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ALTERATIONS OF ACCRUED DIVIDENDS: II*

Arno C. Becht†

3. *Techniques in Removing Accrued Dividends [continued]*

(d) *Exchange of Old Shares for Prior Stock, with Other Changes Making the Old Stock Less Desirable.* If, in addition to its power to issue prior stock, the majority has the power also to alter the other provisions of the old preferred for the worse, it can increase the pressure on dissenters to exchange their shares. This device is so obvious that it is strange that it has not been more employed. Of the five cases found using it, all sustained the amendments. Four of the five cases were decided under the Delaware statutes, but only one of them by the Delaware court. The first of these was *Morris v. American Public Utilities Co.*,[105] which has already been discussed. Next, in *Yoakam v. Providence Biltmore Hotel Co.*,[106] the corporation had first preferred, second preferred and common stock. The first preferred had a 7% cumulative dividend, a redemption and liquidation preference of $110 per share, was entitled to a sinking fund of $20,000 per year for its retirement, had power to elect two directors, and had exclusive voting control on default in the sinking fund or on eighteen months' accrual of dividends. The corporation had met the sinking fund requirement, but dividends of $42 per share had accrued on the first preferred and of $45 per share on the second preferred. The amendment created a class of prior preferred with a par value of $50 and 7% cumulative dividends, and another class of prior preferred with dividends only partially cumulative for two years and thereafter fully so; the amendment also increased the number of shares of common stock. For one share of old first preferred one share of each of the new preferred classes would be issued, plus one half share of common, with the right to take another half share of common for $20 per share. As a condition to the exchange, the stockholder had to waive accrued dividends. The president and vice-president

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105 See the discussion in Part I of this article, 49 MICH. L. REV. 363 at 389-391 (1951). The amendment reduced the redemption price of the shares and took away their voting power. It seemed more convenient, however, to deal with the case as a plain problem in pressure caused by exchanging for prior stock, especially because the voting power was taken away from all the preferred stock, including the new prior issue.

106 (D.C. R.I. 1929) 34 F. (2d) 533. See comments: 15 CORN. L.Q. 279 (1930); 43 HARV. L. REV. 656 (1930); 14 MINN. L. REV. 413 (1930) and note, 16 VA. L. REV. 282 (1930). See also comment, 28 MICH. L. REV. 1009 (1930).

owned all the second preferred and about 80% of the common. They agreed to surrender all the second preferred and its accrued dividends for 20,000 additional shares of common stock. The amendment also provided that dividends were not to be cumulative on the old preferred for the future, that it was to have no voting rights except the right to elect two directors, that it should have no pre-emptive rights, and that its sinking fund should be abolished. The court held that the sinking fund could not constitutionally be abolished, a matter not within the scope of this article,[107] but it sustained all the rest of the amendment under the Delaware law and the provisions of the charter. It held that the corporation could pay dividends on the new prior stock before the accrued dividends on the old stock, so long as rights in existing surplus were protected, and that the amendment properly provided for such protection. The court was certainly fully aware of the effect on dissenters of the provisions limiting the interests of the preferred stock for the future:

> "It is urged by respondent that the exchange of the first preferred stock for the securities described is permissive, not compulsory. This interpretation, however, cannot be taken seriously. The circumstances created in the plan here presented, irrespective of the language employed, amount to compulsion. The exchange is in law compulsory, if to refrain therefrom would result in an obvious and substantial loss. The circumstances created to induce or compel the exchange of all first preferred stock for the securities described are the result of provisions incorporated in the amendments."[108]

The court then catalogued the changes made in the old preferred stock and added:

> "In other words, if the holder of first preferred stock were to elect not to make the exchange, he would be left with a stock still called first preferred, but stripped of nearly every characteristic which gave it value. The outstanding shares would no longer be annually reduced through purchase or redemption from the sinking fund. The dividends thereon would no longer be cumulative, and the stock would be shorn of any effective voice in the management of the affairs of the corporation."[109]

[107] This phase of the decision is discussed in another article, entitled: "Changes in the Interests of Classes of Stockholders by Corporate Charter Amendments Reducing Capital, and Altering Redemption, Liquidation and Sinking Fund Provisions," 36 CORN. L.Q. 1 (1950).

[108] (D.C. R.I. 1929) 34 F. (2d) 533 at 537.

[109] Ibid.

Nevertheless, the court sustained this part of the amendment. The decision means, then, that the majority can, besides introducing a prior stock, attack the future provisions of the old preferred stock.

The California appellate court reached the same result in *Blumenthal v. Di Giorgio Fruit Corp.*,[110] decided under the Delaware statute, in which the amendment, besides providing for exchange for a new prior participating preferred on condition of cancellation of accrued dividends, also removed the cumulative feature of the old stock. And a similar amendment, removing the cumulative feature of the preferred stock was sustained in *Barrett v. Denver Tramway Corp.*,[111] also decided under the Delaware law.

In the only remaining case, the Illinois Supreme Court also approved the amendment.[112] The corporation had preferred stock with a par value of $50 and an 8% cumulative dividend. The amendment created a prior preferred class and a second preferred. The old preferred automatically became the new second preferred, with a par value reduced to $10 per share, but it seems that its liquidation value was not reduced. Hence, it could be argued that the change in par value did not actually change its interests in the property of the corporation. The amendment also destroyed the right of the old preferred to convert to common, unless it was first converted to first preferred with waiver of accrued dividends. Upon conversion to first preferred, 1.4 shares of the new stock were issued for one share of the old, if it was done by a certain date and thereafter the exchange was to be share for share. The plaintiff contended that the amendment made the exchange compulsory. The court said:

> ". . . If there was any compulsion to make the exchange, it arises from the impairment of the value of the preferred stock, and not from any express provision in the amendments. It is not questioned that the value of a class of stock might be so decreased by amendments to the articles of incorporation by creating prior rights in other classes of stock, that a holder, to avoid serious loss, would be compelled to exchange his stock for stock in the class holding the priority."[113]

After recognizing the possibility, the court held that this was not such a case:

[110] 30 Cal. App. (2d) 11, 85 P. (2d) 580 (1938).
[111] (3d Cir. 1944) 146 F. (2d) 701, affirming (D.C. Del. 1944) 53 F. Supp. 198.
[112] Kreicker v. Naylor Pipe Co., 374 Ill. 364, 29 N.E. (2d) 502 (1940).
[113] Id. at 369.

> "In so far as the two classes of stock were to be valued as income producing property with reasonable security for payment, the prior preferred would be preferable for the reason that the dividends accumulated on such class of stock were to be paid in full, prior to the payment of any dividends on the preferred stock. The retention of the preferred stock carried the right to the accrued dividends, and the court cannot, from the facts shown, hold appellant's loss arising from the retention of his old preferred stock would be such that, to avoid serious financial loss, he was compelled to exchange his stock for the prior preferred."[114]

Since the liquidation value of the old stock was not changed, it seems that aside from the loss of the conversion privilege, the alteration of the old preferred was on paper only, and that the substance of the change was less than in those cases in which the cumulative feature of the old stock was removed.

Thus, in five cases the courts have held that the alteration of the old preferred stock in such a way as to put pressure on a dissenter is not an improper use of the amending power. Three of the cases may be questioned since they involved Delaware corporations and were not decided by the Delaware court,[115] and the fourth case contains some indication that if the change were more than formal the court would consider enjoining part of the amendment at least. However, on the whole, the case law at this time indicates that such amendments are perfectly proper exercises of the power of the majority.

(e) *Release of Accrued Dividends For a Consideration.*[116] If a corporation finds it impossible or inconvenient to pay accrued dividends, and yet wishes to reduce or eliminate them, it may offer some other security in exchange for them. If it could compel the exchange of the arrearages for a new issue of stock equal or prior to the old preferred stock itself, the accruals, being wiped out on the books, would no longer call attention to the failure to pay dividends, the preferred stockholders would retain their priority over the common stock, and yet the prospect of resuming dividends on the common shares would be enhanced because the accrued dividends would not have to be paid in cash first. But no such amendments have been found in the reports, perhaps an indication that they have been satisfactory to all parties, and perhaps a consequence of the unwillingness of common

[114] Id. at 370-1.

[115] But it seems that these decisions would probably be approved by the Delaware courts. See the Morris case, discussed in note 105 supra.

[116] See generally, comment, 9 DUKE B.A.J. 76 (1941).

stockholders to vote for them. The only objection to such a plan would be that cash payment of dividends on the preferred stock was being deferred in favor of current dividends on the common stock. The question would be whether this injury, slight in comparison to that inflicted by a voluntary amendment which eliminates arrearages, is outweighed by the advantages of the amendment to the corporation and those interested in it.

Much the same question would be raised by an amendment which proposed a voluntary exchange of accrued dividends for a senior or equal security. The dissenters' only objection would be that other members of their class were moving ahead of them, so that they could maintain an equal position only by accepting the substitution and giving up their chance of cash payment. In the only case raising the question, the court avoided a decision. In *Wilcox v. The Trenton Potteries Co.*,[117] the corporation proposed to issue "funding certificates" for accrued dividends, bearing "interest" at 4% when earned. The preferred shares were to be exchanged for non-cumulative stock also, but this seems to have played no part in the decision. The plan provided that the interest should be payable "in priority to any dividend on the capital stock for such year." This would appear to mean that those who accepted the certificates would be paid 4% on them before the dissenters would receive anything. The court, however, held that the amendment did not mean that "interest" could be paid to those giving consent, without paying dividends to the dissenters, and that if any attempt were made by the corporation to construe it otherwise, the plaintiff could maintain an action for relief. The construction of the plan seems strained, perhaps indicating that the court would not have sustained it if any priority had been given to the consenting stockholders. It seems, however, that in the light of the previous cases the majority of courts would permit the substitution of a security having priority over the old preferred and its dividends, so long as the majority had power to create a prior stock.

If the new security is inferior to the old shares and their dividends, it seems that the dissenters could make no objection because the consenting members of the class would be moving behind them instead of ahead. This problem was presented in *Thomas v. Laconia Car Co.*,[118] in which the corporation proposed to issue one share of no par second preferred, entitled to a $3.50 dividend when earned, in lieu of $70 accrued dividends on each share. The plaintiff dissented and sued to en-

[117] 64 N.J.Eq. 173, 53 A. 474 (Ch. 1902).
[118] 251 Mass. 529, 146 N.E. 775 (1925).

join the plan and to recover her accrued dividends in cash. The court refused relief on the ground that the issue of the new stock would not interfere with the plaintiff's dividend or liquidation rights. As matters turned out, the dissenters had the better of it, for the corporation later dissolved, and the court held, in *Willson v. Laconia Car Co.*,[119] that the dissenters were to be paid par and all accrued dividends, while those who had released their dividends in order to get the second preferred stock could only collect par and the dividends which had accrued since, the assets being insufficient to pay the par value of the preferred stock. These are the only cases found which involved the simple replacement of accrued dividends with other securities, without also altering other rights of the shares.

Only three other cases have been found in which specific securities were offered for the accrued dividends, and these differ from the former in that the exchange was accompanied by exchange of shares or other changes in the old preferred stock. In the first of these, *McKenzie v. Guaranteed Bond & Mortgage Co.*,[120] the amendment proposed that a new preferred be issued share for share for the old, and that a "certificate" be issued for the accrued dividends and carried as a credit to the stockholders on the books. The legal traits of this certificate were not described. The court restrained the entire amendment, but on the ground that the majority had no power to increase the capital. Hence the case would be of no value in the great majority of states where such power exists. The second case, *Johnson v. Bradley Knitting Co.*,[121] did not involve an issue of new stock, but the amendment altered the dividend rate and sinking fund requirements of the old stock, reduced the quick assets provision, and proposed to issue for the accrued dividends a warrant convertible into one and one-fourth shares of common stock. The acceptance of the warrant was optional. The court sustained the rest of the amendment, but held that the plaintiff should be paid his accrued dividends in cash. It is not clear to what extent the court relied upon the corporation's concession of the plaintiff's right to cash in reaching this result. It may have been influenced by the thought that the only other remedy would be to enjoin the issue of the warrants, which would have been unfortunate since the corporation and the other stockholders approved. In the last case, *Ainsworth v. Southwestern Drug Corp.*,[122] the amendment permitted the

[119] 275 Mass. 435, 176 N.E. 182 (1931).
[120] 168 Ga. 145, 147 S.E. 102 (1929).
[121] 228 Wis. 566, 280 N.W. 688 (1938). For discussion, see comments: 6 UNIV. CHI. L. REV. 104 (1938); 1943 WIS. L. REV. 417.
[122] (5th Cir. 1938) 95 F. (2d) 172.

old preferred stockholders to keep their shares without change or to exchange them for a new prior preferred. Stockholders who exchanged were given an income dividend note with interest at 3% for their accrued dividends. Since the other characteristics of the note were not described, the only clear advantage that this gave the consenting stockholders was the interest. The federal court sustained the amendment under the Texas statutes.

This group of cases raises the question whether a corporation which has no power to remove accrued dividends could, by offering a specific security for them, persuade a court to sustain a compulsory amendment which it otherwise would hold illegal. Only two cases have been found in which this has been attempted and in both it was unsuccessful. The amendment in *Patterson v. Durham Hosiery Mills*[123] compelled exchange of the old stock for a new class, and of the accrued dividends for two shares of common stock. The court, holding the amendment illegal, said:

> "If the proposed amendment to the charter were such as to offer reasonable protection to plaintiff's vested right in a mere change of form which would not render it less secure, as, for example, the offer of income dividend notes as was done in *Ainsworth v. Southwestern Drug Corp.*, . . . much of the legal objection might be removed. In fact, the position of the stockholder with reference to his accrued dividends would be actually improved, since dividends are not the debt of the corporation until declared; . . . but we do not consider that the alternative offered plaintiffs is a free choice or that it preserves their right. They have the choice of accepting in exchange for their accumulated dividends shares of the not-so-attractive common stock, or of standing aloof and seeing their stock displaced by a new issue, upon which the corporation intends to pay dividends in contravention of the vested prior rights of the plaintiffs."[124]

Again, in *Harbine v. Dayton Malleable Iron Co.*,[125] the amendment gave one share of common stock for the accrued dividends; the court held the amendment invalid. Hence, it seems that a compulsory exchange of a junior security for accrued dividends will not be sustained if there is no power to take the arrearages away directly.

In many of the cases it is implicit that part of the new stock is given in exchange for the accrued dividends on the old stock, but no

[123] 214 N.C. 806, 200 S.E. 906 (1939).
[124] Id. at 812.
[125] 61 Ohio App. 1, 22 N.E. (2d) 281 (1939).

express consideration for the accrued dividends is stated. In such cases the court, if it holds the amendment valid except for the accrued dividends, will require the plaintiff to exchange, but will have difficulty in deciding how much of the exchange stock he is entitled to, since he is not, like the assenting stockholders, surrendering his accrued dividends. In the one case which discusses this problem, *Dunn v. Wilson & Co.*,[126] the amendment converted each share of old preferred into five shares of common. Although the cancellation of accrued dividends was held invalid, the court held that the other changes were proper and required the plaintiff to exchange his old stock. The corporation then objected that the five shares of common stock into which the preferred was converted included an allowance for accrued dividends, and that the plaintiff therefore should be made to take something less since he was to be paid the accruals in cash. The court held that the defendant was not in a position to raise a problem so difficult of solution:

> ". . . Such a consideration may have been given to the amount of common stock the Class A shareholders should receive to compensate them for their accrued dividends, and the distribution in its larger aspects may be fair. But, this is all wide of the mark for the particular plan agreed upon is illegal as to dissenting shareholders. They are entitled to their accrued dividends before anything is paid to common. If this operates to disrupt the nice distribution under the plan, it is merely the price which must be paid for effecting an illegal plan. Neither the defendant who perfected the illegal plan, nor the shareholders who assented to it, have a standing to complain because the dissenting shareholders demand their full rights under the statute."[127]

It is submitted that this disposition of the question is punitive, but properly so. The court might well decline to enter upon a difficult task of valuation which was made necessary by the failure of the plan to express any concrete consideration for the surrender of the accrued dividends. However, under the *Harbine* case, if the plan does state what part of the exchange is for accrued dividends and if that part is conveniently severable from the rest, it seems proper to limit the plaintiff to the consideration for his shares alone.

In numerous other cases, in deciding the question whether the plan is "fair" the courts have attempted to weigh the value of the old securities against the value of the new ones.[128] Such attempts rest on assump-

[126] (D.C. Del. 1943) 53 F. Supp. 205.

[127] Id. at 208.

[128] As examples of such attempts the following authorities engage in comparison of the earning power and relative priorities of the old and new securities: Shanik v. White

tions concerning the volume of future business, estimates of costs, and other indeterminate factors. But this method, whatever it may do in the future, does not seem as yet to have affected the results of cases dealing with accrued dividends. When the plan is "voluntary," that is, when the old shares and their accrued dividends are left in being, the courts have sustained the amendments, finding the plan fair if they consider the question at all. When the plan is compulsory and there is no power to remove accrued dividends, no case has been found which sustained the amendment merely because something else was given which the court found "fair." Consequently, there is no reason to suppose that the cases would have been decided differently if the amendment had not appeared to give control, or participation in dividends with the common, or some other consideration. It seems then, that such amendments only give a pretext for sustaining changes which the courts would sustain without pretext.

(f) *Elimination of Accrued Dividends by Merger, Consolidation, and Sale of All Assets.* The technique most recently developed for avoiding the payment of accrued dividends uses the merger, consolidation, or sale of all assets. After the decisions in the *Keller*[129] and the *Consolidated Film*[130] cases, the Delaware courts were presented with the litigation in *Federal United Corp. v. Havender.*[131] The plaintiff held preferred stock on which there were $29 of accrued dividends. The corporation merged with a wholly owned subsidiary, and reclassified its

Sewing Machine Corp., 25 Del. Ch. 371, 19 A. (2d) 831 (Sup. 1941), affirming (Del. Ch. 1940) 15 A. (2d) 169; Matter of Woodruff, 175 Misc. 819, 26 N.Y.S. (2d) 679 (1941), affd. without opinion, 262 App. Div. 814, 28 N.Y.S. (2d) 756 (1941); McQuillen v. National Cash Register Co., (4th Cir. 1940) 112 F. (2d) 877, affirming (D.C. Md. 1939) 27 F. Supp. 639; Johnson v. Fuller, (3d Cir. 1941) 121 F. (2d) 618, affirming (D.C. Pa. 1940) 36 F. Supp. 744, cert. den. 314 U.S. 681 (1941); Sander v. Janssen Dairy Corp., (D.C. N.J. 1940) 36 F. Supp. 512. [This amendment was later held invalid in Kamena v. Janssen Dairy Corp., 134 N.J.Eq. 359, 35 A. (2d) 894 (Ct. Err. & App. 1944)]; United Milk Products Corp. v. Lovell, (6th Cir. 1935) 75 F. (2d) 923.

McQuillen v. National Cash Register Co., supra, and Barrett v. Denver Tramway Corp., (D.C. Del. 1944) 53 F. Supp. 198, affd. (3d Cir. 1944) 146 F. (2d) 701, indicate that the loss of the common stock's voting control to the preferred, or the fact that the votes of the common stock are necessary to carry the amendment, are entitled to weight in appraising the "fairness" of the plan. Naturally, with such speculations, the preferred stockholder's relatively determinate right to dividends over the common stock is being transformed into something that may or may not be worth as much. The method, however, as indicated above, has not been used to sustain any amendment which would not probably have been sustained without it.

[129] 21 Del. Ch. 391, 190 A. 115 (Sup. 1936).

[130] 22 Del. Ch. 407, 197 A. 489 (Sup. 1937).

[131] 24 Del. Ch. 318, 11 A. (2d) 331 (Sup. 1940). See comments: 9 DUKE B.A.J. 38 (1941); 39 MICH. L. REV. 1201 (1941); 24 MINN. L. REV. 992 (1940); 25 WASH. UNIV. L.Q. 614 (1940); and 53 HARV. L. REV. 877 (1940).

stock in the process, giving for each share of old preferred stock one share of new preferred with a lower dividend rate and six shares of class A common stock. Two chancellors in the lower court held that there could be no payment of dividends on the common stock of the resulting corporation until the accrued dividends had been discharged.[132] The Delaware Supreme Court reversed, holding that the merger was legal and that the plaintiff would have to make the exchange without receiving payment of his accrued dividends. This was equivalent in effect to sustaining a compulsory amendment eliminating accrued dividends. The basis of the court's decision was that statutes in force when the corporation was chartered provided that the consolidation agreement should state ". . . the manner of converting the shares of each of the constituent corporations into shares of the consolidated corporations. . . ."[133] Distinguishing the *Keller* case, the court said:

> ". . . The decision has no application beyond its philosophy. It has no bearing on the question in dispute. The substantial elements of the merger and consolidation provisions of the *General Corporation Law* as they now appear have existed from the time of the inception of the law. . . . The shareholder has notice that the corporation whose shares he has acquired may be merged with another corporation if the required majority of the shareholders agree. He is informed that the merger agreement may prescribe the terms and conditions of the merger, the mode of carrying it into effect, and the manner of converting the shares of the constituent corporations into the shares of the resulting corporation. A well understood meaning of the word 'convert,' is to alter in form, substance or quality."[134]

The court also relied on the fact that the plaintiff was entitled to an appraisal in which he could recover in cash the full value of his shares.

As a matter of constitutional law the decision is clearly distinguishable from the *Keller* case, in which the only statute that could authorize the amendment was subsequent to the charter. The statute relied on to sustain the merger in the *Havender* case was in force when the com-

[132] In the first opinion in the lower court the Chancellor doubted that dividends on the new preferred stock could be enjoined, but enjoined them as to the common stock. 23 Del. Ch. 104, 2 A. (2d) 143 (Ch. 1938). After the death of the first Chancellor, another enjoined dividends on the new preferred stock as well as the common. 24 Del. Ch. 96, 6 A. (2d) 618 (Ch. 1939). In this he seems to have gone beyond the decisions of the Supreme Court of Delaware. See discussion in Part I of this article, 49 MICH. L. REV. 363 at 389-391 (1951). There is a comment on the decision of the lower court in 38 MICH. L. REV. 214 (1939).

[133] 24 Del. Ch. 318 at 327, 11 A. (2d) 331 (1940).

[134] Id. at 333-4.

pany was chartered, and it is accepted law that what is done under such a statute, whatever else may be wrong with it, does not violate the contracts clause.[135] The construction of the statute as authorizing the removal of accrued dividends is more difficult to justify. The court had twice held that the "... preferences, or relative participating, option or other special rights of the shares . . ." did not include accrued dividends.[136] Its decision that a power to state the ". . . manner of converting the shares . . ." does include them is singularly unconvincing as a matter of English. However, once this linguistic peculiarity is accepted, the *Havender* case is understandable. Since the merger provisions contemplate a complete change of the securities of one corporation into those of another, and since the lack of power to affect accrued dividends might otherwise prevent desirable mergers, a respectable case can be made for the broad construction on policy grounds. These considerations, however, are eliminated by the facts of the case. The merger was with a wholly-owned subsidiary; the same directors were in charge of both parties, and so there was no need for affecting the securities of the parent. The court applied to the statute the same principles of construction that it has applied to the power to issue prior stock, that

[135] The principle is abundantly established by nearly all the cases sustaining amendments. There is, however, this dictum in the Hottenstein case, discussed infra p. 576 ff., at note 139: "A court of the United States bound by the rule of Erie R. Co. v. Tompkins is powerless to afford aid to the stockholder until 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. At such a point a court of the United States might grant injunctive relief under the provisions of the Fourteenth Amendment." 136 F. (2d) at 953. Professor Dodd suggests that the appraisal provision would prevent successful attack by the stockholder on due process grounds in the case before the court, but that in amendment cases, when there is no appraisal provision, the attack might succeed. "Accrued Dividends in Delaware Corporations—From Vested Right to Mirage," 57 HARV. L. REV. 894 at 898 (1944).

It is true that the federal district court, in Yoakam v. Providence Biltmore Hotel Corp., (D.C. R.I. 1929) 34 F. (2d) 533, considered hypothetically whether a state statute reserving the right to alter or amend all contracts thereafter entered into would permit it thereafter to avoid the operation of the contracts clause, and indicated that it would not. But the decision, so far as relevant, merely held unconstitutional an attempt to remove a sinking fund provision for the benefit of the preferred stock, under a statute subsequent to the charter. There is also a suggestion in Pronick v. Spirits Distributing Co., 58 N.J.Eq. 97, 42 A. 586 (Ch. 1899), that permitting alteration of the dividend rate under a general power to amend the charter would impair the obligation of contracts. These are the only statements found which seem to question the position taken in the text, and in view of the mass of cases which proceed on the other assumption it seems impossible to attribute much weight to them. Moreover, one of the dicta refers to the general power reserved by the state to amend charters and the other to a very general power to amend the charter, which are both distinguishable from a specific power reserved to do the very thing complained of.

[136] In the Keller case, 21 Del. Ch. 391, 190 A. 115 (Sup. 1936), and the Consolidated Film case, 22 Del. Ch. 407, 197 A. 489 (Sup. 1937).

is, that if the merger is verbally justified by the statutes, no collateral effects that it may have can be considered.[137] For these reasons the decision has proved a misfortune.

Whatever the merits of the *Havender* case, it opened a highway around the *Keller* and *Consolidated Film* cases which others were not slow to use.[138] In *Hottenstein v. York Ice Machinery Corp.*,[139] the subsidiary was created solely for the purpose of the merger, which was carried through by giving for each share of old preferred with its $88.25 accrued dividends, 15 shares of preferred in the new corporation. The federal court sustained the merger, holding that under the *Havender* case the fact that the subsidiary was formed for the purpose of the union was immaterial. Its comment on the *Havender* case is interesting:

> ". . . If it is fair to say that the decision of the Supreme Court of Delaware in the Keller case astonished the corporate world, it is just to state that the decision of the Supreme Court in Havender astounded it, for shorn of rationalization the decision constitutes a repudiation of principles enunciated in the Keller case and in Consolidated Film Industries v. Johnson, supra."[140]

In *Langfelder v. Universal Laboratories, Inc.*,[141] the same circuit court of appeals sustained a merger with a subsidiary which converted each share of preferred with $88.67 accrued dividends into one share of new preferred and five shares of new common, holding that even a charter provision that the preferred should receive 110% of any reduc-

[137] See comment in 53 HARV. L. REV. 877 at 878 (1940) and note, 38 MICH. L. REV. 214 at 218 (1939). See also Meck, "Accrued Dividends on Cumulative Preferred Stock: The Legal Doctrine," 55 HARV. L. REV. 71 at 93 (1941).

[138] The ground was, perhaps, slightly broken earlier. The court sustained a merger in MacFarlane v. North American Cement Corp., 16 Del. Ch. 172, 157 A. 396 (Ch. 1928), commented on in 45 HARV. L. REV. 929 (1932), in spite of an adverse effect on accrued dividends, but it did not particularly consider them in its decision. Some years before the Havender case, the federal court sustained a sale of all assets in which the old preferred received eight-tenths of a share of new preferred for the old stock and its accrued dividends. The court stated generally that it considered that the plan was permitted by the Delaware law, and that it was fair. United Milk Products Corp. v. Lovell, (6th Cir. 1935) 75 F. (2d) 923.

At about the time of the Havender case, the Texas Court of Civil Appeals held, with respect to a Delaware corporation, that a sale of all assets matured the liquidation provisions of the preferred stock, and that the plaintiff could recover par and accrued dividends. Graham v. New Mexico Eastern Gas Co., (Tex. Civ. App. 1940) 141 S.W. (2d) 389.

[139] (3d Cir. 1943) 136 F. (2d) 944, affirming (D.C. Del. 1942) 45 F. Supp. 436; bill of review den. (3d Cir. 1944) 146 F. (2d) 835, cert. den. 325 U.S. 886 (1945). For a discussion of the lower court's decision see comment, 43 COL. L. REV. 230 (1943) (very critical).

[140] 136 F. (2d) 944 at 950.

[141] (3d Cir. 1947) 163 F. (2d) 804, affirming (D.C. Del. 1946) 68 F. Supp. 209. *Accord:* National Supply Co. v. Leland Stanford Junior University, (9th Cir. 1943) 134 F. (2d) 689, reversing (D.C. Cal. 1942) 46 F. Supp. 389, cert. den. 320 U.S. 773 (1943).

tion in capital plus its accrued dividends to the date of the reduction did not prevent the merger. Hence the federal courts, though critical, have completely enforced the rule of the *Havender* case.[142]

In New York one lower court has reached the same result. In *Zobel v. American Locomotive Co.*,[143] the corporation merged with two wholly owned subsidiaries, giving one share of new preferred, one and three-fourths shares of new common, and $7 in cash for each share of old preferred with its $42.75 of accrued dividends. The purpose of the merger was frankly acknowledged to be the elimination of the arrearages. In sustaining the merger the court said:

> ". . . The existence of a large amount of unpaid cumulative dividends well may be, and in many instances is, detrimental to the best interests of a company, and no showing is here made which enables the court to say that that is not true in this case. Furthermore, the preferred stockholders' present right to the accumulated arrears is not being taken from them without a consideration moving directly to them individually and collectively. Speaking broadly and in terms of practical results, they are being given, in exchange for that right and such other rights as pertain to their present shares, approximately one-sixth of the accumulated arrears of dividends in cash and an additional stock interest in the consolidated company so substantial as to change them collectively from the position of minority to the position of majority stockholders. Whether they will be better off as minority stockholders in a corporation having an immense amount of unpaid cumulative dividends or as majority stockholders in a corporation having no unpaid cumulative dividends is a question of business judgment. It

142 The lower courts in Delaware have also carried out the principles of the Havender case, without qualification. In Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A. (2d) 148 (Ch. 1943), commented on in 42 MICH. L. REV. 332 (1943), the corporation merged with a wholly owned subsidiary when the balance sheet showed assets worth less than the par value and accrued dividends to which the preferred was entitled on liquidation. Each preferred share was converted into one share of new preferred with lower liquidation value and dividends, and five shares of new common. Each share of old common was converted into one tenth of a share of new. The court held that the plaintiff's claims of unfairness could not be sustained. Since the corporation was not being liquidated, it was not correct to measure the rights of the stockholders by the liquidation preferences of the senior stock. The argument of the plaintiff was also said to overlook the fact that the common was losing voting control, while the preferred was gaining in pre-emptive rights, and sinking fund, and conversion privileges. But the court's description of these gains as ". . . changes which may be of substantial value, depending upon future events," [27 Del. Ch. 127 at 134, 32 A. (2d) 148 (1943)] correctly describes the uncertainties with which the courts and the parties are dealing in these cases. See Dodd, "Accrued Dividends in Delaware Corporations—From Vested Rights to Mirage," 57 HARV. L. REV. 894 at 895-6 (1944), for strong criticism of this case.

143 182 Misc. 323, 44 N.Y.S. (2d) 33 (1943).

certainly is not a question which a court can attempt to decide for them. The sole question for the court is whether or not the proposal is violative of their legal rights."[144]

The court's putting the burden on the plaintiff to prove that the accrued dividends were not a burden on the corporation, has been discussed previously.[145] The statement that the question is one of "business judgment" and so outside the scope of judicial review, seems to overlook the shifting of property interests which resulted from the amendment.[146] The court of appeals, in *Anderson v. International Minerals & Chemical Corp.*,[147] sustaining a merger in which the preferred with accrued dividends was converted into one share of new preferred and three and one-half shares of new common, while the old common received one-fourth share of new common for each share of old, put its decision on the terms of the merger statute:

> "In this case we are dealing with the provisions of the New York Stock Corporation Law having to do with merger and consolidation. . . . These provisions differ in language, purpose and subject matter from article 4 relating to the reclassification of shares under which the cases arose upon which plaintiff relies. The whole process of merger and consolidation rests upon the principle of permitting consolidations approved by two-thirds of the shareholders which in the absence of statute would require the consent of all and permitting dissenters, not wishing to go along, the opportunity to have their shares appraised and to retire from the enterprise upon payment to them of the appraised value of their shares."[148]

But this merger was between two independent companies, and the decision does not necessarily imply approval of the *Havender* case.

In New Jersey the courts, after a doubtful beginning, have reached the same result as in Delaware and New York. In *Colgate v. U. S. Leather Co.*[149] the plan of consolidation of the subsidiary, in which the plaintiff held preferred stock, but which was almost wholly owned by

[144] Id. at 325.

[145] See Part I of this article, 49 MICH. L. REV. 363 at 371-372 (1951).

[146] The refusal of the courts to pass upon some amendment questions on the ground that they present merely problems of business judgment is examined and criticized at greater length in another article of this series, entitled: "Corporate Charter Amendments: Issues of Prior Stock, and the Alteration of Dividend Rates," 50 COL. L. REV. 900 (1950).

[147] 295 N.Y. 343, 67 N.E. (2d) 573 (1946). *Accord:* In re Interborough Consolidated Corp., (D.C. N.Y. 1921) 277 F. 455.

[148] 295 N.Y. 343 at 349, 67 N.E. (2d) 573 (1946).

[149] 73 N.J.Eq. 72, 67 A. 657 (Ch. 1907), affd. 75 N.J.Eq. 229, 72 A. 126 (Ct. Err. & App. 1909).

the other company, gave a five percent gold bond for $50, a $50 par share of new preferred and $23.50 of common stock, for each share of old preferred with its accrued dividends. Each share of old common received three-tenths of a share of new. There were about 45.8% of accrued dividends on the old preferred. The applicable statute provided that the plan should set out ". . . the manner of converting the capital stock . . ."; the lower court held that this did not permit conversion of accrued dividends because the latter were a debt or liability of the company, saved by another section of the statute. The Delaware and New York courts have rejected similar arguments under their statutes.[150] The affirmance of the *Colgate* case by the Court of Errors and Appeals was on other grounds and cannot be taken as an approval of the lower court's decision on this point.[151] Many years later, in *Windhurst v. Central Leather Co.,*[152] in which it appears that the corporations were independent, both courts took the opposite view. The consolidation plan gave the old preferred half a share of new preferred, three-fourths of a share of a subordinate participating preferred and $5, in discharge of each old share and its 43% of accrued dividends. The lower court sustained the merger, partly on the ground that this treatment of the preferred stock was equitable and within the power of the corporation, and partly on the ground of laches.[153] The cases can be reconciled on the ground that the first involved a parent-subsidiary merger while the second did not, but the opinions certainly do not rest on such reasoning.

The plaintiffs in the *Windhurst* case also claimed that the merger amounted to a dissolution which entitled the preferred stockholder un-

[150] The Delaware court held in the Havender case that accrued dividends did not make a stockholder a creditor, and that the words, "debts" and "liabilities" in the merger act, from the context, referred to ". . . persons external to the corporation. . . ." 24 Del. Ch. 318 at 336, 11 A. (2d) 331 (1940). The New York Court of Appeals held that accrued dividends did not survive a merger or consolidation as a debt, in Anderson v. International Minerals & Chemical Corp., 295 N.Y. 343, 67 N.E. (2d) 573 (1946).

[151] After the opinion in the lower court, the corporation altered the plan so that it did not affect accrued dividends. The court of errors and appeals nevertheless enjoined the merger on the ground that there was no power to carry it out. 75 N.J.Eq. 229, 72 A. 126 (Ct. Err. & App. 1909).

It should be noted that the lower court in the Colgate case said that the $23.50 of common stock was not stated to be in exchange for the accrued dividends, but that both sides had acted as if it were. It then held that the exchange of common stock for accrued dividends was only an offer, which the stockholder had the power to reject.

[152] 101 N.J.Eq. 543, 138 A. 772 (Ch. 1927), and 105 N.J.Eq. 621, 149 A. 36 (Ch. 1930), affd. 107 N.J.Eq. 528, 153 A. 402 (Ct. Err. & App. 1931). The reasoning is taken from the lower court opinions as the affirmance is practically in the terms of those opinions.

[153] In Clarke v. Gold Dust Corp., (3d Cir. 1939) 106 F. (2d) 598, cert. den., 309 U.S. 671 (1940) the federal court sustained a merger of New Jersey corporations in a way which would be in accordance with the Windhurst case, but it is not clear from the discussion whether there were accrued dividends or not.

der the charter to payment in cash of the par value and accrued dividends. The court held that merger was not a dissolution. But this contention seems to have been successful in Ohio. In *Geiger v. American Seeding Machine Co.*,[154] upon a sale of all assets, the court held that the plan of distribution set forth in the sale could not displace the preferred stockholders' rights to par and accrued dividends before the common stock received anything. The statutes provided for appraisal of dissenters' shares upon sales of all assets, but the court held that appraisal was the remedy only if the stockholder objected to the sale, not if he merely objected to the terms of distribution of the proceeds. The Ohio law was afterwards altered by statute on this point.[155] The Pennsylvania court has also held that a merger amounted to a dissolution, entitling the preferred stockholders to par and accrued dividends before anything was paid to the common stock.[156] Again, however, it seems that subsequent statutes have altered the law. In *Hubbard v. Jones & Laughlin Steel Corp.*,[157] the merger (with two wholly owned subsidiaries) provided that each old share should be converted into one-half share of each of two new types of preferred and one and one-fourth shares of common. The federal court sustained the merger as a fair exercise of the power to convert the shares and held that a statute subsequent to the earlier case made appraisal the exclusive remedy for dissenters. The Virginia court has held that appraisal is not the exclusive remedy in sale of all assets, but that it is in case of merger, so that by merger a corporation can rid itself of accrued dividends.[158]

[154] 124 Ohio St. 222, 177 N.E. 594 (1931).

[155] See Daus v. Otis Steel Co., 11 Ohio Supp. 94 (Common Pleas 1942).

[156] Petry v. Harwood Electric Co., 280 Pa. 142, 124 A. 302 (1924); companion case, 280 Pa. 158, 124 A. 307 (1924).

[157] (D.C. Pa. 1941) 42 F. Supp. 432.

[158] In Powell v. Craddock-Terry Co., 175 Va. 146, 7 S.E. (2d) 143 (1940), the court held as a matter of construction, that the plaintiff was entitled on dissolution only to the par value of his stock, but not to accrued dividends. In Craddock-Terry Co. v. Powell, 180 Va. 242, 22 S.E. (2d) 30 (1942), the court held against vigorous dissent that a sale of all assests was not a dissolution, and that the plaintiff, a preferred stockholder, could not maintain an action for the par value of his stock under the dissolution provisions of the charter, but only an action for statutory appraisal. Then, in the same case on rehearing, 181 Va. 417, 25 S.E. (2d) 363 (1943), the court held in accordance with the previous dissent, that the sale was a liquidation, and that the plaintiff was entitled to the par value of his shares, instead of the value that might be set in an appraisal. Since it had been held as a matter of construction that the plaintiff was not entitled to accrued dividends on liquidation, they could not be recovered, but it seems clear that they could have been if the charter had provided for them.

Subsequently, in Adams v. U.S. Distributing Corp., 184 Va. 134, 34 S.E. (2d) 244 (1945), the plaintiff held preferred stock in a Virginia corporation which merged with a Delaware corporation, and claimed that the merger amounted to a dissolution which entitled him under the Craddock case to par and accrued dividends on his shares. The court held that appraisal was the exclusive remedy in cases of merger and distinguished the Craddock case on the ground that it was a sale of all assets, and governed by different statutes.

Thus, it seems that in every state[159] that has dealt with the problem merger offers a compulsory means of eliminating accrued dividends, decisions to the contrary being quickly changed by statute. It seems queer to protect accrued dividends from amendment while the equally easy method of merger is left open. Explanations based on the appraisal statutes and on the argument that accrued dividends would otherwise bar financially desirable mergers do not ring true when a subsidiary corporation is used for the operation.

4. *Summary*

The law of accrued dividends may be summarized as follows:

(a) Direct removal of accrued dividends is legal when the statutes expressly permit it, describing them by that name, provided the lower court decisions upholding the statutes in New Jersey and New York are approved by their respective appellate courts. Aside from this, direct removal is allowed in Maryland if the state courts there follow the federal interpretation of the statutes, and it seems likely that Illinois will also permit direct removal by corporations chartered under the Business Corporations Act of 1933. With these exceptions, direct removal of accrued dividends is not allowed.

(b) The constitutionality of subsequent statutes authorizing removal of accrued dividends has not been settled; the decisions in New York and Delaware are in conflict and no decisions of the Supreme Court are sufficiently in point to warrant prediction of what it would do.

[159] Except possibly Missouri and Massachusetts. See Jones v. Missouri-Edison Electric Co., (8th Cir. 1906) 144 F. 765, and Opinion of the Justices, 261 Mass. 556, 159 N.E. 70 (1927) (sale of all assets).

A recent decision by the Illinois Appellate Court suggests that Illinois may not follow the trend elsewhere. In Opelka v. Quincy Memorial Bridge Co., 335 Ill. App. 402, 82 N.E. (2d) 184 (1948), the corporation had $100 par value preferred stock, with a 6½% cumulative dividend, and a liquidation preference of par and accrued dividends. By the requisite vote of the stockholders, all the assets of the company were sold to the city of Quincy. Some of the common stockholders received $5 per share from the corporation. The plaintiffs got nothing for their preferred stock and its $104.99 of accrued dividends, but were offered $150 per share under the sale contract. The plaintiffs brought an action in equity, demanding the payment of $204.99 per share out of money on deposit to the corporation's credit. The court, reversing the trial judge, held that the complaint stated a cause of action. The plaintiff was not limited to appraisal, it held, if the sale were fraudulent and illegal as alleged, and the payments to the common stockholders would support those allegations if proved. These payments, it is submitted, would have justified the court without more, but the court went on to review some of the cases in other jurisdictions, and stated that the sale of all assets statute in Illinois did not permit distribution of the proceeds on a basis different from the provisions of the charter and the Corporation Act. The court concluded that if the Illinois legislature had meant to permit elimination of accrued dividends it would have stated its intention expressly. The case is doubtful authority, at least on the last point, in view of Western Foundry Co. v. Wicker, discussed in Part I of this article, 49 MICH. L. REV. 363 at 369 (1951).

(c) Indirect removal of accrued dividends by issuing prior stock and making other alterations damaging to the dissenting old stockholders are sustained in most states, and in those that do not approve the remedies of the dissenter are not very effective, except, perhaps, in New Jersey and North Carolina.

(d) Mergers and consolidations, even if arranged with a subsidiary for the purpose of eliminating accrued dividends, will accomplish compulsory removal in most states that have passed on the question, and where the courts have held that they will not, the legislatures have been prompt to change the rule as far as they could by statute.

(e) Offers of other securities for accrued dividends do not seem to affect the results of the cases..

(f) Plans which offer securities partly for the old stock and partly for accrued dividends without indicating what is for the dividends, are sustained if they are voluntary in form and rejected if they are compulsory, that is, the results of these cases are the same as those in which no express provision is made for accrued dividends. Thus, though some of the cases contain the possibility that a fair plan was offered, and although some of the courts have considered the "fairness" of such plans, it is impossible to say that the results have actually turned on fairness.

The rules, therefore, after the recent flood of cases, remain just what they were in the beginning, except that merger has developed into the most successful direct attack on accrued dividends — so successful that it is perhaps foolish to use any other. The law has reached this condition without a single convincing demonstration in any case of the facts that justify such interference with the property rights of the minority. The state of the cases suggests that judicial and perhaps statutory remedy is needed.

5. *Conclusions*

I have attempted to show at the beginning of this article that accrued dividends are not qualitatively different from other rights of the preferred stockholder, for example, his right to future dividends. The right to accrued dividends arises from contract, and is subject to conditions beyond the personal control of the individual stockholder. Hence it is illogical to distinguish accrued dividends as "vested" or otherwise legally peculiar. On the other hand, it is a fact that accrued dividends represent a measure of priority which the preferred stockholders are entitled to against the common stock, and this priority, which may ultimately be translated into a money return, is one of the things that induced the investor to buy that stock rather than common

stock. Money return is what the preferences given to senior stock are intended to protect; and money return is what the amendments attack when they alter accrued dividends. If the facts justify alteration of accrued dividends the majority should be able to compel the minority in the public interest. The lamentable inconsistency of the voluntary amendment, which accomplishes the end by pressure, should be eliminated;[160] nor should it be necessary to resort to the complications of a merger or sale of all assets to achieve a simple result, if the public interest requires that a change be made.

The public interest which is alleged to require alteration of accrued dividends, meanwhile, is elusive. It appears only in general statements. Upon the demand for concrete facts it dissolves. And if the assault upon these is successful, there is no reason why other preferences should not also be subject to similar change. Under the voluntary plans and mergers, it is as if every certificate of preferred stock bore on it the legend: "This stock is prior to all others, bears 7% cumulative dividends, has a liquidation preference of $110 and accrued dividends, and is entitled to a sinking fund of $50,000 per year, unless a majority of the class which you, as purchaser, have joined, should change its collective mind, in which case this stock is no better than second preferred and perhaps worse, bears 1% dividends which are non-cumulative, has no liquidation or sinking fund rights, and will lose all the dividends that shall have been passed before the majority has made up its mind to terminate your rights." Common sense would advise great caution in entering into such a contract as this, particularly when the cases show what things a majority of a class has often agreed to do to itself. Continuation of the present law, with the present temper of mind which takes full advantage of it, may bring corporations to the place where they cannot raise money on preferred stock and will have to rely on common stock and debt financing. There is very real risk that cumulative preferred stock will cease to be a valuable investment, that those who would otherwise buy it, will insist on a creditor's status which at least puts them beyond reach of their fellows' mistakes.

The chance that preferred stock will be destroyed as an investment device warrants closer consideration of the problems presented by the

[160] It is seldom that the courts and the writers are so far apart on a question with both sides so nearly unanimous. For criticism of voluntary plans on the ground that they are really compulsory, see Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 at 807-8 (1942); Latty, "Fairness—The Focal Point in Preferred Stock Arrearage Elimination," 29 VA. L. REV. 1 at 7, 20 (1942); see also notes: 52 HARV. L. REV. 1331 at 1336-7 (1939); 55 HARV. L. REV. 1196 at 1200 (1942); 33 ILL. L. REV. 212 at 214 (1938); 4 UNIV. CHI. L. REV. 645 at 648 (1937).

accrued dividend cases. If the risk of destruction is great, the public interest may in the end be on the side of preserving it.

(a) *The Constitutional Question.* When the necessary effect of an alteration of accrued dividends is to shift property interests, or to set losses off against the senior instead of the junior securities, the action, if authorized by a statute subsequent to the charter, should be held to violate the due process and contracts clauses. It achieves an improper end by unreasonable means. It is true that the presumption of constitutionality will probably sustain such general statutes as are now common, but this does not by any means conclude the question. The statutes may stand as general enactments, but it is true at the same time that they do not in themselves alter the capital structure of any corporation. The power which the majority exercises in adopting amendments authorized by such statutes, comes in part at least, from the state, and is consequently, a delegated power. The statutes contain no standards to guide the majority in the exercise of the power, and the delegation, moreover, is to a class of persons interested, perhaps adversely, in the subject matter upon which the power is exerted. When the effect of the majority action is to shift interests from one class to another, the way is open to hold that the statute, though constitutional in itself, is being unconstitutionally applied to the facts of the case.

In short, once the stockholder has shown that the effect of the amendment is to shift property interests, the burden of proof should be on the majority and the corporation to show that some overriding public interest requires that the amendment be made.[161] This proof should be concrete, on the facts of the individual case, and not some general assertion that the state needs or might need the change and therefore has the power to authorize all corporations to make it. Just as in eminent domain the condemnor has to show the public purpose in each action, so here, when property is taken, the majority should be required to show that the amendment is necessary in the specific case.

It may be argued that the majority vote for the amendment shows the need for it, and that by requiring such a vote the state automatically limits amendments to cases of necessity. But those who have considered the question outside of judicial proceedings universally denounce the majority vote on the ground that it does not rest on any serious convictions of the need for the amendment. Proxy machinery, more than

[161] For suggestions that the burden of justification should be on the majority see comment, 36 COL. L. REV. 674 at 675 (1936); it seems that Professor Latty's suggestions would also include this: "Fairness—The Focal Point in Preferred Stock Arrearage Elimination," 29 VA. L. REV. 1 at 14, 50 (1942).

anything else, produces the approval.[162] Various arguments based upon corporate need have been examined and found wanting. The presence of accrued dividends, for example, is often said to prevent the corporation from borrowing money, but there is good evidence that they do not prevent credit financing if the corporation is otherwise a sound risk;[163] if it were not, the absence of accrued dividends would not help it. One of the main supports for the amendments has been the claim that they facilitate financing by common stock, but such financing has not in fact followed the amendments.[164] The commonest assumption among the writers is that the apparent reason for the amendment, the desire to pay dividends on the common stock, is also the real one.[165]

[162] On this point there is unanimity among the non-judicial writers. See Latty, "Fairness—The Focal Point in Preferred Stock Arrearage Elimination," 29 VA. L. REV. 1 at 22-23 (1942); see also note, 36 COL. L. REV. 674 at 675 (1936); comment, 25 CORN. L.Q. 431 at 436 (1940); notes: 52 HARV. L. REV. 1331 at 1332 (1939); 54 HARV. L. REV. 488 at 489 (1941); 26 MINN. L. REV. 387 at 395 (1942); 4 UNIV. CHI. L. REV. 645 at 653 (1937); 46 YALE L. J. 985 at 999 (1937).

[163] See Latty, "Fairness—The Focal Point in Preferred Stock Arrearage Elimination," 29 VA. L. REV. 1 at 12 (1942).

[164] See Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780, esp. at 782-3 (1942).

Issuing stock prior to all the old classes for new cash or property seems unlikely to succeed, since the common stock would probably not vote for a measure likely to diminish its chances of dividends. Moreover, such plans would complicate the stock structure, and it may not be sound policy to encourage them. See 4 UNIV. CHI. L. REV. 645 at 655 (1937); a note in 55 HARV. L. REV. 1196 at 1206 (1942) cites this complication of the stock structure as an argument against the voluntary plans.

I once suggested that limiting the power to issue prior stock to cases in which it was issued for cash would enable the courts to defeat the voluntary plans. "The Power to Remove Accrued Dividends by Charter Amendment," 40 COL. L. REV. 633 at 648 (1940). This suggestion has been criticized as academic. Meck, "Accrued Dividends on Cumulative Preferred Stock: The Legal Doctrine," 55 HARV. L. REV. 71 at 95, note 80 (1941). If construed as meaning that stock should not be issued for property, I quite agree. However, issuing it to other members of the plaintiff's class for their old shares is distinguishable from issuing it for fresh consideration, whether cash or property, and it seems quite proper for a court to enjoin any use of the power that achieves ends beyond the direct power of the majority. The suggestion seems to be approved in note, 26 MINN. L. REV. 387 at 397 (1942). It is not different in nature from the numerous proposals that the merger statutes should not be construed as permitting unions of parent and subsidiaries with the purpose of eliminating accrued dividends.

[165] The cases, notably those sustaining mergers of parent and subsidiary, frequently suggest that appraisal is an adequate remedy, and that if it is provided, there is no need for other protection. But the decisions of the New York courts, denying appraisal when the amendment is voluntary [see note 95 in Part I of this article, 49 MICH. L. REV. 363 at 392 (1951)], suggest that this remedy as applied by the courts is not adequate. Moreover, many of the writers on the subject have pointed out defects in the appraisal procedure as it stands now, which make it objectionable even if the stockholder is permitted to use it. See Lattin, "Remedies of Dissenting Stockholders under Appraisal Statutes," 45 HARV. L. REV. 233 (1931); Levy, "Rights of Dissenting Stockholders to Appraisal and Payment," 15 CORN. L.Q. 420 (1930); see also Dodd, "Accrued Dividends in Delaware Corporations—From Vested Right to Mirage," 57 HARV. L. REV. 894 at 895 (1944), and Dodd, "Amendment of Corporate Articles Under the New Ohio General Corporation Act," 4 UNIV. CIN. L. REV. 129 at 164-5 (1930), indicating the be-

Finally, when considering the claims of a public interest in these cases, it should be remembered that the corporation laws of a few states control the corporations of the country. Delaware, Maryland, New Jersey and New York pass laws and their courts determine the constitutional questions presented by them, so far with little guidance from the Supreme Court. If the corporation's property is in another state, and only a small proportion of the stock is held by residents of Delaware, the public policy of the case and the constitutionality of the action are being determined by a legislature and a court which have no contact with the sovereign whose interests are really in issue. This is an immense debit to be subtracted from the claim of public interest in all of these cases. There is some hope that litigation undertaken in the states where the corporations have property might have happier results, but the rule that courts will not interfere in the internal affairs of foreign corporations, and perhaps the crystallization of local interpretations under the full faith and credit clause may prevent successful development along this line. Moreover, it is not unlikely that the enactment of broad amending statutes in other states results from following the corporation states, either blindly, or in an effort to keep local corporations at home, rather than from serious convictions that those powers are necessary to corporate enterprise.

In short, considering the drastic effects of these amendments on contracts and property, it seems that rigorous proof should be required that the majority is serving some public interest when it adopts them. The proof has not been forthcoming. Accordingly, though there is power to enact such legislation under the reserved power and perhaps under the police power as well, the exercise of such power should be carefully scrutinized, and the majority should be held to strict proof of the necessity for the amendment, if it is found to shift property among the classes.

The fear of hamstringing corporations by narrow constitutional interpretation should not prevent the application of this theory. The power to enact the statutes is not denied; the legislation can be passed. If the public interest justifies the application of it in a particular case, presumably that interest can be proved, and it seems no more than reasonable to place the burden of that proof upon those who assert the fact.

lief that a stockholder should not be forced to accept appraisal as the alternative to an amendment that discriminates, and that it may not eliminate constitutional questions, unless eminent domain would be available against the dissenter. See also notes: 36 COL. L. REV. 674 at 675 (1936); 52 HARV. L. REV. 1331 at 1334 (1939); 26 MINN. L. REV. 387 at 397-9 (1942); 54 YALE L. J. 840 at 844-5 (1945).

(b) *Construction of Statutes in Force When the Charter is Granted.* As liberal amending statutes become part of the corporation law in more and more states, constitutional problems presented by subsequent statutes are decreasing in importance. But even under existing statutes, the minority does not necessarily lose all its constitutional objections. Assuming that the conventional view is correct, that the minority has no contracts clause objections to action taken under such statutes the corporate form of business is so essential, and corporate securities are so vital a form of investment, that a stockholder's freedom of contract and property may be taken without due process when advance consent to such actions is extracted as a condition of investment—unless, that is, the corporation were able to establish a public interest in the amendment on the facts of the case. There is, however, very little authority for this position.[166] The same technique could be applied to the powers to issue prior stock and to classify and reclassify stock now so generally reserved; that is, the reservation of such powers, if interpreted to permit the shifting of property without justification, could be held a violation of due process.

A more promising approach, in view of the cases so far decided, would be to urge that the statutes should not be interpreted as authorizing the shifting of property interests, whether they permit the issue of prior stock, reclassification of old stock, or mergers and sales of all assets. Another means to the same end is to hold that, as powers in trust, the majority cannot use them to the advantage of one class and the disadvantage of another.[167] These methods would enable the courts to control amendments, even under existing statutes, without the aid of constitutional limitations.

A decision that an amendment on one or another of these grounds is invalid, would be a poor victory for the dissenter, unless the relief given to him were effective. The courts have a choice between enjoining the entire plan and three kinds of less drastic relief: (1) enjoining dividends on the new stock until accrued and current dividends have been paid on the old; (2) enjoining dividends on the new stock until only the accrued dividends have been paid; (3) permitting dividends on the new stock at once, and merely enjoining dividends on the common stock until the accrued dividends have been paid. If it is practical, an injunction against the consummation of the plan is the best, espe-

[166] What I have found is printed in note 135 supra.

[167] See Berle, "Corporate Powers as Powers in Trust," 44 HARV. L. REV. 1049 (1931). See also, as a clear example of equitable limitations of amending powers, the cases on reduction of capital, cited in note 88 supra.

cially since the majority might wish to withdraw when it finds that dissenters are not bound by it. But if the plan is already executed, the rights of purchasers of all classes of shares after the amendment, and before the decision would raise difficult problems. In such circumstances, it seems sufficient to give the old shares priority as to accrued and future dividends over the new ones. Anything less than this seems inadequate, since giving the new stock priority in current dividends definitely puts a pressure on the dissenters. In cases of partial invalidity, it would be necessary to work out the relief to fit the individual case, but if the decree eliminated pressure on dissenters to accept the illegal part of the amendment, it would be sufficient.

(c) *Methods of Control.* The discussion thus far has been limited to the ways in which the courts could assume power to control amendments. There have been a number of suggestions that the control be turned over to administrative bodies, at least as to amendments that affect accrued dividends.[168] Among these I would class my own earlier suggestion that the statutes be drawn to require judicial approval of the plan before it becomes effective.[169] It seems, however, that both of these methods would cause unnecessary trouble and expense. Very possibly the volume of amendments in most states would not justify the creation of a commission for that work, or even enlargement of the powers of some existing commission. Requiring advance judicial approval would put a heavy burden on the courts, in many cases not justified because no stockholder may care to object to the plan. Neither system would be likely to do enough good to justify its expense. The inherent power of equity to enjoin plans or parts of plans upon the suit of interested parties, seems to offer the least expensive system of relief.

It seems that the proposals to submit amendments to administrative tribunals are open to another most serious objection. As a matter of actual fact, the great bulk of the cases would come before the commissions of a very few states, which would, in consequence, decide these questions for the entire country, without much, if any, hope that they

[168] These suggestions, as least as to amendments which affect accrued dividends, are very common. See Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 at 811 ff. (1942); notes: 52 HARV. L. REV. 1331 (1939); 26 MINN. L. REV. 387 at 396 (1942); 4 UNIV. CHI. L. REV. 645 at 657 (1937); 46 YALE L. J. 985 at 1003 (1937). Some writers have preferred a more extensive judicial control of amendments to administrative procedure. See Latty, "Fairness—The Focal Point in Preferred Stock Arrearage Elimination," 29 VA. L. REV. 1 at 50 (1942), suggesting that legislative action should be taken only if the courts fail to solve the problem. See also note, 36 COL. L. REV. 674 at 676 (1936).

[169] "The Power to Remove Accrued Dividends by Charter Amendment," 40 COL. L. REV. 633 at 650 (1940).

were enforcing the public policy of the states whose property and citizens were involved. Moreover, within the same state there might be gross differences between corporations, according to the state they had selected for incorporating. These, I submit, are very strong objections to the use of state administrative bodies. The only administrative alternative, however, would be to vest the power for the whole country in the S. E. C., or some other federal body. Control of this sort might be constitutional under the reasoning which sustained the Securities and Exchange Act, or unconstitutional under the reasoning of the *Cleary* case.[170] This is only one phase of the evaporation of governmental power in the operation of our federal system, which has left marks all across the law, from business organizations to family relations; amendments from this point of view are only another example of a more general problem which some generation of Americans is going to have to face. If constitutional, the federal body would either be administering amendment statutes passed and altered by the states, or Congress would have to assert power to enact its own general amending laws for state corporations. In any case, federal power could probably be established for only a limited group of corporations, and it is very doubtful that piecemeal control would confer benefits equal to its cost. Hence it seems simpler and more satisfactory to leave the matter to the courts, but to help them with better legislative tools. It becomes necessary, therefore, to consider methods of improving judicial control.

(d) *The Fairness of Plans.* Many writers have suggested, principally in connection with accrued dividends, that a more general and flexible test of "fairness" be substituted for the rigid tests of validity now in use.[171] These proposals originate in an analogy to the "fairness"

[170] Hopkins Federal Savings and Loan Assn. v. Cleary, 296 U.S. 315, 56 S.Ct. 235 (1935). The Court held invalid a federal statute which authorized state building and loan associations to incorporate under federal law, upon vote of a majority of their stockholders.

There is a beginning of federal control over the amendment practices of state corporations, under guidance of the Interstate Commerce Commission, in new section 20b of the Interstate Commerce Act, 62 Stat. 162 (1948), 49 U.S.C. (Supp. 1949) §20b, which provides for modification of the securities of railroads in certain circumstances. This statute is discussed in Hand and Cummings, "The Railroad Modification Law," 48 COL. L. REV. 689 (1948); Hand and Cummings, "Consensual Securities Modification," 63 HARV. L. REV. 957 (1950); Dodd, "Preferred Shareholders' Rights—The Engineers Public Service Company Case," 63 HARV. L. REV. 298 at 306 (1949); see also Billyou, "Corporate Mortgage Bonds and Majority Clauses," 57 YALE L.J. 595 at 606 ff. (1948). The section is also discussed in comment, 58 YALE L.J. 1291 (1949). This material came to the writer's attention after this article was written.

[171] See notes: 52 HARV. L. REV. 1331 at 1333 (1939); 54 HARV. L. REV. 488 at 493 ff. (1941). There are leanings in this direction in my article, "The Power to Remove Accrued Dividends by Charter Amendment," 40 COL. L. REV. 633 at 648 (1940).

tests of the reorganization cases,[172] but the practical reason for them is that the complex amendments possible under the reclassification statutes now in force seem to defy treatment according to any other method. As the discussion has shown, in many of these cases it is impossible to affirm with any confidence whether the new rights are worth more, less, or as much as, the old ones; as long as the burden of proof is on the dissenter to establish unfairness, it is difficult for him to prove his case. The test of fairness would make it easier for the court to protect dissenters in proper cases, while not closing the door on any amendment shown to be necessary.

If such a test were proposed as a substitute for proof by the corporation that the amendment was necessary, there would be a grave objection to it. It is so vague that property interests ought not be subjected to it unless the need is great. But coming after proof of necessity, the test offers additional security to those who lose by the amendment and then it has a valuable function. In addition, if the voluntary amendments continue to be sustained, this test would offer a means of giving the dissenter more protection than he now receives from a mechanical application of the statutes.

"Fairness" as a method of dealing with amendment cases could be introduced by the courts themselves, without additional legislation, either by construing the statutes as requiring it, or by imposing it as an equitable limitation of amending powers. Hence the test has, to recommend it, immediate availability to any court that chooses to use it. So much, then, can be said in favor of introducing this method.

On the other side, even the limited literature which has appeared thus far shows that there would be serious differences concerning the application of the test in individual cases and great difficulty in arriving at a workable definition or definitions of it. For example, since objections to plans result from their tendency to throw losses on the senior class, an analogy to the rule of strict priority in reorganization is suggested at once. Yet the two writers who have discussed this subject most fully are agreed that unmodified strict priority based upon the liquidation rights of the preferred stock would be improper. Professor Dodd indicates that even if the value of the assets is less than the liquidation rights of the preferred stock, the latter loses value simply from the fact that the common stock is in existence with some claims to

[172] The comparison is thoroughly discussed in Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 (1942).

ownership.[173] Professor Latty does not believe that the priority of the preferred stock should necessarily be identified with its liquidation preferences, emphasizes that it should receive something of value for what it gives up, and proposes measurement of value, at least in some cases, in terms of estimated future earning power.[174] On the other hand, it has been proposed that if the common stock is valued as worthless its voting power should be taken away,[175] and an anonymous writer contends that liquidation preferences are the best measure of absolute priority.[176] It is obvious that finding a test of "fairness" which would meet with general approval would be an extremely difficult task.

Another objection to the test is the extreme difficulty of applying a definition even if it were agreed upon. Any test so far proposed would

[173] See Dodd, "Fair and Equitable Recapitalizations," 55 HARV. L. REV. 780 at 795 (1942).

[174] See Latty, "Fairness—The Focal Point in Preferred Stock Arrearage Elimination," 29 VA. L. REV. 1 esp. at 27 ff., 29 ff., and 39-40 (1942).

[175] The court in Barrett v. Denver Tramway Corp., (D.C. Del. 1944) 53 F. Supp. 198, suggested that the Delaware statutes should be amended to provide for valuation of the common stock and for removing its voting power if it is found to be worthless. The decision was later affirmed in (3d Cir. 1944) 146 F. (2d) 701. This suggestion has been approved as far as it goes, by Professor Dodd, "Accrued Dividends in Delaware Corporations—From Vested Right to Mirage," 57 HARV. L. REV. 894 at 899 (1944), but he notes that many unfair plans are proposed when the common stock is not worthless, and that the remedy would therefore only be partial.

I would like to file a caveat. Although the common stock has no asset value, its control of the corporation may be valuable and it may therefore have a market value, or an exchange value of some kind. There is no covenant that it shall lose control when the capital has been impaired. Destruction of this property interest without compensation would, it seems to me, violate the due process clause at least, and perhaps the contracts clause. Altogether this method of approach seems to raise serious problems, both of policy and of constitutional law. In framing another suggested method of approach, I have tried to give recognition to this value of the common stock.

It should be noted that a recent Iowa decision, State ex rel. Weede v. Bechtel, 239 Iowa 1298, 31 N.W. (2d) 853 (1948), lends some color to the contention in the Barrett case that the common stock's voting power should be taken away if it is worthless. The corporation was chartered in Delaware, and operated a utility in Iowa. The amendment created a new class of common stock, and provided that all three classes of its old preferred stock should be exchanged for it in specified ratios. The amendment provided also that a block of 100,000 shares of old no par common stock should be exchanged for 39,468 shares of the new $15 par common stock. The state, in an equity action, asked, inter alia, that the old common stock be declared worthless and the new common issued for it be divested of value and control. The court granted this relief. It found that the net assets of the corporation were several millions of dollars less than the par value and accrued dividends of the old preferred stock, so that the old common was worthless and the issuance of the new common for it violated an Iowa statute. The effect of the decision is to determine the rights of the old common stockholders according to the statute of the state where the corporation was doing business and had assets. It is the only case found in which the validity of the amendment was determined otherwise than by reference to the statutes of the charter state. It suggests a method of limiting the effects of legislation in the corporation states, but it is, of course, doubtful that other courts would follow the decision.

[176] See note, 54 YALE L. J. 840 at 850, 852 (1945).

require valuation of the assets, some means of ascertaining the value of the preferred stock—a hard problem in itself if the liquidating preferences were not accepted as the measure—and some means of valuing the common stock. Any test, moreover, would sometimes require determination of the future earnings of the corporation and of the future market value of the various classes of stock. The risks of error in such inquiries as these are obvious, and property interests that depend on them are precariously situated.

It seems objectionable to subject the interests of stockholders to such doubtful investigations. The risk is of course no greater than in reorganization, and the interests of stockholders are perhaps of less dignity than those involved in the reorganization cases. But reorganization is at least limited to cases of proved insolvency; it is better than the status quo, which would be a race of diligence, followed by piecemeal liquidation at sacrifice prices. Hence if the reorganization test of "fairness" is unsatisfactory, it is at least better than the alternative. That is not so clear in the amendment cases. In the greater part of them there is no proof that the corporation even needs more money, or has any definite plan for getting it when the plan is effective. In almost none of them is there anything like a demonstration that the corporation will not remain a going concern without the amendment. The economic pressures which compel the adoption of drastic remedies in reorganization, then, are absent in the amendment cases. It is submitted that the fairness test, though it offers a means of avoiding the more objectionable results which flow from voluntary amendments and mergers, is not a true solution of the recapitalization problem.

Accordingly, I propose another solution, which seems to be simpler and to avoid the difficulties, especially of valuation, which are inherent in the fairness test. It is based on the assumption that if there is need for an amendment the corporation can prove it, and that in the absence of such proof, it is better to keep the status quo than to force the stockholders into expensive inquiries, whose outcome is likely to be inconclusive. First, require the dissenter to prove that the amendment alters his interests in the property of the corporation, or at least, that it changes them into something whose value is doubtful. Second, require the corporation to prove the specific need which justifies an amendment. Third, if such proof is made, let the majority further sustain the burden of proving that there is no other solution of the difficulty which would not affect the relative priorities of the classes, or which would not affect them as much. The inquiry thus opened should cover other means of raising money, including credit financing. If the corporation

alleges that the amendment is to prepare for common stock financing, the majority should be required to prove the bona fides of that intention, and that there is a reasonable certainty that it can and will be carried out if the amendment is permitted. No weight should be given to the fact that a majority has approved the amendment, and, more important still, no consideration should be given to the fact that the common stockholders would not vote in favor of an alternative which would be less drastic. If the majority fails to sustain the burden of proof on these issues, that is, if it fails to disprove feasible and less drastic alternatives,[177] let the court enjoin the plan entirely, or so much of it as puts pressure on dissenters. The worst that can follow from this procedure is that the status quo would be maintained, that is, the preferred stock would be left with its preferences and the common stock with its control, which it could use to carry out one of the alternatives, if it chose. This suggestion is less likely to produce decisions in favor of amendments than the fairness plan, but that is in its favor if it be true that the real reason behind most of the amendments is to improve the standing of the common stock. At the same time it seems to direct the inquiry into concrete questions of practical financing, rather than into difficult questions of comparative valuation.[178]

[177] It is questionable how this suggestion would be received by some authorities. In Doyle v. Milton, (D.C. N.Y. 1947) 73 F. Supp. 281, the plaintiff, a common stockholder, sued to enjoin an amendment to which he objected, so far as relevant here, on the ground that a prior stock would be issued in such a way as to give control to directors and officers of the corporation. The attack rested principally on the ground that the material used to solicit proxies was false, in that it failed to discuss possible alternatives to the proposed plan. The court denied relief, partly on the ground that the failure to state alternatives was not a falsehood. A memorandum submitted in the case by the S.E.C. stated that alternatives need not be described in proxy material according to its rules. The court added that such a requirement would be impractical.

It must be admitted that the consideration of alternatives would not be easy. But probably no easy method of handling the amendment cases will ever be found, and the question is whether it is not more fair, and less difficult than other ways.

Professor Latty, in "Fairness—The Focal Point in Preferred Stock Arrearage Elimination," 29 VA. L. REV. 1 at 50 (1942), would require the corporation to prove the need for amendment. He also appears to approve consideration by the court of alternatives to the plan actually proposed. It is not clear whether the fact that a plan is "fair" should, in his opinion, exclude the study of alternatives. But he seems to regard the introduction of a "fairness" test as a necessary development. My own belief is that intensive study of alternatives, a method not yet tried, would, on the strength of the cases so far decided, eliminate the need for a "fairness" test, and that the difficulties of defining and applying such a test are persuasive reasons for using the other method.

[178] It should perhaps be reiterated [see note 56 in Part I of this article, 49 MICH. L. REV. 363 at 380 (1951)] that the emphasis upon the determination of facts in this discussion does not rest upon a belief that facts by themselves will solve the problems presented by accrued dividends. The decisions of cases rest, in the end, upon propositions of value, that is, upon the determination and application of standards of value to the facts in the case. But propositions or standards of value cannot be derived from facts alone. As the

This proposed solution, of course, is as immediately available under existing statutes as the fairness test is; it could be applied as a matter of interpretation of the statutes, or as an equitable limitation of the powers granted by them. So far as legislative action can help, it is suggested that the broad amending statutes now commonly enacted should be qualified in the following ways: (a) when an amendment shifts property among classes, the majority should expressly be subjected to the burden of proving that there is a public interest, applicable to the precise facts of the case, which requires an amendment; (b) if such proof is made, the majority shrould be required to sustain the further burden of proving that there is no alternative which would not shift property interests, or would not shift them so drastically. The precise enumeration of these issues, and the express allocation of the burden of proof in these terms, would relieve the courts of the difficulties presented by the present statutes which grant amending power in absolute terms. With this much assistance from the legislatures, it seems that they would be both willing and able to clear up most of the objectionable practices revealed by the cases.

One thing is clear. If the present course of decisions is continued, it is a serious question whether investors can safely purchase preferred stock at a price above the common stock of the same corporation. In all frankness, such certificates should now bear on their faces a statement that they are subject to alteration in a great variety of ways, all to their detriment, and that if business is bad, losses will be visited upon them, regardless of the liquidation and other preferences which they have on paper. It seems not unlikely that corporations will find that the temporary expedients which they have adopted will make it more difficult to attract that part of the market which prefers security to speculation. The short term solution contains the germs of a long term problem in threatening destruction of the value of preferred stock as an investment.[179]

cases stand, however, it seems that what is more needed than anything else at the present time is accurate knowledge of the facts concerning the influence of accrued dividends upon the public. This is a prerequisite, it seems, to the formation of value judgments having any lasting validity in this area of the law.

[179] Concerning the fear that present amendment policies will have dangerous effects upon preferred stock as an investment device, see notes: 26 MINN. L. REV. 387 at 394 (1942); 4 UNIV. CHI. L. REV. 645 at 657 (1937); 54 YALE L. J. 840 at 852 (1945).