NOTES

THE RIGHT TO DIVEST ACCUMULATED ACCRUED ARREARS ON CUMULATIVE PREFERRED STOCK UPON CORPORATE RECAPITALIZATION.—The stockholder who has purchased cumulative preferred stock stands in a more advantageous position than holders of preferred stock in the respect that he is not limited for his share of the earnings to those profits of a particular, stated time.[1] The cumulative characteristic permits the holder to participate in future surplus in satisfaction of his present or past claim as distinguished from the preferred stockholder whose interest is not prospective and if not discharged in the present is lost in the future.[2] A cumulative preferred stock agreement entitled the promisee, before any dividends are paid to the holders of common stock to arrearages on unpaid dividends from previous divident periods.[3] Although dividends may not be deemed to be due until

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1. Wabash R. Co. v. Barclay, 280 U.S. 197, 74 L. Ed. 368 (1927). In Day v. U. S. Cast Iron Pipe & Foundry Co., 96 N.J.Eq 736, 126 Atl. 302 (E. & A. 1924), it was held that preferred shareholders were entitled to enjoin a payment to common shareholders before they were paid dividends which were due them from past years and which had been set aside in a "working capital reserve." The preferred holders had been paid their due dividend for the present year. Under authority of Sec. 18 of N. J. General Corporation Act and the by-laws and charter of the corporation, the court was of the opinion that a "working reserve" could be set up and as such could not be liquidated in favor of common shareholders if made up of payments which were due the preferred shareholders although not distributed. nor could a payment from earnings of the present year been distributed to common holders before the preferred were satisfied, as the claim to the payment of the dividends was a contract right which had vested.—In reality such a holding gives to the preferred shareholder the rights of cumulative preferred shareholders although the court claimed such an interpretation was without merit as under the statute preferred holder had priority as to those years when the earnings were sufficient to pay such dividends. It is significant that the court voted equally.—See also Continental Ins. Co. v. Minneapolis, 283 Fed. 276 (Minn. 1922), where common shareholders were allowed to participate in earnings of previous years which could be distributed even though preferred shareholders had not received the amount of their dividend preference for that year.

2. Collins v. Portland Electric Power Co., 12 F. (2nd) 671 (1926).

3. Penington v. Commonwealth Hotel Constr. Corp., 17 Del. Ch. 394, 155 Atl. 514 (1931); Spear v. Rockl Rockport Lime Co., 111 Me. 285, 93 Atl. 754 (1915).

declared, at maturity the dividend is considered accrued[4] and becomes a present property interest.[5] The right to its ultimate payment against the promisors becomes a vested right.[6] The cumulative holder derives his position either from reliance on an express agreement with the corporation or from an inference which will be employed, in some states, from the fact that a cumulative holder is firstly a preferred stockholder, i.e., if the preferred shareholder is not specially limited by agreement to share only as preferred, his right exists to share in succeeding and subsequent years until his dividend is paid.[7] However, this is not settled law as many courts hold the preferred shareholder to his limited position in abesnce of an agreement to the contrary,[8] and others hold the mere preferred agreement open to interpretation by a strict examination of the by-laws, charter and statute.[9] However, once it is determined that a preferred stockholder's interest is enhanced by the added cumulative feature it is unimportant to take into consideration the source in discussing the breadth and scope of the right. The difficulty arises when a corporation finding itself in a precarious financial status endeavors to amend its charter so as to effectuate a recapitalization plan by which the corporation may be relieved of pressure by standing unpaid accumulations on cumulative preferred stock. The usual method is to offer in return for the relinquishing of the cumulative claims shares in the issues under the recapitalization plan. If all interested stockholders agree to the change no difficulty arises but litigation has ensued where minority stockholders have refused to participate in the relinquishment, claiming the plan is a burden and tends to dissolve their vested right to priority under the agreement with the corporation. Courts have allowed amendments changing features of a class of stock such as the redemption to be paid,[10] the right to cumulative voting

4. *Ibid.*

5. *Ibid.* and General Investment Co. v. American Hide and Leather, 98 N.J. Eq. 326, 129 Atl. 244 (E. & A. 1925).

6. *Ibid.*

7. Fidelity Trust Co. v. Lehigh Valley R. Co., 215 Pa. St. 610, 64 Atl. 829 (1906).

8. Englander v. Osborne, 261 Pa. 366, 104 Atl. 614 (1918).

9. Hazeltine v. Belfast and M. L. R. Co., 79 Me. 411, 10 Atl. 328 (1887).

10. Sec. 18 of the General Corporations Act of New Jersey. Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 Atl. 696 (1923).

power of the stock,[11] and its prospective rights to dividends and the preference to which it is entitled.[12] But recapitalization plans which tend to cancel accumulated arrears accrued prior to the time of such a plan have been frowned upon and barred by the courts as interferring with certain vested definite rights of the stockholders.[13] The distinction between vested and prospective rights is of such importance in determining issues involved in charter amendment cases and the tendency of courts has been to allow a greater elasticity to the corporation in dealing with future rights of stockholders than with those that have become definite and ascertained.[14] It is, however, difficult to apply this distinction to dividends already accrued and the right to accumulated dividends which are to become due in the future, as basically, each stands in a preferable position as to common stockholders in the distribution of the future assets.[15] It is nevertheless significant that the result of litigation has pointed out that as soon as the agreed dividend is matured, it becomes a vested right as against the corporation.[16]

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11. Looker v. Maynard, 177 U.S. 46 (1900); Maddock v. Vorclone Corp., 17 Del. Ch. 39, 147 Atl. 255 (1929).

12. Peters v. U. S. Mortgage Co., 13 Del. Ch. 11, 114 Atl. 598 (1921); *contra*: Pronick v. Spirits Distributing Co., 58 N.J.Eq. 97, 42 Atl. 586 (Ch. 1899).

13. Kennedy v. Carolina Public Service Co., 262 Fed. 803 (1920); Lonsdale Securities v. International Mercantile Marine Corp., 101 N.J.Eq. 554, 139 Atl. 50 (Ch. 1927); McKenzie v. Guaranteed Bond and Mortgage Co., 168 Ga. 145, 147 Se. 102 (1929); Wilson v. Laconia Car Co, 275 Mass. 435, 176 N E. 182 (1930); Willcox v. Trenton Potteries Co., 64 N.J.Eq. 173, 53 Atl. 474 (Ch. 1902).

14. Peters v. U. S. Mortgage Co., 13 Del. Ch. 11, 114 Atl. 598 (1921); Davis v. Louisville Gas & Electric Co, 16 Del. Ch 157, 142 Atl. 654 (1928); Yoakum v. Providence Biltmore Hotel Co., 34 F. (2nd) 533 (1929)—Cumulative preferred stock changed as to its character in the future. Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 Atl. 696 (1923); Randle v. Winona, 206 Ala. 254, 89 So. 790 (1921)—Preferred shareholders may be completely deprived of the right to vote.

15. Corporate Recapitalization by Charter Amendment, 46 YALE L. R. 985, and 1 DEWING, FINANCIAL POLICY OF CORPORATIONS, 1st Ed. (1921): "If a considerable amount of the unpaid dividends accumulate and the company meets with more prosperous conditions, the managers, who probably control the common stock, will often try to induce the preferred shareholders to surrender their claims on the plea of some equitable adjustment."

16. Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 Atl. 696 (1923). As soon as the agreed dividends is mature it becomes a present vested

Delaware, the state of broad corporate policy, has an interesting statutory history in its treatment of the authority to dispel accrued cumulative dividends. Prior to 1927,[17] the case of *Morris v. American Public Utilities*.[18] was presented to the Court of Chancery. A recapitalization was planned which tended to wipe out accrued accumulations. It was decided by the court that the right by statute to change "preferences" in a corporate organization, while broad enough to include the displacement of future accumulations was not to be interpreted as allowing those accumulations which had accrued prior to the attempted action to be subject to forfeiture as they were not such contemplated "preferences." However, in 1927 the Corporation Statute of Delaware[19] was amended to allow corporations to change "special rights" of stock as well as "preferences." Subsequently in *Keller v. Wilson*[20] the added inclusion within the statute, i.e., "special rights," was held by the court to include the right by amendment to divest stockholders of accrued accumulated arrears by a vote of the majority. This interpretation of the statute was a product of the Court of Chancery and was later criticised by the Supreme Court of Delaware in *Consolidated Film Industries v. Johnson*.[21] The latter court was of the opinion that to destroy the right to accumulated arrears was to destroy the right in the nature of a debt. Such action could not be justified by characterizing it as a valid amendment but was of far more significance and effect. The shareholders' contract exists, although he buys with the possibility of having his investment changed, as he assumes such risk upon purchase. He is put on notice by provisions of the statute that his preferences in the future may be displaced. The inclusion of "special rights" may not be deemed to extend the power of amendment so as to charge the stockholder retrospectively as to past accumulated accrued arrears. It was never intended that the amendment to the statute should relate retrospectively, and in order to substantiate such claim there must be clear statutory language to that effect.

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interest.

17. Prior to 1927 "preferences" of outstanding stock could be changed by amendment under authority of statute.

18. *Supra*, note 16.

19. 35 Delaware Laws, C. 35, Sec. 10.

20. (Del. Ch.) 180 Atl. 584 (1935). Refused to apply equitable principle.

21. (S. Ct. of Del.) 197 Atl. 489 (1937).

The result of the foregoing decisions would seem to be that Delaware's corporation statute allows an amendment to a corporation charter which provides that accumulated unpaid dividends in the future may be dispelled by a majority, but as to those dividends which accrued prior to adoption of the amendment, the statute may not be interpreted as giving legislative sanction to the cancellation.

In a recent Ohio case[22] a plan of recapitalization was offered whereby the accumulated dividends on cumulative preferred stock could be deferred in priority to new issues. The corporation allowed the stockholder an option of either accepting shares in the new issue or retaining his old stock. Objection was made by minority stockholders and the Ohio Court of Appeals decided that the stockholder by his contract with the corporation, agreed to permit the creation of a prior stock whenever two-thirds of the shares so voted. Because of the option in favor of the shareholder it was held that his vested contract right was preserved. It is questionable, however, whether such an option has the effect which the court deemed it to have. It is probable that the recapitalization was planned for reason that earnings were at a low ebb with little hope for improvement. Therefore, it is significant that holders of the old stock might be forced to exchange their holdings for the new to prevent a part of the old stock from gaining preference over the other, when the effect of such preference may be to participate in dividends.[23]

New Jersey by statute[24] provides that no corporation may change its outstanding preferred or special stock if the result would be "to reduce the right to cumulative dividends," unless two-thirds in interest of each class of such preferred or special stock shall also vote in favor of the change. Does the statute assert a retrospective privilege to divest accrued accumulations or is the language to be interpreted as limiting the power to effect accumulations to accrue in the future? This question was presented to the Court of Errors and Appeals in 1925 when a corporation intended to issue its unissued stock as a prior preferred stock, to have priority as to principal and cumulation, thereby dispelling the favored position of existing cumulative preferred stock-

22. 133 Ohio St. 567, 15 N.E. (2nd) 127 (1938).
23. 33 ILLINOIS L. R. 212, in which this case is adequately commented upon.
24. Sec. 27 of the General Corporation Act of N. J.

holders. The statutory formalities as to voting and registering were complied with and a non-consenting minority sought to enjoin the corporate recapitalization claiming there was no authority in the charter for such action and further that the agreement was a contract "inter-Esse" between the stockholders and could not be altered unless by unanimous consent of all the stockholders. The court ruled in favor of the recapitalization and answered the contention of the minority by asserting that a corporation may issue prior preferred stock when the power is conferred by statute under which the corporation is organized and further that such statute is part of the charter of every corporation and thereby part of every stockholder's contract. It was pointed out that if there was an express agreement in the charter that no prior stock would be issued, the non-consenting holders could prevail, but in absence of such agreement the cumulative holders assumed a risk of being displaced in preference by future priorities under the terms of their stock agreement. However, if there was an attempt to pay the new prior preferred or common stockholders before the unpaid dividend which had already accrued upon the existing cumulative stock the plan would be enjoined. As to these dividends the holders thereof have a vested contract right as against those who had no priority at the time of maturity of the dividends and as against those who promised to pay, even at some future time, which may not be divested.[25]

In two subsequent decisions of the Court of Chancery, *Windhurst v. Central Leather Co.,* the U. S. Leather Co. in which a merger was contemplated,[26] and *Lonsdale v. International Mercantile Marine Co.,*[27] in which a recapitalization plan was offered which would tend to divest accumulative accrued dividends and in the latter the Vice-

25. General Investment Co. v. American Hide & Leather, 98 N.J.Eq. 326, 129 Atl. 244 (E. & A. 1925). In order that a corporation may change "rights" claimed under a charter, three contracts are involved, (1) corporation and shareholders, (2) state and corporation, (3) that between shareholders. Two objections are presented in that a contract may not be changed without the consent of the parties thereto, and the constitutional restriction of state laws which divest obligations of contract. U. S. Constitution, Art. 1, Sec. 10; 46 YALE L. R. 985. Curran, *Minority Stockholders and the Amendment of Corporate Charters,* 32 MICH L. R. 743. Dodd, *Dissenting Stockholders and Amendments to Corporate Charters.*

26. 105 N.J.Eq. 621, 149 Atl. 36 (Ch. 1930).

27. 101 N.J.Eq. 554, 139 Atl. 50 (Ch. 1927).

Chancellor gave injunctive relief to prevent the contemplated plan, stating not to do so would interfere with the stockholders' vested rights and would tend to lessen the investment value of the stock. It was held to be beyond the corporation, the Court of Legislature to allow the change. Whereas in the former case the Vice-Chancellor states: "In the Lonsdale case there was a surplus of some $17,000,000 in which I felt the secured stockholders had some right which could not be diminished or destroyed in the case of anyone of them without his consent, no such case is presented here. The proofs disclose there is a deficit of $20,000,000 which will continue to mount year by year unless some such corporate step should be allowed as the one these complainants seek to defeat." A criticism has been made of the reasoning in the latter case as "preferred dividends do not become a charge until earned, and while the accumulation of back dividends may be so large as virtually to preclude a distribution to the common shareholders, the accumulation unlike unpaid interest upon fixed obligation do not increase the deficit."[28] However, the Windhurst case was not decided solely upon the ground of a lack of surplus. The decision was supported further in that the minority had withheld its action until the corporation had incurred expenses in furthering its plans and then asserted its obligation; and secondly, that the loss to the stockholders was only 50 cents a share after readjustment,[29] thereby relieving the stockholder of too great a loss in relation to the fact that possible failure of the corporation would ensue. The Court was evidently of the opinion that insolvency of the corporation was inevitable and in order to alleviate a situation which probably would be more costly to the shareholders if the plan were enjoined, allowed the recapitalization. Such result is approved in England as representing an equitable adjustment to a right and necessity which conflict.[30] It would seem that if the cumulative stockholder is presented with a certificate of new stock and such stock is substantially alike in provision to the old he is not harmed to such an extent as to

28. 33 ILLINOIS L. R. 212.

29. "A majority of jurisdictions seem to permit the amendment upon a showing that the business interests of a corporation, including class of stock whose preferences are affected, require the change." *The Modern Corporation and Private Property*, Berle and Means, p. 269.

30. Oban and Aultmore Glenlivet Distilleries, Ltd., 5 Sess. Cas. 1140; Last v. Buller and Co., Ltd., 36 T.L.R. 35 (Ch. 1919); Welsback Incandescent Gas Light Co., Ltd., 1 Ch. 87 (1904).

warrant an injunction to forbid a recapitalization, the sole purpose of which is to prevent the corporation from becoming insolvent. While it is a fact situations are rare in which a stockholder will be enabled to preserve his original position to a substantial extent, yet a majority of the cases present the corporate necessity for recapitalization due to impending disaster.[31]

The stockholder is protected by equitable principles which forbid an oppression of minority by the majority in the exercise of their rights,[32] and while the stockholders have the right by a majority vote to amend the corporate charter such action must be in furtherance and in conformance with equitable principles.[33] The right to amend is not an absolute right despite the power granted by statute and provision in the certificate of incorporation.[34] The tendency is to protect the minority from any oppression by the unified action of the stockholders. It is certainly of equal importance to protect the majority from oppression by the minority. If the corporation may be forced to rest upon a hopeless capital structure by an objection from a minority stockholder who asserts his vested contract right the equitable principle should also run in favor of majority stockholders. If recapitalization is desired not to avoid insolvency but for purpose of accumulating further capital[35] from which the corporation as a whole will greatly benefit and consequently stockholders are placed in a more secure position; and further, if the minority is offered substantially the same advantages in return for their old stock, it would seem an empty gesture to allow the minority a claim of oppression.

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31. Lonsdale v. International Mercantile Marine Co., 101 N.J.Eq. 554, 139 Atl. 50 (Ch. 1927) is a typical example.

32. *Supra*, note 30.

33. *Supra*, note 29.

34. *Ibid.* The state is interested as a matter of public policy to see that a corporation shall posesss such powers as will promote their welfare generally as there is a necessity for a corporation to guide its capital structure, but the state in the furtherance of its interest may not contravene the Constitution of the United States. Davis v. Louisville Gas & Electric Co., 16 Del. Ch. 157, 142 Atl. 654 (1928).

35. Hinckley v. Schwarzchild & Sulsberger Co., 95 N.Y.S. 357, 107 App. Div. 470 (1905); Salt Lake Automobile Co. v. Keith-O'Brien Co., 45 Utah 218, 143 Pac. 1015 (1914).