ACCRUED DIVIDENDS ON CUMULATIVE PREFERRED STOCKS: THE LEGAL DOCTRINE

THE adjustment of accrued dividends on cumulative preferred stock is an absorbing problem both in terms of legal doctrine and practical implications. The problem is essentially dynamic and controversial, calling for the exercise of careful judgments on the basis of public policy. On the one hand, the promotion of healthy corporate enterprise demands that some solution be reached to free capital structures from what Mr. Justice Douglas has aptly characterized as "a morass of accumulated unpaid dividends."¹ On the other hand, to borrow the words of Professor Dodd, the present system of adjusting accrued dividends is giving "to property rights a fluidity and an indefiniteness quite foreign to anything which existed in the corporation law of a century or even a half-century ago."²

The legal literature which within recent years has developed around the subject of dividend arrearages and related aspects of shareholders' rights is so extensive that a word of explanation is in order to justify adding another article to the many already in print. It is not the purpose of this article to examine the accrued dividend problem insofar as it reveals in cross-section the changing nature of our corporate economy. Various writers have effectively demonstrated how accrued dividend adjustments, along with other changes in shareholders' rights, reflect the separation of corporate ownership from control, the conflicts arising between corporate managements and preferred shareholders as a class, and the consequent need for legislative and other types of controls.³ Instead,

¹ DOUGLAS, *DEMOCRACY AND FINANCE* (1940) 134. This comment was directed specifically to the existence in 1938 of some \$432,000,000 of arrears on preferred stocks of public utility companies.

² Dodd, *The Modern Corporation, Private Property, and Recent Federal Legislation* (1941) 54 HARV. L. REV. 917, 923. For a recent judicial recognition of this conflict, see *Davison v. Parke, Austin & Lipscomb, Inc.*, 285 N. Y. 500, 506, 35 N. E.(2d) 618, 621 (1941).

³ The outstanding contributions along these lines are BERLE & MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) 267-70 and *passim*, and RE-

the present objective is to define and clarify the applicable legal doctrine as it has developed in the cases. In this last respect the literature is inadequate, not because doctrinal analysis has been neglected, but rather because a faulty method of approach has tended to produce confused treatment.

One reason for this ineffectual analysis on the doctrinal level stems from the fact that it was not until about 1935 that the accrued dividend problem became sufficiently important to warrant treatment in its own right. While certain of the general surveys of charter amendments appearing prior to that date do represent definite contributions,⁴ they are unsatisfactory for present-day purposes because of their over-concern with constitutional questions revolving about the exercise of the reserve power by state legislatures.⁵ The more recent articles and comments, devoted especially to dividend arrearages, are subject to more specific criticism. Written at a time when the applicable law was seemingly in a state of flux,⁶ they frequently contain generalizations of doubtful validity. Often they have attempted to cover too much territory,

PORT OF THE SECURITIES AND EXCHANGE COMMISSION ON THE STUDY AND INVESTIGATION OF THE WORK, ACTIVITIES, PERSONNEL AND FUNCTIONS OF PROTECTIVE AND REORGANIZATION COMMITTEES, PART VII (1938) 464-67, 501-25, 549-56, and *passim* (hereinafter cited as SEC REP. ON REORGANIZATION COMMITTEES). To these should be added the recent article by Dodd, *The Modern Corporation, Private Property, and Recent Federal Legislation* (1941) 54 HARV. L. REV. 917. See also Notes (1938) 33 ILL. L. REV. 212, (1937) 46 YALE L. J. 985, 999.

⁴ Cades, *Constitutional and Equitable Limitations on the Power of the Majority to Amend Charters* (1928) 77 U. OF PA. L. REV. 256; Curran, *Minority Stockholders and the Amendment of Corporate Charters* (1934) 32 MICH. L. REV. 743; Dodd, *Amendment of Corporate Articles under the New Ohio General Corporation Act* (1930) 4 U. OF CIN. L. REV. 129 (not confined to the Ohio situation), *Dissenting Stockholders and Amendments to Corporate Charters* (1927) 75 U. OF PA. L. REV. 585, 723.

⁵ Most of the cases since 1935 have been concerned with the proper construction of existing corporation statutes rather than with the applicability of new statutes conferring additional power to deal with accrued dividends. It is interesting to note that this shift in emphasis was predicted by Dodd in 1927. *Dissenting Stockholders and Amendments to Corporate Charters*, 75 U. OF PA. L. REV. 723, 744. With the enactment of new statutes by Ohio and Virginia, however, the reserve power question may again become paramount. See note 57 *infra*.

⁶ Recent cases in Delaware in particular indicate that there the state of flux in many respects was more apparent than real. However, the decision which pointed this out in Delaware, *Havender v. Federal United Corp.*, 11 A.(2d) 331 (Del. Sup. Ct. 1940), was so unexpected that no criticism can be made for the feeling that the law was undergoing constant change.

whether by touching upon every aspect of the problem,⁷ or by discussing decisions from seven or more states, each with somewhat different statutory provisions.⁸ As a consequence there is still room for careful study of the fundamental corporate theory underlying the entire problem.⁹

Actually, so far as legal doctrine is concerned, there are only two issues at stake in accrued dividend adjustments. There is first the existence of corporate power to carry out the adjustment in a particular way, or, expressed differently, whether the changes are permissible within the terms of the preferred stock contract. Secondly, there is the extent to which the courts will require an adjustment to be fair and equitable, and the ascertainment of the criteria of fairness which are to be applied.¹⁰ Here it is proposed to explore these two matters only insofar as they have been developed

⁷ For example, in almost every instance some space is devoted to public policy considerations and often a program for reform is outlined. See Notes (1941) 54 HARV. L. REV. 488, (1941) 39 MICH. L. REV. 1201, (1941) 89 U. OF PA. L. REV. 789, (1937) 46 YALE L. J. 985. Or a particular discussion may lean heavily on analogies to alterations in other rights of shareholders. See Notes (1941) 89 U. OF PA. L. REV. 789, (1937) 23 VA. L. REV. 579. Other writers have introduced further matters such as the status of accrued dividends in equity receiverships and bankruptcy reorganizations. See Note (1937) 4 U. OF CHI. L. REV. 645.

⁸ E.g., Becht, *The Power to Remove Accrued Dividends by Charter Amendment* (1940) 40 COL. L. REV. 633 (seven state statutes); Note (1941) 89 U. OF PA. L. REV. 789 (eight state statutes). This same weakness necessarily permeates the legal memorandum in SEC REP. ON REORGANIZATION COMMITTEES, PART VII (1938) 464-610, and KEHL, CORPORATE DIVIDENDS (1941) 210-18. Moreover, there are often two distinct types of statutes involved such as charter amendment and merger provisions, and also vital chronological differences may exist even within a single state. Where the statutory complexities make the going too rough, the decision will be relegated to a footnote or left to the recent case section. E.g., *Kreicker v. Naylor Pipe Co.*, 374 Ill. 364, 29 N. E.(2d) 502 (1940), 8 U. OF CHI. L. REV. 134.

⁹ In appraising the writings on accrued dividends adjustments since 1935, Note (1941) 89 U. OF PA. L. REV. 789 is among the best, in spite of many faults. On the doctrinal level, Note (1938) 12 U. OF CIN. L. REV. 576 is very good, although it is perhaps too purely "legalistic" and tends to ramble. Other worthwhile discussions include: KEHL, CORPORATE DIVIDENDS (1941) 210-18; Becht, *The Power to Remove Accrued Dividends by Charter Amendment* (1940) 40 COL. L. REV. 633; Notes (1941) 54 HARV. L. REV. 488, (1940) 25 CORN. L. Q. 431, (1938) 33 ILL. L. REV. 212, (1937) 4 U. OF CHI. L. REV. 645, (1937) 46 YALE L. J. 985. Individual case notes are worthless for the most part.

¹⁰ This method of dealing with accrued dividend adjustments in a sense is a return to the basic approach suggested by BERLE & MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1932) 248: "In every case, corporate action must be twice tested: first, by the technical rules having to do with the existence and proper exercise of the power; second, by equitable rules. . . ."

in the case law, and in the case law of only two states, Delaware and New Jersey. In both, the applicable body of case law is relatively mature. The Delaware doctrine has assumed for the time being, at least, a definite pattern, while the New Jersey doctrine has apparently progressed beyond that pattern into a second formative period. An interesting contrast is thus afforded. By confining the discussion to these two states, moreover, it is possible to illustrate better the vital interplay between corporation statutes and case law.

THE PREFERRED STOCK CONTRACT

The adjustment of accrued dividends on cumulative preferred stock is essentially a problem of altering the preferred stock contract. For that reason some preliminary consideration of this contract is desirable, even at the risk of repeating much that is elementary. The starting point is of necessity the corporate charter, for it is there that the preferred stock contract is normally found.¹¹ In early American corporate history, "corporate charter" was used rather narrowly to denote the special legislative enactment by which a corporation was created. Today its meaning is much broader and embraces not only the certificate or articles of incorporation, but also the general corporation statute of the state in which a corporation is organized and, to the extent constitutionally permissible, all subsequent amendments of that statute.¹² To adopt the traditional terminology, this corporate charter constitutes a contract tripartite in nature, one contract being between the corporation and the state, a second between the corporation and its shareholders, and a third between the shareholders *inter sese*. While all three contracts may be involved in the present situation, it is the last two which are of primary importance.

Insofar as accrued dividends are concerned, the preferred stock

¹¹ Under certain circumstances the provisions of the stock certificate, the by-laws at the time of issuance of the stock, or the proceedings by which the stock was created may also be pertinent. See Note (1938) 12 U. OF CIN. L. REV. 576, 577; *Johnson v. Fuller*, 36 F. Supp. 744, 747 (E. D. Pa. 1940), *aff'd* 121 F.(2d) 618 (C. C. A. 3d, 1941). For a critical discussion of the conception of the corporate charter as a contract, see Dodd, *Dissenting Stockholders and Amendments to Corporate Charters* (1927) 75 U. OF PA. L. REV. 585, 592.

¹² Section 83 of the Delaware Corporation Law (DEL. REV. CODE (1935) § 2115) specifically provides that the statutory provisions become part of the corporate charter.

contract is mainly concerned with defining the relation between the common and preferred shareholders with respect to the division of the profits of the enterprise.¹³ The language of various charters varies somewhat, but there are surprisingly few differences of substance. A representative provision, stripped of its excess verbiage, reads as follows:

The holders of the Preferred Stock shall be entitled to receive from the surplus and/or net profits of the corporation when and as declared by the Board of Directors fixed cumulative dividends at the rate of four dollars (\$4) per share per annum payable quarterly on the first days of January, April, July, and October in each year and said fixed cumulative dividends upon the Preferred Stock shall be paid or set apart before any dividend shall be paid or set apart on the Common Stock.¹⁴

It is universally recognized in the case of both cumulative and noncumulative preferred stocks that such a provision does not confer on the preferred shareholder any right to receive his dividend until it has been declared. The only right he has is one to receive his dividend as a condition precedent to payment of a dividend upon the common stock. Where cumulative preferred stock is involved, no dividend may be paid on the common stock until not only the current preferred dividend has been paid, but also all preferred dividends for past years. In other words, the right of cumulative preferred stock as against the common stock is to a certain number of dollars, the precise amount depending upon the number of past failures to pay preferred dividends. To be more specific, let us suppose a corporation was organized and began business on January 1, 1939, with common stock and \$4 cumulative preferred stock, the latter having the same provision as to dividends as that set out above. If in December, 1941, no dividends had ever been paid on the preferred stock, in order to pay a common dividend

¹³ Accrued dividends may also create a problem upon liquidation and again the outcome is governed by the preferred stock contract. Cases illustrative of the problem include *Garrett v. Edge Moor Iron Co.*, 194 Atl. 15 (Del. Ch. 1937), *aff'd sub nom.* *Pennsylvania Co. for Insurances on Lives & Granting Annuities v. Cox*, 199 Atl. 671 (Del. Sup. Ct. 1938); *Penington v. Commonwealth Hotel Construction Co.*, 17 Del. Ch. 394, 155 Atl. 514 (Sup. Ct. 1931); *Lloyd v. Pennsylvania Electric Vehicle Co.*, 75 N. J. Eq. 263, 72 Atl. 16 (1909). *Powell v. Craddock-Terry Co.*, 175 Va. 146, 7 S. E.(2d) 143 (1940).

¹⁴ In substance this is the provision in *Consolidated Film Industries, Inc. v. Johnson*, 197 Atl. 489 (Del. Sup. Ct. 1937), discussed *infra* pages 86-87.

there must first be paid on the preferred \$4 for 1941, and also \$4 for 1940 and \$4 for 1939, or \$12 in all. This is so without regard to the existence or non-existence of earnings or surplus for the years 1940 and 1939.¹⁵ It is this right to past dividends, normally called accrued dividends or simply arrearages, which is the focal point of any adjustment.

The precise nature of the preferred shareholder's right to accrued dividends has been the subject of much unilluminating judicial discourse. The mere lapse of time, during which preferred dividends are said to accrue, has been regarded as possessing some magical significance. Of the many characterizations which have been applied, "vested right" is the most popular, although "property right," "substantial right," and "fixed, contractual right" are also well established in the terminology.¹⁶ Moreover, the cases abound in cryptic language such as that describing accrued dividends as having "the nature and character of a debt."¹⁷ While these terms and phrases were uttered in a sincere attempt at explanation, actually they have proved to be misleading and deceptive. Even in their context, where constitutional issues usually were involved, their value is somewhat dubious, and divorced from context they have none at all. Too often they have been accepted as substitutes for reason and analysis. The fundamental point that never should be forgotten is that the right goes no deeper than the particular preferred stock contract in question, and that the principal task is to construe that contract in the light of the articles of incorporation and the pertinent corporation statute.

Some conception of the nature of the right to accrued dividends

¹⁵ In *Day v. United States Cast Iron Pipe & Foundry Co.*, 96 N. J. Eq. 736, 740, 126 Atl. 302, 304 (1924), this was made very clear: "The dividends upon cumulative preferred stock have at all times and for all years past and present, until paid, priority in payment over any and all unpaid dividends upon common stock, whether the net earnings for any particular past or present year were or were not sufficient to pay the stipulated cumulative dividends upon preferred stock for that year. . . ."

¹⁶ This terminology probably had its origin in *Roberts v. Roberts-Wicks Co.*, 184 N. Y. 257, 77 N. E. 13 (1906). It came to full flower in the Delaware cases, from which the various characterizations in the text have been lifted. *Morris v. American Public Utilities Co.*, 14 Del. Ch. 136, 122 Atl. 696 (Ch. 1923); *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 190 Atl. 115 (Sup. Ct. 1936); *Consolidated Film Industries, Inc. v. Johnson*, 197 Atl. 489 (Del. Sup. Ct. 1937); *Federal United Corp. v. Havender*, 11 A.(2d) 331 (Del. Sup. Ct. 1940).

¹⁷ See *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 411, 190 Atl. 115, 124 (Sup. Ct. 1936).

can perhaps be gained by analyzing the sharp distinction the courts have drawn between it and the right to future dividends, which, in contrast to "vested," has been labeled "contingent," "expectant," and "defeasible."¹⁸ This distinction has been the subject of criticism, purportedly on the functional ground that both rights are to *dividends in the future* and consequently are identical.¹⁹ Returning to the hypothetical case, is there any difference in December, 1941, between the right to \$12 of arrearages and the right to the \$1 quarterly dividend which will accrue on January 1, 1942? Each is the right to receive at some future date a certain number of dollars before any dividend, on that same future date or immediately thereafter, can be paid on the common stock. From this standpoint the passage of dividend dates is immaterial except as it increases the amount in dollars to which the preferred stock is entitled prior to payment of any common dividend.²⁰

This analysis is defective, however, for there is a sound basis, also functional, for the distinction. The right to past accrued dividends is a present right and has a present effectiveness which the right to future dividends lacks. Thus, in December, 1941, the right to \$12 of arrearages then and there blocks any common dividend until the \$12 is paid. Were there no such arrearages, a common dividend could be paid, and the right of the preferred stock to \$1 on January 1, 1942, would be wholly irrelevant. Viewed in this light the right to accrued dividends is one of substance possessing the quality of immediate enforceability against the common stock.²¹

Doubtless this very rationale underlies many of the decisions.

¹⁸ See *Consolidated Film Industries, Inc. v. Johnson*, 197 Atl. 489, 493 (Del. Sup. Ct. 1937).

¹⁹ See Note (1937) 46 YALE L. J. 985, 987. This was also the view of the Ohio State Bar Association Committee on Corporation Law, which proposed a specific amendment made part of the Ohio statute in 1939 which is set forth in full note 57 *infra*. In a private communication received in April, 1940, from the chairman of that committee, he stated, *inter alia*: "On principle there is no distinction between the right to an accrued dividend and the right to a future preference, except that through the lapse of time the right to accrued dividends can be stated in dollars." An explanatory note to the same effect is to be found in OHIO CODE ANN. (Throckmorton, Supp. 1940) § 8623-14.

²⁰ Similarly the number of dollars to which the preferred stock is entitled on liquidation prior to the common stock is increased. But that right also is *in futuro* and may never become enforceable.

²¹ Cf. *Penington v. Commonwealth Hotel Construction Co.*, 17 Del. Ch. 394, 155 Atl. 514 (Sup. Ct. 1931); *Garrett v. Edge Moor Iron Co.*, 194 Atl. 15 (Del. Ch.

In addition there are other and related explanations for the tendency to single out accrued dividends as entitled to special protection. Historically, preferred stock in America has at least some kinship to debt securities, such as mortgage bonds, as well as to equity securities as represented by stock. Consequently some tendency can be found to treat accrued dividends somewhat like accrued interest. Furthermore, this special protection of accrued dividends has a psychological basis, for clearly both the preferred stock investor and the corporate management feel, logically or not, that when a preferred dividend date passes without payment, something has happened. It is this which may lead courts to say that just as the cumulative feature may have been an inducement to purchase preferred stock, so also upon the passing of a dividend it may be an inducement to retain that stock.²²

The practical objective in any adjustment of dividend arrearages is the avoidance of paying their full amount in cash. While commentators speak of the "cancellation" or "elimination" of accrued dividends, such descriptions are not always accurate. In many instances "adjustment" is a better label, because the preferred shareholder purportedly receives at least a partial *quid pro quo* for his arrearages. He may receive common stock, additional preferred or new prior preferred, interest-bearing certificates, or various combinations of these with perhaps a little cash included. The face amount of what he receives may or may not be equal to the amount of his dividend arrearages, and the immediately realizable value is invariably much less. Various methods have been employed to carry out such adjustments, but in the main they fall into one of three classifications: the direct charter amendment, the merger or consolidation, and the indirect charter amendment.²³

1937), *aff'd sub nom.* Pennsylvania Co. for Insurances on Lives & Granting Annuities v. Cox, 199 Atl. 671 (Del. Sup. Ct. 1938). *But cf.* dissenting opinion of Judge L. Hand in *Harr v. Pioneer Mechanical Corp.*, 65 F.(2d) 332, 336 (C. C. A. 2d, 1933).

²² See *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 411, 190 Atl. 115, 124 (Sup. Ct. 1936).

²³ The best exposition of these three techniques is in Note, *Elimination of Accrued Dividends in Corporate Reconstruction* (1941) 89 U. OF PA. L. REV. 789. See also Becht, *The Power to Remove Accrued Dividends by Charter Amendment* (1940) 40 COL. L. REV. 633; Notes (1941) 54 HARV. L. REV. 488, (1941) 39 MICH. L. REV. 1201, (1937) 4 U. OF CHI. L. REV. 645.

While all three are substantially similar in basic theory and any differences are principally in form, these terms afford a convenient shorthand expression for particular procedures, and they will be so used throughout this article. The precise technique involved in each will be set forth fully in connection with the Delaware cases. Here it should be noted only that the direct charter amendment and merger or consolidation methods operate directly to convert accrued dividends into some other type of security or occasionally to eliminate them entirely, while the indirect charter amendment method leaves the arrearages in existence but subordinates them to payment of dividends on some new class of shares. In general, the first two methods are said to be compulsory, while the third is optional.²⁴

The principal obstacle to be overcome, regardless of the method employed, is the objection of dissenting preferred shareholders. At one time, of course, there was embedded in American corporation law a doctrine of unanimous consent. In origin a carry-over from partnership law, this doctrine laid down the inflexible requirement that the contracts between the corporation and its shareholders and between the shareholders *inter sese* could not be changed without 100% shareholder consent, except in certain non-fundamental respects.²⁵ As this rule began to stultify corporate progress, it was modified by making the shareholders' contracts, upon their inception, subject to alteration by less than 100% of the shareholders. Thus today charter amendments in Delaware may be carried out upon majority approval, mergers upon two-thirds approval.²⁶ These provisions are found in the corporation statute and as such become part of the corporate charter. As part of the

²⁴ The direct charter amendment and merger methods are compulsory by their very terms, save where appraisal remedies are available. The indirect charter amendment method is more often optional in theory and compulsory in practice. See Note (1938) 33 ILL. L. REV. 212; *cf.* *Kreicker v. Naylor Pipe Co.*, 374 Ill. 364, 29 N. E.(2d) 502 (1940).

²⁵ Even the early cases agreed that majority consent was sufficient for changes of an auxiliary nature which did not have the effect of altering the basic character or purpose of a corporate enterprise. Changes of this type are discussed in SEC REP. ON REORGANIZATION COMMITTEES, PART VII (1938) 464-67, 477-78. See also Curran, *Minority Stockholders and the Amendment of Corporate Charters* (1934) 32 MICH. L. REV. 743, 745; Dodd, *Dissenting Stockholders and Amendments to Corporate Charters* (1927) 75 U. OF PA. L. REV. 585, 587.

²⁶ Sections 26 and 59 respectively. DEL. REV. CODE (1935) §§ 2058, 2091.

charter, the preferred stock contract is subject to this alteration process. The theory is that, upon the original issuance of preferred stock, the investor consents in advance to certain changes in his contract when such changes are approved by the requisite proportion of the shareholders.²⁷ Phrased more traditionally, power has been reserved by the corporation to change the contract, and the problem is one of determining which contractual rights are subject to this reserve power.²⁸ With respect to most rights of the preferred shareholder this procedure has operated smoothly and the dissenter has usually met defeat.²⁹ In regard to his right to accrued dividends, however, as a result of its having been singled out for special protection, he has fared somewhat better. Whether this particular right is subject to change upon less than unanimous consent brings us back to the two questions posed at the beginning of this article. Has the corporation the power to alter the right to accrued dividends over the objection of a single preferred shareholder in the light of a given preferred stock contract? If it has that power, will the courts nevertheless impose any equitable limitations? The answers given by the Delaware and New Jersey courts are now to be explored.

²⁷ The theory extends, of course, to all changes in the preferred stock contract. See Note (1941) 54 HARV. L. REV. 1368 (changes in voting rights). Applicable accrued dividend adjustment cases include *Federal United Corp. v. Havender*, 11 A.(2d) 331, 338 (Del. Sup. Ct. 1940); *Consolidated Film Industries, Inc. v. Johnson*, 197 Atl. 489, 493 (Del. Sup. Ct. 1937); *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 414, 190 Atl. 115, 126 (Sup. Ct. 1936); *Morris v. American Public Utilities Co.*, 14 Del. Ch. 136, 122 Atl. 696 (Ch. 1923). Cf. *Berger v. United States Steel Corp.*, 63 N. J. Eq. 809, 824, 53 Atl. 68, 74 (1902).

²⁸ The phrase "reserve power" is used with reluctance because its many connotations may tend to confuse rather than assist the reader. The "consent in advance" form of statement covers the same field of ideas with more precision and directs attention to the controlling factor. Both modes of expression will be found applicable in either of the two principal situations which arise in accrued dividend adjustments: (1) Where the problem is one of construction of the preferred stock contract (articles of incorporation plus corporation statutes) to ascertain whether the right to accrued dividends had been clearly made subject to change; (2) Where the problem is the constitutional one of determining whether the right to arrears is to be protected against alteration pursuant to a statute enacted after issuance of the preferred stock. See note 5 *supra*.

²⁹ A great number of the preferred shareholder's rights to prior participation in earnings and assets have been held subject to alteration. The only rights which have received anywhere near the protection accorded the right to dividend arrearages are redemption and preemptive rights. See SEC REP. ON REORGANIZATION COMMITTEES, PART VII (1938) 493-518; Notes (1941) 89 U. OF PA. L. REV. 789, 793, (1937) 46 YALE L. J. 985, 991.

THE EXISTENCE OF CORPORATE POWER — THE DELAWARE VIEW

The problem of adjustment of accrued dividends on cumulative preferred stocks first became of general importance in the latter half of the decade 1930-1940 when many of the corporations emerging from the depression were seeking to clear up heavy arrearages.³⁰ While prior to 1936 various courts had indicated that the right to accrued dividends was one especially entitled to protection, it was the decision of the Delaware Supreme Court in that year in *Keller v. Wilson & Co.*³¹ which gave the right its greatest semblance of sanctity. Yet in less than four years the *Keller* case had been stripped of its significance by the superficially startling decision of the same court in *Federal United Corp. v. Havender*.³² In these two cases, together with a few others, is set forth a full exposition of the Delaware view that the only question is one of the existence of corporate power.

Delaware has been the most important state of incorporation since about 1915.³³ Its liberal statute, enacted in 1899, was designed to be attractive not only because of its low incorporation fees and taxes, but also because of the elasticity of its provisions permitting great freedom of action to corporate managements. The charter amendment section of this Delaware statute, Section 26, was particularly well designed to lend itself to this latter objective. Since the first attempts to adjust accrued dividends were on the basis of Section 26, it will be discussed first, reserving the merger statute and cases for subsequent consideration.

The history of Section 26 is fundamental to an understanding of the Delaware charter amendment cases. As originally enacted in 1901, it merely authorized a corporation to amend its charter so as to change its corporate powers and purposes, its corporate name, and to increase or decrease its authorized capital stock.³⁴ In 1909 a clause was added permitting "any other change or alteration."³⁵ In 1917 the procedural requirements of Section 26 were amended to provide for a class vote of preferred stock upon any amend-

³⁰ See Notes (1937) 46 YALE L. J. 985, (1937) 31 ILL. L. REV. 661, 668.

³¹ 21 Del. Ch. 391, 190 Atl. 115 (Sup. Ct. 1936).

³² 11 A.(2d) 331 (Del. Sup. Ct. 1940).

³³ See LARCOM, THE DELAWARE CORPORATION (1937) 155.

³⁴ Del. Laws 1901, c. 167, § 26. The 1901 act was a revision of the original 1899 act which had provided for similar charter amendments in § 135. Del. Laws 1899, c. 273.

³⁵ Del. Laws 1909, c. 155, § 1.

ment altering or changing its preferences.³⁶ Finally in 1927 Section 26 assumed substantially its present form by the addition of the power to amend a charter so as to reclassify capital stock by:

Changing the number, par value, designations, preferences, or relative, participating, optional or other *special rights* of the shares, or the qualifications, limitations or restrictions of such rights. . . .³⁷

Turning now to the cases, there is one decision in 1923, long before *Keller v. Wilson & Co.*, which marks out the pattern of the recent cases. In *Morris v. American Public Utilities Co.*,³⁸ the Court of Chancery³⁹ upheld a recapitalization plan with respect to a corporation formed in 1912 insofar as it superimposed upon an existing preferred stock and arrearages two issues of new prior preferred stock. This part of the plan is an example of what is referred to today as the indirect method of adjusting dividend arrearages. The Chancellor refused, however, to sanction another part of the recapitalization plan whereby accrued dividends of \$24 per share on the existing preferred were to be directly "cancelled."

The reasoning of the Chancellor with respect to the new prior preferred stocks was simple. By the original preferred stock contract the preferred shareholders had consented in advance to the creation, by a majority vote of their class,⁴⁰ of new issues of stock prior to their own with respect to dividends and liquidation rights.

³⁶ Del. Laws 1917, c. 113, § 12.

³⁷ Del. Laws 1927, c. 85, § 10. (*Italics added.*)

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

³⁹ While the Delaware Chancery is a court of first instance, its decisions, like those of the New Jersey Chancery Court, have long met with respect and possess a prestige superior to that of decisions of ordinary intermediate appellate courts. The Chancellor is the highest judicial officer of the state. *Morris v. American Public Utilities Co.* in particular carries authority because it has been specifically approved on several occasions by the Delaware Supreme Court. See *Shanik v. White Sewing Machine Corp.*, 19 A.(2d) 831, 834 (Del. Sup. Ct. 1941); *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 399, 190 Atl. 115, 119 (Sup. Ct. 1936); *Penington v. Commonwealth Hotel Construction Corp.*, 17 Del. Ch. 394, 400, 155 Atl. 514, 517 (Sup. Ct. 1931).

⁴⁰ At the time *Morris v. American Public Utilities Co.* was decided, § 26 provided for a majority class vote whenever an amendment altered "the preferences given to any one or more classes of preferred stock, authorized by the certificate of incorporation." The Chancellor seemingly assumed the clause "authorized by the certificate of incorporation" modified "classes of preferred stock" and not "the preferences given," for he was careful to point out that the alteration was not in the stated preference over the common stock, but in relation to earnings and assets.

In other words, because Section 26 was part of the contract, the corporation had the power to do so. In the course of its opinion the court elaborated the idea that only a "preference" was involved, that the existing preferred stock contract permitted a change in preferences, and hence that there was no basis for objection. This talk of preferences seems to have been relevant only in regard to the question of a majority class vote of the existing preferred. In any event the new prior preferred stocks were held to be superior to the old preferred, and the corporation was expressly permitted to pay dividends upon them without making any payment on the arrearages of the old stock.⁴¹

This alteration he held required a majority class vote of the preferred stock. Section 26 now provides, however, for a majority class vote whenever an amendment alters "the preferences, special rights or powers given to any one or more classes of stock, by the Certificate of Incorporation, so as to affect such class or classes of stock adversely." The clause "certificate of incorporation" now clearly modifies the words "preferences, special rights or powers." As a result the argument can be made that the construction in *Morris v. American Public Utilities Co.* can no longer be applied, because § 26 requires the class vote only when the specific preferences, special rights or powers conferred by the certificate of incorporation are changed and not when the position of the preferred stock in the corporation has been altered. The practice, however, is still to submit such proposed amendments to the preferred stock as a class. And a recent case which dealt with the class vote provision made no reference to this change, although the other changes made by the 1927 amendment were discussed. *Hartford Accident & Indemnity Co. v. Dickey Clay Mfg. Co.*, 21 A.(2d) 178 (Del. Ch. 1941).

⁴¹ 14 Del. Ch. 136, 154, 122 Atl. 696, 705 (Ch. 1923). The holding on this point was approved in *Shanik v. White Sewing Machine Corp.*, 19 A.(2d) 831, 834 (Del. Sup. Ct. 1941). This view should be compared with that in *Yoakam v. Providence Biltmore Hotel Co.*, 34 F.(2d) 533 (D. R. I. 1929), involving a Delaware corporation, where the payment of dividends on a new prior preferred issue from an available surplus existing at the date of the adjustment was prohibited, but was permitted from subsequent earnings of the corporation. *But cf. Johnson v. Fuller*, 36 F. Supp. 744 (E. D. Pa. 1940), *aff'd*, 121 F.(2d) 618 (C. C. A. 3d, 1941), involving a Pennsylvania corporation, where the federal court refused to enjoin payment of dividends on a new prior preferred stock notwithstanding an earned surplus of about \$20,000,000. The court pointed out that this surplus existed in 1933, up to which time dividends had been regularly paid on the old preferred stock, and that from 1933 through 1939 the company paid out more in dividends on the old preferred than had been earned over the same period. Consequently, the surplus was not built up by withholding earnings from the old preferred stock, but since cumulative preferred stock was involved, the date on which the surplus arose would seem to be irrelevant. The court also pointed out that the old preferred stock (no par) had been carried at a stated value less than its liquidating value, and hence the earned surplus actually would be offset by this difference. This last fact, however, would not seem to affect the vital fact that \$20,000,000 of earnings had been withheld.

The second part of the recapitalization plan, which sought to cancel the arrearages, involved an amendment operating directly on the accrued dividends, an example of the so-called direct method. Again the issue was merely one of existence of corporate power in terms of the preferred stock contract. The Chancellor was wholly unable to find that such power existed, for although "preferences" could be altered, the right to accrued dividends was deemed to be considerably more than a preference. In so deciding, the Chancellor made the first forceful use of the "vested right" terminology, and his language has been cited again and again in subsequent decisions. Yet it has been virtually overlooked that his purpose was merely to make clear that the right to the accruals was not a preference and that consequently the preferred shareholders had not consented in advance to the change. Moreover, little attention has been given to the point that the right to accrued dividends was held to be vested only as against the common stock.

There is no doubt but that the 1927 amendment to Section 26, set forth above, was designed to carry even further the liberal policy of the Delaware corporation law. There is also some evidence that the inclusion of "special rights" as a fit subject for alteration was for the specific purpose of permitting the elimination of accrued dividends by the direct charter amendment method which had failed in *Morris v. American Public Utilities Co.*⁴² In the years immediately following 1927 there was no occasion to test out the amended Section 26, but in 1935, when adjustment of accrued dividends had become of practical importance, it was only natural that the problem was approached on the assumption that Section 26 was available and that the chief obstacle was obtaining the requisite majority consent of the preferred shareholders. This assumption, however, received a rude jolt in 1936 in *Keller v. Wilson & Co.*⁴³

Wilson & Company was incorporated in Delaware in 1925. Its authorized capital stock, disregarding a 7% cumulative first preferred which was not involved in the subsequent litigation, consisted of 5% Class A preferred stock, cumulative after 1930, and

⁴² So the Chancellor believed in *Keller v. Wilson & Co.*, 21 Del. Ch. 13, 180 Atl. 584 (Ch. 1935), and such was the understanding of the corporation bar. See also *Harr v. Pioneer Mechanical Corp.*, 65 F.(2d) 332 (C. C. A. 2d, 1933).

⁴³ 21 Del. Ch. 391, 190 Atl. 115 (Sup. Ct. 1936).

common stock. In 1935, when the Class A arrearages amounted to more than \$21 per share, a charter amendment was adopted by a majority vote of each class converting each share of Class A stock and arrearages into five shares of common stock.⁴⁴ An objecting Class A shareholder brought suit to have the amendment declared null and void. The Chancellor, in an opinion wholly consistent with the purported Delaware policy of liberal construction, denied him relief.⁴⁵ On appeal the Delaware Supreme Court startled the corporate world by invalidating the amendment. Indicating that the time had come to halt the "increasing latitude" of the charter amendment power, the court defined the right to accrued dividends in sweeping "vested right" terminology. The most precise of the many definitions by the court stated:

The right to have paid at some future time the accumulation of dividends on preferred stock, was as between the stockholders, a fixed and vested right, having the nature and character of a debt, postponable in enjoyment until the creation of a fund from which payment legally could be made.⁴⁶

⁴⁴ The Class A stock was no par, its stated value was \$50 per share, and its liquidating value and redemption price were each \$75 per share. From December 14, 1934, the date on which the board of directors first proposed the adjustment plan, to February 23, 1935, when the plan became effective, the corporation had an earned surplus of \$2,249,062 available for the Class A stock (slightly over \$7 per share), allowance having been made for total arrears on the 7% first cumulative preferred of \$5,965,260. On December 13, 1934, the day before the plan was proposed, the Class A stock sold at 30 $\frac{3}{8}$ -32 $\frac{3}{8}$ and the common stock at 7-7 $\frac{1}{4}$; on February 25, 1935, the first day on which the Class A stock was no longer listed, the common stock sold at 5 $\frac{7}{8}$ -6. Thus the conversion ratio at the date the plan was proposed bore some relation to the market value of the two classes of shares, with perhaps a slight allowance being made for the arrearages. In every other way, however, it would seem that the Class A shareholders did not receive "fair" treatment under the adjustment. Nor were their sacrifices compensated for in the light of later events. Total dividends paid on the common since the plan became effective have amounted only to \$1.37 $\frac{1}{2}$, all of which were paid during 1935 through 1937. As of May 1, 1941, dividends had accrued on the new senior \$6 preferred stock to the amount of \$6 per share.

⁴⁵ 21 Del. Ch. 13, 180 Atl. 584 (Ch. 1935).

⁴⁶ 21 Del. Ch. 391, 411, 190 Atl. 115, 124 (Sup. Ct. 1936). This particular excerpt was indicated to be a paraphrase of the reasoning in *Penington v. Commonwealth Hotel Construction Co.*, 17 Del. Ch. 394, 155 Atl. 514 (Sup. Ct. 1936). Note also the statement at 412, 190 Atl. at 125: "When the nature and character of the right of a holder of cumulative preferred stock to unpaid dividends, which have accrued thereon through the passage of time, is examined in a case where that right was accorded protection when the corporation was formed and the stock was issued, a just public policy, which seeks the equal and impartial protection of the interests

The decision itself was divided by the court into two parts. The first dealt with the constitutional question raised by the fact that the corporation had been organized prior to the 1927 amendment of Section 26. Assuming not only that the 1927 amendment specifically authorized the direct elimination of accrued dividends (an assumption held to be erroneous in the second part of the decision), but also that the amendment was applicable as a matter of construction to a corporation organized prior to its enactment, the court went on to consider the sufficiency of the reserve power to authorize the alteration of the right to accrued dividends. It then held that the right to arrears, being a vested property right, was "secured against destruction by the Federal and State Constitutions."⁴⁷ The court in effect held that no power existed to make the change because the state could not constitutionally confer such a power. When the Class A stock was issued the holders consented in advance to changes of its preferences, but not to everything which the legislature might choose to propose. Since the right to accrued dividends was more than a preference, the shareholder had not consented to be bound by a majority of his class and unanimous consent was essential. Otherwise his property would be taken away from him in an unconstitutional fashion.⁴⁸

In the second part of the decision the court put aside the constitutional question and addressed itself solely to the matter of whether Section 26 as amended in 1927 did authorize the elimination of accrued dividends. The court was unable to find any such power, and a few months later in another case, *Consolidated Film Industries, Inc. v. Johnson*,⁴⁹ it definitely settled the issue by reiterating this interpretation with respect to a corporation organized after 1927. While the court employed sweeping language, it was made very clear that the basic issue lay in the original preferred stock contract. Thus, as in *Morris v. American Public Utilities Co.*, the consent in advance to change "preferences" was inadequate so far as accrued dividends were concerned, so here the

of all, demands that the right be regarded as a vested right of property secured against destruction by the Federal and State Constitutions."

⁴⁷ See full quotation in note 46 *supra*.

⁴⁸ The court never makes it entirely clear whether it is proceeding under the prohibition against impairment of contracts in the United States Constitution, or the due process clause of the United States and Delaware Constitutions.

⁴⁹ 197 Atl. 489 (Del. Sup. Ct. 1937).

term "special rights" was insufficient. Beneath all the verbiage, it is clear that the court actually meant no more than that general language would be inadequate to empower the adjustment of accrued dividends. Apparently only with precise authorization, perhaps in words of "one syllable," would the court hold that the preferred shareholder had consented in advance to some alteration of his right to dividends which had accrued.⁵⁰

If the *Keller* case and its sequel are analyzed in the light of the more recent decisions in *Federal United Corp. v. Havender* and *Shanik v. White Sewing Machine Corp.*,⁵¹ they will be seen to fit into a neat theoretical pattern in which the all-important issue is the existence of corporate power. But in 1936 the implications of the *Keller* case were not clear, and much speculation ensued as to its limits. Many corporations entirely abandoned pending schemes to cancel or adjust arrears on the assumption that the *Keller* case required payment of arrears in cash in full in order to satisfy dissenters.⁵² In some quarters the case was deemed to indicate that a rule of strict priority, similar to that applicable in equity and bankruptcy reorganizations, would now be applied as between classes of shareholders in recapitalizations.⁵³ On all sides it was felt that a rule of public policy had been laid down under which no statutory provision, however explicit, could operate with respect to cumulative dividends already accrued.⁵⁴

⁵⁰ See 197 Atl. 489, 493 (Del. Sup. Ct. 1937), where the court said, "But he, who contends that the State has conferred a power upon corporations, by charter amendment, to change such a substantial contractual right as the right to dividends on cumulative preferred stock accrued under the contract through time, should be able to point to statutory language so clear and precise as to permit of no reasonable doubt that a retrospective operation was intended." See Curran, *Minority Stockholders and the Amendment of Corporate Charters* (1934) 32 MICH. L. REV. 743, 753.

⁵¹ 11 A.(2d) 331 (Del. Sup. Ct. 1940), *infra* pp. 90-93, and 19 A.(2d) 831 (Del. Sup. Ct. 1941), *infra* pp. 93-95, respectively.

⁵² See Notes (1937) 31 ILL. L. REV. 661, 668, n.35, (1937) 46 YALE L. J. 985, 989, n.12.

⁵³ Such was the opinion of many members of the corporation bar. Cf. also Meck and Cary, *Regulation of Corporate Finance and Management under the Public Utility Holding Company Act of 1935* (1938) 52 HARV. L. REV. 216, 248, n.78. Note (1940) 49 YALE L. J. 1297. This idea was rejected by the Delaware court in 1941. See the excerpt from *Shanik v. White Sewing Machine Corp.*, 19 A.(2d) 831 (Del. Sup. Ct. 1941), note 81 *infra*.

⁵⁴ This is apparent in the many law review discussions of the *Keller* and *Havender* cases.

Yet if the effervescence of language in the *Keller* and *Consolidated Films* cases is disregarded, the rule laid down is the narrow one set forth above. In the *Keller* case in the lower court, the Chancellor made it clear in his opening sentence, which read: "The question in this case is one of corporate power."⁵⁵ To reiterate the general approach of this article, the contractual rights of preferred shareholders are fixed upon the original issuance of the shares. Certain of these rights may be altered in various ways, and to determine which rights can be altered and in what manner, the preferred shareholder must look to his contract, which, of course, includes both the applicable statutes and the articles of incorporation. As a result of these two cases the preferred shareholder in a Delaware corporation knows that his right to accrued dividends is secure from *direct* attack under Section 26. Whether the class of preferred stock to which his shares belong was created before or after 1927, he knows that the 1927 amendment to Section 26 did not confer any power to adjust his accrued dividends.⁵⁶ Even if Section 26 were to be amended so as to provide specifically for the adjustment, elimination, or discharge of accrued dividends, in the manner of a recent Ohio statute,⁵⁷ he knows that such an amendment is ineffective for constitutional reasons if his preferred stock antedated the new statutory provision.⁵⁸ This is true with

⁵⁵ 21 Del. Ch. 13, 14, 180 Atl. 584, 585 (Ch. 1935).

⁵⁶ Indirect types of adjustment plans, of course, were still feasible. See *supra* pp. 82-83 and *infra* pp. 93-94.

⁵⁷ OHIO GEN. CODE ANN. (PAGE, SUPP. 1940) § 8623-14 (3) (i), enacted in 1939, permits charter amendments which "change any or all of the express terms and provisions or designations of issued or unissued shares of any class or series; which change, if desired, may include the discharge, adjustment or elimination of rights to accrued undeclared cumulative dividends on any such class." The same section gives dissenting shareholders an appraisal remedy and § 8623-15 (3) (4) provides for a class vote on the amendment. See also note 19 *supra*.

Virginia also passed a specific provision in 1938, but it is more limited than the Ohio statute. VA. CODE ANN. (Michie, Supp. 1940) § 3780. It provides for charter amendments which create new classes of shares which may be issued for outstanding shares of stock "on the terms and conditions to be stated in such amendment; which said terms and conditions may, if ninety per cent of each class of stockholders affected thereby agree, provide for the elimination of all accrued and undeclared dividends on any class of stock where such dividends have either not been earned or have not been declared because of deficit in the capital of the corporation, whether such dividends have heretofore accrued or may hereafter accrue. . . ." See note 59 *infra*.

⁵⁸ Consolidated Film Industries, Inc. v. Johnson, 197 Atl. 489 (Del. Sup. Ct. 1937); Romer v. Porcelain Products, Inc., 2 A.(2d) 75 (Del. Ch. 1938).

respect not only to cumulative dividends accrued up to the enactment of the statutory amendment, but also to dividends accrued thereafter.⁵⁹ He also knows, however, that he is not entitled to have his dividends accrue with indestructible attributes indefinitely, for he has consented in advance to almost every conceivable change in his right to future dividends.⁶⁰ Thus, at any time under Section 26, a corporation has the power to alter the preferred stock contract so that dividends accruing after the date of the corporate action shall be subject to adjustment, elimination, or discharge upon appropriate shareholder consent.⁶¹ That is, in the Delaware terminology, the right to dividends can be changed from "vested" to "defeasible." Finally, of course, if a preferred stock is issued after the enactment of a specific statute like that in Ohio, the preferred shareholder knows from the beginning that his right to dividends as they accrue is "defeasible."⁶²

⁵⁹ See *Consolidated Film Industries, Inc. v. Johnson*, 197 Atl. 489, 493 (Del. Sup. Ct. 1937); cf. *Dodd, Dissenting Stockholders and Amendments to Corporate Charters* (1927) 75 U. OF PA. L. REV. 723-26. But note the language of the Virginia statute set forth in note 57 *supra*, which is literally applicable to dividends accrued prior to passage of the statute. Unless the Virginia courts hold that the right to accrued dividends is not "vested" when there is no surplus, a construction the statute itself suggests, this attempt would seem to be ineffectual on constitutional grounds. The provision as to dividends which accrue after the enactment, however, may be construed as a directly imposed amendment by the legislature, operating immediately on the right to future dividends. In this way preferred stocks antedating the statute may be partially brought within its purview even if the Delaware cases are followed and no corporate action of the type suggested in the text is taken.

⁶⁰ See discussion *supra* p. 76.

⁶¹ It is not known whether any corporation ever passed such a charter amendment, but there is some precedent in trust indenture provisions permitting less than 100% of the bondholders to waive interest defaults, consent to reductions in interest rates, and the like. A charter provision of this type could easily be inserted at the time a new prior preferred stock is created under an indirect adjustment plan or where a new preferred stock is the consequence of a merger. For many reasons, however, mostly purely human, it is unlikely that such charter provisions will be popular. See Note (1937) 46 YALE L. J. 985, 993. This same result could ensue from a direct legislative enactment making all dividends accruing thereafter "defeasible." See note 59 *supra*.

⁶² A few of the commentators seem to imply, unwittingly of course, that the *Keller* case gave such a protected status to accrued dividends that even a specific statute passed before a preferred stock was issued would be insufficient to permit an adjustment of dividend arrearages. Actually it has always been recognized that power to adjust or even discharge accrued dividends will be effective if it was explicitly conferred upon the initial formation of a corporation. See *Dodd, Dissenting Stockholders and Amendments to Corporate Charters* (1927) 75 U. OF PA. L. REV. 723, 727.

Only twenty days after the decision in the *Keller* case, another Delaware corporation, Federal United Corporation, carried out a merger transaction which was destined to give rise to another decision obliterating, for all practical purposes, the effect of the *Keller* case, and, in addition, creating the anomaly in Delaware of a right which is protected under Section 26, but is not so protected under the merger provisions of Section 59. Federal United Corporation had been organized in 1932, and by 1936 there were accrued dividends of \$29 per share on its outstanding \$6 cumulative preferred stock.⁶³ In that year Federal United Corporation, pursuant to Section 59 of the Delaware corporation law, merged with its wholly owned and inactive subsidiary, the subsidiary being the surviving corporation.⁶⁴ This merger, which was approved by 91.8% of Federal United's outstanding shares, but not by a class vote of the preferred stock,⁶⁵ provided that each \$6 preferred share and arrearages should receive one share of the surviving corporation's new \$3 preferred stock and six shares of its new Class A common stock. Federal United's common shareholders were entitled to exchange share for share for the surviving corporation's new Class B common stock, and, to create a surplus for the surviving corporation out of which dividends could be paid on the new \$3 preferred, certain large common shareholders donated preferred and common shares to the surviving corporation. Prior to the merger Federal United had no earned surplus in excess of the total accruals.⁶⁶

Seven months after the vote on the merger, a \$6 preferred shareholder who had not made the exchange sought to have the merger

⁶³ The stated value of the \$6 cumulative preferred was \$10 per share and the liquidation or dissolution value \$100 per share plus accumulated dividends.

⁶⁴ That the merger was treated as a recapitalization in the minds of Federal United's management seems clear from the statement in the merger plan sent to the shareholders in soliciting their approval: "It is proposed to carry out a voluntary plan for the readjustment of the capital structure of Federal United Corporation by means of a merger. . . ." *Havender v. Federal United Corp.*, 2 A.(2d) 143, 147 (Del. Ch. 1938). The date of incorporation of the subsidiary into which Federal United was merged does not appear in the report, although apparently it was not created for the specific purpose of the merger. See *Havender v. Federal United Corp.*, 6 A.(2d) 618, 621 (Del. Ch. 1939).

⁶⁵ No class vote is provided for by § 59, but merely the votes "representing two-thirds of the total number of shares."

⁶⁶ The capital surplus was \$744,988.16, the total accruals \$510,748. Under Delaware law dividends could be paid out of the capital surplus.

declared void. No claim was made that the terms of the merger were unfair. The case was heard twice in the Chancery Court, once before the late Chancellor Wolcott and again before the present Chancellor.⁶⁷ In both instances it was held that the merger was invalid with respect to the complainant, the principle ground being that a merger of a parent corporation with its wholly owned and inactive subsidiary was not within the purview of the merger statute, especially when its obvious purpose was to circumvent the rule of *Keller v. Wilson & Co.*

On appeal the merger was held valid in an opinion which severely limits, if it does not openly retreat from, the holding in the *Keller* case.⁶⁸ The Supreme Court held first that the merger statute did sanction the merger of a parent with its 100% owned subsidiary,⁶⁹ and secondly, that accrued dividends were not to be protected upon a merger under Section 59 as they were under Section 26. On this second point the court made it entirely clear that the sole issue before it was one of corporate power and not of unfairness.⁷⁰ It stressed the difference between Section 59 and Section 26, especially the fact that the former had been part of the original Delaware corporation statute in 1899. In striking language the court refused to give a narrow construction to Section 59 and instead interpreted its presence at the time Federal United was organized in

⁶⁷ *Havender v. Federal United Corp.*, 2 A.(2d) 143 (Del. Ch. 1938) (Wolcott), 6 A.(2d) 618 (Del. Ch. 1939) (Harrington).

⁶⁸ *Federal United Corp. v. Havender*, 11 A.(2d) 331 (Del. Sup. Ct. 1940).

⁶⁹ On April 13, 1937, § 59A was added to the Delaware corporation statute, dealing with proceedings for merger of parent corporations and wholly owned subsidiaries. The present Chancellor seized upon this as indicative of a lack of power in 1936 under § 59 for a parent and its wholly owned subsidiary to merge. 6 A.(2d) 618, 623 (Del. Ch. 1939). This conclusion can hardly be justified, and the Supreme Court construed § 59A as merely affording a simplified procedure for merger in the parent-subsidiary situation, and not as involving a grant of new power to accomplish a type of merger theretofore barred. 11 A.(2d) 331, 337 (Del. Sup. Ct. 1940). In its turn, however, the Supreme Court illogically seemed to feel that the passage of § 59A was of weight in holding the Federal United merger within the purview of § 59. It should be remembered that the transaction involved the merger of Federal United, the parent, into the wholly owned subsidiary, a procedure just the reverse of the method ordinarily used to eliminate an unnecessary subsidiary. Moreover, § 59A definitely envisages the normal type and provides only for a "one-way" merger of the subsidiary into its parent, and not for the transaction carried out by Federal United.

⁷⁰ No contention was made by the complaining preferred shareholders that the merger plan was unfair or inequitable. See 11 A.(2d) 331, 343 (Del. Sup. Ct. 1940).

1932 as clearly making the complainant's right to accrued dividends defeasible instead of vested in nature. It said:

The average intelligent mind must be held to know that dividends may accumulate on preferred stock, and that in the event of a merger of the corporation issuing the stock with another corporation, the various rights of shareholders, including the right to dividends on preference stock accrued but unpaid, may, and perhaps must, be the subject of reconciliation and adjustment; for, in many cases, it would be impracticable to effect a merger if the rights attached to the shares could not be dealt with.⁷¹

If the case had been one of an ordinary merger between two distinct corporations, there could be little quarrel with the court's reasoning. Under such circumstances adjustment of dividend arrearages is an integral part of the merger process, which, after all, is fairly ancient so far as American corporation law is concerned.⁷² The theory of merger is essentially one of compulsory conversion of shareholders of one corporation into shareholders in another by operation of law. The objecting shareholders have no alternative to this conversion other than to seek the value of their shares under appraisal statutes or other available remedies.⁷³ Except where the terms of the merger are unfair or inequitable, they have no right to insist upon remaining shareholders in the original corporation.

Thus the *Havender* case has drawn a clear distinction between the adjustment of preferred dividends by a compulsory plan under Section 59 and by a compulsory plan under Section 26.⁷⁴ It seems to have opened the door for any corporation which has a wholly

⁷¹ 11 A.(2d) at 338. The court also revived the thesis of *Davis v. Louisville Gas & Electric Co.*, 16 Del. Ch. 157, 142 Atl. 654 (Ch. 1928), that the public interest required this result.

⁷² Statutory merger and consolidation had its origin in America in the early railroad and canal era from 1820 to 1850, probably before any classification of shares. See Note (1935) 45 YALE L. J. 105, 109, n.15. The method of effecting changes by charter amendment is of relatively recent origin.

⁷³ The availability of the appraisal remedy was pointed out but not stressed. See 11 A.(2d) at 338-39.

⁷⁴ Pointing out that there was "a clear distinction between the situations" under § 26 and § 59, and in "the modes of procedure applicable to each," the court declared that not only had there been no invasion of any legal or equitable right in the merger, but also that no "moral wrong" had been committed. It is not an overstatement to say that the opinion in *Keller v. Wilson & Co.* had placed the problem on somewhat of a moral basis.

owned subsidiary or even a partly owned subsidiary to deal with accrued dividends under the merger or consolidation provisions of Section 59. While it does not decide whether a wholly owned subsidiary may be created and then the merger procedure carried out, it is difficult to perceive why such a method should not be upheld.⁷⁵ The fact that the *Havender* case involved a merger of a parent corporation with its own subsidiary is what gives the case its terrific impact on the doctrine of the *Keller* case. Had the court chosen to continue the policy laid down in the *Keller* case, it would have been simple to have adopted the approach of both Chancellors and deem the merger merely technical and a subterfuge. Such a view would have continued to preferred shareholders the protection against compulsory adjustment of accrued dividends other than by payment of cash except in the case of a bona fide merger between non-affiliated corporations, although, of course, it would still have left open the indirect technique of making an offer of new prior preferred in lieu of arrears. In failing to take that position the court seems to have indicated that the *Keller* decision went too far and was basically unsound. On policy grounds this result is open to serious question, but so far as corporate theory is concerned, the cases have now fallen into a neat pattern. The question is merely one of the existence of corporate power in relation to the original preferred stock contract.

It has recently been made clear that the *Havender* case not only upheld the direct method of merger but also dispelled any lingering doubt as to the legality of the indirect charter amendment device under Section 26. In *Shanik v. White Sewing Machine Corp.*,⁷⁶ the Delaware Supreme Court reaffirmed the 1923 case of *Morris v. American Public Utilities Co.*⁷⁷ and upheld the indirect method in a recapitalization designed to clear up arrears of \$31 per share on the \$4 cumulative preferred stock of the White Sewing Machine Corporation which had been issued in 1926. The plan was the traditional one of creating a new class of preferred stock with rights to dividends and on liquidation superior to those of the

⁷⁵ But see Chancellor Wolcott's strong dictum in the opinion on the first hearing, 2 A.(2d) 143, 147 (Del. Ch. 1938). This very point is currently up for decision in the federal district court for Delaware, in litigation involving the York Ice Machinery Company.

⁷⁶ 19 A.(2d) 831 (Del. Sup. Ct. 1941).

⁷⁷ *Supra* pp. 82-84.

existing preferred. The existing preferred shareholders were then given the option of retaining their shares with arrearages or exchanging those shares plus accrued dividends for shares of the new prior preferred and for new common shares. At the time of the plan, the corporation had a substantial deficit from operations.⁷⁸ The plan was approved by a majority vote of both the existing preferred and common classes.

The attack on the plan was directed principally to the priority of the new prior preferred to current dividends as against the arrears on the old preferred, for there was little room for contending that the new prior preferred could not be legally created. The complainant argued that his right to accrued dividends was a vested interest, secure against destruction, and that payment of current dividends on the new prior preferred before payment of arrears constituted just such destruction. In overruling his contention, the court said:

Here the transfer, if made, is purely voluntary, and any dissentient to the plan may keep his original preference stock with all accumulated and unpaid dividends thereon, and his relative position with reference to the common stock (the only preference to which he was ever entitled) remains precisely the same as if no change had been made. His accumulated dividends in arrear are not, in any sense, wiped out, but remain awaiting a legal fund for their payment, and they must be paid before dividends are paid upon the common stock.⁷⁹

Comment on the reasoning behind *Shanik v. White Sewing Machine Corp.* seems at this point rather redundant, but it illustrates once again the attitude of the Delaware courts that the fundamental issue is one of corporate power. The contract of the existing preferred shareholders permitted the creation of a new class of prior preferred, as well as the issuance of such new stock for exist-

⁷⁸ As of Dec. 31, 1937, the deficit from operations was \$4,578,915, and the net deficit, after deducting capital surplus of \$1,411,687, was \$3,167,228. POOR'S INDUSTRIAL MANUAL (1940) 1217. The total accruals as of the same date were \$3,100,000.

⁷⁹ 19 A.(2d) 831, 835 (Del. Sup. Ct. 1941). See also the case below, 15 A.(2d) 169, 173 (Del. Ch. 1940), where the Vice Chancellor said that *Keller v. Wilson & Co.* and *Consolidated Film Industries, Inc. v. Johnson* "by no means hold that language such as that of the charter of this defendant should be construed to express or imply an undertaking that accumulated dividends will in fact, and at all events, be paid. . . ."

ing preferred stock and arrearages.⁸⁰ Again the issue of the fairness of the plan was not before the court and the argument that some principle of fairness should be applied, similar to that developed in equity and bankruptcy reorganizations, received short shrift.⁸¹ The presence of a sizable capital deficit may have influenced the court to some extent, although on the whole it seems to have been irrelevant.⁸² Summed up, the decision is simply the final rivet necessary to complete the thesis that, regardless of the method employed to adjust accrued dividends, the corporate power doctrine is the decisive factor.

EQUITABLE LIMITATIONS AND THE EXISTENCE OF SURPLUS: THE NEW JERSEY CASES

The New Jersey cases afford an equally interesting but somewhat more nebulous picture of the accrued dividends problem.

⁸⁰ The court squarely held that the old preferred stock which could be exchanged for new prior preferred constituted consideration within § 14 of the Delaware statute, permitting payment for stock "by cash, by labor done, by personal property, or by real property or leases thereof." This holding and the similar one in *Johnson v. Lamprecht*, 133 Ohio St. 567, 15 N. E.(2d) 127 (1938), effectively illustrate the practical reaction to such academic suggestions as interpreting statutes authorizing creation of prior stock as permitting issuance of the new prior stock for cash only. See Becht, *The Power to Remove Accrued Dividends by Charter Amendment* (1940) 40 COL. L. REV. 633, 648. See also SEC REP. ON REORGANIZATION COMMITTEES, PART VII (1938) 496-500; *Johnson v. Fuller*, 121 F.(2d) 618, 625-26 (C. C. A. 3d, 1941).

⁸¹ The court said: "The facts of the present case concerning the common stock, the status of the company or the nature of the proceeding do not fall within the category of *Case v. Los Angeles Lumber Products Co.*, 308 U. S. 106, . . . or similar cases cited." 19 A.(2d) 831, 836 (Del. Sup. Ct. 1941). It is doubtful how much weight can be given to this statement, since the court declined on procedural grounds to consider the issue of fairness except as "inextricably interwoven with the issue of legality." 19 A.(2d) at 834.

⁸² No Delaware case has explicitly indicated that the existence of a surplus is even relevant. Surveying the four leading cases, 1936-1941, in one there was a deficit (*Shanik v. White Sewing Machine Corp.*), in one a capital but not an earned surplus (*Federal United Corp. v. Havender*), and in two there were substantial earned surpluses (*Consolidated Film Industries, Inc. v. Johnson* and *Keller v. Wilson & Co.*). The only language at all relevant is in *Keller v. Wilson & Co.*, 21 Del. Ch. 391, 411, 190 Atl. 115, 124 (Sup. Ct. 1936), whence, from the different context of the nature of the right to accrued dividends, this statement can be lifted: "There seems to be no more reason to view the right of the shareholder as vested [where there is a surplus] than in the case where no surplus exists at all, for in either situation the shareholder has no immediately assertable right, nor may he ever have such rights." See also cases discussed in note 41 *supra*.

The corporation-law tradition in New Jersey had its origin some fifty years prior to that of Delaware, and this longer period of evolution, contrary perhaps to normal expectation, has tended to produce confusion. The New Jersey courts, moreover, and especially the chancery courts, have long been known for the relatively greater surveillance which they give to corporate transactions in the interests of investors. Especially pertinent to the present problem is the remark in one opinion: "While it is quite desirable that corporations organized under the laws of New Jersey should have ample proper latitude in making readjustments to meet new and unexpected business conditions, it is even more important that the contractual rights of stockholders of all classes of stock shall be upheld. . . ." ⁸³

In Delaware, it will be recalled, the fundamental issue was one of corporate power in the sense of consent in advance by the preferred shareholders to the adjustment of dividend arrearages by action of the majority. In New Jersey, however, an additional limitation is seemingly imposed which can probably best be described as an equitable requirement of fairness.⁸⁴ So far as language goes, this limitation can also be expressed as a lack of power, but such a description seems inaccurate. In any event our purpose here is to ascertain how and to what extent this additional equitable limitation is imposed.

The existence of corporate power in New Jersey is an important question, and under the proper circumstances the time element can be of just as much significance as in Delaware. Moreover, the reserve power question, so important in the *Keller* case,⁸⁵ is complicated in New Jersey by a doctrine that the reserve power can be exercised so as to affect the contract between the corporation and the shareholders, and that between the shareholders *inter sese*, only if such exercise is in the public interest.⁸⁶ With the

⁸³ Concurring opinion of Judge White in *General Investment Co. v. American Hide & Leather Co.*, 98 N. J. Eq. 326, 338, 129 Atl. 244, 249 (1925).

⁸⁴ This is not to say that the Delaware courts will not and have not imposed equitable requirements of fairness in other situations, some of which are not unlike the present accrued dividends problem. One example is the famous sale of assets case, *Allied Chemical & Dye Corp. v. Steel & Tube Co.*, 14 Del. Ch. 1, 120 Atl. 486 (Ch. 1923).

⁸⁵ See *supra* p. 86.

⁸⁶ This doctrine was established by *Kean v. Johnson*, 9 N. J. Eq. 401 (Ch. 1853),

vicissitudes of this rule we are not here concerned, for it has been of little relevance in the accrued dividend cases.⁸⁷ In this article, in order to view the problem from a different perspective, we shall assume that corporate power does exist; consequently the sole issue for our purposes becomes one of limitations on its exercise.

A brief description of the New Jersey statutory background is helpful. As to charter amendments, both the direct and indirect methods seem to be sanctioned, although the former is of recent enactment. Thus, under Chapter 11 of Title 14 of the Revision of 1937, in substance an amplification of the basic general corporation law of 1896, any corporation, by charter amendment approved by two-thirds of each class, has had the specific power since 1896 to create additional classes of preferred stock, and since 1926 to create new prior preferred or other special stocks.⁸⁸ The 1896 statute alone has been deemed sufficient to confer corporate power to carry out a recapitalization by the indirect method.⁸⁹ Moreover, since 1921 any corporation has apparently had the power to change its preferred stock into common stock and thus accom-

and *Zabriskie v. Hackensack & N. Y. R. R.*, 18 N. J. Eq. 178 (Ch. 1867), with which compare *Black v. Delaware & R. C. Co.*, 24 N. J. Eq. 455 (1873). The most recent leading case is *Allen v. Francisco Sugar Co.*, 92 N. J. Eq. 431, 112 Atl. 887 (1921). That public interest here, as elsewhere, is flexible, see *In re Mechanics Trust Co.*, 119 N. J. Eq. 141, 181 Atl. 423 (Ch. 1935). See also discussion and cases collected in Curran, *Minority Stockholders and the Amendment of Corporate Charters* (1934) 32 MICH. L. REV. 743, 747.

⁸⁷ To a large extent this result has been mere coincidence. Since, however, the time element (date of incorporation in relation to date of enactment of a constitutionally valid empowering statute) is controlling under the corporate power doctrine, the fact that pertinent New Jersey statutes were enacted somewhat earlier than those of Delaware has had some effect. Even more important has been the deliberate avoidance by certain vice chancellors of the lack of corporate power ground when the alternative herein discussed was available. See *Lonsdale Securities Corp. v. International Mercantile Marine Co.*, 101 N. J. Eq. 554, 560, 139 Atl. 50, 52 (Ch. 1927).

⁸⁸ N. J. STAT. ANN. (1939) § 14:11-1. For the specific power to create "one or more classes of preferred stock," see N. J. Laws 1896, c. 185, § 27. It was at one time contended that contrary to the accepted New Jersey construction, this grant permitted creation of preferred stock only where no class of preferred stock already existed. See Note (1925) 11 CORN. L. Q. 78, 80. For the present power to create "one or more classes of preferred or prior preference or other special stock," see N. J. Laws 1926, c. 318, § 7.

⁸⁹ *General Investment Co. v. American Hide & Leather Co.*, 98 N. J. Eq. 326, 129 Atl. 244 (1925).

plish an adjustment by the direct method.⁹⁰ Since 1926 the statute has also contained a provision "for funding or satisfying rights, in respect to dividends in arrears by the issuance of stock therefor or otherwise. . . ." ⁹¹ This provision has never been construed and can be said to have little practical significance, for a funding of arrears could probably be accomplished without such an enactment.⁹² Turning to merger and consolidation, in Chapter 12 of Title 14 of the 1937 Revision, corporate power for domestic corporations was conferred generally in 1893, made part of the general revision in 1896, and in 1929 expanded so as to permit New Jersey corporations to merge or consolidate with foreign corporations.⁹³ This statutory framework does not differ markedly from that of Delaware, except for the provision with regard to funding arrears, and, as has been said, this seems to have been given no vital force.

The additional limitation added by the New Jersey courts, denominated above as a requirement of fairness, cannot be set forth with the same preciseness as the corporate power requirement in Delaware, and its validity is necessarily more doubtful. With this word of caution, it can be said that the rule of fairness seems to revolve about the existence of an earned surplus. When a corporation has an earned surplus at the date of a proposed adjustment of accrued dividends, the preferred stock appears to have a right to that surplus which cannot be divested, at least in favor of the common stock. The preferred shareholders possess in it, as against the common shareholders, what is called in the usual terminology a "vested right." Thus, it is at least evident that in a direct charter amendment adjustment, although the preferred

⁹⁰ N. J. Laws 1921, c. 233, § 1. Cf. *Sander v. Janssen Dairy Corp.*, 36 F. Supp. 512 (D. N. J. 1940).

⁹¹ N. J. Laws 1926, c. 318, § 7.

⁹² The only case which even mentions this provision is *Buckley v. Cuban American Sugar Co.*, 129 N. J. Eq. 322, 329, 19 A.(2d) 820, 823 (Ch. 1940). See *infra* p. 100. See also discussion of the provision in SEC REP. ON REORGANIZATION COMMITTEES, PART VII (1938) 511-14. The preexisting power to create new classes of preferred stock would seem sufficient to have covered funding of arrears on the basis contemplated in *Buckley v. Cuban American Sugar Co.*, "vested rights and contractual obligations" being kept inviolate.

⁹³ N. J. STAT. ANN. (1939) § 14:12-1. For the statutory development, see N. J. Laws 1893, c. 67, § 1; N. J. Laws 1896, c. 185, § 104; N. J. Laws 1918, c. 271, § 1; N. J. Laws 1929, c. 261, § 1.

stock may be converted into common stock, the preferred has a right to its accrued dividends to the extent of the earned surplus, which right must be preserved against the common stock. Likewise, under the indirect charter amendment and the merger methods, the right to accrued dividends is held inviolate as against the common stock. Furthermore, this rule of fairness may also have a second application. It may possibly extend further, so that the right to accrued dividends is vested in an earned surplus, not merely as against the common stock, but generally. In other words, the right to arrears may be so protected that no other class of stock, prior preferred or otherwise, can participate in that surplus unless the arrearages have first been paid in full. But rather than generalize further, we shall proceed to the cases.

This equitable rule of fairness can best be described and analyzed by commencing with the most recent decision and working back from it to several earlier cases. In *Buckley v. Cuban American Sugar Co.*,⁹⁴ in the New Jersey chancery court, a corporation organized in 1906 had the usual capital structure. The preferred was 7% cumulative and had arrears of \$54.50 per share, or in the aggregate, \$3,884,767.50. There existed an earned surplus of over \$16,000,000 at the date of the proposed adjustment.⁹⁵ The plan was an ingenious variation of the indirect method in that the

⁹⁴ 129 N. J. Eq. 322, 19 A.(2d) 820 (Ch. 1940). The precise weight to be given this case is difficult to determine. The Chancellor enjoined the consummation of the plan pending final hearing. The defendant corporation appealed from this interim decree, and after full argument before the Court of Errors and Appeals, the suit was settled. It should not be overlooked, however, that other opinions of New Jersey chancellors at preliminary stages of cases, some of them involving accrued dividends, have been long regarded as authoritative precedents. *E.g.*, *Windhurst v. Central Leather Co.*, 101 N. J. Eq. 543, 138 Atl. 772 (Ch. 1927); *Lonsdale Securities Corp. v. International Mercantile Marine Co.*, 101 N. J. Eq. 554, 139 Atl. 50 (Ch. 1927).

⁹⁵ Presumably this surplus represented earnings accumulated up to 1929, prior to which year the 7% preferred stock had received its dividends in full. During the eleven years, 1929-1939, there were net earnings in five years and net losses in six years. On the basis of figures in *Poor's Industrial Manual* for 1940, 1936, and 1932, the total losses in the eleven years exceeded the total profits by \$2,757,044, while the net earnings for the five years exceeded the total dividends paid by \$3,269,085. If the entire net losses are chargeable against the net earnings, it appears that no net earnings were withheld from the preferred stock during the eleven years. Thus, the court in effect held that the right to accrued dividends was vested in net earnings withheld from the common stock before 1929 and appearing today in the form of earned surplus.

new class of 5½% preferred stock, into which the existing 7% preferred was made exchangeable, was not made a prior class. The two stocks were placed on an equal basis as to current dividends, but these current dividends on both classes were specifically given priority in payment over the \$54.50 of arrears on the 7% preferred. The new 5½% preferred also was redeemable, which the 7% was not, and was convertible into common. The plan allowed the existing 7% preferred shareholders the alternative of retaining their 7% shares with arrears or exchanging each such share for 1.4 shares of the new 5½% preferred and \$14.50 in cash.

It was clear that the corporation had the power to create the new 5½% preferred under the 1896 Act. Under the Delaware rationale, the 7% preferred shareholders gave their consent in advance to such a creation upon a two-thirds class vote, which had been obtained. Likewise the new shares could be issued in exchange for the old 7% stock. Yet on preliminary hearing the Vice Chancellor enjoined the plan, and the nub of the decision seems to have been the \$16,000,000 earned surplus. The opinion itself is mainly a recital of facts and allegations, and aside from a lengthy quotation from an earlier case⁹⁶ and the citation of many others, the only reason given for the result is this statement:

While it can be conceded that a corporation may have the right to provide for funding or satisfying rights, in respect to dividends in arrears by the issuance of stock therefor or otherwise (*R.S. 14:11-1 (n)*), however, the amendment must preserve and hold inviolate vested rights and contractual obligations.⁹⁷

Since the court itself was so chary with explanation, speculation is permissible both as to the limits of the decision and the reasoning behind it. Did the court recognize that under the plan the right, whatever it may be, of the 7% preferred stock to the \$16,000,000 earned surplus was in no sense divested in so far as the common stock was concerned? Why did it seem so willing, aside from the interim nature of the proceeding, to grant an injunction against the consummation of the plan and not content itself with an order reserving the \$16,000,000 earned surplus for the old 7% preferred

⁹⁶ *Lonsdale Securities Corp. v. International Mercantile Marine Co.*, 101 N. J. Eq. 554, 139 Atl. 50 (Ch. 1927).

⁹⁷ 129 N. J. Eq. 322, 329, 19 A.(2d) 820, 823 (Ch. 1940).

stock's accrued dividends?⁹⁸ The cited cases afford some clues as to the rationale of the holding, and when these cases are turned to, the issue is seemingly one of fairness rather than one of corporate power in the Delaware sense.

This New Jersey doctrine assumed whatever form it takes today principally in the years from 1924 to 1927 inclusive. Earlier manifestations can be found, but they are rather unsatisfactory.⁹⁹ The first of the cases in the highest New Jersey court in the 1924-1927 period, *Day v. United States Cast Iron Pipe & Foundry Co.*,¹⁰⁰ now a byword in New Jersey corporation law, strangely enough involved noncumulative preferred stock. It is most famous generally as the culmination of a line of decisions which represent the antithesis of the rule laid down by Mr. Justice Holmes in *Wabash Ry. v. Barclay*.¹⁰¹ Its relevance here lies first in its

⁹⁸ As did the federal court in *Yoakam v. Providence Biltmore Hotel Co.*, 34 F.(2d) 533 (D. R. I. 1929).

⁹⁹ The most important of the earlier cases is *Colgate v. United States Leather Co.*, 73 N. J. Eq. 72, 67 Atl. 657 (Ch. 1907), *rev'd on other grounds*, 75 N. J. Eq. 229, 72 Atl. 126 (1909). The decision, which is discussed in SEC REP. ON REORGANIZATION COMMITTEES, PART VII (1938) 551-52, is not entirely relevant here because it was based to a considerable extent on peculiar language of the corporate charter and on a now obsolete statute. Moreover, the consolidation was viewed as tantamount to a dissolution of the subsidiary, a view since repudiated in New Jersey. *Windhurst v. Central Leather Co.*, 105 N. J. Eq. 621, 149 Atl. 36 (Ch. 1930), *aff'd per curiam*, 107 N. J. Eq. 528, 153 Atl. 402 (1931). For present purposes the value of the case lies in the Vice Chancellor's reliance on the \$7,000,000 earned surplus. After in effect indicating that the consolidation made it possible for the old common stock to participate in this surplus to the detriment of the old 8% preferred, he said (97, 67 Atl. at 667): "The preferred stockholders have on the termination of the business by the consolidation, the right to an account for at least so much or such proportion of the apparent surplus as represents net earnings."

The only other early case, *Lazear v. American Steel Foundries*, 86 N. J. Eq. 21, 252, 98 Atl. 642, 100 Atl. 1030 (1916), where the Court of Errors and Appeals with some dissent adopted a Vice Chancellor's opinion as their own, is too anomalous to be of any use. Compare *American Steel Foundries, Inc. v. Lazear*, 204 Fed. 204 (C. C. A. 3d, 1913).

¹⁰⁰ 96 N. J. Eq. 736, 126 Atl. 302 (1924). This was an affirmance by an equally divided court of 95 N. J. Eq. 389, 123 Atl. 546 (Ch. 1924).

¹⁰¹ 280 U. S. 197 (1930). The other New Jersey cases are *Bassett v. United States Cast Iron Pipe & Foundry Co.*, 75 N. J. Eq. 539, 73 Atl. 514 (1909); *Moran v. United States Cast Iron Pipe & Foundry Co.*, 95 N. J. Eq. 389, 123 Atl. 546 (Ch. 1924), *aff'd*, 96 N. J. Eq. 698, 126 Atl. 329 (1924). The *Wabash* decision is often viewed as standing for the proposition that once a dividend date of non-cumulative preferred stock has passed and no dividend declared, the right to that dividend is gone forever. Actually the holding was somewhat narrower, as careful reading of Mr. Justice Holmes' opinion will show. A large body of legal literature

definition of cumulative preferred stock as contrasted with non-cumulative preferred stock:

The dividends upon cumulative preferred stock have at all times and for all years, past and present, until paid, priority in payment over any and all unpaid dividends upon common stock, whether the net earnings for any particular past or present year were or were not sufficient to pay the stipulated cumulative dividends upon preferred stock for that year; whereas, the like priority of dividends upon non-cumulative preferred stock . . . is limited to the unpaid dividends for those years when such net earnings were sufficient (wholly or in corresponding part) to pay such dividends.¹⁰²

The *Day* case has significance secondly by analogy. There a preferred shareholder, noncumulative indeed, successfully enjoined the payment in 1923 of a common stock dividend out of earnings of the year 1922, the 7% annual current dividend on the preferred for 1922 having been paid in full from 1922 earnings. Yet prior to 1922, in years in which earnings were sufficient to cover the full 7% dividend, dividends had not been paid on the preferred to the extent of \$700,000, the withheld earnings being retained by the corporation as earned surplus.¹⁰³ While statutory construction was largely involved, the over-all emphasis in the opinion was on the idea that this \$700,000 of withheld earnings, in a total earned surplus of some \$2,500,000, was earmarked for the preferred stock, and until it actually was paid, no dividend could be paid on the common, even from current earnings.¹⁰⁴ By anal-

exists with respect to this problem of noncumulative preferred stock. See Berle, *Non-Cumulative Preferred Stock* (1923) 23 COL. L. REV. 358; Frey, *The Distribution of Corporate Dividends* (1941) 89 U. OF PA. L. REV. 735; Lattin, *Is Non-Cumulative Preferred Stock in Fact Preferred* (1930) 25 ILL. L. REV. 148. The problem is still very much alive. Cf., e.g., *Lich v. United States Rubber Co.*, 39 F. Supp. 675 (D. N. J. 1941).

¹⁰² 96 N. J. Eq. 736, 740-41, 126 Atl. 302, 304-305.

¹⁰³ The title of the account was "Working Capital Reserve," but it was made up of surplus profits. See Vice Chancellor Backes' decision below, 95 N. J. Eq. 389, 123 Atl. 546 (Ch. 1924).

¹⁰⁴ The main issue in the *Day* case was whether the noncumulative preferred stock, in view of the provisions of its contract, came within the class of stock designated as preferred in § 18 of the New Jersey Corporation Act of 1896. Section 18 at that time provided for the initial creation of preferred stock and stated that "the holders thereof shall be entitled to receive, and the corporation shall be bound to pay thereon, a fixed yearly dividend, to be expressed in the certificate, . . . before any dividend shall be set apart or paid on the common stock, and such dividends

ogy this same principle of withheld earnings can lead to an identical result in the cumulative preferred stock situation.¹⁰⁵ Moreover, the analogy can be carried a step further because of the basic difference between noncumulative and cumulative preferred stocks. In terms of the excerpt above from the *Day* case, accrued dividends on cumulative preferred stock "have at all times and for all years past and present" priority over the common, and the presence of earnings sufficient to pay the cumulative dividend in any given year is irrelevant. If, for example, a corporation had a slight deficit from operations in one year so that no earnings whatever were attributable to the preferred stock; if the following year the net earnings were sufficient not only to erase the deficit but also to cover the preferred dividend requirements two times, and nevertheless no dividends were paid, then the withheld earnings and the resulting earmarked surplus would be an amount equal to two years' dividend arrearages instead of one, as would be true if the preferred stock were noncumulative. In other words, where preferred stock is cumulative the earnings record of a particular year has no significance. The coexistence of dividend arrearages and earned surplus establishes the fact of withheld earnings, and all earned surplus up to the total amount of the accruals is to be regarded as earmarked for the cumulative preferred stock. Such a result would seem wholly consonant with the equitable considerations motivating the *Day* case, and at least not unduly out of line with the cumulative preferred stock contract.¹⁰⁶

may be made cumulative. . . ." Deeming that the legislative policy revealed the idea of "secured priority," the court held that the particular provisions of the stock contract did "not authorize the payment to the common stockholders of the proposed dividend, while earned available and unpaid dividends on the preferred stock remain undistributed to the preferred stockholders in the corporation's surplus." 96 N. J. Eq. 736, 744, 126 Atl. 302, 306 (1924).

¹⁰⁵ That is, if dividends are permitted to accrue in a year in which earnings were sufficient to pay the preferred dividends, the resulting earned surplus becomes earmarked for the cumulative preferred stock, at least as against the common stock.

¹⁰⁶ On the basis of the cumulative preferred stock contract it can be contended that as a matter of logic the existence of all earned surplus is immaterial so far as cumulative preferred stock is concerned. It can be argued that the priority of the preferred over the common is such that in any adjustment accrued dividends must be compensated for in full before anything can be given to the common, and that protection merely to the extent of an existing surplus is not enough. In substance this seemed to be the view in Delaware of the *Keller* case until the later cases demonstrated the narrow application of that decision. This point may become

The relevance of and the effect to be given to the existence of an earned surplus in an accrued dividend adjustment was the vital issue in a second decision of the New Jersey Court of Errors and Appeals in the year after the *Day* case. In *General Investment Co. v. American Hide & Leather Co.*,¹⁰⁷ the corporation had been formed in 1899 and had some 125,000 shares of 7% cumulative preferred stock outstanding, upon which there were accrued dividends of \$140 per share. To adjust these arrears a recapitalization plan was proposed by which a new class of 8% prior preferred stock was created, into which 35,000 shares of the old 7% preferred were to be exchanged share for share. The plan further provided for the purchase and retirement of 30,000 additional old 7% preferred shares. Adoption of the plan was voted by three-fourths of the old 7% preferred and seven-tenths of the old common. A preferred shareholder sought to enjoin the plan.

In denying an injunction, the court, in an opinion in which nine of the twelve justices agreed, held first that the 1896 Act empowered the corporation to create a new class of preferred shares with rights superior to the old 7% preferred. It then went on, however, to state that if the purchase of part of the old preferred shares for retirement involved the use of any of the earned surplus of \$5,000,000,¹⁰⁸ then the complainant was entitled to an injunction against use of an amount of the surplus in proportion to the number of his shares, since such surplus was in effect earmarked for accrued dividends.¹⁰⁹ Since the adjustment plan before the court did not

clearer if one remembers that the existence of a surplus is relevant where non-cumulative preferred is involved because where there have been past earnings and yet dividends have been withheld, the very existence of that surplus containing withheld earnings gives rise to a right to it, at least as against the common stock. But in the case of cumulative preferred, the right to dividends arises wholly without relation to past earnings or past withholding of dividends. It is this absence of strict logic, in part, which leads one to denominate the New Jersey doctrine as a rule of fairness.

¹⁰⁷ 98 N. J. Eq. 326, 129 Atl. 244 (1925), affirming 97 N. J. Eq. 214, 230, 127 Atl. 529, 659 (Ch. 1925).

¹⁰⁸ In none of the three opinions in the case is it definitely stated that the surplus involved was earned. Its nature, however, could hardly have been otherwise. An analysis of the financial statements of the corporation, as contained in *Moody's Manuals*, covering the period from the date of its organization in 1899 up to 1925, warrants the inference that the entire \$5,000,000 was earned surplus and establishes very clearly that at least the great bulk of the \$5,000,000 was earned surplus.

¹⁰⁹ This issue was really academic since the plan called for the purchase of

have the effect of reducing the earned surplus in any other way, the majority was free to postpone passing on such questions as the legality of a dividend on the new 8% prior preferred from the \$5,000,000 earned surplus until such a dividend was actually declared. To a limited degree then, it can be argued that the majority of the court recognized that the right to accrued dividends should be protected, and be protected generally in the existing surplus rather than be preserved merely as against the common stock.

One judge, however, went on to write a concurring opinion which throws a little light on this particular problem. He agreed that the basic power existed to create a new preferred stock prior to the old preferred both "as to future dividends on the old preferred stock, and also as to priority of payment of principal upon dissolution. . . ." ¹¹⁰ As to the accrued but unpaid dividends, however, he had more difficulty, and he posed this query:

Is that sufficient to authorize the corporation to destroy the cumulative portion of the contract held by preferred stockholders in a retroactive way, so that not only is that cumulative provision modified as to the future (which is a risk which all investors in preferred stock not secured by express contractual provision undertake when they buy such preferred stock), but as to the past also? Can the rights of preferred stockholders to receive compensation according to their contract, even though at some future time, for the period during which their money has already remained invested on the faith of that contract, be absolutely wiped out and destroyed? ¹¹¹

He then went on to cite *Morris v. American Public Utilities Co.* ¹¹² and to hold, contrary to that case, that the complainants had a "vested present property right to have those dividends paid to them at some future time out of earnings of the corporation before

shares for retirement at par (\$100) or less, and the price contemplated was \$70. Under the New Jersey statutes such a purchase could be made from capital. As a result, the reduction would be in the capital allocated to the old 7% preferred and not in the surplus account. If anything, a capital or retirement surplus would be created by the purchase. This aspect of the transaction was recognized by the concurring judge. See 98 N. J. Eq. 326, 334, 129 Atl. 244, 247. Unfairness in another sense was avoided by the majority's requirement that the shares should be purchased for retirement ratably from each shareholder who desired to sell.

¹¹⁰ 98 N. J. Eq. at 338, 129 Atl. at 249.

¹¹¹ *Id.* at 339, 129 Atl. at 249.

¹¹² *Supra* pp. 82-84.

the payment of any dividends which did not have priority over them at the time they from time to time matured."¹¹³ He concluded with the statement that the new prior preferred was superior to the existing preferred as to future accruing dividends, but that no dividends whatever, whether from past surplus or future earnings, could be paid on the new prior preferred until the accrued dividends on the existing preferred had been satisfied. In support of this proposition the *Day* case was cited. Thus he felt that the right to accrued dividends was against the corporation generally, and not merely against the common stock.

The ambiguities and inaccuracies in this concurring opinion should be noted, as well as the fact that it covers vital points upon which the majority opinion was silent, and which were not necessarily before the court. In the first place, the Delaware case of *Morris v. American Public Utilities Co.* did not hold that accrued dividends had to be paid on the old preferred before any dividends could be paid on new prior preferred stock. The Delaware Chancellor made it very clear that whatever right the old preferred stock had was only in relation to the common stock.¹¹⁴ The view expressed in the concurring opinion in the New Jersey case, making the right to accrued dividends superior to current dividends from current earnings on new prior preferred stock, is not dealt with in the majority opinion.¹¹⁵ Secondly, the concurring opinion fails to outline the amount of accrued dividends which were to be regarded as a vested right of the old preferred stock. Were the complainants entitled to a vested right for an amount in proportion to the arrearages on their own shares on the basis of \$17,500,000, the total arrears, or, following the analogy of the *Day* case, on the basis of the existing earned surplus of \$5,000,000? The broad language of the concurring judge could be construed to mean the former.¹¹⁶ But that very language follows a discussion of the

¹¹³ 98 N. J. Eq. at 340, 129 Atl. at 250.

¹¹⁴ See Note (1938) 12 U. OF CIN. L. REV. 576, 587.

¹¹⁵ The majority's protection of the right to accrued dividends in the existing surplus was against diversion of that surplus to the purchase of old preferred shares for retirement. No reference was made, as in the concurring opinion, to the possibility of future dividends from that surplus or from future earnings on the new prior preferred stock. See also discussion of the *Yoakam* case and *Johnson v. Fuller*, note 41 *supra*.

¹¹⁶ This is the view taken in Note (1938) 12 U. OF CIN. L. REV. 576, 588, which stresses the statement that the right of the preferred shareholders was to have their

\$5,000,000 surplus and, moreover, the very citation of the *Day* case indicates the right is vested only to the extent surplus exists. Viewing the majority and concurring opinions as a whole, it can be argued that the vested right of which they speak is in the existing surplus at the time of the adjustment and extends no further. Such an interpretation is especially defensible when it is recalled that we are concerned with considerations of fairness and not with strictly logical rules.¹¹⁷

The two cases above complete the authority of the New Jersey Court of Errors and Appeals in the 1924-1927 period. Several opinions of the chancery court, however, are of some help. In *Lonsdale Securities Corp. v. International Mercantile Marine Co.*,¹¹⁸ decided in 1927, a corporation organized in 1902 sought to recapitalize. It had over 500,000 shares of 6% \$100 par cumulative preferred stock, on which arrearages amounted to \$70 per share, and slightly less than 500,000 shares of common stock. The plan resorted to the direct charter amendment method, apparently on the theory that the 1921 statutory amendment permitted preferred stock to be reclassified into common stock.¹¹⁹ Under the plan the two existing classes of shares were to be replaced by 120,000 shares of new 6% no par cumulative preferred and 720,000 shares of no par common stock. Every five shares of old preferred and accrued dividends were to be exchanged for one share of new preferred and five shares of new common, and each share of old common was to be exchanged for one-fifth share of new common. At the date of the plan there was an earned surplus of over \$17,000,000. Once again a preferred shareholder sought to enjoin the plan.

accrued dividends "paid to them at some future time out of the earnings of the corporation before the payment of any dividends which did not have priority over them at the time they from time to time matured." This may be so general, however, as to be meaningless on this precise point. Other factors tending toward the view that the total arrears were entitled to priority are the concurring judge's apparent feeling that, despite the book surplus, the surplus had not been "ascertained to be available for dividends," and the manner in which he contrasted the modification of the cumulative provision as to the future with modification as to the past so as to find a difference, in which the existence of a surplus played no part. See 98 N. J. Eq. at 339-40, 129 Atl. at 249-50.

¹¹⁷ Compare note 106 *supra* for the strictly logical view. Note (1938) 12 U. OF CIN. L. REV. 576 also exemplifies the purely legalistic point of view.

¹¹⁸ 101 N. J. Eq. 554, 139 Atl. 50 (Ch. 1927).

¹¹⁹ Cf. *Sander v. Janssen Dairy Corp.*, 36 F. Supp. 512 (D. N. J. 1940).

In granting the injunction the Vice Chancellor expressly avoided as unnecessary the possible ground that since the corporation had been organized prior to the 1921 statute, the reserve power of the state was inadequate to confer power to make the amendment for constitutional reasons.¹²⁰ Instead, assuming the existence of such corporate power, he held the plan illegal because it disturbed the old preferred stock's vested right in the \$17,000,000 surplus. He said that the preferred shareholders:

... have become vested with rights as against the holders of the common shares in a surplus of at least some \$17,000,000 that the company has accumulated and also in future earnings and all the other property of the corporation.¹²¹

The first part of this quotation is very clear, for under the facts of the case it was possible for the common stock to come in and share in the existing surplus.¹²² But the cryptic reference to "future earnings" raises the same cloud of ambiguity as in the concurring opinion in *General Investment Co. v. American Hide & Leather Co.* Later in the opinion, however, the Vice Chancellor reverts again to the earned surplus and makes it appear that the accrued dividends were not vested beyond the amount of that surplus:

At the present time the holders of the existing preferred stock would be entitled to all of the existing surplus if the directors should decide to declare a dividend. If that stock is retired in accordance with the proposed plan, then it is readily seen that the requirements of the relatively few shares of no-par-value preferred stock (the new stock) might be satisfied out of a portion of the surplus, and the balance thereof devoted to a payment on the no-par-value common stock which would in part represent and stand in the place of the present common stock. This would be an indirect means of accomplishing a result that is now beyond the powers of the corporation.¹²³

¹²⁰ See note 87 *supra*.

¹²¹ 101 N. J. Eq. at 558, 139 Atl. at 51.

¹²² After the amendment the annual dividend requirements on the new preferred would have been \$720,000. If any common dividend had also been declared a portion would have gone to the old common whose old shares had been converted into new at the ratio of one-fifth new for one old. Such a common dividend could have been charged to the preexisting surplus. This did not occur in *General Investment Co. v. American Hide & Leather Co.*, where the possibility was one of the surplus being used for the benefit of old preferred shareholders who made the exchange.

¹²³ 101 N. J. Eq. at 560, 139 Atl. at 52.

Both the foregoing New Jersey cases involved corporations which had earned surpluses at the time the adjustment was proposed. To test whether the right to accrued dividends is vested to the full amount of the arrearages or only to the extent there is such a surplus, one need only find cases where deficits existed. Unfortunately such cases seem to be very rare and the best authority is one where the question of laches played a significant role in the decision. Yet this case does shed some light on the problem and tends to bear out the conclusion that the right is vested only in so far as there is earned surplus.

In *Windhurst v. Central Leather Co.*,¹²⁴ the Vice Chancellor, who incidentally also rendered the decision in the *Lonsdale* case¹²⁵ and the chancery court decision in the *General Investment Co.* case,¹²⁶ rendered two opinions: one denying an injunction against the plan and the other refusing specific performance. The proposal was one of consolidation whereby a new company was to be formed. The one constituent company had a 7% cumulative preferred stock with arrears of approximately \$43 per share, and common stock. It had a capital deficit of more than \$19,000,000. Under the plan the new company was to have three classes of shares: (1) 7% cumulative prior preference stock; (2) Class A participating convertible stock, no par, entitled to a \$4 dividend before the common, but after the prior preference stock, and to an additional dividend not to exceed \$2 equal to whatever might be paid on the common stock; and (3) common stock. Each old preferred share and accrued dividends was to be exchanged for one-half share of new prior preference stock, three-fourths of a share of Class A stock, and \$5 in cash. Over 90% of the old preferred stock voted in favor of the plan.

Despite the Vice Chancellor's reliance on laches in both *Windhurst* decisions, the two opinions show clearly that the absence of surplus was a vital factor. First, the plan was expressly found to be fair and equitable, emphasis being placed on the fact that the old preferred, by virtue of their new prior preference and Class A shares, would receive \$6.50 in any year before the common stock

¹²⁴ 101 N. J. Eq. 543, 138 Atl. 772 (Ch. 1927), 105 N. J. Eq. 621, 149 Atl. 36 (Ch. 1930), *aff'd per curiam*, 107 N. J. Eq. 528, 153 Atl. 402 (1931).

¹²⁵ *Supra* pp. 107-108.

¹²⁶ *General Investment Co. v. American Hide & Leather Co.*, 97 N. J. Eq. 214, 127 Atl. 529 (Ch. 1925).

would be entitled to any dividend. The Vice Chancellor implied, moreover, that even had the complainant's application for relief been timely, it would have been denied since the plan was fair and equitable. Secondly, he specifically referred to the surplus of \$17,000,000 which existed in *Lonsdale Securities Corp. v. International Mercantile Marine Corp.*,¹²⁷ and drew a distinction:

There was a surplus of some \$17,000,000 in which I felt the preferred shareholders had secured rights which could not be diminished or destroyed in the case of any one of them without his consent. No such situation appears in the case at bar. Upon the other hand the proofs disclose that there is a deficit of almost \$20,000,000 which will continue to mount, year by year, unless some such corporate step should be allowed as the one these complainants wish to defeat.¹²⁸

Any summary of the doctrine developed in the foregoing New Jersey cases is necessarily open to contradiction at various points. Such a summary must be undertaken, however, for the sake of clarification. First and most important, their approach to accrued dividend adjustments is that of equity seeking to formulate a rule of fairness. By assuming the existence of corporate power, they commence where the Delaware cases leave off, and at least attempt, perhaps in a fumbling fashion, to set up some workable standard by which this fairness can be ascertained.

The starting point in this endeavor is the existence of an earned surplus at the date of the accrued dividend adjustment. As long as this surplus is made up of earnings, it does not matter when it came into being. It may have arisen from the direct withholding of preferred dividends, from surplus profits over and above preferred dividend requirements in years prior to the existence of any accruals,¹²⁹ or from any other source. Given such an earned

¹²⁷ *Supra* pp. 107-108.

¹²⁸ 105 N. J. Eq. at 625, 149 Atl. at 38.

¹²⁹ In *Johnson v. Fuller*, 36 F. Supp. 744 (E. D. Pa. 1940), *aff'd*, 121 F.(2d) 618 (C. C. A. 3d, 1941), involving an indirect adjustment by a Pennsylvania corporation, there was an earned surplus of \$20,000,000 which had been built up prior to 1933, up to which time preferred dividends had been regularly paid. From 1933 through 1939 the corporation paid out more in preferred dividends than had been earned on the preferred stock during the same period. The idea of the district court that these facts gave the old preferred no claim on the earned surplus would seem to be erroneous and indicates possible confusion of cumulative with non-cumulative preferred stock. In note 95 *supra*, it is pointed out that the same situ-

surplus available for payment of dividends, the New Jersey courts deem any adjustment plan unfair and inequitable which makes available to the common stock any part of any objecting preferred shareholder's proportionate share of that surplus. An adjustment plan proceeding on the direct charter amendment or merger method is especially likely to have this consequence, because often the preferred stock plus arrearages is wholly or partly converted into common stock. In effect this means that an adjustment plan must provide for accrued dividends of objecting shareholders to the extent of available earned surplus in cash or its equivalent, and provision in stock will be deemed insufficient.¹³⁰ Since the relief granted is usually invalidation of the adjustment, no problem arises as to payment of dividends on new stocks from future earnings.

Where an adjustment plan does not have the effect of opening up an existing earned surplus to the common stock, as in the typical indirect charter amendment adjustment, the New Jersey doctrine is not so clear. Where a new prior preferred stock is created into which the old preferred and arrears may be converted — and every New Jersey case agrees such a prior preferred can be legally created — the cases tend to indicate that the old preferred shareholders still possess some rights in an existing earned surplus even as against the new prior preferred stock.¹³¹ If this is valid, several possibilities for fair and equitable relief exist. The most complete relief would be afforded by enjoining the payment of any dividend whatever on the new prior preferred stock, whether the source be past earned surplus or earnings arising after the creation of the new stock, until payment of the accrued dividends on the old preferred stock. That such sweeping protection of the right to accrued dividends is appropriate was indicated in the concurring opinion in *General Investment Co. v. American Hide & Leather Co.*¹³² and is implicit in the recent holding in *Buckley v.*

ation existed in *Buckley v. Cuban American Sugar Co.*, 129 N. J. Eq. 322, 19 A.(2d) 820 (Ch. 1940).

¹³⁰ This article is the exposition of a theory, and in future cases other factors may alter the picture. If, for example, the provision in stock were clearly equal to the value of the arrearages, or if the corporation were organized after 1926, when the provision for funding arrearages was enacted, a basis for a different result would be afforded.

¹³¹ The validity of this view is vigorously attacked in Note (1938) 12 U. OF CIN. L. REV. 576, 590-93, 598.

¹³² *Supra* p. 25.

*Cuban American Sugar Co.*¹³³ These two cases, however, are hardly decisive of the point, and countervailing policy considerations, such as the undesirability of virtually blocking all adjustment plans, suggest that a more moderate form of relief would be more justifiable. Relief wholly consistent with the earned surplus principle, and with the accepted idea that changes as to the future are less momentous than changes as to the past, would be to restrain payment of any dividend from earned surplus existing as of the date of the adjustment until all accrued dividends on the objecting non-converting shares have been paid.¹³⁴ Future earnings would thus be left as an available source for dividends on the new prior preferred stock.¹³⁵ This much protection for accrued dividends would seem to be supportable under the New Jersey doctrine of fairness, but is open to serious doubts on practical grounds. And even here the evidence is far from conclusive, and final determination still lies in the future.

On logical grounds of contract interpretation, of course, there is some difficulty in drawing a line between the situation where there is an earned surplus and that where there is a deficit, for in both the character of the right to accrued dividends seems precisely the same. Yet as a practical matter the existence of an earned surplus gives the right to accrued dividends a tangible quality, a something in which the right may be said to vest. Moreover, where earnings have been withheld and arrears are nevertheless about to be adjusted, the atmosphere is considerably more one where an injustice, seeming or otherwise, is about to be perpetrated. Whatever the explanation, the fact remains that the New Jersey courts, by indirection perhaps, have at least taken one step toward giving the rights of the preferred shareholder a quality of concreteness and definiteness which appears to be entirely lacking in Delaware since the retreat from the *Keller* case.

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¹³³ *Supra* pp. 99-101.

¹³⁴ The restraining order could extend to the entire past earned surplus if necessary, but more properly should affect only a part thereof, proportionate to the holdings of the objecting preferred shareholders.

¹³⁵ This type of relief was granted in *Yoakam v. Providence Biltmore Hotel Co.*, 34 F.(2d) 533 (D. R. I. 1929).