Power to Remove Accrued Cumulative Dividends--Business Expediency Versus the Law

Leo Salon
gent use, whether he is absent or present, it follows that ownership rather than control, actual or presumed, should be the criterion for determining the rights and liabilities arising from collisions. By amending the Vehicle and Traffic Law so that the negligence of the driver will be imputed to the owner in all cases where the vehicle is used with his consent, express or implied, the legislature may achieve a result that is uniformly just. In addition to putting an end to the anomalous situation which has resulted from the interpretation of Section 59 of the Vehicle and Traffic Law in *Mills v. Gabriel* such an amendment would substitute sound public policy for the fiction that the owner's presence in a vehicle gives him control over the driver.

ANDREW J. GRAHAM.

**POWER TO REMOVE ACCRUED CUMULATIVE DIVIDENDS—BUSINESS EXPEDIENCY VERSUS THE LAW**

"A cumulative dividend is one 'With regard to which it is agreed that if at any time it is not paid in full the difference shall be added to the following payment'. The idea being that arrearages of one year are payable out of surplus earnings in subsequent years." Except as provided for by the contract in the charter all stockholders have fundamentally the same rights. Therefore, a conservative purchaser of stock, who may not wish to take the common risk that a corporation will earn a profit every year or if earned that it will be distributed, buys preferred stock providing for cumulative dividends.

"Before paying dividends to the common stockholders, the stated dividend with all arrearages, if any, must first be paid to these preferred stockholders. As against the common stockholders, the right to this cumulative preferred dividend is fixed and vested though payment thereof has been postponed. When under the charter dividends which are cumulative are not paid, such dividends are said to be accrued cumulative dividends. In New York State it is well

which is in fact, if not in law, a provision for "compulsory insurance" for automobiles, makes it clear that the policy of New York is to place the risk of automobile operation squarely upon the owner rather than upon the public.

1 CENT. DICT.


3 Lloyd v. Pennsylvania Electric Vehicle Co., 75 N. J. Eq. 263, 72 Atl. 16 (1909) ("It has been held, and may be regarded as entirely settled, that calling stock 'preferred stock' does not of itself determine the rights of the holders, for the extent of the preference is to be determined by the terms of the contract").

established that the right to the payment of such accrued dividends, before dividends can be paid on the common stock, is a vested right. Stockholders find, however, that the position of one entitled to accrued cumulative dividends is not always an enviable one, and one simple to protect. The problem of satisfying this accrued debt is often a sore spot in corporate finance. There are many situations wherein the nature of the right and the protections afforded it are challenged at every turn. To say that the Constitution protects vested property and contract rights and that the rights of stockholders to accrued cumulative dividends are therefore within its protection is a matter of over-simplification.

If the corporation earns a profit almost every year and accumulates a surplus there is of course no problem. However, if the contingency against which the stockholder sought assurance occurs, and a long series of lean years results in huge accruals, the corporation very often finds it necessary to reorganize and obtain fresh capital to carry on. The usual method would be to sell stock, but further investment in such a corporation is discouraged. No one wishes to buy stock in a corporation heavily burdened by accrued dividends. The incentive to buy, i.e., the expectation of receiving dividends, is gone for the new stockholders will not be entitled to any dividends until the accrued cumulative dividends are first taken care of. An impasse seems to result for without fresh capital a corporation cannot hope to earn a profit to pay off accrued dividends and it is impossible to obtain the fresh capital until the accrued dividends are paid off. Preferential stockholders are usually in the minority and the conflict with the majority is inevitable. Business expediency favored by the majority calls for the removal of the accrued dividends even if cancellation is necessary. The majority claims that obstreperous stockholders should not be allowed to hold up progress. On the other hand, the minority demands constitutional protection for their contract and vested rights. They claim the corporation must be conducted legally; it may not be operated for the good of the majority stockholders only; it must be operated for the good of all of its stockholders—the minority cannot be sacrificed for the benefit of the majority.

New York State has firmly upheld the legal view of the minority stockholders, though the majority business view is not devoid of all

5 Roberts v. Roberts-Wicks Co., 184 N. Y. 257, 77 N. E. 13 (1906); Wiederson v. Atlantic Cement Products, Inc., 261 App. Div. 305, 25 N. Y. S. (2d) 496 (2d Dep't 1941) (“Cumulative dividends, which have accrued through lapse of time on preferred stock, become vested contractual rights which cannot, without the consent of the stockholder, be destroyed by the reclassification of the capital stock of the corporation, pursuant to section 36 of the Stock Corporation Law”); Davison and Thompson v. Parke, Austin and Lipscomb, Inc., et al., 285 N. Y. 500, 35 N. E. (2d) 618 (1941).

6 See footnote 5, supra (“Balanced against the desire to encourage investment, however, is the sanctity of the rights of contract. The individual preferred stock investor has bargained for certainty in his return and may not be deprived of his bargain without statutory authority.” Davison and Thompson
merit. However, in the case we are considering, the majority is in
the position of a party to a contract which makes no provision for a
contingency that has taken place. Though they may have driven a
bad bargain with the preferred stockholders they are bound by the
contract.\(^7\) This contract problem, in other particulars, has arisen in
the past to hamstring corporate finance. How the issue was met in
the past may well point to the solution of the present problem.

Business necessity always called for numerous and swift organi-
zational changes and therefore the contract between the shareholders
had to be made flexible. The legislature, recognizing the perplexity
of the question, determined to solve it by action under its reserved
powers to alter, amend or repeal corporate charters.\(^8\) Such action
within constitutional limitations\(^9\) proved desirable to solve such
problems. The procedure is as follows: By the authority of its reserved
powers the legislature passes a statute operating prospectively, giving
a certain portion of the shareholders the power to make certain
changes in the contract. When one becomes a shareholder with such
a statute, in effect he is deemed to have consented to the contract as
the law affects it. Since every such statute is as a matter of law read
into the charter a change initiated in accordance with the law is merely
the contract being executed as contemplated. If the shareholder
agreed to the procedure he is not being wronged by it. Exemplifying
such statutes as above referred to we have New York Stock Corpora-
tion Laws, Sections 35, 36, 37 and 38.\(^{10}\) By virtue of these laws a

---

\(^7\) Pearsall v. Great Northern Ry., 161 U. S. 646, 660, 16 Sup. Ct. 705
(1896); Trustees of Dartmouth College v. Woodward, 4 Wheat. 518, 4 L. ed.
629 (U. S. 1819) (Under the doctrine there "firmly established as a canon of
American jurisprudence, the charter of a corporation is deemed a contract");
181, 291 N. Y. Supp. 932, aff'd, 273 N. Y. (memo) 141, 7 N. E. (2d) 708
(1937).

\(^8\) N. Y. Const. art. VIII, § 1, provides: "Corporations may be formed
under general laws; * * *, All General laws and special acts pursuant to this
section may be altered from time to time or repealed."; N. Y. GENERAL CORPO-
RATION LAW § 5, "The charter of every corporation shall be subject to altera-
tion, suspension and repeal, in the discretion of the legislature."

Supp. 278 (1931), aff'd, 256 N. Y. 498, 177 N. E. 17 (1931) ("One limitation
well settled is that the property of the corporation which has been acquired by
it cannot be taken away by the repeal of a charter. Mayor, etc. of New York
v. Twenty-third Street Ry. Co., 113 N. Y. 311, 21 N. E. 60 (1889). There is
no right to change the fundamental character of the corporation. Buffalo &
N. Y. City Co. v. Dudley, 14 N. Y. 336, 338 (1856). * * *

"And alteration and amendment must be reasonable. Shields v. Ohio,
95 U. S. 319, 324, 24 L. ed. 357 (1877)."

\(^10\) N. Y. STOCK CORPORATION LAW § 35: Changes of purposes, powers or
provisions, or number of directors or location of office. A stock corporation
may effect one or more of the following changes:

(A) To extend, limit, or otherwise change its purpose and powers
or other provisions of its certificate of incorporation.
major portion of the stockholders—majority or two-thirds as the law provides in given cases—is enabled to change the purposes and powers of the corporation; the number of directors; or the location of the office. Likewise, changes in respect to shares, capital stock, or capital is authorized. Of course, all this can be done under the statute and charter despite minority objection.

(B) To increase or reduce the number of directors, or to provide that the number of directors, shall not be less than a stated minimum nor more than a stated maximum; but in neither case below the minimum number prescribed by law;

(C) To change the location of its office, if it is not a moneyed corporation: By filing a certificate **. (In some instances a majority vote is needed, in others a two-thirds vote is needed for a valid certificate.)

N. Y. Stock Corporation Law §36: Changes in respect to shares, capital stock or capital. A stock corporation may effect one or more of the following purposes:

(A) To increase or reduce the amount of its capital stock where all of the capital stock is divided into shares having a par value;

(B) To increase or reduce the par value of any of its shares that have a par value;

(C) To provide for the authorization of new shares of any class, with or without par value, and to eliminate any previously authorized shares;

(D) To change all or any of its previously authorized shares with or without par value, issued or unissued, into the same or a different number of shares of any class or classes either with or without par value, or into the same or a different number of both shares with par value and shares without par value, of any classes;

(E) To classify or reclassify any shares, either with or without par value; and to authorize the issuance from time to time in one or more series of the shares of any class of stock which is preferred as to dividends or assets; subject to the limitation prescribed in section eleven; **

N. Y. Stock Corporation Law §37: Subscription and authentication of certificate.

N. Y. Stock Corporation Law §38: Provisions applicable to one or more proceedings under section thirty-six. ** the following provisions shall be applicable to a certificate under section thirty-six. **

8. The liability of the corporation, its officers, directors, and stockholders for corporate debts contracted or obligations incurred prior to the filing of such certificate, shall be unaffected thereby, but for the purpose of enforcing and recovering upon any claim a creditor shall have the same right of recourse against the corporation, its officers, directors and stockholders that he would have had if such certificate had not been filed.

9. If the certificate alters the preferential rights of any outstanding shares, any holder of such shares not voting in favor of such alteration may at any time prior to the vote authorizing such alteration—**—object to such alteration and demand payment for his stock, and thereupon such stockholder or the corporation shall have the right, subject to the conditions and provisions of section twenty-one, to have such stock appraised and paid for as provided in said section. **
The questions that we must answer here are threefold:

1. Does any statute presently in effect authorize the removal of accrued cumulative dividends without payment, by the direct action of a major portion of the stockholders over minority objection?

2. If no such statute exists, has the legislature the constitutional authority to pass such an act under its reserved powers?

3. As the law stands today, what is the best practical solution to the problem other than legislation?

I

In answer to the first question, an examination of the statutes shows that Section 3611 of the New York Stock Corporation Law is the only section necessary to be analyzed. It is the only law dealing with the revision of the corporate charter in respect to stock and stockholder's preferences. Although the statute clearly provides for the reclassification of stock, prospectively, subject to the right of appraisal,12 it does not expressly or by implication authorize the cancellation of a non-assenting stockholder's right to unpaid dividends which have accrued through lapse of time.13 Section 36 makes no mention of accrued cumulative dividends. The statute is comprehensive in scope, and failure expressly to provide for such a situation indicates that no such authority was granted or contemplated by the legislature.14 Any generalization is made more untenable when we consider that the legislature expressly provided under Section 38, subdivision 8, for the survival of corporate debts and contract obligations incurred prior to any reclassification under Section 36.15 It seems that this section should apply in respect to the debt accrued under the contract obligation calling for payment of accrued cumulative dividends.16 It is useless further to consider the problem as one of statutory interpretation and construction. The New York courts

11 See note 10, supra.
12 Davison and Thompson v. Parke, Austin and Lipscomb, Inc., et al., 285 N. Y. 500, 35 N. E. (2d) 618 (1941) ("On the other hand, there can be no doubt that sections 36, 37, and 38 of the Stock Corporation Law contemplate the alteration of certain preferential rights of stockholders under these contracts subject only to the dissenting stockholder's right of appraisal. Matter of Silberkraus, 250 N. Y. 252; Matter of Kinney, 279 N. Y. 423").
15 See note 10, supra.
find no authority for a solution of the problem under present statutes. *Stare decisis* binds the courts and we turn next to the possibility of a change by the legislature.

II

Can the legislature authorize the removal of accrued cumulative dividends? There is grave doubt whether such a power would be a constitutional exercise of the legislature's authority to alter, amend or repeal. The powers reserved by the legislature are subject to limitations. Similarly limited are the rights given by the legislature to a major portion of the stockholders to enact changes in the charter. The legislature cannot directly take vested property without due process; it cannot impair contract rights; the legislature of course cannot delegate more power than it has.

The above view is most certainly sound as to any retroactive legislation of that nature. The property once vested cannot be constitutionally divested. However, there might be a question of whether or not a holder of stock calling for cumulative dividends, who became such a holder with a statute in effect giving a major portion of the stockholders the right to wipe out accrued dividends, would have a vested property or merely a defeasible property in the accrued dividends. If defeasible, the debt may be eliminated according to the process provided for. However, since the legislature does not attempt to delegate in any manner the power to remove accrued cumulative dividends, we will simply leave the second question unanswered. If such legislation is permissible, its advisability is another question left unanswered.

---

27 See note 5, supra.
29 See note 9, supra.
31 See note 20, supra.
34 Davison and Thompson v. Parke, Austin and Lipscomb, Inc., et al., 285
We come next to the third question. What can be done under existing law? We can readily see from the answers to the first two questions that those stockholders who are in favor of wiping out accrued dividends, being faced with emphatic authority against direct action, must solve the problem, if at all, indirectly. And so two practical but indirect methods of nullifying the effect of accrued cumulative dividends have been devised and both seem to have been accepted in New York. The first method consists of inducing a “voluntary” surrender of the accrued dividends. The significant feature is the use of “business” as distinguished from “legal” compulsion. The procedure in brief is as follows: The major portion of the shareholders, desirous of doing away with the accrued dividend, enact an amendment to the charter, under the authority of Section 36, by which it is provided that the future rights and participations of the old preferred stock exist no longer. As part of the same plan a new class of stock with more advantageous rights is then issued. Provision is made whereby the old stock may be traded for the new stock on the condition that a differential be paid which will be equivalent to the amount of the accrued dividends. The problem for the minority stockholder then becomes one of mathematics and business. Which is worth more, the future benefits given by the new stock or the accrued dividends to which he is entitled? The shareholder answers this question for himself. He does not absolutely have to give up his accrued dividends; he may keep them, although amendments in order to accomplish the result intended make it so that it will usually prove unprofitable not to exchange the stock.

Although accomplishing the result by devious means, there seems to be nothing unconstitutional or impracticable about the method. Prospective changes in stock preferences are lawful because of the consent implied from the act of becoming a stockholder with statutes in effect giving shareholders the right to amend the charter in this respect. Moreover, the method appears more fair in the light of New York Stock Corporation Law, Section 38, subdivision 9, whereby the stockholder is entitled to an appraisal of his shares and payment therefor by the corporation whenever the preferential rights of his stock are changed and he does not consent to the change. This

N. Y. 500, 35 N. E. (2d) 618 (1941) (“Solution of the problem is further complicated by the fact that any device the use of which is desirable in proper cases for the elimination of burdensome preferential rights of preferred stockholders may be used in other cases, without regard to corporate needs and for sole benefit of common stockholders”).

26 See note 10, supra.
28 See note 10, supra.
provision for compensation takes the force out of any argument that may be advanced on the theory that property is being taken without due process of law. There is a recognized difference between the compulsion of releasing dividends and making it so advantageous to do so that the act becomes legally voluntary.29

The second indirect method of solving the problem consists primarily of sidetracking the accrued dividends. If the dividend can be made innocuous in so far as it will not hinder the raising of capital by the sale of stock the main issue will have been met. The fact that the dividend remains unpaid will then be the private concern of the preferred shareholders. This result is accomplished when the shareholders insert a prior issue of stock under the authority of Section 36.30 Dividends are made payable on this new issue whether the accrued dividends are satisfied or not. Since the new dividends are not conditioned upon the prior payment of accrued dividends, investment, by the purchase of the new stock, is no longer discouraged. Moreover, the old first preferred stockholder is generally given the right to exchange his old stock for the new stock on the condition that he release his claim to accrued dividends. This last step makes the practice somewhat similar to the first indirect method. The New York courts have upheld the above practice.31

This second method seems subject to some collateral attack in that the right to appraisal is denied to the stockholder whose accrued dividends have been sidetracked. The theory is that appraisal is allowed only when preferences are altered and in this case the nominal preferences were left intact although a more preferred stock has been superimposed.32 The New York Court of Appeals upheld the above theory in the Duer case without an affirmative opinion, but the dissent pointed out the formal construction given the appraisal statute33 and the utter disregard of substance and spirit. Except for this criticism34 the second method of solving the problem is proper and lawful.

Corporations have not always been successful in their efforts to accomplish the result sought. An example of a failure is the case of Strout v. Cross, Austin & Ireland Lumber Co.35 The corporation attempted to satisfy an accrued cumulative dividend by payment of a small portion thereof in cash and a major portion in fifty-year income notes issued by its subsidiaries. A stockholder retained the cash but

30 See note 10, supra.
31 Matter of Dresser, 247 N. Y. 553, 161 N. E. 179 (1928); In re Duer, 270 N. Y. 343, 1 N. E. (2d) 457 (1936).
33 See note 10, supra, § 38, subd. 9.
35 283 N. Y. 406, 28 N. E. (2d) 856 (1940).
returned the notes, notifying the corporation that she had not consented to receive income notes in payment of dividends. The court held that the stockholder need not accept the dividend payment in that manner on the theory that as the cumulative dividend accrued it was in the nature of a general dividend. Once a general dividend is declared or accumulated it is a debt payable by the corporation and payable in cash. Whether an accumulated dividend is payable in cash only is questionable.\[36\] In any event it is dicta in this case for even if the directors might in their discretion declare a property dividend no stockholder could be forced to accept it.\[37\]

**Conclusion**

It is conclusively settled in New York State that accrued cumulative dividends cannot be directly removed. This is the result of proper statutory construction and interpretation. However, by other powers which the legislature has reserved and delegated to a major portion of the shareholders the result can nevertheless be reached in many cases. It is always to be remembered that these indirect means are legal, due to previous or subsequent consent given by the stockholder. Although in many cases it may seem improper to allow one to do indirectly what he cannot do directly, it is not so in this instance. The object to be achieved, i.e., the reorganization of the corporation or the raising of capital, is proper and not against public policy. Of course, if it should become necessary in order to achieve the object to disregard the constitutional protections, the relative "good" in the transaction would be far outshadowed by the "bad". A precedent for taking property without due process should not be established no matter how expedient. However, when as here, the end in view is good there should be no restraint imposed if legal and proper means, no matter how devious, can be found to achieve that end.

If direct action is desirable it is for the legislature to pass the necessary laws. The dicta in the Breslav\[8\] case stating that a statute of the necessary character would be unconstitutional is not entirely sound. It is based on reasoning which begins with the conclusion that the right to accrued dividends (or the immutability of non-callable stock, there considered) is always a vested right without first investigating the source of the vestedness, i.e., the contract. Such rights are made vested by contract and there is no reason why the contract cannot provide that they be defeasible. A statute expressly allowing the removal of accrued cumulative dividends would change

---

37 William v. Western Union Telegraph Co., 93 N. Y. 162, 193 (1883).
the nature of such right, in the hands of future stockholders, from a vested property to a defeasible property. If corporate management needs more freedom of action in this direction the remedy lies with the legislature and not with the courts.

Leo Salon.

LIMITATION OF THE PROHIBITION OF A STATE TO TAX THE FEDERAL GOVERNMENT.

The right of a sovereign state to tax its subjects is universally recognized. This right of taxation, where it exists, is necessarily unlimited in its nature and thus carries with it the inherent power to embarrass and destroy.¹ Both the state government and the federal government possess this right of taxation, but their reciprocal rights and immunities are safeguarded by the observance of two limitations upon their respective powers of taxation: (1) that the exactions of the one must not discriminate against the means and instrumentalities of the other, and (2) that they must not burden the operation of that other.² As early as 1819 it was settled that a state cannot exercise this right of taxation in respect to any of the instrumentalities which the federal government may create for the performance of its constitutional functions.³

The immunity of federal instrumentalities from state taxation may be waived,⁴ wholly or with such limitations and qualifications as may be deemed proper by the law-making power of the nation, but the waiver must be clear and unambiguous.⁵ An officer of the

1 McCulloch v. Maryland, 4 Wheat. 316, 4 L. ed. 579 (U. S. 1819).
3 Mr. Chief Justice Marshall in McCulloch v. Maryland, 4 Wheat. 316, 4 L. ed. 579 (U. S. 1819) said, "The sovereignty of a state extends to everything which exists by its own authority, or is introduced by its permission; but does it extend to those means which are employed by Congress to carry into execution powers conferred on that body by the people of the United States? We think not. Those powers are given by the people of the United States, to a government whose laws made in pursuance of the Constitution, are declared to be supreme. Consequently, the people of a single state cannot confer a sovereignty which will extend over them." See also Farmers and Mechanics Savings Bank of Minneapolis v. Minnesota, 232 U. S. 516, 34 Sup. Ct. 354 (1914); People ex rel. Donn-Hanna Coke Corp. v. Burk, 217 N. Y. Supp. 893, 128 Misc. 195 (1926), aff'd, 248 N. Y. 507, 162 N. E. 503 (1928); Appeal of Van Dyke, 217 Wis. 528, 259 N. W. 700 (1935).
4 "A waiver is the intentional or voluntary relinquishment of a known right," Lehigh Val. R. R. v. Ins. Co., 172 Fed. 364, 97 C. C. A. 62 (1909); "or such conduct as warrants an inference of the relinquishment of such right", Rand v. Morse, 289 Fed. 339 (C. C. A. 1923); "or is inconsistent with claiming it", Marfield v. Cincinnati, D. & T. Traction Co., 111 Ohio St. 139, 144 N. E. 689 (1924).
5 Austin v. Aldermen, 74 U. S. 694 (7 Wall.), 19 L. ed. 224 (1868).