CORPORATE RECAPITALIZATION BY CHARTER AMENDMENT

The drastic curtailment of dividend payments during the lean years following 1929 finds many corporations whose capital structures include cumulative preferred stock entering an era of recovery with accumulations of dividends accrued and unpaid, which must be made up before the common shareholders may participate in current earnings. Numerous corporations in this predicament are seeking to cancel the arrears on their cumulative preferred stock through charter amendment.1 The holders of this class of stock


Practically all state laws provide that any corporation organized thereunder may, from time to time, change or amend its certificate of incorporation as desired. This blanket authority to amend is often reinforced by specific power to make particular modifications.
may be persuaded to release their claims to arrears in return for some concession from those who will benefit by such release. This concession usually takes the form of additional stock, which may or may not be similar to that already possessed by the preferred shareholder. The typical plan of capital readjustment adopted to fund arrears provides that the preferred shareholder exchange his stock with its appurtenant claim to unpaid dividends for new certificates, either preferred or common, with a clean slate.

If all the preferred shareholders can be induced to accept the proposed arrangement, its consummation may be a fairly easy task. Difficulty arises when a minority shareholder takes exception to any impairment of what he may consider his "rights," as found in the corporate charter. One who buys shares of cumulative preferred is considered to make his purchase largely on the faith of certain representations in the charter of the corporation, many of which are promissory in character. The charter obligates the corporation to pay its preferred stockholders stipulated dividends out of earnings at certain periods. It provides further that no distribution shall be made to the common shareholders unless and until full payment shall have been made on the preferred stock for all past dividend periods. Although

The procedure generally followed in adopting amendments under this statutory authority is simple. The board of directors adopts a resolution setting forth the change proposed, declaring its advisability, and calling a meeting of the stockholders to consider and vote upon it. Upon confirmation by the requisite vote, as prescribed by the state laws or the provisions of the original charter, a certificate embodying the change is filed with the Secretary of State.

2. For the purpose of changing various "rights" claimed under a corporate charter it is commonly identified as a tripartite contract, between the state and the corporation, between the corporation and its shareholders, and among the shareholders themselves. This view of the charter offers two barriers to voluntary recapitalization: the rule that a contract cannot be modified without the consent of the parties to it; and the constitutional inhibition against the passing of state laws impairing the obligation of contracts. The incorporation in the charter of reservation of the power to amend obviates to some degree the straightjacketing effect of these impediments to changes in the corporate charter. See supra note 1. For theoretical discussions see Curran, Minority Stockholders and the Amendment of Corporate Charters (1934) 32 MICh. L. Rev. 743; Dodd, Dissenting Stockholders and Amendments to Corporate Charters (1927) 75 U. of PA. L. Rev. 585, 723; Comments (1928) 14corn. L. Q. 85; (1936) 34 MICh. L. Rev. 859; (1928) 77 U. of PA. L. Rev. 256; (1930) 16 VA. L. Rev. 282; (1937) 23 VA. L. Rev. 579; note (1924) 8 MINN. L. Rev. 617.

3. A typical charter provision relating to dividends on the cumulative preferred stock reads as follows: "The holders of the preferred stock shall be entitled to receive cumulative dividends at the rate of seven per cent per annum and no more, payable quarter-yearly on the first days of February, May, August and November in each year, and the corporation shall be obligated to pay the same but only out of its surplus and net profits. Such dividends on the preferred stock shall be payable before any dividend shall be paid upon or set apart for the common stock . . . In no event shall any dividend whatsoever be paid or declared or any distribution made on the common stock, . . . unless and until (1) the full dividend on the preferred stock for all past quarter-yearly dividend periods shall have been paid, and the full dividend thereon for
payment of both arrears and currently accruing dividends on the preferred stock are conditions precedent to any payment of dividends on the common, and although the right to arrears on preferred stock is functionally similar to the right to subsequently accruing dividends on it, in that both are contingent charges ahead of common against net profits to be earned in the future, the courts have singled out the right of the preferred shareholders to payment of their past accrued dividends ahead of any payment to the common as entitled to special protection.4

The consequences which follow from this analysis are graphically illustrated in the history of Wilson & Company, incorporated in Delaware in 1925. By an amendment to its articles of incorporation a year later its authorized capital stock included 5% Class A stock, non-cumulative up to 1930 and cumulative thereafter, and common stock. In 1935 there were accumulated and unpaid dividends on the class A stock amounting to over $21 per share—a total of over $6,600,000 on all the shares of that class issued and outstanding under the 1926 amendment of the corporate charter. In 1935 a recapitalization plan duly adopted by a majority of the stockholders converted each share of Class A stock with its accumulated arrears into five shares of common. A Class A shareholder who refused to join in the exchange sought to have the plan declared void insofar as it purported to destroy his right to be paid the arrears in dividends which had accrued on his stock. To his complaint the corporation interposed a demurrer which was sustained by the court of chancery in Keller v. Wilson & Company6 on the basis of an amendment adopted in 1927 to Section 26 of the Delaware Corporation Law,6 which authorized corporations to amend their charters by reclassifying their outstanding capital stock for the purpose of altering the “participating, optional, or other special rights of the shares.”7 The court of chancery construed the right of cumulative preferred stockholders to be paid arrearages of dividends as a “special right” of that class of stock


7. Prior to the change, the statute conferred merely a general power to amend, with a provision that if any amendment proposed to alter the preference given to any class of preferred stock, the stockholders so affected were to be entitled to vote thereon. 26 PARKER, CORP. MANUAL (1925) 175, 176.
within the amended Section 26. As such a special right it was held subject to alteration by the vote of the majority of the shareholders.9

On appeal to the Delaware Supreme Court the ruling of the Chancellor was reversed on several grounds.9 It was pointed out that Wilson & Company's stock was issued prior to the 1927 amendment to Section 26, at a time when neither the charter nor the statute expressly provided for the cancellation of accrued and unpaid dividends as against the dissent of a shareholder.10 It was supposed that one who at that time invested in cumulative preferred stock relied upon the representation in the charter that accumulated dividends would at some time be entirely satisfied. This representation imparted value to the stock, reflected even during periods when dividends were not declared. To permit the corporation to cancel arrears, even with the consent of the majority of stockholders affected by the plan, would in effect deprive the preferred stockholders who dissented of the right to receive $21 for each share of stock held by them before the holders of the common could be paid any dividends. This was a substantial right, which could not have been extinguished prior to 1927 without unanimous stockholder consent. The court concluded that a retrospective application of the 1927 amendment of the statute to accrued dividends on stock issued in 1926 would raise constitutional doubts on the score of impairing the obligation of contracts,11 and viewed the amendment as inapplicable.

10. For these reasons case law definitely prohibited it. Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 Atl. 696 (Ch. 1923). The chancellor in Keller v. Wilson & Co. assumed that it was to obviate the inhibitions imposed by the Morris case that section 26 was amended. See 180 Atl. 584, 585 (Del. Ch. 1935).

Amendments adopted under statutes enacted subsequently to incorporation have frequently been sustained where the rights affected seem less substantial. See Berger v. United States Steel Corp., 63 N. J. Eq. 809, 53 Atl. 68 (1902), rev'd 63 N. J. Eq. 506, 53 Atl. 14 (Ch. 1902) (retirement of preferred stock out of bonds); Grausman v. Porto Rican-American Tobacco Co., 95 N. J. Eq. 155, 121 Atl. 895 (Ch. 1923), aff'd, 95 N. J. Eq. 223, 122 Atl. 815 (1923) (authorization of no par stock); Hinckley v. Schwarzschild & Sulzberger Co., 107 App. Div. 470, 95 N. Y. Supp. 357 (1st Dept 1905) (authorization of preferred stock).

Amendments making non-assessable stock assessable have been considered to be of this character. Somervelle v. St. Louis Mining & Milling Co., 46 Mont. 268, 127 Pac. 464 (1912); Gardner v. Hope Insurance Co., 9 R. I. 194 (1861).
As a result of this decision, several Delaware corporations which had issued cumulative preferred stock prior to 1927 felt compelled to abandon similar recapitalization plans which had either already received majority shareholder approval at the time the case was decided or were then under consideration. This part of the decision seems inapplicable, however, to the stock of Delaware corporations issued after 1927. Representations in such stock that cumulative dividends undeclared shall be paid before any distribution to the common shareholders might well be deemed subject to the statutory provision in effect at the time the securities were issued that "special rights" of the shares may be changed by majority action. It should make no difference to the legality of such action that the charter amendment is adopted before rather than after maturity of the dividends affected. The right to accumulated dividends which are to become due in the future is functionally the same as the right to dividends already accrued; each represents a preference ahead of common in the distribution of future earnings.

Although the issue was not presented to it, the court in the Keller case declared that even if application of the statute to unpaid dividends on securities issued prior to its enactment were not unconstitutional and even if the "special rights" of that statute included the right to have unpaid dividends accumulate in the future, the recapitalization plan proposed still could not deprive a dissenting stockholder of his claim to arrears, which were viewed as more tangible interests than the "special rights" referred to in the statute. This conclusion was reached by a peculiar interpretation of Section 26, as amended. To avoid a result which might defeat the expectations of investors, Section 26 was construed not as authorizing the cancellation of accrued dividends directly, which its words reasonably seem to mean, but rather as conferring upon corporations the power to amend their charters to provide that they may be cancelled by future action. The court said that so long as the corporation's power to amend its charter had not been exercised, dividends would mature and become payable and would never be subject to cancellation. Thus the result of the Keller case is that while a Delaware corporation which had issued stock after 1927 may amend its


13. But cf. Morris v. American Public Utilities Co., 14 Del. Ch. 136, 149–151, 122 Atl. 696, 701–703 (Ch. 1923) where the court, considering the relations of the stockholders inter se, was of the opinion that "there is every reason to hold that as soon as the agreed dividend which the preferred stockholder is to receive is matured by time, a right to its ultimate payment as against those who have agreed to its payment becomes a vested right. It is a present property interest."
charter so as to provide that accumulated unpaid dividends on that stock may be cancelled, such an amendment cannot be effective to cancel dividends accrued prior to the time of its adoption. The effect of such a charter amendment can only be that a claim to dividends accumulated subsequent to its adoption will thereafter be subject to be defeated by the will of the majority or other requisite number of the stockholders.

There is considerable doubt as to whether the benefits of this type of amendment, permitting dividends accumulated after such amendment to be wiped out by subsequent action of the corporation, will be available where the preferred stock to be affected was issued prior to 1927. Under the first ground of decision in the Keller case, the right of a dissenting stockholder whose stock was issued before 1927 to be paid arrears on his stock was held not to have been affected by the amended Section 26. That case, however, was concerned only with an attempt to cancel arrears accumulated prior to the corporate action there taken. While there may be no distinction, so far as an impairment of the obligation of contracts is concerned, between the right to be paid arrears which have already accrued and the right to be paid arrears which are to accrue later, the considerations of policy which influenced the court would not militate so forcefully against a similar amendment designed to operate prospectively. Merely to place the stockholder on warning that his right to be paid dividends subsequently to accrue is henceforth defeasible is not in financial opinion so drastic a change in stockholders' rights as wiping out arrears already accrued; in that it operates only prospectively and reduces the value of the cumulative feature of the stock, such a charter amendment would be analogous to an amendment converting cumulative preferred prospectively into non-cumulative stock, a change which is valid under Section 26 even as it stood prior to the amendment of 1927. The distinction between "vested" and "prospective" rights is one of the most common issues in charter amendment cases, and corporations are permitted many liberties with the future rights of stockholders which cannot be taken with respect to claims which in some tangible way have been ascertained, measured, or set aside. It seems to be enough of a distinction to justify a court in regarding the logic of the Keller case as inapplicable, so as to permit corporations under Section 26, as amended, to alter the rights of preferred stockholders, whose securities were issued before 1927, to have future dividend claims cumulated.

While the Keller case settles only the law of Delaware, the decision is significant both because of the large number of companies incorporated in Delaware and because of the probable effect of the holding in other jurisdictions. Although courts in general have allowed amendments changing

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14. See notes 4, 13, 16.
16. See supra note 14 and infra notes 17, 18, 19 and 20.
other features of a class of stock, such as its proportionate right to dividends, its redemption price, its voting powers, and the preferences to which it is entitled, no court to which the question has been presented has

17. Peters v. United States Mortgage Co., 13 Del. Ch. 11, 114 Atl. 598 (Ch. 1921) (preferred stock deprived for the future of its existing opportunity to share in surplus remaining after payment of fixed dividends on preferred and common stock); Davis v. Louisville Gas & Electric Co., 16 Del. Ch. 157, 142 Atl. 654 (Ch. 1928) (future reduction in proportionate rights to dividends which class B stock originally had over class A), criticized in Comment (1928) 77 U. of PA. L. Rev. 256, noted (1929) 29 Col. L. Rev. 88, (1928) 14 CORN. L. Q. 85; Yoakam v. Providence-Biltmore Hotel Co., 34 F. (2d) 533 (D. R. I. 1929) (cumulative preferred stock deprived of its cumulative feature for the future), supra note 11; Grausman v. Porto Rican-American Tobacco Co., 95 N. J. Eq. 155, 121 Atl. 895 (Ch. 1923), aff'd, 95 N. J. Eq. 223, 122 Atl. 815 (1923) (common stock endowed with a preferential 7% cumulative dividend over a new issue). Contra: Pronick v. Spirits Distributing Co., 58 N. J. Eq. 97, 42 Atl. 526 (Ch. 1899) (amendment reducing dividend rate on preferred stock voided as against a dissenting stockholder).

18. Where redemption is optional with the corporation, changes therein are liberally allowed. Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 Atl. 695, (Ch. 1923) (redaction in redemption price from $105 to $100 per share); Davis v. Louisville Gas & Electric Co., 16 Del. Ch. 157, 142 Atl. 654 (Ch. 1928) (termination of corporation's option to redeem).


19. An amendment providing for cumulative voting has been sustained. Loeber v. Maynard, 179 U. S. 46 (1900). And an amendment taking away the right to vote cumulatively has also been upheld, notwithstanding that its purpose was to defeat the attempt of minority stockholders to elect a member of the board. Maddox v. Vorclone Corp., 17 Del. Ch. 39, 147 Atl. 255 (1929). Preferred shareholders may be completely deprived of the right to vote. Randle v. Winona Coal Co., 205 Ala. 254, 89 So. 750 (1921); Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 Atl. 696 (Ch. 1923).

Where preferred stock has no voting power except the contingent right of exclusive control upon the non-payment of cumulative dividends for a specified period, such a voting right, being a method whereby the preferred shareholders may preserve their equity in a corporation approaching insolvency and protect their interest in the accumulation of dividends unpaid, serious doubt has been cast whether it would be subject to amendment in the absence of a specific charter provision to that effect. See Yoakam v. Providence-Biltmore Hotel Co., 34 F. (2d) 533, 541 (D. R. I. 1929).

20. Many corporation laws make specific provision for amendments altering preference rights. See e.g., DEL. REV. CODE (1935) §2058; ILL. REV. STAT. ANN. (Smith-Hurd, 1935) c. 32, §157.52; N. Y. STOCK CORP. LAW, §36; OHIO GEN. CODE ANN.
yet upheld a recapitalization plan which cancels accumulated arrears accrued prior to the time of the cancellation.\(^{21}\) Whether the courts of states other than Delaware will give effect to an amendment providing for the cancellation of arrears to be accumulated in the future depends upon the extent and judicial construction of the power of amendment conferred by the corporation laws of the particular state. Most statutes, however, are not so broad as Delaware's Section 26;\(^{22}\) and where they do not include authority to change "preferences" or "special rights" of the shares, such an alteration must be based upon the general power to amend reserved in every corporate charter—a power which, although subject to wide variations of construction, is generally construed more narrowly than Section 26.\(^{23}\)

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\(^{22}\) The corporation laws of Illinois and Ohio are even more liberal in the power to amend granted to corporations than the laws of Delaware. See ILL. REV. STAT. ANN. (Smith-Hurd, 1935) c. 32, § 157.52; OHIO GEN. CODE ANN. (Page, Supp. 1935) §§ 8623-14, 8623-4. Pennsylvania follows closely the Delaware statute. PA. STAT. ANN. (Purdon, Supp. 1935) tit. 15, § 2852-801. New York's stock corporation law is slightly more restrictive and does not include authority to change "special rights." N. Y. STOCK CORPORATION LAW, § 36. With few exceptions, powers to amend by the laws of other states are, in the main, worded generally.

\(^{23}\) See Farbstein v. Pacific Oil Tool Co., Ltd., 127 Cal. App. 157, 15 P. (2d) 766 (1932) (amendment making non-assessible stock assessible upheld though the corporation laws did not specifically provide for such a change); Peters v. United States Mortgage Co., 13 Del. Ch. 11, 114 Atl. 598 (Ch. 1921) (amendment depriving preferred
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As a practical matter, however, it is not likely that many corporations will seek to amend their charters to permit the cancellation of dividends to accrue on preferred stock. In the first place, such an amendment would have no effect upon the accumulated arrears which have been piling up during the depression and which it is the main concern of current recapitalization plans to wipe out. Secondly, the conversion of cumulative preferred into non-cumulative would be a far more direct method of providing for future depressions; for the presence of the power to cancel dividends to accrue would make the cumulative feature of preferred stock illusory and would deprive it of the special attractiveness to the investor which cumulative rights are designed to add. For the contingency against which the holder of cumulative preferred seeks security—a period of no dividend declarations—is likely in the future to compel the cancellation of accrued dividends pursuant to such a charter amendment. It would be more practical for a corporation to continue, in the teeth of the Keller case, to attempt some readjustment whereby preferred stockholders will be induced to surrender their claims to arrears on their shares. And many corporations have followed this course. Although the bargaining position of the preferred stockholders in stock of its existing opportunity to share in surplus remaining after payment of fixed dividends on preferred and common stock sustained under the general power to amend granted by Delaware's Section 26 prior to the amendment of 1927). Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 Atl. 696 (Ch. 1923) (depriving preferred stockholders of right to vote held to be not such a change in property rights as to be exempt from amendment where general power to amend is reserved); Salt Lake Automobile Co. v. Keith-O'Brien Co., 45 Utah 218, 143 Pac. 234 (1914). But see Yoakam v. Providence-Biltmore Hotel Co., 34 F. (2d) 533, 543 (D. R. I. 1929) (extinguishment of the obligation to make prescribed payments to the sinking fund for redemption of preferred stock invalid under general power to amend); Sutton v. Globe Knitting Works, 276 Mich. 200, 267 N. W. 815 (1936) (extension of date of compulsory redemption ineffective under general power to amend); Breslaw v. New York and Queens Electric Light and Power Co., 249 App. Div. 181, 291 N. Y. Supp. 32 (2d Dept 1936) aff'd without opinion, March 16, 1937, N. Y. Times, March 17, 1936, p. 8, col. 5, (corporation cannot make non-callable stock redeemable in absence of specific provision to that effect); Pronick v. Spirits Distributing Co., 58 N. J. Eq. 97, 42 Atl. 586 (Ch. 1899) (general power of amendment insufficient to sustain a change in dividend rates); McKenzie v. Guaranteed Bond & Mortgage Co., 163 Ga. 145, 147 S. E. 102 (1929) (general authority to amend does not confer power to make "vital, radical or fundamental amendments" by majority vote, such as increasing the capital stock or funding unpaid cumulative dividends); Accord: Sutherland v. Olcott, 95 N. Y. 93 (1883).

24. As early as 1921, it was observed that the cumulative feature of preferred stock is of little practical value. "If a considerable amount of the unpaid dividends accumulate, and the company meets with more prosperous conditions, the managers, who probably control the common stock, will often try to induce the preferred shareholders to surrender their claims on the plea of some equitable adjustment." 1 DEWING, FINANCIAL POLICY OF CORPORATIONS (1st ed. 1921) 125, 126. This has been reiterated more forcefully in later editions. Id. (rev. ed. 1926) at 59, 60; id. (3d ed. 1934) at 55.

25. Corporations presently offering recapitalization plans providing for the cancellation of accumulated arrears include Dominion Tar & Chemical Co., Ltd. (March 13,
the recapitalization process may have been improved by the Keller case, it has not been so improved as to make reorganization impracticable. Insofar as the preferred shareholders consent to the plans proposed, they are bound. The impact of the Keller case is felt only in that dissenting stockholders can not be forced to join in the exchange. They have either to be paid off in full or they must be suffered to keep their original shares with the appurtenant claim to arrears.

If the new certificates given to consenting stockholders in exchange for their old shares and for the arrears accumulated on them bear the same provisions as the original preferred stock or are junior to them, no difficulties are created by the refusal of a minority dissenting stockholder to surrender his stock. The dissenter's status in relation to the consenting shareholders has not been jeopardized by such an exchange and he has no cause to complain. But it is likely that in addition to attempting to fund the arrears the recapitalization plan will change other features of the preferred stock. In an effort to simplify and unify the financial structure of the corporation the plan may convert part or all of the preferred stock into common by altering its preferences. The dividend rate on the preferred may be reduced and the price at which it is redeemable at the corporation's option may be decreased. In order to invite participation in the plan, it

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26. The capital structure of Wilson & Company as a result of its recapitalization was not disturbed by the Keller case. The only immediate effect of the decision was the necessity for special treatment of the dissenting shareholders.

27. The plan of reorganization of Amalgamated Leather Companies, Inc., as proposed in its letter to stockholders, dated July 25, 1936, provided for the exchange of each share of outstanding $7 preferred stock (on which had accumulated $105.25 per share as of July 1, 1936) for one share of new $3 preferred stock and 5 shares of new common stock. This necessitated the exchange of each share of common stock outstanding for 2/5ths of a share of new common stock.

Instead of changing outright part of the old preferred stock into common, the plan may make the new preferred stock convertible into common at the option of the holder. This was the procedure followed in the plan of Collins & Aikman Corporation, which provided for the exchange of its 7% preferred stock, of $100 par value, into 5% preferred convertible into 1 2/3rds shares of common stock, each share of which was selling at approximately $60 at the time the plan was formulated. This plan was confirmed by the shareholders Feb. 26, 1937. (Feb. 27, 1937) 144 COMM. & FIN. CHRON. 1432.

And note the plan of Wilson & Company, supra p 987, which converted each share of its Class A stock into 5 shares of common.

28. See e.g., the plans of Amalgamated Leather Companies, Inc. and Collins & Aikman Corp., supra note 27.

29. See e.g., the plan of recapitalization of Marshall Field & Company as outlined in the material soliciting proxies, dated Nov. 28, 1936. As of Sept. 30, 1936, accumulated dividends on the outstanding 7% preferred stock amounted to $31.50 per share. Under the plan, holders of this preferred stock were to receive in exchange for each share
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may be provided that the new stock issued in exchange for the old carry with it a prior preference as to dividends and participation in the assets upon liquidation or dissolution.  

If changes such as these are made in the preferred stock, the refusal of a minority stockholder to join in the exchange for the purpose of relinquishing his claim to arrears may make his relation to the corporation an anomalous one. If the changes other than the funding of arrears are authorized by the corporation laws, the dissenting shareholder is bound by them. Thus while he cannot be compelled to accept any new security insofar as it represents a satisfaction of his claim to arrears, he is bound to accept it insofar as it represents his original stock and is a valid amendment of his "contract" as stockholder, authorized by the corporation laws. Furthermore, since the minority stockholder is entitled to insist that his status within his class be preserved, he should not be deprived of that proportion of the new stock exchanged for the old without arrears merely because he refuses to surrender his claim to arrears. In practice it is extremely difficult to work out this analysis of the rights of the preferred shareholder. Recapitalization plans do not usually distinguish between one part of the stock offer as an exchange for the principal of the old preferred, and another as given for the arrears. Where new shares are offered for both old stock and arrears, it may cause

(a) $11.50 in cash, (b) one share of 6% preferred stock, and (c) 5/6ths of a share of common stock. Whereas the old 7% preferred stock was redeemable at $120, the new 6% stock was made callable at $110. This plan was approved Dec. 26, 1936 (Jan. 2, 1937) 144 COMM. & FIN. COUNC. 110. And note the plan of Consolidated Film Industries, Inc., infra p. 1000. See Morris v. American Public Utilities Co., 14 Del. Ch. 136, 122 Atl. 696 (Ch. 1923).

30. See e.g., the plan of Otis Steel Co., described in the letter to stockholders, dated Oct. 5, 1936. As of Oct. 1, 1936, arrears in dividends on its 7% preference stock of $100 par value amounted to $36.75 per share. It was proposed to create a new 1st preferred stock, without par value, carrying $5.50 in dividends, which was to have priority over the outstanding preference stock. Each share of the old preference stock was to be exchanged for 1.28 shares of the new 1st preferred stock, plus 1/2 share of common stock. What seemed to be a radical alteration in dividend provisions did not, in fact, substantially alter the annual amount to which the preferred stockholder was entitled originally. $5.50 per share on 1.28 shares of the new stock equals $7.04 in dividends per share of old preferred stock.

For another plan which provided for the exchange of an outstanding preferred stock for a prior issue see the proposition of the Goodyear Tire & Rubber Co., as set forth in its Plan for the Rearrangement of Capitalization, dated Sept. 26, 1936. This plan was declared operative on Nov. 27, 1936. N. Y. Times, Nov. 27, 1936, p. 35, cols. 6, 7, 8.


31. See supra notes 17, 18, 19 and 20.

difficulties if the dissenter retains his claim to arrears and at the same time tries to preserve his status with relation to other shareholders of his class, by claiming rights under new shares to the extent that they are offered in exchange for the old alone. The corporation will eventually seek to pay dividends on the new securities issued to the majority in exchange for the original preferred stock plus its accumulations. Where the new securities are prior preference stock, the question will arise whether the corporation may pay dividends on this new class before making payments to dissenters on their original preferred and its arrears. When dividends are declared on the new stock, these payments may represent (a) dividends on stock (the old preferred validly amended) which the dissenter is bound to take and to which he is entitled, and (b) payments on account of accumulated arrears. The minority shareholder may make two demands: (1) That no dividends be paid on the new prior stock unless he also is paid an equal dividend. To the extent that the changes effectuated under the plan were binding upon all stockholders, the dissenter should share in whatever benefits the plan confers in the valid exchange of stock without the arrears. Since the dissenter may not be deprived of the arrears on his stock, the fact that he refused to exchange his shares under the plan in order to preserve his right to those arrears should not preclude him from sharing in the portions of the plan which were properly authorized. (2) That no dividend be paid on the new prior stock unless he also is paid an equal amount on account of his accumulated arrears. To the extent that the new prior stock represents funded arrears a dissenter cannot be compelled to exchange but may retain his claim to those arrears. But to permit the payment of dividends upon stock representing the arrears of the consenting shareholders before paying any of the arrears of the dissenters would not only confine to narrow quarters the protection offered by Keller v. Wilson & Company against the cancellation of accrued dividends, but would effectively render that protection nugatory.33

These two demands of the dissenting shareholder, however, have been rejected in two cases. In Yoakam v. Providence-Biltmore Hotel Company4 it was considered proper for the corporation to pay out of income to be earned subsequent to the adoption of a plan of recapitalization dividends on the new prior stock in advance of satisfying the accrued dividends on the original preferred. The plan there under consideration, however, expressly preserved all rights of non-assenting preferred shareholders with respect to the accumulated earned surplus which at the time of the adoption of the plan was available for dividend purposes.35 The fact that the corporation had accumulated a substantial earned surplus36 which may have been more

33. Cf. note (1924) 8 MINN. L. REV. 617, 618.
34. 34 F. (2d) 533 (D. R. I. 1929).
35. Id. at 541, 542.
36. Id. at 536.
than sufficient to satisfy the claims of all the minority shareholders may perhaps detract from the conclusiveness of the decision, which otherwise clearly accepted the priority given to assenting shareholders with respect to the stock they had received for the arrears.

The same inconclusiveness cannot be urged to distinguish *Matter of Duer*, recently decided in New York. The recapitalization plan there involved invited the holders of the original preferred stock (upon each share of which there had accumulated $32 in arrears) to receive in exchange therefor a new prior preference non-cumulative security, to be preferred as to dividends and on dissolution over the outstanding preferred. Spencer Trask & Company, a preferred stockholder, remained passive; it neither consented to the plan nor surrendered its shares for exchange. When, several years later, the reorganized corporation was dissolved and it was found that its assets would not be sufficient to pay the holders of the new prior preference securities in full, Spencer Trask & Company sought to participate equally with them in the assets. Its petition was denied. The single reason assigned was that when the majority stockholders made the exchange relinquishing arrears, a new contract was made which endowed them with certain preferences on dissolution. The court considered itself powerless to change the priorities thereby created.

The strongest defense of this decision is that it makes for administrative simplicity. Although a new contract had been entered into, which, it is true, a court should not change so far as it concerned those who participated in it, the non-assenting stockholder had no part in that contract. What the court did not discuss was the effect of the new contract as an invasion of rights which had matured under the original contract of Spencer Trask & Company, set forth in the charter.

Inasmuch as the corporation laws of New York do not permit charter amendment to alter "special rights," there would seem to be even less chance in New York than in Delaware to uphold as binding upon dissenters a recapitalization plan cancelling accrued arrears on preferred stock. Therefore it seem anomalous to permit the result reached in *Matter of Duer*, which indicates that arrears may be so subordinated to the claims of stockholders who exchange them for new securities as to lose practically all value as preferred interests. Instead of regarding the new preferred stock as in part an amendment of the original preferred, under which the dissenter could claim equal rights with those consenting, the court treated it as a separate security, with a priority over outstanding shares of the original preferred as complete as if the new stock had been issued for cash. If the courts treat such new securities in this way, the result of the *Duer* case seems inevitable,

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38. N. Y. Stock Corporation Law § 36.
39. See *supra* note 37.
40. See *supra* notes 17, 18, 19, 20 and 32.
for many states permit the issuance of new securities which will rank ahead of existing preferred stock. Although courts have protected investors by classifying the preferred stockholder’s claim to accrued dividends as something more than a “preference” right, and therefore inaccessible to amendment by authority of the statute, that effort will be futile if the corporation is allowed to use its control over conceded preference rights to achieve the end, otherwise prohibited, of forcing preferred stockholders to acquiesce in the plan to fund accumulated arrears on their stock.

The dissenter’s demand that no dividend be paid on the new stock offered under the plan of recapitalization unless he is also paid an equal amount on account of his arrears has been recognized where preferred stock coordinate with the original preferred shares are issued in lieu of accumulated arrears relinquished. In Wilcox v. Trenton Potteries Company such funding certificates bearing 4% “interest” were offered in satisfaction of arrears accumulated on preferred stock. When the directors set aside out of earnings a sum equal to 4% of the funding certificates, they were, at the behest of a dissenter, decreed to be under a duty to set aside a proportionate sum for the benefit of non-assenting preferred shareholders.

In the normal situation, however, any special protection of the minority stockholder’s rights may be largely superfluous. The number of dissenters will ordinarily be negligible, and exchanges made under the recapitalization plan will have reduced to an inconsiderable amount the arrears on the preferred stock which stand in the way of dividends on the common. The corporation will often hasten to pay off these back charges, and the com-


42. It may be that a plan which achieves a funding of arrears indirectly by a coercive manipulation of preferences will be regarded not as involving the corporation’s power to alter preferences but as an illegal effort to divest stockholders of their claims to unpaid accrued dividends. See Yoakam v. Providence-Biltmore Hotel Co., 34 F. (2d) 533, 537 (D. R. I. 1929) (“an exchange at law is compulsory if to refrain from it would result in an obvious and substantial loss.”).

43. 64 N. J. Eq. 173, 53 Atl. 474 (Ch. 1902).

44. Less than two months after adoption of a recapitalization plan by Marshall Field & Company (which funded $20 in arrears on each preferred share) the minority preferred stockholders who did not join in the exchange received $23.50 on each share, which constituted full satisfaction of dividend payments, not only for arrears, but also for the dividend period approaching. See N. Y. Times, Feb. 23, 1937, p. 36, col. 4.
mon stockholders will be in a position to receive long interrupted dividends on their investment.

While funding of arrears does not relieve the corporation of any liability, the corporation's credit standing may be enhanced to some extent. These recapitalization plans usually translate the contingent claim for accrued dividends into a form which interferes less directly with current financing, and permits current earnings to be distributed to more than one class of security holders, a result which allows the corporation either to issue new securities of these types, or to use them as collateral for bank loans. The common shareholders, of course, benefit from the adoption of such a plan by getting a more direct claim against earnings; but in a fair plan which adequately evaluates the interests at stake, they should pay for this advantage by giving the holders of the preferred, in exchange for their arrears, a larger claim to earnings than they had before, either co-ordinate with, or prior to the common. 45

In many recapitalization plans, however, the preferred shareholders have little to gain and much to lose; notwithstanding this fact those plans are usually adopted by overwhelming majorities even of the holders of the preferred. 46 The inference is irresistible that in many cases those who vote approval to these plans do not fully appreciate the significance of their actions. The limitations of the proxy system may be held in large part responsible for this situation.

Recapitalization plans usually first come to the attention of the average shareholder through a letter from the management of the corporation out-

Fewer than 10% of the original preferred stock of the Goodyear Tire & Rubber Company was withheld from exchange under a recapitalization plan which funded over $11 in arrears per share. About two months after the plan was declared operative the Company announced a dividend of $14.75 a share on this unexchanged preferred stock. N. Y. Times, Feb. 9, 1937, p. 31, col. 6. (Feb. 13, 1937) 144 Comm. & Fin. Chron. 1109.

45. Under the plan of recapitalization of Mangel Stores Corporation, for example, each share of 6 3/4% preferred, par $100, was to be exchanged for one share of new $5 preferred of no par value (convertible into 6 shares of common) and, in addition, three shares of new common stock. This change necessitated the increasing of the common stock authorized from 250,000 to 300,000 shares. This plan was adopted Nov. 11, 1936. N. Y. Herald-Tribune, Nov. 13, 1936, p. 44, col. 6.


Over 75% of the preferred shareholders of Revere Copper and Brass Incorporated voted in favor of its plan funding arrears, on Nov. 12, 1936. The management has informed the Yale Law Journal that the only shares which voted against the plan did so erroneously.

More than 95% of the preferred stockholders of the Goodyear Tire & Rubber Co. joined in a recapitalization plan which cancelled over $11 in arrears on each share of their stock. (Feb. 13, 1937) 144 Comm. & Fin. Chron. 1785.
lining the proposed changes and soliciting his proxy. Habitual proxy signers do not stop to read it before giving their approval to whatever the management proposes to do. The consent of more conscientious stockholders may be almost as completely uninformed. The letter may be couched in such terms that the average stockholder is given scant opportunity to realize the full import of the changes proposed. The consent of a stockholder to have the arrears accumulated on his stock cancelled cannot have much meaning to him if he merely complies with a request to turn in his preferred stock "with its appurtenant rights." Stockholders are notorious in sleeping on their rights, and when their proxies are solicited by letters which convey misleading impressions, the interests of stockholders require protection.

The recent dispute between the Securities and Exchange Commission and the management of Consolidated Film Industries concerning the latter's plan of recapitalization is illustrative.47 A special meeting of the stockholders of Consolidated Film was called to be held in October, 1936, for the purpose of obtaining their approval on a proposed plan of recapitalization. A notice of the meeting summarizing the proposed changes was accompanied by a letter from the president urging approval. The plan proposed by the company was in essence that by amendment of its charter the outstanding 400,000 shares of $2.00 cumulative preferred stock (upon each share of which there were accumulated and unpaid dividends of $5) should be reclassified as 500,000 shares of $1.00 preferred stock and 100,000 shares of new common stock; and that the outstanding 524,973 shares of common stock be reclassified as 349,982 shares of new common stock, or 2 shares of the new common for 3 of the outstanding common.

Since its preferred and common stock outstanding were listed on the New York Stock Exchange and registered under the Securities Exchange Act,48 the company, pursuant to Section 1449 of the Act and the regulations promulgated by the Commission thereunder,50 filed with the Commission a copy of its communications soliciting consents to the proposed plan. After the filing of the notice and the president's letter, a complaint made to the Commission by a stockholder impelled it to institute an enquiry. As a result the question was raised as to whether certain statements in the president's letter might be misleading, within the meaning of the Commission's proxy regulations, which require that solicitations for proxies contain no statement

which, at the time and in the light of the circumstances under which it was made, is false or misleading with respect to any material fact.51

The president's letter appeared misleading to the Commission in several particulars:52

(1) The letter stated that "the plan reduces the fixed annual cumulative dividend on the Preferred Stock now outstanding from \$2 to \$1 and provides for the elimination of the accumulated dividends thereon . . . and in lieu thereof gives the present Preferred holder an additional one-quarter share of new Preference Stock and an additional one-quarter share of Common, besides a full half of all dividends declared in excess of \$1." If the preferred stockholder was led to believe, as he well might have been, that he would get, in the additional 1/4 share of new preference stock, something which he did not have before, he would be mistaken. None of the soliciting material indicated that, although the redemption price and liquidating value of the new preference stock was to be \$28 per share, the corresponding redemption price and liquidating value of the old preferred stock was \$35 per share. Thus, although the holder of each share of old Preferred Stock was to receive 1 1/4 shares of the new preference stock, the aggregate redemption price and aggregate liquidating value of the 1 1/4 shares of his new stock was no greater than that of the 1 share of his old preferred stock, \$35. In return, then for 1/4 share of common, par value \$1, the preferred stockholder may have been led to relinquish his claim to accumulated arrears (\$5) and to consent to the reduction in the amount of annual dividends to which he was entitled to a preference.

(2) The president's letter stated that holders of the old common stock would, under the proposed plan, "give up one-third of their present holding of Common Stock." If the preferred shareholders were led to believe that they were to receive one-third of the common stock interest, their expectations were unduly optimistic. While the common shareholders were to receive under the plan two shares of stock for each three shares of common outstanding, the letter did not point out what was equally true—that under the plan, since the total number of shares of common outstanding were to be decreased, the original common shareholders would hold practically 7/9ths of the new common stock. They were in fact to give up only about 2/9ths of their common stock interest to the preferred shareholders.

(3) The letter stated that "the Corporation has not been able to pay the full quarterly dividend on the presently outstanding Preferred Stock since April 1, 1932, although payments on account have been made from time to time." The preferred stockholder who was led to relinquish his claim to arrears as the symbol of a futile hope might have been astonished to learn

52. See supra note 47.
that, had he been more tenacious, the corporation might well have been able
to pay off all the arrears. Despite the assertion contained in the letter, the
net earnings of the Company from January 1, 1932 to December 31, 1935
had in each year been in excess of the annual dividend requirements of the
preferred stock. At the beginning of 1936 the earned surplus of the Com-
pany amounted to almost $3,000,000, more than enough to satisfy the arrears
of dividends on the 400,000 shares of preferred stock outstanding, at $5
per share. If default in dividends was made for reasons other than that
they were not earned, the fact should have been noted to prevent the state-
ment from being misleading.

(4) The President's letter purported to compare the position of the holders
of old preferred stock under the Company's existing capitalization with their
position under the plan. It stated: "On the present basis of distribution and
assuming, for example, $800,000 of earnings available for dividends, the old
Preferred Stock suffers a slight disadvantage under the plan, which, how-
ever, disappears and becomes a benefit if earnings substantially increase." This statement may have been misleading in several particulars. In the first
place, it ignored the fact that under the original capitalization, if there were
any substantial increase in earnings available for distribution in excess of
$800,000, this excess would have been paid entirely to the holders of the old
preferred stock until the aggregate accumulated dividends thereon, which
the preferred stockholders were requested to give up under the plan, were
paid. Secondly, assuming earnings of $800,000, it characterized as "slight"
the disadvantage of the preferred stockholders under the plan. Yet if this
amount of earnings were available for distribution in dividends, a total of
only $683,300 would be payable as dividends on the new preferred and
common stock distributable to holders of present preferred stock under the
plan. On the other hand, if $800,000 were available for distribution in
dividends under the original capitalization, this entire amount would have
been payable on the old preferred stock, even though accumulated arrears
had been previously satisfied.

The abuses in behalf of the management inherent in the present method
of negotiating recapitalization plans may be checked in one of several ways.
It has been suggested that courts of equity be given supervisory power over
these plans—confirming them only when they are equitable to all parties
concerned." This method would involve making affirmative the control of
equity now invoked only when impending recapitalization plans are attacked
by litigious minority stockholders. In such cases the courts have frequently
assessed the fairness and reasonableness of the plans presented for review."
This method of affirmative control by equity, however, does not seem feasible. To require courts to pass on all such plans would impose too great an administrative burden on the judges, who are in any event hardly experts on intricate problems of finance; and courts are wont to accord undue weight to the size of the majority supporting a plan in considering its fairness.\textsuperscript{55}

The Securities Act of 1933\textsuperscript{56} and the Securities Exchange Act of 1934\textsuperscript{57} offer other possibilities of control. One of them might be to condition the consummation of all recapitalization plans of corporations whose securities are subject to federal control upon the approval of the Securities and Exchange Commission, whose function in the process would be to protect the interests of all stockholders. The Commission is better fitted than the judiciary to pass judgment upon the fairness of these plans, but the imposition of this duty would place an overwhelming and perhaps unnecessary load of work and responsibility upon it. A second and more feasible plan would be to revise the form of the statements utilized to solicit proxies for recapitalizations. Under Section 14 of the Securities Exchange Act\textsuperscript{53} the Commission is authorized to make regulations governing the solicitations of proxies in respect to securities registered on the national exchanges. The Commission

\textsuperscript{55} The most forthright statement of this tendency comes from England. In \textit{In re Welsbach Incandescent Gas Light Company, Ltd.}, (1904) 1 Ch. 87, it was observed that whether a scheme does or does not accord exactly with the legal rights of the shareholders, the court may consider whether it is fair or unfair. In so doing, the wishes of the shareholders who are affected by the scheme are taken into consideration. And a majority obtained in favor of a plan was said to go far toward showing that the shareholders regard it as a fair one. In \textit{Perry v. Bank of Commerce}, 116 Miss. 838, 855, 77 So. 812, 814 (1917) the court observed that if it should hold the amendment (decreasing capital stock) to be invalid, the "absurd situation" would result of one stockholder preventing the corporation from changing the amount of its capital stock, which change might be necessary to the best interests of the corporation.


\textit{Cf. Lonsdale Securities Corporation v. International Mercantile Marine Corp.}, 101 N. J. Eq. 554, 139 Atl. 50 (Ch. 1927); \textit{Outwater v. Public Service Corporation}, 103 N. J. Eq. 461, 464, 143 Atl. 729, 730 (Ch. 1928) where the court placed the burden on the majority of the shareholders to show that the plan was fair and equitable, and added that judgment as to fairness is not to be influenced by the heavy vote of approval as it otherwise would be if the vote were independent.

\textsuperscript{56} 48 STAT. 74 (1933), amendments added, 48 STAT. 905 (1934), 15 U.S.C.A. \textsection 77a-77mm (Supp. 1936).

\textsuperscript{57} See \textit{supra} note 48.

\textsuperscript{58} See \textit{supra} note 49.
has already prescribed that such proxies and the material soliciting them be listed with it, and has prohibited false or misleading statements in that material. Extension of these rules to compel disclosure of specific information may be desirable. Where the proxy is solicited to be exercised in connection with any plan of recapitalization, reorganization, or other similar change which affects the rights of any class of security, the rules may be revised to compel a statement of:

(1) The amount of annual dividends to which the holder of the security changed or affected will be entitled under the plan, as opposed to the amount of annual dividends to which he is presently entitled, where the plan changes dividends;

(2) The price or prices on redemption, liquidation and dissolution to which the holder of the security changed or affected will be entitled under the plan, as compared to the price on redemption, liquidation and dissolution to which he is presently entitled, where the plan changes those items;

(3) The preferences to which the holder of the security changed or affected will be entitled under the plan, in juxtaposition to the preferences possessed prior to the plan, where the plan changes preferences;

(4) The effect of the plan on cumulative dividends accrued and unpaid, such statement to be in a simple sentence, where the plan affects such dividends;

(5) The amount of surplus available for dividends at the time of the solicitation, where the plan proposes to cancel or fund accumulations of dividends accrued and unpaid on any security entitled to cumulative dividends;

(6) The effect on the person from whom the proxy is solicited of the failure of the plan to be adopted;

(7) Any remedies, such as appraisal and purchase of shares by the corporation, which the statutes of the state under which the corporation is organized provide for stockholders dissenting from the plan, and the procedure provided by those statutes for obtaining the benefit of such remedies; and

(8) The privilege of the person from whom the proxy is solicited to refuse to sign and return his proxy.

It has been feared that more stringent proxy regulations would have only the negative effect of decreasing the number of stockholders willing to send in their proxies. Implicit in this fear seems to be the general observation that proxies are secured in many instances because stockholders do not know the significance of their approval. The stockholder's interest in knowing the truth does not cease with the issuance of the security under the Securities

60. See supra note 51.
61. See note (1936) 36 Col. L. Rev. 674, 675.