

# Preferred Stock—Law and Draftsmanship†

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PREFERRED STOCK is an anomalous security. It is a debt security when it claims certain absolute rights, especially its right to an accumulated return or to throw the enterprise into receivership for failing to meet its obligations. It is an equity security when it tries to control the enterprise through a practical voting procedure or to share in excess distributions of corporate profits.<sup>1</sup> Of course, a share of preferred stock is actually a composite of many rights. It is entitled to dividends at a set rate which probably accumulate if they are not paid. It is next in line after creditors if the enterprise is liquidated and may share exclusively to a limited amount or participate in any distribution. It is probably subject to redemption and more likely than not has the supposed benefit of a sinking fund to regulate this redemption. A substantial percentage of contemporary issues are convertible into common stock. It may, but probably does not, have preemptive rights in new stock issues. It probably cannot vote in the election of the corporate management but may have some contingent voting rights for certain proposed actions and upon default in dividend payments. Some of these rights are "inherent;" others are granted by statute; still others are voluntary contractual provisions. The purpose of this paper is to examine these rights; to see the extent to which the share contract creates and protects them and the extent to which the law details them when the share contract is defective.

The primary source of a share's legal rights is the share contract.<sup>2</sup> There is no ideal preferred stock but only a collection of attributes which the share contract says makes up a share of preferred stock.<sup>3</sup> The share contract, in turn, is found in the articles of incorporation and the applicable state statutes.<sup>4</sup>

## THE DIVIDEND RIGHT

### *The Cumulative Feature*

Dividend rights of shareholders are contractual. Usually the corporate articles explicitly grant the cumulative feature of dividends ("cumulative"

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<sup>1</sup> GRAHAM & DODD, *SECURITY ANALYSIS* 526 (3d ed. 1951).

<sup>2</sup> E.g., DEL. GEN. CORP. LAW § 151(a) (1953); *Gaskill v. Gladys Belle Oil Co.*, 16 Del. Ch. 289, 146 Atl. 337 (Ch. 1929); see *Bailey v. R.R.*, 17 Wall. 96 (U.S. 1872).

<sup>3</sup> Comment, *Priority Rights of Preferred and Common Shares in Bankruptcy Reorganizations*, 65 HARV. L. REV. 93 (1951).

<sup>4</sup> *Continental Ins. Co. v. Minneapolis, St.P. & S.S.M. Ry.*, 290 Fed. 87 (8th Cir.), cert. denied, 263 U.S. 703 (1923); but see *In re Bruder's Estate*, 302 N.Y. 52, 96 N.E.2d 84 (1950).

is enough)<sup>5</sup> or deny it in as certain terms. Deficient phrasing may lead to conflicting decisions as to the existence of the cumulative feature but the conflict is over construction of a contract. The construction, however, may be influenced by the court's understanding of the "normal rights" of a preferred share of stock. The majority of courts hold that "in the abstract" dividends on preferred stock are cumulative.<sup>6</sup> Such courts are more likely to find confirmation of this cumulative feature in ambiguous contractual language than is a court which has ruled that dividends are noncumulative in the absence of contract.<sup>7</sup> Too, some weight must be given to state statutes on this question, even to their bearing on this problem of construction. New Jersey, for example, provides that

The holders of preferred . . . stocks shall be entitled to receive dividends at such rates, on such terms, and at such times as shall be provided in the certificate of incorporation, . . . and such dividends may be made cumulative.<sup>8</sup>

This language may require a holding that in the absence of contract, dividends are noncumulative—and so indirectly influence interpretation of the articles. Even under such statutes the feature need not be specifically expressed, if the cumulative character appears from the articles.<sup>9</sup>

If the articles specify that dividends shall be noncumulative, several problems remain.<sup>10</sup> Basically they are contractual problems, but interpretation here seems influenced by judicial notions as to the "rights" of such stock labelled "noncumulative" with no further gloss. To the majority of

<sup>5</sup> Bank of America Nat. Trust & Sav. Ass'n v. West End Chemical Co., 37 Cal.App.2d 685, 100 P.2d 318 (1940).

<sup>6</sup> Hazel Atlas Glass Co. v. Van Dyk & Reeves, Inc., 8 F.2d 716 (2d Cir.), *cert. denied*, 269 U.S. 570 (1925) (dictum); James F. Powers Foundry Co. v. Miller, 166 Md. 590, 171 Atl. 842 (1934); Fidelity Trust Co. v. Lehigh Valley R.R., 215 Pa. 610, 64 Atl. 829 (1906); *cf.* Langhen v. Goodman, 275 S.W. 841 (Tex. Civ. App. 1925).

<sup>7</sup> Collins v. Portland Elec. Power Co., 12 F.2d 671 (9th Cir. 1926), *affirming*, 7 F.2d 221 (D. Ore. 1925); Hazeltine v. Belfast & M.H.L.R.R., 79 Me. 411, 10 Atl. 328 (1887); Lockwood v. General Abrasive Co., 210 App. Div. 141, 205 N.Y. Supp. 511 (4th Dep't 1924), *aff'd without opinion*, 240 N.Y. 592, 148 N.E. 719 (1925) (dictum), *cf.* Allen v. Montana Refining Co., 71 Mont. 105, 227 Pac. 582 (1924); see Murphy v. Richardson Dry Goods Co., 326 Mo. 1, 31 S.W.2d 72 (1930).

<sup>8</sup> N.J. REV. STAT. § 14:8-2 (1937).

<sup>9</sup> DEL. GEN. CORP. LAW § 151 (1953) provides that dividends may be made "cumulative or non-cumulative as shall be so stated and expressed"; but the term itself need not be expressed if the phrasing can be construed as cumulative. Garrett v. Edge Moor Iron Co., 22 Del. Ch. 142, 194 Atl. 15 (Ch. 1937), *aff'd sub nom.*, Pennsylvania Co. for Insurance on Lives and Granting Annuities v. Cox, 23 Del. Ch. 193, 199 Atl. 671 (Ch. 1938).

*But see*, MD. ANN. CODE GEN. LAWS art. 23, § 14(a) (3) (1951); N.Y. STOCK CORP. LAW § 11; OHIO REV. CODE ANN. § 1701.06 (Supp. 1952).

<sup>10</sup> Generally, see BALLANTINE, CORPORATIONS 516-523 (rev. ed. 1946). See Stevens, *The Discretion of Directors in the Distribution of Non-Cumulative Preferred Dividends*, 24 GEO. L.J. 371 (1936).

courts these noncumulative dividends are discretionary,<sup>11</sup> but it has been held that a noncumulative stock may nevertheless be "cumulative if earned." If specifically so expressed, the result will follow in all jurisdictions. In New Jersey this "dividend credit" doctrine has been extended to noncumulative stock independently of contractual provision and is based partly on statute and partly on judicial opinion as to "rights" of noncumulative stock.<sup>12</sup> Though it may be that these cases have not interpreted the bare term "noncumulative" as meaning cumulative if earned,<sup>13</sup> they have construed as "cumulative if earned," provisions which other courts would call "noncumulative and discretionary."<sup>14</sup>

### *Right to Participate in Dividends Beyond a Stated Preference*

Since shareholders' dividend rights are contractual, an express statement that the stock does not participate in dividend payments beyond a set rate of return will govern any rules of construction or law otherwise applicable. This and the statement that the preferred stock is entitled to dividends at the rate of x% annually "and no more" are today's common contractual provisions. Disputes can only arise over share contracts creating a set return<sup>15</sup> or a permissive (or maximum) return: "6% annually" or "up to<sup>16</sup> (not exceeding)<sup>17</sup> 6% annually," in each case "before any dividends shall be paid the common." The majority of courts find a limit in

<sup>11</sup> *Wabash Ry. v. Barclay*, 280 U.S. 197 (1930); *Guttmann v. Illinois Cent. R.R.*, 189 F.2d 927 (2d Cir.), *cert. denied*, 342 U.S. 867 (1951); *Joslin v. Boston & M. R.R.*, 274 Mass. 551, 175 N.E. 156 (1931).

For decisions so construing the articles, see the *Guttmann* case, especially in '91 F.Supp. 285, 286 (E.D.N.Y. 1950). For contrary constructions, see *Hazeltine v. Belfast & M.H.L.R.R.*, 79 Me. 411, 10 Atl. 328 (1887); *Crocker v. Waltham Watch Co.*, 315 Mass. 397, 53 N.E.2d 230 (1944); *Murphy v. Richardson Dry Goods Co.*, 326 Mo. 1, 31 S.W.2d 72 (1930); *Wood v. Lary*, 54 Sup. Ct. (47 Hun.) 550 (1st Dep't 1888), *aff'd*, 124 N.Y. 83, 26 N.E. 338 (1891); *Koppel v. Middle States Petroleum Corp.*, 197 Misc. 479, 96 N.Y.S.2d 38 (Sup. Ct. 1950) (Del. Law); see *Collins v. Portland Elec. Power Co.*, 7 F.2d 221 (D. Ore. 1925), *aff'd*, 12 F.2d 671 (9th Cir. 1926).

<sup>12</sup> An analysis of the New Jersey situation is beyond the proper scope of this paper. The New Jersey cases (and most of the previous literature) are discussed in Ashley, *The Future of the Law of Non-Cumulative Preferred Stock in New Jersey*, 5 *RUTGERS L. REV.* 358 (1951). See STEVENS, *CORPORATIONS* 474 (2d ed. 1949).

<sup>13</sup> BALLANTINE, *CORPORATIONS* 523 (rev. ed. 1946).

<sup>14</sup> Compare *Dohme v. Pacific Coast Co.*, 5 N.J. Super. 477, 68 A.2d 490 (1949) with *Guttmann v. Illinois Cent. R.R.*, 91 F.Supp. 285, 286 (E.D.N.Y. 1950), *aff'd*, 189 F.2d 927 (2d Cir.), *cert. denied*, 342 U.S. 867 (1951). Of course, no cause of action exists if full stated dividends have been paid on noncumulative stock, though the profits are much greater. *Welch v. Atlantic Gulf & West Indies S.S. Lines*, 101 F.Supp. 257 (E.D.N.Y. 1951), *aff'd*, 200 F.2d 199 (2d Cir. 1952); *cert. denied*, 345 U.S. 951 (1953).

<sup>15</sup> *Niles v. Ludlow Co.*, 202 Fed. 141 (2d Cir. 1913); *James F. Powers Foundry Co. v. Miller*, 166 Md. 590, 171 Atl. 842 (1934).

<sup>16</sup> *Lyman v. Southern Ry.*, 149 Va. 274, 141 S.E. 240 (1928).

<sup>17</sup> *Scott v. Baltimore R.R.*, 93 Md. 475, 49 Atl. 327 (1901); *Hatch v. Newark Tel. Co.*, 34 Ohio App. 361, 170 N.E. 371 (1930).

all these statements.<sup>18</sup> The maxim that a share of stock is a share of stock unless further rights and limitations are expressed is either ignored<sup>19</sup> or deemed overcome by the contract's terms.<sup>20</sup> The phrasing found in articles to justify this construction seems ambiguous.<sup>21</sup> A minority would hold such stock participating and merely require a "primary" dividend to preferred before payment to common.<sup>22</sup> When that has been paid, however, the force of "not exceeding x%" has been dissipated and further payments are unrestricted.

The articles should specify the extent of participation. After the "primary" dividend, preferred may participate at once in any payments to common or may only participate after an equivalent amount has been paid the common.<sup>23</sup> Articles specifying "preferred shall receive dividends of 7% before any are paid the common, and then are entitled to dividends equal to those paid the common," leave this choice open.<sup>24</sup> The better phrasing would provide for payment of a specific amount to the common (usually

<sup>18</sup> *Niles v. Ludlow Co.*, 202 Fed. 141 (2d Cir. 1913); *Whitney v. Puro Filter Corp.*, 63 F.2d 811 (2d Cir. 1933); *United States v. Liberty Baking Corp.*, 25 F. Supp. 203 (S.D.N.Y. 1938); *Tennant v. Epstein*, 356 Ill. 26, 189 N.E. 864 (1934); *Stone v. United States Envelope Co.*, 119 Me. 394, 111 Atl. 536 (1920); *Scott v. Baltimore & Ohio R.R.*, 93 Md. 475, 49 Atl. 327 (1901); *James F. Powers Foundry Co. v. Miller*, 166 Md. 590, 171 Atl. 842 (1934); *Hatch v. Newark Tel. Co.*, 34 Ohio App. 361, 170 N.E. 371 (1930); *Shimmon v. National Screw & Tack Co.*, 18 Ohio N.P.N.S. 569 (1916); *Duvelius v. Champion Fibre Paper Co.*, 25 Ohio N.P.N.S. 107 (1924), *aff'd without opinion*, 22 Ohio L. Rep. 600 (1924); *Lyman v. Southern Ry.*, 149 Va. 274, 141 S.E. 240 (1928).

<sup>19</sup> *Stone v. United States Envelope Co.*, *supra* note 18.

<sup>20</sup> *Scott v. Baltimore & Ohio R.R.*, 93 Md. 475, 49 Atl. 327 (1901); *Lyman v. Southern Ry.*, 149 Va. 274, 141 S.E. 240 (1928).

<sup>21</sup> In *Scott v. Baltimore & Ohio R.R.*, *supra* note 20, the certificate gave preferred annual noncumulative dividends out of surplus and net profits up to but not exceeding 4% before any dividends to the common. It is arguable that the limit "not exceeding 4%" applies to dividends paid before the common participated, but has no bearing on later participation. *Star Pub. Co. v. Ball*, 192 Ind. 158, 134 N.E. 285 (1922). In *Lockwood v. General Abrasive Co.*, 210 App. Div. 141, 205 N.Y. Supp. 511 (4th Dep't 1924), *aff'd without opinion*, 240 N.Y. 592, 148 N.E. 719 (1925), construction of the participating rights of common stock was at issue. These cases rely on "the ordinary business understanding" of the community—that preferred generally does not participate in excess dividends. See Thompson, *Respective Rights of Preferred and Common Stockholders in Surplus Profits*, 19 MICH. L. REV. 463, 485 (1921). The majority view is criticized in Christ, *Right of Holders of Preferred Stock to Participate in the Distribution of Profits*, 27 MICH. L. REV. 731 (1929), who argues that in the case of stock dividends the majority rule results in an indirect deprivation of voting rights. See also Rowell, *Rights of Preferred Shareholders in Excess of Preference*, 19 MINN. L. REV. 406 (1935).

<sup>22</sup> *Coggeshall v. Georgia Land Co.*, 91 Ga. App. 467, 82 S.E. 156 (1914) (dictum); *Englander v. Osborne*, 261 Pa. 366, 104 Atl. 614 (1918); *Sterling v. Watson Co.*, 241 Pa. 105, 88 Atl. 297 (1913); *Sternbergh v. Brock*, 225 Pa. 279, 74 Atl. 166 (1909); *cf.* *Fidelity Trust Co. v. Lehigh Valley R.R.*, 215 Pa. 610, 64 Atl. 829 (1906). The charter may of course be construed as granting a participating right. In *Ragland v. Broadnax*, 70 Va. (29 Gratt.) 401 (1877), the phrase "nothing shall deprive the state 1st purchaser of the full amount of any further dividend that may be declared" was read to make the stock participating.

<sup>23</sup> Thompson, *supra* note 21.

<sup>24</sup> *Bailey v. R.R.*, 17 Wall. 96 (U.S. 1872).

equivalent per share to that paid the preferred) before admitting the participation. Another problem is the size of the dividend. It should be set per share, not as an aggregate per class, and the certificate should specify participation "share for share" or "at the same rate" as payments to the common, and not "equally with the common."

### *Series and Ratability*

Equal shares receive equal dividends.<sup>25</sup> Some time ago this maxim could be stated in terms of classes of stock: that stock of the same class is entitled to the same payments and preferences. The use of blank stock, however, forces reconsideration of the "discrimination" problem.<sup>26</sup> A company seldom issues at once the total number of shares of a class originally authorized. The privileges and terms of shares issued a few years ago, however, may not arouse market interest today. Amendment of the corporate articles is a relatively cumbersome procedure. Many statutes therefore allow the issue of stock in series,<sup>27</sup> and the board of directors is empowered to set certain privileges for each series at its issue, detailing these changed terms in a certificate of preferences which is part of the articles of incorporation and which must be filed with the latter. The blank stock method should not be used to create shares with priority in dividend and liquidation payments over shares of the same class already outstanding. The power to create priority of rank is in the shareholders and is exercised by a vote to amend the articles of incorporation. An ideal statute, therefore, should not permit the board of directors to usurp this function.

Most statutes clearly limit the power of the board of directors to such changes as are desirable "within" equally-ranking stock. The typical statute provides that

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<sup>25</sup> *Independence Lead Mines Co. v. Kingsbury*, 175 F.2d 983 (9th Cir. 1949); *Penfield v. Davis*, 105 F. Supp. 292 (N.D. Ala. 1952); *Tichenor v. Dr. G. H. Tichenor Co.*, 164 So. 275 (La. 1935); *Hill v. Atoka Coal & Min. Co.*, 21 S.W. 508 (Mo. 1893); *Godley v. Crandall & Godley Co.*, 153 App. Div. 697, 139 N.Y. Supp. 236 (1st Dep't 1912), *aff'd*, 212 N.Y. 121, 105 N.E. 818 (1914); *cf. National Salt Co. v. Ingraham*, 122 Fed. 40 (2d Cir. 1903), *cert. denied*, 201 U.S. 644 (1906). A distinction between salary and dividend payments may be important here since salaries may of course legitimately differ. *Nichols v. Olympia Veneer Co.*, 135 Wash. 8, 236 Pac. 794 (1925); *DeMartini v. Scavenger's Protective Ass'n*, 3 Cal. App.2d 691, 40 P.2d 317 (1935); *Perata v. Oakland Scavenger Co.*, 111 Cal. App.2d 378, 244 P.2d 940 (1952); *compare Klein v. Greenstein*, 24 N.J. Super. 348, 94 A.2d 497 (1953).

Assent to a discrimination is, however, valid. *Speier v. United States*, 9 F. Supp. 1020 (Ct. Cl. 1935); *Louisville Ry. v. United States*, 20 F. Supp. 483 (D. Ky. 1937); *Curtis v. North Side Realty Co.*, 111 Ind. App. 81, 39 N.E.2d 489 (1942); *Farrier v. Ritzville Warehouse Co.*, 116 Wash. 522, 199 Pac. 984 (1921).

<sup>26</sup> See BALLANTINE, *CORPORATIONS* 502 (rev. ed. 1946); STEVENS, *CORPORATIONS* 426 (2d ed. 1949); Berle, *Investors and the Revised Delaware Corporation Act*, 29 COL. L. REV. 563, 567-570 (1929).

<sup>27</sup> DEL. GEN. CORP. LAW § 151 (1953); N. J. REV. STAT. § 14:8-2 (1937); *cf. N. Y. STOCK CORP. LAW* § 11.

... the board of directors may be empowered by the certificate of incorporation to cause such stock to be issued in series with variations as to the rates of dividend payable thereon and as to the terms on which the same may be redeemed and as to the amount which shall be paid to the holders thereof in case of dissolution or any distribution of assets and as to the terms or amount of any sinking fund provided for the purchase or redemption thereof, but the stock of each such series of the same class shall in all other respects be equal.<sup>28</sup>

A corporation subject to such a statute could not create a series ranking prior to previously issued shares in dividend or liquidating distributions, although the amount payable per share may differ. Some state statutes, however, seem to permit a greater grant of powers in derogation of the shareholders' right to pass on certain changes themselves by amendment of the articles. The California statute, for instance, provides in part that

... the articles shall state the preferences, privileges, and restrictions ... and the number of shares constituting each series. In lieu of a statement of the dividend rights, dividend rate, conversion rights, voting rights, rights and terms of redemption (including sinking fund provisions), redemption price or prices, or the liquidation preferences of any class or of any series of any class or the number of shares constituting any series or the designations of such series, the articles may authorize the board of directors, within the limits and restrictions stated therein, to fix or alter the dividend rights, dividend rate, conversion rights, voting rights, rights and terms of redemption (including sinking fund provisions), the redemption price or prices, the liquidation preferences of any wholly unissued class or of any wholly unissued series of any class of shares, or the number of shares constituting any unissued series of any class and the designations of such series, or all of any of them ...<sup>29</sup>

It has been argued that this section should not be construed as allowing a declaration of priority in dividends between series.<sup>30</sup> Although such great power is inconsistent with previously-held notions of the use of blank stock,<sup>31</sup> the language is broad and may justify a broad interpretation. To exclude creation of dividend and liquidation priorities, a California corporation should avoid this statutory phrasing in its articles and should more explicitly define the powers incident to writing a certificate of incorporation.<sup>32</sup> To reap all possible benefits from this section, the articles should plainly specify that liquidation or dividend priorities may also be

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<sup>28</sup> N. J. REV. STAT. § 14:8-2 (1937).

<sup>29</sup> CAL. CORP. CODE § 304; see Loomis, *Corporations Code Amendments*, 23 SO. CALIF. L. REV. 12 (1949).

<sup>30</sup> *Id.* at 13.

<sup>31</sup> BALLANTINE & STERLING, *CALIFORNIA CORPORATION LAWS* 50 (ed. 1949); Berle, *supra* note 26, at 567.

<sup>32</sup> Loomis, *supra* note 29, at 14.

created by board of directors' action.<sup>33</sup> Adoption of the statutory language, however, would unjustifiably confuse and possibly delude prospective shareholders.

Some statutes permit an increase in the number of shares of an as yet wholly-unissued series by action of the board of directors.<sup>34</sup> The most frequent use of this grant is the reissue, as part of such a series, of shares reacquired by the corporation by sinking fund redemption or otherwise. The draftsman may, however, limit the board of directors' power to increase the number of shares of an as yet unissued series, since a company may not find it feasible from a marketability standpoint to give the board of directors the extreme statutory power. Changes in the number of shares of any already outstanding series are properly prohibited in any case. Such shares have been purchased upon certain contractual expectations and if these latter are to be altered or defeated, the change should at least be by amendment of the articles with the attendant requirement of the affected shareholders' consent.

Since the certificate of preferences is not thought to allow changes in the dividend and liquidation priorities of the shares of one class, partial distributions must be shared proportionately. New York requires this by statute:

... when the stated dividends and amounts payable on liquidation are not paid in full, the shares of all series of the same class shall share ratably in the payment of dividends including accumulations, if any, in accordance with the sums which would be payable on said shares if all dividends were declared and paid in full . . . .<sup>35</sup>

The same result, it seems, must follow in any state whose law limits the blank stock method to "market changes." Only in states like California is the issue not resolved, as a consequence of the unduly broad statutory language discussed. Most articles, however, provide this same restriction and require pro rata sharing of partial distributions.

### *Source of the Dividend Payment*

No part of the entire corporate mechanism . . . is more complicated or more poorly designed and comprehended than the legal capital requirements and the attempted safeguards against unsafe distributions to the shareholders such as improper dividends . . . .<sup>36</sup>

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<sup>33</sup> Thus the problem would at least be determined via the Corporation Commissioner's office, CAL. CORP. CODE § 25000 ff. (Corporate Securities Act) ; see Orschel, *Administrative Protection for Shareholders in California Recapitalizations*, 4 STAN. L. REV. 215 (1952).

<sup>34</sup> CAL. CORP. CODE § 304.

<sup>35</sup> N. Y. STOCK CORP. LAW § 11.

<sup>36</sup> Ballantine and Hills, *Corporate Capital and Restrictions Upon Dividends Under Modern Corporation Laws*, 23 CALIF. L. REV. 229 (1935).

Several limits on dividend payments are in vogue.<sup>37</sup> Some statutes use the standard "capital impairment" limitation and permit dividends out of surplus—the excess of net assets (after liabilities) over legal capital.<sup>38</sup> Other statutes permit dividend payments unless they will render the corporation insolvent.<sup>39</sup> A third group permits payment of dividends though there is no surplus, out of net profits of a limited preceding period, as long as the assets exceed the liquidation preferences of all preferred stock and insolvency is not imminent.<sup>40</sup> These statutes create many problems of corporate finance and accounting, discussion of which is beyond the scope of this paper.<sup>41</sup> An awareness of those problems which may be resolved by the draftsman is essential to the preparation of corporate articles.

The common corporate provision for dividends is that they may be paid "out of funds legally available therefor." This phrase equates the source of dividends to the applicable statutory provisions and leaves problems of definition to the latter, where they must in any event be resolved. At times, however, the articles are more restrictive. Some provide for dividends "out of surplus." If the applicable state law allows payments though capital is impaired, the corporation has set its own limits of protection within those of the statute. Similarly, if the statute allows the use of any surplus, including paid-in surplus, a restriction in the articles to "earned surplus" has the same limiting effect. If these restrictions are purposeful, a negative expression would be preferable; viz., that dividends shall not be debited against paid-in surplus.

Usually the limit of the statute is the desired corporate limit; hence the popularity of "out of funds legally available." A recently announced sport concept of "earnings and profits," however, renders one type of statute sufficiently ambiguous to make "out of funds legally available" unsatisfactory.<sup>42</sup> Several statutes provide that dividends may be paid "out of surplus or net profits (or earnings)."<sup>43</sup> Ballantine and Hills in 1935<sup>44</sup> concluded that accounting usage, and not a desire for alternative sources of payments, was responsible for this phrasing.<sup>45</sup> "Profits" (as well as "net

<sup>37</sup> Generally, see BALLANTINE, CORPORATIONS 572 (rev. ed. 1946); STEVENS, CORPORATIONS 446 (2d ed. 1949).

<sup>38</sup> N. Y. STOCK CORP. LAW § 58; MD. ANN. CODE art. 23, § 33 (1951).

<sup>39</sup> MASS. GEN. LAWS c. 156, § 37, and c. 158, § 44 (1948). Probably "equitable insolvency" is meant; see BALLANTINE, CORPORATIONS 578 (rev. ed. 1946).

<sup>40</sup> CAL. CORP. CODE § 1500; DEL. GEN. CORP. LAW § 170 (1953).

<sup>41</sup> An excellent discussion of several problems and citations to more specific works are found in Ballantine & Hills, *supra* note 36.

<sup>42</sup> This has been called the "nimble dividend" problem. See Note, 62 HARV. L. REV. 130 (1948).

<sup>43</sup> Ballantine & Hills, *supra* note 36, at 241 n.51.

<sup>44</sup> *Ibid.*

<sup>45</sup> *Id.* at 242.



earnings") is a periodic account closed out at the end of each period to earned surplus.<sup>46</sup> The use of "surplus" alone, therefore, might lead courts to forbid payment of dividends from the current period's earnings until closed out to surplus.<sup>47</sup> Ballantine and Hills thus treated "profits" and "earnings" as identical terms, which to accountants may be the proper method. But no matter how ill-chosen, several courts including the United States Supreme Court have distinguished "earnings" from "profits," making the latter equivalent to "surplus," in that no profit exists if there is a capital impairment.<sup>48</sup> Recently this distinction has led to the construction of "out of net earnings or surplus" as providing two alternative sources, thus allowing declaration of dividends from current earnings though a capital impairment exists.<sup>49</sup> These decisions have been criticized,<sup>50</sup> but their

<sup>46</sup> SUNLEY & CARTER, CORPORATION ACCOUNTING 57 (1944); Note, 10 OHIO ST. L.J. 255 (1949). See generally, *Dealers' Granite Corp. v. Faubion*, 18 S.W.2d 737 (Tex. Civ. App. 1929); Hills, *Accounting in Corporation Law*, 12 WIS. L. REV. 494 (1937).

<sup>47</sup> Ballantine & Hills, *supra* note 36, at 241. But in *Goodnow v. American Writing Paper Co.*, 73 N.J. Eq. 692, 69 Atl. 1014 (Ct. Err. & App. 1908), *affirming*, 72 N.J. Eq. 645, 66 Atl. 607 (Ch. 1907), the court defined surplus as computed by the excess of net assets (after liabilities) over the par or stated capital, but profits as excess of net assets over whatever lesser amount the shareholders actually paid as consideration for the shares. Thus the statute at issue, permitting dividend payments out of profits or surplus, allowed payment despite the presence of watered stock. But see *National Newark & Essex Banking Co. v. Durant Motor Co.*, 124 N.J. Eq. 213, 1 A.2d 316 (Ch. 1938); see *George E. Warren Co. v. United States*, 76 F. Supp. 587 (D. Mass. 1948); *Carpenter v. New York & New Haven R.R.*, 5 Abb. Pr. 277 (N.Y. 1857). See Ballantine & Hills, *supra* at 242; compare *Borg v. International Silver Co.*, 11 F.2d 147, at 151 (2d Cir. 1925) (*semble*).

<sup>48</sup> *Willcuts v. Milton Dairy Co.*, 275 U.S. 215, 218 (1927); *Lich v. United States Rubber Co.*, 39 F. Supp. 675 (D.N.J. 1941), *aff'd without opinion*, 123 F.2d 145 (3d Cir. 1941); *Mengel Co. v. Glenn*, 50 F. Supp. 765 (W.D. Ky. 1943), *aff'd per curiam*, 145 F.2d 235 (6th Cir. 1944); *William H. Haskell Mfg. Co. v. United States*, 91 F. Supp. 26 (D. R.I. 1950); *Associated Elec. Co. v. United States*, 97 F. Supp. 821 (Ct. Cl. 1951); see *Agnew v. American Ice Co.*, 2 N.J. 291, 66 A.2d 330 (Sup. Ct. 1949).

<sup>49</sup> *United States v. Riely*, 169 F.2d 542, (4th Cir. 1948), *cert. denied*, 335 U.S. 908 (1949); followed in *Grand Traverse Hotel Co. v. United States*, 79 F. Supp. 860 (S.D. Mich. 1948). See *Sumter Farm & Stock Co. v. United States*, 151 F.2d 975 (5th Cir. 1945). *Contra*: *Senior Inv. Corp.*, 2 T.C. 124 (1943); cf. *National Newark & Essex Banking Co. v. Durant Motor Co.*, 124 N.J. Eq. 213, 1 A.2d 316 (Ch. 1938).

The development of this "two source" rule may apparently be traced from language in *Willcuts v. Milton Dairy Co.*, *supra* note 48 at 218. There the court separated surplus and net profits as follows:

... the term "surplus" describes such part of the excess in the value of the corporate assets as is treated by the corporation as part of its permanent capital, usually carried on the books in a separate "surplus account"; while the term "undivided profits" designates such part of the excess as consists of profits which have neither been distributed as dividends nor carried to surplus account . . . . But it is a prerequisite to the existence of "undivided profits" as well as a "surplus" that the net assets of the corporation exceed the capital stock.

Then in *Lich v. United States Rubber Co.*, *supra* note 48 at 681, profits and earnings had to be differentiated if the application of New Jersey's "dividend credit" theory was to be avoided. The court delivered itself of the following:

[Net profits] . . . connotes the clear pecuniary gain remaining after deducting from the gross earnings of the business the expenses incurred in its conduct, the losses sus-

presence should warn draftsmen that companies incorporated in those states should define exactly in their articles the sources of dividends. This problem demonstrates the superiority of the California and Delaware statutes which by-pass the accounting convention that bred this difficulty. They recognize "nimble dividends" despite a capital impairment and place the line of defense at the liquidation preference. This policy may be disputed but at least reliance on their phrasing is justified.<sup>51</sup>

The medium of the dividend payment may create related problems. A company may declare dividends in cash, in property, in stock or bonds of another company or in its own obligations.<sup>52</sup> The difficulty involving preferred stock is the payment of a noncash dividend in satisfaction of the dividend preference. If cumulative dividends are payable in cash, neither the current dividend nor an arrearage is satisfied by a noncash dividend.<sup>53</sup> The shareholder need not accept the dividend and apparently can compel the company to pay him the cash equivalent.<sup>54</sup> Articles expressly permitting use of property dividends would overrule these distinctions.<sup>55</sup>

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tained in its prosecution and the capital invested . . . It is a prerequisite to the existence of net profits that the assets of a corporation exceed the liabilities, including the liabilities on the capital stock. Where the capital is impaired, annual earnings, if insufficient to offset the impairment, do not constitute net profits.

From that, the *Riely* decision was but the next logical step. The "distinction" is still being perpetuated; see *William H. Haskell Mfg. Co. v. United States*, 91 F. Supp. 26 (D. R.I. 1950); *Associated Elec. Co. v. United States*, 97 F. Supp. 821 (Ct. Cl. 1951); McCormick, *Nimble Dividends: Some States Do Permit Dividends Despite Deficits in Accumulated Earnings*, 88 J. ACCOUNTANCY 196 (1949) (including all "dividend source" statutes).

<sup>50</sup> McDowell, *The Theory of Capital in Virginia: An Historical Comma and a Disjunctive Conjunction*, 6 WASH. & LEE L. REV. 35 (1949). Ballantine and Hills foresaw in 1935 the *Riely* construction and argued cogently against it; see note 45 *supra*. See *Mangham v. State*, 11 Ga. App. 440, 75 S.E. 508 (1912).

<sup>51</sup> See BALLANTINE & STERLING, *CALIFORNIA CORPORATION LAWS* 180 (1948).

<sup>52</sup> *Klopot v. Northrup*, 131 Conn. 14, 37 A.2d 700 (1944); *Commonwealth v. Boston & Aroostook R.R.*, 142 Mass. 146, 7 N.E. 716 (1886); *Liebman v. Auto Strop Co.*, 241 N.Y. 427, 150 N.E. 505 (1926); *Wood v. Lary*, 47 Hun. 550 (N.Y. 1888); *Williams v. Western Union Tel. Co.*, 93 N.Y. 162, 192 (1883); *Bankers Trust Co. v. Dietz Co.*, 157 App. Div. 594, 142 N.Y. Supp. 847 (1st Dep't 1913); *Grants Pass Hardware Co. v. Calvert*, 71 Ore. 103, 142 Pac. 569 (1914).

*In re Strong's Will*, 198 Misc. 7, 96 N.Y.S.2d 75 (Surr. Ct., 1950), *aff'd*, 277 App. Div. 1157, 101 N.Y.S.2d 1021 (4th Dep't 1950). For the distinction between stock dividends and split-ups, see *In re Lawrie's Estate*, 119 N.Y.S.2d 906 (Surr. Ct. 1953); *In re Lissberger's Estate*, 189 Misc. 277, 71 N.Y.S.2d 585 (Surr. Ct. 1947). See BALLANTINE, *CORPORATIONS* 565 (rev. ed. 1946); STEVENS, *CORPORATIONS* 454 (2d ed. 1949); Hills, *Consolidation of Corporations by Sale of Assets and Distribution of Shares*, 19 CALIF. L. REV. 349, 356 n.13 (1931).

<sup>53</sup> *Strout v. Cross, Austin & Ireland Lumber Co.*, 283 N.Y. 406, 28 N.E.2d 890 (1940). But assent to such a dividend is binding. *Coon v. Schlümme Dairy Co.*, 294 Mich. 51, 292 N.W. 560 (1940); *Hastings v. International Paper Co.*, 187 App. Div. 404, 175 N.Y. Supp. 815 (1st Dep't 1919).

<sup>54</sup> *Strout v. Cross, Austin & Ireland Lumber Co.*, *supra* note 53. But *cf. Malone v. Armor Insulating Co.*, 191 Ga. 146, 12 S.E.2d 299 (1940); *Corbett v. McClintic-Marshall Corp.*, 17 Del. Ch. 165, 151 Atl. 218 (Ch. 1930).

<sup>55</sup> As in the case of "whiskey dividends." See *In re Wolfe's Estate*, 155 Misc. 190, 279 N.Y. Supp. 605 (Surr. Ct. 1935); BALLANTINE, *CORPORATIONS* 564 (rev. ed. 1946); see *Williams v. Western Union Tel. Co.*, 93 N.Y. 162, 193 (1883).

### Discretion

Occasionally a corporation desires to limit the discretion of its board of directors in the declaration of dividends. Appropriate language to that effect will be honored by the courts as a contractual stipulation to pay dividends upon certain conditions. However, the ordinary provision that dividends shall be paid "when, as and if declared by the board of directors" with or without "in their discretion" will prevent shareholder attack except on "abuse of discretion."<sup>56</sup> "Abuse of discretion" embodies a vague area of fraud and bad faith<sup>57</sup> and, while occasionally proven, is a difficult action to sustain.<sup>58</sup> Whatever this area,<sup>59</sup> it cannot be limited further by the articles, which can do no more than leave the declaration of dividends to the board of directors' discretion; complaints based on an abuse of that discretion cannot prospectively be foreclosed.

Discretion is more frequently and successfully questioned upon construction of the articles. The phrasing must usually differ substantially from that quoted above, for courts are reluctant to find an intent to deprive the board of directors of this discretion.<sup>60</sup> In a few cases, these ques-

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<sup>56</sup> *Bank of America Nat. Trust & Sav. Ass'n v. West End Chemical Co.*, 37 Cal. App.2d 685, 100 P.2d 318 (1940).

<sup>57</sup> The best statement of relevant material is from *Gottfried v. Gottfried*, 73 N.Y.S.2d 692, 695 (Sup. Ct. 1947):

The following facts are relevant to the issue of bad faith and are admissible in evidence: Intense hostility of the controlling faction against the minority; exclusion of the minority from employment by the corporation; high salaries, or bonuses or corporate loans made to the officers in control; the fact that the majority group may be subject to high personal income taxes if substantial dividends are paid; the existence of a desire by the controlling directors to acquire the minority stock interests as cheaply as possible.

These are, however, mainly applicable to close corporations.

<sup>58</sup> Some decisions finding an abuse of discretion and ordering some payments: *O'Neill Co. v. O'Neill*, 108 Ind. App. 116, 25 N.E.2d 656 (1940); *Channon v. Channon Co.*, 218 Ill. App. 397 (1920); *Dodge v. Ford Motor Co.*, 204 Mich. 459, 170 N.W. 668 (1919); *Seitz v. Union Brass Co.*, 152 Minn. 460, 189 N.W. 586 (1922); *Warburton v. John Wanamaker Philadelphia*, 329 Pa. 5, 196 Atl. 506 (1938) (disregarding the corporate entity); *cf. Cratty v. Peoria Law Library Ass'n*, 219 Ill. 516, 76 N.E. 707 (1906); *Lydia E. Pinkham Medicine Co. v. Gove*, 303 Mass. 1, 20 N.E.2d 482 (1939). The suit is in equity. *Rubens v. Marion-Washington Realty Corp.*, 116 Ind. App. 55, 59 N.E.2d 907 (1945). See also *Lesnik v. Pub. Industrials Corp.*, 144 F.2d 968 (2d Cir. 1944); *In re Brantman*, 244 Fed. 101 (2d Cir. 1917); *Titus v. Piggly Wiggly Corp.*, 2 Tenn. App. 184 (1925).

<sup>59</sup> For a recent discussion of "abuse of discretion," see, e.g., *Isley, Rights of the Minority Shareholder to the Corporate Dividend*, 2 DUKE B.A.J. 113 (1952); see also the good discussion in Comment, 19 U. OF CHI. L. REV. 878 (1952); see Note, 38 CORNELL L.Q. 244, 249 (1952).

<sup>60</sup> *Wabash Ry. v. Barclay*, 280 U.S. 197 (1930); *Bessie Tift College v. Barrow Mills*, 39 Ga. App. 261, 146 S.E. 637 (1929); *Pardee v. Harwood Elec. Co.*, 262 Pa. 68, 105 Atl. 48 (1918); *cf. Thatcher v. Chicago Rys.*, 4 F.2d 63 (7th Cir. 1925); *cert. denied*, 270 U.S. 643 (1926); *Harris Trust & Sav. Bank v. Chicago Rys.*, 56 F.2d 942 (7th Cir.), *cert. denied*, 287 U.S. 614 (1932); *Hassett v. Iszard Co.*, 61 N.Y.S.2d 451 (Sup. Ct. 1945). *But see Seattle Trust Co. v. Pitner*, 18 Wash. 401, 51 Pac. 1048 (1898); *cf. Rubens v. Marion-Washington Realty Corp.*, 116 Ind. App. 55, 59 N.E.2d 907 (1945).

tions of construction merge into questions of law. It has been said, for instance, that discretion is somewhat limited when the stock involved is noncumulative;<sup>61</sup> such stock may be of the "mandatory dividend" type though its language is not appreciably different from that used for cumulative stock.<sup>62</sup> The mere statement that the stock was to receive noncumulative dividends at a rate of 6% whenever in any year the net earnings sufficed has been interpreted as mandatory if earnings exist.<sup>63</sup> Cumulative stock is apparently treated more strictly and mere statements of the source of dividend payments do not make such stock mandatory. This or any contract diverting profits to a specific corporate purpose is valid;<sup>64</sup> but the language of these articles is sufficiently ambiguous to provoke litigation. The difficulty apparently arises from an attempt to retain discretionary power in the board of directors while nevertheless setting policy guides for the exercise of their discretion.

Some states have adopted certain variant rules of construction on the issue of discretion. If the dividend is at a set rate with no further qualifications, the Maine courts make payment thereof mandatory if net earnings suffice.<sup>65</sup> Apparently the shares must be nonparticipating but they may be cumulative or noncumulative. Thus a Maine corporation creating stock which is to be paid "dividends at the rate of 6% per annum and no more, payable quarterly" should recognize that the board of directors' discretion has been limited. North Carolina by statute requires distribution of earnings as dividends after the shareholders at a meeting set aside a sum for "necessary working capital;"<sup>66</sup> discretion is thus not only indirect but somewhat limited by the shareholders' direct voice in the distribution.

One other argument against discretion springs from restrictions on payment of dividends on preferred and, more usually, on junior stock by varied financial safeguards found in some modern articles.<sup>67</sup> These limit the board of directors' discretion absolutely against payment below their standards.<sup>68</sup> It may be argued that their existence defines the area of discretion for the

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<sup>61</sup> See BALLANTINE, CORPORATIONS 519-520 (rev. ed. 1946).

<sup>62</sup> See *Crocker v. Waltham Watch Co.*, 315 Mass. 397, 53 N.E.2d 230 (1944); *Koppel v. Middle States Petroleum Corp.*, 197 Misc. 479, 96 N.Y.S.2d 38 (Sup. Ct. 1950) (reserves for contingencies were, however, permitted to exhaust the otherwise available earnings).

<sup>63</sup> *Wood v. Lary*, 47 Hun. (54 Sup. Ct.) 550 (N.Y. 1888).

<sup>64</sup> *Hart v. Bell*, 222 Minn. 69, 23 N.W.2d 375 and 24 N.W.2d 41 (1946).

<sup>65</sup> *Spear v. Lime Co.*, 113 Me. 285, 93 Atl. 754 (1915); *Trust Co. v. Fibre Co.*, 142 Me. 286, 50 A.2d 188 (1946); cf. *Whittemore v. Continental Mills*, 98 F. Supp. 387 (D. Me. 1951).

<sup>66</sup> N. C. GEN. STAT. §§ 55-115 (1950). The cause of action is, then, that the company in bad faith unnecessarily set aside surplus as "necessary working capital." *Gaines v. Mfg. Co.*, 234 N.C. 331, 67 S.E.2d 355 (1951); but the existence of profits must be alleged. *Steele v. Cotton Mills*, 231 N.C. 636, 58 S.E.2d 620 (1950). So must a prior demand for dividends on the board of directors. *Winstead v. Hearne*, 173 N.C. 606, 92 S.E. 613 (1917).

<sup>67</sup> See *Financial Restrictions*, *infra*.

<sup>68</sup> Cf. *Lydia E. Pinkham Medicine Co. v. Gove*, 303 Mass. 1, 20 N.E.2d 482 (1939).

directors, lessening it correspondingly when the surplus rises above the restrictive figure.<sup>69</sup> Financial safeguards common today are primarily designed to meet senior charges and maintain working capital, but a large, overly conservative financial restriction may be vulnerable to the above argument.

### *Financial Restrictions*

. . . persons familiar with financial matters are not satisfied with the protection afforded by the statutory surplus limitations . . .<sup>70</sup>

The basic protection of shareholders against destruction of their proprietary interest is today provided by the financial restrictions found in nearly all articles. The statutory and decisional law concerning these provisions is nonexistent; for they are hyper-legal, offering protection beyond the law's minima.<sup>71</sup> Only construction questions can arise here and generally careful draftsmanship has avoided even these.

Restrictions against dividends to junior stock fall into a few major categories. Some contracts require the existence of a certain amount of total assets, whether in the aggregate or per share. Others require the retention of a certain amount of working capital after the dividend is paid. A third group require a certain surplus position for payment of dividends, which will protect against stock dividends.<sup>72</sup> They are all expressed negatively. A covenant to maintain set margins is a practical absurdity and would give shareholders the right to litigate over their company's financial status at a level far below the usual "breaking point" of equitable insolvency.<sup>73</sup> The most common provision forbids a dividend declaration unless after the putative payment the aggregate dividend payments<sup>74</sup> on all stock from, say, January 1, 1950 are still less than the sum of \$X plus the consolidated net income earned since January 1, 1950 plus proceeds from the sale of junior stock since that date (or net proceeds, after cost of junior

<sup>69</sup> This argument may be inferred from the *Pinkham* case, *supra* note 68.

<sup>70</sup> Ballantine & Hills, *supra* note 36, at 262.

<sup>71</sup> BALLANTINE, CORPORATIONS 591 (rev. ed. 1946).

<sup>72</sup> Raisty, *Working-Capital Safeguards of Preferred Stocks*, 58 J. ACCOUNTANCY 39 (1934); Bradley, *Accounting Aspects of Protective Provisions in Industrial Preferred Stocks*, 23 ACCTG. REV. 385 (1948). Of course, it is possible to limit dividend payments to \$X per year.

A limit on dividends to common of \$10 a year is per share, not aggregate; thus the \$10 per share limit remains though the common is split 5 for 1. *Wagstaff v. Holly Sugar Corp.*, 253 App. Div. 616, 3 N.Y.S.2d 552 (1st Dep't), *aff'd*, 279 N.Y. 625, 17 N.E.2d 681 (1938).

Occasionally, consent of the preferred removes these restrictions. See text *infra* at note 144.

<sup>73</sup> Grossman, *Corporate Securities—Especially Common and Preferred Stocks*, 17 A.B.A.J. 123, 129 (1931); see Rollich, *Some Current Thoughts on Corporate Capitalization*, 1 VAND. L. REV. 553 (1948); Note, 22 VA. L. REV. 440 (1936).

<sup>74</sup> Actually it is "aggregate payments" including dividends, property distributions, sinking fund payments, etc.

stock acquired in any way). The same equation is often expressed so that the consolidated net income (with or without the \$X) is to exceed all payments on all stock plus the cost of all junior shares acquired (or usually, net cost after proceeds from the sale of junior shares).<sup>75</sup>

Careless drafting may indirectly destroy the effect of the safeguard. If instead of "all payments to all stock" the phrase read merely "dividend distributions," sinking fund payments or nondividend distributions could be made without entering into the equation, thus destroying the provisions' value.<sup>76</sup> Or if the provision were that all payments should not exceed the sum of dated consolidated net income plus *proceeds from the sale of junior stock*, common stock could be refunded by an acquisition and reissue, bloating the amount legally available for junior dividends (by raising the limit which these dividends may not exceed) though the clause intends to count only net proceeds after cost of acquiring any junior stock. Though open to abuse, this latter aberration is still common.

Certain legitimate exceptions may of course be made in these clauses. Thus when the dividend restriction reads "all payments to all junior stock shall not exceed . . .," etc., it normally exempts refunding—the acquisition of junior shares out of proceeds from the sale of new junior shares. Otherwise these payments to acquire the old shares are "payments on junior stock" which reduce the permissible dividend payments. Further, dividends payable in junior stock are usually exempt from the restriction "all payments . . . ." However, if dated consolidated surplus, not net income, is used in the equation, payments may in effect be limited anyway—if the applicable state law requires capitalization of earned surplus upon the declaration of stock dividends.<sup>77</sup>

A more direct provision implementing the Delaware type of statute requires that after the putative payment consolidated net current assets equal 150% of this and all prior stock's liquidation preferences. Several variations of this type of protection are used: after the dividend, consolidated net current assets are to remain above \$X, or (rarely, since it is little used) above consolidated funded debt; or that consolidated net tangible assets remain 200% of consolidated fixed liabilities plus preferred stock (at par). Except for the size of the protection these are all of the same sort. Often the clause provides that assets are to equal a multiple of several items, which usually intends a multiple of the aggregate of these items. A sentence creating the latter in the disjunctive, as "assets to be two times fixed liabilities, plus preferred stock" is therefore, whether intended or not,

<sup>75</sup> E.g., Certificate of Incorporation, Shellmar Products Corp. (1951); compare Bradley, *supra* note 72.

<sup>76</sup> N. Y. STOCK CORP. LAW § 58; see, e.g., MD. ANN. CODE GEN. LAWS art. 23, § 33 (1951).

<sup>77</sup> CAL. CORP. CODE § 1506.

an evasion of the supposed protection.<sup>78</sup> A simple yet proper protection which does not run this risk is often found, expressed absolutely or relatively: after the putative payment capital and surplus shall remain above \$X; or that the year's total dividend and other distributions be no more than one-third of that year's net income. Unless the latter were construed as a general expression of dividend policy, requiring that so much be paid out,<sup>79</sup> these are effective means of protecting the preferred's share in the corporate assets.

As to all these clauses, it is vital that all payments, distributions, acquisitions, etc., include those of subsidiaries; otherwise the provisions can be totally avoided. Also many of these clauses are based on the dollar ratio between certain items—net current assets, tangible assets, etc.—which are vague until defined.<sup>80</sup> The definition is a contractual matter detailed in most articles. Thus defective definitions of these concepts might weaken the supposed protection. If the articles are silent as to meaning, the more or less standard accounting interpretations would govern in litigation. It is because the courts honor any contractual definition, no matter how unusual accounting-wise, that exact definition becomes important.

#### THE LIQUIDATION PREFERENCE

Preferred shares do not participate before common stock in distributions upon liquidation, dissolution or winding-up unless the share-contract or a statute so specify.<sup>81</sup> Statutes may provide for preferential participa-

<sup>78</sup> But see *BALLANTINE & JENNINGS, P-H STUDENTS CORPORATION LAW SERVICE* 12,040 (1952).

<sup>79</sup> *E.g.*, *Crocker v. Waltham Watch Co.*, 315 Mass. 397, 53 N.E.2d 230 (1944).

<sup>80</sup> Even in the typical clause described, that "all payments to all stock shall not exceed \$X plus dated consolidated net income plus net proceeds from sale of junior stock," the valuation of the last may be complicated by the existence of a conversion privilege. The value assigned for converted shares should then perhaps be specified. *E.g.*, *Certificate of Incorporation, Tung-Sol Electric Inc.* (1952).

<sup>81</sup> *Otis & Co. v. Securities and Exchange Comm'n*, 323 U.S. 624 (1945); *Continental Ins. Co. v. United States*, 259 U.S. 156 (1922); *Gaskill v. Gladys Belle Oil Co.*, 16 Del. Ch. 289, 146 Atl. 337 (Ch. 1929); *Lloyd v. Pennsylvania Elec. Vehicle Co.*, 75 N.J. Eq. 263, 72 Atl. 16 Ct. Err. & App. 1909; *People v. New York Building-Loan Banking Co.*, 50 Misc. 23, 100 N.Y. Supp. 459 (Sup. Ct. 1906); *Thomas Branch & Co. v. Riverside Mills*, 139 Va. 291, 123 S.E. 542 (1924); *cf. Hatch v. Newark Tel. Co.*, 34 Ohio App. 361, 170 N.E. 371 (1930); *Williams v. Renshaw*, 220 App. Div. 39, 220 N.Y. Supp. 532 (3d Dep't 1937). But see *Haworth v. Hubbard*, 220 Ind. 611, 44 N.E.2d 967 (1942). Generally, see *Annotation*, 25 A.L.R.2d 788 (1952).

A shareholder's debt to the company is a set-off. *In re Schmoll's Estate*, 193 Misc. 203, 83 N.Y.S.2d 743 (Surr. Ct. 1948); compare *Carson v. Tompkins*, 41 D. & C. 558 (Pa. 1941). But a dividend distribution made during operation after the company's charter had expired is not. *Langer v. Fargo Mercantile Co.*, 48 N.D. 545, 186 N.W. 104 (1921). Any assets of the company, including stock of another company, are proper subjects for distribution, and may be so demanded. *Robinson v. Pittsburgh Oil Refining Corp.*, 14 Del. Ch. 193, 126 Atl. 46 (Ch. 1924).

tion to a varied extent<sup>82</sup> and modern corporate articles specifically grant the preference. Some statutes have specifically denied the preference unless granted by the articles, thus restating the common law rule.<sup>83</sup> If the statute requires that the certificate of incorporation express the preference, a bylaw attempting to do so is ineffective.<sup>84</sup>

Since participation is usually stated, the difficult issue is the limiting effect of the preference. Is the preferred paid for both par and dividend accruals before the common participates? Does the preferred participate with the common in the distribution of any further amounts? Both questions involve construction of a contract.<sup>85</sup> A well-known New York decision held that a preference of "par and dividend accruals" permits only payment of the par amount if dividends had not been earned; a dividend could not accrue in the absence of profits, in the sense that the company could not have paid one during those years.<sup>86</sup> The overwhelming majority of courts hold the contrary and construe a preference of "par and dividend accruals" to permit the full preference although there were no profits, since dividends accrue on cumulative stock even if not earned.<sup>87</sup> Many articles specify that the sum payable does not depend on earnings, or call for the distribution of "a sum equal to par (or a stated amount) and accruals," or an equivalent.

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<sup>82</sup> A previous Michigan statute so provided: *Compare* Laws 1915, §9050. *Cf.* Maxwell v. Eddy Paper Co., 232 Mich. 356, 205 N.W. 111 (1925). The usual rule applies today: MICH. COMP. LAWS §§ 450.70, 450.73 (1948). Most statutes merely permit the issue of stock with such preferences: CAL. CORP. CODE § 1100 (1951); DEL. GEN. CORP. LAWS § 151 (1953); MD. ANN. CODE GEN. LAWS art. 23, § 14 (1951); N.J. REV. STAT. § 14.8-2 (1937); N.Y. STOCK CORP. LAW § 11.

<sup>83</sup> *E.g.*, a previous Delaware statute, Laws 1917, § 7, p. 325. See Gaskill v. Gladys Belle Oil Co., 16 Del. Ch. 289, 146 Atl. 337 (Ch. 1929).

<sup>84</sup> Gaskill v. Gladys Belle Oil Co., *supra* note 83.

<sup>85</sup> With the rare exception of a statute—like WIS. STAT. § 182.13(1) (1927)—which itself defines the liquidation preference (then limited to the par value in the case of asset distribution not from profits). *Cf.* Welch v. Land Development Co., 246 Wis. 124, 16 N.W.2d 402 (1944). Today the section permits a preference in the distribution of assets, with no limit as to source (see 1951 statutes). The result of the earlier reading was to prevent preferred shareholders from getting a sum equal to par and dividend arrears unless the dividend arrears had been earned. Hull v. Pfister & Vogel Leather Co., 235 Wis. 653, 294 N.W. 18 (1940).

<sup>86</sup> Wouk v. Merin, 128 N.Y.S.2d 727 (1st Dep't. 1954); Michael v. Cayey-Cagus Tobacco Co., 190 App. Div. 618, 180 N.Y. Supp. 532 (1st Dep't 1920), reaching by construction the result of the old Wisconsin statute. *Michael* was cited for the opposite proposition in Sbanik v. Empire Power Corp., 58 N.Y.S.2d 176 (Sup. Ct. 1945), *aff'd without opinion*, 270 App. Div. 925, 62 N.Y.S.2d 760 (1st Dep't 1946), *aff'd without opinion*, 296 N.Y. 664, 69 N.E.2d 818 (1946).

<sup>87</sup> Fawkes v. Farm Lands Co., 112 Cal. App. 374, 297 Pac. 47 (1931); Penington v. Commonwealth Hotel Construction Corp., 17 Del. Ch. 394, 155 Atl. 514 (Sup. Ct. 1931); Willson v. Laconia Car Co., 275 Mass. 435, 176 N.E. 182 (1931); Johnson v. Johnson, 138 Va. 487, 122 S.E. 100 (1924); Drewry Co. v. Throckmorton, 120 Va. 859, 92 S.E. 818 (1917); Hay v. Hay, 38 Wash.2d 513, 230 Pac.2d 791 (1951); *cf.* Hildreth v. Western Realty Co., 62 N.D. 233, 242 N.W. 679 (1932); Hayman v. Morris, 46 N.Y.S.2d 482, 493 (Sup. Ct. 1943) (Virginia law).



Participation beyond the preferential distribution is doubtful. If the articles are silent the majority of courts find no participation preference and require pro rata distribution—to preferred and common—of all assets.<sup>88</sup> Where the contract specifies that payment to the preferred of par and arrears is payment in full there is no excess participation.<sup>89</sup> There is no American case authority concerning excess participation beyond a stated preference.<sup>90</sup> The bare statement of rights of preferred stock in liquidation<sup>91</sup> is not helpful. Similar problems arise from the varied types of participation possible, as in participation in dividends beyond a stated preference.<sup>92</sup> Preferred may participate equally (or in stated ratio) with common at once after the fixed preferential payment, or after common has received, exclusively, a similar (or stated) amount.<sup>93</sup> The participation may be equal per class, or equal per share.<sup>94</sup> Any arrangement desired, whether because of peculiar capital contributions involved,<sup>95</sup> prior dividend or asset distributions or any other reason will be honored by the courts if expressed.<sup>96</sup>

<sup>88</sup> See note 81 *supra*.

<sup>89</sup> *Williams v. Renshaw*, 220 App. Div. 39, 220 N.Y. Supp. 532 (3d Dep't 1927); *cf. Powell v. Craddock-Terry Co.*, 175 Va. 146, 7 S.E.2d 143 (1940).

<sup>90</sup> See text at note 15 *supra* for discussion of litigious phrasing in case of excess dividend participation applicable here. *BALLANTINE, CORPORATIONS* 508 (rev. ed. 1946); see *Notes*, 39 CALIF. L. REV. 568 (1951), 30 MICH. L. REV. 281 (1931). In *Powell v. Craddock-Terry Co.*, *supra* note 89, the court construed a contractual provision that the preferred was to be paid cumulative dividends of 6%, to receive par and accruals and a premium upon redemption, and "to be preferred as to assets" in liquidation, as giving the preferred only par and no more (neither dividend arrearages nor excess participation) upon liquidation. See *Hungerford & Terry Co. v. Geschwindt*, 24 N.J. Super. 385, 94 A.2d 540 (1953).

<sup>91</sup> *Tourtelot v. Commissioner of Int. Rev.*, 189 F.2d 167 (7th Cir. 1951); *Clarke v. Armstrong*, 151 Ga. 105, 106 S.E. 289 (1921); *Craycraft v. National Building & Loan Ass'n*, 117 Ky. 229, 77 S.W. 923 (1904) (equality of shares); *Standard Oil Co. of Louisiana v. Apex Oil Corp.*, 190 Tenn. 376, 229 S.W.2d 775 (1950) (equality of shares subject to set-offs).

<sup>92</sup> See *Thompson*, *supra* note 21; note 94 *infra*.

<sup>93</sup> Participation to a given amount would probably mean "per share." *Wagstaff v. Holly Sugar Corp.*, 253 App. Div. 616, 3 N.Y.S.2d 552 (1st Dep't 1938), *aff'd*, 279 N.Y. 625, 17 N.E.2d 681 (1938).

<sup>94</sup> For a discussion of these possibilities and the actual practices followed, see *Stevens, Stockholders Participation in Assets on Liquidation*, 10 J. BUS. U. OF CHI. 46, 70 (1937). He favors:

... a class participation arrangement providing that the preferred and the common shall participate in the assets each as a class in proportion to their respective contributions to capital stock represented by the issue of capital stock for cash or other assets without preference and up to the total amount contributed by the preferred stockholders. This is all that is necessary to prevent not only dilution of the preferred stockholders' contribution through split-ups, stock dividends, and the like but also preferred participation in assets in excess of preferred stock contributions.

<sup>95</sup> See *Starr v. Engineering Contracting Co.*, 149 Neb. 390, 31 N.W.2d 213 (1948).

<sup>96</sup> If the contract entitles the shareholder to payment of the liquidation price in cash, a property distribution can be attacked. *Hills, Consolidation of Corporations by Sale of Assets and Distribution of Shares*, 19 CALIF. L. REV. 349, 356 n.13; *BALLANTINE, CORPORATIONS* 681, 734 (rev. ed. 1946); *Craddock-Terry Co. v. Powell*, 181 Va. 417, 25 S.E.2d 363 (1943). This is the normal situation. If no medium is specified the question remains doubtful. See *Hills, supra*. Some statutes permit even compulsory distributions in kind, however. *E.g.*, CAL. CORP. CODE § 5005; see *BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS* 470 (ed. 1949).

If assets are not sufficient to pay the liquidation preference in full the stated priority of classes usually governs. Rarely is the distribution prorated so that the part of all classes is paid before the arrears on even the prior preferred. More in doubt from the standpoint of construction is priority in case of insufficient assets of series within a class. The articles may dispel all doubt by requiring strict pro-rating for all series of that class—in the ratio of the total amount due each, since the arrearage per series differs.<sup>97</sup> Some statutes provide for this pro-rating, as for dividend payments.<sup>98</sup> But without help from these two sources the warning previously given is again in point for those corporations whose local law might permit each series' statement of preferences to extend even to priority of payment.<sup>99</sup>

The most important issue in drafting or construing the articles' liquidation clause is its scope. What is a liquidation, dissolution or winding-up (the common phrase)? Against what corporate action does even a seemingly all-inclusive clause fail to provide protection? In the absence of contractual provision a transfer of one company's assets to another has been held not a liquidation,<sup>100</sup> but depending on the exact transaction the opposite result may be reached.<sup>101</sup> A merger or consolidation is not a liquidation or dissolution.<sup>102</sup> A mere suspension of business, because of physical plant or equipment destruction, for example, is no dissolution.<sup>103</sup> But a reduction

<sup>97</sup> *E.g.*, Certificate of Organization, American Cyanamid Company (1948).

<sup>98</sup> N. J. REV. STAT. § 14:8-2 (1937); N. Y. STOCK CORP. LAW § 11.

<sup>99</sup> See *Series and Ratability*, *supra*.

<sup>100</sup> *Buck v. Kleiber Motor Co.*, 97 F.2d 557, 98 F.2d 903 (9th Cir. 1938); see *Treat v. Hubbard-Elliott Copper Co.*, 4 Alaska 497 (1912) (court denied company power to sell all its assets to another, attempted under clause allowing company to "lease, exchange and dispose of stock"; laches prevented upset of the sale); *cf. Mills v. Penn-Lox Co.*, 36 N.E.2d 828 (Ohio 1940); *Powell v. Craddock-Terry Co.*, 175 Va. 146, 7 S.E.2d 143 (1940); *Levin v. Pittsburgh United Corp.*, 330 Pa. 457, 199 Atl. 332 (1938) (shareholder entitled to his share of corporate assets in case of sale of assets, consolidation or merger; company not liquidating but continuing, the dissenting shareholder held entitled to dividends accrued during the interim); compare *Farish v. Cieneguita Co.*, 12 Ariz. 235, 100 Pac. 781 (1909), with *Tanner v. Lindell Ry.*, 180 Mo. 1, 79 S.W. 155 (1904). See STEVENS, CORPORATIONS 571 (2d ed. 1949).

<sup>101</sup> A sale of assets may be called a dissolution. *Coler v. Tacoma Ry. & Power Co.*, 65 N.J. Eq. 347, 54 Atl. 413 (Ct. Err. & App. 1903); *Geiger v. Seeding Mach. Co.*, 124 Ohio St. 222, 177 N.E. 594 (1931); *cf. Craddock-Terry Co. v. Powell*, 181 Va. 417, 25 S.E.2d 363 (1943); *Graham v. New Mexico Eastern Gas Co.*, 141 S.W.2d 389 (Tex. Civ App. 1940).

<sup>102</sup> *Windhurst v. Central Leather Co.*, 105 N.J. Eq. 621, 149 Atl. 36 (Ch. 1930); *Anderson v. Cleveland-Cliffs Iron Co.*, 87 N.E.2d 384, 389 (Ohio App. 1940). *Contra: Petry v. Harwood Elec. Co.*, 280 Pa. 142, 124 Atl. 302 (1924), criticized, BALLANTINE, CORPORATIONS 688 (rev. ed. 1946). In *Garrett v. Reid-Cashion Land Co.*, 34 Ariz. 245, 270 Pac. 1044 (1928), and *Doe Run Lead Co. v. Maynard*, 283 Mo. 646, 223 S.W. 600 (1920), statutes regulating dissolution were held inapplicable to attempted consolidations.

Changing two classes of stock into one class is not a liquidation of either. *Bailey v. Tubize Rayon Corp.*, 56 F. Supp. 418 (D. Del. 1944).

<sup>103</sup> *Miller v. Audenried*, 67 N.J. Eq. 252, 57 Atl. 1076 (Ch. 1904).

of capital preparatory to an increase for a new issue has been held a partial liquidation, *i.e.*, its burden must fall on the common.<sup>104</sup>

Many of these results are obviated by, or written into, corporate articles. The liquidation preference by its terms covers liquidation, dissolution and winding-up, whether voluntary or not. Usually merger, consolidation and sale, and lease or any conveyance of assets are expressly excepted from the preference. These contractual terms control. Occasionally, however, the exception is not stated. The result is reliance on not entirely clear judicial rules which may find a liquidation preference applicable. Whatever the intent of the corporation, it cannot be deemed expressed by omission. The amounts payable on liquidation are always specified. If proceedings are involuntary the stock receives a par or stated figure plus the accrued dividends (or an equivalent thereof); if voluntary, that plus a premium,<sup>105</sup> either an arbitrary figure or the redemption (nonsinking fund) premium, usually on a declining sliding scale.

The dispute over the scope of "liquidation," the problem of reorganizations, has been fairly well settled by the courts. In a Chapter X (or § 77B) reorganization<sup>106</sup> the liquidation preference is used; concerning preferred stock, especially that not wholly carried through to the new company in its old form, the reorganization is a liquidation.<sup>107</sup> The dividend arrears and possibly the premium are part of the preferred's "value" which must be met under the absolute priority rule.<sup>108</sup> But in a proceeding under the "death sentence" clause of the Public Utility Holding Company Act (simplifications)<sup>109</sup> the voluntary or involuntary liquidation preference (and incidentally, the redemption clause) need not be used.<sup>110</sup> The absolute pri-

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<sup>104</sup> *Page v. Whittenton Mfg. Co.*, 211 Mass. 424, 97 N.E. 1006 (1912); *cf. Willson v. Laconia Car Co.*, 275 Mass. 435, 176 N.E. 182 (1931).

<sup>105</sup> A premium if par value is the first amount; if no par, the set figure includes any "premium" payable. See Stevens, *Stockholders Participation in Assets on Liquidation*, 10 J. BUS. U. OF CHI. 46 (1937).

<sup>106</sup> 11 U.S.C. §§ 501 ff (1946); 11 U.S.C. § 207 (1946).

<sup>107</sup> *Central States Elec. Corp. v. Austrian*, 183 F.2d 879 (4th Cir. 1950), *cert. denied*, 340 U.S. 917 (1951); *In re Portland Elec. Power Co.*, 162 F.2d 618 (9th Cir.), *cert. denied*, 332 U.S. 837 (1947).

<sup>108</sup> *In re Chicago, G.W.R. Co.*, 29 F.Supp. 149, 159 (N.D. Ill. 1939); *cf. In re Childs Company*, 69 F.Supp. 856 (S.D. N.Y. 1946); *In re Midland United Co.*, 58 F.Supp. 667, 671 (D. Del. 1944); *In re National Food Products Corp.*, 23 F.Supp. 979 (D. Md. 1938). See Note, 60 HARV. L. REV. 1343, 1344 (1947).

<sup>109</sup> 15 U.S.C. §§ 79k (Supp. 1951).

<sup>110</sup> *Otis & Co. v. Securities and Exchange Comm'n*, 323 U.S. 624 (1945); *In re Electric Bond & Share Co.*, 73 F.Supp. 426 (S.D. N.Y. 1946); see Dodd, 58 HARV. L. REV. 604 (1945); Dodd, *Preferred Shareholders' Rights—The Engineers Public Service Company Case*, 63 HARV. L. REV. 298 (1949); Billyou, *supra* note 3, criticizing the *Otis* case and the decision in *Securities and Exchange Comm'n v. Central-Illinois Securities Corp.*, 338 U.S. 96 (1949). Billyou notes that the common shareholders in *Central States Elec. Corp. v. Austrian*, 183 F.2d 879 (4th Cir. 1950), *cert. denied*, 340 U.S. 917 (1951), could under Virginia law abolish the pre-

ority principle as a rule of law would doubtless defeat any contractual attempt at expanding it,<sup>111</sup> and a bankruptcy court's determination of the effect of any transaction here is independent of statements by the company and shareholders as to what they wish that effect to be.<sup>112</sup> This is similar to a contractual provision (further to protect the preferred stock) that the preferred or a percentage of the class could, as agent of the company, petition it into bankruptcy or reorganization.<sup>113</sup> Still uncertain is the power to contract that a certain preference shall be effective upon simplification or reorganization. The Public Utility Holding Company Act's purpose would be stultified if shareholders could contract that the preferred should be entitled to its liquidation preference in case of any merger, consolidation, reorganization or simplification by internal operation or by statute.<sup>114</sup> But could not a certificate specify that in case of a statutory reorganization the liquidation preference should be limited, for instance, to the par value of the shares? No statutory policy is affected by such a provision, for the rule that dividend arrearages must be paid in a reorganization is based only upon the shareholders' contract—and the court's determination that a reorganization is a liquidation.

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ferred's accruals. He believes this to be a factor militating against full recognition of the preferred's arrearage, especially since the preferred could not forestall this alteration by petitioning the company into reorganization—for they lack this latter power. 65 HARV. L. REV. 93, at 98; see note 113 *infra*. In *Priority Rights of Security Holders in Bankruptcy Reorganization*, 67 HARV. L. REV. 553 (1954), Billyou effectively demolishes the supposed distinction between the c. X and § 11 treatments, showing that the first does not in fact exist. Since current worth governs actually in both, he argues against use of the liquidating value, and for the investment value approach here. Concerning these rights in statutory reorganizations generally, see Dodd, *The Relative Rights of Preferred and Common Shareholders in Reorganization Plans Under the Holding Company Act*, 57 HARV. L. REV. 295 (1944). See also Billyou, *Railroad Reorganization Under Section 20b of the Interstate Commerce Act*, 39 VA. L. REV. 459, 462-5, 481 (1953).

<sup>111</sup> That is, usurping the judicial function in providing that a reorganization shall be considered, say, a merger and not a liquidation. For an analogy, see the power of the court in these statutory proceedings to compel acceptance of liquidating distributions in kind. BALLANTINE, *CORPORATIONS* 734 (rev. ed. 1946) and authorities cited.

<sup>112</sup> *Price v. Gurney*, 324 U.S. 100 (1945).

<sup>113</sup> A shareholder cannot file an involuntary petition against the company though dividends have accumulated. *In re Pittsburgh Terminal Coal Co.*, 30 F. Supp. 106 (W.D. Pa. 1939), *aff'd without opinion*, 109 F.2d 1020 (3d Cir. 1940) and 130 F.2d 872 (3d Cir. 1942), *cert. denied*, 318 U.S. 761 (1943). See Note, 60 HARV. L. REV. 1343 (1947).

<sup>114</sup> 11 U.S.C. § 95(e)(2) (1946) forbids even a shareholder who is a creditor from joining in the filing of an involuntary petition against his company.

<sup>115</sup> Dodd, 58 HARV. L. REV. 604, 609, 610 (1945). Dodd put the solution upon "normal expectations of individuals" in this instance. But may not the policy of the statute supersede even that position?

<sup>116</sup> *Shafer v. Home Trading Co.*, 227 Mo. App. 347, 52 S.W.2d 462 (1932); *Currier v. Lebanon Slate Co.*, 56 N.H. 262 (1875); *Barton & Woodworth v. Port Jackson Co.*, 17 Barb. 397 (N.Y. 1854); *Verplanck v. Mercantile Ins. Co.*, 1 Edw. Ch. 84 (N.Y. 1831) (by statute); *Darnell-Love Lumber Co. v. Wiggs*, 144 Tenn. 113, 230 S.W. 391 (1921). See *Ellsworth v. Lyons*, 181 Fed. 55 (6th Cir. 1910); *Yukon Mill & Grain Co. v. Vose*, 201 Okla. 376, 206 P.2d 206 (1949).

## THE REDEMPTION PRIVILEGE

The power of a corporation to purchase its own stock, once the subject of some doubt,<sup>116</sup> is today recognized by the majority of jurisdictions.<sup>116</sup> Many statutes grant it,<sup>117</sup> some, at least by implication, forbidding its exercise in certain instances.<sup>118</sup> Many statutes also forbid reduction of capital except in specified ways.<sup>119</sup> Some courts recognize that the purchase of shares beyond an available surplus is invalid under these statutes,<sup>120</sup> but others—mistakenly—permit purchases, believing the statute inapplicable because no formal reduction of the capital stock has taken place.<sup>121</sup> When no statute is involved the same split is found concerning the “use” of capital to purchase shares.<sup>122</sup>

Courts today seldom void a contract to purchase shares. But the contract is subject to avoidance if at the time of payment or performance the company is insolvent,<sup>123</sup> the payment would harm creditors<sup>124</sup> or capital

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<sup>116</sup> *Harrison J. Barrett, trustee v. W. A. Webster Lumber Co.*, 275 Mass. 302, 175 N.E. 765 (1931); *Dupee v. Boston Water Power Co.*, 114 Mass. 37 (1873); *City Bank of Columbus v. Bruce & Fox*, 17 N.Y. 507 (1858); *Grigsby v. Ainsworth*, 13 Tenn. App. 372 (1930); *Turner v. Goetz*, 184 Wis. 508, 199 N.W. 155 (1924); *Marvin v. Anderson*, 111 Wis. 387, 87 N.W. 226 (1901); *San Antonio Hardware Co. v. Sanger*, 151 S.W. 1104 (Tex. Civ. App. 1912); see *Schneider v. Mingenback*, 139 F.2d 86 (10th Cir. 1943); *Mannington v. Hocking Valley Ry.*, 183 Fed. 133 (S.D. Ohio 1910); *Fayette Realty & Finance Co. v. Commonwealth*, 229 Ky. 556, 17 S.W.2d 722 (1929); *Cohn v. Schultz-Costlow Co.*, 229 App. Div. 174, 241 N.Y. Supp. 250 (1st Dep't 1930). See generally, BALLANTINE, *CORPORATIONS* 603 (rev. ed. 1946); STEVENS, *CORPORATIONS*, 275-286 (2d ed. 1949); Wormser, *The Power of a Corporation to Acquire Its Own Stock*, 24 YALE L.J. 177 (1915); Dodd, *Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law*, 89 U. OF PA. L. REV. 697 (1941).

<sup>117</sup> CAL. CORP. CODE § 1100; DEL. GEN. CORP. LAW § 151 (and see § 243) (1953); MD. ANN. CODE GEN. LAWS art. 23, § 14(5) (1951) (at company's or holder's option); N. J. REV. STAT. § 14:8-3 (1937); N. Y. STOCK CORP. LAW §§ 11, 35; PA. STAT. tit. 15, § 151 (1936); OHIO CODE ANN. § 8623-4 (Supp. 1952) (at company's or holder's option). See BALLANTINE, *CORPORATIONS* 610 (rev. ed. 1946).

<sup>118</sup> E.g., CAL. CORP. CODE § 1706.

<sup>119</sup> CAL. CORP. CODE §§ 1904, 1905; DEL. GEN. CORP. LAW § 244 (1953); cf. *Uffelman v. Boillin*, 19 Tenn. App. 1, 29, 82 S.W.2d 545, 562, 563 (1935).

<sup>120</sup> Since the capital is then impaired. *Botz v. Helvering*, 134 F.2d 538 (8th Cir. 1943); *Tapscott v. Mexican Colorado River Land Co.*, 153 Cal. 664, 96 Pac. 271 (1908); *McGill Co. v. Underwood*, 161 App. Div. 30, 146 N.Y. Supp. 362 (3d Dep't 1914); *Koni v. Cody Detective Agency*, 76 Wash. 540, 136 Pac. 1155 (1913); see *Porter v. Plymouth Gold Min. Co.*, 29 Mont. 347, 74 Pac. 938 (1904); *Uffelman v. Boillin*, 19 Tenn. App. 11, 82 S.W.2d 545 (1935); *Farmers Union Co-op Gin Co. v. Taylor*, 197 Okla. 495, 172 P.2d 775 (1946) (general corporation laws in this respect held inapplicable to cooperatives).

<sup>121</sup> *Dupee v. Boston Water Power Co.*, 114 Mass. 37 (1873); *San Antonio Hardware Co. v. Sanger*, 151 S.W. 1104 (Tex. 1912); see *In re Culbertson's*, 54 F.2d 753 (9th Cir. 1932). See BALLANTINE, *CORPORATIONS* 607 (rev. ed. 1946).

<sup>122</sup> See notes 115 and 116 *supra*; *Reagan Bale Co. v. Heuermann*, 149 S.W. 228 (Tex. 1912).

<sup>123</sup> This is the “Massachusetts rule”; see BALLANTINE, *CORPORATIONS* 607 (rev. ed. 1946). *Scriggins v. Thomas Dalby Co.*, 290 Mass. 414, 195 N.E. 749 (1935); *Dupee v. Boston Water Power Co.*, 114 Mass. 37 (1873); *Campbell v. Grant Trust & Sav. Co.*, 97 Ind. App. 169, 182 N.E. 267 (1932); *McIntyre v. Beiment's Sons*, 146 Mich. 74, 109 N.W. 45 (1906); *San Antonio*

would be impaired,<sup>125</sup> depending on the substantive rules of purchase applicable locally.<sup>126</sup> If at that time one of these limitations is violated, the contract is unenforceable.<sup>127</sup> These doctrines apply to contracts to redeem as well as to contracts of purchase.<sup>128</sup> The former are but a form of the latter, except where statutory treatment purposely differs.<sup>129</sup> Though stock is issued "redeemable on 1/1/1950" and "matures" on that date, it is not then a debt enforceable against outside creditors.<sup>130</sup> If can only claim a relative priority over other shareholders. As to them, however, the obligation may be enforced though a receivership results and the company is wound up, for the shareholders have so contracted.<sup>131</sup> Thus, a contract of compulsory redemption is interpreted to require redemption "if the company is not insolvent or will not thereby become insolvent" (or harm creditors or impair capital).<sup>132</sup>

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Hardware Co. v. Sanger, 151 S.W. 1104 (Tex. Civ. App. 1912); see Booth v. Union Fibre Co., 142 Minn. 127, 171 N.W. 307 (1919); Black v. Hobart Trust Co., 64 N.J. Eq. 415, 53 Atl. 826 (Ch. 1902); Weaver Power Co. v. Elk Mountain Mill Co., 154 N.C. 76, 69 S.E. 747 (1910).

<sup>124</sup> Guaranty Trust Co. v. Galveston City Ry., 107 Fed. 311 (5th Cir. 1901); Gunther Grocery Co. v. Hazel, 179 Ky. 775, 201 S.W. 336 (1918); 1st Nat. Bank of Boyne City v. Heller Sawdust Co., 240 Mich. 688, 216 N.W. 464 (1927); Koepler v. Crocker Chair Co., 200 Wis. 476, 228 N.W. 130 (1929); see Westerfield-Bonte Co. v. Burnett, 176 Ky. 188, 195 S.W. 477 (1917).

<sup>125</sup> Consolidated Music Co. v. Brinkerhoff Piano Co., 64 F.2d 884 (10th Cir. 1933); Hazel Atlas Glass Co. v. Van Dyk & Reeves, Inc., 8 F.2d 716 (2d Cir.), *cert. denied*, 269 U.S. 570 (1925); Moseley v. Briggs Realty Co., 320 Mass. 278, 69 N.E.2d 7 (1946); see Schulte v. Boulevard Gardens Land Co., 164 Cal. 464, 129 Pac. 582 (1913); Hurley v. Boston Ry. Holding Co., 315 Mass. 591, 54 N.E.2d 183 (1944).

<sup>126</sup> A distinction may be drawn between redemption and redemption at a price including accrued dividends. The first, at par, may be permitted even from capital if creditors are not injured, while accruals would be paid only if a surplus existed. Cring v. Sheller Wood Rim Mfg. Co., 98 Ind. App. 310, 183 N.E. 674 (1932).

<sup>127</sup> Duddy-Robinson Co. v. Taylor, 137 Wash. 304, 242 Pac. 21 (1926); see notes 123-125 *supra*.

<sup>128</sup> See, e.g., Hazel Atlas Glass Co. v. Van Dyk & Reeves, Inc., 8 F.2d 716 (2d Cir.), *cert. denied*, 269 U.S. 570 (1925); Campbell v. Grant Trust & Sav. Co., 97 Ind. App. 169, 182 N.E. 267 (1932); Sutton v. Globe Knitting Works, 276 Mich. 200, 267 N.W. 815 (1936); Koepler v. Crocker Chair Co., 200 Wis. 476, 228 N.W. 130 (1929); BALLANTINE, CORPORATIONS 510 (rev. ed. 1946); STEVENS, CORPORATIONS 283 (2d ed. 1949).

<sup>129</sup> Compare, e.g., CAL. CORP. CODE § 1705 with § 1706(c).

<sup>130</sup> Vanden Bosch v. Michigan Trust Co., 35 F.2d 643 (6th Cir. 1929); Mathews v. Bradford, 70 F.2d 77 (6th Cir. 1934); *In re Greenbaum Bros. & Co.*, 62 F. Supp. 769 (E.D. Pa. 1945); Allied Magnet Wire Co. v. Tuttle, 199 Ind. 166, 154 N.E. 480 (1926); Booth v. Union Fibre Co., 142 Minn. 127, 171 N.W. 307 (1919); Warren v. Queen & Co., 240 Pa. 154, 87 Atl. 595 (1913). In *Allied Magnet*, "if dividends not paid for 90 days after due, redeemable at holder's option" was construed as limited by "dividends to be paid out of earnings only," so that if there were no earnings, the failure to pay dividends did not activate the redemption clause.

<sup>131</sup> Westerfield-Bonte Co. v. Burnett, 176 Ky. 188, 195 S.W. 477 (1917); cf. Ammon v. Cushman Motor Works, 128 Neb. 357, 258 N.W. 649 (1935); see BALLANTINE, CORPORATIONS 511 (rev. ed. 1946).

<sup>132</sup> Hamilton v. Meiks, 210 Ind. 610, 4 N.E.2d 536 (1936); Mueller v. Kraeuter & Co., 131 N.J. Eq. 475, 25 A.2d 874 (Ch. 1942); cases cited at note 130 *supra*.

Most articles give the corporation power to repurchase and redeem stock at its option. Specific features of redemption of a particular class of stock are usually detailed by the board of directors in the certificate of preferences (under delegation of authority from articles and statute). The company is usually given the right to redeem all or part of the particular stock at its option. Compulsory redemption clauses are seldom used today except for sinking fund purposes. Some statutes forbid such clauses since they make possible a potential fraud on creditors and other shareholders.<sup>133</sup> Compulsory redemption in any event is somewhat anomalous to the nature of preferred stock.

The option to redeem preferred shares . . . is not a preference for the benefit of the shareholders, but a . . . safeguard to enable the corporation to retire an obligation or a claim on the earnings, usually at a premium, when it becomes advisable for purposes of corporate financing.<sup>134</sup>

Rarely does a corporation fail to express in its articles that redemption shall be in the board of directors' discretion. The contract may, however, fail to specify how redemption is to be accomplished, simply calling certain stock "redeemable." If so, redemption is probably at the company's option.<sup>135</sup> Again, today's articles require redemption at a given figure plus accrued dividends. Though there is a type of inchoate right to the latter by virtue of corporate membership,<sup>136</sup> a contractual provision denying accruals at liquidation or at redemption is apparently valid.<sup>137</sup> Most articles, too, permit total or partial redemption. The latter is obviously open to abuse, for the company, by redeeming insiders' stock before any decline, can enable these persons to pull out of the company before a storm, leaving less favored shareholders in a relatively worse position.<sup>138</sup> To avoid this, most

<sup>133</sup> CAL. CORP. CODE § 1101 (except by a sinking fund out of earnings only); BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 201 ff (ed. 1949).

<sup>134</sup> BALLANTINE, CORPORATIONS 509 (rev. ed. 1946).

<sup>135</sup> Fox v. Johnson & Wimsatt, Inc., 127 F.2d 729 (D.C. Cir. 1942). But a clause like "redeemable at par and accruals at any dividend date from 1916 to 1936" has been held to require redemption. Affeldt v. Dudley Paper Co., 306 Mich. 39, 10 N.W.2d 299 (1943); cf. Star Pub. Co. v. Ball, 192 Ind. 158, 134 N.E. 285 (1922).

<sup>136</sup> Hill v. Partridge Co-operative Equity Exchange, 168 Kan. 506, 214 P.2d 316 (1950); General Inv. Co. v. American Hide & Leather Co., 98 N.J. Eq. 326, 129 Atl. 244 (Ct. Err. & App. 1925); see Affeldt v. Dudley Paper Co., note 135 *supra*.

<sup>137</sup> Williams v. Renshaw, 220 App. Div. 39, 220 N.Y. Supp. 532 (3d Dep't 1927). But see Affeldt v. Dudley Paper Co., 306 Mich. 39, 10 N.W.2d 299 (1943). The shareholder's right to the dividend arrearage in this situation has been questioned. See Liebschutz v. Schaffer Stores, 279 App. Div. 96, 103 N.Y.S.2d 476 (3d Dep't 1951).

<sup>138</sup> Compulsory redemption as a matter of law may have to be "proportionate." Crimmins Peirce Co. v. Kidder Peabody Acceptance Corp., 282 Mass. 367, 185 N.E. 383 (1933); General Inv. Co. v. American Hide & Leather Co., 98 N.J. Eq. 326, 129 Atl. 244 (Ct. Err. & App. 1925); cf. Currier v. Lebanon Slate Co., 56 N.H. 262 (1875); Downs v. Jersey Cent. Power & Light Co., 115 N.J. Eq. 448, 171 Atl. 306 (Ch. 1934); Berger v. United States Steel Corp., 63 N.J. Eq. 809, 53 Atl. 68 (Ct. Err. & App. 1902); see Niagara Shoe Co. v. Tobey, 71 Ill. App. 250 (1896). Accrued dividends may be included though the certificate is silent. Affeldt v. Dudley Paper Co., 306 Mich. 39, 10 N.W.2d 299 (1943).

articles provide that selection of shares for a partial redemption be made "by lot, or pro rata." Certainly this provision is desirable; yet some articles say "by lot, pro rata or as the board of directors decides," or simply the latter. These are nothing more than loopholes. In the latter case a court might hold that the intent of the total redemption provision called for an objective selection; in the first instance discrimination would seem to result. In any event, the possibility of judicial leniency does not justify such phrasing.<sup>139</sup>

### *Source of Funds for Redemption*

Many statutes permit the use of stated capital, as well as surplus, for redemption—possibly as an exception to normal rules regarding purchase of stock.<sup>140</sup> The point made in discussing dividends applies here. Unless the corporation for some real or imagined business reason wishes to limit the source from which redemption is possible, its articles should specify, as do most modern certificates, that redemption payments may be made "from any legally available source or fund." A carelessly self-imposed restriction against use of capital is an even greater limit here than in the case of dividends, for here it removes a source, whereas capital is not usually available for dividends in any event.

### *Redemption with Dividends Accrued*

The redemption price, as stated, customarily includes accrued dividends. Thus compulsory redemption would not deprive a shareholder of his accrual, but would leave him in a position similar to that found upon liquidation.<sup>141</sup> If there is no surplus then redemption at a price including arrearages permits partial liquidation of some of a single class of stock.<sup>142</sup> In states that permit this practice,<sup>143</sup> and everywhere if a surplus exists,

<sup>139</sup> State *ex rel.* Waldman v. Miller-Wohl Co., 3 Terry 73, 28 A.2d 148 (Super. Ct. Del. 1942) (dictum that if there were no provision but "the company may redeem," discriminatory selection would be valid).

<sup>140</sup> CAL. CORP. CODE § 1706; DEL. GEN. CORP. LAW § 243 (1953) (limiting capital reduction permitted); MD. CODE ANN. GEN. LAWS art. 23, § 28(b)(1) (1951) (limiting consideration payable to such stock); N. J. REV. STAT. § 14:8-3 (1937); OHIO ANN. CODE § 8623-39 and 41 (Supp. 1952).

<sup>141</sup> Barring one probability and one possibility. First, amendment of the articles eliminating these rights; second, an unlikely (and unsound) use of the *Liebschutz v. Schaffer Stores*, 279 App. Div. 96, 108 N.Y.S.2d 476 (3d Dep't 1951), reasoning; and see *In re McKinney*, 306 N.Y. 207, 117 N.E.2d 256 (1954). If retirement, by contract, is at par and arrearages, it has been held that the same must be given shares cancelled pursuant to a capital stock reduction. *Kennedy v. Carolina Pub. Serv. Co.*, 262 Fed. 803 (N.D. Ga. 1920).

<sup>142</sup> See *Crimmins & Peirce Co. v. Kidder Peabody Acceptance Corp.*, 282 Mass. 367, 185 N.E. 383 (1933).

Some statutes, however, allow only payment for stock representing capital to be charged against capital. DEL. GEN. CORP. LAW § 243 (1953); N. J. REV. STAT. § 14:8-3 (1937); *cf.* note 140 *supra*.

<sup>143</sup> As in California (CORP. CODE § 1706) and perhaps Maryland, (CODE ANN. GEN. LAWS art. 23, § 28(b)(3) (1951); *cf.* note 140 *supra*).



shareholders must depend on the contractual phrasing for complete protection if that is desired, or for an exact statement of the practices permitted.

Many articles forbid redemption of less than all stock of a class if dividends are in arrears, or permit it only if the remaining stock of that class consents thereto, usually by a two-thirds vote.<sup>144</sup> Total redemption of an issue is nearly always allowed. Discrimination between equal shares of stock is prevented, but the junior stock's right to corporate assets is not assured.<sup>145</sup> Forbidding any partial redemption in the absence of surplus when dividends have accrued is a stringent sanction. Yet if a substantial surplus exists equal distribution thereof might be justified.<sup>146</sup> Any later partial redemption could be out of capital alone (without any arrearages to be paid off, perhaps). The possibility of abuse is magnified if the board of directors may choose for redemption any stock they wish.

More important to guard against, if thought desirable, but rarely even recognized in the articles is a company's practice of purchasing, on the open market and thus without paying dividend arrearages, stock on which dividends have accrued. Voluntary redemption or purchase is of course permissible without payment of arrears since the holders themselves offer the stock at that price.<sup>147</sup> The effect on other shareholders and on market prices of this practice, especially if systematically and purposely carried out, has been decried by legal writers.<sup>148</sup> They have discussed the possibility of checking abuse by a selling shareholder's suit based on breach of a fiduciary duty to disclose to the seller the company's method of passing dividends and depressing prices.<sup>149</sup> It has also been proposed that underwriters

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<sup>144</sup> *E.g.*, Certificate of Incorporation, Bigelow-Sanford Carpet Company, Inc. 1951).

<sup>145</sup> The application of this provision to sinking funds, and redemptions made through their use, is discussed at note 176 *infra*.

<sup>146</sup> Similarly, see suggestion of BALLANTINE, CORPORATIONS 621, n.74 (rev. ed. 1946); *King Mach. Co. v. Caporaso*, 2 N.J. Super. 230, 63 A.2d 270 (1949).

<sup>147</sup> See *Downs v. Jersey Cent. Power & Light Co.*, 115 N.J. Eq. 448, 171 Atl. 306 (Ch. 1934).

<sup>148</sup> Note, 14 U. OF CHI. L. REV. 66 (1946).

<sup>149</sup> *Id.* at 71. A similar action has been sustained where redemption of some stock just preceded liquidation of the company at a much higher payment per share. *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); *but compare Geller v. Transamerica Corp.*, 53 F. Supp. 625 (D. Del. 1943), *aff'd*, 151 F.2d 534 (3d Cir. 1945). See *Mount v. Seagrave Corp.*, 112 F. Supp. 330 (S.D. Ohio 1953).

A remedy under Regulation X-10B-5 of the Securities and Exchange Act of 1934 has also been suggested. 15 U.S.C. § 78j (1939); 17 CODE FED. REG. § 240.10b-5 (1947); Notes, 14 U. OF CHI. L. REV. 66, 72 (1946), 59 YALE L.J. 1120 (1950). See also Latty, *The Aggrieved Buyer or Seller or Holder of Shares*, 18 LAW & CONTEMP. PROB. 505 (1953).

An attack on an otherwise valid purchase because liquidation would give the shareholder a better price was dismissed in *Graham-Newman Corp. v. Franklin County Distilling Co.*, 26 Del. Ch. 233, 27 A.2d 142 (Ch. 1942). But the redemption process cannot be unilaterally waived by the company in order to liquidate the stock before a requested redemption becomes effective. *People ex rel. Colby v. Imbrie & Co.*, 126 Misc. 457, 214 N.Y. Supp. 53 (Sup. Ct. 1926), *aff'd without opinion*, 216 App. Div. 713, 214 N.Y. Supp. 819 (1st Dep't 1926). *But see Liebschutz v. Schaffer Stores*, 279 App. Div. 96, 108 N.Y.S.2d 476 (3d Dep't 1951).

insist on contractual provisions against purchase of stock while dividends are in arrears.<sup>150</sup> Such a blanket sanction, however, cannot be justified when purchase of stock is a company's statutory right and good extrinsic business reasons exist therefor. Yet some protection against abuse of the power to purchase stock is important. A few companies have tried a balance and provide that while dividends are in arrears the company or subsidiaries shall not buy preferred stock except pursuant to offers made in writing or by publication to all preferred shareholders, on such terms as the board of directors, after considering the respective arrears, rates and other relative rights and preferences of each series, decides will afford fair treatment among the series.<sup>151</sup> As complete protection against a potential abuse this is not entirely satisfactory. The "fair price" set in the board of directors' discretion still gives the company a chance to avoid full payment of dividend arrearages. Nevertheless, in seeming to forbid purchases on the open market during arrearage periods, this clause is an effective preventive of the noted abuses. It may be too harsh in preventing—if it does—open purchases entirely, but a lesser sanction still avoiding abuse is difficult to create.

### *The Sinking Fund*

A sinking fund provides for the periodic retirement of preferred stock, as distinguished from stock that merely may be repurchased.

The benefits of a sinking fund are of a twofold nature. The continuous reduction in the size of the issue makes for increasing safety and the easier repayment of the balance at maturity. Also important is the support given to the market for the issue through the repeated appearance of a substantial buying demand.<sup>152</sup>

This continuous reduction is not a certainty; as well be seen, the shares are not always retired. But if reduced, the progressively fewer remaining shareholders are somewhat more sure of dividend payments. Under the usual sinking fund contract, the corporation regularly reduces its dividend obligations and thus gains flexibility for planning future financing. Conflicting rights will thus arise which require strict compliance with sinking funds' terms and which indirectly encourage exact phrasing of each provision.<sup>153</sup>

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Once it is announced that certain stock has been called for redemption, it is binding, analogous to dividend declarations. *Taylor v. Axton-Fisher Tobacco Co.*, 295 Ky. 226, 173 S.W.2d 377 (1943).

<sup>150</sup> Note, 14 U. OF CHI. L. REV. 66, 74 (1946).

<sup>151</sup> E.g., Certificate of Incorporation, Bigelow-Sanford Carpet Company, Inc. (1951).

<sup>152</sup> GRAHAM & DODD, SECURITY ANALYSIS 308 (3d ed. 1951). See Loomis, *supra* note 29, at 14; I DEWING, FINANCIAL POLICY OF CORPORATIONS 263 (4th ed. 1941).

<sup>153</sup> See *Daniels v. Indiana Trust Co.*, 222 Ind. 36, 51 N.E.2d 838 (1943); *Thompson v. Fairleigh*, 300 Ky. 144, 187 S.W.2d 812 (1945); *Ashley v. Keith Oil Corp.*, 73 F.Supp. 37 (D. Mass. 1947); *Leezer v. Fluhart*, 105 Wash. 618, 178 Pac. 817 (1919). Compare *Whitridge v. Mt. Vernon Woodberry Cotton Duck Co.*, 210 Fed. 302 (D. Md. 1913); *California Gas and*

The first important contractual provision concerns the source of sinking fund payments. What net worth accounts may be charged with the periodic creation of the reserve? A sinking fund redemption is a purchase and the use of capital accounts might therefore be permitted. Several statutes so provide.<sup>154</sup> But *compulsory* sinking fund redemption or purchases upon selection by the company result in discrimination, though permissible, between equal shares of stock. If sinking fund reserves are charged against capital and the redeemed shares are fully paid though no earnings exist, the remaining stock's value and its chances to be similarly redeemed in the future are lessened. A sinking fund provision understood as above probably did not contemplate such further discrimination. Therefore a more limited use of these funds is recognized by some statutes. The California statute, *e.g.*, permits compulsory redemption through use of sinking funds only to the extent of the company's net earnings for any year or years.<sup>155</sup> Elsewhere, if the articles allow the fund to be charged against "any sources legally available," the discrimination described may result, depending upon the applicable statute. Therefore a better reading might be "any surplus funds available," permitting use of paid-in and other contribution surplus. Most articles do permit the use of any source legally available. In fact, however, the priority of dividends over sinking fund payments and the usual restrictions on purchases if dividends accrue lessen the possibility of charging the sinking fund reserve to capital.

The sinking funds themselves are basically of two types and often a corporation uses both.<sup>156</sup> In one, enough funds are set aside annually or at each given date to redeem a given percentage of stock, as of the date on which the sinking fund obligation to redeem begins, which most articles set a considerable time after the stock issue. In the other type the amount is more directly calculated at a particular percentage of annual income or at part of the excess of income over a specified amount, or variants thereof. The latter is necessary where financial restrictions, as on the payment of dividends, are created elsewhere in the articles. This type of fund is not

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Elec. Co. v. Union Trust Co., 178 Cal. 65, 172 Pac. 146 (1918); *Weinman v. Blake & Knowles Steam Pump Works*, 156 App. Div. 168, 140 N.Y. Supp. 1085 (1st Dep't 1913), *aff'd without opinion*, 214 N.Y. 702, 108 N.E. 1110 (1915).

<sup>154</sup> See DEL. GEN. CORP. LAW §§ 243 and 244 (1953); MD. ANN. CODE GEN. LAWS art. 23, §§ 28(b)(1) and (b)(2) (1951); N. Y. STOCK CORP. LAW § 28 (Supp. 1953); OHIO CODE ANN. § 8623-4(4) (b) (Supp. 1952).

<sup>155</sup> CAL. CORP. CODE § 1101 (1951) (*compare* § 1706); see N. J. REV. STAT. § 14:8-21 (1937). For a construction that this still permits charging the reserve to capital—to the amount of net earnings—see BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 202-203 (ed. 1949).

<sup>156</sup> See the sinking fund provisions digested in SPENCER-TRASK, PREFERRED STOCKS, INDUSTRIAL AND PUBLIC UTILITY ISSUES (5th ed. 1951). Generally, see Jones, *Redeemable Corporate Securities*, 5 So. CALIF. L. REV. 83, 93 (1931).

affected by statutory or contractual restrictions on the source of the reserve; it is net income.

Some states permit nimble dividends from the net profits of a preceding accounting period despite a deficit.<sup>157</sup> In those states corporate articles may so define these financial terms as to make these profits available for sinking fund purposes.<sup>158</sup> It may be that a California corporation, for instance, could pay dividends out of net earnings and then charge further sinking fund payments—up to the amount of these earnings—against the already impaired capital. In fairness to remaining shareholders, however, redemption in this situation is not warranted and should be explicitly forbidden. An important similar problem is met by a direction to cumulate any deficits. If the fund is to be made up of x% of net income (before or after dividends) without a minimum absolute figure, fund payments may become irregular, ceasing in bad years and only partially made up in good ones. Unless the deficits accumulate a sinking fund arrearage much like a dividend arrearage is then created.

The board of directors must without discretion reserve enough money to redeem the stated amount of stock.<sup>159</sup> The payment cannot be enforced, however, if earnings do not exist, or if existing earnings are sufficient only for dividends on the preferred,<sup>160</sup> or if there is a dividend arrearage. Payments *into* the sinking fund, not merely purchases by the fund, should be forbidden if dividends cumulate; otherwise these payments may have to be continued. Since dividends are phrased in "discretionary" and sinking funds in "mandatory" language, the latter might be entitled to priority; the need for declaring the contrary priority is therefore obvious.

The absence of earnings may relieve the company of its purchase obligations, for while it is not the usual practice, sinking funds are often made cumulative only if earned. A certain degree of indirect policy conflict arises here, but as long as distributions to junior stock are definitely subordinate

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<sup>157</sup> CAL. CORP. CODE § 1500(B); DEL. GEN. CORP. LAW § 170 (1953).

<sup>158</sup> See note 155 *supra*.

<sup>159</sup> A transfer of funds may apparently be compelled. *Cf. McKay v. Rochester & Lake Ontario Water Serv. Corp.*, 247 App. Div. 499, 286 N.Y. Supp. 801 (4th Dep't 1936), *aff'd*, 272 N.Y. 528, 4 N.E.2d 432 (1936).

<sup>160</sup> See *Peterson v. New England Furniture & Carpet Co.*, 210 Minn. 449, 299 N.W. 208 (1941); *Wainwright Trust Co. v. Murat Temple Ass'n*, 212 Ind. 475, 9 N.E.2d 91 (1937). But see *Nothiger v. Coroon & Reynolds Corp.*, 179 Misc. 721, 40 N.Y.S.2d 191 (Sup. Ct. 1943), *rev'd on other grounds*, 266 App. Div. 299, 42 N.Y.S.2d 103 (1st Dep't 1943), *aff'd mem.*, 293 N.Y. 682, 56 N.E.2d 296 (1944). A provision in this sinking fund clause called for payments to the fund annually out of surplus or net profits. Another section forbade the purchase or redemption of stock while dividends were in arrears. It was held this was not passed on by the appellate courts) that payments to the fund would have to continue during dividend arrearages, though they would merely accumulate. For the importance of careful drafting in such cases, see also BALLANTINE, LATTIN & JENNINGS, *CASES AND MATERIALS ON CORPORATIONS* (1953), especially c. X, "Planning the Preferred Share Contract."

to the sinking fund obligation no detriment to preferred stock appears. Rather, detriment depends on the importance attached to the sinking fund's function. If its existence is thought important for financial or market reasons it should perhaps be entirely cumulative. Otherwise money which because of prior years' deficits should now be available to the preferred shareholders may be distributed to the common stock. Consequently, most articles today make this type of fund fully cumulative.

What is a shareholder's status under such a sinking fund? It was said that he may compel payment into the fund if earnings therefor exist; this should be qualified slightly. The conventional contract makes payments mandatory, and a shareholder may enforce that provision. If the articles merely require that enough funds be set apart regularly to redeem a given percentage of outstanding stock, the statutory and decisional rules discussed previously would apply. Payment would be limited to prevent harm to creditors.<sup>161</sup> The right to compel sinking fund payments may by specific terms be further restricted by the articles though they seem to make the fund obligation mandatory. A more practical protection would give preferred shares some voting control upon default in sinking fund payments, as is universally the case when dividends are passed,<sup>162</sup> but this provision is rarely found today.

It is not here but in the provisions for exact performance of the sinking fund obligations that the possibilities of illusory expectations lie. The most obvious chance of abuse, though least important in practice, is in selection of the stock to be redeemed. Arbitrary choice<sup>163</sup> is to be condemned for letting favorites bail out in bad times.<sup>164</sup> Most articles provide nondiscriminatory treatment. A few do not regulate the method of selection in the sinking fund clause but have a "pro rata" proviso in the redemption instrument.<sup>165</sup> While a court might incorporate the latter into sinking fund clauses, or possibly find equal treatment required in absence of a proviso for unequal selection, the clause should be repeated in the sinking fund provision to avoid any chance of dispute.<sup>166</sup>

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<sup>161</sup> *THE REDEMPTION PRIVILEGE, supra*. Suit was therefore permitted in *Ammon v. Cushman Motor Works*, 128 Neb. 357, 258 N.W. 649 (1935), and denied in *Miller v. Smith Building Co.*, 118 Neb. 5, 223 N.W. 277 (1929). See *Borst v. East Coast Shipyards, Inc.*, 105 N.Y.S.2d 228 (Sup. Ct. 1951).

<sup>162</sup> See the contractual provisions at issue in *Vogtman v. Merchants Mortgage & Credit Co.*, 20 Del. Ch. 364, 178 Atl. 99 (Ch. 1935).

<sup>163</sup> The previous discussion of this objectionable provision applies. See text at note 138 *supra*.

<sup>164</sup> See *Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, 8 N.E.2d 895 (1937); *Stieglitz v. Electrol*, 60 N.Y.S.2d 490 (Sup. Ct. 1945).

<sup>165</sup> See *State ex rel. Waldman v. Miller-Wohl Co.*, 3 Terry 73, 28 A.2d 148 (Sup. Ct. Del. 1942).

<sup>166</sup> If enough money is to be paid to redeem a given percentage of stock issued at a given date, a corporation could lessen the fund's usefulness by later issuing more stock. The articles

Abuses may also occur through use of the "alternative purchase" method. Nearly all articles empower the company to purchase shares at or below the redemption price and credit these shares against its sinking fund obligation at the sinking fund redemption price.<sup>167</sup> If these purchases are restricted to public offers, *i.e.*, purchases on the stock exchange, little chance of abuse arises. Dangerous, however, is the provision that the purchase, in lieu of sinking fund redemption, may be by the company's private and select offer to buy. Here a discrimination specifically disapproved in the normal redemption section returns. An offer to repurchase (even at prices below the sinking fund redemption price) may be an unfair gain to a few favored shareholders.<sup>168</sup> The "discretionary" phrase used in many articles, that purchase shall be "at the best price obtainable, considering the amount purchased," will not prevent this abuse. It may indeed add one of its own, for the phrase "considering the amount purchased" can easily be construed to permit a repurchase at prices higher than the market price, up to the sinking fund redemption price. This results in a direct evasion of the "non-discriminatory selection" requirement without even the benefit to the company of cheapness.

The limitations on the corporate power to purchase shares if endangering solvency are not clear. California, for instance, permits the purchase of stock out of capital if "to redeem or purchase shares subject to redemption."<sup>169</sup> Though no judicial authority exists pro or con, it can be argued that a *private purchase* of stock out of capital in the described circumstances would be legal. The only restriction then would prevent harming creditors or reducing corporate assets below the remaining preferred's liquidation preference.<sup>170</sup> It is obvious that an important function of a sinking fund redemption now is to let a company reduce its capital structure at opportune times without sharing proportionate amounts of earned surplus with the "retired" shareholders. This benefit to the company when it purchases, *e.g.*, from the stock exchange, is further heightened by the customary provision that it may then credit these purchases against the sinking fund obligation not at purchase but at sinking fund redemption prices. Another common provision allows a company which has bought in

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should set the percentage at "the greatest number of shares (or the aggregate par, or stated capital, value) outstanding any time after x date," to cover subsequent issues. *New York Trust Co. v. Portland Ry.*, 197 App. Div. 422, 189 N.Y. Supp. 346 (1st Dep't 1921).

<sup>167</sup> But *cf.* note 172 *infra*.

<sup>168</sup> See *Martin v. American Potash & Chemical Corp.*, 92 A.2d 295 (Del. Sup. Ct. 1952), 41 GEO. L.J. 255 (1953), allowing a private purchase of stock per DEL. GEN. CORP. LAW § 244 (old § 28) (1953). Fairness, said the court, is a matter to be determined for each case alone.

<sup>169</sup> CAL. CORP. CODE § 1706(c); see BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 203 (ed. 1949).

<sup>170</sup> CAL. CORP. CODE § 1708, allowing the use of reduction surplus with certain safeguards. See also § 1907.

one year more stock than it needs to satisfy that year's fund obligation to credit the excess against succeeding years' obligations. Payments to the sinking fund at that time are thus escaped.

Sinking fund payments are usually prohibited if dividends are unpaid because purchases at depressed prices while dividends are in arrears would be especially discriminatory. This practice is forbidden by nearly all articles today. The variations in phrasing are unimportant as long as the prohibition clearly applies to all ways and methods by which the company could, in satisfaction of its sinking fund obligation, purchase stock. The only exception is the insignificant one that money already in the sinking fund (legitimately paid) may be used for redemption or alternative purchases. But since the sinking fund is not used to create a reserve for the wholesale redemption of an issue,<sup>171</sup> its only justification is the support which its periodic purchasing demands give the stock market. It is not an effective mechanism to carry out a systematic redemption.

There are other ways in which the phrasing of these clauses could dilute the sinking fund's apparent usefulness. Impending redemption normally spurs the shareholder into exercising any existing conversion privilege, providing the exchange benefits him. Usually the sinking fund obligation may be satisfied with these converted shares to the extent of the annual (or periodic) requirement and at the call price.<sup>172</sup> If more shares are converted than are needed the excess may be credited against future sinking fund obligations. An important problem, therefore, concerns survival of the conversion privilege. Since the articles allow redemption their silence permits the construction that the conversion privilege ends when the redemption price is deposited for the use of these shares.<sup>173</sup> The spread between the market value of preferred and common to that date may not have been enough to induce conversion, whereas the imminence of redemption may be just enough additional incentive. Hence, a period of grace should be given shareholders to enable them to exercise this privilege before actual redemption.

It occasionally happens that at the time a dividend is passed a company has already made a periodic payment to the fund. Most articles allow this money to be used for redemption. An existing balance is thus freed from the contingent dividend "obligation." In case of intervening insol-

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<sup>171</sup> Compare bond sinking funds: *Chicago & I.R.R. v. Pyne*, 30 Fed. 86 (S.D.N.Y. 1887); *Missouri K. & T. Ry. v. Union Trust Co.*, 156 N.Y. 592, 51 N.E. 309 (1897), which are so used.

<sup>172</sup> But a few articles use the converted shares as a credit only at cost of acquisition, not at the redemption price. See *Certificate of Incorporation, Pittsburgh Coke & Chemical Corp.* (1951).

<sup>173</sup> *Jones*, *supra* note 156; see *P. W. Brooks & Co. v. North Carolina Pub. Serv. Comm'n*, 37 F.2d 220 (4th Cir. 1930) (charter construction).

vency, however, the unused fund—a corporate asset—is still subject to creditors' claims.<sup>174</sup> Since sinking fund redemption must normally be at the call price plus dividend arrearages, an unexpected discrimination might arise in the posited case if the sinking fund were used to pay not only the call price but also the dividend arrearage. To avoid this most articles qualify the corporation's right to "use up" the sinking fund balance. The dividend arrearages must be paid from separate corporate funds. The permissible source of these "dividend payments" is doubtful, but it seems that the ordinary statutory dividend restrictions do not apply; instead reference must be made to statutory purchase provisions.<sup>175</sup>

The most important problem posed by sinking fund redemption concerns the disposition of redeemed shares. Redemption does not mean retirement, though some contrary authority exists.<sup>176</sup> If the articles do not dispose of the redeemed shares these shares are deemed treasury shares—not an asset of the company, properly speaking, but a deduction from its net worth account. They are authorized shares and issued, though not presently outstanding.<sup>177</sup> The company may resell them.<sup>178</sup> It is important, then, that the draftsman exactly provide for their disposition. Silence or permission to reissue these shares seems contrary to the purpose of the sinking fund. Such reissue permits an increase in stock possibly beyond that which the board of directors could authorize, without subjecting this increase (at any terms they see fit to set) to shareholder approval. This practice is contrary to the conventional method of issuing equally ranking stock.<sup>179</sup>

Most articles contain some restrictions against reissue. The majority require that all redeemed stock be retired, cancelled and not reissued. Others forbid only reissue without further formality as part of the presently outstanding issue or a series of a class, but do allow reissue as part

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<sup>174</sup> See text at note 130 *supra*. The opposite result holds for bonds. *Equitable Trust Co. v. Green Star S.S. Corp.*, 291 Fed. 650 (S.D.N.Y. 1922), *aff'd*, 297 Fed. 1008 (2d Cir. 1924); *First Union Trust & Sav. Bank v. Bernardin*, 60 F.2d 419 (8th Cir. 1932).

<sup>175</sup> In California purchases of stock subject to redemption may be charged against capital accounts, which probably permits the payment to include the dividend arrearage. But if a compulsory redemption, as by a sinking fund, the debt may only be allowed to the extent of net earnings. CAL. CORP. CODE § 1706. But California allows payment of dividends, through capital is impaired, if the liquidation preference is kept intact and creditors are not harmed. § 1500 (b).

<sup>176</sup> *Borg v. International Silver Co.*, 11 F.2d 147 (2d Cir. 1925); *Barrett v. Webster Lumber Co.*, 275 Mass. 302, 175 N.E. 765 (1931); *but compare Venner v. Public Util. Comm'n*, 302 Ill. 232, 134 N.E. 17 (1922).

<sup>177</sup> 2 MOONITZ & STAEHLING, ACCOUNTING, AN ANALYSIS OF ITS PROBLEMS 158-168 (1952); CAL. CORP. CODE § 1714.

<sup>178</sup> 2 MOONITZ & STAEHLING, *supra* note 177; CAL. CORP. CODE § 1713; DEL. GEN. CORP. LAW § 243 (1953); MD. ANN. CODE GEN. LAWS art. 23, § 28(g) (3) (1951); N.Y. STOCK CORP. LAW § 28.

<sup>179</sup> *Compare McNulta v. Corn Belt Bank*, 164 Ill. 427, 45 N.E. 954 (1897), *with Peck v. Elliott*, 79 Fed. 10 (6th Cir. 1897).



of a new series of preferred or part of any presently outstanding series which contains no such restriction. While not so extreme as to permit a reissue this still avoids the regular procedure of issuing stock and does not require shareholder consent at the time of reissue. Reissue of redeemed stock thwarts commonly-held expectations of shareholders. It emphasizes the need for re-examining present opinions concerning the purpose of sinking funds in preferred stock issues.

### *Mechanics of Redemption*

The actual process of redemption is identical for casual redemption and for sinking fund redemption. To the shareholder, notice of redemption may mean the end of his rights and status as a member of the corporate enterprise. Adequate notice of redemption is essential. California's detailed statute, which only applies if there is no other provisions, sets a minimum permissible advance notice and a maximum time limit before which notice may not be given.<sup>180</sup> The articles can do no better than adopt these limits and perhaps leave the actual notice (upon redemption) for resolution of the board of directors.

Subject to any provisions in the articles with respect to the notice required for redemption of such shares, the corporation may give notice of the redemption of any or all such shares by causing a notice of redemption to be published in a newspaper of general circulation in the county in which the principal office of the corporation is located at least once a week for two (2) successive weeks, in each instance on any day of the week, commencing not earlier than sixty (60), nor later than twenty (20) days before the date fixed for redemption. The notice of redemption shall set forth all the following:

- (a) The class or series of shares or part of any class or series of shares to be redeemed.
- (b) The date fixed for redemption.
- (c) The redemption price.
- (d) The place at which the shareholders may obtain payment of the redemption price upon surrender of their share certificates.<sup>181</sup>

Most articles provide for similar details in the notice, and require that attention be called to conversion rights. Usually a qualifying proviso is added—that failure to mail notice to a shareholder does not affect the validity of the redemption proceedings.<sup>182</sup> Otherwise an unnotified shareholder might attack the whole redemption instead of having merely his rights as shareholder extended until correct notice of redemption is given him. It might be thought desirable that failure to mail (or defects in mail-

<sup>180</sup> CAL. CORP. CODE §§ 1701-1703; see N. J. REV. STAT. § 14:8-3 (1937). The California regulation only applies if conflicting provisions in the articles are absent.

<sup>181</sup> CAL. CORP. CODE § 1701.

<sup>182</sup> CAL. CORP. CODE § 1702.

ing) notice of redemption should extend the conversion privilege for a corresponding time but the bookkeeping difficulties involved and the danger of upsetting the whole redemption weigh against such consideration.<sup>183</sup>

What are the pertinent dates affecting shareholders' rights after notice of redemption? Some authority suggests that the notice and irrevocable deposit of the redemption funds end the existence of the stock and the shareholders' status as such. In practice, however, the result depends on the method of payment adopted. If the company itself sets apart a fund to which the shareholders shall look, their status and rights may continue until the actual redemption date. If the company deposits this money irrevocably with an agent "in trust," the shareholders' rights may end upon the date of that deposit although the deposit date considerably precedes the redemption date. In that case, adequate notice of place and agent for payment must be included in the notice.<sup>184</sup>

The corporation must have performed its obligations before the shareholders' rights are ended.<sup>185</sup> If sufficient money is not set aside or deposited with an agent, no change in the shareholders' status occurs either at the date of deposit or of actual redemption, regardless of language to that effect in the articles, the board of directors' resolution or the notice of redemption.<sup>186</sup> The putative redeemed shareholder still has all a shareholder's rights. He may sue for dividends declared to others of his class and may even sponsor a derivative suit.<sup>187</sup> It is not settled whether he may sue the company to compel redemption (payment of the redemption price)<sup>188</sup> or possibly for damages for failure to redeem (upon subsequent decline of the market price, for example). Previously described restrictions on the purchase of shares are applicable. The contract to redeem or purchase may be enforced as against other shareholders but not against the claims of creditors.

Another issue for the draftsman to resolve is the exact status of redeemed stock at these various dates. What is the effect of the notice of redemption, of deposit or of the redemption date on the shareholder's dividend, liquidation, conversion and voting rights? It is arguable that a court would order a dividend which was declared after the date of deposit

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<sup>183</sup> But see note 159 *supra*.

<sup>184</sup> See CAL. CORP. CODE § 1703.

<sup>185</sup> *Mueller v. Howard Aircraft Corp.*, 329 Ill. App. 570, 70 N.E.2d 203 (1946).

<sup>186</sup> *Ibid.*

<sup>187</sup> *Cf. Craftsman Finance & Mortgage Co. v. Brown*, 64 F.Supp. 168 (S.D.N.Y. 1945).

<sup>188</sup> He may not compel redemption at a different price because the price was an integral element in the board of directors' exercise of discretion. *Corbett v. McClintic-Marshall Corp.*, 17 Del. Ch. 165, 151 Atl. 218 (Ch. 1930). But see *McKay v. Rochester & Lake Ontario Water Serv. Corp.*, 247 App. Div. 499, 286 N.Y.Supp. 801 (4th Dep't 1936), *aff'd*, 272 N.Y. 528, 4 N.E.2d 432 (1936).

of the redemption price to be paid to these "redeemed" shareholders without provision therefor in the articles,<sup>189</sup> but the phrase "this stock is deemed no longer outstanding" is strong persuasion to the contrary. If state law permits and the company intends that dividends shall not be paid these shareholders, that can be explicitly stated. A company purposely hesitating to do so for fear of lessening the financial attractiveness of its stock invites the charge that its silence is an attempt to delude the investor. Most articles make no special disposition of this issue. The conversion privilege, on the other hand, is normally explicitly retained until shortly before the redemption date. To avoid any possible later suit by shareholders—and simply to benefit them—the company might well include a specific notice covering the present terms and rate of conversion, as well as the time remaining for exercise of the privilege.

Most shareholder complaints, however, are not based on retention of their "status," but on "equitable" grounds. If, for example, the board of directors resolved to redeem certain stock shortly before liquidating the company, thus making possible much higher liquidating payments to the remaining shareholders, a cause of action for breach of the directors' (and possibly the majority's) duty to the minority (redeemed) group is possible.<sup>190</sup> But if the redemption was really part of a plan to benefit the remaining shareholders unjustifiably, a cause of action would be stated whether the liquidation was voted or occurred before or after the redemption date. The survival of complainants' rights is not *qua* their "shareholder" status at the time of the majority's action. The only genuine survival of the shareholder status would result from a company's failure to perform its redemption obligations as above discussed.<sup>191</sup> But if the company performs its obligations, the only rights are to exercise the conversion privilege, if expressed, and to receive the redemption price.

Money unclaimed because stock has not been turned in remains in trust for several years, apparently covering the applicable statute of limitations, and then reverts to the company. "Shareholders" seeking payment thereafter must look to the company. The only litigable issue arising here

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<sup>189</sup> See CAL. CORP. CODE § 1703. *But see* *Borst v. East Coast Shipyards, Inc.*, 105 N.Y.S.2d 228 (Sup. Ct. 1951).

<sup>190</sup> *Zahn v. Transamerica Corp.*, 162 F.2d 36 (3d Cir. 1947); *Taylor v. Axton-Fisher Tobacco Co.*, 295 Ky. 226, 173 S.W.2d 377 (1943); *cf.* *Thompson v. Fairleigh*, 300 Ky. 144, 187 S.W.2d 812 (1945); see *Specht v. Eastwood-Nealley Corp.*, 25 N.J. Super. 69, 95 A.2d 485 (1953). But the mere fact that liquidation would bring a higher price is not grounds for attacking the redemption. *Compare* *Brown v. Eastern States Corp.*, 86 F. Supp. 887 (D. Md. 1949), *aff'd*, 181 F.2d 26 (4th Cir. 1950). See *Irvine v. Old Kentucky Distillery*, 208 Ky. 414, 271 S.W. 577 (1924). Redemption may possibly be used to defeat an impending appraisal procedure by a shareholder. *Liebschutz v. Schaffer Stores Co.*, 276 App. Div. 1, 93 N.Y.S.2d 125 (4th Dep't 1949); see *Southern Production Co. v. Sabath*, 87 A.2d 128 (Sup. Ct. Del. 1952); note 149 *supra*.

<sup>191</sup> *Mueller v. Howard Aircraft Corp.*, 329 Ill. App. 570, 70 N.E.2d 203 (1946).

is the burden of loss resulting from an agent's bankruptcy or other failure. If the deposit was irrevocable some statutes and most articles seem to shift the loss to the shareholders, calling the trust company their agent.<sup>192</sup> The interest or dividend provision, on the other hand, would tend to a debt, not trust, construction. None of the articles explicitly provides that the shareholder bears the loss in case of failure; consequently, the answer must depend upon construction of the company-agent agreement and the notice of redemption. Interpretation of the documents' conventional phrasing seems to favor the company.<sup>193</sup>

What constitutes a redemption is one problem nowhere resolved by contractual terms. The issue arises chiefly in simplifications under the Public Utility Holding Company Act<sup>194</sup> or in corporate reorganizations.<sup>195</sup> If a stock issue is cancelled or paid off in these processes, does the contract or law require payment of any applicable redemption premium? The general answer has been no, where the lower court or responsible agency has not seen fit to include the premium,<sup>196</sup> but if ordered paid its inclusion has been upheld.<sup>197</sup> Could the articles require payment of the premium by specifying that stock cancelled in reorganization has been redeemed?<sup>198</sup> As in the case of liquidations, the objection to such a clause is that it is basically bootstrap phrasing—an attempt to withhold from the bankruptcy courts their power to define the legal effects of certain proceedings upon stock which has been presented to the court (by the petition) for disposition.<sup>199</sup> The *Central States* doctrine by definition does not apply.<sup>200</sup> That rule only allots to certain stock more value, because of its liquidation preference, once the court decides that the activity at issue is a liquidation. The rule does not apply to let a company define for the court what the

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<sup>192</sup> CAL. CORP. CODE §§ 1701-1703.

<sup>193</sup> *Masonic Widows' & Orphans' Home v. Title Ins. & Trust Co.*, 248 Ky. 787, 59 S.W.2d 987 (1933); *Empire Trust Co. v. Panola Cotton Mills*, 149 S.C. 8, 146 S.E. 612 (1929). *Contra*: *La Salle Hotel Realty Co. v. Taft*, 85 F.2d 339 (7th Cir. 1936); BALLANTINE, CORPORATIONS 511 (rev. ed. 1946). *Cf.* *Perpetual Self Winding Watch Corp. v. City Bank Farmers Trust Co.*, 169 Misc. 366, 7 N.Y.S.2d 684 (Sup. Ct. 1938).

<sup>194</sup> 15 U.S.C. § 79 (1951).

<sup>195</sup> Chapter X of the Chandler Act, 11 U.S.C. §§ 501 ff (1946).

<sup>196</sup> *Massachusetts Mutual Life Ins. Co. v. Securities and Exchange Comm'n*, 151 F.2d 424 (8th Cir. 1945), *cert. denied*, 327 U.S. 795 (1946); *In re Standard Gas & Elec. Co.*, 151 F.2d 326 (3d Cir. 1945), *cert. denied*, 327 U.S. 796 (1946); *In re New England Pub. Serv. Co.*, 73 F.Supp. 452 (D.Me. 1947), 94 F.Supp. 343 (D.Me. 1950); *In re Consolidated Elec. & Gas Co.*, 55 F.Supp. 211 (D.Del. 1944); *Springfield Gas & Elec. Co. v. Graves*, 359 Mo. 182, 221 S.W.2d 197 (1949).

<sup>197</sup> *Securities and Exchange Comm'n v. Central-Illinois Securities Corp.*, 338 U.S. 96 (1949); *In re United Pub. Util. Corp.*, 52 F.Supp. 975 (D.Del. 1943).

<sup>198</sup> See *In re Electric Bond & Share Co.*, 73 F.Supp. 426 (S.D.N.Y. 1946).

<sup>199</sup> *Price v. Gurney*, 324 U.S. 100 (1945).

<sup>200</sup> *Central States Elec. Power Corp. v. Austrian*, 183 F.2d 879 (4th Cir. 1950), *cert. denied*, 340 U.S. 917 (1951).

activity in question ("cancelling" an issue) in fact is. That is the court's function—a requisite to evolving the reorganization plan.

#### THE CONVERSION PRIVILEGE

"Conversion is the act of exchanging one class of security for another, the conversion privilege being created by a written contract between the privilege holder and the granting company.<sup>201</sup> The conversion privilege, of all a conventional issue's provisions, is least affected by rules of law and most dependent on the share contract. Recent conversion instruments approximate present standards of perfection; there is hardly a conceivable occurrence affecting shareholders that has not been provided for or at least recognized.<sup>202</sup>

#### *Mechanics of Conversion*

The conversion privilege is a contract, whether construed as an option or as a continuing offer, and the shareholder's acceptance by conversion must comply with the terms of the privilege. If the instrument is silent as to time of exercising the privilege, it must be exercised within a reasonable time.<sup>203</sup> The company is under no duty to call the shareholder's attention to his conversion privilege,<sup>204</sup> not even when he presents the security for payment at the company's request.<sup>205</sup> Further, a person attacking the company's failure to honor the conversion must be a holder of the security at time of suit.<sup>206</sup>

Since the process of conversion must be performed according to the terms of the instrument, the question of "reasonable time of conversion" is not important today. Corporate articles either grant the conversion privilege for a limited time only or by implication permit its exercise as long as

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<sup>201</sup> Hills, *Convertible Securities—Legal Aspects and Draftsmanship*, 19 CALIF. L. REV. 1 (1930).

<sup>202</sup> The importance of draftsmanship and the contractual basis of shareholders' rights is stressed in BALLANTINE, LATTIN & JENNINGS, *supra* note 160, especially c.X, "Planning the Preferred Share Contract."

<sup>203</sup> Holland v. Cheshire Ry., 151 Mass. 231, 24 N.E. 206 (1890). There an option to convert to anyone "subscribing after February 1" was not exercisable 33 years after that date. Catlin v. Green, 120 N.Y. 441, 24 N.E. 941 (1890); cf. Loomis v. Chicago, Milwaukee & St. Paul Ry., 102 Fed. 233 (2d Cir. 1900): once the convertible bonds mature, the privilege ends if the company is willing to pay the bondholder upon presentation. Loring v. Lamson Hubbard Corp., 249 Mass. 272, 143 N.E. 916 (1924); see Larsen v. The Lilly Estate, 34 Wash.2d 39, 208 P.2d 150 (1949). Compare Totten & Co. v. Tison, 54 Ga. 140 (1875); Doubleday v. Kalamazoo Citizens' Loan & Inv. Co., 268 Mich. 280, 256 N.W. 337 (1934); Rosenkrans v. Lafayette, B. & M. R. Co., 18 Fed. 513 (C.C.D. Ind. 1883).

<sup>204</sup> Catlin v. Green, 120 N.Y. 441, 24 N.E. 941 (1890).

<sup>205</sup> Johnson v. Richmond, F. & P. R.R., 101 Va. 156, 43 S.E. 193 (1903); P. W. Brooks & Co. v. North Carolina Pub. Serv. Co., 37 F.2d 220 (4th Cir. 1930).

<sup>206</sup> Otherwise he might recover damages though having sold the stock to a bona fide buyer who might himself demand conversion. Denney v. Cleveland & Pittsburgh R.R., 28 Ohio St. 108 (1875).

the stock is outstanding. Further, as time passes, problems of actual conversion become more and more remote because of the use of sliding conversion rates which by making the conversion price less and less favorable induce early exercise of the privilege.

The conversion privilege is usually construed as a continuing offer and must be accepted in conformity with the offer's terms. Thus a declaration of willingness to convert before maturity does not constitute acceptance if actual surrender of the securities is required.<sup>207</sup> Presentment before maturity is not troublesome since convertible stock seldom has a set maturity date. But the same cases and rules apply to conversion before redemption as to conversion before the end of a limited conversion period. Acceptance of conversion must be complete by the date set, which requires—as specified by the articles—written notice of the shareholder's election to convert and actual surrender, by that date, of the shares to be converted.<sup>208</sup> Exact compliance is important if the shareholder is attempting to reap a coming dividend or other distribution or to participate in a crucial election.

Likewise, the time at which the preferred shareholder becomes a common shareholder after surrender of the shares should be exactly set forth.<sup>209</sup> To avoid any dispute many articles provide that the putative shareholders shall be treated as shareholders of record as of the date of surrender of their convertible shares.<sup>210</sup> The propriety of such a provision is obvious. Sliding rates making conversion periodically less profitable lead many shareholders to delay exercising their privilege until just before a shift in the conversion rate. Their status as junior shareholders should therefore be set as of an exact date, and the articles should specify as of what date the conversion is effective. It is otherwise disputable whether the conversion rate used is that in effect the day the shares were surrendered or the day new shares were issued. An instrument deeming the shares converted as of the surrender date is commendable, as is a direct statement that the

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<sup>207</sup> *Chaffee v. Middlesex R.R.*, 146 Mass. 224, 16 N.E. 34 (1888). But if the complainant could have surrendered the securities in time but did not because the company expressed its refusal to accept them in any case (mistakenly believing the maturity date had arrived) he has a cause of action for its failure to convert. *Ibid.* And the company cannot prevent conversion by closing its transfer books (for purposes of dividend payments) at this time, reopening them after the issue matures. *Jones v. Terre Haute & Richmond R.R.*, 57 N.Y. 196 (1874).

<sup>208</sup> *Spratt v. Paramount Pictures, Inc.*, 178 Misc. 682, 35 N.Y.S.2d 815 (Sup. Ct. 1942).

<sup>209</sup> The decision in *Jones v. Terre Haute & Richmond R.R.*, 57 N.Y. 196 (1874), however, seems to forbid discriminatory classification, at least concerning dividend payments, for it required dividends to be paid to shareholders who could not be entered as such until the transfer books reopened—at a date after the dividend had been declared to shareholders of record as of a date before complainant exercised his conversion privilege. *But see Gay v. Burgess Mills*, 30 R.I. 231, 74 Atl. 714 (1909). See Hills, *supra* note 201, at 17.

<sup>210</sup> See *Kaiser Aluminum & Chemical Corp., Certificate of Preferences of the 5% Cumulative Preferred Stock* (1952).

effective conversion rate shall be the one in effect the day the shares were surrendered.

The corporation for its part must remain able to convert the stock<sup>211</sup>—by retaining enough shares of the junior class. The time to provide for this is when the convertible securities are issued, not upon impending exercise of the privilege. Today most articles at least recognize that simple fact and require the company to keep available out of its authorized and unissued common stock, for conversion only, enough stock to effect the conversion of all convertible stock at any time outstanding. Usually if more is issued the company should amend its articles to increase this authorized amount.<sup>212</sup> If the company fails to maintain this stock account, or otherwise is unable or refuses to meet this obligation, a cause of action is stated.<sup>213</sup> Complainant must be a holder of the stock at time of bringing suit,<sup>214</sup> but he need only allege that he was a "holder" of the security when the cause of action arose.<sup>215</sup> Any facts showing that the complainant is not a shareholder of record at the time of suit,<sup>216</sup> such as a sale of his shares before bringing suit, may be pleaded as an affirmative defense.<sup>217</sup> The conventional articles permit conversion by any "holder" of the convertible stock, apparently leaving this issue to the cited conflicting decisions.<sup>218</sup> By infer-

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<sup>211</sup> Failure to obtain permission from the involved regulatory agency in time to meet demands for conversion is actionable. *Marony v. Wheeling & Lake Erie Ry.*, 33 F.2d 916 (S.D. N.Y. 1929); followed in *Cheatham v. Wheeling & Lake Erie Ry.*, 37 F.2d 593 (S.D. N.Y. 1930). It is no excuse that all stock legally authorized is issued and that the company cannot reasonably obtain enough to fulfill its obligation. *Bratten v. Catawissa R.R.*, 211 Pa. 21, 60 Atl. 319 (1905); *Hills*, *supra* note 201, at 12.

<sup>212</sup> CAL. CORP. CODE § 1105 requires such action. See N. Y. STOCK CORP. LAW § 27 (1953).

<sup>213</sup> The action may be one for breach of contract. *Chaffee v. Middlesex R.R.*, 146 Mass. 224, 16 N.E. 34 (1888); *Tagart & Bennett v. Northern Cent. R.R.*, 29 Md. 557 (1868) (but the successor company, as in a merger, cannot be required to keep the old company in a position to perform); see *Hills*, *supra* note 201, at 15. An actual sale of the old stock may be needed, to show actual damages suffered by refusal to convert. *Cheatham v. Wheeling & Lake Erie Ry.*, 37 F.2d 593 (S.D. N.Y. 1930).

The action may be in conversion (trover), the company's refusal to make the transfer on its books being called an improper exercise of dominion over the shareholder's property. *United States Cities Corp. v. Sautbine*, 126 Okl. 173, 259 Pac. 253 (1927).

<sup>214</sup> See also *Todd v. Maryland Casualty Co.*, 155 F.2d 29 (7th Cir. 1946).

<sup>215</sup> *Marony v. Wheeling & Lake Erie Ry.*, 33 F.2d 916 (S.D. N.Y. 1929). As long as the articles allowed a mere "holder" to convert, the allegation of "holder" was enough.

<sup>216</sup> *Cheatham v. Wheeling & Lake Erie Ry.*, 37 F.2d 593 (S.D. N.Y. 1930), holding that the *Marony* case had not passed on the validity of an affirmative defense that complainant was not a shareholder of record.

<sup>217</sup> *Marony v. Wheeling & Lake Erie Ry.*, 33 F.2d 916 (S.D. N.Y. 1929); *Denney v. Cleveland & Pittsburgh R.R.*, 28 Ohio St. 108 (1875). In the *Cheatham* case the court added that a nominee holding a street certificate could not qualify as a "holder," though the assignment was irrevocable; criticized, *Hills*, *supra* note 201, at 14, as unnecessary since a proper surrender of stock will effect a valid conversion.

<sup>218</sup> *But see Todd v. Maryland Casualty Co.*, 155 F.2d 29 (7th Cir. 1946), holding that a pledgee (the Reconstruction Finance Corporation) may exercise the conversion privilege, "holder" and "owner" being distinguished.

ence, however, a holder of a street certificate can exercise the privilege, for most articles provide that the holder shall pay the transfer taxes if he wants the new shares issued in the name of one other than himself.<sup>219</sup> Nevertheless, an express grant allowing them to exercise the privilege may be a desirable part of the instrument.

### *Protection Again Dilution of the Conversion Privilege*

The corporate articles protect shareholders from certain actions affecting the value of the conversion privilege. When new stock is split two for one the holder of a security convertible into that stock should get twice as many shares when he converts. When more stock of the new class or of stock convertible thereto at a different price than that in effect for the holder of the convertible security is issued, an arithmetical series of adjustments is needed to correct for this change. The conversion price or rate is part of the conversion instrument. If the contract adds nothing else no corrections or adjustments can be demanded. The shareholder cannot—because of his *conversion* privilege—share in a stock dividend paid to the common before he converted,<sup>220</sup> nor demand the new multiplied amount resulting from a stock split.<sup>221</sup> It is the law's failure to protect shareholders against dilution of their conversion privilege that has allowed contractual provisions to occupy this segment of corporate regulation.

Easily provided for are stock splits, combinations and reclassifications (substitutions and exchanges). The simplest way is to give the converting shareholder the number of shares of new stock he would have gotten had he converted just before the split-up or other transaction, and then had participated as a common shareholder in the exchange, reclassification, split-up or combination.<sup>222</sup> Most articles simply provide that the conversion price (or rate) shall be proportionately decreased or increased. A few even include payment of a stock dividend in this clause,<sup>223</sup> but this is often unsatisfactory. If the company regularly pays small stock dividends in lieu of cash dividends such correction gives the preferred shareholder excessive protection. Even if the stock dividend is "extraordinary" the mere "proportionate correction" which treats the dividend as a type of stock split-up may not accurately reflect all factors involved. Some of the stock may be a substitute for a cash dividend, and only part be equivalent to a

<sup>219</sup> Actually this clause is used to permit the issue of the new certificate to nominees, but the phrase allows the argued construction.

<sup>220</sup> *Sutliff v. Cleveland & Mahoning R.R.*, 24 Ohio St. 147 (1873).

<sup>221</sup> *Gay v. Burgess Mills*, 30 R.I. 231, 74 Atl. 714 (1909); *cf. Pratt v. American Bell Tel. Co.*, 141 Mass. 225, 5 NE. 307 (1886); *Hills*, *supra* note 201, at 21. These cases involve convertible bonds, but the principle is the same.

<sup>222</sup> This is the phrasing recommended by *Hills*, *id.* at 22-23, and used, e.g., in the Certificate of Incorporation of Continental Can Co. (1951).

<sup>223</sup> E.g., Certificate of Incorporation of Sonotone Corp. (1951).



stock split. The applicable state law often requires the transfer of earned surplus to a capital account when a stock dividend is paid. The common shareholder may subjectively consider this removal of an available dividend source sufficient reason for not changing the conversion rate. This problem, however, is seldom recognized in corporate articles.<sup>224</sup>

The most important single adjustment is made when additional common stock is issued or sold for a consideration below the present conversion price. Not only is this the most common transaction affecting the conversion privilege, but the conventional articles define "issue of additional shares" to include such diverse items as the payment of stock dividends, the giving of subscription warrants, and the issue of stock convertible into common. This adjustment feature is thus the greatest protective clause in the instrument. The adjustment is made in the conversion price, which may be called the "basic conversion price" if, as is often the case, it increases at regular intervals. If one "basic conversion price" has already been adjusted before a new period occasions a rise, the increase from the adjusted conversion price of the second period is at the same rate as the originally contemplated change from one basic conversion price to that of the next period.<sup>225</sup> If the basic conversion price of the next period were to rise the requisite percentage from the first period's *basic* conversion price instead of from the lower *adjusted* conversion price, the anti-dilution protection would be illusory.

The conventional adjustment formula sets the new conversion price (X) at the sum of the old conversion price (C) times the number of common shares presently outstanding (O) plus the number of new shares to be issued (N) times the issue price per share (P), divided by the total number of common shares (O+N) that will be outstanding:

$$X = \frac{CO + NP}{O + N} \quad ^{226}$$

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<sup>224</sup> Hills, *supra* note 201, at 23-24. He suggests specific exemption from adjustment of stock dividends below a set limit. It is possible that the common provision dispensing with adjustments if the effect on the conversion price is below x cents could instead be used. But this is often cumulative so that the adjustment is only postponed until a few such dividends have been paid. His suggestion therefore seems preferable. Because a cash dividend with an accompanying stock subscription warrant should be (and generally is) treated as a stock dividend requiring adjustment, the simple correction method should generally not be used. This transaction creates problems of arithmetic better treated by use of a regular adjustment of the conversion price or rate using a conversion formula, as done for regular stock issues.

<sup>225</sup> *Id.* at 26 gives an illustration.

<sup>226</sup> GRAHAM & DODD, *SECURITY ANALYSIS* 536 (3d ed. 1951). The phrasing varies but this is the correct generalized reduction. A more complete instrument would add common stock sold *above* the conversion price to "O" at that price: e.g., Certificate of Incorporation, Sonotone Corp. (1951); see note 230 *infra*. "O" should be defined to include (as it usually does) treasury shares of common stock as well as stock reserved for conversion of convertible securities. This is necessary since some state statutes define treasury shares as not outstanding. CAL.

Two theories of adjustment exist, depending on the definition of "dilution" used. One employs the conversion price as its base, although the market price of the preferred stock may be less. It is independent of market values. The other, rather uncommon, provides for adjustment whenever new common stock is issued below the present common's market value.<sup>227</sup> This market price theory is an admission that the theoretical bases for the existence of convertible securities are false.<sup>228</sup> It recognizes that shareholders retain the convertible stock for speculative purposes; otherwise they would have exercised the conversion privilege by this time. It thereby gives the preferred shareholder more than he bargained for, since it protects *as an investment* the speculative gain accrued to this time.

The company and junior shareholders would benefit by a provision to raise the conversion price whenever common stock is issued for a consideration above the presently effective conversion price. The preferred shareholders originally contributed capital for the opportunity to share in future profits with the common (by converting into that class). They bargained for an increase in the company's net worth and a corresponding increase in the common's market value. If the company then issues new common at that higher market price the preferred gains more than was expected, since it can still convert at a proportionately high ratio. As a matter of corporate policy the preferred's "right" to share in the equity of *new* common shareholders may be questioned, especially as it hampers further common stock financing. It is difficult, however, to correct for this effect. To provide that the conversion price shall be increased in the same manner that a decrease is computed is not enough. The preferred shareholders would be deprived of the benefit of the market and book value increase, which they have a right to enjoy whenever they choose to convert. The best solution may be an indirect one. In adjusting for an issue *below* the effective conversion price, shares previously issued above the presently effective conversion price<sup>229</sup> should be included in the equation at that higher price.  $C \text{ times } O$  should thus mean the old conversion price times the number of shares outstanding which were *issued at or below* that price, but those issued at a

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CORP. CODE § 1714. In those states treasury shares would not be included in the equation by a mere general phrase. Although this total number thus includes shares held by the company, only stock issues above that number would bring the adjustment machinery into use.

<sup>227</sup> BALLANTINE & JENNINGS, *supra* note 78, at 12,052; GRAHAM & DODD, *supra* note 226, mentions another rare adjustment: simply to the new price at which the new stock is issued. This is an unwarranted boon to the convertible securities not found today. Generally, see BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 703, n. 14, 712 (1949).

<sup>228</sup> GRAHAM & DODD, SECURITY ANALYSIS 523-529 (3d ed. 1951).

<sup>229</sup> This is, that "O" in the cited formula includes shares thus previously issued at that rate.

higher price should be multiplied by that higher price, not by the old conversion price.<sup>230</sup>

Preferred shareholders may justifiably expect adjustment provisions to apply to all possible transactions that could affect their conversion privilege. The list of transactions which require adjustment should be inclusive. In this respect today's articles are comprehensive and commendably broad. The standard procedure is to set up the above basic adjustment method and then so to define *issue of shares* as to include all possible transactions affecting the privilege, including the issue of other securities convertible into common stock, the granting of subscription warrants for common and convertible stock and often the payment of a stock dividend (in common or convertible securities). The problem in all three named situations is to create a proper valuation process and in the first two to time the adjustments properly.

If a company could issue securities convertible into common stock below the present preferred stock's conversion price the conversion privilege would be effectively diluted. The adjustment made in recognition of this potential dilution is a complex one. The usual practice is to take the sum of the total consideration received for the convertible securities *when issued or sold* plus the least aggregate additional consideration receivable upon actual conversion of the total issue, and to divide this by the greatest number of common shares issuable if all these convertible shares were in fact converted. If the resultant price is below the presently effective conversion price, this maximum number of common shares issuable upon total conversion of the new convertible stock is deemed issued or sold, at this resultant price, at the time the new convertible shares are first issued. The conversion price of the existing convertible stock is then adjusted downwards as already described. This common provision requires, however, that if the "resultant price" thus computed is *above* the then-existing conversion price, no adjustment shall be made upon issue of the new convertible securities. But an adjustment will be made at the time of actual conversion if the sum of the consideration for actual conversion plus the original consideration for the issue is below the present conversion price. In practice, however, this is never necessary, for if this total consideration for the new issue was less at the time of issue than the present convertible stock's conversion price, it will be less now upon actual conversion.

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<sup>230</sup> The previously stated formula would then read 
$$X = \frac{CO \times HF \& NP}{O \times F \& P}, \text{ where } (H)$$

(or H') is the higher issue price (prices) of the stock issued in the interim and (F) (or F') is the number of further shares issued at that higher price or prices. "O" would then be re-defined as the number of common presently outstanding issued below whatever conversion price was in effect at each respective time of issue.

See also the discussion in Hills, *supra* note 201, at 28; and the Certificate of Incorporation, Sylvania Electric Products, Inc. (1951).

The same basic method is followed when subscription warrants for or options to buy common stock or securities convertible into common stock are granted. Readjustment is made when the right to exercise the warrant or option expires, since these warrants are usually good for a limited time only. If stock dividends are adjusted by this method instead of by the simple correction method previously described, they are usually deemed issued "without consideration." The conversion price is accordingly adjusted downwards by the standard formula. It is frequently provided, however, that if the stock dividend is on preferred stock, it is deemed issued for a consideration equal to the "dividend right" of that stock.

If some shares remain unconverted when this new stock's conversion privilege ends (if limited or upon redemption), the total number of common shares earlier deemed outstanding becomes excessive. The conversion instrument therefore provides for a reduction in the number deemed outstanding and for a corresponding upward readjustment of the present conversion price. Otherwise the preferred shareholders are unjustifiably benefited.

Adjustments for noncash transactions are also important to the preferred shareholders. Common stock issued for property will dilute the privilege as effectively as if issued for cash. If the company declares a property dividend (neither in cash nor in stock) which is an extraordinary distribution, some recognition of the effect, too, should be had. Most conversion instruments therefore provide that if common or convertible securities or warrants for them are issued for noncash consideration, the stock (including that issuable pursuant to conversion or exercise of the warrants as above computed) shall be deemed issued for cash equivalent to the fair value of that consideration as determined by the board of directors. The issue of stock in exchange for assets of another business taken over by the corporation illustrates the utility of such a provision. If common stock and convertible securities and warrants are issued together as one transaction, the board of directors should be allowed to apportion the consideration. When property dividends or distributions are paid out some "fair valuation" thereof by the board of directors should also be permitted. If regular small property dividends are declared in lieu of cash dividends, as by an investment company or in the case of "whiskey dividends," an exclusion from adjustment may be desirable.

Not all transactions nor even all share issues are normally included for adjustment. Treasury shares are generally excluded, usually by including in the count of common stock originally outstanding common stock reserved to satisfy any conversion. Since more stock may have to be issued for these purposes it, too, should be specifically excluded, or the original exclusion clauses should be broader: *e.g.*, covering shares issued for the conversion of shares of this series or class at any time. Employee stock option

plans are usually excluded from the adjustment section, though a maximum limit should be set for them.<sup>231</sup> Finally, no adjustment need normally be made if it would result in less than, say, a 30 cent change in the conversion price. These lesser changes are nearly always made cumulative and require computation for adjustment when that limit is reached.

When preferred stock is to be redeemed, timely notice is given the shareholders to let them exercise their conversion privilege.<sup>232</sup> At times a statement informing them of their exact rights of conversion is included. Similar notice is common in case of coming distributions (other than regular cash dividends) or offers of subscription warrants, to let the preferred shareholders convert and receive these advantages. Another useful and common clause provides that the record date of share ownership taken for purposes of dividends or subscription rights shall be deemed the date on which the distribution was made or the stock (issuable upon exercise of the rights) was issued, thus requiring downward adjustment of the conversion price as of that time.<sup>233</sup> In the case of dividends this is a desirable practice. A preferred shareholder converting after such record date could not receive the dividend. He should at least be able to "buy" the common stock ex-dividend instead of in effect paying for a dividend he will not get. This practice is also justified when subscription rights and the like are granted. Preferred shareholders are given notice and have time to convert.<sup>234</sup> If they do not convert and the exercise of the rights would dilute their conversion privilege, the conversion price is still adjusted downward, so they may be better off than before.<sup>235</sup>

### *Protection Against Destruction of the Conversion Privilege*

The law does not recognize the survival of the conversion privilege upon a change of the corporate existence unless the successor entity assumes a conversion obligation. Liquidation or dissolution of the company, even if voluntarily produced, ends the privilege.<sup>236</sup> Mergers and consolidations which create a new company and end the existence of the constituent cor-

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<sup>231</sup> Hills, *supra* note 201, at 29, mentions a further exclusion: of shares issued to acquire certain designated property. But this should be limited to specific transactions already contemplated when the articles or certificate of preferences were drawn.

<sup>232</sup> See *Merritt-Chapman & Scott Corp. v. New York Trust Co.*, 184 F.2d 954 (2d Cir. 1950), *cert. denied*, 340 U.S. 931 (1951).

<sup>233</sup> But it is wise to delay *actual* adjustment until the date of issue or distribution (though made *as of* the earlier date) and so to permit no adjustment if the company abandons the plan.

<sup>234</sup> The notice must of course be timely. See *Merritt-Chapman & Scott v. New York Trust Co.*, 184 F.2d 954 (2d Cir. 1950), *cert. denied*, 340 U.S. 931 (1951).

<sup>235</sup> See text following note 230, *supra*. See also Guthmann, *Measuring the Dilution Effect of Convertible Securities*, 11 J. BUS. U. OF CHI. 44 (1938).

<sup>236</sup> *Parkinson v. West End St. Ry.*, 173 Mass. 446, 53 N.E. 891 (1899); see *Lisman v. Milwaukee, L. S. & W. Ry.*, 161 Fed. 472 (E.D. Wis. 1908).

porations also end conversion privileges.<sup>237</sup> The conversion obligation is not taken over in the standard "assumption of all contracts, debts, engagements, and liabilities" of the old company by the new one.<sup>238</sup> The commonly accepted theory of these old cases is that the conversion privilege is a mere chance to speculate on an increase in the market value of the company's stock. It does not bind the company to insure to the holder thereof his ability or opportunity to use it.<sup>239</sup> Here again, however, the conversion instrument has provided the expectable protection.

The conventional instrument first defines the applicable area. The transactions usually included are consolidations, mergers, conveyance of all or substantially all assets to another company, capital reorganizations and reclassifications of the capital stock. If any of these occur the instrument usually provides that upon conversion the convertible stock is entitled to the same stock and number as a holder of the company's common stock would or did receive at the time of that transaction. The conversion rate is often set more exactly by providing that the preferred shareholder gets what he would have had had he exercised his privilege just before the transaction, as when a periodic change in the basic conversion price just then occurred.

This requirement is enforced in various ways. Simplest is the mere statement that in case of any such action the convertible stock shall be convertible into the stock of the resulting company (as then provided). Impliedly, the successor company must obligate itself in the merger agreement to perform this condition. Other instruments explicitly state that the successor company shall make effective provisions to carry out these conversions and shall promise to deliver to the old preferred shareholders their rightful shares or property.<sup>240</sup> The preferred could bring suit to enjoin the

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<sup>237</sup> *Parkinson v. West End St. Ry.*, 173 Mass. 446, 53 N.E. 891 (1899); *Tagart & Bennett v. Northern Cent. Ry.*, 29 Md. 557 (1868). Only if the consolidated company is found to be the same entity may the conversion privilege remain. *John Hancock Mut. Life Ins. Co. v. Worcester, Nashua & Rochester R.R.*, 149 Mass. 214, 21 N.E. 364 (1889); *Day v. Worcester, Nashua & Rochester R.R.*, 151 Mass. 302, 23 N.E. 824 (1890). But this is rare and these two cases have in effect been discredited. See the *Parkinson* case, *supra*. See generally, Hills, *supra* note 201, at 31-34; *Einstein v. Rochester Gas & Elec. Co.*, 146 N.Y. 46, 40 N.E. 631 (1895).

<sup>238</sup> *Tagart & Bennett v. Northern Cent. Ry.*, 29 Md. 557 (1868). By the same token, there is no cause of action against the successor company or one purchasing all the assets of the old company, for failing to keep the old company in a position to perform on the conversion instrument: *Ibid.*, *Lisman v. Milwaukee, L. & W. Ry.*, 161 Fed. 472 (E.D. Wis. 1908); *Welles v. Chicago & N.W. Ry.*, 163 Fed. 330 (E.D. N.Y. 1908).

Even if the successor company were obligated under the conversion instrument, there is no protection against dilution of the privilege; text at note 221 *supra*. But see *Rosenkrans v. Lafayette, B. & M. Ry.*, 18 Fed. 513 (C.D. Ind. 1883) as to conversion before such dilution.

<sup>239</sup> *Lisman v. Milwaukee, L. S. & W. Ry.*, 161 Fed. 472 (E.D. Wis. 1908); see *Hackett v. Northern Pacific Ry.*, 36 Misc. 583, 73 N.Y. Supp. 1087 (Sup. Ct. 1901); *Weidenfeld v. Northern Pacific Ry.*, 129 Fed. 305 (8th Cir. 1904).

<sup>240</sup> *E.g.*, Certificate of Incorporation, *Sylvania Electric Products, Inc.* (1951). The Certificate of Incorporation, *Fedders-Quigan Corporation* (1951) provides that the successor company shall as partial consideration for the merger promise to carry out these provisions.

consummation of any such agreement if appropriate provisions of this sort had not been included, unless this protective clause was in the meanwhile voted away.

Successive transactions of this sort are difficult to control. The conversion instrument cannot, for example, specify the adjustments for two consecutive mergers. Instead it provides that the same methods of computation shall apply to whatever stock setup results from the first transaction and to the same activities covered by the original conversion instrument. Since not even the same definitions may apply, however, a common simple proviso is that the company at the time of, say, a merger, shall make the necessary adjustments for the application of the protective clauses. The provisions of the conversion instrument will then apply, where suitable, to successive stock classifications. Thus the articles can attempt to perpetuate an effective conversion privilege.<sup>241</sup>

The difficulty of creating an exact conversion instrument results not only from the possibility of these later mergers or other transactions of unknown dimensions, but also from the natural inability to foresee all possible corporate actions that can affect the conversion privilege. Some blanket statement is desirable, usually separate from the "appropriate adjustment" clause just mentioned. In case of any transaction materially affecting the preferred shareholders (in the board of directors' judgment) the company is often directed to employ an independent accountant to prescribe any adjustments needed to preserve the preferred's conversion rights. The board of directors shall then make this recommended adjustment. The more comprehensive the conversion instrument, the less the need for reliance on this provision.<sup>242</sup>

### *Disposition of Converted Shares*

Many articles provide that shares converted shall be cancelled and not reissued.<sup>243</sup> Others provide that they may be applied as a credit against sinking fund obligations. These latter may in turn require their cancellation or permit their reissue.<sup>244</sup> No harm peculiar to the conversion privilege results to preferred shareholders if the shares are not cancelled. A reissue for a lesser consideration, however, should be covered in the instrument to

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A conversion may be effected (apart from mergers and such) by the company giving the preferred shareholders stock of another company. *Wellner v. Gerth*, 81 N.J.L. 10, 79 Atl. 895 (Sup. Ct. 1911).

<sup>241</sup> The mechanics of adjusting the conversion rate and price in successive transactions are shown in *Hills*, *supra* note 201, at 36-38.

<sup>242</sup> But it is unwise to substitute this type of clause in place of more exact adjustment provisions for each adverse corporate action, as is partially the case in the Certificate of Incorporation, *Celanese Corporation of America* (1951).

<sup>243</sup> And see N. Y. STOCK CORP. LAW § 27 (and 1953 amendment).

<sup>244</sup> See text at note 176 *supra*.

prevent dilution of the remaining shares. Otherwise they might be excluded from adjustment if not thought to fit under the "treasury share" label.<sup>245</sup> The only difficulty a draftsman should resolve arises when the conversion instrument provides that converted shares shall be cancelled but permits them to be credited against a sinking fund obligation, and the sinking fund provisions permit reissue of redeemed shares. Despite that latter proviso the cancellation requirement should be clearly expressed, to avoid an inconsistent and ambiguous result. In practice, however, this problem is not important since those articles permitting reissue after redemption usually permit reissue after conversion.

#### DIRECT AND PROTECTIVE VOTING RIGHTS

Voting is the theoretical means of shareholder control over corporate actions. Electing the board of directors is ideally the indirect means of expressing opinions and desires concerning corporate policies. Voting blanket approval of management's activities over the preceding period has a similar purpose. The voting requirements for a particular action—a merger or an issue of new preferred stock—are the more direct means of expressing consent. These are important transactions, final in their effect on the shareholder-company relation. Their effect justifies and requires the prior consent of each shareholder.

Modern preferred stock by its own contract is usually nonvoting.<sup>246</sup> The typical articles deny any vote to the preferred, "except as hereinafter provided." They then specify the actions—usually those set out in the statute—upon which the preferred may vote.<sup>247</sup> Apart from this vote on certain transactions, discussed below, nearly all articles today disinter the voting right—to some extent—upon default in payment of dividends.<sup>248</sup>

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<sup>245</sup> See text at note 226 *supra*.

<sup>246</sup> All shares vote unless the contract creating them specifies otherwise. *In re American Elevator & Mach. Co.*, 73 F. Supp. 473 (W.D. Ky. 1947); *Phenix Mut. Fire Ins. Co. v. Rouillard*, 92 N.H. 228, 29 A.2d 134 (1942). Specifying otherwise is permitted by statute. CAL. CORP. CODE § 1100; DEL. GEN. CORP. LAW § 151 (1953); MD. ANN. CODE GEN. LAWS art. 23, § 4 (1951); N. J. REV. STAT. § 14:8-1 (1937); N. Y. STOCK CORP. LAW §§ 11, 51; OHIO CODE ANN. § 8623-4 (Supp. 1952). A statute giving one vote per share unless otherwise provided, followed by one allowing cumulative voting if provided in the articles, does not modify the latter only; therefore a contractual denial of any vote is valid. *People ex rel. Browne v. Keonig*, 133 App. Div. 756, 118 N.Y. Supp. 136 (1st Dep't 1909).

Statutes, which all permit issue of non-voting stock, themselves usually list certain actions so vitally affecting the shareholder as to require his prior approval in any case. CAL. CORP. CODE §§ 3634, 3635; DEL. GEN. CORP. LAW § 242 (1953); N. J. REV. STAT. § 14:11-3 (1937); N. Y. STOCK CORP. LAW § 51; OHIO CODE ANN. § 8623-15(4) (Supp. 1952). On these transactions the company cannot deprive the shareholder of his voting right. See *Kentucky Package Store, Inc. v. Checani*, — Mass. —, 117 N.E.2d 139 (1954); *Aver v. Dressel*, — N.Y. —, 118 N.E.2d 590 (1954).

<sup>247</sup> Contractual disputes may arise here. See *Personal Industrial Bankers, Inc. v. Citizens Budget Co.*, 80 F.2d 327 (6th Cir. 1935), *cert. denied*, 298 U.S. 674 (1936).



The typical clause creates the voting right, in the preferred stock as a class, when three or four or six *nonconsecutive* dividend payments (*i.e.*, on the specified dividend dates) have been missed.<sup>249</sup> When nonconsecutive, the corporation cannot avoid the shift in control by paying a dividend just often enough—as on one quarterly dividend date annually—to keep the provision suspended. The purpose of the clause would be vitiated if more dividends could be passed than are needed to activate the voting right just as long as they are not passed consecutively.<sup>250</sup> A provision that the control shifts “whenever four dividend payments are missed” is ambiguous and should be avoided as provoking dispute. It is certainly construable as “consecutive,” but if that result is desired it should be expressed. Such phrasing is a source of potential abuse by creating a stock seeming to differ from what it in fact is.

The vote given is usually the right to elect a given number of directors.<sup>251</sup> This number may range widely: one, three, the greatest minority, the least majority or all.<sup>252</sup> But given the right to vote,<sup>253</sup> certain mechanical aids are needed to activate this right. The present management's failure to call a meeting for an election of the board of directors under the new rules when the required default occurs may be actionable, though a mere delay until the next regular annual meeting might be legitimate. Most articles permit a small group (about 5%) of the preferred shareholders to call a special meeting for election of “their” directors. A shareholder is usually given access to the company's stock books for this purpose. The meeting is usually of all shareholders, since unless the preferred elects the whole board some common-elected directors will remain. A quorum of preferred shareholders must be present or represented; the percentage varies in the articles. If less are present the election cannot be held. It might be argued, unless the contrary were specified, that the absence of a quorum of common shareholders would also prevent holding the election. Most articles there-

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<sup>248</sup> As a *financial* protection this is of debatable value. GRAHAM & DODD, SECURITY ANALYSIS 311 (3d ed. 1951).

<sup>249</sup> Or as it is sometimes phrased, “if a dividend has been missed and not made up after six dividend dates.” Certificate of Incorporation, Sonotone Corp. (1951). This strengthens the protection still more.

<sup>250</sup> GRAHAM & DODD, SECURITY ANALYSIS 311 (3d ed. 1951).

<sup>251</sup> Sometimes the number of places is increased upon default, the preferred electing the excess. Certificate of Incorporation, Tung-Sol Electric, Inc. (1952).

<sup>252</sup> And should provide for proportional increase if the number of directors is increased. See a similar abuse (but from a reduction in the number) in *Bond v. Atlantic Terra Cotta Co.*, 139 App. Div. 671, 122 N.Y. Supp. 425 (1st Dep't 1910).

If two classes of preferred stock are outstanding they may be limited to voting together for the number of directors which the junior stock alone would be entitled to if in default. Certificate of Incorporation, Sylvania Electric Products Inc. (1951).

<sup>253</sup> *E.g.*, for the greatest minority or “the greatest minority or three, the lesser,” to take care of changes in the number of directors. Certificate of Incorporation, Davison Chemical Corp. (1952).

fore specify that the lack of a quorum of common shareholders is immaterial to the preferred's voting, and vice versa. If absence of a quorum of preferred shareholders prevents preferred's voting, the status quo remains. A few articles specifically provide that the common stock may then elect the number of directors otherwise allocated the preferred.<sup>254</sup> The preferred shareholders, however, should be entitled to try again at the next meeting even though a dividend has meanwhile been paid, if the default is not yet cured. For the same reasons a provision that in absence of a quorum of preferred shareholders the preferred present shall vote with the common may be objectionable—if another default is required for preferred to try again.<sup>255</sup>

Assuming a default occurs when four nonconsecutive dividends are missed, the voting right then created continues until the default is cured. "Cure" may be by full payment of the total arrearage or it may be by payment of sufficient dividends to reduce the arrearage to one less dividend than the least amount originally activating the voting right.<sup>256</sup> Many articles allow retention of the voting control by the preferred until the arrearage is completely paid.<sup>257</sup> The futility of constant voting shifts if payment of only the excess accumulation beyond the default level cured the default right might lead a court to require full payment even though the articles speak merely of "revesting upon curing of the default."<sup>258</sup> In

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<sup>254</sup> Certificate of Incorporation, Kaiser Aluminum & Chemical Corp. (1952). In this case, however, there should be a provision for another election as soon as a later call resulted in the necessary quorum. See, e.g., Certificate of Incorporation, Tung-Sol Electric, Inc. (1952).

<sup>255</sup> Of course all these protective provisions may be illusory if the preferred has no means of sponsoring an independent slate of directors but votes only for a group sponsored by the management. For a suggestion that underwriters should undertake the sponsorship of an independent group in this case, see GRAHAM & DODD, *SECURITY ANALYSIS* 312 (3d ed. 1951). For disputes over access to stocklists, see *Alaska Airlines v. People ex rel. Bowman*, 206 F.2d 203 (9th Cir. 1953).

<sup>256</sup> See *Ellingwood v. Wolf's Head Oil Refining Co.*, 27 Del. Ch. 356, 38 A.2d 743 (Ch. 1944).

<sup>257</sup> Here too contractual disputes may arise. In the *Ellingwood* case, *supra* note 256, the articles gave preferred the right to elect the board of directors upon an equivalent of two years' dividend default, "to the exclusion of any such right on the part of the holders of the common stock until the corporation shall have declared and paid for a period of a full year a 6% dividend on the preferred stock, when the right to vote . . . shall revert to the holders of the common stock . . . . The said right of the preferred stock . . . shall survive any exercise of such election and a subsequent reversion of the right to vote to the common stock . . . and the subsequent right to a reversion of the voting power to the common stock in the event of the payment of a full year's 6% dividend shall be a continuing privilege and right of said common stock and its holders." Dividends were in default well over the required amount when the preferred exercised its rights. A full year's 6% dividend was paid. The common then tried to regain voting control. It was held that the preferred could then immediately recapture the voting right, for it would really vest in the common only when the arrearage had been reduced below the two year default level. A new two year default was not required.

<sup>258</sup> E.g., Certificate of Incorporation, Tung-Sol Electric, Inc. (1952); but see *Ellingwood v. Wolf's Head Oil Refining Co.*, 27 Del. Ch. 356, 38 A.2d 743 (Ch. 1944).

any event, the right of "return" is subject to revesting in the preferred when another arrearage of "default size" develops. This undoubtedly results though the contract be silent as to revesting upon later default.

Usually the default is to be cured "as quickly and expeditiously as possible." This provision expresses the policy that the preferred shareholders' control is strictly an interim affair for a specific purpose and not a substitute for the basic corporate control structure.<sup>259</sup> Yet any legal sanction involved in the clause is doubtful. It might be wise to make payment in these circumstances mandatory (given earnings)—protecting common shareholders against an unnecessarily long period of control by the preferred's management. It would also protect the preferred shareholders, if the new board of directors is really another management board, from a mere continuation of the former no-payment policy.<sup>260</sup> Whenever the default is cured, the exclusive right to vote for the board of directors returns to the common stock. To prevent lame-duck directorates many articles require a new meeting after a default is cured and most specifically end the preferred directors' terms of office at once.<sup>261</sup>

The requirement that preferred shares approve certain contemplated transactions constitutes the remaining group of voting provisions usually found in the articles. The consent required is usually two-thirds of the preferred shareholders voting as a class, or of a particular series if the action affects the shares in separate series. If the sanction of voting is at all effective against certain actions, class voting is the only feasible method. Straight voting of preferred and common stock would be no protection; numerically the common is usually greater.<sup>262</sup> Further, statutes often

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<sup>259</sup> GRAHAM & DODD, *SECURITY ANALYSIS* 311 (3d ed. 1951).

<sup>260</sup> In other words, fair treatment must be given both when dividends are passed because of lack of earnings and when passed despite earnings.

In this case, a vacancy should be filled by those who elected the previous incumbent. For an analogous problem in cumulative voting, see *In re Rogers Imports, Inc.*, 202 Misc. 761, 116 N.Y.S.2d 106 (Sup. Ct. 1952).

<sup>261</sup> It is often suggested that the same shift of voting control be used for certain other contingencies. Specifically, a vote if sinking fund payments are in default, and if earnings do not exceed a certain minimum figure, have been proposed. GRAHAM & DODD, *SECURITY ANALYSIS* 312 (3d ed. 1951). Such provisions are seldom found, though occasionally a voting shift upon default in sinking fund payments is used: *Charter of Consolidated Grocers Corp.* (1952). In that case similar problems may arise. See *Alleghany Corp. v. Guaranty Trust Co. of New York*, 23 F. Supp. 203 (S.D.N.Y. 1938), *aff'd*, 97 F.2d 367 (2d Cir. 1938).

<sup>262</sup> Where upon default the preferred was entitled to the same voting powers as holders of the common stock, the provision merely restated the "common law concept" of one vote per share and did not create in the preferred as a group a voting right equal to that of the numerically superior common. *State ex rel. Cullitan v. Campbell*, 135 Ohio St. 238, 20 N.E.2d 366 (1939). Generally, see Stevens, *Stockholders' Voting Rights and the Centralization of Voting Control*, 40 Q. J. ECON. 353 (1926); Stevens, *Voting Rights of Capital Stock and Shareholders*, 11 J. BUS. U. OF CHI. 311 (1938); *Booma v. Bigelow-Sanford Carpet Co.*, 330 Mass. 79, 111 N.E.2d 742 (1953).

require class voting upon those actions for which preferred shareholders must be given a voting right.<sup>263</sup> A class vote is usually taken of the *outstanding* stock,<sup>264</sup> not of that issued, nor apparently of that present and voting. Those actions affecting shareholders severely are usually to be permitted only upon approval of two-thirds of the class or series,<sup>265</sup> according to most statutes.

What actions must be submitted to shareholder class approval? The issue of prior preferred stock or an increase in the number of an existing issue, the voluntary dissolution, liquidation or winding-up of the corporation, the sale of all or substantially all its assets and its merger or consolidation with another corporation are the usual actions for which the prior approval of the preferred shareholders as a class must be obtained.<sup>266</sup> Since

<sup>263</sup> See note 246 *supra*.

<sup>264</sup> *Market St. Ry. v. Hellman*, 109 Cal. 571, 42 Pac. 225 (1895); see *Missouri Valley Grocery Co. v. Hall*, 45 N.D. 419, 178 N.W. 193 (1920). But the Charter of Merck & Co., Inc. (1951) requires "a two-thirds class vote and a vote of at least one half of the outstanding preferred" from which it can be inferred that otherwise only approval by two-thirds of the stock present and voting would be needed.

<sup>265</sup> For a criticism of the sufficiency of a two-thirds class vote, see Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 1 (1942) *passim*.

<sup>266</sup> *California*: CORP. CODE § 3634: a two-thirds class vote:

- (a) To authorize the corporation to levy assessments thereon.
- (b) To reduce the dividend rate thereof.
- (c) To make noncumulative, in whole or in part, as to dividends shares which had theretofore been cumulative.
- (d) To reduce the redemption price thereof.
- (e) To reduce any amount payable thereon upon voluntary or involuntary liquidation.
- (f) To eliminate, diminish, or alter adversely conversion rights pertaining thereto.
- (g) To create or increase voting rights pertaining thereto.
- (h) To create, increase, or alter advantageously any options or rights granted to the holders thereof to purchase other shares of the corporation.
- (i) To change adversely any sinking fund provision relating thereto.
- (j) To rearrange the priority of such outstanding shares so as to make them subject to the preferences of other than outstanding shares as to distributions by way of dividends or otherwise.

§ 3635: Majority vote of all other stock:

- (a) To make nonassessable shares which had theretofore been assessable.
- (b) To increase the dividend rate thereof.
- (c) To make cumulative, in whole or in part, as to dividends shares which had theretofore been noncumulative.
- (d) To increase the redemption price thereof.
- (e) To increase any amount payable thereon upon voluntary or involuntary liquidation.
- (f) To create, increase, or alter advantageously conversion rights pertaining thereto.
- (g) To create or increase voting rights pertaining thereto.
- (h) To create, increase, or alter advantageously any options or rights granted to the holders thereof to purchase other shares of the corporation.
- (i) To change advantageously the relative priority thereof as to distributions, whether by way of dividends or otherwise, by the rearrangement of the relative priorities of the classes or series of shares of the corporation theretofore authorized.

*Delaware*: GEN. CORP. LAW § 242 (1953): Majority class vote for "change of preferences, special rights or powers." § 251: Two-thirds non-class vote for mergers.

*New Jersey*: REV. STAT. § 14:11-3 (1937): Two-thirds class vote for reduction of dividend rate, reduction of right to cumulative dividends, reduction of redemption or liquidation amount, or satisfying dividend arrearages; but specifically *not* for issue or prior preferred.

some statutes require approval of the preferred for any action adversely affecting, for example, "the preferences, special rights or powers" of a class,<sup>267</sup> the articles may include a similar general statement; or they may achieve the same effect by adding, to a general denial of voting rights, "except as required by statute." This type of statute leaves determination of voting rights in some cases in the courts' hands, requiring litigation to determine inclusion of any specific action.<sup>268</sup> The content of the quoted phrase has, however, been defined with some certainty, at least in major corporation states.<sup>269</sup> Certain other actions commonly require the approval of a *majority* by class of the preferred shareholders. Often included are an increase in the number of the present preferred or the creation of an equally-ranking preferred, and frequently any of the already-mentioned actions—if permitted by applicable state law. Again, a statute may require prior approval of certain actions by majority class vote; these must then be considered.<sup>270</sup> Another action often subject to either two-thirds or majority class approval, though not usually so required by law, is the creation or assumption of indebtedness beyond certain limits.<sup>271</sup>

These voting rights may to a great extent be engendered by statutory pressure but at least in detail they are contractual provisions and should be as comprehensive and clear as any other part of the articles. Adoption of the statutory phrasing is often unsatisfactory where the statute itself requires interpretation. The transactions not requiring approval, too, are often not sufficiently defined. If approval is required for the "authorization" of prior preferred stock, an attempted redemption of a present preferred through new financing may be blocked because disapproval is voted by these present preferred shareholders. For the company's protection approval should be needed only for an *issue* of the new prior preferred, instead of making the company redeem the old class before the new stock

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*New York*: STOCK CORP. LAW § 51: "Vote" (no more) upon reclassifications per § 35, adversely affecting rights. § 35(3): Reclassifications is: altering designations, preferences, privileges or voting powers, or affecting redemption rate, dividend rate, cumulative or non-cumulative or dividend accruals, unexpended sinking fund payments, or preemptive rights.

*Ohio*: CODE ANN. § 8623-15(4) (Supp. 1952): Increase or reduce par value, change shares into a different number, change express terms and provisions of the class prejudicially, or of a prior class prejudicially to the present one, authorize conversion of other classes into the present one, change the corporate business or reduce par value so as to reduce the stated capital. § 8623-15 (3): Two-thirds class vote required for these except if the corporate articles provide for a lesser percentage (but they must require at least a majority) or a greater percentage.

<sup>267</sup> E.g., DEL. GEN. CORP. LAW § 242 (1953).

<sup>268</sup> See *Hartford Accident & Indemnity Co. v. W. S. Dickey Clay Mfg. Co.*, 26 Del. Ch. 411, 24 A.2d 315 (Ch. 1942).

<sup>269</sup> See ALTERATION OF PREFERRED STOCK'S CONTRACTUAL RIGHTS, *infra*.

<sup>270</sup> See CAL. CORP. CODE § 3635.

<sup>271</sup> See text following note 278 *infra*.

has even gone through the lengthy authorizing process.<sup>272</sup> Some articles overcome this obstacle by excepting from the consent requirement any prior preferred stock created to renew an existing issue, or by some similar phrasing.<sup>273</sup>

Prior approval may be legitimately dispensed with in various situations, most of which are covered by the share contract. Often a minimum issue of stock is exempt from the requirement. Also common is a provision that approval of an issue of equally-ranking stock may be dispensed with if certain financial controls are met. Thus if after the issue the sum of all debt and preference stock does not exceed a given percentage of consolidated net tangible assets,<sup>274</sup> approval of an issue may be foregone. More rarely the same exception is permitted for issues of prior preferred stock. Such exemptions do not seem desirable. Any "prior" stock issue puts a burden on the company (and on the present preferred) extending into the future, where financial conditions are unknown. A presently favorable financial position is not logically a substitute for the protection thought to reside in the approval requirement. Another more legitimate exemption is granted mergers or consolidations in which the present company absorbs a subsidiary.<sup>275</sup> As this statement alone is defective, not accounting for stock reclassifications which may result though the subsidiary is wholly owned, many articles require that no new stock classes arise because of the merger.

Several types of corporate action may circumvent these protective requirements. The most obvious opportunity arises from the failure to include subsidiaries' actions within these limitations. If partial purchase or redemption while dividends are in arrears is forbidden without consent, a purchase of this preferred stock by a subsidiary evades the protection. The mere issue of stock by a subsidiary may be objectionable if it removes a source of assets previously available to the parent's preferred stock, upon which the present preferred shareholders may have relied when they purchased their holdings.<sup>276</sup> It may also be desirable to include (for approval) the *sale* by the parent or subsidiary of a subsidiary's preferred stock, already issued but held by it or by the parent. This prevents an evasion of the approval requirement if, for instance, the stock was originally issued to the parent—which does not require approval.<sup>277</sup> Since a

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<sup>272</sup> BALLANTINE & JENNINGS, *supra* note 78, at 12,037.

<sup>273</sup> E.g., Charter of Merck & Co., Inc. (1951).

<sup>274</sup> Or "assets plus all the senior stock of the company and its subsidiaries."

<sup>275</sup> A merger may also be exempt if the present preferred is bought up or redeemed at that time. Certificate of Incorporation, Shellmar Products Corp. (1951).

<sup>276</sup> If such stock is issued to the parent company, however, an exception from consent requirements may be allowed. Certificate of Incorporation, Shellmar Products Corp. (1951).

<sup>277</sup> This sanction also enforces a company's fiduciary obligation, while still a partial owner of the subsidiary, not to release control of the subsidiary to outside interests for an inadequate consideration. See Charter of Merck & Co., Inc. (1951).

complete sale of the subsidiary may not be objectionable it is often permitted without approval.<sup>278</sup> It seems, however, that here too the present preferred shareholders have a legitimate interest in the consideration received and should be entitled to prevent such action, as in the case of a partial liquidation or sale of assets.

The creation of indebtedness should *a fortiori* be subject to the preferred shareholders' prior approval, for it affects their interests as much as does the issue of prior preferred stock. Many articles require a two-thirds class vote for any indebtedness; others are satisfied with the majority's approval. Naturally these limitations should include the same actions by a subsidiary. A comprehensive provision will detail the types of indebtedness whose creation or assumption requires this consent, but will also avoid unnecessary obstruction by exempting actions which themselves are either protected or common and only incidental to the operation of a business.

A "good faith" provision (not to be confused with that common for Delaware corporations) in common use is to the general effect that a two-thirds or majority class vote is required for any amendments "changing the terms or provisions of a class in a substantially prejudicial manner."<sup>279</sup> By this clause, however, a shareholder may be given opportunity to complain and perhaps litigate over vague areas of corporate action. Occasionally the clause is tied to a more specific activity, usually the proposed satisfaction of accrued dividends by means other than in cash, or at a different dividend rate.<sup>280</sup> This is a desirable provision and may be a substitute for doubtful judicial remedies of the shareholder. But it is also a contractual concession by the shareholder that he will accept property dividends in satisfaction of a dividend arrearage if the requisite majority agree, thus vitiating his possible right to demand cash payment.<sup>281</sup> It may even override an earlier provision in the articles that each share is entitled to "cash dividends."

It is occasionally suggested that high percentages of approval be required—higher than the statutory percentages, if any. The desire for these high levels of consent has two sources. One is the understandable attempt to give minority interests in close corporations (especially those supplying capital) a veto power over corporate actions. This is shown by voting requirements of 90%, 87½%, or 81⅔%, evidencing the division of shares. The other arises from the tendentious claim that the majority or

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<sup>278</sup> Or if the controlling stock is relinquished to the subsidiary.

<sup>279</sup> Certificate of Incorporation, Pittsburgh Coke & Chemical Corp. (1951).

<sup>280</sup> *Ibid.*

<sup>281</sup> And overcoming the effect of *Strout v. Cross, Austin & Ireland Lumber Co.*, 283 N.Y. 406, 28 N.E.2d 890 (1940).

two-thirds requirement has proven ineffective to control management in the large corporations with atomistic share ownership. Whatever the reasons, such greater percentages are occasionally found. Apart from a determination of their extent, size and general desirability, the draftsman should not fail to collate them to statutory requirements. In a few states the legality of voting requirements higher than those set by statute may be in doubt,<sup>282</sup> in which case a two-thirds approval may be the greatest protection possible. The same comment applies to the occasional suggestion that certain corporate actions be prohibited entirely. Dividends on junior stock, for example, can be forbidden if preferred dividends are in arrears. But stronger prohibitions may infringe on the freedom of a board of directors and thus be invalidated.<sup>283</sup>

#### ALTERATION OF PREFERRED STOCK'S CONTRACTUAL RIGHTS

The corporate articles create the rights, preferences, privileges and powers of the preferred stock. A corporation may, however, alter these features by appropriate action, as recognized by the articles themselves. These alterations may go further than a shareholder thought possible at the time he purchased his holdings. Included in the definition of "rights, preferences and privileges"—all of which can be altered by appropriate vote—may be features which he thought to be intrinsic and unalterable elements of his stock. Their change or elimination is usually considered a legal problem unaffected by the protective provisions of the articles. But

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<sup>282</sup> See New York Leg. Doc. (1951) No. 65(H) at 10, 11, 37, detailing the reasons for amendment of N. Y. STOCK CORP. LAW § 9. Previously "veto powers" of higher percentages had been held void. *Benintendi v. Kenton Hotel, Inc.*, 294 N.Y. 112, 60 N.E.2d 829 (1945); see *Israels, The Close Corporation and the Law*, 33 CORNELL L.Q. 488 (1948); *Israels, The Sacred Cow of Corporate Existence*, 19 U. OF CHI. L. REV. 778, 780 (1952). Even if the requirement is permitted, it may not be a veto requirement (i.e., phrased negatively). *Aldridge v. Franco Wyoming Oil Co.*, 24 Del. Ch. 349, 14 A.2d 380 (Ch. 1940).

Many statutes specifically permit a higher requirement in the articles. N. Y. STOCK CORP. LAW § 9; OHIO CODE ANN. § 8623-15(3) (Supp. 1952). *Ripin v. Atlantic Mercantile Co.*, 205 N.Y. 442, 98 N.E. 855 (1912); *Sellers v. Joseph Bancroft & Sons Co.*, 25 Del. Ch. 268, 17 A.2d 831 (Ch. 1941); see Note, 18 U. OF CHI. L. REV. 139 (1950). Generally, see O'Neal, *Giving Shareholders Power to Veto Corporate Decisions*, 18 LAW & CONTEMP. PROB. 451 (1953).

If a statute permits amendment by a two-thirds class vote, a provision requiring a greater class vote for certain actions may be eliminated by a two-thirds class vote unless the articles specify that a greater class vote is needed to amend that particular provision. *Warren v. 536 Broad St. Corp.*, 6 N. J. Super. 170, 70 A.2d 782 (1950). This construction has been criticized, see Note, 18 U. OF CHI. L. REV. 139, 142 (1950), and seems unsound. Cf. *Ripin v. Atlantic Mercantile Co.*, *supra*. But it should warn draftsmen to protect such provisions by a further provision specifying the vote needed for amendment; see *Sellers v. Joseph Bancroft & Sons Co.*, *supra*.

<sup>283</sup> A prohibition against the issue of prior stock is an example. See pp. 70-71 *infra* for a discussion of the possibility of buttressing the high voting requirements. See *Israels, supra* note 282; O'Neal, *Resolving Disputes in Closely Held Corporations*, 67 HARV. L. REV. 786 (1954).



certain extra-legal safeguards against the elimination of some features of a preferred share may validly be created by the articles themselves. Some of these have been listed incidentally to the discussion of such specific rights as conversion or redemption.

A full discussion of permissible alterations and methods of alteration would be far beyond the scope of this paper and unnecessarily add to the present literature on this phase of corporation law.<sup>284</sup> A sketchy outline of the changes and the methods of alteration permissible by law today should suffice.

The most notorious alteration is the elimination of preferred stock's dividend arrearages. Statutes permitting certain changes by a class vote may speak of alteration of preferences, privileges, etc., specifically including in their definition the alteration of accrued dividends.<sup>285</sup> Such a statute clearly permits the elimination of dividend arrearages (provided the necessary consent is obtained) whether by direct amendment reclassifying the shares<sup>286</sup> or by more indirect means.<sup>287</sup> The statute is constitutional; it is within the "constitutionally reserved power" of a state, a part of its "police power," to affect shareholder-company contractual relations.<sup>288</sup> It has been held retroactive to cancel arrearages accumulating before its enactment.<sup>289</sup> Most jurisdictions, however, permit direct "amendment-out"

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<sup>284</sup> Generally, see BALLANTINE, LATTIN & JENNINGS, *supra* note 160, c. XIII, "Fundamental Changes in Organization," for a case treatment of these changes. The best recent study of most of these ways of altering the rights of preferred shareholders and a collection of the applicable case law may be found in a series of papers by Professor Becht: *Alterations of Accrued Dividends*, 49 MICH. L. REV. 363, 565 (1951); *Corporate Charter Amendments: Issues of Prior Stock and the Alteration of Dividend Rates*, 50 COL. L. REV. 900 (1950); *Changes in the Interests of Classes of Stockholders by Corporate Charter Amendments Reducing Capital, and Altering Redemption, Liquidation and Sinking Fund Provisions*, 36 CORNELL L.Q. 1 (1950). Citations to the previous literature will be found there. A good discussion of the alterations of preferred stock's voting rights may be found in Note, 37 CORNELL L.Q. 768 (1952).

<sup>285</sup> E.g., N. Y. STOCK CORP. LAW § 35—a complete statute detailing the alterations allowed.

<sup>286</sup> Or by an amendment eliminating the present preferred and compelling exchange for a different stock. See *Janes v. Washburn Co.*, 326 Mass. 356, 94 N.E.2d 479 (1950); *Sherman v. Pepin Pickling Co.*, 230 Minn. 87, 41 N.W.2d 571 (1950); *Davison v. Parks, Austin & Lipscomb, Inc.*, 285 N.Y. 500, 35 N.E.2d 618 (1941) (not allowed).

<sup>287</sup> As by a merger or issues of prior preferred stock; see text at note 314 *infra*.

<sup>288</sup> *McNulty v. W. & J. Sloane*, 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. N.Y. 1945), decided by the late Justice Shientag. The case contains an excellent brief discussion of the general alteration problem and is the prototype of the modern cases. It discusses and rejects the confusing "vested rights" doctrine in dividends as having caused most of the difficulty over retroactive applicability of those new statutes permitting elimination of accrued dividends. Generally, compare *Roberts v. Robert Wicks Co.*, 184 N.Y. 257, 77 N.E. 13 (1906).

<sup>289</sup> *McNulty v. W. & J. Sloane*, 184 Misc. 835, 54 N.Y.S.2d 253 (Sup. Ct. 1945). See *Arstein v. Robert Reis & Co.*, 77 N.Y.S.2d 303 (Sup. Ct. 1948), *aff'd without opinion*, 273 App. Div. 963, 79 N.Y.S.2d 314 (1st Dept' 1948), *leave to appeal denied*, 298 N.Y. 931, 81 N.E.2d 335 (1948), *cert. denied*, 335 U.S. 860 (1948); *McQuillen v. National Cash Register Co.*, 27 F. Supp. 639 (D. Md. 1939), *aff'd*, 112 F.2d 877 (4th Cir.), *cert. denied*, 311 U.S. 695 (1940); *Harbme v. Dayton Malleable Iron Co.*, 61 Ohio App. 1, 22 N.E.2d 281 (1939).

of dividend arrearages only if they accrued after the enactment of such a statute, and not retroactively.<sup>290</sup> Others permit retroactivity if it is clearly expressed.<sup>291</sup> A statute permitting a general change of "preferences" usually does not grant permission to eliminate dividend arrearages,<sup>292</sup> although some jurisdictions read that phrase more liberally and do allow such elimination.<sup>293</sup> Direct "amendment-out," however, is not the only method that may be used. A statute regulating the merger of corporations upon appropriate consent incidentally permits any necessary alteration of the stock structure, including the elimination of arrears.<sup>294</sup> This power is thought implicit in the definition of the power to effect mergers and consolidations.<sup>295</sup> The creation of a new prior preferred stock (as permitted by the articles upon consent) and the voluntary exchange of present preferred stock for that new prior issue—incidentally relinquishing the dividend arrearage—is allowed.<sup>296</sup> It is valid if the statute under which it is accom-

<sup>290</sup> In this context, the effect of such conclusory language as "vested rights" can be seen. *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 190 Atl. 115 (Ch. 1936); see *Harbine v. Dayton Mal-leable Iron Co.*, 61 Ohio App. 1, 22 N.E.2d 281 (1939); *Wheatley v. A. I. Root Co.*, 147 Ohio 127, 69 N.E.2d 187 (1946); *Schaffner v. Standard Boiler & Plate Iron Co.*, 150 Ohio St. 454, 83 N.E.2d 192 (1948); *Schaad v. Hotel Easton Co.*, 369 Pa. 486, 87 A.2d 227 (1952); Comment, 3 BUFF. L. REV. 364 (1953).

<sup>291</sup> Cf. *Western Foundry Co. v. Wicker*, 403 Ill. 260, 85 N.E.2d 722 (1949); *Janes v. Washburn Co.*, 326 Mass. 356, 94 N.E.2d 479 (1950).

<sup>292</sup> *Harr. v. Pioneer Mechanical Corp.*, 65 F.2d 332 (2d Cir.), *cert. denied*, 290 U.S. 673 (1933); *Davison v. Parke, Austin & Lipscomb, Inc.*, 285 N.Y. 500, 35 N.E.2d 618 (1941); *Wiedersum v. Atlantic Cement Products, Inc.*, 261 App. Div. 305, 25 N.Y.S.2d 496 (2d Dep't 1941); *Weckler v. Valley City Mill Co.*, 93 F.Supp. 444 (W.D. Mich. 1950), *aff'd*, 188 F.2d 367 (6th Cir. 1951); cf. *Kennedy v. Carolina Pub. Serv. Co.*, 262 Fed. 803 (D. Ga. 1920). But see BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 372 (1949). See *Patterson v. Durham Hosiery Mills*, 214 N.C. 806, 200 S.E. 906 (1939); *Clark v. Henrietta Mills*, 219 N.C. 1, 12 N.E.2d 682 (1941); *Patterson v. Henrietta Mills*, 219 N.C. 7, 12 S.E.2d 686 (1941), for the North Carolina law on similar general statutes.

<sup>293</sup> *Western Foundry Co. v. Wicker*, 403 Ill. 260, 85 N.E.2d 722 (1949); *Sherman v. Pepin Pickling Co.*, 230 Minn. 87, 41 N.W.2d 571 (1950).

<sup>294</sup> DEL. GEN. CORP. LAW § 251 (1953); *Federal United Corp. v. Havender*, 24 Del. Ch. 318, 11 A.2d 331 (Supp. Ct. 1940); *Donohue v. Heuser*, 239 S.W.2d 238 (Ky. 1951); *Anderson v. International Minerals & Chemical Corp.*, 295 N.Y. 343, 67 N.E.2d 573 (1946); *Zobel v. American Locomotive Co.*, 184 Misc. 323, 44 N.Y.S.2d 33 (Sup. Ct. 1943). But see *Colgate v. United States Leather Co.*, 73 N.J. Eq. 72, 67 Atl. 657 (Ch. 1907). See also *Porter v. C. O. Porter Mach. Co.*, 336 Mich. 437, 58 N.W.2d 135 (1953).

<sup>295</sup> DEL. GEN. CORP. LAW § 251 (1953). The merger may be with a paper subsidiary expressly created for that purpose, with no independent business validity. *Hottenstein v. York Ice Mach. Corp.*, 136 F.2d 944 (3d Cir. 1943).

<sup>296</sup> *Blumenthal v. DiGiorgio Fruit Corp.*, 30 Cal.App.2d 11, 85 P.2d 580 (1938); *Shanik v. White Sewing Mach. Corp.*, 25 Del. Ch. 371, 19 A.2d 831 (Sup. Ct. 1941); *Kreicker v. Naylor Pipe Co.*, 374 Ill. 364, 29 N.E.2d 502 (1940), *cert. denied*, 312 U.S. 659 (1940); *Longson v. Beaux-Arts Apartments, Inc.*, 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); *Johnson v. Lamprecht*, 133 Ohio St. 567, 15 N.E.2d 127 (1938); *Johnson v. Fuller*, 121 F.2d 618 (3d Cir.), *cert. denied*, 314 U.S. 681 (1941); *Ainsworth v. Southwestern Drug Corp.*, 15 F.2d 172 (5th Cir. 1938); cf. *Thomas v. Lacomia Car Co.*, 251 Mass. 529, 146 N.E. 775 (1925); *Vulcan Corp. v. Westheimer & Co.*,

plished permits alteration of "special rights" or of "dividend accruals" specifically<sup>297</sup> and in some jurisdictions if of "preferences, privileges and powers" generally.<sup>298</sup> Since modern statutes are phrased to permit alteration of specific rights and some include dividend arrearages therein,<sup>299</sup> only problems of statutory construction (retroactivity) and of the constitutionality of retroactive statutes are still genuinely arguable. Lack of fairness of a particular plan independently of the admitted power to promulgate it<sup>300</sup> is no longer an independent criterion of validity in most jurisdictions.<sup>301</sup>

The other dividend rights may be amended in almost all jurisdictions by the methods outlined above.<sup>302</sup> Cumulative shares may be made noncumu-

34 N.E.2d 278 (Ohio 1938), *appeal dismissed*, 135 Ohio St. 136, 19 N.E.2d 901 (1939). *But see* Buckley v. Cuban American Sugar Co., 129 N.J. Eq. 322, 19 A.2d 820 (Ch. 1940). See also Baker v. Standard Lime & Stone Co., —Md.—, 100 A.2d 823 (1953).

<sup>297</sup> As N. Y. STOCK CORP. LAW § 35.

<sup>298</sup> See *Sherman v. Pepin Pickling Co.*, 230 Minn. 87, 41 N.W.2d 571 (1950). Four methods are available for this elimination: Reclassification to remove an accrual; amendment to wipe out the present stock; issue of new prior stock; mergers and reclassifications.

<sup>299</sup> CAL. CORP. CODE § 3634; cancellation is presumably permitted, see BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 373 (1949); DEL. GEN. CORP. LAW § 242 (1953). MD. ANN. CODE GEN. LAWS art. 23, § 10 (1951) (cancellation of accruals permitted). N. J. REV. STAT. § 14:11-3 (1937) (accruals may be "satisfied"). N. Y. STOCK CORP. LAW § 35 (accruals may be "satisfied"). OHIO CODE ANN. § 8623-14 (Supp. 1952) (accruals may be eliminated). PA. STAT. ANN. tit. 15, § 2852-801 (1936) as amended by Act 352, I Sessions of 1949, II Laws Pa. 1773 (1949).

<sup>300</sup> See Dodd, *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780 (1942); Latty, *supra* note 265.

<sup>301</sup> Barrett v. Denver Tramway Corp., 146 F.2d 701 (3d Cir. 1944); Porges v. Vadsco Sales Corp., 27 Del. Ch. 127, 32 A.2d 148 (Ch. 1943); Zobel v. American Locomotive Co., 184 Misc. 323, 44 N.Y.S.2d (Sup. Ct. 1943); Anderson v. Cleveland-Cliffs Iron Co., 87 N.E.2d 384 (Ohio App. 1948); Johnson v. Fuller, 121 F.2d 618 (3d Cir.), *cert. denied*, 314 U.S. 681 (1941); Hubbard v. Jones & Laughlin Steel Corp., 42 F. Supp. 432 (W.D. Pa. 1941).

Only in New Jersey does the test of fairness seem to retain some force. Wessel v. Guantanamo Sugar Co., 134 N.J. Eq. 271, 35 A.2d 215 (Ch. 1944), *aff'd per curiam*, 135 N.J. Eq. 506, 39 A.2d 431 (Ct. Err. & App. 1944); Kamena v. Janssen Dairy Corp., 133 N.J. Eq. 214, 31 A.2d 200 (Ch. 1943), *aff'd without opinion*, 134 N.J. Eq. 359, 35 A.2d 894 (Ct. Err. & App. 1944); Buckley v. Cuban-American Sugar Co., 129 N.J. Eq. 322, 19 A.2d 820 (Ch. 1940). *But see* Franzblau v. Capital Securities Co., 2 N.J. Super. 517, 64 A.2d 644, 649 (1949). For a trend in Delaware, see *Canada Southern Oils, Ltd. v. Manabi Exploration Co.*, 96 A.2d 810 (Sup. Ct. Del. 1953), and *Beanelt v. Brevil Petroleum Corp.*, 99 A.2d 236 (Ch. Del. 1953).

An articulate discussion may be found in Bailey v. Tubize Rayon Corp., 56 F. Supp. 418, 423-425 (D. Del. 1944). See BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 376 (1949); Latty, *Exploration of Legislative Remedy for Prejudicial Changes in Senior Shares*, 19 U. OF CHI. L. REV. 759 (1952).

The equitable issue arises in all the alterations: change of preferred to common, *State ex rel. Weede v. Bechtel*, 239 Iowa 1298, 31 N.E.2d 853 (1948) (creation of the conversion privilege), *Starr v. Engineering Contracting Co.*, 149 Neb. 390, 31 N.E.2d 213 (1948) (reduction of the number of shares), *Theis v. Durr*, 125 Wis. 651, 104 N.W. 985 (1905). Fraud, bad faith or mismanagement must be alleged. *Shanik v. Botany Worsted Mills*, 133 N.J. Eq. 219, 31 A.2d 226 (Ch. 1943).

<sup>302</sup> See generally, STEVENS, CORPORATIONS 574 ff (2d ed. 1949).

lative<sup>303</sup> or cumulative if earned,<sup>304</sup> or the dividend rate may be altered.<sup>305</sup> Preferred shares may be converted into common shares.<sup>306</sup> Very few jurisdictions forbid any of these actions under a general statute (speaking, e.g., of "rights and preferences").<sup>307</sup> As more states adopt specific statutes this problem loses importance. Retroactivity of these statutes is not a serious issue, for most courts do not call these contractual features "vested

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<sup>303</sup> *Blumenthal v. DiGiorgio Fruit Corp.*, 30 Cal.App.2d 11, 85 P.2d 580 (1938); *Western Foundry Corp. v. Wicker*, 403 Ill. 260, 85 N.E.2d 722 (1949); *cf. Weckler v. Valley City Mill Co.*, 93 F.Supp. 444 (W.D.Mich. 1950), *aff'd*, 188 F.2d 367 (6th Cir. 1951) (invalid because of the accrual feature); *cf. Sherman v. Pepin Pickling Co.*, 230 Minn. 87, 41 N.W.2d 571 (1950); *Wheatley v. A. I. Root Co.*, 147 Ohio 127, 69 N.E.2d 187 (1946) (invalid because of the accrual feature); *Ainsworth v. Southwestern Drug Corp.*, 95 F.2d 172 (5th Cir. 1938); *Yoakam v. Providence Biltmore Hotel Co.*, 34 F.2d 533 (D.R.I. 1929) (invalid because of the sinking fund feature).

<sup>304</sup> *Johnson v. Fuller*, 121 F.2d 618 (3d Cir.), *cert. denied*, 314 U.S. 681 (1941); *Transportation Building Co. v. Daugherty*, 74 Cal.App.2d 604, 169 P.2d 470 (1946).

<sup>305</sup> *Langfelder v. Universal Laboratories, Inc.*, 163 F.2d 804 (3d Cir. 1947); *Johnson v. Fuller*, 121 F.2d 618 (3d Cir.), *cert. denied*, 314 U.S. 681 (1941); *Ainsworth v. Southwestern Drug Corp.*, 95 F.2d 172 (5th Cir. 1938); *Yoakam v. Providence Biltmore Hotel Co.*, 34 F.2d 533 (D.R.I. 1929); *Blumenthal v. DiGiorgio Fruit Co.*, 30 Cal.App.2d 11, 85 P.2d 580 (1938); *Shanik v. White Sewing Mach. Corp.*, 25 Del. Ch. 371, 19 A.2d 831 (Sup. Ct. 1941); *Federal United Corp. v. Havender*, 24 Del. Ch. 318, 11 A.2d 331 (Sup. Ct. 1940); *Western Foundry Co. v. Wicker*, 403 Ill. 260, 85 N.E.2d 722 (1949); *Kreicker v. Naylor Pipe Co.*, 374 Ill. 364, 29 N.E.2d 502 (1940), *cert. denied*, 312 U.S. 659 (1941); *Sherman v. Pepin Pickling Co.*, 230 Minn. 87, 41 N.W.2d 571 (1950); *Franzblau v. Capital Securities Co.*, 2 N.J. Super. 517, 64 A.2d 644 (1949); *Sander v. Janssen Dairy Corp.*, 36 F.Supp. 512 (D.N.J. 1940); *Anderson v. International Minerals & Chemical Corp.*, 295 N.Y. 343, 67 N.E.2d 573 (1946); *In re Kinney*, 279 N.Y. 423, 18 N.E.2d 645 (1939); *Anderson v. Cleveland-Cliffs Iron Co.*, 87 N.E.2d 384 (Ohio App. 1948); *Harbine v. Dayton Malleable Iron Co.*, 61 Ohio App. 1, 22 N.E.2d 281 (1939); *Johnson v. Lamprecht*, 133 Ohio St. 567, 15 N.E.2d 127 (1938); *Harvey v. National Drug Co.*, 30 D. & C. 318 (Pa. 1937). *Cf. Clarke v. Gold Dust Corp.*, 106 F.2d 598 (3d Cir. 1939), *cert. denied*, 309 U.S. 671 (1940); *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 190 Atl. 115 (Ch. 1936) (invalid because of the accrual feature); *Gidwitz v. Armour & Co.*, 299 Ill. App. 618, 20 N.E.2d 175 (1939); *Buckley v. Cuban-American Sugar Co.*, 129 N.J. Eq. 322, 19 A.2d 820 (Ch. 1940) (invalid because of the accrual feature). See *Matter of Silberkraus*, 250 N.Y. 242, 165 N.E. 279 (1929).

<sup>306</sup> *Hottenstein v. York Ice Mach. Corp.*, 136 F.2d 944 (3d Cir. 1943); *Johnson v. Fuller*, 121 F.2d 618 (3d Cir.), *cert. denied*, 314 U.S. 681 (1941); *Hubbard v. Jones & Laughlin Steel Corp.*, 42 F.Supp. 432 (W.D.Pa. 1941); *Anderson v. Cleveland-Cliffs Iron Co.*, 87 N.E.2d 384 (Ohio App. 1948); *cf. Keller v. Wilson & Co.*, 21 Del. Ch. 391, 190 Atl. 115 (Ch. 1936) (invalid because of the accrual feature); *Davison v. Parke, Austin & Lipscomb, Inc.*, 285 N.Y. 500, 35 N.E.2d 618 (1941) (same); *Schaffner v. Standard Boiler & Plate Iron Co.*, 150 Ohio 454, 83 N.E.2d 192 (1948) (ineffective to wipe out accruals); *Schaad v. Hotel Easton Co.*, 369 Pa. 486, 87 A.2d 227 (1952) (invalid because of the accrual feature).

<sup>307</sup> Preferred non-participating shares may be made participating (in excess dividends), *Harvey v. National Drug Co.*, 30 D. & C. 318 (Pa. 1937), or more commonly, the reverse. *Peters v. United States Mortgage Co.*, 13 Del. Ch. 11, 114 Atl. 598 (Ch. 1921); *Davis v. Louisville Gas & Elec. Co.*, 16 Del. Ch. 157, 142 Atl. 654 (Ch. 1928); *In re Kinney*, 279 N.Y. 423, 18 N.E.2d 645 (1939).

Par stock may be changed to no par. *Russell v. Louis Melind Co.*, 348 Ill. App. 188, 108 N.E.2d 504 (1952).

<sup>307</sup> See *Schaad v. Hotel Easton Co.*, *supra* note 306.

property rights" and therefore permit their alteration under the "reserved power" doctrine.<sup>308</sup>

Rights upon liquidation may be altered in the same manner.<sup>309</sup> It might be argued that the right to par and accrued dividends on liquidation is analogous to the ordinary arrearage right,<sup>310</sup> but the contrary view has been adopted and an alteration in effect removing this arrearage is generally valid.<sup>311</sup> Again the broad statute permitting alteration of "rights and preferences" is sufficient authority<sup>312</sup> and the alteration may be by a direct stock amendment,<sup>313</sup> by a merger,<sup>314</sup> or by the issue of prior preferred shares with a provision for voluntary exchange.<sup>315</sup>

Nonredeemable stock may be made redeemable<sup>316</sup> and the redemption

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<sup>308</sup> These dividend rights are, in other words, mere "preferences" which may be changed by appropriate statutory action.

<sup>309</sup> They are only preferential. See *Sterling v. Mayflower Hotel Corp.*, 93 A.2d 107 (Sup. Ct. Del. 1952).

<sup>310</sup> See *Central States Elec. Corp. v. Austrian*, 183 F.2d 879 (4th Cir. 1950), *cert. denied*, 340 U.S. 917 (1951) and *In re Portland Elec. Power Co.*, 162 F.2d 618 (9th Cir.), *cert. denied*, 332 U.S. 837 (1947) on this argument; text at note 108 *supra*.

<sup>311</sup> *Sander v. Janssen Dairy Corp.*, 36 F. Supp. 512 (D.N.J. 1940); *Transportation Building Co. v. Daugherty*, 74 Cal.App.2d 604, 169 P.2d 470 (1946); *Shanik v. White Sewing Mach. Corp.*, 25 Del. Ch. 371, 19 A.2d 831 (Sup. Ct. 1941); *Application of Woodruff*, 175 Misc. 819, 26 N.Y.S.2d 678 (Sup. Ct. 1941), *aff'd mem.*, 262 App. Div. 814, 28 N.Y.S.2d 756 (4th Dep't 1941) (giving a greater one to prior preferred leaving the old preferred with a potential deficit at liquidation). *Cf. Hubbard v. Jones & Laughlin Steel Corp.*, 42 F. Supp. 432 (W.D. Pa. 1941); *Sherman v. Pepin Pickling Co.*, 230 Minn. 87, 41 N.W.2d 571 (1950).

<sup>312</sup> *Shanik v. White Sewing Mach. Corp.*, *supra* note 311.

<sup>313</sup> *Sander v. Janssen Dairy Corp.*, 36 F. Supp. 512 (D.N.J. 1940); *Sherman v. Pepin Pickling Co.*, 230 Minn. 87, 41 N.W.2d 571 (1950); *cf. Transportation Building Co. v. Daugherty*, 74 Cal.App.2d 604, 169 P.2d 470 (1946).

<sup>314</sup> *Hubbard v. Jones & Laughlin Steel Corp.*, 42 F. Supp. 432 (W.D. Pa. 1941).

<sup>315</sup> *Shanik v. White Sewing Mach. Corp.*, 25 Del. Ch. 371, 19 A.2d 831 (Sup. Ct. 1941); *Application of Woodruff*, 175 Misc. 819, 26 N.Y.S.2d 678 (Sup. Ct. 1941), *aff'd mem.*, 262 App. Div. 814, 28 N.Y.S.2d 756 (4th Dep't 1941).

The reduction of capital stock is similarly permitted by these statutes. *Langfelder v. Universal Laboratories, Inc.*, 163 F.2d 804 (3d Cir. 1947); *In re Radio-Keith-Orpheum Corp.*, 106 F.2d 22 (2d Cir. 1939), *cert. denied*, 308 U.S. 622 (1940); *Lich v. United States Rubber Co.*, 39 F. Supp. 675 (D.N.J. 1941), *aff'd without opinion*, 123 F.2d 145 (3d Cir. 1941); *Williams v. Davis*, 297 Ky. 626, 180 S.W.2d 874 (1944); *Haggard v. Lexington Util. Co.*, 260 Ky. 261, 84 S.W.2d 84 (1935); *Shanik v. Botany Worsted Mills*, 133 N.J. Eq. 219, 31 A.2d 226 (Ch. 1943); *Merz v. Interior Conduit & Insulation Co.*, 20 Misc. 378, 46 N.Y.2d 243 (Sup. Ct. 1897); *cf. Sapperstein v. Wilson & Co.*, 31 Del. Ch. 139, 182 Atl. 18 (Ch. 1935); *Woodruff v. Columbus Inv. Co.*, 135 Ga. 215, 68 S.E. 1103 (1910); *Francke v. Axton-Fisher Tobacco Co.*, 289 Ky. 687, 160 S.W.2d 23 (1942).

Though reduction of capital stock is against one of the preferred's preferences, a contract denying them the vote for a reduction has been upheld. *Williams v. Davis*, *supra*. But this depends upon the applicable statute.

<sup>316</sup> *Buckley v. Cuban-American Sugar Co.*, 129 N.J. Eq. 322, 19 A.2d 820 (Ch. 1940); *Zobel v. American Locomotive Co.*, 184 Misc. 323, 44 N.Y.S.2d 33 (Sup. Ct. 1943); *Application of Woodruff*, 175 Misc. 819, 26 N.Y.S.2d 678 (Sup. Ct. 1941), *aff'd mem.*, 262 App. Div. 814, 28 N.Y.S.2d 756 (4th Dep't 1941); *Cowan v. Salt Lake Hardware Co.*, 221 P.2d 625 (Utah 1950). *But see Breslav v. New York & Queens Elec. Light & Power Co.*, 249 App. Div.

price or date of already redeemable stock may be altered.<sup>317</sup> The redemption privilege is one of the typical preferences included in the phrase "privileges and preferences" and may legitimately be altered or eliminated under any of these statutes.<sup>318</sup> A sinking fund provision, whether out of net earnings<sup>319</sup> or even from capital,<sup>320</sup> may be removed<sup>321</sup> or a prior class may be given such a privilege.<sup>322</sup>

Elimination of voting rights seems to be allowed if reserved to the company by a general statute.<sup>323</sup> The distinction between the voting right

181, 291 N.Y. Supp. 932 (2d Dep't 1936), *aff'd mem.*, 273 N.Y. 593, 7 N.E.2d 708 (1937) (not included in the general reclassification statute). *Cf.* Davison v. Parke, Austin & Lipscomb, Inc., 285 N.Y. 500, 35 N.E.2d 618 (1941).

<sup>317</sup> Sander v. Janssen Dairy Corp., 36 F. Supp. 512 (D.N.J. 1940); Transportation Building Co. v. Daugherty, 74 Cal.App.2d 604, 169 P.2d 470 (1946); Shanik v. White Sewing Mach. Corp., 25 Del. Ch. 371, 19 A.2d 831 (Sup. Ct. 1941); Kreicker v. Naylor Pipe Co., 374 Ill. 364, 29 N.E.2d 502 (1940), *cert. denied*, 312 U.S. 659 (1941); Dratz v. Occidental Hotel Co., 325 Mich. 699, 39 N.W.2d 341 (1949); *In re Seiler*, 239 App. Div. 400, 267 N.Y. Supp. 567 (1st Dep't 1933); Wheatley v. A. I. Root Co., 147 Ohio 127, 69 N.E.2d 187 (1946); King v. Ligon, 180 S.C. 224, 185 S.E. 305 (1936). For the situation vice versa, see Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 142 Atl. 654 (Ch. 1928). *Cf. In re Kinney*, 279 N.Y. 423, 18 N.E.2d 645 (1939); see Koeppler v. Crocker Chair Co., 200 Wis. 487, 228 N.W. 130 (1929). *But see* Sutton v. Globe Knitting Works, 276 Mich. 200, 267 N.W. 815 (1936) (forbidding extension of maturity date under a "general statute" passed after the stock was issued to the plaintiff); Hay v. Big Bend Land Co., 32 Wash.2d 887, 204 P.2d 488 (1949) (forbidding alteration of call price under a general statute); Weckler v. Valley City Mill Co., 93 F. Supp. 444 (W.D. Mich. 1950), *aff'd*, 188 F.2d 367 (6th Cir. 1951).

<sup>318</sup> See Davis v. Louisville Gas & Elec. Co. and Shanik v. White Sewing Mach. Corp., *supra* note 317.

<sup>319</sup> Longson v. Beaux-Arts Apartments, Inc., 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).

<sup>320</sup> If permissible by statute: Wheatley v. A. I. Root Co., 147 Ohio 127, 69 N.E.2d 187 (1946). See Aladdin Hotel Co. v. Bloom, 200 F.2d 627 (8th Cir. 1953) (bondholder).

<sup>321</sup> Longson v. Beaux-Arts Apartments, Inc., *supra* note 319; *cf.* Anderson v. Cleveland-Cliffs Iron Co., 87 N.E.2d 384 (Ohio App. 1948); Davison v. Parke, Austin & Lipscomb, Inc., 285 N.Y. 500, 35 N.E.2d 618 (1941) (not effective concerning the dividend accruals); see Aladdin Hotel Co. v. Bloom, *supra* note 320. *Contra:* Yoakam v. Providence Biltmore Hotel Co., 34 F.2d 533 (D.R.I. 1929) (forbidding alteration of sinking fund provisions under a general statute).

<sup>322</sup> Wheatley v. A. I. Root Co., 147 Ohio 127, 69 N.E.2d 187 (1946). If action under a general statute is not held valid, a subsequent detailed statute may not be given retroactive effect. Sutton v. Globe Knitting Works, 276 Mich. 200, 267 N.W. 815 (1936); see Breslav v. New York & Queens Elec. Light & Power Co., 249 App. Div. 181, 291 N.Y. Supp. 932 (2d Dep't 1936), *aff'd mem.*, 273 N.Y. 593, 7 N.E.2d 708 (1937).

But designating a sinking fund as a "vested right" or a "contractual obligation" exempt from alteration as a preference, as in Yoakam v. Providence Biltmore Hotel Co., 34 F.2d 533 (D.R.I. 1929), seems unique.

<sup>323</sup> BALLANTINE & STERLING, CALIFORNIA CORPORATION LAWS 371 (ed. 1949); Note, 37 CORNELL L.Q. 768 (1952). Topkis v. Delaware Hardware Co., 23 Del. Ch. 125, 2 A.2d 114 (Ch. 1938); Maddock v. Vorclone Corp., 17 Del. Ch. 39, 147 Atl. 255 (Ch. 1929); Morris v. American Pub. Util. Co., 14 Del. Ch. 130, 122 Atl. 696 (Ch. 1923); Quilliams v. Hebbbronville Util., Inc., 241 S.W.2d 225 (Tex. Civ. App. 1951) (no mention of a statute); *cf.* Looker v. Maynard, 179 U.S. 46 (1900); Marcus v. R. H. Macy & Co., 297 N.Y. 38, 74 N.E.2d 228 (1947); see Aldridge v. Franco Wyoming Oil Co., 24 Del. Ch. 349, 14 A.2d 380 (Sup. Ct. 1940). *Contra:*

and, say, the redemption right is not too significant,<sup>323a</sup> but the few cases discussing voting rights seem more strict than related cases concerning other preferences.<sup>324</sup> The newer "specific" statutes usually do not include the voting right as one alterable by appropriate amendment.<sup>325</sup> This failure may be due to the rare occurrence of voting preferred stock but it has led to the construction that failure to include the voting right in the statute evidences an intent to exclude it.<sup>326</sup> The general statute has, as said, been used to alter certain voting rights: changing from cumulative to straight voting,<sup>327</sup> or altering the percentage of voting control given the preferred shareholders.<sup>328</sup>

Other rights may be altered or eliminated. The conversion privilege may be removed or other stock may be given a conversion right under a general statute.<sup>329</sup> The preemptive right may today be similarly abrogated.<sup>330</sup> A few statutes specifically define the scope of this right and the extent of permissible restrictions on it.<sup>331</sup> A general increase of capital stock is also

Faunce v. Boost Co., 15 N.J. Super. 534, 83 A.2d 649 (1951); Page v. American British Mfg. Co., 129 App. Div. 346, 173 N.Y. Supp. 734 (1st Dep't 1908); cf. Lord v. Equitable Life Assurance Soc'y, 194 N.Y. 212, 87 N.E. 443 (1909); State ex rel. Swanson v. Perham, 30 Wash.2d 368, 191 P.2d 689 (1948) (statutory construction); see Brooks v. State ex rel. Richards, 3 Boyce 1, 79 Atl. 790 (Sup. Ct. Del. 1911).

Elimination of the voting rights by merger is permissible. Clarke v. Gold Dust Corp., 106 F.2d 598 (3d Cir. 1939), cert. denied, 309 U.S. 671 (1940); Hottenstein v. York Ice Mach. Corp., 136 F.2d 944 (3d Cir. 1943); see Outwater v. Pub. Serv. Corp. of New Jersey, 103 N.J. Eq. 461, 143 Atl. 729 (Ch. 1928), aff'd, 104 N.J. Eq. 490, 146 Atl. 916 (Ct. Err. & App. 1928).

If the statute does not require voting, the articles may remove the right. St. Regis Candies, Inc. v. Hovacs, 117 Tex. 313, S.W.2d 429 (1928); see Schutze v. Austin Saengerrunde, 244 S.W.2d 341 (Tex. Civ. App. 1951).

In simplifications pursuant to the Public Utility Holding Company Act, a voting requirement may be ignored. *In re American & Foreign Power Co.*, 80 F. Supp. 514 (D. Me. 1948); see Leary, *Voting Rights in Preferred Stock Issues Under the Public Utility Holding Company Act of 1935*, 27 TEX. L. REV. 749 (1940); Leary, "Fair and Equitable" Distributing of Voting Power, 52 MICH. L. REV. 71 (1953).

<sup>323a</sup> French v. Cumberland Bank & Trust Co., 194 Va. 415, 74 S.E.2d 265 (1953).

<sup>324</sup> Faunce v. Boost Co., 15 N.J. Super. 534, 83 A.2d 649 (1951); cf. Lord v. Equitable Life Assurance Soc'y, 194 N.Y. 212, 87 N.E. 443 (1909).

<sup>325</sup> California and New York do. CAL. CORP. CODE § 3634; N. Y. STOCK CORP. LAW § 35.

<sup>326</sup> Faunce v. Boost Co., 15 N. J. Super. 534, 83 A.2d 649 (1951); see Note, 37 CORNELL L.Q. 768 (1952).

<sup>327</sup> Maddock v. Vorclone Corp., 17 Del. Ch. 39, 147 Atl. 255 (Ch. 1929); Quilliams v. Hebronville Util., Inc., 241 S.W.2d 225 (Tex. Civ. App. 1951).

<sup>328</sup> Hottenstein v. York Ice Mach. Corp., 136 F.2d 944 (3d Cir. 1943); Zobel v. American Locomotive Co., 184 Misc. 323, 44 N.Y.S.2d 33 (Sup. Ct. 1943).

<sup>329</sup> Cf. Gidwitz v. Armour & Co., 299 Ill. App. 618, 20 N.E.2d 175 (1939); Buckley v. Cuban-American Sugar Co., 129 N.J. Eq. 322, 19 A.2d 820 (Ch. 1940); see Starr v. Engineering Contracting Co., 149 Neb. 390, 31 N.W.2d 213 (1948). As to the conversion of an enterprise by merger, see Opdyke v. Security Sav. & Loan Co., 157 Ohio St. 121, 105 N.E.2d 9 (1952).

<sup>330</sup> Gottlieb v. Heyden Chemical Corp., 90 A.2d 660, 91 A.2d 57 (Del. Sup. Ct. 1952); Milwaukee Sanitarium v. Swift, 238 Wis. 628, 300 N.W. 760 (1941). See Morawetz, *The Preemptive Right of Shareholders*, 42 HARV. L. REV. 186 (1928); Gord v. Iowana Farms Milk Co., —Iowa—, 60 N.W.2d 820 (1953).

<sup>331</sup> A model statute is N. Y. STOCK CORP. LAW § 39; see the new Georgia statute discussed in O'Neal, *Business Corporations*, 4 MERCER L. REV. 12 (1952).

permissible unless desired for an improper purpose.<sup>332</sup> Reduction of capital is permissible if approved by the shareholders. Any of these rights discussed can disappear or be amended away in a consolidation.<sup>333</sup> The shareholder's contract includes the statutes so empowering the company. Any discussion concerning the absolute protection of shareholders' presently valid contractual rights must start from there.<sup>334</sup>

How can the share contract, if desired, insulate certain of the shareholders' rights from these statutes and this corporate power? Protective voting, the requirement that prior approval be obtained for these actions, is in common use, though its details could in many cases be more effectively drafted. Occasionally, protective voting requiring approval of a high number of shares is used. Some doubt as to its validity has at times been expressed but these higher requirements are generally valid. A well-written contract, however, should include a further provision that the "high-vote" requirement for the given actions cannot itself be eliminated or reduced except by the same percentage of approval.<sup>335</sup> The unwelcome marketing effect of these provisions has prevented their general adoption; further, too high a requirement encourages strike tactics and obstructs the management of the company. Refinancing even to these drastic degrees may after all be legitimately required. A contrary view presupposes that preferred stock possesses certain qualities which the law does not recognize as inherent features.

Another attempted protection is a provision that upon any merger or consolidation the preferred shall have the right to receive par and accrued dividends. This type of protection has been challenged as a usurpation of statutory procedure. If the merger, for instance, is validly carried out by appropriate vote and by its terms the exchange of stock is detailed, the latter governs though it does not give the preferred these prescribed amounts. The provision is an invalid attempt to circumvent the statute permitting such mergers upon appropriate consent.<sup>336</sup> For Delaware cor-

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<sup>332</sup> Subject of course to the statutory (and contractual) consent requirements.

<sup>333</sup> Apart from the issue of fairness, to whatever degree it is apropos in a particular jurisdiction; note 301 *supra*; *Eisenberg v. Central Zone Property Corp.*, 116 N.Y.S.2d 124 (Sup. Ct. 1952); See *Brill v. Blakeley*, 281 App. Div. 532, 120 N.Y.S.2d 713 (1st Dep't 1953).

<sup>334</sup> Compare the group of articles by Professor Becht, cited in note 284 *supra*. For suggestions including the use of SEC advisory reports on proposed plans, extension of the appraisal method, the election of a majority of directors by preferred shareholders upon dividend defaults, the more liberal use of "nimble dividends" and shifting the burden of proving fairness to the corporation, see Latty, *Exploration of Legislative Remedy for Prejudicial Changes in Senior Shares*, 19 U. OF CHI. L. REV. 759 (1952).

<sup>335</sup> See text and authority cited at note 282 *supra*.

<sup>336</sup> *Langfelder v. Universal Laboratories, Inc.*, 163 F.2d 804 (3d Cir. 1947); *Jones v. St. Louis Structural Steel Co.*, 267 Ill. App. 576 (1932).

California by statute permits these provisions: CORP. CODE § 4123 (1951); see BALLANTINE, LATTIN & JENNINGS, *supra* note 160, at 1015.



porations a two-thirds *nonclass* vote suffices for mergers,<sup>337</sup> but a Delaware corporation may legitimately provide for higher *class voting* requirements than the statutory requirement.<sup>338</sup> Thus a three-fourths class vote may be prescribed for the direct amendment of the articles. But since the merger statute calls for a nonclass vote, it may be that a high class-voting requirement for a merger is invalid, following the *Langfelder v. Universal Laboratories, Inc.*<sup>339</sup> reasoning. If Section 251 forbids a requirement that par and arrearages be paid upon consolidation it may similarly forbid a high class vote requirement. Were it not for the *Sellers v. Joseph Bancroft & Sons Co.* decision one might logically suppose that even a higher non-class voting requirement would be invalid.<sup>340</sup> But corporate articles nearly always require consent of two-thirds (or a majority) of the preferred shareholders as a class for the consummation of any merger agreement, and since these clauses have never been questioned it may legitimately be concluded that even a higher class voting requirement would be valid in Delaware. Hence the *Langfelder* rule is confined to its facts: an absolute provision that a merger shall have a given effect on the stock cannot control a validly consummated merger which does not provide for that effect.

The rule may, however, be extended to apply to other corporate actions. If the articles, for example, require the payment of par and accruals to the present preferred shareholders upon issue (by appropriate amendment) of prior preferred stock, would they not be an illegal attempt to circumvent a "direct amendment" statute which permits a compulsory exchange for a new stock issue without the satisfaction of dividend arrears? The *Langfelder* case is a perplexing obstacle to the use of such protective devices, assuming they are financially desirable.<sup>341</sup>

Minimal statutory protection, whatever the area, is not generally thought exclusive. The whole tenor of this argument has been the legitimate use of contractual provisions more comprehensive than those afforded by law. If dividends may be paid from surplus, is a contractual restriction to earned surplus illegal? If the dividend rate may be altered by a two-

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<sup>337</sup> DEL. GEN. CORP. LAW § 251 (1953).

<sup>338</sup> *Sellers v. Joseph Bancroft & Sons Co.*, 25 Del. Ch. 268, 17 A.2d 831 (Ch. 1941); text following note 283 *supra*; DEL. GEN. CORP. LAW § 102(b) (4) (1953). See *Seaman v. Ironwood Amusement Corp.*, 283 Mich. 220, 278 N.W. 51 (1938).

<sup>339</sup> 163 F.2d 804 (3d Cir. 1947).

<sup>340</sup> Invalidity aside, it would be extremely impracticable. If a corporation had issued 900,000 common and 100,000 preferred shares, and approval of a majority of the preferred were thought desirable for any given corporate action, a 95% consent requirement would be necessary.

<sup>341</sup> The case's importance has been minimized because these provisions are today seldom found; see Fergusson, *Recent Developments in Preferred Stock Financing*, 7 J. FINANCE 447 (1952). But their absence may be due to the effect of the decision. Further, the doubt the case throws upon contractual class-voting requirements for mergers, though perhaps ultimately unfounded, makes it worthy of attention.

thirds class vote, is a contractual requirement of a three-fourths class vote illegal? The *Langfelder* case posits a situation differing only in degree. The protection of the conversion privilege affords an instructive analogy. Corporate articles provide for the appropriate adjustments of convertible securities and of the conversion price in case of mergers and consolidations (assuming that the stock survives the merger). These provisions have never been challenged, yet they are of the same sort as that found illegal in the *Langfelder* case. True, this protection may be wiped out by appropriate amendment in the merger transaction, as the *Langfelder* protection was, but if protected by a requirement that an 85% class vote was needed to eliminate it, it would hardly be an illegal circumvention of the statutory merger proceedings. The *Langfelder* decision may be justified to this extent: that unless the provision there in issue is *further* protected (by requiring a high vote to eliminate it), it will fall along with the other rights of the shareholder upon proper consummation of a merger. But the indication that it is illegal to include such a provision is unjustified. That result, as a matter of fact, does not necessarily follow: in *Langfelder* the provision was not so protected and if the conclusions here criticized are at all present in the case they are merely unfortunate dicta.

If this paper's argument is justified, the use of such provisions should be considered. It does not seem that corporate financing would be appreciably hampered. The present use of appraisal procedures as a remedy indicates that a fair payment to dissenters does not generally bar these mergers and recapitalizations. Giving the shareholder par and accrued dividends, for example, would not burden a company more than appraisal payments do unless its financial condition were poor. Although but an unpleasant potentiality, this possible burden apparently discredits the use of absolute payments of this magnitude for dissenters. Since the appraisal procedure is roughly related to market value, it is admittedly far less stringent in bad times.<sup>342</sup> Furthermore, objections to the use of capital for such repurchases may be valid. The same reasons cause the rejection of any provision forbidding amendments unless certain financial controls are met. These are not feasible tools for reconciling the protection of shareholders' contractual rights with the desire and need for legitimate alteration of the corporate structure, but are really attempts to introduce some idea of "absolute priority" into the sphere of "internal reorganization."<sup>343</sup>

These objections suggest an approach which may be satisfactory. If a merger or recapitalization is undertaken, any proposed treatment of dis-

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<sup>342</sup> See N. Y. STOCK CORP. LAW § 21; see Levy, *Rights of Dissenting Shareholders to Appraisal and Payment*, 15 CORNELL L.Q. 420 (1930).

<sup>343</sup> By "internal reorganization" is meant any of the discussed changes—reclassification, consolidation, etc.—affecting the contractual expectations of shareholders.

senting shareholders cannot be greatly variant from that now in existence. The needs of flexible management and organization discourage any fuller payment beyond that provided for by the appraisal remedy (which is statutory). If retained, the protection commonly found in the conversion instrument and other parts of the articles will give some fuller satisfaction in the case of consolidation or reclassification. But the real or imagined needs of the company, it must be recognized, prevail over a shareholder's right of full withdrawal and in practice no contractual reversal of that situation will find favor.

It is entirely feasible, however, to adopt contractual restrictions upon the free use of the internal reorganization process. The articles could provide that proposed corporate transactions affecting enumerated rights be submitted to an independent auditor or analyst. He would examine the proposal in light of the supposed need—depending upon the company's financial position and external competitive and financial forces—as weighed against the effect on shareholders. His approval would be required for the action. Then the treatment of dissenting shareholders (if appropriate consent was obtained for the action) would proceed as at present. This is no fanciful solution. Today's conversion instruments contain a remarkably similar provision: any action which might affect the shareholders' conversion privilege must be submitted to an independent auditor who prescribes proper adjustments. The problem presented to the analyst is admittedly not as broad under the conversion instrument as it would be in this proposal; but even the latter is within the scope of the profession's competence. The limits of the inquiry could be defined. The analyst might simply have to "prove" the company's submitted conclusions concerning the *necessity* of a specific change to obtain certain new capital or refinancing, without questioning the need for the financing itself.

Courts have struggled with similar controls in the name of "fairness" and generally abandoned them. That is as it should be. The issue is one of corporate power. The present proposal is an internal contractual limitation on that power's free exercise. It may have to be fenced about by a further restriction against its elimination by amendment and is, therefore, subject to the implications of the *Langfelder* rule. But if those implications are as unsound as has been contended, they should not prove an obstacle to this type of provision. It seems to be the only *feasible* way of saving shareholders' contractual expectations from indiscriminate elimination by reserved corporate amending powers.