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FINANCIAL PACKAGING IN PERSPECTIVE

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Much attention has been given to the current breed of financial expert who appears to gain attractive "leverage" for his firm's stockholders by devising imaginative new financial packages. Despite recent market reverses for the shares of leading conglomerates, many sophisticated observers in the financial community have exhibited a certain amount of awe at the creative boldness of a James Ling or a Charles Bludhorn in constructing these complex financing proposals.[1] It is the contention of this article that there is little if anything which is "new" either in the specific financing instruments now being used or in combinations thereof. Rather, whatever genius that can reasonably be attributed to these financial managers stems from their skill in adapting long-established financing instruments to new environmental circumstances.

There are really only four basic categories of financial instruments from which to choose: the common share, the preferred share, the debt instrument and the equity option or warrant. Clearly, none of these is a contemporary creation. No one would question the central role of the common stock and debt instrument dating from the very earliest organized business firms. Preferred shares can also be traced to several of the first English companies in the mid-sixteenth century.[2] Warrants (and the related equity conversion privilege) go back almost as far — there is a record that a Welsh silver miner issued warrants in connection with a refinancing in 1690.[3]

The terms incorporated in these securities offer considerably more opportunity for innovation. Such features as the income provision, equity participation, liquidation claim, and voting rights can be varied to produce a much larger matrix of possible packages than is indicated by the initial four security types. Even so, it is difficult to conceive of a financial package which does not have historical precedent. For instance, much attention has been given to a bond-warrant package devised by Ling-Temco-Vought, Inc. to effect a recapitalization several years ago.[4] The important features were the ability to use the bonds at par as a substitute for cash to exercise the warrants and the issuer's option to lower the warrants' exercise price by certain amounts for limited time periods. An essentially similar financing package, described by Arthur Stone Dewing in his classic treatment of financing instruments,[5] was in use during the economic boom of the 1920's.

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1 *Some Candid Answers from James J. Ling*, FORTUNE, Aug. 1969, at 92.

2 W. SCOTT, JOINT STOCK COMPANIES TO 1720 ch. I (1912).

3 *Id.* at ch. II.

4 *Some Candid Answers from James J. Ling*, FORTUNE, Sept. 1969, at 137.

5 A. DEWING, A STUDY OF CORPORATION SECURITIES 381 (1934).

The historic ebb and flow of these more complex financing instruments appears to be influenced by at least three important factors: (1) the trend in the securities markets; (2) the memory span of the financial and business community; and (3) the changing environmental constraints surrounding the financing decision.

TREND OF THE MARKETS

Dewing observed that certain financing instruments tend to surface in the latter stages of protracted bull markets.[6] He suggested that the most likely explanation of this phenomenon was a relaxation of investor fears about a market decline, encouraged by a sustained upward trend in stock prices. In such an atmosphere, investors displayed a willingness to participate in hybrid security financings (involving equity options and other special features) without raising serious questions as to their marketability under adverse market conditions. His hypothesis acquires contemporary credibility in the bull market of the 1960's; a recent study showed a marked change in the composition of corporate financings during the bull market period 1964-1968, from relatively uncomplicated securities in the earlier stages to relatively more sophisticated financing instruments in the latter stages of that equity market advance.[7]

MARKET'S MEMORY SPAN

The oftentimes unsatisfactory market performance of these sophisticated securities in the wake of the inevitable collapse of an exhausted bull market is the key to understanding the second determinant of the ebb and flow in complex financial packaging. The market has a long memory and appears to harbor a grudge against investment vehicles which have yielded inordinant losses.

The warrant is a case in point. Although it was a popular financing vehicle during the bull market of the 1920's, its inherent price volatility threw it into disrepute in the 1930's.[8] The warrants of the American and Foreign Power Company, for instance, were initially attached to $270 million of second preferred stock. At their peak price of $175 in 1929, they had a market value in excess of $1 billion. Their price declined disastrously in the wake of the 1929 crash, and in the recapitalization finally completed in 1952 the warrants were valueless although American and Foreign Power remained solvent.[9]

The stigma surrounding this form of equity option persisted until the mid-1960's, when investors began to "discover" all over again that the warrant was often more valuable than the then dominant convertible option

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6 *Id.*

7 Hayes & Reiling, *Sophisticated Financing Tool: The Warrant*, HARV. BUS. REV., Jan.-Feb. 1969, at 137.

8 B. GRAHAM, D. DODD & S. COTTLE, SECURITY ANALYSIS 656 (4th ed. 1962).

9 *Id.* at 657.

because the detachment of the equity option from the bond gave the investor greater flexibility.[10] Yet Dewing had long before established this same point when he observed that "corporations found that . . . investor customers would pay more when the warrant was removable [from the bond] and, therefore, subject to a separate and independent market."[11] It apparently took the passing of a generation of aggrieved investors and shell-shocked corporate financial officers before an objective reexamination of the merits of the warrant could be made. Its complete rehabilitation was marked by the January, 1970 announcement that American Telephone and Telegraph Company would employ warrants as part of a giant ($1.5 billion) rights offering to its stockholders and that the New York Stock Exchange would relax its no-warrants rule in order to list the company's new equity options.[12]

ENVIRONMENTAL CONSTRAINTS

Given the financial markets' natural preference for simple, clearly-understood financing arrangements, however, it is questionable whether either an extended bull market or investor amnesia would ever encourage widespread use of sophisticated financial instruments were it not for the shifting environmental constraints on corporate financing and personal investing. While there have undoubtedly been dips and rises in such regulation in the past, the general trend in the United States during the twentieth century appears to be in the direction of increasing controls. Today, for instance, complex tax laws and accounting conventions exert powerful influences — either consciously or inadvertently — on corporate financing arrangements. Their impact on the usefulness of preferred stocks and convertible debentures will serve here as illustrations.

Preferred stocks had fallen into disfavor in the post-World War II period partly because the tax laws gave an advantage to debentures with tax-deductible interest and partly because preferred shares were associated with financial weakness.[13] This stigma arose, it should be noted, because preferred shares were often created as substitutes for debt instruments in the capital structures of companies unable to service their fixed obligations during the Depression. As with warrants, they continued in disfavor during the 1950's and many companies sought to demonstrate their financial integrity by retiring all preferred issues which remained outstanding from the Depression years.

It required the merger boom of the 1960's to bring preferred shares back into their own, largely due to the structure of the tax laws which made it difficult to effect a tax-free exchange without using some form of

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10 Hayes & Reiling, *supra* note 7.

11 A. DEWING, *supra* note 5, at 401.

12 N.Y. Times, Jan. 23, 1970, at 33, col. 8.

13 Donaldson, *New Framework For Corporate Debt Policy*, HARV. BUS. REV., Mar.-Apr. 1962, at 117.

voting stock.[14] Because the common share offered no flexibility in terms, financial officers turned to the preferred stock, which could be essentially a "blank check" to management, issuable in special series with terms tailored to a particular group of investors.

As an example of just how far an alert management can go in constructing a special financial instrument to circumvent tax barriers, consider the terms of a tender offer made by Kinney National Corporation for the stock of Warner Brothers — Seven Arts Ltd. in 1969.[15] Kinney's offer was designed to outbid a competing proposal from another Warner suitor which included a taxable warrant. Kinney sought to make its own package tax-free by replacing the warrant feature with a unit of a special series of preferred stock convertible for 10 years into one Kinney common share upon payment of $37 (the current market price of the Kinney common) or upon the surrender of 15 additional shares of the preferred. The preferred was to pay a nominal dividend and would be entitled to one-half of a vote, an essential feature of a tax-free exchange.[16] In most other respects, this security is equivalent to a warrant in everything but name, and appears to be largely a creation of the current tax laws.

The impact of accounting conventions on financial packaging is illustrated by the changing attitude toward convertible debentures. In a companion article in this *Symposium*,[17] Professor Henry B. Reiling points out that prior to 1967, companies were permitted to exclude convertible options from the calculation of earnings per share as reported to stockholders. This made it attractive for aggressive financial managers to attempt to market this quasi-equity security in the place of a straight common stock offering because, among other benefits, the issuing company received a higher price for the underlying common shares[18] and temporarily avoided dilution. Beginning in 1967, a change in accounting principles[19] made the convertible debenture less attractive by reclassifying many such issues as common stock equivalents. This prompted some innovative financial managers to turn to the bond-warrant combination, which continued to be excluded from the definition of a common stock equivalent until 1969.[20] Even in the wake of the 1969 bulletin, the practical dilution implications of the warrant are significantly less onerous than those of the convertible option and it continues to be the favored vehicle.

In conclusion, there is little today that is really "new" in corporate

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14 INT. REV. CODE of 1954, §§ 368(a)(1)(B), (C).

15 MOODY'S INDUSTRIALS MANUAL, Mar. 11, 1969, at 1479.

16 INT. REV. CODE of 1954, §§ 368(a)(1)(B), (C).

17 *See* Reiling, p. 880 *supra*.

18 Brigham, *An Analysis of Convertible Debentures: Theory and Some Empirical Evidence*, 21 J. FINANCE 35 (1966).

19 AICPA, *Accounting for Lawyers*, ARB No. 9 (1966).

20 AICPA, APB OP. No. 15 (1966).

financings. We operate along an historical continuum in which financing techniques are largely predictable as a function of the prevailing business environment and the near-term history of the financial markets. This observation may encourage aspiring financial experts to become more serious students of business history.