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Cancellation of Accrued Dividends on Preferred Stock Under General Reservation in Charter of Power to Make Amendments Changing Terms of Outstanding Stock

CANCELLATION OF ACCRUED DIVIDENDS ON PREFERRED STOCK UNDER GENERAL RESERVATION IN CHARTER OF POWER TO MAKE AMENDMENTS CHANGING TERMS OF OUTSTANDING STOCK

Of especial interest to corporation counsel in recent years has been the question whether a scheme for capital adjustment may include the cancellation of accrued dividends on preferred stock. Under the Maryland statute such a change requires unanimous consent of the holders of the preferred issue affected unless the charter contains an appropriate reservation of the amending power.[1] The larger Maryland corporations in many, if not most, cases operate under charters which contain express reservations of amending power. A typical form of clause is as follows: "The corporation reserves the right to make any amendment authorized by law, including amendments changing the terms of outstanding stock, provided that any such amendment shall require the vote of the holders of two-thirds of the stock affected thereby."[2]

This typical situation in Maryland may be contrasted with the similar one in Delaware. Such reservations are seldom found in Delaware charters. The reason is that since 1915 the Delaware law has contained a provision that an amendment altering or changing the "preferences" of preferred stock may be made, provided holders of a majority of the stock affected vote in favor of the change.[3] The

[1] Md. Code, Art. 23, Sec. 28.

[2] Frequently the charter, in place of requiring consent of a majority or two-thirds of the stock affected, merely specifies the vote required by law for amendments not changing outstanding stock. Such vote is two-thirds of each class of voting stock. Art. 23, Sec. 29. But under another section the charter may specify that any action may be taken by a majority of each class, or by a majority of all votes to which the shares of all classes of voting stock are, in the aggregate, entitled. Art. 23, Sec. 23.

[3] Del. Rev. Code 1915, Sec. 1940; Del. Laws, Vol. 29, Ch. 113, Sec. 12.

statutory provision was "read into" the charter,[4] and it was thought that the language was broad enough to include any desired change in the rights of preferred stock. The Chancellor held, however, that the statute did not permit cancellation of accrued dividends, although the right to preferential dividends accruing after amendment might be taken away by such amendment.[5] The statute was then revised to permit, by the same vote, amendments changing the "preferences, or relative, participating, optional, or other *special rights of the shares.*"[6] The phrase "special rights" had been relied on in an English case, cited by the Delaware Chancellor, which had permitted cancellation of accrued dividends by an "extraordinary resolution", under a reservation in the Articles of power to change special rights of stockholders.[7] This Delaware amendment was adopted in 1927. In November, 1936, the Delaware Supreme Court held that the language used in the amended statute was not broad enough to include cancellation of accrued dividends, and, if so interpreted, its application to dividends accrued on stock issued prior to 1927 would be unconstitutional.[8] Reargument was denied on February 19, 1937.[9]

The United States District Court in Rhode Island had previously held that a Delaware corporation, organized before 1927, could not take advantage of the 1927 statute so as to cancel accrued dividends which were covered by existing surplus.[10] This distinction between accrued dividends covered by existing surplus and those not so covered has not been approved by the Delaware courts.[11]

As a result of the recent Delaware decision several corporations chartered in that state have abandoned plans for readjustment of their capital structure which included cancellation of accrued dividends.[12] On the other hand several

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[4] Peters v. United States Mortgage Co., 13 Del. Ch. Rep. 11, 114 Atl. 598 (1921); Morris v. American Public Utilities Co., 14 Del. Ch. Rep 136, 122 Atl. 696 (1923).

[5] Morris v. American Public Utilities Co., *supra.*

[6] Del. Laws, Vol. 35, Ch. 85, Sec. 10.

[7] Last v. Butler & Co., Ltd., (1919) Ch. Div. 36. And see In re Welsbach Incandescent Gas Light Co., Ltd., (1904) 1 Ch. 87.

[8] Keller v. Wilson & Co., (Del. Sup. Ct. 1936), Prentice-Hall Corp. Serv., Par. 20, 677; reversing 180 Atl. 584 (Del. Ch. 1935).

[9] Prentice-Hall Corp. Serv., Par. 20, 728. The decision has been approved in (1937) 35 Mich. L. Rev. 620; (1937) 23 Va. L. Rev. 579.

[10] Yoakam v. Providence Biltmore Hotel Co., 34 F. (2d) 533 (D. C. R. I. 1929).

[11] See opinion of Del. Sup. Ct. in Keller v. Wilson & Co., *supra*, note 8.

[12] Prentice-Hall Corp. Serv., Par. 20, 678.

Maryland corporations have announced that they are going forward with similar plans.

Pertinent parts of the Maryland statute are as follows:

> "Every corporation of this State . . . may . . . amend its charter and thereby accomplish any one or more of the following objects: . . . the classification or reclassification of all or any part of the capital stock; and the making of any other amendment that may be desired provided that such amendment shall contain only such provisions as it would be lawful or proper to insert in an original certificate of incorporation made at the time of making such amendment."[13]

Since the new capital stock provisions can be so worded as to "contain only such provisions as it would be lawful or proper to insert in an original certificate", avoiding mention of the right to accrued dividends under the previous wording of the charter, the broad power to make "any . . . amendment that may be desired" seems to cover the cancellation of accrued dividends. Under the power to reclassify, the Articles of Amendment, it may be assumed, would contain an additional clause transforming the old cumulative dividend stock into the new stock. While the power to reclassify might not be sufficient by itself,[14] it may

[13] Md. Code, Art. 23, Sec. 28, last amended by Acts, 1922, Ch. 309. An extended history of the amending provisions of the Maryland corporation statute appears in Brune, Maryland Corporation Law, 76-82, Sec. 63.

[14] See Breslav v. New York & Queens El. Lt. & P. Co., 291 N. Y. S. 932, decided by the Appellate Division of the New York Supreme Court, December 4, 1936, Prentice-Hall Corp. Serv., Par. 20, 697, N. Y. Law Journal, December 14, 1936, affirmed without opinion by N. Y. Ct. of Apps. March 16, 1937. The *Breslav* case, holding that the power to classify and reclassify shares did not authorize an amendment making non-callable stock callable, contains a comprehensive review of the cases on valid and invalid exercise of a general reserved power to amend. *Examples given of valid exercise:* Lord v. Equitable Life Assur. Soc., 194 N. Y. 212, 87 N. E. 443 (1909) (mutualization of stock insurance company by enfranchisement of all policyholders); Looker v. Maynard, 179 U. S. 46 (1900) (cumulative voting for directors); Miller v. The State, 15 Wall. 478 (1873) (change in voting rights); Hinckley v. Schwarzschild & S. Co., 107 App. Div. 470, 95 N. Y. Supp. 357 (1905) (authorizing issuance of preferred stock); Somerville v. St. Louis Mining & Milling Co., 46 Mont. 268, 127 Pac. 464 (1912) (authorizing majority of stockholders to assess holders of full-paid stock); Randle v. Winona Coal Co., 206 Ala. 254, 89 So. 790 (1921) (authorizing conversion of par value stock into stock of no par value); Davis v. Louisville Gas & Electric Co., 16 Del. Ch. 157, 142 Atl. 654 (1928) (authorizing the majority of the stockholders of all classes to withdraw the right to retire Class A stock and, after certain dividends had been paid on Class A and Class B stocks, to abolish Class B's superior interest in the sharing of further dividends by equalizing the stock of both classes); Gardner v. Hope Ins., 9 R. I. 194 (1869) (non-assessable stock made assessable); Venner v. U. S. Steel Corp., 116 Fed. 1012 (1902) (change in rates of dividends). *Examples of invalid exercise:* Lord v. Equitable Life Assur.

be invoked to sustain the procedural directions for issuance of the new stock in place of the old.

As previously indicated, amendments "changing the terms of outstanding stock", require unanimous consent of that stock in the absence of a charter reservation. The statutory provision is as follows:

> "No amendment of the charter of a corporation shall be valid which changes the terms of any of the outstanding stock by classification, reclassification or otherwise, in the absence of a reservation in the charter of the right to make such amendment, unless such change in the terms thereof shall have been authorized by the holders of all of such stock at the time outstanding, by vote at a meeting or in writing with or without a meeting; and in the case of any such change of terms of outstanding stock, the articles of amendment shall, in addition, to other matters required by law, affirmatively set forth that the holders of such stock have duly authorized such change of terms. The word 'terms' as used in this section in reference to stock is intended to mean only the contract rights of the holders thereof as expressed in the charter and shall be so construed."[15]

Soc., *supra* (deprivation of right to vote for all directors; reason: right to vote is "vested"); Stokes v. Continental Trust Co., 186 N. Y. 285, 78 N. E. 1090 (1906) and Dunlay v. Avenue M Garage & R. Co., 253 N. Y. 274, 170 N. E. 917 (1930) (deprivation of pre-emptive right; reason: pre-emptive right is an "inherent" right); Page v. American & British Manufacturing Co., 129 App. Div. 346, 113 N. Y. Supp. 734 (1908) (reduction of voting power by reduction of stock; reason: right to vote is "vested"); Yoakum v. Providence Biltmore Hotel Co., 34 F. (2d) 535 (D. C. R. I. 1929) (elimination of sinking fund and dividend arrearages; reason: impairment of "vested" rights); Sutton v. Globe Knitting Works, 276 Mich. 200, 267 N. W. 815 (1936) and Vanden Bosch v. Michigan Trust Co., 35 F. (2d) 643 (C. C. A. 6th, 1929) (postponement of redemption date; reason: impairment of "vested" rights); Garey v. St. Joe Mining Co., 32 Utah 497, 91 P. 369 (1907) (making non-assessable stocks assessable; reason: impairment of obligation of contract); Coombes v. Getz, 285 U. S. 434 (1932) (repeal of statutory liability of directors to creditors for money embezzled by officers; reason: impairment of "vested" rights); Roberts v. Roberts-Wicks Co., 184 N. Y. 257, 77 N. E. 13 (1906) (elimination of dividend arrearages; reason: impairment of "vested" rights); General Investment Co. v. American Hide & Leather Co., 98 N. J. Eq. 326, 129 Atl. 244 (1925) (elimination of dividend arrearages; reason: impairment of "vested" rights); Lonsdale v. International Mercantile Marine Co., 101 N. J. Eq. 534, 139 Atl. 50 (1927) (elimination of dividend arrearages; reason: impairment of "vested" rights); Pronik v. Spirits Distributing Co., 38 N. J. Eq. 97, 42 Atl. 586 (1899) (reduction of dividend rate; reason: impairment of "vested" rights).

See also for other illustrations of the extension of and limitations upon the reserved power in (1927) 75 Univ. of Pa. Law Review 725; (1930) 43 Harvard Law Review 656; (1929) 20 Columbia Law Review 88; (1928) 14 Cornell Law Quarterly 85; and 105 A. L. R. 1452.

[15] Md. Code, Art. 23, Sec. 28.

The "reservation in the charter of the right to make such amendment" excepts a corporation from the requirement of obtaining a vote of the stock affected (if non-voting stock), unless the charter itself so requires. Moreover, the language of this portion of the statute lends strong support to the view that any amendment *changing the terms* of outstanding stock may be made under a charter reservation.[16] The right of a preferred stockholder to accumulated unpaid dividends is called by the Delaware Court a "vested right", a "right in the nature of a debt", rights that "accrue to them (stockholders) by virtue of the contract."[17] Consideration of the nature of the right, and these characterizations of it, place it among the "contract rights of the stockholders as expressed in the charter", which is the Maryland statutory definition of the "terms of outstanding stock."[18] If, under the statute, these contract rights cannot be changed except with unanimous consent of the holders, in the absence of a charter reservation, is it not clear that the existence of the reservation permits the change by such vote as the charter may specify?

Other considerations, beyond the scope of this note, may enter into the situation. The reservation itself must be appropriately worded. Doubt may be expressed whether a reservation which does not specify the vote required for an amendment changing outstanding stock may safely be relied upon.[19] Moreover, in all cases in which rights of

[16] Unless affirmative force is given to this language, the requirement of unanimous consent, in the absence of a reservation, seems meaningless. It may be argued that affirmative force can be accorded the provision with respect to changes in future dividends, future relative preferences, or future voting rights without authorizing cancellation of dividend arrearages. This assumes, however, that the clause requiring unanimous consent for certain amendments is broader in scope than the reservation in that clause. Such a conclusion would seem to require a distortion of the words used, for, taken literally, the language requiring unanimous consent is inoperative when the charter contains an appropriate reservation. Hence the reference to a charter reservation may be expected to furnish a controlling consideration, either through its own affirmative force or through influencing a broad rather than narrow interpretation of the general power of amendment previously referred to. The question is purely one of statutory construction, as there are no Maryland cases sufficiently near the point to be of assistance on either side of the argument.

[17] Keller v. Wilson & Co., supra, note 8. Whether these rights are "vested" would seem to depend upon whether Section 28 authorizes them to be taken away without unanimous consent of the holders thereof, by such vote as is specified in the charter. Use of the term "vested rights", therefore, adds nothing to the force of the stockholder's contention, as it is an argument from the conclusion—it begs the question. If Section 28 authorizes dividend arrearages to be cancelled, the right to such dividends can be vested only in a defeasible sense.

[18] Md. Code, Art. 23, Sec. 28.

[19] Cf. Brune, Maryland Corporation Law, p. 75, note 53.

stockholders are readjusted, by amendment, consolidation or otherwise, to the advantage of a controlling group or class, it is believed that a court of equity may inquire into the fairness of the proposed change and whether it serves the interests of the corporation as a whole.[20] Clearly, if the unfairness of the plan is so gross and apparent as to constitute fraud, the courts will interfere in spite of the adoption of the plan in strict accordance with statutory and charter provisions.[21]

[20] See authorities cited Brune, *op cit.*, p. 82.

[21] See Homer v. Crown Cork & Seal Co., 155 Md. 66, 88, 141 Atl. 425 (1928); Mortgage Bond Assn. v. Baker, 157 Md. 309, 145 Atl. 876 (1929); Hagerstown Furniture Co. v. Baker, 155 Md. 549, 142 Atl. 885 (1928).