DIGESTS OF LEADING LAW REVIEW ARTICLES


Status of Holders of Hybrid Securities: Stockholders or Creditors. 45 Yale L.J. 907 (March 1936).

The number of recent cases involving the status of holders of the so-called “hybrid securities” and the possibility that the same problem may arise in proceedings under 77 B of the Bankruptcy Act have caused increasing interest in this subject. As these two articles show, the hybrid securities have some of the characteristics of both stocks and bonds. The status of the holder is midway between that of owner and that of creditor. Usually, he seeks to be put in the latter classification.

Among the hybrid types are redeemable stocks, participating operation certificates, subscriptions to Tontine insurance, participating bonds, income bonds, voting bonds, trade certificates, etc. The particular name given to a security by the issuing corporation does not determine its classification. Usually the courts look for the characteristics which are typical of stocks or of bonds. A security which gives the holder no voice in the management of the corporation, or which provides for payment out of gross returns rather than out of net profit, or which calls absolutely for payment of a fixed amount at a fixed time, or which is secured by a mortgage or trust deed, is similar in these respects to a bond. On the other hand, a security with voting rights, or which is payable only out of net earnings, or whose interest is dependent on earnings, is in these respects similar to a stock. No particular characteristic is alone determinative of the classification of a given hybrid security, nor do the courts apply a quantitative test. Each case is decided on its facts thus making it difficult to determine in advance the status of the holder.

It has also been urged that the “general equities” should govern; that the holders of hybrids containing the promise of abnormal profits should not be classed as creditors. But such a test would be even more indefinite. Similarly, a test based on the intention of the issuer is difficult to apply. Some courts have held that if hybrids have been represented on the balance sheet to prospective creditors as stocks and if the holders
have not protested against such representations, the creditors should be
classed prior to these holders. Since some creditors would not have relied
on the representations and since some holders would not have known of
them, this test also would lead to considerable confusion. Generally,
courts have been unfavorable to hybrid securities and have called them
stocks unless they were clearly certificates of indebtedness.

The possible combinations of stock or bond characteristics seem
almost unlimited. No adequate test by which the status of holders can
be determined in advance has been suggested. One solution of the
problem would require a simplification of corporate structure and financ-
ing. The present trend seems to be in this direction, but to provide for
such simplification by general law is almost impossible. Mr. Hansen sug-
gests that the courts might arbitrarily class all hybrids as credit items.
If this were done, it would be more difficult for the corporation to
obtain credit from other firms, and, as a result, the use of hybrids would
be discouraged. On the other hand, the Yale comment suggests that
some aid may come through state Blue Sky laws, the Securities Act of
1933, and the Securities Exchange Act of 1934. If the status of hybrids
is not clear, the Commission may require that the registration statement
make it clear. The status indicated therein could be considered as a
highly important factor in any controversy which might arise.

LIABILITY OF THE LAWYER FOR BAD ADVICE — Nathan Isaacs
— Harvard Graduate School of Business Administration,

The lawyer's liability to his client has been affected by the nine-
teenth century prejudice for contract making. The result is a theory
of implied contract, both historically and analytically unsound. He is
said to represent himself as having "the ordinary legal knowledge and
skill common to his profession." But average facts do not conclude
specific cases, even if the average were ascertainable. Moreover, the
courts are thus thrust back to a standardized conception of the lawyer's
skill which the contractual approach sought to avoid.

Further, liability is not based upon a money consideration. The
form of action is generally in tort. If the lawyer warrants his advice
as true his function is destroyed, for he must tell his client to concede
all doubtful points to save himself.

Except for fraud or other tortious act, liability is owed solely to the
client; that is, it is determined by privity of contract. This conception