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CHANGES IN THE INTERESTS OF CLASSES OF STOCKHOLDERS BY CORPORATE CHARTER AMENDMENTS REDUCING CAPITAL, AND ALTERING REDEMPTION, LIQUIDATION AND SINKING FUND PROVISIONS*

Arno C. Becht†

A corporate capital structure consisting of one or more classes of preferred stock, and one or more types of common stock, is familiar. The preferred stock usually has, besides its preference in dividends, a preference upon dissolution or liquidation of the corporation. It may also have a conditional or unconditional contract for redemption, with or without a contract for maintaining a sinking fund to carry out the redemption. The effect of these provisions is to place the first risk of a shrinkage in the value of the assets upon the common stock, which is usually compensated by enjoying the voting control, and by a claim to the residue of the assets without sharing the speculative profits with the senior classes. These arrangements presumably reflect a demand for investments of particular types. Those who prefer a small but relatively certain return, invest in preferred stocks, while those who are willing to take speculative risks, or who expect to profit from the exercise of control, buy common stock.

It is clear that, as between classes of stock, reductions of capital and alterations of the redemption, liquidation and sinking fund provisions, may shift interests in the property of the corporation from one class to another, and may reduce or destroy the relative security for which the purchasers of preferred stock bargain. If an amendment has this effect, it is nearly certain that what the senior securities lose will pass to the common stockholders. It is the purpose of this article to ascertain to what extent such shiftings of property interests are permitted by the law, and to consider whether the cases indicate any necessity for a change in the law or its administration.[1]

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† See Contributors' Section, Masthead, page 95, for biographical data.

[1] Creditors, of course, have an interest in reductions of capital and redemption of stock,

I. Reductions of Capital

A reduction of capital may merely reflect losses which have already occurred, and, by removing the impairment of capital, will make current profits available for dividends. Even if a corporation has no impairment of capital, a reduction may still be desired, so that the corporation may continue in business on a reduced scale, using the surplus for partial liquidation, or other purposes. So long as a reduction is charged properly against the different classes of stock, no real change occurs in the interest of any stockholder, and it could be argued that no express authority should be required for it. It has nevertheless been held that a reduction executed without authority was void against one who did not consent to it.[2] Express authorities to reduce capital, however, are very common, and so long as the reduction is fairly distributed among the stockholders, amendments under such authority have uniformly been sustained.[3]

So long as a reduction leaves each stockholder with the same propor-

since these may result in distribution to stockholders while outstanding debts go unpaid, but such claims raise quite different problems and are not considered in this article, except briefly as they may affect the enforcement of a contract to redeem.

[2] Campbell v. American Zylonite Co., 122 N. Y. 455, 25 N. E. 853 (1890); see Bechtel Trust Co. v. Iowa-Wisconsin Bridge Co., 19 F. Supp. 127 (N. D. Ia. 1937), *aff'd* 98 F. 2d 416 (8th Cir. 1938), *cert. denied* 305 U. S. 650 (1938), *rehearing denied* 305 U. S. 676 (1939).

[3] Such amendments only change the paper description of the stockholders' rights, without changing their actual interests in the least. Thus, in American Alkali Co. v. Campbell, 113 Fed. 398 (C. C. E. D. Pa. 1902), the court, while saying that the point could not be raised in that action, indicated its belief that a stockholders' resolution to reduce the preferred stock by three-fifths, leaving the corporation in possession of that amount for future use, was valid, because the two-fifths was the sum actually paid in on the stock. See also *In re* Radio-Keith-Orpheum Corp., 106 F. 2d 22 (2d Cir. 1939), *cert. denied* 308 U. S. 622 (1940), *rehearing denied,* 309 U. S. 694 (1940), in which, in reorganization proceedings long after the amendment, a stockholder complained of an alteration of his preferred stock into one-sixth of a share of common stock. Since the class junior to his old preferred was cancelled by the amendment, there was no change in his proportionate interest in the corporation, and the court held that " . . . contract rights of the Class A holders were not diminished by a mere reduction in the number of Class A shares outstanding, or by change of name to common stock." 106 F. 2d, 22, 27.

In Williams v. Davis, 297 Ky. 626, 180 S. W. 2d 874 (1944), the majority voted to reduce both the common and the preferred stock, and the court held this binding on the plaintiff, a dissenting preferred stockholder, because it was proper, under the charter of the corporation, to reduce both classes proportionately. See also Morganstern v. American Malting Co., 87 N. J. Eq. 358, 100 Atl. 166 (Ct. Err. & App. 1917). (Common stockholder had valid complaint against amendment that reduced common more than preferred, but the corporation's offer to give him enough common to maintain his proportionate position removed the ground for complaint against the amendment.)

See also Romer v. Porcelain Products Inc., 23 Del. Ch. 52, 2 A. 2d 75 (Ch. 1938), in which the amendment reduced both the preferred and the common stock by one half. The court held for the defendant on the ground of laches, but indicated that the amendment had not affected the property interests of the stockholders, because everyone held equal tionate interest as against others of his own and different classes, no property interest of his is affected by the amendment, and consequently a subsequent statute authorizing reduction in this way would not offend either the due process or the contracts clause. The question has seldom arisen. In *Heller Investment Co. v. Southern Title and Trust Co.*,[4] a corporation having only common stock reduced the stock by three-tenths and authorized a new prior stock. In a dissenting stockholder's suit to compel the corporation to issue new common to him, share for share for his old, the court held that a subsequent statute authorizing the amendment was a proper exercise of the reserved power. The plaintiff claimed that the statute violated the due process clause, to which the court replied that the contracts clause would be a more appropriate provision, but held that there was no objection under either clause. In the only other case found dealing with the constitutional question as between classes of stock, the court's language seems to go beyond its decision. The corporation, acting under a subsequent statute, proposed to retire its preferred stock by issuing bonds of the same value in lieu of it.[5] To the claim that this changed the relative proportions of the different securities, the court replied that such amendments were permitted under the reserved power:

> ... it must be held that, although the result of carrying out the alteration provided for in the act of 1902 may be to change, to some extent, the relations of the different security holders to each other, such statute is not obnoxious to the provisions of the constitution forbidding the passage of laws impairing the obligations of contracts.[6]

Although the court in this passage evidently intended to hold that the state could alter the relations of the security holders, the actual amendment did not disturb the seniority of the preferred stock; the case then would be a poor precedent for a subsequent statute authorizing such changes.

The power to reduce capital usually is general in terms, without provision that the reduction shall be fair among the classes. Yet, numerous cases have recognized the need for equitable limitations on such powers, as otherwise the class with the most voting power could charge losses entirely against the others. Thus, in *Kennedy v. Carolina Public Service*

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numbers of shares of both classes except the plaintiff, who had transferred all of his common, but only part of his preferred, to his wife.

The same principle applies to increases in the number of common shares. See Falk v. Dirigold Corp., 174 Minn. 219, 219 N. W. 82 (1928).

[4] 17 Cal. App. 2d 202, 61 P. 2d 807 (1936).

[5] Venner Co. v. U. S. Steel Corp., 116 Fed. 1012 (C. C. S. D. N. Y. 1902).

[6] 116 Fed. 1012, 1014 (C. C. S. D. N. Y. 1902). The court did not say whether the objecting stockholder held preferred or common stock, but its reasoning is only consistent with his holding common stock.

Co.,[7] the amendment reduced the preferred stock by two-fifths, and the common stock only by one-fifth. The court, in a suit by preferred stockholders, annulled the amendment on the ground that a general power to reduce capital did not authorize disproportionate charges against different classes of stock:

> ...Unless the corporation happened to be entirely unable to pay its preferred stock on dissolution, such action would amount to a gift by the meeting from the property belonging to the preferred stockholders to the common stockholders, and a gift until dissolution of a corresponding interest in the earnings of the corporation. As regards the common stockholders, the preferred stockholder is really an incumbrancer on the assets of the corporation, and so remarkable a power could hardly have been intended to be given a stockholders' meeting.[8]

The court, however, went on to hold that even if the reduction had been proportionate it should have been enjoined because the preferred stock could only be reduced by payment of the redemption price. But, if the terms of the two classes of stock were such that a proportionate reduction would have been fair, it seems that the redemption provision should not have applied; the majority was not trying to buy in the stock, but merely to make the books reflect the condition of the capital accurately. Hence, it is submitted that the second reason for the decision is objectionable, although the result is sound.

Admitting that a reduction must be "fair", there is often great difficulty in deciding upon a just division among different classes of stock. Three things must be looked to—dividends, liquidation preferences, and voting power. If the prior class is preferred in dividends and assets, a reduction charged entirely against the common stock would be proper, so far as assets and earnings are concerned. If the corporation should recoup its losses, the common stock would still take everything after the preferences of the senior class were satisfied. But the reduction would cut down the voting power of the common stock, would perhaps even cost it control; yet control is part of the reason for taking a subordinate interest in assets, and may be worth something when the interest in assets is not. For this reason the court in *Page v. American and British Mfg. Co.*,[9] enjoined an amendment which charged all of an impairment of capital against the common stock, when the preferred had priority both in dividends and in assets:

> The capital stock of a corporation may be increased or reduced as authorized by statute, but in the absence of express statutory provision the

[7] 262 Fed. 803 (N. D. Ga. 1920).

[8] *Id.* at 805.

[9] 129 App. Div. 346, 113 N. Y. Supp. 734 (1st Dep't 1908).

right of the individual stockholder to the proportionate voice in the conduct of the affairs of the corporation and equitable interest in its property which his stock gives him when he becomes a stockholder must be preserved. The interest of the plaintiff in the property if dissolution were to take place now might not be affected by the action taken because on dissolution the preferred stock was first to be paid in full, but the right of a stockholder to a voice in the management of a corporation in which he has invested money is a property right and vested interest entitled to protection under the Constitution . . . if the stock be reduced, a reduction must be upon lines which will leave each stockholder the same proportionate interest and right in the corporation as he had before the reduction. If, therefore, the capital stock be divided into preferred and common stock, there must be a reduction of both in the proportion that the issue of each bears to the other. It may be that there can be no reduction of preferred stock. If so, there can be no reduction as to common stock without unanimous consent, and in such case the general authority to reduce capital stock should be held not to be applicable.[10]

In *Page v. Whittenton Mfg. Co.*,[11] the facts were similar except that the preferred stock, besides preferences in dividends and assets, had a right to participate in dividends after both classes had been paid 6% in a given year. The amendment reduced the common stock from 8,000 to 1,000 shares, and then provided for an increase to 4,000 shares by issuing 3,000 shares to the stockholders for cash. The court sustained the amendment, saying:

...The plan, while not so expressed in terms, operates as a partial liquidation which would have to be borne equally by both classes of stock if the preference had been limited only to dividends. . . . But the common stock cannot participate in any distribution of assets until the stipulated priority of the preferred stock as to both dividends and assets has been satisfied. If by the shrinkage of quick assets or of working capital, even if not sufficient to cause general liquidation, new capital must be raised by first reducing the outstanding capital and then increasing it within the authorized limit, the common stock, which under the contract assumed the burden, must be first resorted to even to the point of extinction before the preferred stock can be compelled to contribute.[12]

Both of these courts, then, recognized equitable limitations on the power to reduce capital, the second as much as the first; the difference was only that the second court did not consider the voting power a relevant factor in determining fairness. Even this may have been due to failure to argue the point, for the court did not mention it in the opinion.

If the view of the first *Page* case is taken, reductions of capital when there is more than one class of stock, will be difficult, since the preferred stock cannot be reduced at all without taking its dividend and asset

[10] *Id.* at 348-9, 113 N. Y. Supp. at 735-6.
[11] 211 Mass. 424, 97 N. E. 1006 (1912).
[12] *Id.* at 428, 97 N. E. at 1007-8.

preferences pro tanto, while the common stock cannot be reduced alone without taking its voting power. The amendment could increase the voting power of each remaining share of common stock, so that it retained its proportionate voting strength, but this solution would cause trouble if the corporation should later wish to issue more common stock to the public. Either the new common shares would have greater voting power than they deserved proportionately to the preferred stock, or there would be two classes of common stock with different voting powers. In many cases the preferred stock has no voting power; then it would not matter how much the voting power of the common stock was reduced. Hence, if there is power to reduce or remove the voting power of the preferred stock, this might be used to leave the common stock in control. A recent decision suggests another possible solution, if the common stockholders can be induced to support it. The corporation in *Hay v. Big Bend Land Co.*,[13] had a six per cent cumulative preferred stock which was entitled to a preference of par ($100) and accrued dividends on dissolution. The amendment, *inter alia,* reduced the par value of each share of common stock from $100 to ten dollars. At the suit of a party who held a small amount of preferred stock and a larger amount of common, the court held that this reduction of the common stock was fair, because the preferred stock had a priority in assets.[14] This device, of course, avoided any effect upon the voting power of the common stockholders, and so was unobjectionable on that ground; nor would it affect the amount any common stockholder would receive on dissolution, since the preferred stock was limited to its priority.[15]

In *Hildreth v. Western Realty Co.*,[16] the reduction threatened the destruction of the voting power of the preferred stock. The latter was entitled to 6% cumulative dividends and to share in further dividends after the common had been paid 6% in any year. It was redeemable at the option of the corporation at par and accrued dividends. The directors proposed to use a large surplus to redeem preferred stock without paying the accrued dividends on the redeemed shares, but leaving them still owing. The plan would have transferred control to the common stock. At the suit of a preferred stockholder, the court held that while

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13 32 Wash. (2d) 887, 204 P. 2d 488 (1949).

14 The court indicated that the authorities left it in some doubt how this reduction should be charged against the two classes of stock, but finally concluded that the amendment should be sustained, even though the reduction was greater than necessary to remove the impairment of capital.

15 For discussion of other provisions of the amendment see p. 7 and note 17, *infra.*

16 62 N. D. 233, 242 N. W. 679 (1932).

normally a reduction should have been enforced against both classes equally, reduction of the preferred stock was proper in this case because the corporation had been formed for the purpose of winding up another; the preferred stockholders were in fact creditors who had taken stock for their claims. It held, however, that the money could not be used to retire shares without paying the accrued dividends on them, so as to increase the number of shares retired and turn the control over to the common stock before the accrued dividends had been paid. The court rested this result on construction of the charter, but it seems an equally clear case of imposing equitable limitations on a power to reduce capital. The *Hay* case reached the same result, holding that redemption of the preferred shares without prejudice to the right to accrued dividends but without paying them, would unfairly reduce the voting power of the preferred stockholders.[17]

The only case which appears not to recognize an equitable limitation on the power to reduce capital, is *Ecker v. Kentucky Refining Co.*,[18] which is perhaps explainable on other grounds. A preferred stockholder objected to an amendment reducing the common stock from $1,000,000 to $200,000 and the preferred from $600,000 to $200,000. If the preferred stock had priority in dividends and assets, all the loss should have been charged against the common stock, with some provision for maintaining its voting strength. If the preferred stock had priority only as to dividends, its dividends ought not to have been reduced, but its liquidation rights should have been. That perhaps could have been accomplished by reducing its par value, while stating its dividend priority in terms of dollars per year. The court sustained the amendment simply on the ground that the statutory power to reduce capital had been strictly followed, which may mean either that the court did not recognize an equitable obligation, or that the objection was not argued. In a later case, *Haggard v. Lexington Utilities Co.*,[19] the corporation worked out the equities in drafting the amendment, and the court sustained it. The preferred stock had a par value of $100, a redemption price of $107.50 and a cumulative dividend of 6½%. The amendment reduced the capital by cutting the par value of the preferred stock to $25, but it provided for a $6.50 annual dividend and did not alter the redemption price. Assuming

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17 Hay v. Big Bend Land Co., 32 Wash. 2d 887, 204 P. 2d 488 (1949), discussed on an-another point, p. 6 *supra*. See also note 14 *supra*. There was another reason for the result in this case, as the plan of redemption included installment payments for the redeemed shares, and the court held it objectionable for this reason also.

18 144 Ky. 264, 138 S. W. 264 (1911).

19 260 Ky. 261, 84 S. E. 2d 84 (1935).

that the liquidation rights of the preferred stock were the same as the redemption rights, the amendment did not disturb any of its priorities.[20]

Another problem in equitable limitations arises when the purpose of the reduction is to remove an impairment of capital in order to make dividends possible for both classes of stock. Senior stock may claim that the whole original amount of capital must be built up in order to restore its security, before any dividends should be paid, and that the reduction is an avoidance of this obligation. There is little authority on the question and that little seems to be in conflict. The preferred stockholder in the *Haggard* case made the objection, but the court held that this was a legitimate purpose of the amendment. Two New York decisions seem to be contrary, at least in policy. In *Matter of Kinney*,[21] the amendment provided for voluntary exchange of each share of old preferred for one and one-third shares of new prior preferred, while the common stock was reduced from a stated value of $10 to $1 per share, creating a surplus of almost a million and a half dollars. The Court of Appeals held that the amendment altered the "preferential rights" of the preferred stockholders, and entitled them to an appraisal. The transfer to surplus, it said, would permit the use of the money for dividends or for the purchase of stock, thereby reducing the assets upon which the preferred stock relied for earning power and security. Again, in *Rochester Gas and Electric Corp. v. Maltbie*,[22] the court sustained an order of the state public service commission, which refused a utility permission to transfer $3,000,000 from capital to a "contingency reserve", since the funds might be used for dividends if carried in the latter account, thus reducing the security of the preferred stock. These cases might be distinguished from the *Haggard* case on the ground that the *Kinney* case was merely a construction of the appraisal law while the *Rochester* case concerned the regulatory powers of the public service commission. But they both rest on the notion that the original capital must not be used for dividends so long as the preferred stock is outstanding. The applicable statutes in these cases, however, authorized reductions of capital; such statutes seem contrary to an implied duty to preserve the original capital intact

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[20] In Williams v. Davis, 297 Ky. 626, 180 S.W. 2d 874 (1944), the court sustained an amendment which reduced the preferred stock, on the ground that the reduction was properly proportionately enforced against the preferred and common alike. Since the rights of the preferred stock were not stated, it is impossible to compare this case with the others.

[21] 279 N.Y. 423, 18 N.E. 2d 645 (1939), *reversing* 254 App. Div. 660, 4 N.Y.S. 2d 377 (1st Dep't 1938).

[22] 258 App. Div. 682, 18 N.Y.S. 2d 630 (3d Dep't 1940), *reversing* 172 Misc. 359, 15 N.Y.S. 2d 163 (Sup. Ct. Albany County 1939), *aff'd without opinion*, 284 N.Y. 626, 29 N.E. 2d 936 (1940).

when the stated majorities vote to reduce it. Accordingly, it is submitted that the *Haggard* case is the better authority, in the absence of express covenant.[23]

Reductions of capital offer opportunities to force an exchange of shares with effects on other interests of the stockholders, for example, on accrued dividends. In all but one of the cases, neither the court nor the parties considered the reduction problem, and they are valueless as precedents.[24] In the one case, *Lazear v. American Steel Foundries*,[25] the New Jersey court sustained an amendment which reduced the capital and required the exchange of each share of preferred stock for 77% of its par value in common stock, 20% in debentures, and $3 in cash. The court held the amendment compulsory and binding in spite of the conversion of preferred to common, because the statute for reduction of capital had been followed. The decision also rests on laches, which may explain it. Certainly the New Jersey court has not in other cases permitted rigid construction of amendment powers to the detriment of preferred stockholders.[26]

In summary, the courts are agreed that equitable limitations should be applied to reductions of capital, although there is difficulty in determining what constitutes "fairness" in a given case. By altering par values and voting rights, and by expressing dividends in amounts instead of percentages, reductions can almost always be executed without shifting

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23 But see comment on the Kinney case, 39 COL. L. REV. 1037 (1939), approving the result on the ground that maintenance of the original capital is necessary to protect the prior stock's interest in assets and dividends. See also Comment, 52 HARV. L. REV. 1011 (1939).

24 See Ainsworth v. Southwestern Drug Corp. 95 F. 2d 172 (5th Cir. 1938); Harr v. Pioneer Mechanical Corp. 2 F. Supp. 517 (S. D. N. Y. 1932), *mod.*, 65 F. 2d 332 (2d Cir. 1933) *cert. denied* 290 U. S. 673 (1933); McQuillen v. National Cash Register Co., 27 F. Supp. 639 (D. C. Md. 1939), *aff'd* 112 F. 2d 877 (4th Cir. 1940); Sander v. Janssen Dairy Corp., 36 F. Supp. 512 (D. C. N. J. 1940); Kamena v. Janssen Dairy Corp., 134 N. J. Eq. 359, 35 A. 2d 894 (Ct. Err. & App. 1944), *affirming* 133 N. J. Eq. 214, 31 A. 2d 200 (Ch. 1943); Wessel v. Guantanamo Sugar Co., 135 N. J. Eq. 506, 39 A. 2d 431 (Ct. Err. & App. 1944), *affirming* 134 N. J. Eq. 271, 35 A. 2d 215 (Ch. 1944); Roberts v. Roberts-Wicks Co., 184 N. Y. 257, 77 N. E. 13 (1906), *reversing* 102 App. Div. 118, 92 N. Y. Supp. 387 (4th Dep't 1905).

25 86 N. J. Eq. 252, 98 Atl. 642, and 100 Atl. 1030 (for the unofficial report of the dissenting opinion) (Ct. Err. & App. 1916), *affirming* 86 N. J. Eq. 21 (Ch. 1915) (opinion of lower court reported in 98 Atl. 642).

26 The New Jersey courts have for example regularly protected accrued dividends against alteration by charter amendment. Lonsdale Securities Corp. v. International Mercantile Marine Co. 101 N. J. Eq. 554, 139 Atl. 50 (Ch. 1927); Kamena v. Janssen Dairy Corp., 134 N. J. Eq. 359, 35 A. 2d 894 (Ct. Err. & App. 1944), *affirming* 133 N. J. Eq. 214, 31 A. 2d 200 (Ch. 1943); Wessel v. Guantanamo Sugar Co., 135 N. J. Eq. 506, 39 A. 2d 431 (Ct. Err. & App. 1944), *affirming* 134 N. J. Eq. 271, 35 A. 2d 215 (Ch. 1944).

property between classes. So long as the reduction is fair, it seems the better view to permit it for the purpose of making dividends available to both classes of stock, even though it reduces the amount of assets protecting the preferred stock, unless there is an express covenant to the contrary.

II. REDEMPTION OF STOCK[27]

An issue of stock often contains a promise by the corporation to redeem on a certain day or on certain contingencies. Whatever may be said about dividend rates and accrued dividends, it seems that such a promise is clearly a binding contract within the contracts clause; the rights which it gives the stockholder might properly be held property within the due process clause as well. Yet, since performance of such contracts might result in the preference of stockholders over creditors, state interference for the protection of creditors seems justified. But it is certainly more questionable whether the state has sufficient interest in such contracts to alter them for the benefit of other stockholders or the corporation.

The decisions leave no room for doubt that redemption agreements are enforceable contracts. Assuming that no injury to creditors is threatened by redemption, the courts have permitted stockholders to compel it.[28] But, if the provision does not prescribe the assets out of which the redemption shall be made, there is an ambiguity: the corporation may contend that it cannot be compelled to redeem if it has to liquidate all or part of its property in order to do so. It seems unlikely that common stockholders would contract for redemption on such terms, and yet, the redemption provision shows that the preferred stockholders were bargaining for an extraordinary protection. In *Westerfield-Bonte Co. v. Burnett*,[29] the Kentucky court held the contract enforceable, although the corporation would be forced to sell its assets in order to discharge the obligation. The court expressly rejected an argument that the contract should be construed as calling for redemption only out of surplus. The New Jersey court also has permitted enforcement, although it required

[27] See generally, Notes, 27 COL. L. REV. 587 (1927); 83 U. PA. L. REV. 888 (1935); Curran, *Minority Stockholders and the Amendment of Corporate Charters*, 32 MICH. L. REV. 743 at 772 (1934).

[28] Affeldt v. Dudley Paper Co., 306 Mich. 39, 10 N.W.2d 299 (1943); Ammon v. Cushman Motor Works, 128 Neb. 357, 258 N.W. 649 (1935); Rowan v. Texas Orchard Dev. Co., 181 S.W. 871 (Tex. Civ. App. 1916), *app. for writ of error refused,* 190 S.W. XVI (1916).

[29] 176 Ky. 188, 195 S. W. 477 (1917). See also Gunther Grocery Co. v. Hazel, 179 Ky. 775, 201 S.W. 336 (1918). *But see* Smith v. Southern Foundry Co. 166 Ky. 208, 179 S.W. 205 (1915).

partial liquidation by sale of the stock of a subsidiary.[30] The Massachusetts court, on the other hand, in *Crimmins and Peirce v. Kidder Peabody Corp.*,[31] indicated the possibility of a different view. The corporation had issued class A preferred for the assets of another corporation, and had sold class B preferred for cash. Both classes were redeemable, but class B had an option to compel redemption, which a large number of its holders exercised. Holders of class A sued to enjoin the redemption because it would leave a surplus too small for the redemption of their shares. The court held that considering the origin of the two classes of stock, it was proper to permit the redemption of class B, but by expressly noting that there was no allegation that the redemption would prevent the corporation from continuing its business, the court apparently intended to reserve that question. Since it is easy to draft around this difficulty, it is unlikely that it will become important in litigation.

A similar question may arise when shares of the same class are redeemable in series. In *Miller v. Smith Building Co.*,[32] the corporation issued preferred stock, contracting to redeem different series at different dates. After doing business for a time the corporation suffered losses, so that, after payment of its debts, there were not sufficient assets to pay all the preferred stock. Holders of series maturing later, sued for the appointment of a receiver and to establish that all the preferred shares were entitled to share equally in the remaining assets. The court granted the relief, reasoning that the earlier maturing stock had a preference over the rest only in earnings, and that a reasonable construction of the contract required equal sharing by all the series if payment were to be made out of capital. This result seems correct, since the various issues had not bargained for priority over each other, and the different maturity dates were predicated on the corporation's staying in business.

Occasionally the objection to redemption comes from stockholders who are unwilling to give up their shares on the terms provided in the contract. Thus, in *Hackett v. Northern Pacific Ry. Co.*,[33] the preferred stock was subject to retirement at the option of the company at any time within twenty years. The corporation proposed to retire preferred stock and to issue common stock, with pre-emptive rights for the common stockholders. The court held that the plaintiff, a preferred stockholder, had

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30 Mueller v. Kraeuter & Co., Inc., 131 N.J. Eq. 475, 25 A.2d 874 (Ch. 1942). But shares redeemable on contingency need not be redeemed where the contingency has not happened. Farrish-Stafford Co. v. Charlotte Cotton Mills, 157 N. C. 188, 72 S. E. 973 (1911).

31 282 Mass. 367, 185 N.E. 383 (1933).

32 118 Neb. 5, 223 N.W. 277 (1929). See Comment, 8 NEB. L.B. 308 (1930).

33 36 Misc. 583, 73 N. Y. Supp. 1087 (Sup. Ct. N. Y. County 1901).

no valid objection to this plan, because he had contracted for retirement, and had no foundation for his claim of pre-emptive rights. A more questionable result was reached in *Zahn v. Transamerica Corp.*,[34] in which the corporation had issued two classes of common stock. Class A had a cumulative dividend of $3.20; the class B then took $1.60 per share, and thereafter both classes shared equally. On liquidation class A was to receive twice as much as class B, but class A was callable at $60 per share and accrued dividends. When the corporation had a very large surplus the directors, dominated by the holder of a majority of the class B shares, voted to redeem the A stock. The court permitted a holder of class A shares to recover the difference between the call price and the amount receivable on liquidation, on the ground that the directors had exercised the call privilege in violation of their duty to all the stockholders. Seldom does the preferred stockholder in these cases receive more than he should; but the call provision is put into charters to determine the price at which the senior stock may be liquidated. Hence this decision seems to deprive the common stockholders of the speculative profit for which they bargained when they took a subordinate position.[35]

The courts' treatment of these provisions as contracts accords with the intention of the parties, but for obvious reasons a great majority of courts, sometimes aided by statute, have held that they are unenforceable against the corporation if it would endanger the rights of creditors.[36]

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[34] 162 F. 2d 36 (3d Cir. 1947), *reversing* 63 F. Supp. 243 (D. C. Del. 1945).

[35] A similar and very interesting problem was presented in Starring v. American Hair and Felt Co., 21 Del. Ch. 380, 191 Atl. 887 (Ch. 1937), *aff'd on opinion below,* 21 Del. Ch. 431, 2 A. 2d 249 (Sup. 1937), but the case unfortunately went off on other grounds. The corporation had two classes of preferred stock and one class of common with sole voting power. There were about 160,000 shares of common stock, and about 40,000 of these had come into the hands of non-tanners. The common stock was redeemable at book value, but not less than $5 or more than $100 per share. The corporation proposed to redeem the common stock in order to keep control in the hands of tanners. The court enjoined the redemption on the ground that under the Delaware statute there was no power to redeem a common stock. The corporation contended that the action was a reduction of capital, but the court nevertheless enjoined the action, on the ground, inter alia, that the shares to be taken had not been chosen by lot in accordance with the statute. Had the power to redeem existed, the problem would have been similar to that in the *Zahn* case, i.e., whether the redemption could be enforced for the benefit of the majority. It seems again that to deny redemption would take away part of the contract for which the majority bargained.

[36] *In re* Hicks-Fuller Co., 9 F. 2d 492 (8th Cir. 1925). But this seems to contradict the Iowa decisions; see Allen v. Northwestern Mfg. Co., 189 Iowa 731, 179 N.W. 130 (1920); Vanden Bosch v. Michigan Trust Co., 35 F. 2d 643 (6th Cir. 1929); Rider v. Delker & Sons Co., 145 Ky. 634, 140 S. W. 1011 (1911); McIntyre v. Bement's Sons, 146 Mich. 74, 109 N.W. 45 (1906); Booth v. Union Fibre Co., 137 Minn. 7, 162 N.W. 677 (1917); S. C., 142 Minn. 127, 171 N.W. 307 (1919); Culver v. Reno Real Estate Co., 91 Pa. 367 (1879); Warren v. Queen & Co., 240 Pa. 154, 87 Atl. 595 (1913); Reagan Bale Co. v.

A minority have held that the redeeming stockholder is entitled to equality with general creditors.[37] The best explanation of the majority view is found in this extract from *Booth v. Union Fibre Co.*,[38] in which the court held that the corporation was insolvent and that the redemption provision therefore could not be enforced:

> The question has not often arisen. It is directly or substantially held in well considered cases that the obligation of the corporation to redeem will not be enforced after it has become insolvent and its capital stock depleted, and its refusal will not in such a situation constitute a breach of its agreement to redeem, though it is not in liquidation, and though no creditor is asking for relief. . . . Some are put upon the ground that the promise to redeem is conditional on the solvency of the corporation when the time to redeem comes; or that preferred stockholders are not entitled as against creditors to prior payment except from profits; or that the property of the corporation cannot lawfully be used in retiring stock when debts exist and insolvency is impending; or loosely upon the ground that a payment to stockholders in such a situation is against public policy. Such holdings harmonize with G. S. 1913, sec. 6450, which is directed against the distribution of the assets of a manufacturing corporation until the creditors are paid, or the payment of a dividend when the corporation is insolvent. We accept the doctrine of these cases as sound and applicable, and hold that under the circumstances disclosed by the record the plaintiff is not entitled to recover.[39]

Hence, in most courts, either no legislative action is necessary to protect creditors, or the legislation already exists; in minority view states the legislature should have power to prevent injury to creditors through redeemable stock. But a general power to alter redemption provisions could be used to the great damage of preferred stockholders, when there is in fact no risk to creditors. For example, a majority might vote to deny redemption in order to keep the money of the preferred stockholders in the business to increase the earnings of the common stock. It seems that the state has no interest in this matter sufficient to answer the preferred stockholders' complaint that their money is kept subject to risks, longer than they bargained for when investing. No decision has been found on the exact point. Conversely, if a corporation has power to redeem one class of stock, thus giving the other class an opportunity to become the sole owners of the business, the latter also has an interest which seems entitled to protection under the due process and contracts

Heuermann, 149 S.W. 228 (Tex. Civ. App. 1912); see Mueller v. Kraeuter & Co., Inc., 131 N.J. Eq. 475, 25 A.2d 874 (Ch. 1942).

37 Butler v. Beach, 82 Conn. 417, 74 Atl. 748 (1909); Allen v. Northwestern Mfg. Co., *supra* note 36; Keyes v. Blue Bell Medicine Co., 34 S. D. 297, 148 N. W. 505 (1914).

38 142 Minn. 127, 171 N.W. 307 (1919). (For the opinion upholding the sufficiency of the complaint in this case, see 137 Minn. 7, 162 N. W. 677 (1917).)

39 142 Minn. 127, 131, 171 N. W. 307, 309 (1919).

clauses. Admitting that the minority should be bound by an election of the majority not to redeem at a particular time, it seems that the state lacks sufficient interest in the matter to justify its authorizing a majority of the non-redeemable class to give up the redemption provision altogether. But the only decision in point is the other way. In *Davis v. Louisville Gas and Electric Co.*,[40] the court sustained a subsequent statute authorizing an amendment that reduced the dividend rate on one class and made the other irredeemable. The argument for this amendment was that the corporation wished to raise money by making the redeemable class more attractive. However, it seems questionable to put the burden of financing on one class, while the other obtains the benefit.[41]

The courts are divided on the question whether, in the absence of constitutional objections, a dissenting stockholder can maintain an action to compel redemption of his shares although a majority of his class has voted not to enforce the redemption provision. One court has held that he may, at least when the vote of the majority was taken after the redemption contract had matured.[42] Another court has reached the same result without such a limitation.[43] The Wisconsin court has indicated that an amendment changing a contract for redemption on a particular date to a contract for redemption at the option of the corporation was not binding on a dissenter, but the court refused redemption because the payment would have endangered creditors.[44] On the other hand, in *King v. Ligon*,[45] the South Carolina court held that a power to impose conditions or attach penalties to a class by a two-thirds vote, authorized an amend-

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40 16 Del. Ch. 157, 142 Atl. 654 (Ch. 1928). Compare Taylor v. Axton-Fisher Tobacco Co., 295 Ky. 226, 173 S.W. 2d 377 (1943), holding that after the directors had voted to redeem a callable stock they had no power, as against a subordinate class, later to make the redemption optional with the holders of the redeemable class.

41 The broad construction of the reserved power in the *Davis* case and the court's justification of the amendment are criticized in another article of this series. Becht, *Corporate Charter Amendments: Issues of Prior Stock and the Alteration of Dividend Rates*, 50 COL. L. REV. 900 (1950).

42 Affeldt v. Dudley Paper Co., 306 Mich. 39, 10 N.W. 2d 299 (1943).

43 Savannah Real Estate, etc., Co. v. Silverberg, 108 Ga. 281, 33 S.E. 908 (1899).

44 Koeppler v. Crocker Chair Co., 200 Wis. 476, 228 N.W. 130 (1930). Some doubt is thrown on the authority of this case by Johnson v. Bradley Knitting Co., 228 Wis. 566, 280 N.W. 688 (1938), in which the court sustained an amendment which reduced the dividend rate on preferred stock, and reduced its sinking fund provision. The majority distinguished the *Koeppler* case on the ground that the contract for redemption and the date of redemption were indorsed on the stock certificates, creating a hybrid security with some of the attributes of a debt. The dissenting judges in the *Johnson* case were of the opinion that it effectually overruled the *Koeppler* case. The majority's distinction certainly throws some doubt on the binding quality of a redemption provision which is simply characteristic of the class and not specially indorsed on the certificates.

45 180 S.C. 224, 185 S.E. 305 (1936).

ment which removed a contract for redemption. Since the corporation was in receivership at the time of the action, the same result could have been reached without affirming the amendment. Hence, most of the very few cases are against permitting a majority to affect these provisions.

The same considerations would apply to an amendment which postponed the date of redemption, for this also is a vital change in the contract. If the amendment does not bind dissenters, they, of course, take priority over those who approve.[46] The Michigan court has held that language saving vested rights in a subsequent statute authorizing charter amendments, would prevent postponement of the date of redemption against a dissenter:

> . . . Assuming, as we fairly may, that in the absence of the redemption provision plaintiff would not have purchased his stock, or that defendant's undertaking to redeem was an inducing cause in consequence of which plaintiff did purchase, the provision for redemption was something more than a mere incident to corporate relationship, it was a definite contractual undertaking, the proposal for which antedated and consummation of which coincided with the purchase of the stock by plaintiff, who prior to that time was not identified with the corporation. This being true, appellee's contention above noted is not tenable.[47]

The redemption price of a class of stock is at least as important as any other part of the redemption contract; alterations of this term so obviously shift property interests among classes, that one would expect the courts to be as hostile to them as to other changes in the contract. Oddly enough, the few cases sustain alterations of the price term, thereby raising doubts of the trend shown in the other cases. In *Morris v. American Public Utilities Co.*,[48] the statutes at the time of the charter provided that the preferred stock should be subject to redemption at such price, not below par, "as may be expressed in the certificate of incorporation or any amendment thereof." The court sustained an amendment which reduced the redemption price from $105 to $100, on the ground that it was authorized by this language. But the inference is almost irresistible that the statute was intended to permit an amendment of the charter to state the redemption price of a new class created by that amendment.[49]

46 Vanden Bosch v. Michigan Trust Co., 35 F.2d 643 (6th Cir. 1929). The amendment, however, was apparently voluntary, those willing to accept the postponed date merely exchanging their shares for others with the new date. But concerning the priority given to those whose shares matured earlier, contrast Miller v. Smith Building Co., 118 Neb. 5, 223 N.W. 277 (1929), discussed *supra*, pp. 11 *et seq.*

47 Sutton v. Globe Knitting Works, 276 Mich. 200, 209-10, 267 N.W. 815, 818 (1936). See approving comment, 35 MICH. L. REV. 323 (1936); disapproving comment, 4 UNIV. CHI. L. REV. 139 (1936).

48 14 Del. Ch. 136, 122 Atl. 696 (Ch. 1923).

49 The preferred stockholders can, of course, protect themselves in Delaware by increasing

Again, in *Transportation Co. v. Daugherty*,[50] the court, without any consideration of the powers conferred in the charter or the statutes, indicated that it would sustain an amendment that reduced the call price of the preferred stock from $50 to $30, on the sole ground that the larger price was based on an overvaluation of the corporation's property. However, if that valuation, without actionable mistake or fraud, was the basis used by the stockholders in bargaining for their rights, it seems immaterial that it was higher than the facts warranted.

On the whole, most of the few courts which have passed on the question do not permit removal of the redemption feature, or postponement of the date, so long as the rights of creditors are not affected, but these decisions do not square with those which permit alteration of the price, —at least as vital a change as the others. There is no judicial consideration of the inconsistent results which are being reached. If there is reason to criticize the destruction of accrued dividends, for example, there is at least equally good reason to contend that the redemption rights of the preferred stock should be beyond reach of the majority.

The final problem in the redemption of stock is whether the majority has power to make a non-redeemable stock redeemable. There are at least two reasons why such power should be denied. The first is that the preferred stockholders, if there is no provision for redemption of those shares, have presumably taken their stock in the belief that they are embarked for the whole voyage and are entitled to share in all the fruits of it. This is especially persuasive if the preferred stock has a right to participate in dividends or assets beyond its stated preferences, but even if it has not, the dividend rate may be generous and the security safer than could be purchased elsewhere with the money. It is unlikely that the common stockholders or the management would think of redemption at all, unless the corporation was unusually prosperous. The second reason is, that the redemption must be at a rate, and to permit that rate to be set by the methods usual in amendment cases would be to make the minority accept a price fixed by the majority. Such subject matter seems singularly unpromising for solution by charter amendment. The only reason that readily appears for permitting such amendments is, that the corporation might be able thereby to make the junior securities more

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the majority necessary for amendment by express charter provision. Sellers v. Joseph Bancroft & Sons Co., 23 Del. Ch. 13, 2 A.2d 108 (Ch. 1938) (prelim. hearing); 17 A.2d 831 (Ch. 1941) (final hearing). But compulsory reduction of the redemption price, brought about by a sale of all assets, was sustained in United Milk Products Corp. v. Lovell, 75 F.2d 923 (6th Cir. 1935), *cert. denied* 295 U.S. 751 (1935).

50 74 Cal. App. 2d 604, 169 P.2d 470 (1946).

valuable for the purpose of raising money by public sale. This, however, puts the whole burden on the preferred stock, which in effect is forced to get out of the corporation so that financing can be managed in the interest of the common stockholders. True policy considerations in favor of such amendments are as difficult to find as those supporting the elimination of accrued dividends.

Except when the nature of the corporate property is such that eminent domain is applicable,[51] no case has been found sustaining an amendment which made non-redeemable stock redeemable. The Georgia court has held one such change invalid on the old-fashioned ground that it was a reduction of capital and therefore a fundamental change which required unanimous consent.[52] The New York appellate division, in *Breslav v. New York and Queens Electric Light and Power Co.*,[53] held that a power to classify and reclassify stock did not authorize an amendment making preferred stock redeemable at $105, less than its actual value, and that if so construed, the subsequent statute conferring the power would violate both the contracts and the due process clauses:[54]

> . . . Generally, when it is proposed to exchange new stock for old, a dissenting stockholder has the right to accept the new stock and remain a stockholder or retire and receive the value of his stock. Plaintiff has no such choice. She must get out of the corporation. The majority has so decreed. The statute does not vest the majority with any such power. To hold it does is to hold the majority enjoys a right tantamount to the sovereign right of eminent domain. Defendants are attempting, under the guise of classification or reclassification of the preferred stock, to impair the obligation of plaintiff's contract with the corporation and to divest plaintiff of her present vested and permanent interest in the corporation.[55]

The Oklahoma Supreme Court recently reached the same result in *Yukon Mill & Grain Co. v. Vose*,[56] in which the plaintiff held a preferred stock issued at a time when neither the charter nor the statutes made provision

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51 It has been held that shares in a public utility operated by the state can be condemned under the eminent domain power if their holders do not assent to the terms of an exchange. Opinion of the Justices, 261 Mass. 523, 159 N.E. 55 (1927); Opinion of the Justices, 261 Mass. 556, 159 N.E. 70 (1927).

52 Johnson v. Tribune-Herald Co., 155 Ga. 204, 116 S.E. 810 (1923).

53 249 App. Div. 181, 291 N.Y. Supp. 932 (2d Dep't 1936), *aff'd and certified question answered*, 273 N.Y. 593, 7 N.E.2d 708 (1937) (no opinion). See Note, 46 YALE L. J. 1055 (1937).

54 The Court of Appeals had already awarded an appraisal when an amendment *inter alia*, provided for exchange of shares for a retirable stock. Matter of Silberkraus, 250 N. Y. 242, 165 N.E. 279 (1929), *reversing* 224 App. Div. 268, 229 N.Y. Supp. 735 (3d Dep't 1928). See also Matter of Seiler, 239 App. Div. 400, 267 N.Y. Supp. 567 (1st Dep't 1933), and comment on the *Seiler* case in 19 CORNELL L. Q. 470 (1934).

55 249 App. Div. 181, 189, 291 N. Y. Supp. 932, 941.

56 206 P.2d 206 (Okla. 1949).

for its redemption. Shortly after the charter, the law was amended to permit redeemable preferred stock. The charter was allowed to lapse by mistake, and then was renewed. After the renewal, an amendment was adopted, by what process was not stated, which called the preferred stock for redemption at $100 and accrued dividends, a total of $105. The court enjoined the amendment, holding that the statute revealed no intention to make pre-existing stocks redeemable, and that the reserved power, limited to matters in which the state had an interest, did not authorize interference with the private rights between the stockholders and the corporation and between the stockholders inter se. It is clear that the court relied upon the contracts clause in reaching this result; its quotations from other sources suggest that it relied upon the due process and equal protection clauses as well. It plainly considered the amendment unfair to the preferred stockholders:

> The defendant corporation in this case has been very successful and well managed, and no doubt it would be to the financial advantage of the common stockholders to retire this preferred stock; but in its infancy, this corporation sold preferred stock to the plaintiffs and a valid contract was made with them, and the Legislature, the defendant corporation, and this Court are without authority to deny to these plaintiffs their constitutional rights.[57]

Under these decisions the right to a non-callable stock is of equal dignity with the right to accrued dividends and is equally protected against direct attack. The question then is whether the courts will allow the majority, as in the accrued dividend cases, to exert pressure on the minority to compel it to accept a redeemable stock.[58] The most direct

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[57] *Id.* at 211.

[58] The reference is to the practice of issuing a stock prior to an old preferred with accrued dividends, and offering it to preferred stockholders who are willing to release their accrued dividends. The result is to give those who assent to the amendment and give up their accrued dividends a preference in assets and in dividends over those who refuse to make the exchange, thus putting pressure on the latter to change their minds and make the exchange. Not exchanging involves risk, as those who take the new stock become prior to the dissenters upon liquidation. Matter of Duer, 270 N.Y. 343, 1 N.E.2d 457 (1936). "Voluntary" plans designed to induce the surrender of accrued dividends have often been upheld. Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 Atl. 696 (Ch. 1923); Shanik v. White Sewing Machine Corp., 25 Del. Ch. 371, 19 A.2d 831 (Sup. 1941), *affirming* 15 A.2d 169 (Del. Ch. 1940). The Ohio Supreme Court has sustained such a plan, but indicated that it would permit dissenters to have an appraisal of their stock. Johnson v. Lamprecht, 133 Ohio St. 567, 15 N.E.2d 127 (1938), *affirming* 30 N.E.2d 1019 (Ohio App. 1937). The New York courts have denied the dissenter even an appraisal under such circumstances. Matter of Woodruff, 175 Misc. 819, 26 N.Y.S.2d 679 (Sup. Ct., Monroe County, 1941), *aff'd without opinion*, 262 App. Div. 814, 28 N.Y.S.2d 756 (4th Dep't 1941); Longson v. Beaux-Arts Apts., 265 App. Div. 951, 38 N.Y.S.2d 605 (2d Dep't 1942), *aff'd without opinion*, 290 N.Y. 845, 50 N.E.2d 240 (1943). See also Matter of

authority on this point is *Johnson v. Lamprecht*,[59] in which the Ohio court sustained an amendment providing for a new prior stock, exchangeable for the old preferred at the option of the holder. The object of the amendment was to eliminate accrued dividends, but the new stock was also retirable at $105; the court sustained the amendment on the ground that it was only voluntary, indicating that it would have "serious doubts" of the validity of a compulsory exchange which eliminated accrued dividends and made stock callable. The New Jersey court also has sustained, under a subsequent statute, an amendment which permitted preferred shareholders to exchange 40% of their holdings for bonds, a change which, equally with the issue of prior stock, appears to put pressure on dissenters.[60] Hence, it seems that the experience with accrued dividends could be repeated with non-callable stock.

The tendency toward protection of the preferred stockholder, which is more pronounced in these cases than in those involving accrued dividends, is probably due to the fact that corporations have not used the volun-

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Kinney, 279 N.Y. 423, 18 N.E. 2d 645 (1939), *reversing* 254 App. Div. 660, 4 N.Y.S. 2d 377 (1st Dep't 1938), in which the Court of Appeals denied an appraisal because of the use of a prior stock to encourage the release of accrued dividends, but allowed it on account of a reduction of capital. I have dealt with these plans more at length in another article of this series. Becht, *Alterations of Accrued Dividends,* to be published in a forthcoming issue of MICH. L. REV.

59 133 Ohio St. 567, 15 N.E. 2d 127 (1938), *affirming* 30 N.E. 2d 1019 (Ohio App. 1937).

60 Berger v. U.S. Steel Corp., 63 N.J. Eq. 809, 53 Atl. 68 (Ct. Err. & App. 1902), *reversing* 63 N. J. Eq. 506, 53 Atl. 14 (Ch. 1902). See also U. S. Steel Corp. v. Hodge, 64 N. J. Eq. 807, 54 Atl. 1 (Ct. Err. & App. 1903), *reversing* 64 N. J. Eq. 90, 53 Atl. 601 (Ch. 1902). The amendment was sustained against the objections of a person who was probably a common stockholder in Venner Co. v. U.S. Steel Corp., 116 Fed. 1012 (C.C.S.D.N.Y. 1902). See note 5, *supra*, for explanation of this case. A retirement of preferred stock was also sustained against the objections of a common stockholder in Weidenfeld v. Northern Pacific Ry. Co., 129 Fed. 305 (8th Cir. 1904).

But the New Jersey court enjoined a merger in Outwater v. Public Service Corp., 104 N.J. Eq. 490, 146 Atl. 916 (Ct. Err. & App. 1929) *affirming on the opinion below* 103 N.J. Eq. 461, 143 Atl. 729 (Ch. 1928) on the ground that the shares for which the dissenters would have to exchange were redeemable in three years. Hence the merger device cannot be used in New Jersey to make stock redeemable, although a "voluntary" amendment is valid. The rule of the *Outwater* case contrasts strangely with the decision in Windhurst v. Central Leather Co., 101 N.J. Eq. 543, 138 Atl. 772 (Ch. 1927), and 105 N.J. Eq. 621, 149 Atl. 36 (Ch. 1930), *aff'd* 107 N. J. Eq. 528, 153 Atl. 402 (Ct. Err. & App. 1931), sustaining a plan of merger which converted each old share of preferred stock and its 43% of accrued dividends into half a share of new preferred stock, three-fourths of a share of a subordinate preferred stock, and $5 in cash. The court relied partly on laches as justification for the result.

Contrast Zobel v. American Locomotive Co., 182 Misc. 323, 44 N.Y.S. 2d 33 (Sup. Ct., N.Y. County, 1943), sustaining a merger of parent and subsidiaries, although the old non-callable preferred was exchanged for a new preferred callable at $115. The point, however, was not discussed, and perhaps not argued.

tary exchange technique so often. There is no reason to suppose that a court which permits this method to be used to circumvent accrued dividends would deny its use to evade an obligation to redeem or as a device to make non-callable stock callable.[61]

III. Liquidation Provisions[62]

The question of what matures a liquidation provision, so that the stockholders are entitled to enforce it, is beyond the scope of this article, which is limited to the question of the majority's power to alter liquidation provisions, whether or not they have matured. It is clear that such provisions are contracts, resembling accrued dividends, and redemption provisions, in that the performance of them is conditional upon future events. As with redemption provisions, however, it is difficult to show any reason why the state should have an interest in them so long as they do not interfere with the rights of creditors. Indeed, since they only operate when the corporation is going out of business, the state can hardly claim that its interest in keeping concerns going warrants meddling with them, unless one credits the argument that money can be raised by increasing the attractions of a class of stock to investors through change of liquidation rights.

Under the few cases now decided, liquidation provisions have received almost no protection. The Ohio appellate court has sustained an amendment which converted all the preferred stock into common,[63] because the statutes permitted it when the corporation was chartered, and because appraisal was the exclusive remedy of dissenters.[64] The New York appel-

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61 Yet the New Jersey court, which permitted the exchange of stock for bonds in the *Berger* case (*supra* note 60) has given more protection than most against voluntary plans attacking accrued dividends. See General Investment Co. v. American Hide & Leather Co., 97 N.J. Eq. 214, 127 Atl. 529 (Ch. 1925) and 97 N.J. Eq. 230, 127 Atl. 659 (Ch. 1925), *modified* 98 N. J. Eq. 326, 129 Atl. 244 (Ct. Err. & App. 1925), and Buckley v. Cuban American Sugar Co., 129 N.J. Eq. 322, 19 A.2d 820 (Ch. 1940).

62 Some cases have presented necessarily a problem in the alteration of liquidation provisions, but the decisions have been reached without consideration of such problems, perhaps because the parties did not insist on their rights. See Bailey v. Tubize Rayon Corp., 56 F. Supp. 418 (D.C. Del. 1944); United Milk Products Corp. v. Lovell, 75 F.2d 923 (6th Cir. 1935), *cert. denied* 295 U.S. 751 (1935); Keller v. Wilson & Co., 21 Del. Ch. 391, 190 Atl. 115 (Sup. 1936), *reversing* 21 Del. Ch. 13, 180 Atl. 584 (Ch. 1935).

63 Williams v. National Pump Corp., 46 Ohio App. 427, 188 N.E. 756 (1933), *error dismissed* (for lack of debatable constitutional question), 126 Ohio St. 457, 186 N.E. 403 (1933). The statute relied on as permitting the amendment authorized changes in par value and in the express terms and provisions of any class of shares.

64 Appraisal, as it now stands, is, however, not a satisfactory remedy in many respects. See Lattin, *Remedies of Dissenting Stockholders under Appraisal Statutes*, 45 Harv. L. Rev. 233 (1931), and Levy, *Rights of Dissenting Stockholders to Appraisal and Payment*, 15 Cornell L.Q. 420 (1930).

late division has approved an amendment which provided for exchange of a $100 par value stock for one share of preferred stock with a par value and liquidation preference of $25 and one-fourth of a share of common stock; the court held that the preferred stockholder was not even entitled to an appraisal under the New York statute which provided for that remedy in cases of alterations of the "preferential rights" of the shares.[65] Against these decisions there is only *Wessel v. Guantanamo Sugar Co.*,[66] in which the amendment converted each share of preferred stock and its accrued dividends into $40 of 5% debentures and 14 shares of $5 par value common stock, while the common stock received two-fifths of a share of new common for each share of old. The New Jersey court held that this amendment was compulsory and for that reason invalid.[67] Hence, as the cases stand, the Ohio court sustains such amendments because of the appraisal statute, the New York court denies even an appraisal if the amendment is voluntary, and the New Jersey court will enjoin only if the amendment is compulsory.

A far more serious challenge to liquidation provisions is rapidly developing in the merger cases. Three cases under the Delaware statutes and one in Ohio establish that by merging, the majority can change liquidation provisions compulsorily. In *Porges v. Vadsco Sales Corp.*,[68] the Delaware chancery court sustained a merger with a wholly owned subsidiary which converted each share of preferred stock with a liquidation preference of $100 and accrued dividends into a share of preferred stock with a liquidation preference of $50, and five shares of common stock. The court relied in part on the transfer of voting control to the preferred stock as showing the fairness of the action. The federal district court has sustained under the Delaware law, an amendment which

[65] Matter of Woodruff, 175 Misc. 819, 26 N.Y.S.2d 679 (Sup. Ct., Monroe County, 1941), *aff'd without opinion*, 262 App. Div. 814, 28 N.Y.S.2d 756 (4th Dep't 1941).

[66] 135 N.J. Eq. 506, 39 A.2d 431 (Ct. Err. & App. 1944), *affirming* 134 N.J. Eq. 271, 35 A.2d 215 (Ch. 1944).

[67] The court, after enumerating the losses to the preferred stock, which included accrued dividends, preferred future dividends, liquidation preferences, redemption and sinking fund provisions, *inter alia*, said:

> . . . For those contractual rights preferred stockholders are offered $40 debentures carrying 5% interest and a share in $5 par new common stock with holders of the present common stock, on a basis which will give to preferred stockholders 60% of such new stock and 40% thereof to present common stockholders. Thus preferred stockholders who are not now required to share in losses the defendant may sustain until after the interests of common stockholders are exhausted, will be required to stand 60% of any such loss, and those common stockholders who have no present hope of dividends will be enabled to share with the preferred stockholders immediately in dividends to be declared out of a bookkeeping capital surplus of $2,609,346.95.

134 N. J. Eq. 271, 276, 35 A. 2d 215, 217-8 (1944).

[68] 27 Del. Ch. 127, 32 A. 2d 148 (Ch. 1943).

changed the $60 liquidation preference of the stock to one share of class B stock of a corporation which was purchasing all the assets of the company.[69] The court rested its decision on the public interest in having the sale executed and on the ground that the common stockholders would not vote for the plan unless they received some securities from the transaction.[70] Recently a Circuit Court of Appeals approved a merger with a subsidiary, in which preferred stock with an express covenant to receive 110% of any amount by which it might be reduced, was changed to one share of preferred stock with a stated value of $50 and five shares of common stock.[71] A lower court in Ohio has approved an amendment changing the liquidation provisions of preferred stock to one-fourth of a share of preferred class B, and one share of common stock, all in a corporation which proposed to purchase the assets of the company.[72] The only authority found contrary to these is *Copeland v. United Shoe Machinery Co.*,[73] in which the preferred stock was entitled to share alike with the common stock upon liquidation. The corporation proposed, upon merger with another, to issue a preferred stock with a $25 par value, entitled to $35 and accrued dividends on liquidation. The New Jersey court enjoined the merger:

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

70 . . . If the preferential right of $60 a share remains unaltered, it would be impossible in this case to obtain the vote of the common stockholders in favor of the sale and dissolution, because there could not possibly be any rational basis, under the circumstances, for the common stock voting in approval. One thing is certain. Nothing can be accomplished, either in law or in life, by calling the recalcitrants names. The reality of the situation confronting Postal's management called for some inducement to be offered to the common stockholders to secure their favorable vote for the plan. It seems to me of little moment whether that approval was voiced at one or two meetings. The fact is something had to induce the common stockholders to come along. This court and the Delaware courts have recognized the strategic position of common stock to hamper the desires of the real owners of the equity of a corporation, and the tribute which common stock exacts for its vote under reclassification and reorganization.

52 F. Supp. 763, 771 (D. C. Del. 1943).

71 Langfelder v. Universal Laboratories Inc., 163 F. 2d 804 (3d Cir. 1947), *affirming* 68 F. Supp. 209 (D. C. Del. 1946).

72 Daus v. Otis Steel Co., 11 Ohio Sup. & C. P. Dec. 94 (Common Pleas, 1942).

73 84 N. J. Eq. 276, 94 Atl. 404 (Ch. 1915), *aff'd on the opinion below,* 85 N. J. Eq. 209, 95 Atl. 549 (Ct. Err. & App. 1915). In an earlier case, Beling v. American Tobacco Co., 72 N. J. Eq. 32, 65 Atl. 725 (Ch. 1907), the court sustained a consolidation which replaced the plaintiff's $10,000 of preferred stock with $13,333 face value of bonds. The court answered the plaintiff's argument that the bonds would take away his chance to share in the assets on dissolution if there should be more than enough to pay all the stock, by saying that the common stock had control and the directors would see to it that there was no more surplus on dissolution than would be needed to pay off all the stock. The decision rests so much on laches and the impossibility of undoing the consolidation, that it is not a very persuasive authority on the other point. Compare Doubleday v. Kalamazoo Citizens Loan & Investment Co., 268 Mich. 280, 256 N. W. 337 (1934), in which the corporation replaced the preferred stock with bonds. The court refused to hold, much later, that the bonds were illegal but permitted the dissenter to exchange for them if he chose.

> It is obvious that whatever be the comparative market value of these respective rights, they are *different*. If the actual value of the stock, and of the property which the stock represents, should greatly exceed the par value of all the stock, preferred and common, then the stockholder would, as far as can now be seen, lose by the merger; if it should fall short of that par value, he would gain.[74]

Under these authorities, except in New Jersey, if a compulsory amendment would fail, which seems likely, a merger, perhaps with a controlled subsidiary, would effectually alter an inconvenient liquidation preference. Thus, voluntary amendments and mergers or sales of all assets are the most likely line of attack for liquidation preferences, just as they are for accrued dividends.

IV. Sinking Fund Provisions

Preferred stock often contains covenants binding the corporation to set aside a certain amount each year for protection or redemption of the preferred stock. These provisions are clearly contractual; but they are necessarily conditional, for, by analogy to the redemption cases, the corporation could not use funds which were needed to pay debts for the sinking fund.[75] They raise numerous problems of construction, with which the courts have dealt as with any other contract. Thus, in *Longson v. Beaux-Arts Apartments*,[76] the charter provided that the corporation had to pay its whole earned surplus into a sinking fund so long as more than 26,250 shares of preferred stock were outstanding. The court held that the corporation had no duty, in years of profits, to make up payments for its years of defaults. In *Wildermuth v. Lorain Coal and Dock Co.*,[77] the charter provided for a sinking fund of eight cents per ton of coal mined, and the court held that the corporation was obliged to make up defaults before it could pay dividends on the common stock, and that the preferred stockholders were entitled to an appraisal because of an amendment that abolished the arrearages in the sinking fund. It seems that the terms of the charters clearly justify this difference in interpretation.

Assuming the contractual nature of sinking funds, it is difficult to see how they differ from accrued dividends or future dividends. All are conditional upon the corporation's earning profits; all are priorities over the common stock. The only difference in favor of sinking funds might

[74] 84 N. J. Eq. 276, 279, 94 Atl. 404, 405 (Ch. 1915).

[75] See Note, 27 Col. L. Rev. 587, 591-2 (1927).

[76] 265 App. Div. 951, 38 N. Y. S. 2d 605 (2d Dep't 1942), *aff'd without opinion* 290 N.Y. 845, 50 N.E.2d 240 (1943).

[77] 138 Ohio St. 1, 32 N.E.2d 413 (1941).

be that the preferred stockholders could compel a corporation to set aside the sinking fund money, if it were not needed for debts, whereas they cannot usually maintain an action for dividends or accrued dividends. Yet, they cannot maintain an action for money out of the sinking fund, unless they have some other contractual right to it, such as a redemption provision, and they can enjoin the payment of dividends on common stock in violation of the dividend rights of the preferred stockholders, even when they cannot sue for their own dividends. Therefore, sinking funds do not appear to be any more "vested" or unconditional than dividend rates. The cases are not numerous enough to show whether any different treatment is in store for them than has been accorded to dividends.

The only case found involving the constitutionality of a subsequent statute authorizing the removal of a sinking fund provision is *Yoakam v. Providence Biltmore Hotel Co.*,[78] in which the amendment abrogated the sinking fund of the old preferred stock and provided for a voluntary exchange for new prior preferred. The court held that the sinking fund could not be taken under the statute in force when the corporation was chartered in Delaware, authorizing alteration of "preferences," because the fund was more than a preference. The corporation then argued that the amendment was authorized by a subsequent statute providing for amendment of the "relative, participating, optional, or other special rights of the shares." The court held that this, so far as it authorized removal of the sinking fund, was beyond the scope of the state's reserved power, reasoning that the state could not reserve power to impair the obligation of a contract to which it was not a party.[79] Expressing its sense of the need for some limitation upon the scope of the reserved power, the court suggested the following questions:

> If a state were to pass an act reserving the right to alter or amend all contracts subsequently entered into, whether between individuals or corporations, would any one seriously urge its validity? Could a state by its own act thus invalidate the clear intendment of article 1, sec. 10, of the Constitution, by the theoretical reasoning that all contracts thereafter would be made with this reservation read into them as a term and condition, and would not, therefore, be impaired?[80]

After this, the court concluded that the reserved power did not extend to matters which the corporation shared in common with natural persons, and which resulted from the law generally rather than from the grant of

78 34 F.2d 533 (D.C. R.I. 1929). See disapproving comment, 15 CORNELL L. Q. 279 (1930).

79 34 F. 2d 533, 545 (D. C. R. I. 1929).

80 *Id.* at 546.

corporate entity. It stated that although the cases on the subject could not be reconciled, the results of the decisions were consistent with reasonable general principles.[81] It concluded with this attack upon the practical effects of the amendment in the case before it:

> To say that a general reservation on the part of the state of a right to repeal or enact future amendments to the corporation law gave to the state a power to authorize the cancellation of this agreement, is to disregard every sound principle of law and to misconstrue legal history. As a matter of fact, the state has repealed nothing, and by its amendments it purported to extend the powers of the corporation. In this case the majority of the first preferred stockholders have seized upon an apparent extension of authority as a means by which to abrogate a corporate commitment to other stockholders, to which commitment the state never was a party, and in respect to which there has been no showing of public interest, and only a meager, if any, showing that the abrogation of the sinking fund agreement would enable the corporate entity to function better as an owner and operator of the Biltmore Hotel.[82]

This seems to be as nearly unanswerable as the vagueness of conceptions in the amendment field permits. However, if the premise upon which this article is built, that there is no qualitative difference between dividends, accrued dividends, and liquidation preferences of the shares, is true, the reasoning extends over the whole of the amendments treated in this article.

Besides this decision on the constitutional point, there are two others in which the courts have refused to allow tampering with sinking funds. In *Davison v. Parke, Austin & Lipscomb*,[83] the New York Court of Appeals held that a power to classify and reclassify stock did not authorize the abrogation of arrearages in a sinking fund. Again, in *Wessel v. Guantanamo Sugar Co.*,[84] the New Jersey court enjoined an amendment which made many other changes including the elimination of a sinking fund.[85] On the other hand, in *Johnson v. Bradley Knitting Co.*,[86] the Wisconsin court held that a general amending power authorized reduction of a sinking fund provision from 3% to 2%, and reduction of a quick

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81 *Id.* at 546.

82 *Id.* at 547.

83 285 N.Y. 500, 35 N.E.2d 618 (1941), *modifying* 260 App. Div. 860, 23 N.Y.S.2d 557 (1st Dep't 1940) (no opinion), *affirming* 173 Misc. 782, 19 N.Y.S.2d 117 (Sup. Ct., N.Y. County 1940) *appeal denied,* 260 App. Div. 924, 24 N.Y.S.2d 982 (1st Dep't 1940) (no opinion). See also 165 Misc. 32, 299 N.Y. Supp. 960 (Sup. Ct., N.Y. County, 1937), for denial of plaintiff's motion for judgment on the pleadings in the same case.

84 135 N.J. Eq. 506, 39 A.2d 431 (Ct. Err. & App. 1944), *affirming* 134 N.J. Eq. 271, 35 A.2d 215 (Ch. 1944).

85 The statute relied upon authorized the change of preferred to common stock and such other amendment as might be desired.

86 228 Wis. 566, 280 N.W. 688 (1938).

asset ratio from 120% to 60% of the par value of the preferred stock. The court's justification was that the amendment was necessary to the welfare of the corporation, which necessity was said to be proved by the size of the majority that approved the amendment. In *Haggard v. Lexington Utilities Co.*,[87] the charter provided that no dividends should be paid on the common stock until the surplus equalled $13 per outstanding preferred share. A charter amendment reduced the par value of the preferred stock from $100 to $25, but left its dividends and redemption prices the same. The amendment also provided that dividends could be paid on the common stock if there were a surplus of $13 per preferred share, but that not more than 50% of the net earnings should be paid in dividends on the common until the surplus was $88 per preferred share. The amendment then, reduced the sinking fund, with a contract to build it up again in part, meanwhile making dividends available for the common stock. The court sustained it as a valid exercise of the power to reduce capital.

The sinking fund's relative immunity from assault thus far seems to be more the result of its scarcity in corporate charters than anything peculiar in its legal nature. While approving the decision in the *Yoakam* case that such obligations are beyond the reach of the state's reserved power, one must remember the possibility that voluntary amendment and merger could wreck a sinking fund as quickly as any other right of a preferred stockholder.

V. Conclusions

The four kinds of provisions considered in this article all protect the stockholder's ultimate interest in the property of the corporation. It is true that his rights under all of them are conditional. The claims of creditors may qualify his contracts for redemption or for sinking fund security; reductions of capital may be affected by the rights of creditors and of other classes of stock; his liquidation rights are, at least, subject to the condition that there be a liquidation, which is contingent upon many matters not under his personal control. The qualified nature of his rights, however, should not obscure the fact that they are bargained for, paid for, and are intended to protect him against certain foreseen and well-known risks. The alteration of them shifts, or may shift, his interest in property of the corporation to other classes of stockholders,— a fact which requires that such alterations should be given very serious consideration.

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[87] 260 Ky. 261, 84 S.W.2d 84 (1935).

(a) *Constitutional Questions*

When an amendment of these rights of the stockholder actually does shift property interests, the action, if it is justified by a statute subsequent to the charter, seems to violate both the contracts and the due process clauses of the Constitution, unless the public interest is strong enough to warrant the effect upon private property. The enactment of general statutes authorizing such amendments, supported by the presumption of constitutionality, may stand as a valid exercise of the police or reserved powers. But the power exercised by the majority under such statutes is in part a delegated power, coming from the state, and is applied by a group interested in the subject matter, uncontrolled by any express standards stated in the statute. Hence, the application of the statute in any particular case may be attacked as unconstitutional, and the foundation of such an attack is laid when the dissenter shows that the amendment affects his interest in the property of the corporation. It seems proper then to place on the proponents of the amendment the burden of proving that the public interest requires the change in that particular case. The proof exacted at this point should not be a generalization, that such amendments are or may be necessary to corporate enterprise in general. It should be a specific demonstration that that amendment is required by the situation of that corporation. When the amendment, if it stands, will take property without compensation, it seems that this burden is not too severe.

The arguments presently offered for such amendments, both by the proponents of plans and by courts sustaining them, fall far short of this requirement. The majority vote in favor of the amendment is not, it is submitted, a substitute for proof of the need for the amendment; it results more from the automatic operation of the proxy machine than from the exercise of informed judgment by investors.[88] Moreover, the claim of a public interest in the amendment cases should be qualified by recognizing the fact that vast numbers of corporations are chartered in states where they have neither property nor stockholders. The usual practice is to bring suits against amendments in the courts of the charter state, which means that the public policy finally applied is that of a sovereign which has no more than an official connection with the persons and property involved.

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88 Numerous writers have expressed this opinion. See Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 1, 22, 23 (1942); Note, 36 COL. L. REV. 674, 675 (1936); Comment, 25 CORNELL L.Q. 431, 436 (1940); Note, 52 HARV. L. REV. 1331, 1332 (1939); Note, 54 HARV. L. REV. 488, 489 (1941); Note, 26 MINN. L. REV. 387, 395 (1942); Note, 4 UNIV. CHI. L. REV. 645, 653 (1937); Note, 46 YALE L. J. 985, 999 (1937).

These factors, it is submitted, show that a fresh and full consideration of the constitutional question would be timely, and should result in less willingness to sustain amendments under subsequent statutes on the strength of easy generalizations. A comparison of the decisions giving constitutional protection to irredeemable preferred stock and to sinking fund provisions[89] with those permitting alteration of accrued dividends under subsequent statutes[90] creates serious doubt as to whether the courts are aware of the similarities, analytical and practical, which underly the different cases. A new approach to the constitutional problems should lead to more consistent results.

(*b*) *Statutory Construction*

Amendments under statutes in force when the corporation is chartered might be attacked constitutionally, on the ground that advance consent to such amendments, considering the importance of investments in corporate securities at the present day, violates the due process clause by interfering with freedom of contract and with the security of ownership. There is little hope, however, that any court will adopt such a position.[91]

Accordingly, a more promising approach is to urge that the broad amending powers which are common today should not be construed as authorizing amendments which shift property interests in the corporation. The importance of some such principle, whether by way of equitable limitation[92] or otherwise, is increasing as more companies are chartered under the newer statutes, so that constitutional protection becomes steadily less possible. Some hope for the success of such a theory is derived from the

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89 See the discussions, at pp. 17-18 *et seq., supra* and pp. 24-25 *et seq., supra.*

90 McNulty v. W. & J. Sloane, 184 Misc. 835, 54 N. Y. S. 2d 253 (Sup. Ct., 1945); Arstein v. Robt. Reis and Co., 77 N. Y. S. 2d 303 (Sup. Ct., N. Y. County 1948), *aff'd without opinion,* 273 App. Div. 963, 79 N. Y. S. 2d 314 (1st Dep't 1948), *leave to appeal denied* 298 N. Y. 931, 81 N. E. 2d 335 (1948), *cert. denied* 335 U. S. 860 (1948). *Contra:* Keller v. Wilson & Co., 21 Del. Ch. 391, 190 Atl. 115 (Sup. 1936). These decisions are discussed in another article in this series. Becht, *Alterations of Accrued Dividends,* to be published in a forthcoming issue of MICH. L. REV.

91 There is a dictum suggesting that an injunction might issue under the Fourteenth Amendment if a reclassification should cancel accrued dividends without adequate compensation, in Hottenstein v. York Ice Machinery Corp., 136 F.2d 944, 953 (3d Cir. 1943), *bill of review denied* 146 F. 2d 835 (3d Cir. 1944), *cert. denied,* 325 U. S. 886 (1945). This is the only judicial indication I have found that a due process attack might be made upon action taken under a statute in force when the corporation was chartered. There are dicta that action under an existing statute might violate the contracts clause in Yoakam v. Providence Biltmore Hotel Co., 34 F. 2d 533 (D. C. R. I. 1929), and in Pronick v. Spirits Distributing Co., 58 N. J. Eq. 97, 42 Atl. 586 (Ch. 1899), but the scarcity of such expressions is almost an authority against them.

92 See Berle, *Corporate Powers as Powers in Trust,* 44 HARV. L. REV. 1049 (1931).

relative unanimity with which the courts have imposed equitable duties upon the power to reduce capital.[93]

The greatest need for limitation of absolute powers is arising now, as the discussion has shown, in cases involving voluntary plans and mergers. Voluntary plans rest upon the power to issue prior stock, which can be used, by exchanging it for old shares, to put pressure upon dissenters.[94] General merger and consolidation statutes are the source of a more dangerous power still, since those plans, if they are sustained, are compulsory.[95] The trend of the cases suggests that no interests of the preferred stockholder are safe from such attacks; the only protection possible is the application by the courts of some theory which will limit those powers.

"Equitable limitations" and "limited construction" are rather vague guides to offer for administration in a case law system. Perhaps for this reason, it has been suggested that a general standard of "fairness," by analogy to the reorganization cases, should be applied to amendments affecting accrued dividends.[96] It seems not unlikely that the same test will be offered for application to the amendments considered in this article. But the "fairness" test depends upon difficult and expensive valuations of assets and of classes of stock, and it seems unlikely, at best, to produce any definite standard of comparison at all. The interests of stockholders are too valuable to be left to so tenuous a safeguard. There is not the same urgent necessity that has compelled us, in cases of reorganization and insolvency, to adopt so questionable a solution. Accordingly, it seems worth while to look for a solution in some other direction.[97]

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93 See the discussion, pp. 3-7 *et seq., supra.*

94 See, for example, the discussion of Johnson v. Lamprecht, pp. 18-19, *supra.* The successful use of the voluntary plans to eliminate accrued dividends is discussed in note 58, *supra.*

95 The successful use of mergers and consolidations to alter liquidation preferences is discussed at pp. 21-23 *et seq., supra.* The same devices have been allowed to eliminate accrued dividends. See, for example, Federal United Corporation v. Havender, 24 Del. Ch. 318, 11 A. 2d 331 (Sup. Ct. 1940). The cases are discussed in another article in this series. Becht, *Alterations of Accrued Dividends,* to be published in a forthcoming issue of MICH. L. REV.

96 Dodd, *Fair and Equitable Recapitalizations,* 55 HARV. L. REV. 780 (1942); Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination,* 29 VA. L. REV. 1 (1942).

97 The application of the "fairness" plan to accrued dividend alterations, and the difficulties and shortcomings associated with it in those cases, are discussed in another article in this series. Becht, *Alterations of Accrued Dividends,* to be published in a forthcoming issue of MICH L. REV.

(c) *The Burden of Proof, and Legislative Action*

There is another possibility which seems to avoid the difficulties inherent in the "fairness" test. The courts can administer the burden of proof, in combination with limited construction or equitable limitations, in such a way as to avoid the objectionable results which the cases now reach. In an action to enjoin an amendment, it seems fair to require the complaining stockholder to prove that the amendment alters his interest in the corporation, or at least, so changes it that comparison of his position before and after the amendment is difficult or impossible. If the dissenter can maintain this burden, the burden of proof should then be put upon the majority to show that the condition of the corporation requires an amendment, and to show that there is no feasible alternative which would accomplish the objective without affecting the senior securities or without affecting them so drastically.[98] It is submitted that this method of handling the cases would be easier to administer than the "fairness" plan, would be less expensive than valuation of the assets and of the various classes of securities, and would protect dissenters at least as effectively. There is no doubt, too, that the courts would be greatly aided if the amendment statutes were to state these issues and expressly allocate the burdens of proof in the way here suggested.

The alternative to these suggestions, is, it seems, an adherence to the present practice, which affords occasional protection by an appeal to constitutional clauses or to equitable limitations, while voluntary plans, mergers, and consolidations threaten to wipe out even these piecemeal defenses. If there is any economic reason for having preferred stock in the first place, there is also, it seems, every reason for keeping it preferred after it is sold, and for preserving it from the losses which other classes have bargained to bear. Unless protection, both legislative and judicial, is given to it, it is greatly to be feared that preferred stock will become as much a risk-bearing security as common stock is, and will cease to appeal to those investors who, for reasons best known to themselves, prefer not to buy common stock.

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98 The suggestion that the court review the alternatives to a plan of recapitalization may not be well received. A memorandum filed by the S. E. C. in Doyle v. Milton, 73 F. Supp. 281 (S. D. N. Y. 1947), states that proxy solicitations need not, under its rules, discuss alternatives to a plan, and the court, relying upon this, went on to state that such an inquiry would be impractical. The court denied relief to a common stockholder who was attacking a plan on the ground, *inter alia,* that it would result in the issuance of a prior stock so as to give control to officers and directors of the company.

It is true that study of alternatives to the proposed plan would not be simple. But it seems to be the only resource left, except the adoption of the "fairness" test, which seems to be a more complicated method still.