California Law Review

Volume XIX

NOVEMBER, 1930

Number 1

Convertible Securities—Legal Aspects and Draftsmanship

INTRODUCTION

A STUDY of the legal aspects of convertible securities is of little value unless it includes the draftsmanship of provisions in modern instruments which create the conversion privilege and the current statutory regulations. There do not appear to be more than sixty reported decisions dealing with the conversion privilege and less than a third of these make any substantial contribution to the law. Practically all of the decisions concern corporate bonds convertible into common stock and about half of the useful decisions were decided between 1860 and 1880. There seem to be no cases of value on the related and newer subject of stock purchase warrants, and none of importance on convertible stocks.

Conversion is the act of exchanging one class of security for another, the conversion privilege being created by a written contract between the privilege holder and the granting company. Practically all litigation respecting the conversion privilege has resulted from a simple failure or refusal of the company to issue its shares upon conversion or from a change in the circumstances which existed at the time the contract was made. The period of time during which conversion may be demanded, the proper measure of damages, and the general rights and remedies of the privilege holder and of the company upon a failure to convert have been the subject of many of these cases. Most of the remaining litigation has been due to changes in stock structure or organization such as a recapitalization, consolidation, merger or sale of assets, not anticipated at the time of the issuance of the privilege and consequently not provided for in the conversion instrument.

Poor draftsmanship and a disregard of possible corporate changes, rather than a general misunderstanding of the conversion privilege, may be set down as the principal causes of litigation on this subject. The decisions resulting from such litigation have acted as danger signals, attorneys have become more careful and litigation has been

reduced to a minimum. Improvements in legal draftsmanship were later followed by the enactment in several states of statutes regulating the creation of the conversion privilege and restricting the conversion price. Both have contributed toward perfecting the conversion instrument itself. The modern instruments are not ideal in all respects but they show a sincere attempt by the draftsman to produce a document which is accurate and comprehensive and at the same time simple and workable. The improvement in the form and substance of the conversion instrument has prevented the growth of a long line of judicial interpretations, but has produced a wealth of documentary material. This study, therefore, attempts to outline the law as reflected by judicial decisions and statutes and to analyze the modern conversion instrument.

THE CONVERSION PRIVILEGE

Conversion may be broadly defined as the act of exchanging securities of one class for securities of a different class, the exchange being effected by a surrender of the original security and the issuance to the holder of a new security in its place. Convertible securities are corporate securities which may, pursuant to their terms, be changed into or exchanged for other securities, such as bonds or notes exchangeable for preferred or common stock, or preferred stock exchangeable for common stock. Except in isolated cases the privilege of conversion is optional with the holder of the security, and senior securities are convertible into junior securities of the same company. In each case the privilege of conversion is created or evidenced by a certificate of incorporation, trust indenture, deed of trust or other document setting forth in full the terms and conditions under which the privilege may be exercised. In this study all such documents are, for the sake of brevity, called the conversion instrument.

The conversion privilege is inherently the same whether attached to corporate obligations or to shares of stock. Bonds, notes and shares of stock retain their respective characteristics upon being made convertible into other securities, the conversion privilege being an optional and alternative right of the holder in addition to and separate from the right to be paid a sum of money or to exercise the usual rights of a stockholder. Although the privilege may not be divorced from the holder of the security to which it is attached, it is no part of the security itself and must be construed as if embodied in a separate instrument.¹ Fundamentally, it is an independent optional right. The

¹ *Hotchkiss v. National Banks* (1874) 88 U. S. (21 Wall.) 354; *Lisman v. Milwaukee, Lake Shore & Western Ry. Co.* (C. C. Wis. 1909) 161 Fed. 472, *aff'd.* (C. C. A. 7th, 1909) 170 Fed. 1020, certiorari denied (1909) 214 U. S. 520; *P. W. Brooks & Co. v. North Carolina Public Service Co.* (D. C. N. C. 1929) 32 F. (2d)

privilege is, however, inseparably connected with the security which evidences it and is available only to the holder.² It may not be exercised by, or transferred to, one who is not the holder of the security itself. A transfer of the security acts also as a transfer of the privilege.³

The right to be paid the principal amount of, and the interest on, a corporate obligation is in no way prejudiced if the holder of such obligation has the privilege of converting it into shares of stock of the obligor. Consequently the invalidity of the conversion privilege has no effect whatsoever on the validity of the obligation or on the liability of the obligor to discharge the debt represented thereby.⁴

The fact that a corporate obligation may be converted into shares of stock of the obligor does not affect the negotiability of the obligation itself. A convertible obligation is not an alternative covenant of the company to pay in money or in shares of its stock, as the option to receive money or shares rests in the holder and not in the maker. The privilege is no part of the promise to pay a sum of money on a fixed day but is a separate and independent covenant which in no way affects or destroys the negotiability of the instrument which it accompanies.⁵ Furthermore a collateral or attached script agreement granting to the holder of a corporate obligation the privilege of conversion into stock does not affect the negotiability of the obligation.⁶ It has been held,

800, *aff'd.* (C. C. A. 4th, 1930) 37 F. (2d) 220; *Wood v. Whelen* (1879) 93 Ill. 153; *Parkinson v. West End Street Ry. Co.* (1899) 173 Mass. 446, 53 N. E. 891; *Denney v. Cleveland & Pittsburg Ry. Co.* (1875) 28 Ohio St. 108; *Gay v. Burgess Mills* (1909) 30 R. I. 231, 74 Atl. 714.

For scholarly discussions of convertible securities, see *BERLE, STUDIES IN THE LAW OF CORPORATION FINANCE* (1928) chapter VII; *BALLANTINE, MANUAL OF CORPORATION LAW AND PRACTICE* (1930) 909, 913, 996, 1002, 1011, 1029.

² *Denney v. Cleveland & Pittsburg Ry. Co.* (1875) 28 Ohio St. 108.

³ *Denney v. Cleveland & Pittsburg Ry. Co.* (1875) 28 Ohio St. 108. But see *Maroney v. Wheeling & Lake Erie Ry. Co.* (D. C. S. D. 1929) 33 F. (2d) 916; *Cheatham v. Wheeling & Lake Erie Ry. Co.* (D. C. N. Y. 1930) 37 F. (2d) 593. In speaking of the conversion privilege in *Lisman v. Milwaukee, Lake Shore & Western Ry. Co.* (C. C. Wis. 1909) 161 Fed. 472, the court said: "It is not negotiable and when it passes by assignment the assignee steps into the shoes of the assignor."

⁴ *Hotchkiss v. National Banks* (1874) 88 U. S. (21 Wall.) 354; *Lisman v. Milwaukee, Lake Shore & Western Ry. Co.* (C. C. Wis. 1909) 161 Fed. 472; *Wood v. Whelen* (1879) 93 Ill. 153; *Parkinson v. West End Street Ry. Co.* (1899) 173 Mass. 446, 53 N. E. 891; *Muhlenberg v. Philadelphia & Reading R. Co.* (1864) 47 Pa. 16.

⁵ *Hotchkiss v. National Banks* (1874) 88 U. S. (21 Wall.) 354; *Lisman v. Milwaukee, Lake Shore & Western Ry. Co.* (C. C. Wis. 1909) 161 Fed. 472; *Pratt v. Higginson* (1918) 230 Mass. 256, 119 N. E. 661, 1 A. L. R. 714; *Welch v. Sage* (1872) 47 N. Y. 143, 7 Am. Rep. 423.

⁶ *Hotchkiss v. National Banks* (1874) 88 U. S. (21 Wall.) 354; *Hodges v. Shuler* (1860) 22 N. Y. 114; *Welch v. Sage* (1872) 47 N. Y. 143, 7 Am. Rep. 423.

however, that the conversion privilege itself is not negotiable, and that when the privilege passes by assignment the assignee takes only the rights of the assignor.⁷

The holder of a convertible obligation is not a stockholder in equity or at law nor is he a subscriber to shares of stock of the issuing company. Being merely the holder of a contractual privilege pursuant to which he has the option of becoming a stockholder he can acquire none of the rights of a stockholder unless and until he complies with all of the terms and conditions of his contract.⁸ It has therefore been held that such holder has no right to question the declaration or payment of cash or stock dividends, the authorization or issuance of additional shares of the class issuable upon conversion, or the change in par value of existing shares issuable upon conversion.⁹

Stock purchase warrants and convertible securities are closely related in that both are contractual options for the purchase of shares. A conversion instrument and a warrant instrument are substantially alike in principle and draftsmanship, and a warrant instrument will contain all the essential adjustments and other protective features later referred to as customary in conversion instruments. Taking them as a class the only essential difference is in the consideration payable. A warrant is exercised by the payment of cash, while a privilege of conversion is exercised by the surrender of a corporate obligation or a share of stock. In some cases, however, the obligation to which a warrant is attached upon original issue may be surrendered in lieu of cash, in which case the warrant is in effect a detachable conversion privilege as well as a true warrant. Practically all warrants are attached to corporate obligations or to shares of stock upon original issuance, and the company can select the type of security best suited to its corporate structure by determining whether it would prefer to receive cash upon the exercise of an option warrant or obtain the discharge of an obligation, or of stock carrying a fixed redemption and dissolution value, upon the exercise of a conversion privilege.

⁷ *Lisman v. Milwaukee, Lake Shore & Western Ry. Co.* (C. C. Wis. 1909) 161 Fed. 472. See also *Van Allen v. Illinois Central R. Co.* (1861) 20 N. Y. Super. Ct. (7 Bosw.) 515.

⁸ *Pratt v. American Bell Telephone Co.* (1886) 141 Mass. 225, 5 N. E. 307, 55 Am. Rep. 465; *Chaffee v. Middlesex R. Co.* (1888) 146 Mass. 224, 16 N. E. 34; *Parkinson v. West End Street Railway* (1899) 173 Mass. 446, 53 N. E. 891; *Gay v. Burgess Mills* (1909) 30 R. I. 231, 74 Atl. 714.

⁹ *Pratt v. American Bell Telephone Co.* (1886) 141 Mass. 225, 5 N. E. 307; *Sutliff v. Cleveland & Mahoning Railroad Co.* (1873) 24 Ohio St. 147; *Gay v. Burgess Mills* (1909) 30 R. I. 231, 74 Atl. 714.

POWER OF A CORPORATION TO ISSUE CONVERTIBLE SECURITIES

The power of a corporation to issue obligations and to grant the privilege of conversion to the holders thereof has not been seriously questioned, even in the absence of statutory permission. The issuance of convertible bonds, debentures and other obligations has been recognized by the courts as a common practice of corporations¹⁰ although it has been stated in one decision that the common law right of a corporation to incur indebtedness and to issue evidences thereof does not include the right to issue bonds convertible into shares of its stock.¹¹ Granting that a corporation has the power to issue obligations convertible into shares of its stock such power may apparently be exercised irrespective of whether the corporation is at the time in a position legally to issue its shares upon the exercise of the conversion privilege. The power of a corporation to issue binding obligations having an optional conversion privilege is held to be a primary power, and in no way dependent upon its authority to issue shares upon the conversion of such obligations. Some early decisions have gone so far as to hold that convertible obligations may be issued where the authority to do so has been given by charter or statute, notwithstanding that the exercise of the conversion privilege would result in an increase of the authorized shares of such corporation without the consent of its shareholders.¹² As a condition precedent to the issuance of convertible obligations modern

¹⁰ In *P. W. Brooks & Co. v. North Carolina Public Service Co.* (D. C. N. C. 1929) 32 F. (2d) 800, 802, the court stated, in regard to the practice of issuing convertible bonds, that "the validity of such a provision has been recognized throughout this country to such an extent that it is needless to cite any authority to support this view."

¹¹ *Wall v. Utah Copper Co.* (1905) 70 N. J. Eq. 17, 26, 62 Atl. 533, 536. Pitney, V. C., made the following statement: "The next point made by the complainant is that there is no authority by the common law or by our statute for issuing convertible bonds of this character. They argue, and rightly, that the right to issue bonds and secure them by mortgage is not given by any statute, but rests entirely upon the common law right of a corporation to incur indebtedness, and that right does not include a right to issue bonds convertible into stock." But see *Behnont v. Erie Railway Company* (1869) 52 Barb. (N. Y.) 637.

¹² *Wood v. Whelen* (1879) 93 Ill. 153. It was there held that a bondholder would be charged with notice that he might not be able to convert his bond into stock unless the stockholders should thereafter assent. *Behnont v. Erie Railway Company* (1869) 52 Barb. (N. Y.) 637; *Ramsey v. Erie Railway Company* (1869) 38 How. Pr. (N. Y.) 193. See also *Farmers Loan and Trust Co. v. Hewitt* (1922) 94 N. J. Eq. 65, 118 Atl. 267.

The Erie Railway cases were decided under a statute permitting directors to create convertible bonds, and the court held that such power permitted the directors to create additional shares and issue such shares upon conversion of the bonds. The New York statute now requires the consent of stockholders, but such consent having been given, permits the directors to file an amended certificate of incorporation creating the necessary shares. N. Y. STOCK CORPORATION LAW (1923) §16, N. Y. Laws 1923, c. 787, as amended by N. Y. Laws 1926, c. 148.

legal practice and business precaution demand, however, that a corporation have an authorized capitalization sufficient to meet all conversion requirements, and that adequate shares be reserved for the exercise of such privilege. It is now understood that the existence of a power to issue convertible obligations does not dispense with the necessity of creating shares in strict compliance with statutory requirements, which may be issued upon conversion. Shares of stock may not be issued, even upon conversion, until they have been properly created.

The authority of a corporation to issue shares of stock convertible into other shares seems to have received practically no judicial attention.¹³ Corporation statutes generally permit the issuance of more than one class of shares with various preferences, privileges, optional or other rights. The privilege of conversion has been customarily accepted as being within the bounds of such statutes, and corporations have been left free to grant the conversion privilege to their stockholders upon such terms and conditions as they have seen fit.

The statutes of several states now expressly permit the issuance of convertible securities and impose various limitations and regulations in respect thereto.¹⁴ Stockholders' consent for the issuance of corpo-

¹³ In *General Inv. Co. v. Bethlehem Steel Corp.* (1917) 88 N. J. Eq. 237, 102 Atl. 252, the power of a corporation to issue preferred stock convertible into common stock without statutory permission was questioned. The court did not pass upon the question but indicated that such stock could be issued on the ground that "the company unquestionably may issue preferred stock and may retire that preferred stock by buying it with the acquiescence of its holders and may issue common stock which may be purchased with the proceeds of the preferred."

¹⁴ In specifying the classes of stock which may be issued by a corporation the words "convertible" or "conversion" are used in the statutes of Alabama, Colorado, Louisiana, Mississippi, Nevada, Ohio, Pennsylvania and Virginia. The word "optional" is used in Delaware. Comprehensive statements of the conversion privilege and certain regulatory provisions are found in the statutes of Kentucky, Maryland, Michigan, Nevada, New Jersey and Ohio.

The issue of obligations convertible into stock is specifically permitted by the statutes of Kentucky, Maryland, Michigan, Nevada, New Jersey, New Mexico, New York, Ohio and Tennessee.

The Kentucky statute states that a corporation "may provide that the holders of its bonds shall be entitled, upon terms prescribed by it, to convert the same into the stock of the corporation, whether common or preferred, and that holders of its preferred stock shall be entitled, upon terms prescribed by it, to convert the same into bonds or other obligations of the corporation." KY. STATUTES (Carroll, 1915) §564-1, as amended by Ky. Acts 1926, c. 73. This authorization of stock convertible into bonds is unique.

The statutes of Maryland are by far the most comprehensive. (MD. ANN. CODE (Bagby, 1924) art. 23, §§41-45; Md. Laws 1929, c. 565; Md. Laws 1927, c. 581.) Such statutes cover the following matters: A definition of "convertible securities"; a statement that the authorization of the issuance of convertible stock shall constitute the authorization of the issuance of the stock into which such stock is convertible; a statement that the authorization of the issuance of convertible securities shall constitute the authorization of the issuance of the stock

rate obligations convertible into stock is required by practically all of such statutes. In some states the amount of consideration for which convertible securities may be issued is limited.

into which they are convertible, if and when such stock shall have been authorized; a prohibition against the issuance of stock or convertible securities for personal services to be rendered in the future; a statement that stock having a par value or securities convertible into shares of such stock may be issued for money or other consideration less than the par value of such shares or of the shares into which such securities are convertible; the power of the board of directors to authorize the issuance of shares of any class having a par value for money at not less than the par value thereof and to authorize the issuance of convertible securities, except securities convertible into shares of stock without par value, for money at not less than the par value of the shares into which such securities are convertible; and a full statement of the procedure by which shares of stock and convertible securities of a corporation may be issued, with necessary charter provisions.

The laws of Michigan provide that "the preferred stock may be made convertible at the option of the holder into common stock or any other class of stock, bonds or other securities on terms clearly set forth in the articles and expressed in the certificates therefor. In case provision for such conversion is so made, such corporation shall at all times have on hand in its treasury, sufficient shares of its common stock or such other stock as may be stipulated for, to carry such conversion into effect. (Mich. Acts 1921, No. 84, Pt. II, c. 2, §3.) The law also provides that, upon proper stockholders' consent, the directors may confer on the holder of any obligation "the right to convert the principal thereof into stock of the Corporation; and if the capital stock shall not be sufficient to meet the conversion when made, the stockholders shall from time to time, authorize an increase of capital stock sufficient for that purpose in the manner hereinabove prescribed." (Mich. Acts 1921, No. 84, Pt. II, c. 2, §12, as amended by Mich. Acts 1927, No. 335.)

The statutes of Nevada provide that "any preferred or special stocks of any class or series thereof may be made convertible into, or exchangeable for, shares of any other class or classes or of any other series of the same or any other class or classes of stock of the Corporation at such price or prices or at such rates of exchange and with such adjustments as shall be stated and expressed in the Certificate or Articles of Incorporation, or any amendment thereto, or in the resolution or resolutions providing for the issue of such stock adopted by the Board of Directors as hereinabove provided" (NEV. GENERAL CORPORATION LAWS (1925) §11, as amended by Nev. Stat. (1929) c. 216, §2). The statute further provides that a corporation may, upon certain stockholders' consent, "issue bonds, which, if therein so declared, shall be convertible at par at the option of the holder into fully paid common stock of the Corporation at par, within any period therein described not less than two years from the issue thereof; and in such case the board of Directors may authorize the issue of the common stock into which such bonds, by their terms, shall be convertible" (Revised Laws of 1912, §1138).

New Jersey provides that "any preferred or special stock may be made convertible into stock of any other class or classes upon such terms and conditions as shall be expressed in the Certificate of Incorporation or any amendment thereof, provided that stock without par value shall not be made convertible into stock with par value, unless the stated capital received upon the issuance of such stock without par shall be at least equal to the par value of the stock into which the same is made convertible" (N. J. COMP. STAT. (1910) §18, as amended by N. J. Acts 1926, c. 318, §6, and by N. J. Acts 1927, c. 313). As to convertible obligations, the statute states "every corporation organized under this act shall have

The general rules of equity are applicable to the issuance by a corporation of convertible securities. Courts of equity will not interfere with the issuance of convertible securities in strict compliance with law and upon terms that are fair, but injunctive relief will be granted if the conversion privilege is unfairly used as a stock issuance device. It has been held that an issue of bonds which have been made convertible into stock, not in good faith but for the purpose of keeping control of the corporation in the hands of certain directors, may be enjoined.¹⁵ Likewise the issuance of convertible bonds as a part of a fraudulent device to increase the capital stock may be restrained by injunction.¹⁶ On the other hand it has been held that an issue of convertible bonds will not be enjoined upon a showing that the issue was not in bad faith or for the purpose of confiscating the stockholdings of minority stockholders.¹⁷ Nor will an injunction be granted if the transaction takes place openly and in strict conformity with law, even if the conversion will operate to give a particular stockholder control of the corporation.¹⁸

power, with the consent of two-thirds in interest of the holders of each class of stock having voting powers, to issue bonds, debentures or other obligations convertible into stock of any class upon the terms in the manner and under the conditions provided in an agreement to which the Corporation shall be a party, and under which the same are issued; provided that bonds, debentures or other obligations convertible into stock with par value shall not be issued for less than the par value of such stock" (N. J. COMP. STAT. (1910) §29a, as amended N. J. Acts 1926, c. 318, §9).

In Ohio shares of stock having "conversion rights" and obligations convertible into stock, may be issued. Detailed regulatory provisions are made for the issue and sale of securities convertible into shares having par value at a price less than the par value of the shares issuable on conversion (OHIO GEN. CODE (Throckmorton, 1926) §8623-18, as amended by Ohio Laws 1929, p. 413).

Under the laws of New York (N. Y. STOCK CORPORATION LAW (1923) §16, N. Y. Laws 1923, c. 787, as amended by N. Y. Laws 1926, c. 148) the directors, when authorized by the stockholders, "under such regulations as they may adopt, may confer on the holder of any debt or obligation, secured or unsecured, the right to convert the principal thereof within such period and upon such terms and conditions as may be fixed by the resolution of the directors conferring the right of conversion, into stock of the corporation." Further provision is made that in case the authorized capital of the corporation is not sufficient to meet all conversion requirements, the directors may file a certificate of increase without further action of the stockholders.

¹⁵ *Baldwin v. Hillsborough & Cincinnati Ry. Co.* (1853) 1 Ohio Dec. (Reprints) 546.

¹⁶ *Belmont v. Erie Railway Company* (1869) 52 Barb. (N. Y.) 637.

¹⁷ *Farmers Loan and Trust Co. v. Hewitt* (1922) 94 N. J. Eq. 65, 118 Atl. 267, *aff'd*. 94 N. J. Eq. 187, 118 Atl. 926. See also *Berger v. United States Steel Corporation* (1902) 63 N. J. Eq. 506, 53 Atl. 14, reversed in 63 N. J. Eq. 809, 53 Atl. 68.

¹⁸ *Allen v. San Francisco Sugar Co.* (C. C. A. 3rd, 1912) 193 Fed. 825.

CONSIDERATION FOR ISSUANCE OF CONVERTIBLE SECURITIES

In determining the amount of consideration which a corporation must receive upon the issuance and sale of its convertible obligations, it is necessary to consider the rate or price at which such obligations may be converted by the holders into shares of stock as well as the value of the consideration actually received by the corporation for the obligations themselves. Obligations convertible into shares having a par value have come under judicial scrutiny in this respect but there seem to be no decisions dealing with the issuance of corporate obligations convertible into shares without par value. It is well settled that a corporation may not issue obligations convertible into shares having a par value at a price materially less than the principal amount of the obligations. Likewise the conversion privilege of such obligations, to be valid, must be at a rate or price which will be equivalent to the payment of the par value of the shares which are to be received upon conversion. Conversion is thus treated like an ordinary subscription to shares, except that the consideration received by the corporation upon the exercise of such subscription right is a discharge of the obligation to which the conversion privilege is attached rather than a payment in cash or property. Stockholders may obtain injunctive relief against a violation of these principles.¹⁹

The treatment of obligations convertible into shares without par value is not so simple. The actual value of shares having a par value is rarely equal to their par value, yet in determining the value at

¹⁹ In *Carver v. Southern Iron and Steel Co.* (1910) 78 N. J. Eq. 81, 78 Atl. 240, it was held that a dissenting stockholder could enjoin the issuance of debentures at 93 cents on the dollar convertible into preferred stock having par value at 70 cents on the dollar. Likewise in *Mosely v. Koffyfontein Mines, Ltd.* [1904] 2 Ch. 108, the court enjoined as void an issuance of debentures at a discount of 20 per cent convertible into shares at their par value on the ground that the debentures were capable of being used as a means of issuing shares at a discount. In *Sturges v. Stetson* (C. C. Ohio 1858) Fed. Cas. No. 13,568, it was held to be a good defense to an action on an executory contract to purchase certain railroad shares that such shares had been issued upon the conversion of a bond, such bond having been issued at a discount and being convertible into shares of stock at par. In *Van Allen v. Illinois Central Railroad Co.* (1861) 20 N. Y. Super. Ct. (7 Bosw.) 515, it was held that a corporation could issue bonds at fifty per cent of their par value, convertible into stock upon payment of the other fifty per cent. In *Re Petition Erie R. Co.* (1916) P. U. R. 1916D 113, it was held that under a New York statute a railroad, with the consent of two-thirds of its stockholders and the Public Service Commission, could issue bonds convertible into stock at any price not less than the market value of such stock, and accordingly the Erie Railroad was authorized to issue bonds convertible into stock at fifty cents on the dollar. An interesting discussion of bonds convertible into land at a discount may be found in *Howard Estates Development Co. v. Metropolitan Trust Co.* (1924) 208 App. Div. 138, 203 N. Y. Supp. 97. See also *Welles v. Chicago Northwestern Ry. Co.* (C. C. N. Y. 1908) 163 Fed. 330; *Bulkeley v. New York, New Haven & Hartford Ry. Co.* (1914) 216 Mass. 432, 103 N. E. 1033.

which such shares may be issued by a corporation the accepted standard is their par value. Shares without par value have no pre-determined standard of value and may usually be issued for such consideration as the board of directors determines. As the actual value of shares without par value may be readily ascertained at the time obligations convertible into such shares are issued and the conversion rate or price fixed, it seems reasonable to hold that the conversion rate or price must have a fair relation to actual values at such time. Where a corporation retires its obligations upon their conversion into stock, the issuing price of such stock, so far as the corporation's federal income tax is concerned, is considered to be the issuing price of the obligations plus the amount of amortized discount previously taken as a deduction by the corporation.²⁰

The value at which shares of stock convertible into other shares may be issued has not been determined at law but it seems to follow from the analogy of convertible obligations that shares with or without par value may not be converted into shares having par value at a rate less than the par value of the shares issued upon conversion, nor into shares without par value unless the conversion rate or price is reasonably fair. Stockholders may rely to some extent upon their rights of pre-emption as additional protection against a dilution of surplus through the operation of a conversion privilege.

The issue price of convertible securities has been regulated in some states by statute. The New Jersey statute provides that "bonds, debentures or other obligations convertible into stock with par value shall not be issued for less than the par value of such stock,"²¹ but Ohio permits the issuance and sale of "securities convertible into shares having par value at a price less than the par value of the shares issuable on conversion" under certain conditions and regulations.²² Nevada allows the conversion of stock "at such price or prices or at such rate of exchange and with such adjustments" as may be expressed in the certificate of incorporation.²³ The laws of Maryland contain detailed regulations for the issuance of convertible stocks and convertible obligations pursuant to which "fully paid and non-assessable shares of stock having a par value or securities convertible into fully paid and non-assessable shares of such stock may be issued for a consideration in money less than the par value of such shares or of shares into which such securities are convertible, or for a consideration other than money, the actual value of which is less than the par value of such shares or of the shares into which such securities are convertible" and pursuant to

²⁰ I. T. 2347; C. B. June, 1927, p. 86.

²¹ N. J. COMP. STAT. (1910) §29a, as amended by N. J. Laws 1926, c. 318, §9.

²² OHIO GEN. CODE (1926) §8623-16, as amended by Ohio Laws, 1929, p. 413.

which convertible stocks may be issued for such consideration as the board of directors may deem advisable.²⁴

PREEMPTIVE RIGHTS AS TO CONVERTIBLE OBLIGATIONS

The preemptive right of shareholders in connection with an issue of convertible obligations is not satisfactorily defined in the statute or decision law, but there is authority for the statement that shareholders have a preemptive right to subscribe for convertible obligations to the same extent that they would have a right to subscribe for the shares of stock into which such securities are convertible.²⁵

It has been held in New Jersey that an issue of bonds convertible into stock amounts to an issue of stock, and that convertible bonds can only be issued subject to the preemptive right of stockholders to share ratably therein.²⁶ A proposed issue of corporate bonds convertible into stock will not be enjoined, however, if it is the intention of the company to offer such bonds to its stockholders in proportion to their holdings, although stockholders failing to respond might suffer loss by a depreciation in the value of their stock holdings.²⁷

On the other hand it has been held that the New York statute, apart from an agreement between the stockholders as to a right to subscribe, does not recognize or preserve any preemptive right of subscription to bonds which have an incidental stock conversion privilege.²⁸ This decision seems sound as the New York statute authorizes the conferring of the privilege of conversion "on the holder of any debt or obligation," without distinguishing between the holders of obligations already outstanding, obligations to be created in the future, or obligations to be created simultaneously with the conferring of the conversion privilege.

The holders of convertible obligations are in a different position. They are not stockholders and have no preemptive right to subscribe

²³ NEVADA GENERAL LAWS §11, as amended by Nevada Laws 1929, c. 216, §2.

²⁴ MD. ANN. CODE (Bagby 1924) § 41, as amended by Md. Laws 1929, c. 565, §43, and Md. Laws 1927, c. 581.

²⁵ BERLE, *STUDIES IN THE LAW OF CORPORATION FINANCE* (1928) chapter VII; Frey, *Shareholders' Preemptive Rights* (1929) 38 YALE L. J. 563.

²⁶ Wall v. Utah Copper Co. (1905) 70 N. J. Eq. 17, 62 Atl. 533.

²⁷ Farmer's Loan & Trust Co. v. Hewitt (1922) 94 N. J. Eq. 65, 118 Atl. 267, *aff'd*. 94 N. J. Eq. 187, 118 Atl. 926.

²⁸ Venner v. American Telegraph & Telephone Co. (1920) 110 Misc. Rep. 118, 181 N. Y. Supp. 45, *aff'd*. 196 App. Div. 960, 188 N. Y. Supp. 956. It must be noted that in this case an opportunity for proportional subscription was given to the shareholders upon reasonable notice. See also Hackett v. Northern Pacific Ry. Co. (1901) 36 Misc. 583, 73 N. Y. Supp. 1087.

to new stock, although the issuance of new stock might dilute or destroy the value of the conversion privilege.²⁹

OBLIGATION TO CONVERT — ACTION FOR FAILURE

The issuance of securities having a conversion privilege imposes an obligation of reasonable diligence upon the company granting the privilege, and requires it to keep itself in readiness lawfully to comply with its obligation to convert.³⁰ A refusal or failure to effect a conversion upon proper demand constitutes a breach of contract for which the privilege holder is entitled to sue for damages.³¹ It has been held that the obligation to issue shares upon conversion is irrevocable and will not be excused on the ground that the company has no stock available at the time and can acquire none except by bidding it up in the open market at a ruinous rate.³² A court of equity will not, however, grant specific performance of an agreement to issue shares in discharge of a convertible obligation.³³

²⁹ *Pratt v. American Bell Telephone Co.* (1886) 141 Mass. 225, 5 N. E. 307, 55 Am. Rep. 465; *Parkinson v. West End Street Railway* (1899) 173 Mass. 446, 53 N. E. 891; Note (1928) 52 A. L. R. 238.

³⁰ In *Marony v. Wheeling & Lake Erie Ry. Co.* (D. C. S. D. 1929) 33 F. (2d) 916, the defendant railroad had failed to obtain authority of the Interstate Commerce Commission to issue shares of common stock upon the conversion of preferred stock prior to the demand for conversion. Seventeen days after the demand authority was granted upon proper application but it was held that the defendant could not plead lack of authority as an affirmative defense as it had failed to anticipate such demand for seven years and had failed to have shares of its common stock available to issue upon conversion. See also *Cheatham v. Wheeling & Lake Erie Ry. Co.* (D. C. N. Y. 1930) 37 F. (2d) 593, decided on similar facts.

A corporation need not keep itself in readiness to effect conversion except during the period its obligations are convertible. *Pratt v. American Bell Telephone Co.* (1886) 141 Mass. 225, 5 N. E. 307, 55 Am. Rep. 465.

³¹ *Lisman v. Milwaukee, Lake Shore & Western Ry. Co.* (C. C. Wis. 1909) 161 Fed. 472; *P. W. Brooks & Co. v. North Carolina Public Service Co.* (D. C. N. C. 1929) 32 F. (2d) 800, *aff'd.* (C. C. A. 4th, 1930) 37 F. (2d) 220; *Marony v. Wheeling & Lake Erie Ry. Co.* (D. C. S. D. 1929) 33 F. (2d) 916; *Chaffee v. Middlesex R. Co.* (1888) 146 Mass. 224, 16 N. E. 34; *John Hancock Mutual Life Insurance Co. v. Worcester, Nashua & Rochester Ry. Co.* (1889) 149 Mass. 214, 21 N. E. 364; *Van Allen v. Illinois Central Railroad Co.* (1861) 20 N. Y. Super. Ct. (7 Bosw.) 515; *Denney v. Cleveland & Pittsburg R. Co.* (1875) 28 Ohio St. 108.

³² *Bratten v. Catawissa R. Co.* (1905) 211 Pa. 21, 60 Atl. 319. But see *General Investment Co. v. Bethlehem Steel Corp.* (1917) 88 N. J. Eq. 237, 102 Atl. 252.

³³ *Chaffee v. Middlesex R. Co.* (1888) 146 Mass. 224, 16 N. E. 34; *Hackett v. Northern Pacific Ry. Co.* (1901) 36 Misc. Rep. 583, 73 N. Y. Supp. 1087. In *Franco-Texan Land Company v. Bousselet* (1888) 70 Texas 422, 7 S. W. 761 shares of stock of a land company were exchangeable for land and specific performance was decreed. See also *Chicago & Great Western Ry. Land Co. v. Peck* (1885) 112 Ill. 408; *Howard Estates Development Co. v. Metropolitan Trust Co.* (1924) 208 App. Div. 138, 203 N. Y. Supp. 97; *Rommel v. Summit Branch Coal Co.* (1901) 18 Pa. Super. Ct. 482; *Girard Trust Co. v. Summit Branch Coal Co.* (1903) 22 Pa. Super. Ct. 495.

The holder of an obligation convertible into stock has the privilege of electing between two alternative modes of satisfaction, but he cannot resort to both. The issuance of shares upon conversion discharges the obligation to pay money, and the payment of money operates to extinguish the privilege of conversion.³⁴ After receiving payment of the obligation the holder cannot return the money and demand shares of stock on the ground that he had forgotten about its convertibility.³⁵ The acceptance of payment in discharge of a convertible obligation, even under protest and reservation, extinguishes the right of action for a wrongful failure to convert.³⁶ Such right of action may be kept alive, however, by an agreement on the part of the defendant company that the discharge of the obligation will not act as a waiver of the right to get shares of stock or the value thereof.³⁷

In an action for wrongful failure to convert a corporate obligation into stock it has been held that the plaintiff must allege that he was the holder of the obligation at the time the cause of action arose and at the time of bringing suit.³⁸ On the other hand it has been held that

³⁴ *P. W. Brooks & Co. v. North Carolina Public Service Co.* (D. C. N. C. 1929) 32 F. (2d) 800; *Denney v. Cleveland & Pittsburg R. Co.* (1875) 28 Ohio St. 108. In *Denney v. Cleveland & Pittsburg R. Co.*, at 112, Scott, C. J., in an able opinion, comments upon the rights of a privilege holder as follows: "But if the company were to refuse the conversion of the bond into stock upon his demand, several courses would be open to him at his election. 1. He might waive, for the present, the right thus denied him, continue to draw his interest as it might accrue, and demand the principal at maturity, or renew his demand for conversion at any time thereafter before the payment of the principal. Or 2. He might divest himself of all interest in the subject-matter, and invest another party with all his rights, including the right of election as to the mode of performing the contract, by the sale and transfer of the bond. Or 3. He might stand upon and abide by the election and demand already made, and on his right to convert the bond into capital stock; and might by action recover, by way of damages for the breach of the contract, the full market value of the stock wrongfully withheld from him. But such recovery would be a bar to any other or further suit on the bond; and the payment of such damages would place the defendant in the same legal position as though the stock had been issued upon demand."

³⁵ *Johnson v. Richmond, Fredericksburg & Potomac R. Co.* (1903) 101 Va. 156, 43 S. E. 193.

³⁶ *Savage v. United States* (1875) 92 U. S. 382; *P. W. Brooks & Co. v. North Carolina Public Service Co.* (D. C. N. C. 1929) 32 F. (2d) 800. In *Savage v. United States*, plaintiff had the option of converting his treasury notes or asking their payment in gold. The treasury tendered plaintiff legal tender which was worth 32 cents less on the dollar than gold. Plaintiff protested against acceptance but did accept the legal tender and surrendered the notes. It was held that plaintiff was not entitled to recover the difference.

³⁷ *Chaffee v. Middlesex R. Co.* (1888) 146 Mass. 224, 16 N. E. 34.

³⁸ In *Denney v. Cleveland & Pittsburg R. Co.* (1875) 28 Ohio St. 108, the plaintiffs alleged that they became holders of certain convertible bonds; that they presented such bonds for conversion; that the defendant wrongfully refused to convert; and that they had acquired by assignment similar rights of action against

it is unnecessary for the plaintiff to allege that he was the holder of shares convertible into other shares at the time of bringing suit, an allegation that he was the holder at the time the cause of action arose being sufficient.³⁹ If it can be shown, however, that the plaintiff transferred his stock before he brought action and that such transfer in legal effect constituted an election by the plaintiff to waive his right of action or constituted a release of the defendant's liability to plaintiff, or if it can be shown that the plaintiff had ceased to be a party in interest, such facts may be pleaded as an affirmative defense admitting but avoiding the cause of action.⁴⁰

It has also been held that the privilege of converting one class of stock into another is in effect an offer to each person who becomes a holder of record of such stock, and, like any other offer, can be accepted or availed of only by the persons to whom it is made. Under such decision the holder of a "street certificate" would not be a stockholder of record and would not be entitled to bring action for a failure to convert as he could not show that he was a stockholder of record at the time he tendered his certificate for conversion.⁴¹ In another case an allegation that the plaintiff was a "holder" of preferred stock was held sufficient without allegation as to whether or not the plaintiff was a holder of record, as the certificate of incorporation stated that "any holder of preferred stock" might convert such stock into common stock.⁴² There seems to be no sound reason for limiting the privilege to stockholders of record, and stock transfer agents are not interested in the record ownership of certificates of stock surrendered for conversion except for transfer tax purposes. Conversion is always effected upon a proper surrender.

The refusal of a corporation to convert at the demand of a bondholder creates in such holder a right of action which does not affect

the defendant from the holders of similar bonds. The court sustained a demurrer to the plaintiff's petition because it was not alleged that the plaintiffs were, at the commencement of their action, the owners and holders of any of the convertible bonds issued by the defendant. See discussion of this case in *Cheatham v. Wheeling & Lake Erie Ry. Co.* (D. C. N. Y. 1930) 37 F. (2d) 593.

³⁹ *Marony v. Wheeling & Lake Erie Ry. Co.* (D. C. S. D. 1929) 33 F. (2d) 916.

⁴⁰ *Marony v. Wheeling & Lake Erie Ry. Co.* (D. C. S. D. 1929) 33 F. (2d) 916. In *Cheatham v. Wheeling & Lake Erie Ry. Co.* (D. C. N. Y. 1930) 37 F. (2d) 593, the court stated that the validity of an affirmative defense of transfer had not been passed upon in the *Marony* case and that it did not consider the defense good when applied to the transfer of convertible stock. See also *Denney v. Cleveland & Pittsburg R. Co.* (1875) 28 Ohio St. 108.

⁴¹ *Cheatham v. Wheeling & Lake Erie Ry. Co.* (D. C. N. Y. 1930) 37 F. (2d) 593.

⁴² *Marony v. Wheeling & Lake Erie Ry. Co.* (D. C. S. D. 1929) 33 F. (2d) 916.

the other bondholders as a class, and it is a right which may be asserted without the necessity of resorting to the trustee of the bonds as an intermediary. The usual requirement of trust indentures that the trustee shall prosecute all actions contemplates such actions as are in the interest of the bondholders as a class and does not apply to a single cause of action which does not affect the other bondholders.⁴³

In determining the measure of damages applicable in an action for wrongful failure to convert securities into shares of stock, the courts follow the general rule applied in actions for non-delivery of property under contract, the property not having been paid for, which is the difference between the contract price and the market value of the property on the day the contract was broken. The weight of authority is that damages are measured by the value of the stock deliverable immediately after a proper demand for conversion.⁴⁴ It has been held, however, that a plaintiff is not entitled to damages unless he sells the securities tendered for conversion or unless he otherwise fixes the amount of damages by an actual transaction.⁴⁵

TIME OF EXERCISE OF CONVERSION PRIVILEGE

The period of time during which securities may be converted into stock is usually limited by the instrument creating or evidencing such privilege. The privilege may become exercisable immediately upon the issuance of the securities, upon a subsequent day certain, upon any day within certain fixed limits, upon the declaration of dividends or upon the happening of an event. Likewise, the privilege may by its terms be perpetual or may terminate on a day certain, upon or prior to redemption, or upon a consolidation, merger, or sale of assets. The conversion privilege, being solely a matter of contract, may have such limitations and restrictions as the parties thereto may desire.

⁴³ *P. W. Brooks & Co. v. North Carolina Public Service Co.* (D. C. N. C. 1929) 32 F. (2d) 800.

⁴⁴ *Van Allen v. Illinois Central R. Co.* (1861) 20 N. Y. Super. Ct. (7 Bosw.) 515; *Bratten v. Catawissa Railroad Co.* (1905) 211 Pa. 21, 60 Atl. 319; *Tagart v. Northern Central R. Co.* (1868) 29 Md. 557; *Chaffee v. Middlesex R. Co.* (1888) 146 Mass. 224, 16 N. E. 34; *Howard Estates Development Co. v. Metropolitan Trust Co.* (1924) 208 App. Div. 138, 203 N. Y. Supp. 97.

⁴⁵ *Cheatham v. Wheeling & Lake Erie Ry. Co.* (D. C. N. Y. 1930) 37 F. (2d) 593. In that case preferred shares were convertible into common shares. When the market for common shares was much higher than for preferred shares the plaintiff bought preferred shares with the intention of conversion, but upon demand the company refused to convert and action was brought to recover the paper loss. It did not appear that the plaintiff had sold or agreed to sell the common shares and had demanded conversion in order to fulfill his contract. The court denied recovery and held that the right to recover must be founded upon damages actually suffered.

Where there is no limitation upon the time during which the conversion privilege may be exercised such privilege, being an option, must be acted upon within a reasonable time or the privilege holder will be chargeable with laches and will be deemed to have waived his privilege.⁴⁶ The privilege of converting an obligation into stock, unless specifically limited, may be exercised at any time during the life of the obligation, but terminates at its maturity, and the deposit of funds at maturity sufficient to discharge the obligation in accordance with the terms of a trust indenture effects a termination of the conversion privilege, although the obligations may thereafter remain uncanceled.⁴⁷ An agreement extending the time of payment of a convertible obligation does not extend the time during which such obligation may be converted into stock.⁴⁸

The redemption of convertible obligations or convertible stocks destroys the conversion privilege, and provision is always made to that effect.⁴⁹ It is usually provided that the privilege shall cease and determine at a specified number of days, say five or ten, prior to the redemption date, but it is not uncommon to provide that conversion may take place up to and including the date fixed for redemption. In some instances obligations will be accepted for conversion if properly mailed within a fixed number of days prior to the redemption date.

The holder of a convertible obligation must strictly comply with all the terms and provisions of the conversion instrument relating to time, presentation, surrender or demand before conversion may be effected.⁵⁰

⁴⁶ *Tagart v. Northern Central Ry. Co.* (1868) 29 Md. 557; *Chaffee v. Middlesex R. Co.* (1888) 146 Mass. 224, 16 N. E. 34; *Catlin v. Green* (1890) 120 N. Y. 441, 24 N. E. 941; *Landis v. Western Pennsylvania Ry. Co.* (1890) 133 Pa. 579, 19 Atl. 556.

⁴⁷ *Loomis v. Chicago, Milwaukee & St. Paul Ry. Co.* (C. C. A. 2d, 1900) 102 Fed. 233; *Carpenter v. Chicago, Milwaukee & St. Paul Ry. Co.* (1907) 119 App. Div. 169, 104 N. Y. Supp. 152, *aff'd*. 192 N. Y. 586, 85 N. E. 1107.

⁴⁸ *Muhlenberg v. Philadelphia & Reading Railroad Co.* (1864) 47 Pa. 16.

⁴⁹ *P. W. Brooks & Co. v. North Carolina Public Service Co.* (D. C. N. Y. 1929) 32 F. (2d) 800.

⁵⁰ In *Carpenter v. Chicago, Milwaukee & St. Paul Ry. Co.* (1907) 119 App. Div. 169, 104 N. Y. Supp. 152, *aff'd*. 192 N. Y. 586, 85 N. E. 1107, railroad bonds were convertible "at any time within ten days after any dividend shall have been declared and become payable" upon the delivery with unmatured coupons attached. A bondholder demanded conversion more than sixty days after a dividend was payable, and again demanded conversion after the bonds had matured. The court held that the bondholder had not complied with the provisions of the bond and that he was not entitled to conversion. In a similar case it was held that a bondholder who did not exchange his bonds while dividends were being declared and paid was not entitled to do so after dividends had ceased by reason of the absorption of the company by another, as authorized by a statute of the state in force when the bonds were issued. *Welles v. Chicago & Northwestern Ry. Co.* (C. C. N. Y. 1908) 163 Fed. 330. See also *Loomis v. Chicago,*

An interesting Massachusetts case has held that the surrender of a bond for conversion on a Monday was too late as the bond matured on the preceding Sunday, but that an offer, made to the company ten minutes after its official "close of business" on Saturday, to present bonds for conversion was a sufficient compliance with the terms and provisions of the instrument. The "close of business" must not be at an unreasonable time.⁵¹

Certificates of stock issued upon conversion are customarily issued as of a "conversion date," which may be several days prior to the actual date of issuance. This date is the date of the last act necessary to complete conversion and marks the change from the old to the new. It may be the last date upon which surrender, notice, or payment of fractional adjustments is made, or any subsequent time at which all conditions precedent have been fulfilled. An exact determination of the conversion date is of particular importance in case adjustments of interest or dividends are to be made, or in case there is any question as to the voting or subscription rights of new stockholders.

DIVIDENDS AND INTEREST

Unless specifically so provided in the conversion instrument a privilege holder is not entitled, upon the conversion of a corporate obligation, to receive accrued interest thereon to the conversion date. Likewise, the corporation cannot require the privilege holder to reimburse

Milwaukee & St. Paul Ry. Co. (C. C. A. 2d, 1909) 102 Fed. 233; *Lisman v. Milwaukee, Lake Shore & Western Ry. Co.* (C. C. Wis. 1909) 161 Fed. 472; *Campbell v. London & Brighton Ry. Co.* (1846) 5 Hare 519, 67 Eng. Reprint 1017.

In *John Hancock Mutual Life Insurance Co. v. Worcester, Nashua & Rochester Ry. Co.* (1889) 149 Mass. 214, 21 N. E. 364, railroad bonds were convertible "at any time after the completion of the road." In *Pratt v. American Bell Telephone Co.* (1886) 141 Mass. 225, 5 N. E. 307, 55 Am. Rep. 465, notes were convertible only on two specified dates. See also *Muhlenberg v. Philadelphia & Reading R. Co.* (1864) 47 Pa. 16; *Pearson v. London & Croydon Ry. Co.* (1845) 14 Sim. 451, 60 Eng. Reprint 468.

⁵¹ *Chaffee v. Middlesex R. Co.* (1888) 146 Mass. 224, 16 N. E. 34. In that case two sets of facts are presented. Bonds dated February 1st, 1875, and maturing on February 1st, 1885, contained a clause whereby they could be converted at any time before maturity unless redeemed. February 1st, 1885, was a Sunday and the bonds were held to mature on Saturday, January 31st, 1885. On Monday, February 2nd, 1885, certain bonds were surrendered for conversion and it was held that time was of the essence and that the presentation was too late to effect a valid conversion. On the other hand the company was notified at 3:10 o'clock in the afternoon of Saturday, January 31st, 1885, that bonds would be presented for conversion as soon as they could be taken from a safe deposit box. The company refused to accept the bonds, as the official time for the close of business of the company was at 3 o'clock. It was held, however, that the bondholder had made a proper demand for conversion and that presentation of the bonds themselves was not necessary in view of the company's attitude that the bonds had been received too late. The court stated that the bonds could be presented "at any reasonable time" on the date of maturity.

it for dividends accrued or earned upon the shares issued or on account of undivided surplus represented by such shares. Immediately upon conversion the privilege holder abandons his right to receive interest and acquires such dividend rights as the stock issued to him may carry. A privilege holder who effects conversion and becomes a stockholder is thereby entitled to share with other stockholders of the same class in all subsequent cash or stock dividends.⁵² It has even been held that a corporation cannot deprive its new stockholders of current dividends by declaring them payable to stockholders of record as of a date prior to the date of conversion and that dividends declared after the conversion date are payable on all shares then issued including shares issued upon conversion, although the resolution declaring such dividends sets a payment record date prior to the conversion date.⁵³

On the other hand a privilege holder is not entitled to share in cash or stock dividends paid prior to the conversion date or to dividends payable after the conversion date to stockholders of record as of a prior date.⁵⁴ It has also been held that the right to receive interest upon a convertible obligation terminates upon the conversion of such obligation into stock,⁵⁵ and it would seem to follow from such decision that the holder would not be entitled to an adjustment for accrued interest in the absence of a contractual provision therefor. Adjustments of dividends or interest are never made unless required by the conversion instrument.

Pursuant to the provisions of practically every conversion instrument, however, an adjustment of interest is made upon the conversion of bonds or debentures into common or preferred stock, but in approximately half of such cases the instrument makes no provision for an adjustment of dividends. Dividend adjustments, if required at all, are

⁵² *Pratt v. American Bell Telephone Co.* (1886) 141 Mass. 225, 5 N. E. 307; *Jones v. Terre Haute & Richmond R. Co.* (1874) 57 N. Y. 196; *Sutliff v. Cleveland & Mahoning Railroad Co.* (1873) 24 Ohio St. 147; *Gay v. Burgess Mills* (1909) 30 R. I. 231, 74 Atl. 714.

⁵³ *Jones v. Terre Haute & Richmond R. Co.* (1874) 57 N. Y. 196. Cash and stock dividends were declared December 17th payable January 6th to stockholders of record on the preceding November 30th. Plaintiff's bonds were received by the company for conversion on December 3rd and the certificates of stock issued upon conversion were also dated December 3rd. It was held that the plaintiff was entitled to both the cash and stock dividends.

⁵⁴ *Sutliff v. Cleveland & Mahoning Railroad Co.* (1873) 24 Ohio St. 147; *Gay v. Burgess Mills* (1909) 30 R. I. 231, 74 Atl. 714. In *Gay v. Burgess Mills*, a dividend of 50 per cent payable 10 per cent annually during five years was declared payable to stockholders of record on the date of declaration. The holder of a convertible bond exercised his conversion privilege after such record date and it was held that he was not entitled to participate in any part of such dividend payment.

⁵⁵ *Sutliff v. Cleveland & Mahoning Railroad Co.* (1873) 24 Ohio St. 147.

more apt to be required upon the issuance of preferred stock than upon the issuance of common stock. The treatment of convertible obligations and convertible stock differs materially in this respect for no apparent reason. Generally no adjustments of dividends upon the shares surrendered or upon the shares issued are required by the conversion instrument, but if adjustments are made with respect to one class of shares they are also made with respect to the other. It is unusual to have adjustments of dividends on one class alone.

The computation of interest adjustments upon coupon obligations or fully registered obligations without coupons is comparatively simple as in each case the interest is computed from the last interest payment date to the date of conversion at the established rate. Accrued interest whether represented by unmatured coupons or not is abandoned upon conversion as the obligation itself and all unmatured coupons are surrendered. The adjustment of dividends on common or preferred stock is more difficult, as several matters must be considered: dividends upon preferred stock may or may not be cumulative; common stock dividends may be regular or extraordinary, and may be payable in cash or in stock; the conversion date may be subsequent to the record date for determining the stockholders entitled to dividends and prior to the dividend payment date; and dividends may be passed or reduced upon the dividend payment date next following the conversion date. To avoid drawing up complicated adjustment provisions covering all contingencies some conversion instruments merely state the rule and provide that adjustments shall be made pursuant to resolution of the board of directors so that dividends shall not be paid for the same period upon the shares surrendered and the shares issued. Similar provisions may be made for the adjustment of interest, in which case adjustments are made upon the basis of credit to the company for dividends in course of accrual since the last dividend payment date and credit to the privilege holder for interest accrued since the last interest payment date. Any sums found due from either on such adjustments are paid in cash upon the delivery of the stock certificates. Dividend adjustments are sometimes avoided by paying interest from the conversion date to the next following dividend payment date or by permitting the privilege holder to retain one unmatured coupon. These methods are inaccurate and unusual.

A composite dividend adjustment provision for convertible bonds or debentures covering practically all contingencies, would appear somewhat as follows:

1. The company shall pay to the holder of the converted obligation interest not previously paid on such obligation to the conversion date.
2. The holder shall pay to the company:

(a) A sum equal to dividends upon the common stock issued upon conversion from the last date of payment of dividends to the date of conversion at the rate per annum at which the last common stock dividend was paid; or

(b) A sum equal to dividends accrued upon the preferred stock issued upon conversion from the next preceding regular dividend payment date to the conversion date at the established preferred stock dividend rate, as the case may be.

3. In case the conversion date shall be subsequent to or on an ex-dividend date, and on or before the dividend payment date for the current dividend period, the holder shall not be required to pay the company any sum by way of adjustment of dividends as provided in No. 2 above, but the company shall pay to the holder either of the following (whichever may be provided in the conversion instrument):

(a) Interest upon the obligation to and including the current dividend payment date; or

(b) Interest upon the obligation to the conversion date, plus a sum equal to dividends upon the stock issued upon conversion from the conversion date to and including the current dividend payment date at the last common stock dividend rate or at the established preferred stock dividend rate, as the case may be.

4. In case the company shall not pay dividends on the dividend payment date next following the conversion date, or shall pay dividends at a rate less than the rate at which the holder paid the company a sum to adjust dividends as provided in No. 2 above, the company shall pay to the holder within a specified time an amount equal to the sum so paid by the holder to the company less the amount, if any, which the sum paid by the holder would have been if computed at the rate at which dividends were so paid.

As a general rule no adjustments are made on account of extraordinary cash dividends, and no adjustments are made for stock dividends unless the company has adopted the policy of paying regular stock dividends, in which event adjustments are usually paid in cash on the basis of the market value of all dividend stock in excess of certain permitted dividends. As a protection to the privilege holder the conversion instrument may provide that no stock or extraordinary cash dividends shall be paid without first notifying the privilege holder and giving him an opportunity to convert and share in the dividend.

DILUTION OR CHANGE OF THE CONVERSION PRIVILEGE

Instruments creating or evidencing the conversion privilege generally anticipate such changes in the corporate structure as might cause a dilution, change or destruction of the privilege, and provide adjustments and restrictions for its protection. Unless protected the conversion privilege may be changed or diluted upon the happening of the following events to the shares issuable upon conversion: A split-up or consolidation of shares; an exchange or substitution of shares; the

payment of stock dividends; the issuance of additional shares for less than a fixed consideration; the issuance of other securities convertible into the same class of shares at a lesser rate or price; the issuance of subscription rights with or without a contemporaneous cash dividend; the distribution of assets to the holders of senior securities; or the issuance of other classes of shares having a preference upon redemption, liquidation or dissolution. Furthermore, the privilege may be destroyed upon a consolidation, merger, sale of assets or dissolution unless it is protected in the conversion instrument, by statute, or by the agreement of reorganization.

There are few decisions on this subject and they are not helpful except as a warning against careless draftsmanship of the conversion instrument. These decisions indicate that the conversion privilege attached to a convertible obligation is subject to dilution and change at the will of the corporation, as the privilege holder is not a stockholder and has no voice in the affairs of the corporation. Mr. Justice Holmes held in a Massachusetts case that the conversion privilege "imposes no restriction upon the obligor in regard to the issue of new stock, although the issue may be upon such terms as to diminish the value of the right. It is simply an option to take stock as the stock may turn out to be when the time for choice arrives. The bondholder does not become a stockholder by his contract in equity any more than at law."⁵⁶ It has also been held that the holder of a convertible obligation has no vested right or title to any particular shares of stock and is not legally or equitably entitled, upon conversion, to the benefit of an issue of additional shares.⁵⁷ Under similar reasoning it has been held that the holder of a convertible bond has no ground of complaint against an adjustment in capitalization amounting practically to the splitting up of shares ten for one,⁵⁸ and that a privilege holder, upon conversion, is not entitled to the benefit of any stock dividends paid prior to the

⁵⁶ *Parkinson v. West End Street Ry. Co.* (1899) 173 Mass. 446, 53 N. E. 891.

⁵⁷ *City of Aurora v. Cobb* (1863) 21 Ind. 492; *Pratt v. American Bell Telephone Co.* (1886) 141 Mass. 225, 5 N. E. 307; *Gay v. Burgess Mills* (1909) 30 R. I. 231, 74 Atl. 714.

⁵⁸ *Gay v. Burgess Mills* (1909) 30 R. I. 231, 74 Atl. 714. In that case a corporation having an authorized capitalization of 10,000 shares of the par value of \$10 per share, and an issue of bonds convertible into "Ten (10) shares of the Capital Stock of the Burgess Mills of the par value of \$10 each," reduced the par value of its shares from \$10 to \$1 and then increased the number of its authorized shares from 10,000 to 1,000,000 shares. Proceedings were brought primarily to enjoin the payment of certain dividends, and the corporation offered to issue, upon conversion, 1000 shares of the par value of \$1 per share in lieu of 10 shares of the par value of \$10 per share. The court confirmed the offer, but took occasion to state that the bondholders had no grounds of complaint against a diminishing of the value of the conversion privilege.

conversion date.⁵⁹ There seem to be no related decisions upon the rights of holders of convertible stock, but except as changed by preemptive rights the rules should be the same.

All convertible obligations of the same issue and all convertible stocks of the same class should be treated alike with respect to adjustments, whether such obligations or shares be outstanding or not at the time adjustments are made. It is a common practice of corporations to have authorized shares of convertible stock not yet issued, and not infrequently to have authorized but unissued convertible obligations. Unless such obligations or shares, when issued, carry the same conversion privilege as all others theretofore issued, confusion is bound to follow as the difference in conversion value would not appear upon the face of the stock certificate or upon the obligation. It is well to provide in the certificate of incorporation that all shares of a class of convertible stock shall be considered to have been issued and to have become outstanding immediately after the incorporation of the company notwithstanding that such shares may actually be issued and become outstanding on a subsequent date. A similar provision may be made for convertible obligations of the same issue in case all of such obligations be not issued at the same time.

As the law affords no protection, the conversion instrument has taken its place and has covered every contingency within workable limits. It is well to examine the more important protective features one at a time.

Split-up or Consolidation of Shares. It is important to provide in every conversion instrument that in case the shares issuable upon conversion are subdivided into a greater number of shares or combined into a lesser number of shares, the number of shares issuable upon conversion shall be replaced by the number of the subdivided or consolidated shares, as the case may be. A privilege holder is thereby treated as if he had exercised the conversion privilege immediately prior to the subdivision or consolidation.

Exchange or Substitution of Shares. A similar provision is customarily made to protect the conversion privilege in case the shares issuable upon conversion are changed into the same or a different number of shares of any other class or classes. In such case it is provided that, for the purposes of any conversion, the shares of new stock issued

⁵⁹ *Sutliff v. Cleveland & Mahoning R. Co.* (1873) 24 Ohio St. 147. A corporation, having outstanding convertible bonds, paid a stock dividend of about 47 per cent on its outstanding shares. The plaintiff demanded conversion of his bond into stock and also demanded the 47 per cent stock dividends theretofore paid, but it was held that he was limited upon conversion to the number of shares designated upon his bond without benefit of the prior stock dividend.

or issuable in exchange for each share of old stock shall as a unit be deemed the equivalent of each share of such old stock. The standard method is to provide in the instrument that in case the company shall change the stock issuable upon conversion into the same or a different number of new shares of the same or of any other class or classes, the privilege holder, upon conversion, shall be entitled to receive, in lieu of the old stock which he would have become entitled to receive but for such change, a number of shares of the new stock equivalent to the number of shares of new stock that would have been issued to him in exchange for such number of shares of old stock which he would have been entitled to receive if he had exercised his conversion privilege immediately prior to such change. In other words, he gets what he would have received if he had converted and then exchanged.

Stock Dividends. Unless protected in the conversion instrument the privilege may be diluted and practically destroyed by the payment of dividends in stock of the class issuable upon conversion. Stock dividends are, of course, payable to a privilege holder who has effected conversion and become a stockholder at a date on or prior to the record date set for the determination of stockholders entitled to such dividends. A privilege holder who has not become a stockholder, however, should be protected against a dilution of his privilege upon the payment of stock dividends prior to the conversion date, or upon the payment of stock dividends after the conversion date to stockholders of record as of a date prior to the conversion date. The payment of a stock dividend in which the privilege holder is not entitled to participate reduces the conversion privilege in the same proportion as the total number of shares outstanding immediately after the stock dividend bears to the total number of shares outstanding immediately prior to such stock dividend.

There are two recognized methods of protecting the conversion privilege in this respect. One is to treat the dividend shares as "additional shares" issued for no consideration. This method will be considered later. The other is to deal with the problem directly by incorporating in the conversion instrument a special protective provision which may be worded substantially as follows: "That in case at any time or from time to time the company shall declare and pay on or in respect of the class of stock issuable upon conversion, any dividend of shares of stock of any class or classes, the privilege holder, upon exercising the conversion privilege after the date of record of the holders of stock to whom such stock dividend is payable, shall be entitled to receive the shares of stock theretofore issuable upon conversion together with the dividend stock which would have been issuable if the

conversion privilege had been exercised immediately prior to the record date." A variation of this method is to provide that the number of shares issuable upon conversion shall be increased in the same proportion as the number of shares outstanding immediately prior to the stock dividend was increased by the payment of such dividend.

If the company has adopted or expects to adopt a policy of paying regular stock dividends in lieu of or in addition to cash dividends, it is advisable to provide that the conversion rate shall not be adjusted except upon the payment of stock dividends in excess of a certain limited number of shares. Exceptions have been made for dividends of one-sixteenth of a share for any calendar year, dividends that would not reduce the then prevailing rate "by at least \$2 per \$100 of par value," and the like. In some cases stock dividends paid on stock issued upon conversion, or on stock issued for special purposes, and the stock issued successively as a stock dividend on shares so issued, are also excluded in computing the adjusted conversion rate. To prevent an abuse of the requirement that adjustments be made upon the payment of stock dividends it is advisable to provide that the company shall be deemed to have declared and paid a stock dividend if at any time it shall declare and pay a dividend in cash and shall contemporaneously, or substantially contemporaneously therewith, give to the holders of the class of stock issuable upon conversion the right to subscribe for additional shares of such stock at a price which would yield to the company in the aggregate substantially the amount of such cash dividend so declared.

Sale of Additional Shares Below Fixed Price. Conversion is fundamentally the act of exchanging one class of security for another. The ratio of exchange may be stated in the conversion instrument by specifying the number of shares into which a security is convertible, or by specifying the price per share at which such shares are issuable. The former is generally called the "conversion rate" and the latter the "conversion price." Often both terms are used in the same instrument to express complicated conversion adjustments. The terms "basic conversion rate" and "basic conversion price" connote the initial or unadjusted conversion rate or price applicable at the time as distinguished from the "adjusted conversion rate" or "adjusted conversion price." The foundation of all adjustments is the conversion rate, the conversion price being a secondary calculation used to adjust the conversion rate in case additional shares are issued at less than a fixed price. If a \$1000 bond is convertible into 25 shares of stock the conversion rate is 25 and the conversion price is \$40. An increase of the conversion rate amounts to a reduction of the conversion price, and vice versa.

Unless the privilege is to be protected against dilution in the event of the sale of additional shares for less than a fixed price, it is more convenient to express all adjustments in shares or numbers of shares without reference to a conversion price. "Basic" rates or prices need not be used unless the conversion rate or price is subject to periodic changes irrespective of adjustments.

The basic conversion rate or price is not necessarily constant throughout the life of a convertible security. Many instruments provide that obligations are convertible at different rates or prices during different periods, the number of shares issuable being gradually reduced. In such cases the basic rate or price changes with each successive period of time but is constant during any one period. Adjustments are generally calculated from the basic rate or price then in effect.

The maximum number of shares which may be issued by a corporation and the minimum price at which additional shares may be issued without adjusting the conversion rate are fixed in the conversion instrument. The number of shares is usually fixed at the number outstanding or to be outstanding immediately after the convertible securities are issued, plus the maximum number of shares issuable upon the conversion of such securities and, in some cases, plus shares issuable upon the conversion of other securities, upon the exercise of warrants, or for the acquisition of particular properties. If the ratio of exchange is expressed in a number of shares the conversion price is the amount in dollars resulting from dividing the principal amount of the obligation converted by the number of shares issuable upon conversion, but if the ratio of exchange is expressed in dollars the conversion price is usually fixed at a price a little higher than the price at which the shares were initially sold to the public. The sale of additional shares at a price less than the conversion price does not necessarily dilute the conversion privilege from an investment or trading point of view, as the conversion price is generally higher than the price at which the shares originally outstanding were issued. A fall in market value alone is never a cause for adjusting the conversion price, but a fall in market value recognized by the company upon the issuance of additional shares is frequently a cause for adjustment. The conversion price is not reduced to the price at which the additional shares were issued, but is reduced proportionately in accordance with a fixed formula, which strikes an average issue price, using the conversion price as the original issue price. In a simple case the conversion price is reduced to the quotient resulting from dividing (a) the aggregate value of all shares outstanding immediately prior to the issuance of the additional shares computed at the prevailing conversion price plus the value of the consid-

eration received by the company for such additional shares, by (b) the number of shares outstanding immediately prior to the issuance of additional shares increased by the number of additional shares issued. Assuming, for example, that the conversion price is \$50 per share and that the company has presently outstanding 80,000 shares. The company then issues 20,000 additional shares at \$40 per share, and thereafter issues 20,000 more shares at \$45 per share. The conversion price is adjusted twice, from \$50 to \$48 and then from \$48 to \$47.50, computed as in (a) and (b) following:

$$\begin{aligned} \text{(a)} \quad & \frac{(80,000 \times \$50) + (20,000 \times \$40)}{(80,000 + 20,000)} = \$48 \\ \text{(b)} \quad & \frac{(100,000 \times \$48) + (20,000 \times \$45)}{(100,000 + 20,000)} = \$47.50 \end{aligned}$$

The above example is typical of the computations required in many of the simpler conversion instruments, and illustrates the underlying principles of conversion price adjustment upon the issuance of additional shares. In case the adjusted conversion price must be changed into an adjusted conversion rate, such rate may be computed by dividing the principal amount of the obligation surrendered by the adjusted conversion price.

There are many methods of adjustment and they differ in several respects, especially if the conversion rate or price is subject to periodic basic adjustments. The conversion rate may decrease, or the conversion price increase, from year to year, but adjustments made during any one period may or may not be carried over in whole or in part to the succeeding period, depending upon the particular terms of the conversion instrument. It is not uncommon to find periodic changes in the basic conversion price without adjustments between successive periods, in which event adjustments during any one period are computed without taking into consideration adjustments made during prior periods. At the same time it is often provided that upon any adjustment of the conversion price the adjusted conversion price shall continue in effect until another adjustment is made or until the next date fixed for a change of the basic conversion price, and that upon such date the conversion price then in effect shall be increased in the same proportion as the basic conversion price is increased, or the basic conversion rate reduced, as the case may be. Following the above example, assume that the basic conversion price for the first period is \$50 and for the second period is \$60, and that the adjusted conversion price in effect at the end of the first period is \$47.50. During the second period 20,000 additional shares are issued at \$50 per share. The adjusted conversion price is increased by 20% to \$57.00 at the beginning of the second

period, being in the same proportion as the basic conversion price is increased (from \$50 to \$60), and is then adjusted upon the issuance of the additional shares to \$56.00, such latter adjustment being made in the usual manner.⁶⁰

An indenture of Tri-Utilities Corporation⁶¹ represents one of the

⁶⁰ The computation is:

$$\frac{(120,000 \times \$57) + (20,000 \times \$50)}{(120,000 + 20,000)} = \$56$$

⁶¹ Tri-Utilities Corporation and The Chase National Bank of the City of New York, as Trustee, dated as of September 1st, 1929, providing for the issue of 5 per cent convertible gold debentures, Series of 1929.

Another interesting indenture is that of American I. G. Chemical Corporation and I. G. Farbenindustrie Aktiengesellschaft with The National City Bank of New York, as Trustee, dated as of May 1st, 1929. This indenture is rather confusing but may be taken as an example of the elaborate fashion in which conversion adjustments are sometimes made. There are eight different conversion rates for eight conversion periods. The conversion price is adjusted upon the issuance at any time of additional shares at a price less than the adjusted conversion price then in effect, and also at the beginning of each new conversion period if the prevailing adjusted conversion price is less than the basic conversion price for that period. Adjustments are computed in accordance with a rather complicated formula which takes into consideration graduated percentages of the values received upon the issuance of additional shares during all preceding periods and during the current conversion period. To arrive at the formula let S equal the maximum number of shares which may be issued without adjusting the conversion rate, shares issued in excess of such number being "additional shares." Let R equal the basic conversion rate, P equal the basic conversion price, V equal the value received by the company upon the issuance of additional shares, and N equal the number of additional shares issued. The numbers following the respective letters indicate the different conversion periods, the first four periods being shown as follows:

Conversion Period	Basic Conversion Rate	Basic Conversion Price	Value received for additional shares	Number of additional shares issued
1	R 1	P 1	V 1	N 1
2	R 2	P 2	V 2	N 2
3	R 3	P 3	V 3	N 3
4	R 4	P 4	V 4	N 4

The adjusted conversion price during each of the first four conversion periods would be the result of the following computations:

$$\begin{aligned}
 1. & \frac{(S \times P 1) + V 1}{S + N 1} \\
 2. & \frac{(S \times P 2) + \left(\frac{R 1}{R 2} \times V 1 \right) + V 2}{S + N 1 + N 2} \\
 3. & \frac{(S \times P 3) + \left(\frac{R 1}{R 3} \times V 1 \right) + \left(\frac{R 2}{R 3} \times V 2 \right) + V 3}{S + N 1 + N 2 + N 3} \\
 4. & \frac{(S \times P 4) + \left(\frac{R 1}{R 4} \times V 1 \right) + \left(\frac{R 2}{R 4} \times V 2 \right) + \left(\frac{R 3}{R 4} \times V 3 \right) + V 4}{S + N 1 + N 2 + N 3 + N 4}
 \end{aligned}$$

As $\frac{R 1}{R 2}$ equals $\frac{P 2}{P 1}$

by substituting P in the proper place the element of R may be withdrawn from the formula.

rare cases in which the conversion price adjustments are based upon the actual sales price of additional shares rather than upon a reduction in the average issue price of all shares, assuming the conversion price to be the same as the original issue price. To accomplish this a new element of "minimum price" (arbitrarily taken at about 85% of the conversion price) is created, and the total number of shares initially outstanding is discarded from the computations. In that indenture the conversion rate per \$1,000 principal amount of debentures is as follows: 17 shares during the first period, 14 shares during the second period, and 10 shares during the third period. Provision is made that in case additional shares are sold for less than \$50 per share during the first period, \$60 per share during the second period, or \$85 per share during the third period (being the "minimum price" for each period), the current conversion price (computed by dividing the number of shares then issuable into \$1,000) shall be reduced by an amount equal to the difference between the minimum price and the price at which such shares are sold. Upon a reduction of the conversion price the conversion rate is thereupon changed by increasing the number of shares issuable upon conversion to such number as shall be the result of dividing the reduced conversion price into the principal amount of the debentures to be converted. The indenture contains another unusual feature which does not appear in the great majority of conversion instruments but which deserves recognition. It is provided that if the conversion price has been reduced and additional stock be thereafter sold at a higher price than the price which was used to compute the then applicable reduced conversion price, the conversion price thereafter shall be increased as follows:

(x) The number of shares sold, in determining all previous changes in the conversion price, shall be multiplied by the sales price thereof;

(y) The shares sold at a price higher than the price which was used to compute the then applicable reduced conversion price shall be multiplied by the actual sales price thereof;

(z) The sum of the shares included in (x) and (y) and the sum of the multiplications provided for in (x) and (y) shall be determined, and the sum of the shares shall be divided into the sum of the multiplications, and the quotient resulting from such division shall be the amount per share at which each said share shall have been deemed to have been issued. An amount equal to the difference between the minimum price and the said quotient, provided said quotient is smaller than the minimum price, is then deducted from the current conversion price, and the remainder constitutes the increased conversion price.

The rate of conversion is thereupon changed by reducing the number of shares issuable upon conversion to such number as shall be the result of dividing such increased conversion price into the principal amount of the debentures to be converted.

The conversion rate is increased and reduced under such indenture in the following manner:

	Conversion Rate per \$1000 Debentures	Current Conversion Price (number of shares divided into \$1000)	Minimum Price
First period	17 shares	\$58.82	\$50
Second period	14 shares	71.42	60
Third period	10 shares	100.00	85

Suppose that during the first period 20,000 shares are sold at \$45 per share. The conversion price would be reduced from \$58.82 to \$53.82 thereby increasing the conversion rate from 17 shares to 18.58 shares:

$$\text{Adjusted conversion price} = (58.82 - [50 - 45]) = 53.82$$

$$\text{Adjusted conversion rate} = (1000 \div 53.82) = 18.58$$

Thereafter during the same period 10,000 additional shares are sold at \$48 per share. The reduced conversion price would be increased from \$53.82 to \$54.82, thereby reducing the conversion rate from 18.58 shares to 18.24 shares:

$$\begin{array}{r} 20,000 \times 45 = 900,000 \\ 10,000 \times 48 = 480,000 \\ \hline 30,000 \qquad 1,380,000 \\ 1,380,000 \div 30,000 = 46 \end{array}$$

$$\text{Adjusted conversion price} = (58.82 - [50 - 46]) = 54.82$$

$$\text{Adjusted conversion rate} = (1000 \div 54.82) = 18.24$$

In arriving at the adjusted conversion price certain shares issued for particular purposes may be conveniently excluded from the computations and issued for any consideration without requiring a price adjustment. While drafting a conversion instrument the capital set-up of the company and the inter-relation of its various securities are of major importance. Furthermore an ample margin of shares should be reserved to cover outstanding commitments and to carry out any existing program of expansion. The following should be considered when deciding on shares to be excluded:

(a) Shares to be issued upon conversion (such shares are universally excluded).

(b) Shares to be issued upon the conversion of other securities or upon the exercise of warrants (generally not excluded unless senior securities were initially outstanding).

(c) Shares which may be issued to acquire certain designated properties.

(d) Shares issued upon any subdivision or combination of excluded shares.

(e) Shares issued as a dividend on excluded shares.

(f) Any issue of shares which would not materially change the conversion price (by designating a minimum number of shares or a percentage of change).

(g) A limited number of shares which may be issued during any period as stock dividends.

(b) Shares which may be issued to employees.

As adjustments of the conversion rate depend upon the price at which additional shares are issued, the conversion instrument should prescribe rules for determining the amount of consideration received, whether shares be issued for cash, property, services, as a stock dividend, upon conversion of other securities or upon the exercise of options or warrants. Following are the general rules of valuation:

(a) In case shares are issued for cash the amount received by the company therefor is deemed to be the actual value of the consideration received for such shares, without deducting the amount of any commissions or other expenses paid or incurred for underwriting or otherwise (in some cases, however, reasonable underwriting charges are permitted).

(b) In case shares are issued as a stock dividend the company is deemed to have received no consideration, or "zero dollars," for such shares. In rare cases shares issued as a stock dividend are considered as having been issued for a consideration equal to the amount of earned surplus capitalized thereby.⁶²

(c) In case shares are issued upon the conversion of other obligations, stock or securities, the shares so issued are deemed to be issued for cash equal to the net consideration received by the company for the issuance of such obligations, stock or securities converted. (The principal amount of the obligation converted is sometimes taken as the consideration received.)

(d) In case shares are issued upon the exercise of warrants the consideration received therefor is deemed to be the net amount of cash paid to the company upon the exercise of such warrants.

(e) In case shares are issued for a consideration other than cash, the value of such consideration shall be as determined by the board of directors, within prescribed limitations, in authorizing the issue of such stock.

Subscription Rights and Dividends. As an additional protection against a dilution of the privilege it is often provided in the conversion instrument that in case the company shall declare a stock dividend, or make any distribution (other than regular cash dividends) to the holders of its common stock issuable upon conversion, or in case the company shall offer for subscription to its stockholders any additional common stock, then the company shall give to the privilege holders previous notice of the record date of such dividend, distribution or subscription, such notice to be given by mail and by publication for a stated period, to the end that during such period the privilege holders

⁶² See *The United Light and Power Company, Articles of Amendment of Charter*, Maryland, June 6, 1929.

may exercise their conversion rights and be entitled as stockholders to share in the dividend or distribution, or to exercise the subscription rights. In the case of preferred stock convertible into common stock it is quite usual to provide that if the company shall offer any stock subscription rights to the holders of its common stock, the holders of preferred stock shall be entitled to subscribe for and purchase, at the same price per share at which such stock is offered to the holders of common stock, the number of shares of such stock for which they would be entitled to subscribe if they had been holders of record of the number of shares of common stock into which their preferred stock was then convertible.

CONSOLIDATION, MERGER, SALE OF ASSETS OR DISSOLUTION

Privilege holders have practically no rights upon a termination of the corporate existence of the company which granted the privilege, whether it terminates by reason of a consolidation, merger, dissolution or otherwise. Such rights as they do have are granted by statute or by an agreement of reorganization under which the successor company undertakes to protect the privilege. The obligation of a corporation to convert does not survive dissolution, and need not be discharged before the corporation makes a final distribution of its assets. It seems to be recognized that a corporation may discontinue its business and dissolve without regard to the conversion rights of the holders of its stock, bonds or other securities.⁶³ This is certainly true with respect to a privilege of conversion created by incorporation.

Upon a reorganization the conversion privilege will terminate or survive, depending upon whether or not the corporate existence of the grantor is continued. Generally speaking, a merger of two or more corporations takes place when one of such corporations retains its corporate existence and absorbs the others, which thereby lose their corporate existence. A consolidation of two or more corporations is effected when a new corporation is created to take the place of the

⁶³ *Lisman v. Milwaukee, Lake Shore & Western Ry. Co.* (C. C. Wis. 1909) 161 Fed. 472; *Parkinson v. West End Street Railway* (1899) 173 Mass. 446, 53 N. E. 891. Mr. Justice Holmes, in *Parkinson v. West End Street Railway* (1899) 173 Mass. 446, 448, 53 N. E. 891, 892, issued the following *dictum*: "So, if the corporation which made the bond finds it for its interest to go out of existence at or before the maturity of the obligation, the option given to the bondholder will not stand in the way. The option gives him merely a *spes*, not an undertaking that the corporation will continue for the purpose of making it good. This being so, we are not prepared to admit that, if the corporation should be dissolved at the time fixed for the bondholder's choice, he would be entitled to claim a proportionate share of the assets of the company. We do not decide the question, but we do not think it clear that the contract operates except in the event of the corporation happening to remain a going concern, so that the promise can be fulfilled in a literal sense by the delivery of a certificate of stock."

constituent corporations which are themselves dissolved in the process. The effect of a consolidation, with respect to the extinction of the constituent companies and the creation of a new company or the continued existence of one or more of the constituent companies, depends upon the statute under which the consolidation is effected. The weight of authority is that a new company comes into existence by the consolidation and that the constituent companies no longer exist except to the extent authorized by the statute under which the consolidation is made.

With respect to consolidations, the decided cases differentiate between the promise to pay the principal and interest of a convertible obligation and the promise to issue shares of stock upon the conversion of such obligation, and take the stand that a mere assumption or guarantee of the obligation by a successor company does not bind the successor to issue its shares upon conversion. The weight of authority seems to be that a corporation may disregard the conversion privilege of its outstanding obligations and even vitiate such privilege by consolidating with another corporation. This is true in the face of a statute providing that the consolidated corporation shall assume all of the duties, restrictions and liabilities of its predecessors. Conversion is considered to be a privilege of the holder which does not become an obligation of the grantor company unless and until the holder takes steps necessary to exercise the privilege. Mr. Justice Holmes in a leading Massachusetts case has stated that "a consolidation which makes no arrangement for furnishing stock in the new company, and which ends the existence of the old ones, as a general rule may be presumed to put an end to the right of bondholders to call for stock, not because the law has not machinery for keeping such a right alive, but because, not being bound to do so, it has made dispositions which manifestly take no account of the right."⁶⁴ Under similar reasoning it has also been held that the right to convert a corporate obligation into stock of the predecessor company which granted the right terminates upon the consolidation of such company with another.⁶⁵

⁶⁴ *Parkinson v. West End Street Railway* (1899) 173 Mass. 446, 449, 53 N. E. 891, 892. In that case a street railway corporation issued bonds which were subsequently made convertible into stock of the issuing company by an act of the legislature. The railway then consolidated with another railway company under a statute making the successor company "subject to all the duties, restrictions, and liabilities" to which the issuing company was subject. Subsequently, the consolidated company was purchased by the defendant under a similar statute. The plaintiff held bonds of the original issuing company and demanded their conversion into stock of the defendant. Upon the submission of an agreed statement of facts it was held that the plaintiff could not maintain his action.

⁶⁵ In *Taggart v. Northern Central Ry. Co.* (1868) 29 Md. 557, the plaintiff was the holder of certain convertible bonds of the York & Cumberland Railroad Company which, with three other railroads, consolidated into the defendant

On the other hand a consolidation or merger which does not destroy the existence of the constituent companies and which considers the consolidated or merged company as a continuation of the identity and existence of the constituent companies, does not impair or destroy a conversion privilege attached to the obligations of a constituent company. It has been held under such circumstances that the successor company must recognize the conversion rights granted by a predecessor company and issue its own shares upon conversion.⁶⁶ Cases of this type are rare and usually of little value as precedents. Assuming that the privilege is kept alive and that the successor company must issue its own shares upon conversion, there is yet no rule of law permitting or requiring an adjustment of the number or class of shares issuable

railroad under acts of the legislatures of Pennsylvania and Maryland providing that each railroad should remain liable for its respective debts and liabilities unless such debts and liabilities should be assumed by the defendant. Nine years after the consolidation, the plaintiff demanded of the defendant that his bonds be converted into stock of the York & Cumberland Railroad Company. This the defendant refused to do and was upheld by the court. After remarking that the defendant was guilty of laches in the matter, the court stated that "by the act of consolidation the York and Cumberland Railroad Company ceased to exist as a separate corporation so far as respected its power to create, or issue certificates of capital stock. By the terms of the consolidation, all its shares of capital stock were actually surrendered up and cancelled, and thereafter all its property and franchises were represented by the capital stock of the Northern Central Railway Company, the new corporation, to which all its property had been transferred. It is true all its debts, liabilities and obligations were assumed by the new corporation, and among them the liability and obligation created by the bonds. That appears on the face of the bonds, to be to pay a certain sum of money with interest, or to convert the same into stock of the York and Cumberland Railroad Company, at the option of the holder. The primary object of the bonds was to secure the payment of the money, while they gave to the holder the alternative right to convert. This last has become impossible by the act of consolidation, for there is no such stock nor any power to create it."

⁶⁶In this connection see the decisions of Mr. Justice Holmes upon similar facts in *Day v. Worcester, Nashua & Rochester R. Co.* (1890) 151 Mass. 302, 23 N. E. 824, and *John Hancock Mutual Life Insurance Co. v. Worcester, Nashua & Rochester Railroad Co.* (1889) 149 Mass. 214, 21 N. E. 364, in which it was held that the consolidation of a lessor corporation and a lessee corporation did not cut off the right of a holder of convertible bonds of the lessor corporation, and that such holder had the right to convert his bonds at par into the stock of the consolidated corporation. In *Parkinson v. West End Street Railway* (1899) 173 Mass. 446, 447, 53 N. E. 891, 892, Mr. Justice Holmes said that these cases "went to the verge of the law" and that the decision "depended on the peculiar intimacy of the corporations united, and the fact that the consolidation was little more than a formal step." See also *Child v. New York & New England R. Co.* (1880) 129 Mass. 170; *India Mutual Insurance Co. v. Worcester, Nashua & Rochester Railroad Co.* (1890) 25 N. E. 975 (Mass.).

In *Cayley v. Cobourg R. Co.* 14 Grant's Chancery 571 (Upper Canada 1868) it was distinctly held that an act authorizing the amalgamation of two railroad companies did not and could not extinguish the conversion privilege incident to the bonds of one of the constituent companies.

upon conversion in the event that the stockholders of the predecessor company receive shares of stock of the successor company upon an exchange basis.⁶⁷

The conversion privilege may also be destroyed or made valueless by a sale as an entirety of the assets of the granting company. Although a sale of assets without dissolution would leave a naked privilege of conversion into shares of the selling company which granted the privilege, the purchasing company is under no obligation to the privilege holder to issue its own shares upon an exercise of the privilege. Cases arising from the reorganization of the Milwaukee, Lake Shore & Western Railway Company are interesting in this connection and decide that the holders of convertible bonds issued by a selling company may not legally demand the conversion of their bonds into shares of stock of the purchasing company, although the assets of the seller were sold to the purchaser subject to "all the existing debts, liabilities, and obligations" of the seller.⁶⁸ The courts have given various reasons in support of this rule, the strongest being that the conversion privilege was created, issued and accepted subject to such rights as the granting company might have by virtue of the statute law to sell or otherwise dispose of its assets as an entirety and to discontinue its business. At the same time these cases are further evidence that a privilege of conversion, unexercised prior to a sale of assets, is not a debt, liability or obligation of the selling company which must be assumed by the purchaser.

As the law itself is of little assistance the conversion instrument again steps in and requires that a successor company recognize the conversion privileges granted by its predecessors in case such privileges are endangered by a consolidation, merger or sale of assets. The instrument may insist upon recognition as a condition precedent to any such reorganization or may merely provide that the privilege must be recognized in the event a reorganization is accomplished by an exchange of shares. Standard clauses have been developed for this purpose. In the case of bonds convertible into common stock they would read substantially as follows:

- (a) The company covenants and agrees that in case it shall consolidate or merge with, or shall sell its property as an entirety or substantially as an entirety to, any other corporation, proper provision will be made as

⁶⁷ A *dictum* in *Rosenkrans v. Lafayette, Bloomington & Muncie Ry. Co.* (C. C. Ind. 1883) 18 Fed. 513, is interesting on this point and suggests the possibility of adjusting the conversion rate.

⁶⁸ *Lisman v. Milwaukee, Lake Shore & Western Ry. Co.* (C. C. Wis. 1909) 161 Fed. 472; *Welles v. Chicago & Northwestern Ry. Co.* (C. C. N. Y. 1908) 163 Fed. 330.

part of the terms of such consolidation, merger or sale, that the holder of any bond will thereafter be entitled to convert it into the same kind and amount of securities (including in that term stock of any class or classes) and other assets as may be issuable or distributable by the terms of such consolidation, merger or sale with respect to the number of shares of common stock into which such bond is convertible at the time of such consolidation, merger or sale.⁶⁹

(b) In case the company shall consolidate with or be merged into any other corporation or shall convey all or substantially all of its property and assets to any other corporation while the conversion privilege of the bonds remains in effect, and in connection with any such consolidation, merger or conveyance, shares, securities or other property shall be issuable or deliverable for its common stock, then as a part of such consolidation, merger or conveyance, lawful provision shall be made so that the holders of bonds may thereafter convert the same into the same kind and amount of shares, securities or other property as may be issuable or deliverable upon such consolidation, merger or conveyance with respect to the number of shares of common stock of the company which would have been deliverable upon conversion of bonds on the conversion basis which would otherwise be in effect at the time of such conversion; and after such consolidation, merger or conveyance the right of conversion of the bonds shall be to receive such shares, securities or property in lieu of common stock of the company.⁷⁰

Successive consolidations, mergers or sales bring up new problems as the conversion instrument rarely goes beyond a single organization, but relies upon an agreement of "due and punctual observance and

⁶⁹ Taken from Indenture of International Telephone and Telegraph Corporation and The National City Bank of New York, Trustee, dated January 1, 1929, relating to issue of Ten-Year Convertible 4½% Gold Debenture Bonds.

⁷⁰ Taken from First Supplemental Indenture of General Public Service Corporation to Bank of New York and Trust Company, Trustee, dated July 1, 1929, relating to issue of Gold Debentures, 5½% Convertible Series due 1939.

Variations may, of course, be made in these provisions. Under Collateral Trust Indenture of Alleghany Corporation and Guaranty Trust Company of New York, Trustee, dated June 1, 1929, each \$1000 bond is convertible into 7 shares of preferred stock and 10 shares of common stock. For the purpose of conversion the preferred stock is computed at \$100 per share and the common stock at \$30 per share. The indenture contains the usual requirement that the bondholders shall be entitled to convert their bonds into the same amount, kind and class of securities as may be distributable to stockholders. In case cash is paid to the preferred stockholders and securities delivered to common stockholders, the indenture provides that the successor company may issue its own preferred stock upon conversion to the extent of \$700. With respect to the remaining \$300 the bondholder is entitled to such securities as were distributable to the common stockholders. The privilege of conversion terminates if only cash is distributable upon a sale of assets.

A number of conversion instruments cut off the conversion privilege upon a consolidation, merger or sale of assets and merely require that the company give advance notice of the transaction to all privilege holders so that they may convert and, as stockholders, share in the securities distributed. In this connection see Indenture of Tri-Utilities Corporation and The Chase National Bank of the City of New York, as Trustee, dated as of September 1, 1929.

performance" on the part of each successor company to cover future changes. The word "company," as used in the original conversion instrument, is taken to mean the last successor company and binds it to observe and perform (by way of novation) all of the terms and conditions of the original instrument. The term "common stock," as defined in the original conversion instrument, includes any stock at the time issuable upon conversion whether issued by the granting company or not. Some conversion instruments, however, provide that the number and class of shares issuable upon conversion shall become fixed immediately after the first consolidation, merger or sale of assets and shall thereafter be subject to no adjustments whatsoever. This is an unnecessary and sometimes dangerous clause, but founded with good intentions and for the purpose of cutting short the uncertainties of a future reorganization. It would seem better to leave the clause out entirely.

Those provisions of the conversion instrument which protect the privilege against dilution or change in the event of a stock dividend, split-up or consolidation of shares, change of classification of shares, issuance of subscription rights, and the like, apply with equal force to all successor companies. The requirement that each successor company recognize the privilege becomes operative by virtue of the original instrument as each reorganization is consummated, and special provisions applicable to successor companies are unnecessary. On the other hand, it has been found impossible to draft a satisfactory provision protecting the conversion privilege granted by a predecessor company from dilution upon the issuance of additional shares by a successor company. The maximum number of shares which may be issued and the minimum price at which additional shares may be issued without adjusting the conversion rate are specified in almost all conversion instruments, and, as the capital structure of a successor company is unknown at the time the instrument is executed, a basis for adjusting the conversion rate upon the issuance of additional shares by a successor company cannot be anticipated. Although conversion instruments never contain a formula for these adjustments lawyers familiar with the subject have little difficulty in arriving at a proper adjustment whenever the occasion arises. Their method is simply to expand or contract the computations required by the original instrument so that they will fit the capital set-up of the successor company.

The following example shows the customary adjustments and the manner in which they are made. Company A acquires Company B by a consolidation, merger or purchase of assets, and thereafter Company A issues additional shares to acquire the assets of Company

C. Both acquisitions are accomplished by an exchange of shares, the shares of A being issued to the stockholders of B and C for a consideration equal to the conversion prices, respectively, of the shares of B and C. Convertible bonds of B and C are assumed by A, and A is required to recognize the conversion privileges attached to such bonds. The outstanding capitalization of each company, the maximum number of shares of each which may be issued and the minimum price at which additional shares may be issued without adjusting the conversion rate, are as follows:

	A	B	C
Shares outstanding, and maximum number which may be issued without adjusting the conversion rate	100,000	200,000	150,000
Conversion rate per \$1000 bond.....	10	25	20
Conversion price per share, and minimum price at which additional shares may be issued.....	\$100	\$40	\$50

I. A acquires B, and issues to B stockholders 1 share of A for 2 shares of B. The number of shares originally outstanding by A, the number of shares issued to B stockholders, and the respective conversion rates and prices of the A and B bonds will be as follows:

	Shares	Conversion Rate	Conversion Price
A.....	100,000	11.11 shares	\$90.00 (*)
B.....	100,000 (**)	12.5 shares (***)	80.00

$$(*) \frac{(100,000 \times \$100) + (100,000 \times \$80)}{100,000 + 100,000} = \$90$$

$$(**) \frac{200,000}{2} = 100,000$$

$$(***) \frac{25}{2} = 12.5$$

II. A thereafter acquires C, and issues to C stockholders 1 share of A for 1½ shares of C. The number of shares originally outstanding by A, the number of shares previously issued to B stockholders, the number of shares issued to C stockholders, and the respective conversion rates and prices of the A, B and C bonds will be as follows:

	Shares	Conversion Rate	Conversion Price
A.....	100,000	11.76 shares	\$85.00 (*)
B.....	100,000	12.76 shares	78.33 (**)
C.....	100,000 (***)	13.33 shares (***)	75.00

$$(*) \frac{(200,000 \times 90) + (100,000 \times 75)}{200,000 + 100,000} = 85.00$$

(**) The maximum number of shares which may be issued by A without adjusting the conversion rate on B bonds is reduced from 200,000 to 100,000 shares, and the minimum price at which A may issue additional shares is increased to \$80, as 2 shares of B were exchanged for one share of A. As 200,000 shares were outstanding before any shares were issued to acquire C, that number is used as a basis for computation. The computation is:

$$\frac{(200,000 \times \$80) + (100,000 \times \$75)}{200,000 + 100,000} = \$78.33$$

$$(***) \frac{150,000}{1\frac{1}{2}} = 100,000$$

$$(****) \frac{20}{1\frac{1}{2}} = 13.33$$

Company A thereupon completes its acquisition of Company B and Company C, and has outstanding 300,000 shares of stock and three issues of bonds, each convertible into a different number of shares. The conversion rate of the bonds issued by A, and the conversion rates of the bonds originally issued by B and C and assumed by A, will be subject to adjustment in case A issues additional shares at less than the prevailing conversion prices of \$85, \$78.33 and \$75, respectively. Consequently whenever an adjustment is required in the conversion rate of the B bonds by the issuance of shares at less than \$78.33 per share an adjustment must also be made in the conversion rate of the A bonds, and whenever an adjustment is required in the conversion rate of the C bonds by the issuance of shares at less than \$75 per share adjustments must also be made with respect to the A and B bonds. Actual situations similar to this are not infrequent.

CONCLUSION

As may be noted from the preceding pages there is little law upon the subject of convertible securities which is of any value as a guide. The cases which have been decided must be confined within the limits of the facts upon which they are based and, as so limited, must not be cited to support any general rule of law applicable to all conversion instruments. A dearth of judicial decisions is to be expected where the subject is comparatively new, but it is uncommon to find a field of law in which the courts have been so completely displaced by the lawyers. As practically all of the modern conversion instruments have been prepared by experienced corporation lawyers in connection with important financial transactions they are rarely misunderstood by the company, the trustee or the investor. Except for the adjustments which are required upon a sale of additional shares at less than the conver-

sion price or by reason of a second consolidation, merger, or sale of assets, there is nothing in the conversion instrument which would make its interpretation difficult for the layman. The instrument is merely a contract pursuant to which the privilege holder is given an option to exchange his securities for other securities of a different class. Being a contract, the instrument creates only such rights and imposes only such burdens as the parties thereto have specified in their agreement.

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NEW YORK, N. Y.