SECURITIES COMMISSION: Whether less than all holders of preferred may consent to change in priorities so as to bind those not consenting.

February 18, 1943.

Hon. C. Warren Day,
Securities Commissioner,
Indianapolis, Indiana.

Dear Sir:

I have before me your letter in which you state that you have before you an application to register an aggregate principal amount of $135,700 of Leasehold Mortgage Bonds of Marion-Washington Realty Corporation. You state that it is proposed that these Leasehold Mortgage Bonds will be exchanged, par for par, with all of the presently outstanding preferred stock of the corporation. You state further that the plan of exchange is entirely voluntary and cannot be operative until three-fourths of the outstanding preferred stock consents to the creation of the mortgage involved in the reorganization. You set out at length what you regard as the pertinent provisions of The Articles of Incorporation, including a copy of the proposed Mortgage Bonds already referred to. It is admitted by all parties concerned that the Mortgage Bonds, if and when issued, will be prior in point of preference to the existing preferred stock.

In view of the above facts, you submit a group of questions, in answer to which you desire an official opinion. Your first question is as follows:

"Is the issuance of mortgage bonds valid when the terms of such bonds seek to allocate the net earnings of the corporation in view of the allocation which the Articles of Incorporation require with respect to the payment of dividends and the retirement of outstanding preferred stock; a conflict of allocations being inevitable unless the holders of all of the outstanding
preferred stock indicate their desire to make the proposed exchange?"

Your second question is:

"Do the Articles of Incorporation of this company extend to the holders of three-fourths of the outstanding preferred stock, the right to divest the minority preferred holders of the dividend and retirement fund established for the benefit of the preferred stock?"

You then set out a quotation from The Articles of Incorporation of the company to the effect that:

"The holders of the common stock shall have the right at any time to mortgage the property of this corporation, or to cause the same to be sold; provided, however, that the proceeds of such mortgage or sale shall yield an amount sufficient to retire in full at par plus accumulated dividends (less any dividends theretofore paid in connection with such stock) all outstanding preferred stock; and provided, further, that the proceeds of any such mortgage or sale shall be used for retiring such preferred stock."

Based upon the above quoted language in the Articles of Incorporation, you ask another group of questions as follows:

"Does this particular paragraph set out the specific method by which this company may retire its outstanding preferred stock, prior to maturity, so as to incur a bonded indebtedness in lieu of preferred stock?"

Assuming an affirmative answer to the last above question, you next ask as to whether the company must avail itself of this right before being permitted to proceed under the plan of reorganization as described in your letter.

I desire, first of all, to consider your second question since, as I view it, a correct answer to this question will indicate the answer to the other questions. The question as submitted is as follows:

"Do the Articles of Incorporation of this company extend to the holders of three-fourths of the outstanding-
ing preferred stock, the right to divest the minority preferred holders of the dividend and retirement fund established for the benefit of the preferred stock?"

An interpretative consideration of the Articles of Incorporation is necessary. Article 2 of the Articles of Incorporation, among other things, provides as follows:

"The corporation shall have no power to incur or permit to be incurred any floating indebtedness in excess of $5000.00 (taxes and other governmental charges not delinquent excepted) without first securing the written consent of the holders of three-fourths of its outstanding preferred stock;

"The corporation is authorized to mortgage its interest in the foregoing property for an amount not exceeding $5000.00, the proceeds of such mortgage to be used in connection with the acquisition of the above described property. Other than said mortgage herein referred to said corporation shall not be authorized to mortgage its interest in said leasehold or the improvements on said real estate without first securing the written consent of the holders of three-fourths of its outstanding preferred stock, nor shall such property be assigned or conveyed without securing the written consent of the holders of three-fourths of the outstanding preferred stock."

Article 6 of the Articles of Incorporation provides, among other things, as follows:

"The particulars of preference of the preferred stock over the common stock shall be as follows:

"The shares of the preferred stock shall mature on October 31, 1950. The holders of the shares of preferred stock shall be entitled to receive non-cumulative dividends in an amount not to exceed 6% in any one year payable as hereinafter outlined, and said shares of preferred stock shall be callable at any time upon thirty days written notice at par plus accumulated dividends at the rate of 6% per annum (less any dividends theretofore paid in connection with such stock)."
The Article then proceeds to set out the retirement preference of such stock in the event of liquidation or at the maturity of the preferred stock. Thereafter the Articles contain the following statement:

“Dividends shall be paid on the preferred stock out of earnings as hereinafter set out. During each fiscal year from the total gross income of this corporation there shall be deducted all taxes, operating expenses, maintenance, repairs and obligations due under the mortgage referred to in the purpose clause of these Articles of Incorporation, together with other proper corporate charges. As long as any preferred stock is outstanding all income remaining after the deductions hereinbefore referred to, but before any charges for depreciation or obsolescence, shall be used for the payment of dividends and the retirement of preferred stock, 65% of such remaining income to be used for the payment of dividends on the preferred stock, which shall not exceed 6% in any one year, and the remaining 35% to be placed in a sinking fund, which fund shall be used by the Fiscal Agent of the corporation in purchasing preferred stock of this company at the lowest price obtainable.”

The Articles continue, providing that whenever $1000.00 has been accumulated for the sinking fund for retirements or whenever the Board of Directors may deem advisable the Fiscal Agent shall notify all of the preferred stockholders of the company’s willingness to receive offers from the stockholders to purchase and retire preferred stock and makes detailed provisions as to how the retirement shall take place. As a part of the same Article it is also provided as follows:

“The corporation shall not authorize or issue any stock or class of stock having priority, preference over or equality with the preferred stock now outstanding, either as to earnings or assets. In the event that said 65% of the net earnings hereinbefore referred to shall be more than enough to pay a dividend of 6% in any one year, on the preferred stock outstanding, such surplus still remaining shall be added to the earnings
represented by said 35% and used for the purchase and retirement of preferred stock as herein set out.”

Also note the following provision of the same Article 6:

“The holders of the common stock shall have the right at any time to mortgage the property of this corporation, or to cause the same to be sold; provided, however, that the proceeds of such mortgage or sale shall yield an amount sufficient to retire in full at par plus accumulated dividends (less any dividends there-tofore paid in connection with such stock) all outstanding preferred stock; and provided, further, that the proceeds of any such mortgage or sale shall be used for retiring such preferred stock.”

Article 7 of the Articles of Incorporation, among other things, provides as follows:

“Mortgage or sale of the corporation’s property and authorization to incur floating indebtedness in excess of the amount of $5,000 (exclusive of taxes and other governmental charges not delinquent) shall require the written consent of the holders of three-fourths of the outstanding preferred stock.”

If the reorganization plan contemplates the issue of another class of stock having priority and preference over, or even equal with, the preferred stock now outstanding, it seems to me that such an issue would be in violation of the contract set out in Section 6 of the Articles of Incorporation, since the Article expressly provides that: “the corporation shall not authorize or issue any stock or class of stock having priority, preference over or equality with the preferred stock now outstanding either as to earnings or assets.” The Articles of Incorporation so provide, and I have been unable to find, anything in them whereby less than the entire number of preferred stockholders could agree to the contrary so as to bind any minority.

As I understand it, however, the question involved here is the right to mortgage the property held by the corporation, and upon that subject I find two perfectly consistent methods
available. First, there is the right of the common stockholders to mortgage entirely irrespective of the wishes of the present preferred stockholders. That provision is found in Article 6 and expressly provides that the holders of the common stock shall have the right at any time to mortgage the property of the corporation if the proceeds of the mortgage shall yield an amount sufficient to retire in full at par, plus accumulated dividends, all outstanding preferred stock, provided the proceeds of such a mortgage are used for the retiring of the preferred stock. The other provisions are in Article 2 and Article 7, both of which seem clearly to be sufficient to authorize the corporation to mortgage its interest in the real estate, with the written consent of the holders of three-fourths of its outstanding preferred stock. It will be sufficient, I think, to quote from the provision of Article 7 as follows:

"Mortgage or sale of the corporation's property and authorization to incur floating indebtedness in excess of the amount of $5,000 (exclusive of taxes and other governmental charges not delinquent) shall require the written consent of the holders of three-fourths of the outstanding preferred stock."

It is true that the authority so granted is somewhat indirect in its statement, but I think, considered as a whole, it is clear that the Articles do authorize the mortgage of the company's property with the written consent of the holders of three-fourths of the outstanding preferred stock.

It remains to be determined as to whether, under such provisions, the corporation may legally borrow money with the written consent of the holders of three-fourths of the preferred stock. On this subject I desire to refer to the case of Johnson v. Fuller et al., decided by the Circuit Court of Appeals of the Third Circuit on June 27, 1941. The appellant in that case was the holder of one hundred shares of the preferred stock of the Curtiss Publishing Company, which he purchased in February, 1940. This preferred stock was issued in 1926 pursuant to a resolution of the stockholders passed in December, 1925. A part of that resolution was printed on the reverse side of each preferred stock certificate and reads as follows:

"Mortgage or sale of the corporation's property and authorization to incur floating indebtedness in excess of the amount of $5,000 (exclusive of taxes and other governmental charges not delinquent) shall require the written consent of the holders of three-fourths of the outstanding preferred stock."
“So long as any of the Preferred Stock remains outstanding, the Company will not, without the consent of the holders of two-thirds of the Preferred Stock outstanding, create any mortgage debt or other obligation which would be entitled to payment out of the assets of the corporation prior to the Preferred Stock, * * * nor shall the Company, without such consent, create any other issue of stock which shall in any way impair the rights of the holders of the present issue of Preferred Stock.”

Johnson v. Fuller et al., 121 Fed. 2nd, p. 620.

It will be unnecessary to go into detail with respect to the reasoning of the Court other than to say that it was contended by the appellant that the priority attaching to his stock could not be changed by the consent of the holders of two-thirds of such stock. The appellee contended simply that the disadvantages of the appellant with respect to his stock were no more than he had bargained for, pointing out that the contract between the Company and himself embodied in the resolution creating the preferred stock stated specifically that, by the consent of two-thirds of the preferred stock outstanding, the Company may issue other issues of stock, which may impair the priority of the preferred stock then existing. The Court considered a number of the cases and gave an exhaustive review of some of those cases, concluding as follows:

“Assuming, as we must, that the resolution creating the preferred stock, passed on December 16, 1925, constituted an essential part of the contract between the corporation and the holders of preferred stock we can perceive no reason why the company with the consent of more than two-thirds of the holders of preferred stock was not entitled to create prior preferred stock, issue additional shares of common stock and the debentures.” Johnson v. Fuller et al., 121 Fed. 2nd, p. 625.

An application for certiorari to the Supreme Court of the United States was denied on November 10, 1941.

See 314 U. S. p. 618.
See also Francke et al. v. Axton Fisher Tobacco Co. (Ky.), 160 S. W. 2nd at p. 27.

As earlier referred to in this opinion, the right to authorize an issue of stock having a priority, or even equality with the preferred stock outstanding, is expressly prohibited by the Articles of Incorporation. I think, however, upon the authority of Johnson v. Fuller et al., supra, that the right to mortgage the property of the corporation, which would create an obligation prior to that of the existing preferred stock is expressly provided for by the Articles, where the consent to such a mortgage is given by the holders of three-fourths of the preferred stock and where, as here, it appears that the method of exchange does not create a capital liability to the company without an adequate consideration in return. Your second question is answered accordingly.

I think your first question is answered by what I have already said in answer to the second question. The corporation through the vote of its common stockholders could not legally issue such mortgage bonds unless it raised sufficient money to pay off the entire preferred stocks and unless such fund was used for such purpose; but I think under the terms of the charter with the written consent of the holders of three-fourths of the preferred stock, the issuance of such mortgage bonds would be valid. Your remaining questions refer to the effect of the last paragraph of Article 6 of the Articles of Incorporation, the question being as to whether said paragraph already referred to sets out the only method by which the preferred stock may be retired. The answer to this is that such provision is the only provision available to the corporation through action of its common stockholders alone. However, as already indicated, the right to mortgage the property with the written consent of the holders of three-fourths of the preferred stock is, in my opinion, clearly provided for in the Articles of Incorporation and so long as the exchange of preferred stock for such bonds is voluntary, I think such an exchange would not be invalid affecting as it does the retirement of such part of the preferred stock as is exchanged for the bonds.