Stock Dividends--Eliminating Accrued But Undeclared Cumulative Dividends by Charter Amendment

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favor one class of persons or property over another in paying public utility rates. If the tenants of the Edwin Markham Houses and other projects of a like nature are given lower electric rates, tenants in privately owned houses must of necessity pay higher rates than they otherwise would. It is not as if all the tenants in such projects were of the lower income group and all families outside are of a higher income group. The tenants of the Edwin Markham Houses form but a very small fraction of the families in the income group in which they fall. Justice Crouch, who wrote the opinion in the Muller case, made this observation:

The designated class to whom incidental benefits will come are persons with an income under $2,500 a year, and it consists of two-thirds of the city's population. (Italics added.)

Just why a small fraction of the city's population should pay lower rates than others in the same income group, the court in the Staten Island case does not make clear. What the court said in Board of Education v. Baker as to taxation is just as applicable to public utility rates. A discriminatory reduction of rates:
Relieves one class of persons or property from its obligation to bear its share of the expenses ... no matter how deserving of assistance that class may be, and throws a correspondingly heavier burden upon all other classes.

The conclusion to be reached is that no reported decision prior to the Staten Island case held city-owned residential houses to be "public buildings" in the sense that they are entitled to lower electric rates; that the great majority of the cases, both in New York and in sister states, hold them to be "private" for tax purposes; and that the Richmond County Supreme Court was not bound by the Muller case nor any other cited case to hold that such houses are entitled to lower electric rates as "public buildings". Allowing city-owned residential houses to qualify as "public buildings" in order to obtain lower electric rates appears to be discriminatory and violative of Section 65, Subdivision 2, of the New York Public Service Law.

ISAAC G. McNATT.

STOCK DIVIDENDS—ELIMINATING ACCRUED BUT UNDECLARED CUMULATIVE DIVIDENDS BY CHARTER AMENDMENT

In Dodge v. Ford Motor Co., the court said, "A business corporation is organized and carried on primarily for the profit of stockholders." Every stockholder, when purchasing shares of stock in a

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20 N. Y. Public Service Law § 65, subd. 2, cited supra note 1.
21 N. Y. City Housing Authority v. Muller, 270 N. Y. 333, 1 N. E. (2d) 153 (1936).
22 Cited supra note 18.
23 Cited supra note 1.
corporation, expects to get some financial return on the money he has paid in to the corporation. He has a right to believe that "the gains or profits realized by the corporation, at least from its active transactions constitute profits and surplus which are available for dividends." 2 Usually he has a definite place in the order of receiving his dividend because of the type of stock he owns.

When a dividend is declared out of the earnings of the corporation and a fund is set aside, such dividend becomes the property of the owners of the shares of stock, no matter whether payable immediately or at a future time. 3 An assignment by a stockholder of his stock certificate after the declaration of a dividend does not carry with it dividends previously declared though said dividends be payable at a future time. 4 This exists now completely apart from the contract between the corporation and the stockholder. As soon as a dividend is lawfully and fully declared out of surplus profits, the corporation becomes indebted from that moment to each stockholder for the amount of his share, and he may recover the same in an action against the corporation. 5 The declaration of a dividend creates no contractual relation between the corporation and the stockholder. Rather it creates a debt in favor of the latter against the corporation. 6

If the stock is of the non-cumulative type, when the period in which dividends are normally to be declared passes and no dividends have been declared, the stockholder knows he will never receive any return for that past period, and he looks only to the future for profit. "However, if the contract with the corporation guarantees or entitles him in general terms to a certain annual dividend, not making the dividend payable in each year dependent upon the profits of that year, the dividends are cumulative." 7 In such case, if the profits in any year are not sufficient to pay the dividend, it must be paid, in addition to subsequent dividends, out of the profits of future years before any dividends can be paid to the holders of any other stock. Thus, no dividend may be declared on the non-cumulative stock until all back dividends have been made upon the cumulative stock. It is only the holder of cumulative stock who may expect any return for the years he has held the stock without receiving any dividend. Until the declaration of a dividend, the profits form part of the assets of the corporation and an assignment before declaration carries with it the stockholder’s proportional share of all the assets including all undeclared dividends. 8 However, until a dividend has been declared,

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6 See note 3 supra.
7 Ballantine, Private Corporations (1927).
8 Baundage v. Baundage, 60 N. Y. 544 (1875).
the stockholder has no legal right to maintain an action against the corporation for a share of the profits. It can make no difference that the profits have reached such proportion and that the corporation is in such condition that the directors should declare a dividend. It may even be that the corporation may dissolve sometime in the future without his ever having received any return whatsoever.

The nature of the stockholder's interest in the undistributed surplus, or in the absence of this, the assets of the corporation, when he is a holder of cumulative stock and dividends have not been paid for a number of years, is very difficult to define or limit although easily labeled. To call that to which he feels entitled even an "undeclared dividend" is in itself a misnomer, because it cannot actually be a dividend until set aside or earmarked, otherwise, of course, it would be working capital. However, this term is used for want of a better name. The declaration of dividends lies in the discretion of the directors. It is for them to say whether profits shall be distributed to the stockholders or retained for corporate business. The only right a stockholder has to compel a dividend to be declared is recourse to a court of equity. "But courts of equity will not interfere in the management of the directors unless it is clearly made to appear that they refuse to declare a dividend when the corporation has a surplus of net profits which it can without detriment to its business, divide among its stockholders and when a refusal to do so would amount to such an abuse of discretion as would constitute a fraud, or breach of that good faith which they are bound to exercise towards the stockholders."

In some cases actions have been prosecuted wherein a court of equity has declared that directors should distribute the corporation's surplus as dividends; in many more cases the court has used its discretion and refused to order directors to issue a dividend.

From a legal point of view, this interest as distinguished from the interest in a declared dividend does not exist apart from the contract creating it; it is not a debt enforceable against the corporation; it does not result in a legally enforceable claim at any time. It is an equitable interest only, the realization of which lies in the discretion of the court.

From an economic point of view, this interest may or may not

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9 Godley v. Crandad & Godley, 212 N. Y. 121, 105 N. E. 818 (1914).
10 Stevens v. United States Steel Corp., 68 N. J. E. 373, 59 Atl. 905 (1905).
14 See note 9 supra.
be a valuable one. Part of the consideration paid for the stock was paid for the preference attaching to cumulative stock; such a stock is considered to be worth more than stock in the same corporation alike in every respect other than the cumulative feature; it may be deemed to be a more secure investment than stock of another type. However, with the passage of every succeeding interval without a declaration of dividend the value of the stock is apt to decrease rather than to increase to the extent of the undeclared but awaited dividend. No one would say that a cumulative stock on which dividends had been undeclared for fifteen years had now an enhanced value by virtue only of the failure of a declaration of dividend. The stockholder may sell his stock at the market value or retain it in the hope that someday the corporation may again declare a dividend. Retaining it will depend on a great number of factors important among which are the market in general, and the strength, reputation and integrity of the corporation in particular. In many instances the stockholder's economic interest may amount only to a pious hope.

Many cases decided in New York and elsewhere and many writers on the subject have beclouded the issue completely by calling this interest a "vested right of property" or a "vested property interest". This is due to failure of complete analysis and as a result to looking at the accrued but unpaid dividend as a definite fund set apart and belonging absolutely to the stockholder. But it is no such thing; it is wholly contingent upon a number of factors which may never materialize. It is a very elusive intangible. At best it is a preference to which the stockholder is entitled.

When a corporation finds that after a long period during which it has been unable to pay dividends, it is beginning to realize profits and that it would now like to entice new money into the corporation, to expand and place the corporation on a firmer footing for the benefit of all its stockholders, then it feels this preference a definite drain on its aspirations for a new lease on life.

Every allowable and allowed change in the financial structure of corporations has been the result of considering changed business conditions, furthering the corporate interests, fairness to the stockhold-


er's realization of fiduciary obligations of the directors.\textsuperscript{17} Considering these factors and striving to meet the problem squarely, the legislature in 1943 amended Section 36 of the Stock Corporation Law\textsuperscript{18} so that a corporation may now by a two-thirds vote of the shares of each class reclassify its shares so as to eliminate cumulative dividends, whether accrued or not, which may have been declared.

In declaring this amendment to be constitutional\textsuperscript{19} Justice Shientag held that the new amendment was enacted to specifically allow elimination of such dividends, that it should be read as a business man would read it and apply it to dividends accrued before amendment. He held that in the past those dividends were not erased because there was no express statutory authority under which it could be done and that now since Section 36 gave authority they could be eliminated.

However, if the stockholders' interest in these dividends were a "vested property right", eliminating them would be taking property without due process of law and would raise a constitutional question. This would be true whether there were statutory power or not, if dividends already accrued before the power was given were to be eliminated. It is because this interest, as we have seen, is merely a preference and not a "vested property right" that it may be eliminated. This could rightfully have been done under Section 36\textsuperscript{20} of the Stock Corporation Law as it was before amendment with the right to appraisal under Sections 38 and 21. It would have been considered an extreme use of the reserve power,\textsuperscript{21} but it would have been no more than that. The court declared in Hottenstein \textit{v. York Ice Machinery Corp.},\textsuperscript{22} "A court of the United States bound by the rule of the \textit{Erie R. R. v. Tompkins}\textsuperscript{23} is powerless to afford aid to the

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  \item\textsuperscript{17} Curran, \textit{Amendment of Corporate Charters} (1934) 32 Mich. L. Rev. 743, 775.
  \item\textsuperscript{18} Section 36 of the Stock Corporation Law provides in part as follows:
    "A stock corporation may effect one or more of the following purposes:
    (E) To classify or reclassify any shares, whether with or without par value. The creation, alteration or abolition, in whole or in part, of designations, preferences, privileges or voting powers of any shares previously authorized, or the restrictions or qualifications thereof (including the creation, alteration or abolition of any provisions or rights in respect of (a) the redemption of any shares or (b) any cumulative or non-cumulative dividends whether or not accrued, which shall not have been declared . . . ) shall be deemed to be a classification or reclassification of such shares for the purpose of this section and of section 37 and section 51 . . . ."
  \item\textsuperscript{19} McNulty \textit{v. W. & J. Sloane}, N. Y. L. J., March 5, 1945.
  \item\textsuperscript{20} Section 36 of the Stock Corporation Law:
    "(E) To classify or reclassify any shares, either with or without par value . . . ."
  \item\textsuperscript{21} Curran, \textit{Amendment of Corporate Charters} (1934) 32 Mich. L. Rev. 743.
  \item\textsuperscript{22} Hottenstein \textit{v. York Ice Machinery Corp.}, 136 F. (2d) 944 (C. C. A. 3d, 1943).
  \item\textsuperscript{23} \textit{Erie Railroad Co. v. Tompkins}, 304 U. S. 64, 58 Sup. Ct. 817 (1938).
\end{itemize}
stockholder until reclassification reaches that degree of unfairness where it amounts to a cancellation of the preferred stockholders' accumulated unpaid dividends without adequate compensation therefor under the law either by way of a share in the equity of the surviving corporation or the payment of money. At such a point a court of the United States might grant injunctive relief under the provisions of the Fourteenth Amendment.” The right of appraisal, which is the only practical way allowing adequate compensation to the dissenting stockholder, is provided for in the law.

We must be careful, however, to afford the minority stockholder an adequate measure of relief at all times on the ground of fairness to all. Since his only recourse is to a court of equity when he has not received dividends, we should make this path one not too difficult nor fraught with too many financial hazards. Otherwise court review and judicial scrutiny will become far from a potent weapon. Today with Section 61-b of the General Corporation Law imposing rather severe and arbitrary financial prerequisites on a minority plaintiff, we have definitely diminished his safeguard, and as a result may allow unscrupulous corporations to take advantage of our interpretation of Section 36 to the detriment of the minority stockholder.

KATHARINE CURNEN MULLEN.

LIMITATIONS OF CORPORATE BY-LAWS

The by-laws of a corporation have been called the rule of its life. It is usually the first and most important duty of the stockholders to adopt them; it is a matter of practical if not legal necessity. The power resides in the stockholders, though they may delegate it to the directors. At common law the power to make and adopt by-laws was inherent in every corporation as one of its necessary and inseparable legal incidents.

In New York, the power to adopt by-laws is expressly authorized by Section 14, Subdivision 5, of the General Corporation Law. The

24 Section 61-b of the General Corporation Law provides as follows:

“Security for expenses.
In any action instituted or maintained in the right of any foreign or domestic corporation by the holder or holders of less than five per centum of the outstanding shares of any class of such corporation’s stock . . . unless the shares . . . have a market value in excess of fifty thousand dollars, the corporation . . . shall be entitled . . . to require the plaintiff . . . to give security for the reasonable expenses . . . .”

1 § FLETCHER, CYCLOPEDIA OF CORPORATIONS (1931) § 4166.
2 “Grant of general powers.
Every corporation as such has power though not specified in the law under which it is incorporated: . . . (5) to make by-laws, not inconsistent