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CORPORATIONS-EFFECT OF MERGER UPON APPARENT RIGHTS OF STOCKHOLDERS UNDER PREFERRED STOCK Contracts

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CORPORATIONS—EFFECT OF MERGER UPON APPARENT RIGHTS OF STOCKHOLDERS UNDER PREFERRED STOCK CONTRACTS—A period of comparative business prosperity following an economic depression is certain to stimulate schemes of corporate reorganization aimed at the preferred stock contract, and particularly at adjustment or cancellation of unpaid dividends on cumulative preferred stock. When a corporation having an outstanding issue of cumulative preferred stock has survived a period of depressed earnings, it is likely to find itself emerging into a more prosperous period burdened with preferred dividend accumulations that would take years to satisfy from anticipated future earnings alone. Obviously, there is little reason for optimism on the part of the owners of common stock if, according to the usual rule,[1] they must wait until the preferred stock contract is satisfied before any of the expected future earnings can be distributed to them. The common stockholders are interested in some means of fulfilling the preferred stock contract other than by payment of all the dividends called for, which means either that all the preferred stockholders must consent to something less, or that some procedure must be employed which will conclude the interests of the preferred stockholders without their consent or with the consent of less than all. Apart from payment, there are two principal means of adjusting the apparent priorities of all the preferred shareholders with less than their unanimous consent. One of these methods involves amendment of the corporate charter,[2] and the other takes the form of merger, consolida-

[1] 11 FLETCHER, CYC. CORP., perm. ed., §5296 (1931); 12 id., § 5447.

[2] On the subject of the effect of charter amendments on preferred stock, see, inter alia, Management Plans without Aid of Committees, REPORT OF S.E.C. REORGANIZATION COMMITTEES, PART VII, pp. 109-197, 464-525 (1938); BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 208 et seq. (1932); KEHL, CORPORATE DIVIDENDS 200 et seq. (1941); Curran, "Minority Stockholders and the Amendment of Corporate Charters," 32 MICH. L. REV. 743 (1934); Meck, "Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine," 55 HARV. L. REV. 71 (1941); Becht, "The Power to Remove Accrued Dividends by Charter Amendment," 40 COL. L. REV. 633 (1940); Dodd, "Dissenting Stockholders and

tion, or sale of corporate assets. It is the purpose of this comment to examine the effect of merger upon some of the provisions of the preferred stock contract.

I

The power to merge depends entirely upon statute,[3] and every case relating to the impact of merger necessarily involves some statutory construction. For purposes of illustration, use of the Delaware merger statute seems appropriate because of the great number of corporations organized in that state,[4] because many of the leading cases in the field concern Delaware corporations, and because the statute is typical of those states which have general merger statutes.[5] The Delaware statute authorizes merger of any two or more domestic corporations, and provides:

> ". . . The directors, or a majority of them, of such corporations as desire to consolidate or merge, may enter into an agreement signed by them and under the corporate seals of the respective corporations, *prescribing the terms and conditions of consolidation or merger, the mode of carrying the same into effect, . . . as well as the manner of converting the shares of each of the constituent corporations into shares of the consolidated corporations. . . .*"[6]

The statute further states that the agreement shall become effective upon approval of two-thirds of the total number of shares of capital stock of each constituent corporation, and compliance with certain administrative provisions. The possible consequences of a literal application of the statute are readily apparent.

In fitting the merger statute into the field of permissible corporate acts, the basic principle involved is that the corporate charter, of which the corporation statutes are a part,[7] constitutes a contract between the

Amendments to Corporate Charters," 75 UNIV. PA. L. REV. 585 (1927); and annotations, 6 A.L.R. 802 (1920), 67 A.L.R. 765 (1930), and 133 A.L.R. 653 (1941).

[3] BALLANTINE, CORPORATIONS, rev. ed., § 289 (1946).

[4] LARCOM, THE DELAWARE CORPORATION (1937), traces the development of popularity of incorporation under Delaware law.

[5] S.E.C. REPORT ON REORGANIZATION COMMITTEES 531, note 19 (1938). The REPORT lists thirty-three states as probably permitting merger without special legislative action. Id. 526.

[6] DEL. REV. CODE (1935), c. 65, § 2091. (Italics supplied.) An additional provision, § 2091A of the code, expressly provides for merger of Delaware principals with subsidiaries incorporated in Delaware or elsewhere [Del. Laws (1937), c. 131, § 2], but this was held to add nothing to the power of Delaware corporations, as concerns merger with a wholly-owned Delaware subsidiary. Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A. (2d) 331 (1940).

[7] 13 AM. JUR., Corporations, § 73. In Delaware, this is expressly provided by statute. Del. Rev. Code (1935) c. 65, § 2115.

state and the corporation,[8] between the corporation and the stockholders, and among the stockholders *inter sese*.[9] Therefore, a merger attempted in violation of the contract is at least voidable by one whose rights thereunder are impaired without his consent. But what rights does a stockholder have under the contract, and when may he be said to have waived or consented to their impairment? If a corporation charter and certificates of stock issued under the charter provide that each share of preferred stock shall be entitled to a 7 per cent cumulative preferred dividend, it would seem that the preferred stockholder has a contractual right to receive those dividends. If the charter and stock certificate say that the corporation will pay the preferred stockholder in cash 110 per cent of the amount of the reduction in value of his stock in the event of merger, that, too, would appear to be a contractual right. At least it is probable that those are rights which the preferred shareholder in fact believes he is receiving when he purchases his stock. But under the Delaware type of statute, such a stockholder is likely to discover that he has failed to consider the effect of the provision authorizing a merger upon the "terms and conditions" and in such "manner of converting the shares" as the directors may prescribe and of which two-thirds of the stockholders may approve. On the premise that the merger statute is a part of the charter and that the charter is the measure of the stockholders' contractual rights, the courts have regarded the effect of merger upon the apparent rights of the stockholders as a question almost exclusively controlled by statutory interpretation.

It is for this reason that Delaware corporations have found merger an effective vehicle through which to eliminate preferred dividend arrearages. In 1936, the Delaware Supreme Court decided *Keller v. Wilson & Co., Inc.*,[10] holding that a reserved power to change "special rights of shares"[11] by charter amendment could not be used as a basis for amending away accrued but unpaid preferred stock dividends.[12]

[8] Trustees of Dartmouth College v. Woodward, 4 Wheat. (17 U.S.) 518 (1819).

[9] On the tripartite contract concept of corporate charters, see Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 A. 696 (1923).

[10] 21 Del. Ch. 391, 190 A. 115 (1936). See also, Consolidated Film Industries v. Johnson, 22 Del. Ch. 407, 197 A. 489 (1937).

[11] Del. Rev. Code (1935) c. 65, § 2058.

[12] But this reserved power has been held to permit a corporation to issue new prior preferred stock, making the old preferred and its accrued unpaid dividends subordinate to the dividend preferences of the new issue. Shanik v. White Sewing Machine Corp., 25 Del. Ch. 371, 19 A. (2d) 831 (1941). Thus, by authorizing the issue of a new preferred stock in exchange for the old preferred with arrearages, a corporation may effectively, although indirectly, coerce the holders of the old preferred into converting their shares and surrendering their rights to unpaid dividends by the simple expedient of paying dividends on the new stock to the exclusion of the

Despite the sweeping "vested rights" language of the *Keller* case, four years later the same court, in *Federal United Corp. v. Havender*,[13] held that the arrearages could be compounded by merger.[14] In dismissing a bill to have the merger declared void, the court in the *Havender* case said that the merger statute gave notice to "the average intelligent mind"[15] that rights to accrued dividends were subject to adjustment in the event of merger. The statute had been in force since the inception of the state's General Corporation Law, said the court, and was written into every corporate charter, informing the stockholder when he acquired his stock that his right to accrued dividends was defeasible by merger.[16]

The harsh result of holding arrearage elimination to be a question solely of corporate power[17] was softened only slightly by the Vice-Chancellor of Delaware in *Porges v. Vadsco Sales Corp.*[18] Since the *Havender* case had not raised the question of fairness,[19] an attack on that ground appeared to be the only course left open to the dissentient stockholder. In the *Porges* case, a preferred stockholder contended that a proposed merger was unfair to the point of "constructive fraud" because the allocation of converted shares under the merger agreement would give the old common stockholders new stock with a book value of at least $500,000 in exchange for old stock which was under water

old. Accord: Kreicker v. Naylor Pipe Co., 374 Ill. 364, 29 N.E. (2d) 502 (1940); Johnson v. Lamprecht, 133 Ohio St. 567, 15 N.E. (2d) 127 (1938). But cf. Patterson v. Durham Hosiery Mills, 214 N.C. 806, 200 S.E. 906 (1939).

[13] 24 Del. Ch. 318, 11 A. (2d) 331 (1940).

[14] The courts and writers have gone to great lengths in attempting to distinguish the Havender case from the Keller case. The explanation of Professor Meck, that the distinction lies solely in the extent of corporate power reserved under the different statutory provisions relating to amendment and merger, appears to be quite acceptable. Meck, "Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine," 55 HARV. L. REV. 71 (1941). Still, from the point of corporate practice resulting from the two decisions, there is much force in the statement of Judge Biggs in Hottenstein v. York Ice Machinery Corp., (C.C.A. 3d, 1943) 136 F. (2d) 944 at 951, that "Havender broke Keller's back."

[15] Federal United Corp. v. Havender, 24 Del. Ch. 318 at 334, 11 A. (2d) 331 (1940).

[16] Judging from the court's analysis of the Keller case, a different result might have been reached had the corporation been organized before the enactment of the statute. Id. at 333. The court avoided the problem of retroactivity of a later statute expressly providing for mergers of principals with subsidiaries (supra, note 6) by holding it to be merely declaratory of the general power to merge under the earlier statute. Id. at 332.

[17] Meck, "Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine," 55 HARV. L. REV. 71 (1941).

[18] (Del. Ch. 1943) 32 A. (2d) 148.

[19] The plaintiff's generous concession that the merger involved in the Havender case was "fair and equitable" may have been his greatest mistake. See Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 at 801 (1942).

to the extent of nearly $2,000,000. While the court acknowledged that "the exercise of the statutory right of merger is always subject to nullification for fraud," it said that when "constructive fraud" is charged "the unfairness must be of such character and so clearly demonstrated as to impel the conclusion that it emanates from acts of bad faith, or a reckless indifference as to the rights of others interested, rather than from an honest error in judgment."[20] Viewing all the provisions of the proposed merger, the court found no fraud to fit its definition and dismissed the bill.

2

This view, that arrearage elimination by merger is valid unless conceived in fraud or bad faith, has been adopted wholesale by several federal courts under an application of the doctrine of *Erie R. Co. v. Tompkins*.[21] In fact, it has been carried even farther than the state courts have gone. In *Hottenstein v. York Ice Machinery Corp.*,[22] the Circuit Court of Appeals for the Third Circuit held that arrearage destruction by merger was valid under Delaware law even though the merger was illusory in substance, the defendant corporation having created a subsidiary for the express purpose of merging with it. The whole arrangement was frankly a "paper" merger designed solely to effect a recapitalization, yet the court said: "A court of the United States bound by the rule of *Erie R. Co. v. Tompkins* is powerless to afford aid to the stockholder unless reclassification reaches that degree of unfairness where it amounts to a cancellation of the preferred stockholders' accumulated unpaid dividends without adequate compensation therefor under the law, either by way of a share in the equity of the surviving corporation or by the payment of money under section 61 of the General Corporation Law.[23] At such a point a court of the United States might grant injunctive relief under the provisions of the Fourteenth Amendment."[24] But the court also noted that "at such a point the courts of Delaware might well hold that a merger was void because of constructive fraud."[25] That observation would appear to indicate that any constitutional limitation on the power to merge would be equivalent to the equitable limitation ascribed to the *Porges* case in the case of fraud.

The most recent case involving recapitalization by merger of Dela-

[20] 32 A. (2d) 148 at 151 (1943).

[21] 304 U.S. 64, 58 S.Ct. 817 (1938).

[22] (C.C.A. 3d, 1943) 136 F. (2d) 944.

[23] This is the provision providing for appraisal and payment of the value of shares of stockholders who dissent from merger. Del. Rev. Code (1935) c. 65, § 2093.

[24] (C.C.A. 3d, 1943) 136 F. (2d) 944 at 953.

[25] Supra, note 16.

ware corporations is *Langfelder v. Universal Laboratories, Inc.*,[26] also decided by the Third Circuit Court of Appeals. The merger involved in the *Langfelder* case was the same merger which had been upheld by the Vice-Chancellor of Delaware in *Porges v. Vadsco Sales Corp.*,[27] but the plaintiff in the *Langfelder* case sued under a different theory.[28] Under a charter provision stating that preferred shareholders would be paid accumulated dividends plus 110 per cent of the amount of "reduction in value" of such stock resulting from reduction of the capital stock of the corporation, the plaintiff, a preferred stockholder, sued for breach of contract. His argument was that his stock had been "reduced in value" by 45 dollars per share, inasmuch as each share of 100 dollars par value preferred stock in the old corporation was converted by the merger into new stock of a total stated and par value of only 55 dollars, and that the charter gave him a right to receive 110 per cent of the amount of this reduction, plus about 90 dollars per share in dividend arrearages. The court was not impressed. Regarding the case as governed solely by state law under the doctrine of *Erie R. Co. v. Tompkins*,[29] the court concluded that even had the charter provided for payment of the amount of reduction in the express event of merger, and that a debtor-creditor relationship should immediately arise on such reduction, the merger statute would still permit the corporation to evade such provisions. "Allowing the doctrine [of the *Havender* case] the fullest scope we think it must be conceded that any and all rights inherent in any class of stock could be obliterated by merger unless the terms of the merger agreement were so unfair, inequitable, or fraudulent as to meet the bar of the *Porges* decision or that set up in this court's opinion in Hottenstein."[30] Instead of attempting to construe the charter provision as not contemplating the exchange of stock in a merger arrangement within the meaning of the word "reduction," the court assumed that the provision was intended to include merger cases and further that it was intended to create a debtor-creditor relationship between the corporation and the preferred stockholders in the event of such a reduction. But, argued the court, until the reduction took place, the stockholders were not debtors but stockholders; until the reduction their rights were purely contractual rights

[26] (C.C.A. 3d, 1947) 163 F. (2d) 804.

[27] Supra, note 18.

[28] And he apparently thought it was a sound theory. Before bringing the suit into a federal court, the plaintiff had carried the case through three New York state courts. The New York Court of Appeals affirmed the two lower court decisions and sustained a dismissal of the suit by the trial court as a proper exercise of the discretion to decline jurisdiction of controversies involving foreign corporations. Langfelder v. Universal Laboratories, Inc., 293 N.Y. 200, 56 N.E. (2d) 550 (1944).

[29] Supra, note 21.

[30] (C.C.A. 3d, 1947) 163 F. (2d) 804 at 807.

inherent in stock ownership and hence subject to conversion by merger under the doctrine of *Federal United Corp. v. Havender*.[31] According to the court's analysis, there could be no debt until there was a reduction and no reduction until there was a merger, but since merger destroyed the contract to create a debt in the event of reduction the plaintiff was not yet a creditor when the reduction occurred. But why should not the merger, the reduction, and the creation of the debt be regarded as occurring simultaneously? Theoretically, the very instant the merger becomes effective there is a reduction in the value of the preferred stock, which, according to the charter, creates a debt in favor of the stockholder. And yet, in some unexplained way, the court held that the merger converted the rights of the stockholder qua stockholder before it reduced the value of his stock. Unless the court regarded the reduction in value as occurring only upon a physical exchange of the stock certificates, or unless it considered the fact of merger to have detonated a chain reaction which affected the rights of the stockholders qua stockholders before it reached the point of reducing the value of their stock, the decision is somewhat difficult to justify analytically. An Illinois appellate court decision[32] antedating both the *Havender* and *Keller* cases reached the same result as that of the *Langfelder* case, under a somewhat similar charter provision,[33] by holding the provision to be in derogation of the merger statute and absolutely void. But the court in the *Langfelder* case did not purport to place its decision on that ground,[34] preferring instead to rely on an application of the *Havender* doctrine and the *Erie R. Co.* case. The *Langfelder* decision is a striking illustration of the extent to which corporate action in destruction of apparent rights of minority stockholders can be carried through the device of recapitalization by illusory merger under the Delaware statute.

3

This is not to say that the same result would necessarily be reached under other statutes. In New Jersey, for example, under a statute

[31] Supra, note 13.

[32] Jones v. St. Louis Structural Steel Co., 267 Ill. App. 576 (1932).

[33] "The consolidation or merger of such company at any time, or from time to time with any other company or companies shall not be regarded or construed to be a dissolution of said corporation within the meaning hereof but no such merger shall in any way impair the rights of the preferred stock." Id. at 280.

[34] The court referred to the Illinois decision, however. (C.C.A. 3d, 1947) 163 F. (2d) 804 at 808. It also held that the defendant corporation was not estopped by the charter provision promising to pay in the event of reduction in value of the preferred stock, because such an estoppel would be in derogation of the merger statute. But the court did not in terms hold the charter provision void, but only ineffective because it had been changed by the merger before it could create a debt according to its terms.

much like that of Delaware but differing in some respects,[35] preferred shareholders seem to be regarded as having a "vested right" in any earned surplus of the corporation which cannot be destroyed by any plan contemplating elimination of preferred dividend arrearages, at least where the common stockholders would benefit.[36] This limitation is termed one of "fairness."[37] In the absence of an earned surplus, however, New Jersey appears willing to go along with Delaware to the extent of permitting merger to destroy accumulated unpaid preferred stock dividends.[38] The New Jersey concept of fairness is seemingly based upon the idea that the shareholders are entitled to fair exchange value of their shares and an exchange carrying relative equality in the new company,[39] and appears to bear no necessary relation to the Delaware concept, which is defined in terms of the absence of bad faith.[40] From the point of view of the shareholder whose apparent rights are taken from him by merger, neither of these limitations seems adequate; from the point of view of the majority of stockholders who approve the plan, any further limitation would seem oppressive. One writer has suggested,[41] along the line of the New Jersey view, that no merger so destructive of apparent rights should be upheld unless the preferred stockholder receives the substantial equivalent of what he gives up, or unless justified by corporate need. Another suggestion has been that the merger should be held unfair as against preferred stockholders unless it provides for maintaining their absolute priority over the common stockholders,[42] a standard

[35] N.J. Rev. Stat. (1937) § 14:12-2.

[36] Meck, "Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine," 55 HARV. L. REV. 71 at 95 et seq. (1941).

[37] Id. at 96.

[38] Windhurst v. Central Leather Co., 101 N.J. Eq. 543, 138 A. 772 (1927), 105 N.J. Eq. 621, 149 A. 36 (1930); affd. per curiam, 107 N.J. Eq. 528, 153 A. 402 (1931).

[39] Outwater v. Public Service Corp. of New Jersey, 103 N.J. Eq. 461, 143 A. 729 (1938); affd. per curiam, 104 N.J. Eq. 490, 146 A. 916 (1929). The case is discussed in Lattin, "Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders," 30 MICH. L. REV. 645 at 663 (1932).

[40] Porges v. Vadsco Sales Corp., (Del. Ch. 1943) 32 A. (2d) 148. See also Bailey v. Tubize Rayon Corp., (D.C. Del. 1944) 56 F. Supp. 418, applying the same view to a charter amendment case. Zobel v. American Locomotive Co., (N.Y. Co. S.Ct. 1943) 44 N.Y.S. (2d) 33, applies the same test under the New York merger statute.

[41] Latty, "Fairness—The Focal Point in Preferred Stock Arrearage Elimination," 29 VA. L. REV. 1 (1942). S.E.C. REPORT ON REORGANIZATION COMMITTEES, Part VII (1938), points out that corporate need would justify the usual merger provision in relatively few cases.

[42] Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 (1942). Professor Dodd points to Patterson v. Durham Hosiery Mills, 214 N.C. 806, 200 S.E. 906 (1939); and Buckley v. Cuban American Sugar Co., 129 N.J. Eq. 322, 19 A.

comparable to that applied to corporate reorganization plans under Chapter X of the Bankruptcy Act.[43]

In general, however, such suggestions have not been judicially accepted, and the courts have been disinclined to limit the power to merge. Of course, if the provisions of this merger are not authorized by statute, they are invalid under the ordinary principles of *ultra vires* acts.[44] As indicated by the cases discussed above, the same is true if the merger is fraudulent. If, however, the provisions of the merger plan can be construed to fall within the merger statute as a "term or condition of merger" or a "manner of converting the shares," and are not outlawed by other statutory prohibitions, the plan is likely to be upheld. There seems to be no public policy, at least in Delaware, against the elimination by merger of accrued unpaid and undeclared dividends,[45] nor, according to the *Langfelder* case, against the conversion of other rights apparently given by charter. Other jurisdictions share the same view.[46] So long as the statutes are construed as being a part of the stockholders' contract, the constitutional prohibition against state impairment of contract obligations[47] can apparently afford no protection if the state has reserved the power to alter and amend the corporation laws.[48] This is certainly true where the merger statute was in force before the corporation was organized.[49] The dictum in *Hottenstein v. York Ice Machinery Corporation*[50] indicates that the federal due process clause[51] might afford relief in a proper case, but the point at which that clause may be invoked to defeat a merger has ap-

(2d) 820 (1940), as supporting his view. Id. at 817. Both the cited cases involved charter amendments and not mergers.

[43] 11 U.S.C. (1946) § 621. The leading case on the bankruptcy test of fairness is Case v. Los Angeles Lumber Products Co., Ltd., 308 U.S. 106, 60 S.Ct. 1 (1939). It may be noted that in the Porges cases, the plaintiff complained that common stockholders, whose equity of ownership in the corporation had no book value whatever, were allowed under the merger plan to participate in the ownership of the corporation resulting from the merger. The fact that the plan was upheld as fair indicates that Delaware, at least does not consider the absolute priority test of fairness under the Bankruptcy Act applicable to merger cases.

[44] William B. Riker & Son Co. v. United Drug Co., 79 N.J. Eq. 580, 82 A. 930 (1912).

[45] See the remarks of Hulbert, J., in In re Community Power & Light Co., (D.C. N.Y. 1940) 33 F. Supp. 901 at 915.

[46] New York: Zobel v. American Locomotive Co., (N.Y. Co. S.Ct. 1943) 44 N.Y.S. (2d) 33; Pennsylvania: Hubbard v. Jones & Laughlin Steel Corp., (D.C. Pa. 1941) 42 F. Supp. 432.

[47] U.S. Const., Art. I, § 10.

[48] Trustees of Dartmouth College v. Woodward, 4 Wheat. (17 U.S.) 518 (1819).

[49] Goldman v. Postal Telegraph, Inc., (D.C. Del. 1943) 52 F. Supp. 763.

[50] (C.C.A. 3d, 1943) 136 F. (2d) 944.

[51] U.S. Const., Amend. XIV, § 1.

parently not yet been reached. Due process objections have been raised in a few cases,[52] but have been disposed of on the theory that the dissenter had notice that his rights were subject to change by merger and that the statutory right to demand appraisal and payment of the value of his shares provides an adequate remedy if he does not approve of the merger.

The fact that appraisal statutes usually give the dissenter an election to demand appraisal of his shares and payment of their "fair value" or "fair market value" in the event of merger[53] probably accounts for much of the leniency with which merger plans have been treated. On the other hand, the fact that the remedy of appraisal and payment is not ordinarily available[54] for the protection of stockholders who dissent from corporate readjustment by charter amendment is at least one reason why the courts have regarded the charter amendment cases with much closer scrutiny. In the merger cases, the idea that the appraisal statute affords adequate relief to the dissenting stockholder often dominates the courts' reasoning. In many instances, the appraisal statute is said to be the exclusive remedy if the merger is not unauthorized, unfair or fraudulent,[55] which is only another way of expressing the conclusion reached in the *Havender* case and succeeding cases. It has often been argued that although appraisal statutes are in law deemed to provide an adequate remedy, they do not provide an adequate remedy in fact.[56] The argument proceeds on the theory that the stockholder frequently does not know that he has an appraisal remedy until he has waited too long to be able to invoke the statute's protection,[57] that the procedure is expensive, time-consuming, and compli-

[52] Hottenstein v. York Ice Machinery Corp., (C.C.A. 3d, 1943) 136 F. (2d) 944 (merger); Hubbard v. Jones & Laughlin Steel Corp., (D.C. Pa. 1941) 42 F. Supp. 432 (merger); Goldman v. Postal Telegraph, Inc., (D.C. Del. 1943) 52 F. Supp. 763 (charter amendment).

[53] S.E.C. REPORT ON REORGANIZATION COMMITTEES 593 (1938).

[54] Ibid.

[55] The cases are collected in 87 A.L.R. 597 (1933); and 162 A.L.R. 1237 (1946).

[56] S.E.C. REPORT ON REORGANIZATION COMMITTEES, Part VII, 590 et seq. (1938) presents an excellent factual study of the inadequacies of statutory appraisal. See also Robinson, "Dissenting Shareholders: Their Right to Dividends and the Valuation of Their Shares," 32 COL. L. REV. 60 (1932); Lattin, "Remedies of Dissenting Stockholders Under Appraisal Statutes," 45 HARV. L. REV. 233 (1931); Levy, "Rights of Dissenting Shareholders to Appraisal and Payment," 15 CORN. L.Q. 420 (1930); Weiner, "Payment of Dissenting Stockholders," 27 COL. L. REV. 547 (1927).

[57] It should be noted that no proxy solicitation under the Securities and Exchange Act can be made without furnishing the person being solicited a "proxy statement" containing, inter alia, an outline of the rights of appraisal of dissenters and the statutory procedure required to be followed in order to perfect such rights. S.E.C. Regulation X-14, Schedule 14 A-2.

cated, and that the stockholder is driven to an election between acceptance of the merger provisions or pursuing the statutory appraisal remedy and is thus forced to accept the former as the lesser of two evils. The argument is appealing, but is based upon the assumption that the dissenting stockholder is entitled to more protection than the appraisal statute gives. Whether this assumption be true is largely a question of policy.

4

Nearly every merger involves competing policy considerations. Undoubtedly there are strong reasons of policy in support of the proposition that every stockholder should be permitted to retain the absolute preferences which he in fact thought he was receiving when he purchased his stock. On the other hand, there are cogent reasons for holding that a corporation should be permitted to reorganize and throw off the shackles of preferred stock dividend arrearages and similar burdens if that is the course approved by a large majority of the corporate owners affected. It is clear that both propositions cannot prevail. When a means is afforded to dissenters to withdraw from the enterprise under an appraisal statute, the courts have been strongly disposed to uphold the action of the majority.

There are several reasons for such a conclusion. In the first place, the appraisal statutes, while not free from objection, do provide some relief. That such relief is available to one party to a disputed merger is at least a factor weighing in favor of the other. In the absence of some such compensatory element, the court would have to provide a substitute,[58] or be forced to hold the dissenter's right to be either absolute or nonexistent. The statutory appraisal procedure has been regarded as giving a *sufficiently* adequate remedy to justify the court in forcing the dissenter to elect between that remedy and maintaining his readjusted status of ownership in the new corporation. The second principal reason which has led the courts to uphold adjustments of stockholder preferences by merger is found in the broad phraseology of the merger statutes. The liberal wording of these statutes permits liberal interpretation and makes it easy for the court, if it is disposed to do so, to say that the dissenter had notice that his rights were subject to alteration by merger. Theoretically, the same reasoning would apply even though there were no appraisal statute, but the existence of an appraisal remedy makes the result appear less harsh. There are other, more obscure reasons for upholding the power of the corporate

[58] A nonstatutory right of appraisal has been allowed in a few cases. See Barnett v. Philadelphia Market Co., 218 Pa. 649, 67 A. 912 (1907); Winfree v. Riverside Cotton Mills Co., 113 Va. 717, 75 S.E. 309 (1912); Nice Ball Bearing Co. v. Mortgage Building & Loan Assn., 310 Pa. 560, 166 A. 239 (1933).

majority to dictate fair terms of merger. One such reason is a policy in favor of encouraging business and industry, and hence of encouraging corporate methods. The very existence of a merger statute is indicative of a policy of the state favoring the corporate majority or other proportion of ownership which the statute prescribes for approval of mergers. Further, it is frequently difficult to determine whether a dissenting stockholder is complaining in perfect good faith or whether he is merely a "professional privateer"[59] seeking to obstruct a healthy recapitalization merely to exploit the nuisance value of his stock. Certainly the court should have little sympathy for the latter.

These considerations give some indication of the reasons prompting a judicial inclination to look with disfavor upon a minority stockholder who seeks to block majority action under the merger statutes. The desire to uphold a fair merger may at times lead a court to arrive at its conclusion by using premises of questionable soundness, as in the *Langfelder* case. Although the logic of that decision is far from flawless, and although a more forthright approach to the problem presented might have called for holding that the charter provision there in question was void because it attempted to derogate from the merger statute,[60] the result announced does not necessarily require that the case be criticized. If the considerations behind the decision are sound, there is good reason to support its conclusion.

However the court may have reached its decision, the *Langfelder* case makes it clear that so long as a preferred stockholder must rely solely on his status as a preferred stockholder[61] he has no absolute preferences, no matter how strongly the charter may be worded. That proportion of the stockholders to which the merger statute has given the power to approve the terms, conditions, and manner of converting the shares, owes no duty to the minority except to act in good faith and without fraud.[62] A liberally-phrased merger statute, the *Havender*

[59] Vice-Chancellor Lane's description of the late Clarence Venner in General Investment Co. v. Bethlehem Steel Corp., 88 N.J. Eq. 237, 102 A. 252 (1917).

[60] As in Jones v. St. Louis Structural Steel Co., 267 Ill. App. 576 (1932).

[61] If the corporation has actually declared a dividend before the merger is approved, but has not paid that dividend, the stockholder may well claim that he was a creditor of the corporation before the merger, as well as a stockholder, and that no merger plan can lawfully destroy that debt.

[62] With this statement should be compared the result reached in the recent case of Zahn v. Transamerica Corp., (C.C.A. 3d, 1947) 162 F. (2d) 36, where the court held that majority stockholders could not redeem preferred stock if such redemption resulted in profit to the majority stockholders at the expense of the minority, even though such redemption complied with every charter and statutory provision relating to such redemption, the "fiduciary relationship" being found to exist at least where the redemption was attempted as part of a plan for liquidating the corporation. The court did not feel bound by state law, which would have seemed to dictate a

case, and the *Erie R. Co.* case are sufficient to foreclose all other apparent rights in those jurisdictions which choose to follow[63] the Delaware view.

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contrary result, because the facts were held to be sui generis. The case is discussed in 46 MICH. L. REV. 1061 (1948).

[63] It is certain that the Erie R. Co. case does not require a federal court to follow state court decisions if the merger violates the due process or contract clauses. In Irving Trust Co. v. Day, 314 U.S. 556 at 561, 62 S.Ct. 398 (1942), the court said "When this Court is asked to invalidate a state statute upon the ground that it impairs the obligation of a contract, the existence of the contract and the nature and extent of its obligation become federal questions for the purpose of determining whether they are within the scope and meaning of the Federal Constitution, and for such purposes finality cannot be accorded to the views of a state court." No mention was made of the Erie R. Co. case.