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Rights of Holders of Preferred Stock to Dividends in Conjunction with Distribution of Surplus to Common Stockholders

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itable corporation will be held liable for the torts of its mere servants and agents but not for those whom the court considers to be independent contractors.[56]

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RIGHTS OF HOLDERS OF PREFERRED STOCK TO DIVIDENDS IN CONJUNCTION WITH DISTRIBUTION OF SURPLUS TO COMMON STOCKHOLDERS.

A legal problem arises when the certificate of incorporation or other certificate creates preferred stock, entitling the holder to a specific preferential dividend before anything is paid to the common stockholders, but contains no provision whatever respecting its right to share in any surplus profit in excess of the stipulated dividend.[1] Three different accountings can be made of the surplus in the distribution of dividends in such event. 1. The preferred will receive its stipulated dividend; the common will receive an equal share and the balance will be divided *pro rata* between both classes. 2. The preferred will receive its stipulated dividend, and the common will receive the balance even though it may be in excess of the amount paid to the preferred. 3. The preferred will receive its stipulated dividend and then share with the common in the balance, so that the preferred will always get the greater share to the extent of its preference.[2] The problem can be framed simply. Does the preferred stockholder, in the absence of a contractual provision, have any right at all to participate in the distribution of the dividend fund, after it has been paid the amount of the preference?

Two theories have been adopted by the courts in arriving at a solution. 1. The preferred stockholder presumptively yields nothing in compensation for the benefits he receives; that he has and holds

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[56] Doctors, nurses, professors, instructors, etc.

It is interesting to note that since this article has been submitted for publication, one similar to it has been published in 12 IND. L. J. 96 and reprinted in the New York Law Journal of Nov. 13, 1937 under the heading of "The Liability of Charitable Corporations for Torts of Servants". The author, building his article around Sheehan v. North Country Community Hospital, 273 N. Y. 163, 7 N. E. (2d) 28 (1937), arrives at practically the same conclusion as the present writer. He states that "There is ample reason to believe that other courts will be influenced by this present view (to apply the doctrine of respondeat superior to charitable corporations where the tort is committed by a mere employee while acting in that capacity) because New York decisions are considered to be the leading authorities in this branch of law".

[1] 12 FLETCHER, CYC. CORP. (Perm. ed.) § 5448.

[2] Thompson, *Respective Rights of Preferred and Common Stockholders in Surplus Profits* (1921) 19 MICH. L. REV. 463.

all the rights of the common stockholder and in addition has his preferential rights. This may be called the Pennsylvania rule. 2. The preferred stockholder, in receiving greater security of his preferential rights, impliedly agrees to accept such rights in lieu of equal participation and the fact that this theory is the one that is accepted by business men. This may be called the English rule.[3]

The first case on this problem was decided in Maryland in 1901.[4] The previously existing preferred stockholders of the defendant corporation were entitled, according to the language of their certificates, to a "perpetual dividend of six per centum per annum and no more." The reorganization agreement provided that "the preferred stock should be entitled to receive any dividend declared by the directors, up to, but not exceeding four per cent per annum, before any dividends shall be set apart or paid upon the common stock." In an action by a preferred stockholder who wanted to share with the common above his four per cent, the court said that "if the words, *not exceeding,* did not constitute a limitation upon the dividend rights of the preferred stock, then the words were meaningless." [5] Great emphasis was placed upon the fact that this issue of preferred stock was put on the market due to a reorganization and that the men who devised the system of reorganization could not have meant that the preferred should share with the common as the plaintiff contended.[6]

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[3] Stone v. United States Envelope Co., 119 Me. 394, 111 Atl. 536 (1920). Compare Englander v. Osborne, 261 Pa. 366, 104 Atl. 614 (1918) (which sets forth the Pennsylvania rule) with Will v. United Lankat Plantations Co. [1912] 2 Ch. 571 (giving the English rule). See also Note (1931) 79 U. OF PA. L. REV. 466.

[4] Scott v. Baltimore & Ohio R. R., 93 Md. 475, 49 Atl. 327 (1901).

[5] Although at first blush it would seem that "not exceeding" meant just that, the argument of the court is criticized in a leading article by Mr. Christ, *Rights of Holders of Preferred Stock to Participate in the Distribution of Profits* (1927) 27 MICH. L. REV. 731. He believes the language to be ambiguous. It may mean no more than four per cent either before or after any dividends are paid to the common or it may mean no more than four per cent until after the common get four per cent.

[6] No cases were cited by the court in its decision and it was admitted that none could be found on the point. The court went on to say, however, that "the plaintiff's argument (that the preferred share with the common after the common get four per cent) can be supported by cogent reasoning, yet, in a case like this, where so much exactness of detail is observable in the plan, where the interests involved are so great, it would be most unreasonable to assume that, when the schedule for the issue of 40 million dollars of preferred stock was included in the plan, everything was not put there that the parties intended should be there." It was insisted by the plaintiff that the fact that the old preferred read six per cent and no more and the new preferred omitted "and no more" was significant in indicating the intention of the parties. The court, however, found that the omission of the words "and no more" was of no significance whatever. The pre-existing preferred stock was issued to conform with the requirements of the statutes of 1868 and 1835. Both statutes contained the words "no more" and it was proper that they should be there, so that the intention of the Legislature should be clearly expressed. Here the preferred stock was issued with the assent of all the stockholders and to carry out the plan of reorganization.

In 1909, the case of *Sternbergh* v. *Brock* was decided in Pennsylvania.[7] By resolution, it was provided that "the preferred stock of the defendant corporation should be entitled to receive a cumulative yearly dividend of five per cent, before any dividends shall be set apart or paid on the common stock." The plaintiff, who was a holder of the common stock, filed a bill in equity alleging that the preferred stockholders were not entitled to receive more than five per cent per annum and praying the court to enjoin the payment of any dividend in excess of that amount. *Held,* where there is no stipulation in the contract to the contrary, the weight of authority clearly favors the right of preferred stockholders to share with the common stockholders in all profits distributed, after the latter have received an amount equal to the stipulated dividend on the preferred stock.[8]

Opposed to this Pennsylvania decision, the leading English case on this point, *Will* v. *United Lankat Plantations Co.,* was decided in 1912.[9] The Court of Appeals unanimously reversed the Chancery Division and held that the preferred stockholders were entitled only to the stipulated preference. The court argued that "it is reasonable to believe that one who is receiving a preference as to dividends is thereby promising in return to give up all rights to dividends in excess of his preference and that it is generally so regarded by business men." "They (the attorneys for the preferred shareholders)", continued the court, "treat shares as though they were born into the world, all equal; and as if preferences was a kind of subsequent attachment to them; but the whole of the attributes of a preference share are limited and defined on its birth. One cannot be aware to any extent of what goes on on the Stock Exchange without knowing that preferential shares and stock are ordinarily spoken of and regarded, as shares or stock which carry a fixed preferential dividend, and are not entitled to anything more."

In the same year, the federal court had an opportunity to discuss the problem and agreed with the English courts.[10] The case involved the construction of a New Jersey statute which provided that "preferred stockholders are entitled to a fixed yearly dividend, not exceeding eight per cent, which is to be paid before any dividend can be declared on the common." It was held that the surplus profits belonged to the common stockholders. "The common stockholder",

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[7] Sternbergh v. Brock, 225 Pa. 279, 74 Atl. 166 (1909). Accord: Fidelity Trust Co. v. Lehigh Valley R. R., 215 Pa. 610, 64 Atl. 829 (1906). Followed later in Sterling v. Watson Co., 241 Pa. 105, 88 Atl. 297 (1913); Englander v. Osborne, 261 Pa. 366, 104 Atl. 614 (1918).

[8] Thompson, *op. cit. supra* note 2, asks, "What authorities?" Since up to this time there were only two cases decided on this point, one in Pennsylvania for the proposition and one in Maryland, against, he says, "this statement might only have been a judicial smoke-cloud."

[9] Will v. United Lankat Plantations Co. [1912] 2 Ch. 573, *aff'd* [1914] A. C. 11.

[10] Niles v. Ludlow Valve Mfg. Co., 202 Fed. 141 (C. C. A. 2d, 1913), *cert. denied,* 231 U. S. 748, 34 Sup. Ct. 320 (1913).

said the court, "bears substantially all the losses of adversity and are entitled to the gains of prosperity. We find nothing in the law of the certificate or in the past action of the defendant to indicate that anyone connected with the business supposed that the preferred stockholders were to share equally with the common stockholders in the division of surplus earnings." [11]

Stock Dividends.

The problem can be further complicated by the declaration of a stock dividend rather than one in cash. The owner of preferred stock may find his power of control injured and his capital interest lessened if the court decides that he is limited only to his stated preference. In *Stone* v. *United States Envelope Co.*[12] the preferred shareholders were denied the right to subscribe to an issue of common stock on the same terms as the common shareholders, because the preferred stock provided that the preferred stockholders should receive seven per cent per annum before any dividends were declared on the common. As the new stock was offered at a price below its value, the common stockholders argued it was, in effect, a dividend, and that the preferred shareholders had no right to subscribe. This contention was upheld. Business custom and the sentiment of the ordinary investor as to cash dividends was relied upon by the court as reason for limiting the preferred to the stipulated preference and applied this same reasoning to a stock dividend. The same rule, which led to a peculiar result, was applied in the federal court in *Niles* v. *Ludlow Valve Mfg. Co.*,[13] discussed above. The plaintiff, owner of 100 shares of eight per cent preferred stock, brought suit to be allowed to participate in a stock dividend. He lost and the preferred shareholders were lowered to a minority standing in voting power, whereas before the dividend they had a majority. The point of voting power, however, was not raised in the case.[14]

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[11] *Contra:* Star Publishing Co. v. Ball, 192 Ind. 158, 134 N. E. 285 (1922). In this case, the Indiana court, in construing one of their statutes similar to that of New Jersey, decided that this meant that after dividends are paid on the common, preferred stock may participate in dividends to any amount. "The preferred stockholder," said the court, "is as much a party to this business venture as the common stockholder, and is entitled to all the rights of the common stockholder, except as modified by statute and contract."

[12] Stone v. United States Envelope Co., 119 Me. 394, 111 Atl. 536 (1920). The by-laws of the corporation read: "The preferred shares shall be entitled to cumulative dividends payable out of the net earnings of the corporation at the rate of seven per cent per annum, before any dividends are declared or paid on the common shares."

[13] Niles v. Ludlow Valve Mfg. Co., 202 Fed. 141 (C. C. A. 2d, 1913), *cert. denied*, 231 U. S. 748, 34 Sup. Ct. 320 (1913).

[14] Rowell, *Rights of Preferred Shareholders in Excess of Preference* (1935) 19 MINN. L. REV. 406 ("the dividend changed the position of the preferred from that of carrying the whip hand in the ratio of 4 to 3, to that of a minority

Realizing that the decisions in these two cases were not fair to the preferred stockholder, the Virginia court decided that the preferred stockholder should be allowed to participate in stock dividends, even in face of an express limitation of rights to dividends, whenever a denial of such participation "will disturb the equilibrium of voting power" or wherever necessary "to protect its rights on dissolution." [15] In the Virginia case, a preferred stockholder, in spite of the fact that the preferred certificate entitled him to a six per cent dividend and no other, sued his corporation for damages sustained by him because of its refusal to divide with the preferred stockholders a stock dividend of twenty-five per cent issued to the common. He argued that both his voting rights and his rights to share in the assets were impaired by the issue of the stock dividend. *Held,* for the plaintiff.

"It is true", said the court, "that the preferred stockholders were entitled to no dividends in excess of six per cent, and that the residue of the profits might, if deemed for the best interest of the corporation, be paid to the common stockholders in cash dividend. But the board of directors had no authority to declare a stock dividend, in whole or in part in favor of, or sell the new stock exclusively to, the holders of the common stock. The reason is obvious. A cash dividend is essentially different from a stock dividend. The distribution of the former in no way prejudices the rights of the preferred stockholder while the distribution of the latter to the common stockholders seriously affects his interest in the corporation." [16]

The latest case on this point is *Tennant* v. *Epstein,* decided by the Illinois court in 1934.[17] Here, the preferred stock was preferred as to assets upon dissolution and seven per cent on dividends. In 1929, a stock dividend was declared; one share of common for each share of common or preferred. Immediately following this issue of common, a cash dividend was declared on all common stock, which in effect gave the original preferred shareholders a dividend of seven per cent on their preferred, plus the dividend on the common. The plaintiff, a common stockholder, filed a bill in equity praying for a cancellation of the common stock which formed the stock dividend and for the repayment of the cash dividend thereon to the corporation. The decree was granted and the directors were enjoined from paying more than seven per cent per annum on preferred stock. Said the

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standing in the ratio of 2 to 3"). See also Morawetz, *The Preemptive Right of Shareholders* (1928) 42 Harv. L. Rev. 186.

[15] Riverside & Dan River Cotton Mills, Inc. v. Branch & Co., 139 Va. 291, 123 S. E. 542 (1924); *idem,* 147 Va. 509, 137 S. E. 620 (1927). The preferred stock certificate read "said stock shall not entitle holder thereof to receive out of the profits of the Company, any greater or other dividend than said six per cent annually." This case discussed by Rowell, *Rights of Preferred Shareholders in Excess of Preference* (1935) 19 Minn. L. Rev. 406.

[16] Riverside & Dan River Cotton Mills, Inc. v. Branch & Co., 139 Va. 291, 310, 123 S. E. 552, 547 (1924).

[17] Tennant v. Epstein, 356 Ill. 26, 189 N. E. 864 (1934); (1934) 83 U. of Pa. L. Rev. 91; (1935) 33 Mich. L. Rev. 439.

court: "We think that *Stone* v. *U. S. Envelope Co.*,[18] *Niles* v. *Ludlow Valve Mfg. Co.*,[19] and *Will* v. *United Lankat Plantations Co.*[20] are in accord with business usage and the expectation of investors when they purchase shares of stock. The preferences stated in the stock certificate are a delimitation of the rights of preferred stockholders. The majority of stockholders in voting power cannot deprive common stockholders of cash dividends by withholding dividends on such stocks, piling up a surplus, and indefinitely voting to themselves stock dividends not provided for in the articles of incorporation."

Conclusion.

The essential difference between the Pennsylvania rule and the English rule seems to lie in the truth of the hypothesis upon which the respective views are based—either that in the absence of express provisions one way or the other, diversified classes of stock are born equal, or are in their very creation subject to preferences or limitations.[21] Basically, it would appear that the preferred stockholders' contract is that of the common stockholder, plus any preferential rights given him by the terms of the agreement. Therefore, the logical result is to consider that preferred stockholders are entitled to share equally (saving any express affirmative or negative provisions in the contract) with the common stock in any dividends paid after the preferred dividend, and an equal amount as a common dividend.[22] The preferred stockholder is as much a party to the business venture as the common stockholder, except as modified by statute or contract. There is nothing inherent in the nature of a preferred stock which should imply a waiver of any rights the result of which is to classify such stock as inferior to the common issue.[23] A stock preferred as to dividends merely stipulates what one class of holders is entitled to

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[18] Stone v. United States Envelope Co., 119 Me. 394, 111 Atl. 536 (1920).

[19] Niles v. Ludlow Valve Mfg. Co., 202 Fed. 141 (C. C. A. 2d, 1913), *cert. denied*, 231 U. S. 748, 34 Sup. Ct. 320 (1913).

[20] Will v. United Lankat Plantations Co. [1912] 2 Ch. 573, *aff'd* [1914] A. C. 11.

[21] Thompson, *op. cit. supra* note 2.

[22] Note (1936) 16 BOSTON U. L. REV. 189. In Englander v. Osborne, 261 Pa. 366, 104 Atl. 614 (1918), the court quoted approvingly 2 CLARK AND MARSHALL, PRIVATE CORPORATIONS (1901) § 417c: "In the absence of special provisions, the holders of preferred stock in a corporation are in precisely the same position, both with respect to the corporation itself and with respect to the creditors of the corporation as the holders of the common stock, except only that they are entitled to receive dividends on their shares, to the extent guaranteed or agreed upon, before any dividends can be paid to the holders of the common stock."

[23] Note (1935) 7 ROCKY MT. L. REV. 73 ("why should courts of law bow to public ignorance and change the whole concept of corporate ownership to cover up poor draughtmanship?").

receive before the other class shall be entitled to anything. It becomes a matter of priority in time as to declaration of dividends. One must be declared before the other. Therefore, it does not seem that a mere preference as to time of payment should operate as a limitation upon the total amount of dividend to which the preferred stock can become entitled.[24]

If the assumption is true, that business men buy preferred stock under the belief that they will be limited to the amount of their preference, it does not follow that it is true that the right to receive dividends above the amount of the preference is lost merely because most men think it lost.[25] The priority of the preferred stockholder rests upon the contract and beyond the provisions of such contract they occupy no position toward the company different from that of the holders of common stock.[26] Since both Pennsylvania and England agree that this type of contract is not ambiguous and should be interpreted within its four corners, courts should render inadmissable extrinsic evidence of the actualities of the business world, since, theoretically, there remains nothing doubtful requiring explanation.

But the majority of our courts do not follow this reasoning. In place of theory, the common-sense understanding of the business man is adopted, and the contract interpreted by what both parties thought it meant.[27] The argument that rights once acquired cannot be lost by thinking them so does not permit the interpretation given to the contract by the contracting parties. The question is whether a right is ever acquired, when the contracting parties understand their words as negativing such a right. The business man's view is therefore evidence of what the contracting parties had agreed. Trading a right to a *pro rata* share in all earnings in return for a prior right to a specified ratio of earnings is reasonable.[28]

No New York cases have been decided on this point.[29] The

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[24] Christ, *Rights of Holders of Preferred Stock to Participate in the Distribution of Profits* (1929) 27 MICH. L. REV. 731.

[25] *Ibid.*

[26] Englander v. Osborne, 261 Pa. 366, 104 Atl. 614 (1918).

[27] Following the dicta laid down in Scott v. Baltimore & Ohio R. R., 93 Md. 475, 49 Atl. 327 (1901), the Maryland court in James F. Powers Foundry Co. v. Miller, 166 Md. 590, 171 Atl. 842 (1934) again held that "in view of what we regard is the common understanding of the investing public, it is the opinion of this court that the sound rule is, unless otherwise provided, that the preferred stock dividends are limited to the rate prescribed by the charter of the issuing corporation and stated in the certificate." The preferred stockholders, in this case, every year received their six per cent, but the common stockholders in 1926 received a dividend of 430%, and in 1927 and 1928 received 150%.

[28] Rowell, *Rights of Preferred Shareholders in Excess of Preference* (1935) 19 MINN. L. REV. 406.

[29] The case of Lockwood v. General Abrasive Co., 201 App. Div. 141, 205 N. Y. Supp. 511 (4th Dept. 1924), *aff'd*, 240 N. Y. 592, 148 N. E. 719 (1924), is cited by STEVENS, CORPORATIONS (1936) § 107, p. 419, as sustaining the proposition that New York follows the Pennsylvania rule. In Lockwood v. General Abrasive Co. the certificate of incorporation provided that the pre-

Committee on Stock List of the New York Stock Exchange would require before listing a preferred stock that the stock disclose just what its preferences are in excess profits. To date the problem has never arisen on the New York Stock Exchange and the views of the members and traders of the Exchange cannot be ascertained.

The question may still be considered an open one.[30] The Virginia court sums up the problem by saying:

> "I do not think that either rule can be gathered from the decisions of the courts as a maxim of the law applicable to all cases. It may be that in some cases the failure to make any provision as to participating in excess dividends would naturally be construed as granting such participation, while in other cases the failure to make such provisions would be held as a denial of participation. That question must be decided in the light of all the language of the contract, giving effect to every provision in it, and construing it in the light of the circumstances in which the parties stood." [31]

SAMUEL LEVINE.

ILLUSORY ASPECT OF CORPORATE CONTRACT TO REPURCHASE STOCK.

The New York Penal Law[1] declares, "A director of a stock corporation who concurs in any vote or act of the directors of such corporation, or any of them by which it is intended * * * 5. to apply any portion of the funds of such corporation except surplus, directly or indirectly to the purchase of shares of its own stock is guilty of a misdemeanor". The Penal Law is naturally construed as permitting a corporation to purchase its own shares from surplus.[2] A majority

ferred were entitled to receive seven per cent cumulative dividends and the common stock to receive annual dividends of seven per cent, any surplus to be distributed pro rata to preferred and common. The question raised was whether the common shareholders were entitled to cumulative dividends before the two classes became entitled to participate equally. *Held,* that the contract does not so provide, citing Englander v. Osborne, 261 Pa. 366, 104 Atl. 614 (1918). But in Pennsylvania the rule had been laid down that the preferred stockholders share with the common in excess profits in the absence of any provision negativing such intent. In Lockwood v. General Abrasive Co. the certificate of incorporation expressly provided for such participation. The case merely holds, therefore, that the preferred are entitled to all arrearages (being cumulative) before the common get their annual dividend and then both classes share.

[30] 1 COOK, CORPORATIONS (6th ed.) § 269.

[31] Lyman v. Southern Ry., 149 Va. 274, 141 S. E. 240 (1928).

[1] PENAL LAW c. 40, § 664.

[2] Grasselli Chemical Co. v. Aetna Explosive Co., 258 Fed. 66 (S. D. N. Y. 1918); *In re* Fechheimer Fishel Co., 212 Fed. 357 (C. C. A. 2d, 1914); Richards v. Weiner, 207 N. Y. 59, 100 N. E. 592 (1912); Cross v. Beguelin, 252 N. Y. 262, 169 N. E. 378 (1929).