THE INVESTOR'S LEGAL GUIDE

Second Edition

by Stanley L. Kaufman

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INTRODUCTION

The most dangerous pitfalls for the investor are Ignorance and Laziness. *Under today's conditions, the* unsuccessful investor can no longer lay the blame for his losses at the door of his broker or at the portals of the Stock Exchange. In fact, the largest brokerage house in the world has for its motto a slogan "Investigate—then Invest", and the major Stock Exchanges are continually stressing the desirability for caution on the part of the small investor.

Yet, the ignorance of the average investor is astonishing. A recent survey indicated that a large proportion of stockholders were under the impression that the prices of securities were fixed from day to day by the Stock Exchange! Another large percentage of investors had no conception whatever of the difference between a stock and a bond! This attitude on the part of the general public is all the more surprising when one considers the care and study which the average citizen puts into the other important economic problems that arise during his every day life. For instance, if Mr. Investor is buying a house, he will shop carefully, study many factors in connection with his proposed purchase, and finally attempt to arrive at an informed and intelligent decision.

Or take the case of Mr. Bernard Businessman who after fifteen years of hard work and self-denial, has saved the sum of $20,000.00. He now plans to give up his job and to go into a business of his own. He hears that an interest in a good going business owned by Mr. Myron Management is for sale. Mr. Businessman naturally has so much respect and concern for his capital of $20,000 that he decides to minimize any risk by thoroughly checking his new venture. First he makes a careful investigation in the community concerning the general reputation of his prospective associate for honesty and business ability. Then he orders and studies a report from a credit agency. Next, he carefully analyzes the recent balance sheets and earning statements of the business and seeks the advice of an accountant. If he is cautious he will consult other people in the same line of business to determine whether there are any boobytraps which do not appear on the surface. Mr. Businessman will also seek the advice of his attorney, and may even call upon existing customers of the business to get their reaction to the quality and desirability of the products and services sold to the public. Finally, having weighed the indicated income and possibilities of growth against the calculated risks, and having discussed the matter intensely for days with his friends and relatives, Bernard Businessman purchases an interest in Mr. Management's business, crosses his fingers and hopes for the best.

Now, let's examine the case of Mr. Irwin Investor who by blood, toil and tears has accumulated a similar amount of $20,000 which he has conservatively invested in savings banks and Series E Savings Bonds. He decides to invest this money in stock in order to increase his income and perhaps make a "capital gain". One of the members of the club to which Mr. Investor belongs, buys and sells stocks from time to time, and frequently talks about his financial exploits—particularly about his "paper profits". He introduces Mr. Investor to his broker. The brokerage office radiates a pleasant air of prosperity. There is a Board Room in which the ever-changing prices are posted amidst a pleasant hum of activity. There is a busy ticker spewing forth impressive ribbons of tape. The customers are well-dressed and appear quite respectable. Mr. Investor is then introduced to one of the partners of the firm and is duly impressed by the latter's talk of prospective "stock-splits", "cutting a melon", and expected oil field discoveries. Before you can say "Bernard Baruch", Mr. Investor may find himself the owner of assorted corporate securities—knowing little or nothing about his purchases.

Whether or not he eventually profits by his stock purchases, one thing is clear—Mr. Investor has risked his hard earned capital with hardly a fraction of the careful analysis which he would have put forth had he been investing the same funds in a business of his own. True, he may have relied upon the expert advice of his broker, but he has ignored the maxim "Investigate—then Invest". Would he rely implicitly upon the advice of a business broker when buying a private business, without making a careful independent investigation on his own behalf? Obviously not. Would he rely blindly on the advice of a real estate broker when purchasing land? Yet, four out of five investors purchase stocks and bonds on our national Stock Exchanges without having any clear notion of the underlying economic value and legal organization of the corporation in which they are buying an ownership share.

Although corporation law and corporation finance may appear to be complex when approached superficially, the writer has never encountered and never expects to encounter a corporate concept which could not be explained to an average student—provided, of course, that the writer himself clearly understood the problem.

It is the aim of this book to present to prospective investors in simple terms a practical working notion of the organization and nature of corporations, the buying and selling of corporate securities, and of the rights of investors.

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Chapter 1

CORPORATE SECURITIES

The most primitive businesses were "one-man businesses" or "one-man farms". These primitive enterprises were necessarily limited in their size and in the type of business which they could undertake because the capital of a single entrepreneur was limited in amount, and because his death would usually disorganize the business. To eliminate these obstacles in the path of commercial growth, *partnerships* were developed, a partnership being an organization of several persons to carry on a business and to share in its profits and losses. However, when a partner died, his heirs were entitled to a reckoning and were entitled to be paid out by the surviving partners. Since a partnership thus terminated at the death of any partner, there was obvious disorganization and lack of continuity. Moreover, each partner was personally responsible for the debts of the partnership to the full extent of his own assets, and one obviously had to be very well-acquainted with his partner before undertaking the risk of joining him in a business enterprise.

To eliminate the danger of this personal liability, the *limited partnership* was created. This consisted of one or more active partners who actually ran the business, and one or more "silent partners" who merely put up funds. The general partners were fully and personally liable for all partnership obligations, whereas the limited partners, who had no voice in the management, were only responsible to the extent of the funds which they had invested in the particular business. The limited partnership is still used by many stock brokerage firms because, until recently, the corporate form of doing business was not permitted by the New York Stock Exchange. The limited partnership is also employed in the organization and capitalization of Broadway shows. Here, the producer of the show is usually the general partner, while the "angels" are limited partners with no power to participate in the management of the business.

Other forms of business organization have existed but none have been so successful as the *corporation* in achieving: (1) perpetuity of existence, (2) limited financial responsibility of participants, and (3) the ability to accumulate vast amounts of capital. Corporations have existed for centuries and are commonly regarded by historians and economists as being one of the most important factors in the growth of the democratic capitalist system and in the advancement of technological science. Unfortunately, however, on many occasions in the past corporations have been vehicles for the deception and looting of the public—commencing with the famous "South Sea Bubble", in which many anxious investors were ruined centuries ago, and continuing into our own generation, when the many frauds and abuses of the 1920's resulted in the considerable governmental regulation of corporate activities now existing and discussed in Chapter 2.

Organization of Corporations

The corporation is a "creature of the State". It can only be organized because the Law of the State of New York or of Delaware or of any other State or Nation provides that several human beings may join together to create the non-human new "person" which is the corporation. It is created in the United States by filing with the appropriate State Government an application for a Charter or Certificate of Incorporation which expressly contains the powers which the corporation is expected to exercise, and also sets forth the general outlines of its proposed financial structure.

After it has come into existence, the corporation is considered a separate entity in itself. If the corporation earns $100.00, it is taxed as a separate entity on the $100.00 it has earned. After it has paid its tax and the balance of its earnings have been paid over to its human stockholders, they too are each taxed upon the money that they have received. Recently, there has been a tendency to refer to this as "double taxation", but actually the practice of levying a separate tax upon the corporation as an entity and thereafter upon the stockholders is perfectly consistent with the legal concept of a corporation as a legal person separate and distinct from its shareholders. Nevertheless, there have been recent changes in the Federal Tax Laws in the direction of eliminating at least part of this so-called "double taxation".

After the corporation is organized and comes into existence, shares of stock are issued to stockholders, usually in return for money or property. The stockholders then elect a board of directors; the board of directors then appoints officers; and finally the officers hire employees and the business is ready to commence.

Corporate Securities

"Securities" is the name employed to describe generally all the pieces of paper which represent (1) shares of the ownership of the corporation, or (2) money owed by the corporation.

Ownership Securities

Ownership of a corporation is in the form of shares of *stock*. If a corporation has issued 1,000 shares of its stock of which Mr. A owns 500 shares, Mr. B owns 300 shares, and Mr. C owns 200 shares, this merely means that A owns 1/2 of the business, B owns 3/10ths of the business and C owns 2/10ths of the business. If the business is worth $100,000, each share of stock is worth $100. Stock may be "common stock" or "preferred stock".

PREFERRED STOCK: So-called because it is usually preferred over the common stock when dividends are paid. Dividends are such portion of the earnings of the corporation that the people in charge of the corporation (namely the board of directors) have in their sound discretion decided to distribute to the stockholders, after retaining a sufficient amount of the earnings in the treasury to provide for the future growth of the business and for other contingencies. Preferred stockholders will be paid their dividends out of earnings before the common stockholders receive anything. Usually, preferred stock provides for a fixed return, for instance, $6.00 per annum. Thus, if the company earns only enough to pay a $4.00 dividend on each share of preferred stock, the common stock, which has only a junior claim to the earnings, will receive nothing. However, if the company earns in excess of $6.00 for each share of preferred stock—let us say $15.00 per share—the preferred stock will nevertheless only receive $6.00, and the remaining $9.00 will go to the common stockholders.

Preferred stock dividends may be *cumulative or non-cumulative.* Cumulative means that if dividends are "skipped" for any year because there are insufficient earnings or for any other reason, the amount that is skipped, namely the arrears, accumulates in amount from year to year, and these accumulated preferred stock arrearages and all current preferred stock dividends must be completely paid before dividends can be paid to the common stockholders.

Non-cumulative preferred stock is unattractive to the investor because any dividends on such stock which are missed or skipped for any year are irretrievably lost even though there may have been sufficient earnings in the particular year to have paid dividends. These earnings, if retained in the treasury and not paid to the non-cumulative preferred stockholders, may be used in a later year to pay dividends on common stock. In this way directors could, if they so desired, very easily hoard a large fund for the benefit of the common stockholders by the simple technique of omitting to pay preferred dividends in years when the company is well-able to pay them. Such schemes, however, have been successfully attacked in the Courts as a violation of the directors' duty to be fair to *all* stockholders, and not to benefit one class of stockholders at the expense of another.

Preferred stock is often *callable,* that is, if the corporation discovers in the future that money can be obtained for corporate purposes cheaper than by paying $6.00 per share per annum to each share of preferred stock, the corporation will then have the right to "call" or pay off the preferred stock at its par value, plus any accumulated dividends, and usually plus a modest premium to compensate the investor for the inconvenience of having his investment interrupted through no choice of his own.

Preferred stock usually does not carry the right to vote. Occasionally, however, it may be entitled to vote like the common stock. Frequently preferred stock will have a restricted voting right which may only be exercised by the preferred stockholders if and when a default in preferred dividends has occurred and has persisted for a stated period of time. Preferred stock sometimes has more votes per share than each share of common stock. Although this is rather rare, it exists in the case of United States Steel Corporation in which each share of preferred stock is entitled to six votes whereas each share of common stock is only entitled to one vote. However, since United States Steel Corporation has approximately 53,000,000 shares of common stock outstanding and only 3,600,000 shares of preferred stock, the control of the corporation is, nevertheless, in the common stock.

The various preferred stock dividend provisions and voting provisions discussed above are basically, like all corporation securities, the result of a bargaining process between the company and the prospective purchaser of the stock. The investment banker, who ordinarily "floats" or sells the securities when they are issued to the public, is an expert in determining what provisions are necessary to make the security attractive and saleable. Like the merchandise manager of a department store, he will advise the corporation as to precisely what provisions the public will find attractive in the light of market conditions existing at a particular date.

Recently, The X Gas Pipeline Company sold 150,000 shares of $4.90 dividend preferred stock at $100.00 per share through a syndicate of investment bankers. It was announced that the proceeds of the sale would be used to help finance the company's new construction program. This stock was made callable at any time at prices up to

$105.00 per share. The $5.00 bonus or premium to the shareholder in the event that the stock is called, is, as we previously stated, in order to compensate the stockholder for the inconvenience of having his investment interrupted and his money returned to him against his will should the company in the future decide to do so.

Another recent preferred stock issue which will serve to illustrate the varied fashions in preferred stocks which different companies deem attractive to investors, is the sale of 202,000 shares of $50.00 par value, 4.5% *convertible* preferred stock by the ABC Brass Company. This stock is convertible into common stock until April 30, 1959 at a conversion price of $50.00 for the common, and at higher prices after April 30, 1959.

Preferred stock is also preferred over common stock should the company go out of business because of financial difficulties or for some other reason. If the company originally issued its preferred stock to the stockholders for $100.00 per share and its common stock for $50.00 per share, and if, on liquidation, it is discovered that there is only $125.00 of assets to cover both preferred and common stock, the preferred stock would be paid $100.00 (the original amount which the preferred stockholders invested), whereas, each common share would be paid only the remaining $25.00. The common stock would thus sustain a loss of $25.00 per share. The foregoing illustrates that preferred stock is a safer investment than common stock so far as it tends to preserve the dollar integrity of the original investment. Of course, if the corporation only has $75.00 in assets for each share of preferred stock, the preferred stock may sustain a loss of $25.00 per share, but in that event the common stock investment would be lost entirely. Going one step further, if the corporation's debts are so large that there is nothing left on liquidation for either preferred or common stock, then both classes of stockholders would lose their investment entirely.

The various provisions as to accumulation of dividends, preferences as to dividends and on liquidation, voting rights, callability, convertibility can all be found in the corporation's charter (on file in its office and with the Secretary of the State of incorporation), and in exceedingly fine print on the stock certificate.

COMMON STOCK: This is the stock owned by the entrepreneur—the risk taker—the true owner of the business. The common stockholder is paid his dividends only after all expenses of doing business, interest on money borrowed, taxes, and dividends on the preferred stock are first paid. He is in the position of greatest risk if the business is unsuccessful, but there is no ceiling on his profits if the venture should prove to be successful. The common stock usually is the only voting stock of the corporation and the common stockholders have the power to elect the directors who will guide the destiny of the corporation. Common stock is sometimes divided into different *classes* and each class may have different voting and other rights. For instance, in the case of a well-known paint company, the Class A stock has the right to elect 1/3 of the board of directors voting as a class, and the Class B stock has the right to elect 2/3 of the board of directors. Such an arrangement is usually in order to keep control in an inside clique. Preferred stock, which as stated above carries a fixed rate of return, will usually not have any great fluctuation in price since an investor will not normally pay much more than $100.00 for an investment which, by its terms, will never earn for him more than $5.00 or $6.00 each year. The value of common stock, however, may fluctuate quite widely as it may earn a great deal more (or less) next year than it earned this year. A share of common stock which paid $5.00 in dividends this year would have a value as an investment of perhaps $100.00, whereas if the business improves to such an extent that $10.00 in dividends is paid next year, this common stock will obviously rise greatly in price. It is obvious that the stockholder who owns a share of stock which he expects will pay him $10.00 per year will only sell that share of stock at a price well above $100.00.

Debt Securities

Corporate *debt securities* are quite different from stocks. Debt securities may be *bonds, debentures* or *notes.* These are the pieces of paper which the corporation gives out to the lender when the corporation borrows funds. The holders of these securities are creditors rather than owners of the business, and these securities accordingly do not have the right to vote.

BONDS: The most solid, safe and secure of all corporation securities is the *bond.* Corporation bonds are long term loans, usually secured by a mortgage on all or a part of the fixed assets of the corporation. Fixed assets are such things as factories, machinery, real estate, etc. If the corporation runs into financial difficulties or must for any reason be liquidated, the first claim against the assets (ahead of common stock, preferred stock and some taxes), belongs to the bondholder. Bonds do not pay dividends, they pay *interest.* The word "dividend" signifies the type of return which comes to the owner of a business. "Interest" signifies the type of return which comes to the creditor of a business. If the interest is not paid on the bonds, as agreed, it will result in the foreclosure of the mortgage. No matter how successful a business may be, the amount of interest paid to the bondholders does not increase. It is precisely the same situation as if an individual were to borrow $100.00 for a year at 6% interest. If the borrower thereafter received a raise in salary and a large inheritance from a rich uncle, he would still only be obligated at the end of the year to pay back $100.00 and $6.00 interest.

Because of the comparative safety of bonds as an investment, they yield a relatively low return. Good corporation bonds at the time that this book is written yield about 3¼% to 3½% interest on the amount invested. This is very little more than the yield on government bonds, which indicates that it is the general opinion of investors that the promise of a good corporation to pay its debt, secured by a mortgage on its property, is practically as safe as the promise to pay of the United States Government. This compares with a return on common stocks which, at the time of writing, varies from about $4\frac{1}{2}\%$ to 7% for good and reputable corporations. Since common stockholders take a greater risk than bondholders (who have the first claim against the assets of the corporation under their mortgage), common stockholders demand a higher return on their money.

Obviously all of the bondholders of a corporation—and there may be thousands of bondholders—cannot join together as a practical matter to take a mortgage as security for the money they have lent the corporation. In actual practice, the corporation gives a mortgage on its property to a bank or trust company, and the bank or trust company holds the mortgage as trustee for the numerous bondholders. In the event that the corporation fails to pay the principal or interest, it is the duty of this trustee to foreclose the mortgage and to dispose of the corporation's property for the benefit of the bondholders. Only if there is something left over after disposition of the corporate property and payment in full to the bondholders, do the preferred stockholders (and finally the common stockholders) receive anything.

DEBENTURES: Like bonds, *debentures* are long term loans to the corporation but usually they are not secured by a mortgage. Therefore, if a corporation has both bonds and debentures, the bondholders, who are secured by a mortgage on specific property are in the more protected position. Debentures, however, often contain other protective provisions for the debenture holders, such as an agreement by the corporation to accumulate a "sinking fund" out of earnings to provide for the eventual repayment of the debentures. These are funds which are ear-marked year by year and accumulated for that purpose.

NOTES: Corporation *notes* are pieces of paper which represent short term loans to the corporation, the lender or noteholder usually being a bank or insurance company. The corporation note usually represents a multi-million dollar loan (in the case of large corporations), and is held by a single institution rather than by thousands of members of the public as is usually the case in bonds, debentures, preferred stock and common stock. However, many banks and insurance companies also invest in bonds and debentures in sizeable amounts because the amount of stock which they are permitted to buy is limited by law. In the recent past, there has been a tendency to relax the laws to permit the purchase of more common and preferred stocks by banks and insurance companies in order to increase their rate of income. Stocks, bonds and debentures are the securities which are commonly bought and sold on Stock Exchanges. Notes are not.

Priorities

Thus, if the assets of a corporation were to be sold and distributed to the various investors, they would be paid in the following order of preference:

(1) The bond holders would first be paid all the principal and interest that was due to them.

(2) The debenture holders would be paid the funds that had been accumulated for their benefit in the sinking fund and would then share with the noteholders any remaining funds sufficient to pay off the sums which the debenture and noteholders had loaned to the corporation.

(3) The preferred stockholders would then be paid the stated value of the preferred stock and any accumulated dividends; and

(4) The common stockholders would receive such of the corporation's assets as might be left over.