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CORPORATIONS-DIVIDEND RIGHTS-ELIMINATION OF DIVIDEND ACCUMULATIONS BY DIRECT CHARTER AMENDMENT

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COMMENTS

CORPORATIONS—DIVIDEND RIGHTS—ELIMINATION OF DIVIDEND ACCUMULATIONS BY DIRECT CHARTER AMENDMENT[1]—The many recent discussions of the problem of dividend accumulations show that

[1] This is one of the three methods commonly employed in eliminating or circumventing dividend accumulation rights. See note, 89 UNIV. PA. L. REV. 789 at 794 et seq. (1941).

plausible grounds exist for reaching a conclusion in favor of either the minority preferred shareholder who wishes to retain these rights, or the majority preferred and common shareholders who, with the corporate management, desire to eliminate or circumvent them.[2] It is not the purpose of this comment to re-open that controversy, though it may be observed that the current trend of both legislation and decision favors the interests of the latter group.[3] Rather, this discussion assumes that the current trend is the correct view and will examine the possibilities of eliminating dividend accumulations by direct charter amendment.

Before proceeding further, a brief review of the analysis applicable to elimination of dividend accumulations may be helpful. Theoretically, there are two distinct types of dividend accumulation cases. First, there is the case in which no significant changes have been made in the corporation statutes between the issuance of the preferred shares involved and the attempt to eliminate dividend accumulations thereon. Here, the sole question is whether the corporation statutes authorize the elimination, and this is, of course, a problem of construction.

In brief, the methods are as follows: (1) the direct charter amendment method whereby the dividend accumulations are voted out of existence through amendment of the corporate articles; (2) the indirect charter amendment whereby a new class of preferred stock is voted into existence, having dividend preference over the old preferred on which dividend accumulations exist; the old preferred shareholders are given a choice of exchanging their shares for the new preferred without dividend accumulations or retaining their old preferred shares with dividend preference over the common stock; (3) the merger method, which includes technical mergers and technical consolidations, whereby *A* corporation, having accumulated dividends on its preferred shares, merges with *B* corporation so that the *A* corporation preferred shareholders get *B* corporation shares without dividend accumulation rights in exchange for their old stock.

[2] 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); Curran, "Minority Stockholders and the Amendment of Corporate Charters," 32 MICH. L. REV. 743 (1934); Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 (1942). The above are only a few of the excellent articles in this field.

[3] See 58 N.Y. Consol. Laws Ann. (McKinney, 1940) §36(E) as amended by c. 600, Laws of 1943; 3 Ohio Code Ann. (Throckmorton's Baldwin, 1940) §§8623-14, 15; Va. Code Ann. (Cum. Supp., 1940) §3780; the foregoing statutes specifically authorize elimination of dividend accumulations with the consent of varying majorities of the preferred shareholders affected. The following decisions are typical examples: McQuillen v. National Cash Register Co., (D.C. Md. 1939) 27 F. Supp. 639; Johnson v. Bradley Knitting Co., 228 Wis. 566, 280 N.W. 688, 117 A.L.R. 1276 (1938); Johnson v. Lamprech, 133 Ohio St. 567, 15 N.E. (2d) 127 (1938); Kreicker v. Naylor Pipe Co., 374 Ill. 364, 29 N.E. (2d) 502 (1940); Shanik v. White Sewing Machine Corp., 25 Del. Ch. 371, 19 A. (2d) 831 (1941); Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A. (2d) 331 (1940); Porges v. Vadsco Sales Corp., (Del. Ch. 1943) 32 A. (2d) 148; Hubbard v. Jones & Laughlin Steel Corp., (D.C. Pa. 1941) 42 F. Supp. 432; Langfelder v. Universal Laboratories, (C.C.A. 3rd, 1947) 163 F. (2d) 804.

Secondly, there is the case in which it has been decided that the corporation statutes in existence when the preferred shares were issued did not authorize elimination of dividend accumulations, but in which the following additional statutory provisions are involved: (a) a reserved power statute[4] which existed when the preferred shares were issued, and (b) an amendment to the corporation statutes, enacted after the preferred shares were issued, which does permit the elimination of dividend accumulations. Here, a constitutional question is raised as to whether, consistently with due process of law and the sanctity of contracts, preferred shareholders may be retroactively deprived of their rights in dividend accumulations. It will be observed, however, that the same general question of statutory construction underlies both types of cases, namely, just how specific must statutory language be to limit the dividend accumulation rights of preferred shareholders in the inception of the preferred stock contract.[5] A premise that the preferred shareholder accepted his shares subject to limitations on his cumulative dividend rights is, therefore, essential to the conclusion that elimination of dividend accumulations is possible in either type of case. In the light of the foregoing, we may turn to an examination of the direct charter amendment method of dealing with dividend accumulations in both of these basic types of situations. In so doing, a recent decision by the Supreme Court of Illinois is deserving of special consideration.

I

The Western Foundry Decision

The Western Foundry Company, hereafter referred to as *P* corporation, was organized in 1925 under Illinois law,[6] and issued both cumulative preferred stock and common shares. *D* was an original subscriber of preferred stock, and, by 1941, dividend accumulations on the preferred exceeded $70 per share. In that year, the directorate

[4] These statutes, which all states have, provide that the legislature reserves the power to amend or repeal the corporate charter or articles of incorporation by subsequent legislation, 7 FLETCHER, CYC. CORP., perm. ed., §3674 (1932).

[5] The specific construction problems involved in the two types of cases are different of course. In the first type, the issue is whether the language of the state corporation statutes authorized the majority shareholder to eliminate or circumvent dividend accumulation rights by amendment of the articles; in the second, the issue is whether the language of the reserved power statute authorized the legislature to confer retroactively the power to eliminate or circumvent dividend accumulation rights upon the majority shareholders by a later amendment of the corporation statutes.

[6] Gen. Corp. Act of 1919, Ill. Rev. Stat. (1925) c. 32.

proposed an amendment of the articles of incorporation cancelling all unpaid dividend accumulations on the preferred stock, and at a shareholders' meeting the amendment was approved by some ninety-seven percent of the shares of each class. *D* dissented and continued to assert his right to the accumulated dividends on his preferred shares; and, to settle the issue, *P* corporation brought suit under the Illinois Declaratory Judgment Act[7] to determine the validity of the amendment. A trial court judgment for the corporation was reversed on appeal to the appellate court; on further appeal to the Supreme Court of Illinois, *held*, appellate court judgment reversed and that of the trial court affirmed. The preferred shares were originally issued subject to the right of a two-thirds majority in interest of the preferred shareholders to eliminate dividend accumulations by direct charter amendment. *Western Foundry Co. v. Wicker*, (Ill. 1949) 85 N.E. (2d) 722.

What the principal case holds is that the general language of the Illinois corporation statutes existing when *D*'s preferred shares were issued permitted the insertion of a provision in the corporate articles allowing elimination of dividend accumulations by amendment,[8] and that the *P* corporation articles so provided.[9] Or, to state the matter differently, the principal case is of the first general type discussed above.[10] No detailed analysis of the language thus construed by the Illinois court nor detailed comparison with other language construed otherwise in other cases[11] will be embarked upon here. In the opinion of the writer, however, the Illinois court's construction was more liberal

[7] Ill. Rev. Stat. (1947) c. 110, §181(1).

[8] The relevant statutory language is as follows: A corporation may include in its articles, "Any other provisions, not inconsistent with law . . . creating, defining, limiting and regulating the powers of . . . the stockholders or any class or classes of stockholders." Ill. Rev. Stat. (1925) c. 32, §4(13); a corporation has the power "to have a capital stock . . . and to divide such capital stock into such classes, with such preferences, rights, values and interests as may be provided in the articles of incorporation." Ill. Rev. Stat. (1925) c. 32, §6(4).

[9] The relevant language of the articles of incorporation of the Western Foundry Co. is as follows: ". . . the corporation shall not, without the consent of the holders of at least two-thirds (⅔) in amount of the preferred stock of the corporation at the time outstanding, expressed either in writing or by their affirmative vote at a meeting called for that purpose, (1) alter or change the preferences hereby given to the preferred stock, or any of the provisions contained in respect of the preferred stock . . .;" and then, "Subject to the limitations hereinabove set forth, the authorized capital stock of the corporation may be changed, *the rights and preferences of the preferred stock may be changed* and different classes of preferred stock may be created. . . ." Principal case at 727.

[10] Introductory analysis, pp. 657-659, supra.

[11] In some cases, such as the principal case, the language which must be construed is in the articles of incorporation, while in others, for example, Consolidated Film Ind., Inc. v. Johnson, 22 Del. Ch. 407, 197 A. 489 (1937), it is a part of the corporation statutes of the state. This distinction is without importance, however, since both the articles and the state corporation statutes are part of the preferred stock contract.

than that previously accorded by the highest court of any state.[12] If this construction is accepted, the conclusion of the court rests on the following simple logic: (1) the preferred shareholders' dividend rights are purely contractual; (2) the corporation statutes and *P* corporation articles are parts of the preferred stock contract;[13] (3) these statutes and articles, existing when the preferred shares were issued, authorized the elimination of dividend accumulations by amendment of the articles; (4) hence the preferred shareholders' rights were so limited in their inception and the challenged amendment is according to the contract and valid.

It is clear that the above is a formal justification for subjecting dividend accumulations to elimination by direct charter amendment. It is more doubtful whether the use of this formula is desirable. True, the recent judicial and legislative trend seems to indicate a preference for permitting corporations to avoid payment of depression-accumulated dividends by some means or other;[14] but the question remains whether the direct charter amendment method offers the best compromise between the competing interests involved. The two alternative methods commonly employed, those of indirect charter amendment[15] and of merger,[16] are well known. A brief comparison of these three methods seems to be in order. From the standpoint of the corporate management and the common shareholders, the direct charter amendment would seem preferable because of its simplicity.[17] More difficulty arises when the interests of the minority preferred shareholders are considered. It is probable that the purchasing preferred shareholder would not realize that his dividend accumulation rights

[12] A case wherein the local statutes contained language quite similar to that of the articles of the Western Foundry Co., and in which the court held elimination of dividend accumulations not authorized, is Consolidated Film Ind., Inc. v. Johnson, 22 Del. Ch. 407, 197 A. 489 (1937). Two federal decisions reached the result of the principal case in construing general statutory language, Harr v. Pioneer Mech. Corp., (C.C.A. 2d, 1933) 65 F. (2d) 332, and McQuillen v. Nat. Cash Reg. Co., (D.C. Md., 1939) 27 F. Supp. 639, but the former was an interpretation of Delaware law subsequently disapproved by the Delaware court in Keller v. Wilson & Co., 21 Del. Ch. 391, 190 A. 115 (1936).

[13] See Morris v. Am. Public Util. Co., 14 Del. Ch. 136, 122 A. 696 (1923) for a discussion of the tri-partite contract between state, corporation and shareholders which is created by the organization of a stock corporation.

[14] See statutory provisions and cases cited in note 3, supra. The statutes specifically authorize elimination of dividend accumulations by charter amendment. The cases there cited permitted elimination by direct charter amendment, circumvention by indirect charter amendment, or elimination by merger.

[15] Note 1, supra.

[16] Ibid.

[17] If the indirect charter amendment method is employed, new stock must be issued, while if the merger method is employed, it is necessary to go through the formalities of working out an exchange of shares.

were subject to impairment by any of the three methods.[18] Further, the power of the majority in interest of the preferred shareholders to protect themselves within the corporation by voting against impairment of their dividend accumulation rights is probably substantially the same under each of the three methods.[19] With respect to judicial control, aimed at securing fairness for the minority preferred shareholder who dissents, there are differences in the three methods, but the significance thereof is disputed. As between the direct and indirect charter amendment methods, there is the difference that the former eliminates dividend accumulations completely, while the latter retains them as against the common stock and creates new preferred stock with preference over the old. The old preferred shareholders are then given an option to surrender their shares for the new preferred, thus losing their dividend accumulations. Although many courts may have been impressed with this distinction,[20] some eminent legal scholars are not, arguing that the choice given the preferred shareholders is in fact illusory.[21] As between both charter amendment methods and the merger method, there is the difference that, where the latter is employed, appraisal statutes commonly guarantee a dissenting shareholder the fair market value of his shares.[22] This remedy is less commonly

[18] It would seem that the statutory language construed in each of the following cases would give approximately the same amount of notice to a prospective preferred stock purchaser: Consolidated Film Ind., Inc. v. Johnson, 22 Del. Ch. 407, 197 A. 489 (1937) (involving a direct charter amendment); Shanik v. White Sewing Machine Corp., 25 Del. Ch. 371, 19 A. (2d) 831 (1941) (involving an indirect charter amendment); and Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A. (2d) 331 (1940) (involving a merger).

[19] Under either charter amendment method, the amendment must be approved by a shareholder's vote, although not always by a majority of the preferred shareholders affected, S.E.C. REPORT ON REORGANIZATION COMMITTEES, Part VII, 473-75 (1938); in general, the report does not regard this voting right as having received adequate protection via requirements of notice, etc., id., p. 525. Where the merger method is employed, the right of the preferred shareholder to protect himself by his ballot seems even less secure, for only a minority of state statutes require approval of the merger plan by a majority of the shareholders of each class of stock affected, id., p. 535. Some writers, of course, do not evidence much faith in these voting rights as a safeguard to the rights of minority shareholders. Note, 54 HARV. L. REV. 488 at 489, 497 (1941).

[20] At any rate, the indirect method has generally been upheld, while the direct method has not. See notes 31 and 32, infra. It may be argued, of course, that differences in the statutes under construction account for the differences in result; however, such a view leaves a rather knotty problem unanswered, namely, if the courts assume that the direct and indirect methods are equivalent, how can they justify a view of legislative intent which convicts the legislatures of having forbidden elimination of dividend accumulations by one means and approved the same result by another, more complex, method?

[21] See, for example, the harsh words of Professor Dodd, who refers to this choice as, ". . . an option between the frying pan and the fire." Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 at 818 (1942).

[22] S.E.C. REPORT ON REORGANIZATION COMMITTEES, Part VII, 593 (1938).

available to shareholders dissenting from a charter amendment.[23] Again, some courts have thought the appraisal remedy significant,[24] while various writers have dissented vigorously, on the grounds that the remedy has many practical limitations.[25] Perhaps the safest conclusion on the relative merits of these several methods is that none of them deals effectively with the matter of fairness to minority preferred shareholders,[26] while the simpler charter amendment method is better suited to the needs of the corporate management. If this conclusion is accepted, and we adhere to our assumption that some means of dispensing with dividend accumulations is desirable, it would seem that the Illinois court reached a satisfactory result in the principal case.

II

Current Status of the Law

The recent trend of legislation and decisions, being directly contrary in result to the older cases,[27] has resulted in conflicts among and within different jurisdictions, if the equivalence of the several methods of attacking dividend accumulations is accepted. Dealing first with the cases of the first general type discussed above[28]—those in which only a construction problem is raised—a further classification may be conveniently made between those jurisdictions which have specific statutes permitting elimination of dividend accumulations and those which have not. Where there are no specific statutes, the following diversities appear: (1) the North Carolina decisions forbid impairment of dividend accumulations by either direct or indirect charter amendment,[29] while the Illinois cases are exactly contra;[30] (2) excluding New Jersey, it appears that only one state court of last resort has permitted elimina-

[23] Ibid.

[24] Cases are collected in 162 A.L.R. 1237 (1946) and 87 A.L.R. 597 (1933).

[25] Lattin, "Remedies of Dissenting Shareholders under Appraisal Statutes," 45 HARV. L. REV. 233 (1931). See also the highly critical conclusions drawn in S.E.C. REPORT ON REORGANIZATION COMMITTEES, Part VII, Appx. B, IV, 590 (1938).

[26] This is clearly the premise of Professor Dodd, who argues for a new approach to the question of fairness through application to recapitalizations of the absolute priority rule developed in connection with corporate reorganizations. Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 (1942).

[27] The classic example of this change of heart is found in the Delaware cases, see note, 57 HARV. L. REV. 894 (1944).

[28] Introductory analysis, pp. 657-659, supra.

[29] Patterson v. Henrietta Mills, 216 N.C. 728, 6 S.E. (2d) 531 (1939); Patterson v. Durham Hosiery Mills, 214 N.C. 806, 200 S.E. 906 (1938).

[30] See the principal case and Kreicker v. Naylor Pipe Co., 374 Ill. 364, 29 N.E. (2d) 502 (1940).

tion of dividend accumulations by direct charter amendment,[31] while, again excluding New Jersey, it seems that only one such court has objected to impairment of these rights by indirect charter amendment;[32] (3) courts which have refused to allow elimination by direct charter amendment have nevertheless allowed elimination by merger;[33] (4) New Jersey cases refuse to allow elimination or impairment by any method where the corporation has a surplus from which to pay all or part of the accumulated dividends,[34] it not being clear what view is taken where there is no such surplus. In those states where there are specific statutes permitting elimination of dividend accumulations, there is, of course, no construction problem. Turning to the second general type of case discussed above[35]—where the constitutional issue of the scope of the reserved power statutes is involved—there are further diversities. In jurisdictions lacking specific statutes permitting elimination of dividend accumulations, there appear to be no direct holdings on this issue, although there are dicta to the effect that due process of law and the sanctity of contract rights would be infringed by retroactive application of a statute which did permit elimination of dividend accumulations.[36] Two of the states with specific statutes have dealt with the problem and reached diametrically opposite conclusions. A New York trial court decision,[37] probably approved by the New York Court of Appeals,[38] has held that retroactive application of the New York Statute of 1943[39] was authorized by the existence of a reserved power

[31] The principal case; two federal decisions reached the same conclusion in interpreting language strikingly similar in the first case and perhaps even more general in the second: Harr v. Pioneer Mech. Corp., (C.C.A. 2d, 1933) 65 F. (2d) 332; McQuillen v. Nat. Cash Reg. Co., (D.C. Md. 1939) 27 F. Supp. 639; however, the former decision was an interpretation of Delaware statutes specifically disapproved by the Delaware Supreme Court in Keller v. Wilson & Co., 21 Del. Ch. 391, 190 A. 115 (1936).

[32] Patterson v. Durham Hosiery Mills, 214 N.C. 806, 200 S.E. 906 (1938).

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

[34] For a discussion of the New Jersey cases, see Meck, "Accrued Dividends on Cumulative Preferred Stocks: The Legal Doctrine," 55 HARV. L. REV. 71 (1941); a recent New Jersey case in which the existence of a surplus prevented the elimination of dividend accumulations is Wessel v. Guantanamo Sugar Co., 134 N.J.Eq. 271, 35 A. (2d) 215 (1944).

[35] Introductory analysis, pp. 657-659, supra.

[36] Keller v. Wilson & Co., Inc., 21 Del. Ch. 391, 190 A. 115 (1936); without making specific reference to this problem, the language of the North Carolina court in Patterson v. Durham Hosiery Mills, 214 N.C. 806, 200 S.E. 906 (1938) suggests a similar attitude.

[37] McNulty v. W. & J. Sloane, 184 Misc. 835 (1945) 54 N.Y.S. (2d) 253.

[38] Anderson v. International Minerals & Chemical Corp., 295 N.Y. 343 at 351, 67 N.E. (2d) 577 (1946).

[39] 58 N.Y. Consol. Laws Ann. (McKinney, 1940) §36(E) as amended by c. 600, Laws of 1943.

statute when the preferred shares involved were issued. The Supreme Court of Ohio has held the opposite in interpreting a similar statute.[40]

III

Conclusions

By way of summary, a few observations may be tendered. It is apparent that the principal case is in accord with the current trend, but its desirability is debatable. It is desirable if we assume that the protection of the reliance interests of the individual preferred shareholder is less important than eliminating dividend accumulations, and, in addition, that the direct charter amendment method of reaching this result is not inferior to the indirect charter amendment and merger methods. For those who are willing to make these assumptions, the principal case is a valuable precedent because of the very liberal statutory construction indulged in by the Illinois court. Referring again to the two general types of dividend accumulation cases,[41] and recalling that the principal case is of the first type, we may observe that statutory language no more specific than that involved in the principal case was not uncommon in corporation statutes of the pre-depression period.[42] Hence the problem of depression-accrued dividends might well be solved in other states by use of the principal case as precedent. In those jurisdictions which have already held that their older corporation statutes did not authorize elimination of dividend accumulations, the liberal construction of the principal case may still be useful as a basis for arguing, before the legislature, that the local reserved power statute limited the dividend accumulation rights of the preferred shareholders, and therefore, that the legislature can and should permit elimination of dividend accumulations by retroactive amendment. If it is argued in reply that a court, which had previously held the general language of its corporation statutes inadequate to authorize elimination of dividend accumulations, would be unlikely to take a different view of the general language of its reserved power statutes, a partial answer is that

[40] Wheatley v. A. I. Root Co., 147 Ohio St. 127, 69 N.E. (2d) 187 (1946), followed in a more recent case, Schaffner v. The Standard Boiler & Plate Iron Co., 150 Ohio St. 454, 83 N.E. (2d) 192 (1948).

[41] Introductory analysis, pp. 657-659, supra.

[42] See the successive Delaware statutes construed in Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 A. 696 (1923) and Keller v. Wilson & Co., 21 Del. Ch. 391, 190 A. 115 (1936). See also the Maryland provisions dealt with in McQuillen v. National Cash Register Co., (D.C. Md. 1939) 27 F. Supp. 639.

this appears to be exactly what has already happened in the state of New York.[43] A further answer is that the recent trend of the cases dealing with dividend accumulation rights is well established, though it is hardly the result of adherence to consistency with prior decisions.

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[43] McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N.Y.S. (2d) 253 (1946) holds that the New York reserved power statute permitted retroactive application of the 1943 amendment to the New York law which permits elimination of dividend accumulations. Previous to the enactment of this statute, New York cases had repeatedly held that the general language of the New York statutes did not authorize such elimination, Roberts v. Roberts-Wick Co., 184 N.Y. 257, 77 N.E. 12 (1906); Davison v. Parke, Austin & Lipscomb, Inc., 285 N.Y. 500, 35 N.E. (2d) 618 (1941).