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Corporations - Preference Rights on Dissolution

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CORPORATIONS—PREFERENCE RIGHTS ON DISSOLUTION—The capital structure of the defendant corporation consisted of class *A*, class *B*, and preferred stock. According to the articles of association, the class *A* stock was entitled to a ten percent dividend before any dividend was paid on the class *B*. After the class *B* stock had also received a ten percent dividend, the two classes were to share equally in any further dividends. The charter further provided that on dissolution the holders of the class *A* stock were entitled to cash to the amount of the par value of their stock before any payment in liquidation was made to the holders of the class *B* stock. Upon dissolution of the defendant, the class *A* stockholders claimed the right to share equally with the class *B* stockholders in surplus assets remaining after both had received the par value of their stock. *Held,* all assets remaining after the holders of class *A* stock have received par value are to be distributed to the class *B* shareholders. The preference given class *A* stockholders on dissolution is clearly exhaustive. *Mohawk Carpet Mills, Inc. v. Delaware Rayon Company,* (Del. Ch. 1954) 110 A. (2d) 305.

Historically, stock preferences may be divided into two types: (1) rights with respect to dividends, and (2) rights concerning the distribution of assets on dissolution.[1] The relative rights of the various classes of stockholders with regard to these preferences is a matter of contract, governed by the corporate charter.[2] When these rights are clearly set forth in the charter there is no problem. The difficulty arises when the articles allocate a given preference to one class of stock without stating the rights of all the stockholders after the stipulated preference has been realized. The problem then becomes one of construction, with a lack of agreement among the courts as to the effect of this omission in the charter. When the preferred stock is granted a preference with respect to dividends, without more, most courts hold that this provision is exhaustive, and that all dividends declared after the preferred stock has received this preference belong to the common.[3] Many factors have been relied on to sustain this position,[4] but the basic foundation of the majority view lies in the maxim *expressio unius est exclusio alterius*,[5] backed up by a "common understanding" of the investing public as to the nature of preferred stock.[6] A few courts, adhering to the theory that all classes of stock are equal in the absence of provision to the contrary, allow the preferred stock to share in dividends beyond the stated preference,[7] once the common has received an amount equal to the priority given the preferred.[8] The advocates of this view maintain that the

[1] Goldman v. Postal Telegraph Inc., (D.C. Del. 1943) 52 F. Supp. 763. See generally 39 CALIF. L. REV. 568 (1951).

[2] STEVENS, HANDBOOK ON THE LAW OF PRIVATE CORPORATIONS, 2d ed., 468 (1949).

[3] Scott v. Baltimore & O. R. Co., 93 Md. 475, 49 A. 327 (1901); Stone v. United States Envelope Co., 119 Me. 394, 111 A. 536 (1920); Tennant v. Epstein, 356 Ill. 26, 189 N.E. 864 (1934). See Rowell, "Rights of Preferred Shareholders in Excess of Preference," 19 MINN. L. REV. 406 (1935).

[4] Will v. United Lankat Plantations Co., [1912] 2 Ch. 571, affd. [1914] A.C. 11 (implied term of the contract); Niles v. Ludlow Valve Mfg. Co., (2d Cir. 1913) 202 F. 141 (common stockholders bear loss in times of adversity and thus should receive benefit in times of prosperity); Scott v. Baltimore & O. R. Co., note 3 supra (skillfully drawn charter taken as indication that all rights were stated and nothing left to construction).

[5] Tennant v. Epstein, note 3 supra; Stone v. United States Envelope Co., note 3 supra.

[6] "Surely the phrase 'preferred stock' holds out to the ear of the ordinary investor no promises of participation in earnings beyond his preferential dividend." Stone v. United States Envelope Co., note 3 supra, at 398. See also Powers Foundry Co. v. Miller, 166 Md. 590, 171 A. 842 (1934).

[7] Englander v. Osborne, 261 Pa. 366, 104 A. 614 (1918); Sternbergh v. Brock, 225 Pa. 279, 74 A. 166 (1909); Star Publishing Co. v. Ball, 192 Ind. 158, 134 N.E. 285 (1922).

[8] Although Professor Thompson in his article, "Respective Rights of Preferred and Common Stockholders in Surplus Profits," 19 MICH. L. REV. 463 (1921), lists *pari passu* sharing of *all* dividends after the preferred has received its preference as a possible theory, he is quick to point out that this theory has not been accepted by any court. Indeed, in Niles v. Ludlow Mfg. Co., note 4 supra, the court rejected the preferred shareholders' claim based on the minority view partially because a logical extension of this position would allow the preferred to share equally in all earnings in excess of its preferential dividend. As a practical matter, the preferred stockholders usually concede the right of the common stock to an amount equal to the preference involved before claiming a *pari passu* share. See principal case at 306.

preferred stock's preference as to time should not create an automatic preference as to amount for the common stock.[9] Some courts have drawn a distinction between cash and stock dividends, recognizing an exception to the majority view when a stock dividend is involved and when denial of equal participation among the preferred and common stock would affect the voting control, or interest in total corporate assets, of the preferred stock.[10]

The second branch of stock preferences, rights to surplus assets on dissolution, has been litigated less frequently. The principal case appears to be the first American case to deal with the problem. The early view of the English courts was that after the common stock had received an amount equal to the liquidation priority given the preferred, both should share equally in the remaining assets.[11] Dissolution rights were distinguished from those involving dividends,[12] and the burden placed on the common stockholders to show why both classes should not share equally.[13] In 1949, however, in *Scottish Insurance Corp. v. Wilsons and Clyde Co.*,[14] and *Re Isle of Thanet Electric Supply Co.*,[15] prior authority was overruled and a rule of law adopted similar to the majority rule on dividend preferences.[16] All assets remaining after the preference given to the preferred stock prima facie belong to the holders of the common, with the burden resting on the preferred stockholders to show that the charter provides otherwise. In this fashion, preferred shareholders were reduced to a position paralleling that of debenture holders.[17] Besides the fact that the holding of the court in the principal case is in accord with existing authority, further support for the decision may be found in the fact that the defendant's charter specifically provided for *pari passu* sharing of dividends, while remaining silent on this matter in the case of dissolution.[18] As pointed out above, the rights of stockholders in excess of stipulated preference depend on the construction given the corporate charter. For this reason, as in other areas of the law involving questions of construction, the desired objective lies not so much in

[9] See Christ, "Right of Preferred Stock to Participate in the Distribution of Profits," 27 MICH. L. REV. 731 (1929).

[10] Ibid.; Riverside and Dan River Cotton Mills, Inc. v. Thomas Branch and Co., 147 Va. 509, 137 S.E. 620 (1927). But see Niles v. Ludlow Mfg. Co., note 4 supra.

[11] In re William Metcalfe and Sons, Ltd., [1933] 1 Ch. 142; In re Fraser and Chalmers, Ltd., [1919] 2 Ch. 114; In re Espuela Land & Cattle Co., [1909] 2 Ch. 187. *Contra*, In re National Telephone Co., [1914] 1 Ch. 755.

[12] See Will v. United Lankat Plantations Co., note 4 supra. But see BALLANTINE, CORPORATIONS, rev. ed., §217 (1946).

[13] In re William Metcalfe and Sons, Ltd., note 11 supra; In re John Dry Steam Tugs, Ltd., [1932] 1 Ch. 594.

[14] [1949] A.C. 462.

[15] [1949] 2 All E.R. 1060.

[16] For a comprehensive analysis of the development of English law on this subject and the significance of the Scottish Insurance and Isle of Thanet cases, see "Participating Rights of Preference Shares," 209 LAW TIMES 36 (1950); "Rights of Preference Shares in Winding Up," 1950 SCOTS LAW TIMES 69.

[17] Scottish Ins. Corp. v. Wilsons and Clyde Coal Co., note 14 supra.

[18] In this connection see also the articles of association involved in Re Isle of Thanet Electric Supply Co., note 15 supra, and In re National Telephone Co., note 11 supra.

which particular construction is chosen as in the formulation of a definite rule that can be relied on in the future. Careful draftsmen will leave nothing to construction by including in the charter an express provision granting or denying participation rights. However, for purchasers of stock in corporations having articles which are silent as to participation rights on dissolution, the existence of a definite rule of construction is invaluable.

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