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Rights of Preferred Shareholders in Excess of Preference

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The compilers of American encyclopedias dismiss all questions relating to the distribution of profits in excess of preferences, as between preferred and common shareholders, by saying that, where no contract is found, preferred shareholders may participate equally with the common in a fund remaining for distribution after common stockholders have received a dividend equal in amount to that paid in priority to the preferred.\textsuperscript{1}

For this they cite some cases.\textsuperscript{2} The writer, however, while finding cases opposed to the encyclopedias, finds himself unable to agree either with the encyclopedias or with any of the American cases standing with them or against them.

The rights of a stockholder are contractual,\textsuperscript{8} and where clear provisions are found in the statutes, charter, by-laws, subscription contract, certificate of stock, or elsewhere, such contracts are of course controlling. However, as it will appear below,\textsuperscript{4} the courts may in some cases override what appears to be an iron-clad clause, where supposedly conflicting rights appear. Accordingly, it will be necessary to investigate the rights of the parties as determined by law, in the absence of express agreements.

It should be noted, too, that as the rights of stockholders are contractual we may not regard a certificate of stock as a single commodity bought and sold on the market. The certificate may carry voting rights; it may entitle the holder to a pro rata share in the profits earned and declared in dividends; and it may represent an aliquot share in the assets of the corporation. It may carry all these rights, or some of them, or none of them. As stock may be "preferred" in ways limited in number only by the ingenuity of business men and their lawyers, fruitful discussion of the rights of holders of this stock must therefore deal with the prob-
RIGHTS OF PREFERRED SHAREHOLDERS

lems separately, in relation to the effect of action taken by the corporation on each one of these rights.

As to the first problem—rights to cash dividends—no further distinction need be made other than restricting the question to stock preferred at least as to dividends, the express contract of which does not preclude a right to dividends in excess of the preference. Stock dividends are, however, a far more complicated matter. These must be dealt with by considering them more particularly in connection with stock preferred only as to dividends, to stock preferred both as to dividends and assets, and to stock preferred in one or both of these ways but deprived of voting rights.

I. Cash Dividends

In the absence of express contract, preferred shareholders have no right to participate in the distribution of cash dividends beyond the amount of their preference.

With this proposition we take our first leave of American precedents. The only discovered cases dealing squarely with the problem are three Pennsylvania cases directly opposed to the suggested view.

The most recent of these decisions, Englander v. Osborne, will serve to present the argument in favor of the preferred shareholder. In this case the defendant corporation, in which the plaintiff held six per cent. cumulative preferred stock, had paid no dividends on any of its stock for nine years. At the end of this lean period it proposed to pay a dividend of fifty-four per cent. to both common and preferred stockholders. The plaintiff filed his bill to restrain the payment of more than six per cent. to the common, unless the preferred were allowed to share equally with the common stockholders in the amounts available for distribution in excess of fifty-four per cent. to preferred and six per cent. to common shareholders.

His position was sustained. The court argued that stock was stock, and anything called stock which merely had an extra "frill" stock without any attendant frill. The preference consists merely of the promise on the part of the corporation to pay the preferred shareholder dividends before the payment of dividends to the common shareholder. Dewing, Financial Policy of Corporations 43.

5What Mr. Dewing calls the "simple unadorned preferred stock . . . stock without any attendant frill. The preference consists merely of the promise on the part of the corporation to pay the preferred shareholder dividends before the payment of dividends to the common shareholder." Dewing, Financial Policy of Corporations 43.


7The words of the contract were: "The holders of the preferred stock
Among these rights inherent in the nature of stock is the right to participate equally with other shareholders in the distribution of profits.\(^8\) "The priority of the preferred stockholders 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... Both classes of stockholders are entitled to share equally in the excess."\(^9\)

The opposite position is taken by the English case of *Will v. United Lankat Plantation Co.*,\(^10\) in which Farwell, L. J., states his view with engaging charm:

"I do not follow the very ingenious argument of counsel for the respondent in this respect. They treat the shares as though they were born like babies into the world, all equal; and the preference was a sort of rank which was an accidental attachment to such of them as happen to be members of the House of Lords; but, with great respect, the birth of the preference share limits in its very inception the whole of its attributes."\(^11\)

The argument of the English court fully agrees with that of the Pennsylvania cases in so far as they hold the rights of the preferred stockholder to be contractual and to be exactly those of an ordinary stockholder unless limited by contract. The reasoning diverges, however, when the English court admits the existence of an *implied* contract in addition to the *express* contract.\(^12\) The court argues: (a) it is reasonable to believe that one who is receiving a preference as to dividends is thereby promising in return to give up all right to dividends in excess of his preference; (b) it is generally so regarded by business men.\(^13\)

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\(^8\)See 14 C. J. sec. 817 and cases cited.


\(^11\)Will v. United Lankat Plantations Co., Ltd., (1912) 107 L. T. R. 360, 362. It is worth a note to mention that the reference to the House of Lords as an "accidental attachment" is omitted from the Law Report's version of Lord Justice Farwell's views.

\(^12\)The express contract in *Will v. United Lankat Plantations Co., Ltd.*, (1912) 107 L. T. R. 360, read: "... the holders thereof to be entitled to cumulative preferential dividends at the rate of ten per cent per annum... and that such preference shares rank, both as regards capital and dividend, in priority to the other shares."

\(^13\)The court relied on a statement in Palmer's Company Precedents, 11th ed., p. 814, to the effect that "It is generally assumed that where preference
One argument against this position may be dismissed with a word. It is stated in a recent law review article as follows:

"Suppose that, for the sake of discussion, we admit that this assumption is true . . . that the ordinary buyer does buy preferred stock under the belief that he will be limited to the amount of the preference. It does not follow that it is true that his right to receive dividends above the amount of the preference was lost merely because most men in his position would think it lost."^{14}

It is, of course, true that rights, once required, cannot be lost by thinking them so, but it is submitted that the question is whether a right is ever acquired when the contracting parties understood their words as negativing such a right.

The same writer offers another argument against the view here taken. Other rights inherent in the nature of "stock" are not lost, he points out, by the according of a preference as to dividends.

"... In the absence of some provision to the contrary in the contract, . . . all shareholders are owners of equal rights, in proportion to the number of shares held by each shareholder."^{15} All are equally entitled to vote in stockholders' meetings.^{16} The owner of each share is entitled to one aliquot part of assets remaining upon dissolution."^{17}

From these analogies it is concluded that the right to participate equally in surplus earnings is not taken from the preferred shareholder "in the absence of some provision to the contrary." Assuredly, but it is again submitted that the question is whether or not there is a provision to the contrary, express or implied. Surely it is far-fetched to argue an implied promise to relinquish voting rights or rights to an aliquot share of assets on dissolution, in return for a promise of preferred dividends. Such trades are manifestly unreasonable and are understood by no one to be the consequence of receiving a preferred dividend right. Trading a right to a pro rata share in all earnings in return for a prior right

\[\text{shares are given a fixed preferential dividend at a specified rate that impliedly negatives any right to take any further dividend, and probably this assumption is well founded.}\]

^{14}Jay Finley Christ, Right of Holders of Preferred Stock to Participate in the Distribution of Profits, (1929) 27 Mich. L. Rev. 731.


to a specified ratio of earnings is, however, reasonable and often done.

The choice, then, between these two views will be determined solely by whether an implied agreement to forego a chance for speculative gain is construed to result from the acceptance of an express priority in the payment of a specified dividend. The other courts will do is anybody's gamble.

The following discussion will, where necessary, deal with the problems involved from the standpoint of both positions taken with respect to the payment of cash dividends. For brevity, the view favoring the preferred shareholder will be called the "Pennsylvania rule," and that denying the holder of preferred shares further rights beyond his preference will be called the "English rule."

II. Stock Dividends

In the absence of express contract, the rule as to stock dividends is the same as the rule as to cash dividends.

This proposition is stated separately as more extended argument will be necessary to support it, although the rule is followed by every discovered case except one. The writer is unable to agree with any of these cases, and will find it necessary to supplement the rule with subsidiary corollaries needed to protect important rights of stockholders. A review and criticism of two representative cases will serve to present the problem.

18 It should be pointed out, too, that the circumstances of the issue, the objects of the agreement, whether the preference stock was issued in the normal course of business or as a "trade" for bonds during a reorganization, and so forth, may determine the decision as to the existence of an implied contract. See 1 Cook, Corporations, 8th ed., sec. 269; Scott v. Baltimore & O. R. Co., (1901) 93 Md. 475, 49 Atl. 327.

19 As indicating that the Maryland court would favor the English court's view, see Scott v. Baltimore & O. R. Co., (1901) 93 Md. 475, 49 Atl. 327, in which a certificate providing that "the holders of preferred stock... are entitled to receive in each year... such yearly dividend as the board of directors may declare, up to, but not exceeding, four per centum, before any dividends shall be set apart or paid upon the common stock" was held to be an express contract limiting the preferred to four per cent and no more. It seems clear that the words "not exceeding" could have been construed, had the court wished, as applying to the percentage preferred in time (i.e., before any amount was paid on the common) rather than to the amount payable to the preferred at any time. See also James F. Powers Foundry Co. v. Miller, (Md. 1934) 171 Atl., 842.

The first of these is *Niles v. Ludlow Valve Mfg. Co.* In that case the defendant corporation, having a capitalization of 4000 shares of cumulative preferred stock receiving annual dividends of eight per cent, and preferred also "as to capital," and 3000 shares of common stock, authorized the issue of 3000 shares of common pursuant to a vote passed at a special stockholders' meeting. Plaintiff, non-consenting owner of 100 shares of preferred, brought suit to be allowed to participate in this dividend.

He lost. The court argued substantially as has been done above in support of the "English rule" and reasoned that as "the common stockholders bear substantially all the losses of adversity" they should be "entitled to the gains of prosperity." It was apparently not seen by the court that it was awarding to the common stockholders not only the "gains of prosperity" of the past but the power to direct the achievement of that prosperity in the future. As the preferred stock carried voting rights, the 4000 shares of preferred stock could, prior to the distribution of this dividend, have controlled the company. The dividend changed the position of the preferred from that of carrying the whip hand in the ratio of four to three to that of minority standing in the ratio of two to three.

This point was evidently not raised in the case. The dissenting judge does not mention it, relying solely on the argument for the "Pennsylvania rule" outlined above.

In *Riverside and Dan River Cotton Mills v. Branch,* however, the preferred shareholder was better advised. He sued the corporation in assumpsit 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, arguing that both his voting rights and his rights to share in the assets were impaired by the issue of the stock dividend.

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21 (C.C.A. 2d Cir. 1913) 202 Fed. 143. The Niles case is followed in *Stone v. U. S. Envelope Co.,* (1920) 119 Me. 394, 111 Atl. 536, where the preferred shareholders were denied the right to subscribe to an issue of common stock on the same terms as the common shareholders. As the stock was offered at a price below its value, the common stockholders argued it was, in effect, a dividend, and that preferred shareholders had no right to subscribe. This contention was upheld. See also *Hatch v. Newark Telephone Co.,* (1930) 34 Ohio App. 361, 170 N. E. 371, in accord with the Niles Case. Cf. *Tenant v. Epstein,* (Ill. 1934) 189 N. E. 564, discussed in (1935) 19 MINNESOTA LAW REVIEW 239.

22 (1927) 147 Va. 509, 137 S. E. 620.
In spite of an express provision in the certificate limiting the preferred stock to a six per cent. dividend and no more, the plaintiff was awarded damages amounting to the market value of the shares the court held should have been issued to him.

This decision appears even more startling than that in the Niles Case. A preferred stockholder may not have a cash dividend in excess of his preference, but he may be awarded cash damages to the amount of the value of stock he should have been given—ascertained on a basis of the market value of that stock, and entirely aside from whatever value there may have been in the lost voting and capital share rights—all this on a plea that his voting and capital share rights have been impaired!

There appear to be at least three possible grounds for the result of this case, each of which it will be well to examine. The most obvious basis is that pointed out in criticism of the Niles Case above. The preferred shareholders had voting and capital rights which would be impaired by denying them a right to stock dividends. The language of the court indicates that this is the main ground for the decision.

"... A distribution of shares of stock . . . as a stock dividend to common stockholders alone, when the preferred stockholders are preferred as to dividends only, seriously affects the interest of the preferred stockholder in the corporation, affecting his voting influence and diminishing his interest in the assets of the corporation . . . The issuance of a stock dividend to the common stockholders to the exclusion of the preferred stockholders, is an impairment of the rights of the latter which entitles them to relief in equity if the stock has not been delivered, or to damages for breach of a contract obligation if it has."24

This is the interpretation put upon the case by Mr. Christ, author of the law review article referred to above, and supported as the correct view. That writer's conclusion, in brief, is that preferred stock should be entitled to participate in stock dividends, even in the 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."26

<table>
<thead>
<tr>
<th>Footnote</th>
<th>Reference</th>
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<tbody>
<tr>
<td>23</td>
<td>23rd ed. 147 Va. 509, 516-7, 137 S. E. 620, 622-23.</td>
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<td>24</td>
<td>(1927) 147 Va. 509, 516-7, 137 S. E. 620, 622-23.</td>
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<tr>
<td>25</td>
<td>(1927) 147 Va. 509, 516-7, 137 S. E. 620, 622-23.</td>
</tr>
<tr>
<td>26</td>
<td>Christ, Right of Holders of Preferred Stock to Participate in the Distribution of Profits, (1929) 27 Mich. L. Rev. 731.</td>
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23"... Said stock shall not entitle the holder thereof to receive out of the profits of the Company, any greater or other dividend than said six per cent annually."

24(1927) 147 Va. 509, 516-7, 137 S. E. 620, 622-23.


26Christ, Right of Holders of Preferred Stock to Participate in the
It seems difficult to find support in the law of contracts for such a view. Since the rights of a stockholder in these matters are contractual, the terms of that contract must be ascertained as of the time of its execution, and may not be varied thereafter. The suggested position, however, will alter the contract in the oscillating light of ensuing events. Where the issue of the dividend would shift the "equilibrium of voting power," the preferred shareholder may have his dividend; where the dividend is of a lesser amount, no right to it will be given to the preferred stockholder.

There are two ways out of this difficulty. One is to regard the "equilibrium" disturbed as that between individual holders of stock and hence come frankly to the result that any stock dividend, however small, must be divided with the preferred shareholders. The contract will then never vary, but will be construed as allowing cash dividends exclusively to common stockholders but requiring the division with preferred shareholders of stock dividends. This "way out" will be examined later in connection with a second possible ground for the Riverside Mills Case. 27

The second way possible is that apparently taken by Mr. Christ. He restricts the meaning of "disturb the equilibrium of voting power" to a disturbance, not between some individual holder and another, but to a transfer of controlling power from the preferred stockholders as a group to the common stockholders as a group. 28 This position is scarcely less difficult, for to get around the objection as to varying the terms of the contract in the light of later events we must interpret the express provision that "the preferred stock is entitled to a preferred dividend of N per cent. and no more" as impliedly meaning, further, "except that when the paying of a stock dividend to the common stock will shift the voting control of the corporation from the preferred shareholders as a class to the common shareholders as a class, the preferred stock shall be entitled to share pro rata with the common in this dividend."

Mr. Christ found himself unable to view with any favor the implied contract supported by the English courts in cases involving

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27Infra, p. 414.
28Christ, Right of Holders of Preferred Stock to Participate in the Distribution of Profits, (1929) 27 Mich. L. Rev. 731, 745. "... If the common shares are more numerous, its majority is increased [by a dividend shared by both]; if the preferred shares are more numerous, they must outnumber the common shares more than two-to-one [if the preferred is non-voting] in order that the distribution of a 100 per cent stock dividend be capable of shifting the control from the common to the preferred."
cash dividends. Here the common stockholders are by express contract entitled to the whole of any dividend paid beyond that allotted in priority to the preference shares. Shall we say that they have impliedly agreed to relinquish that right in the event the distribution of a dividend to them will carry with it the added boon of voting control of the corporation? The question seems to carry its own answer.

A second ground to support the result of the *Riverside Mills Case* was suggested above by noting the practical result of one meaning of "disturb the equilibrium of voting power." That is that an express contract denying a right to "dividends" in excess of the preference does not extend to a denial of rights to a "stock dividend." Some language of the court would seem to support this interpretation.

"The object and purpose of the limitation was to prevent the holders of preferred stock from receiving a dividend in excess of six per cent. upon preferred stock, and not to preclude them from becoming holders of common stock, or from receiving a dividend on common stock which other holders of common stock might receive."\(^2\)

Under this view of the case the result would seem to be the same if the preferred stock were preferred both as to dividends and assets and deprived of voting rights. In such a case no impairment of the rights of preferred shareholders would result from the stock dividend, and the policy of protecting such rights would not enter in.

The argument, in brief, is that something is said in the contract about "dividends," but nothing is said about "stock dividends." Therefore, there being no express contract to alter the original equality of all stock, every share, preferred and common alike, may have stock dividends equally.\(^3\) The reasoning would possibly be the same where no contract is expressly provided, if we follow the "English rule," and that of the *Niles Case*, that the preferred shareholder has no rights in the surplus even in the absence of an express agreement. Is it valid? Or does the express agreement as to "dividends" entail an agreement as to

\(^2\)Language in Branch v. Riverside Mills, (1924) 139 Va. 291, 303, 123 S. E. 542, 545, infra, p. 415, quoted with approval in the principal case.

\(^3\)Mathematics applied to the facts of the case indicate that a startling inequality may be the result of this quest for equality. The corporation's capitalization was 60,000 shares of common and 75,000 shares of preferred. 15,000 dividend shares were issued to common stockholders, each of these shares being valued by the jury at $200. Assuming all preferred stockholders
“stock dividends?” And does the implied agreement as to “dividends” extend to “stock dividends?”

It seems to the writer that the only answer to both questions is in the affirmative. Business men do not indulge in such refined thinking. Stock dividends are not such uncommon occurrences as not to come within the average man’s conception of “dividend.” They should, therefore, be included in an agreement, express or implied, to forego any rights to dividends in excess of an expressed preference.

A third ground of possible support for the *Riverside Mills Case* is that in Virginia stockholders still have preemptive rights. The preferred stockholder has no right to a dividend, but when that dividend is in the form of stock, the issue of which will dilute his interest in the corporation, the stockholder’s preemptive right may enter in and overbalance the denial of dividends beyond an expressed preference.

There is also language in the decision to lend color to this third suggested basis. The case purports to follow a previous decision involving the same parties, which accorded the preferred stockholders a right to subscribe to a new issue of common stock on the same terms as those offered to common stockholders, and quotes with approval from that case:

should assert their rights, we may construct the following table on the value in dollars to each class resulting from the transaction:

<table>
<thead>
<tr>
<th>No. of Shares</th>
<th>Dividend</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common</td>
<td>60,000</td>
<td>15,000</td>
</tr>
<tr>
<td>Preferred</td>
<td>75,000</td>
<td>Equiv. of 8,333 shares</td>
</tr>
</tbody>
</table>

Assuming, further, that damages paid by the corporation will be paid by all stockholders ratably, we may subtract one-half of the damages from the preferred value and one-half from the common (including the dividend shares), leaving:

<table>
<thead>
<tr>
<th>Class</th>
<th>Value from Transaction</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common</td>
<td>$2,166,667</td>
</tr>
<tr>
<td>Preferred</td>
<td>833,333</td>
</tr>
</tbody>
</table>

**Total** .......................... $3,000,000

The net result is apparently that the common stockholders have been forced to disgorge $833,333 of their dividends to the preferred. They have a good deal left.

Mr. Dewing points out that stock dividends were issued as early as 1670 by the East India Company, and that the New York Central declared a stock dividend in 1869. It is true, however, that such dividends did not come into their present general use until after the World War. Dewing, *Financial Policy of Corporations*, 566.

Branch v. *Riverside & Dan River Mills*, (1924) 139 Va. 291, 123 S. E. 542. Statutes in several states either abolish preemptive rights or allow the corporation to abolish them by appropriate provisions in the charter. See infra, p. 423, note 55.

"It is clear that the preference does not deprive the preferred stockholder of his preemptive right to subscribe to his pro rata share of the new issue of stock."34

Shortly following this quotation, the court avers that "the principles upon which that case was decided . . . are applicable to the case at bar."35 The conclusion of the court that the same principles cover both cases is, it is submitted, correct. But does it follow that both cases were decided correctly? The burden of the present discussion is to argue that they were not; that preferred stockholders should not be given a preemptive right when giving them that right will result in giving them a dividend to which they are not by their contract entitled.36

This view, as applied to holders of stock preferred as to assets and having no further rights in assets beyond the preference ("non-participating" shares), is supported by Mr. Morawetz in an article in the Harvard Law Review. He writes:

"To give to the non-participating shareholder a share dividend or a right to take additional shares at a price below their actual value would be, in effect, to give them an extra dividend out of surplus to which they are not entitled, and this extra dividend would be at the expense of the holders of the common and participating shares. . . . If non-participating shareholders have any preemptive right in case of the issue of additional shares, it can be only a right to take a proportionate part of the additional shares upon payment of their actual value. . . . If shares can be bought and sold freely in the market, their value is their market price."37

The case of "participating" shareholders, who are preferred only as to dividends and hence have equal rights with the common in the assets on dissolution, Mr. Morawetz says is considerably different. In their case the issue of new stock is a dilution of their capital interests, and they must be protected.38 The argument may be best presented by an example.

A corporation has issued 1000 shares of stock preferred as to dividends, but not as to assets, and 1000 shares of common, both at $100 a share. Its total capital comes, then, to $200,000.

34(1924) 139 Va. 291, 303, 123 S. E. 542, 545.
36Issuing stock to shareholders at less than its market value is equivalent to declaring them a dividend in the amount less than the market value. Stone v. U. S. Envelope Co., (1920) 119 Me. 394, 111 Atl. 536.
In time it collects a surplus of $100,000. At this stage the "book value" of every share of stock, preferred and common, has risen to $150 a share because of this surplus and the shareholders' equal rights to it. A stock dividend of 1000 common shares is declared to common stockholders. As a result of this transaction the number of shares has been raised to 3000, the capital to $300,000, and the book value of each share is now $100. The common stockholders each have a total value of $200 where before they had only $150. Clearly the preferred stockholders have been robbed of $50 a share by the dividend.

But is it clear? One thing should be pointed out—that the value of a right to participate in assets on dissolution, taken alone, is much overrated. It does not in fact add to the market value of a security appreciably unless the increased book value is reflected either in greater safety or in higher dividends. The preferred stock we are dealing with here is amply safe, with a large surplus behind it. And the dividend stays the same, no matter how high the book value may go. The market value cannot go up as does that of common stock with an increase in book value. The market value of safe preferred stock remains constant at a figure set by capitalization of the annual dividend rate. This being so, the preferred stockholder has merely been "robbed" of a value he had not, and on which as a practical matter he may never realize. For this loss we are going to compensate him by giving him a valuable, salable right to which he would not otherwise be entitled. It seems to the writer that this is too much of a good thing.

In sum, it is the contention of this paper that the giving of a share in a stock dividend is a "windfall" to the holder of preference shares which goes far beyond what is necessary for the protection of his voting and capital interests. It may be granted that these rights should be protected. It will be the purpose of the balance of this paper to suggest how they may be protected without over-protecting them to the detriment of the rights of common shareholders.

39Holders of shares preferred only as to dividends have equal rights with the common in surplus earnings not declared in dividends. Continental Co. v. United States, (1922) 259 U. S. 156, 42 Sup. Ct. 540, 66 L. Ed. 871.
40The claims of creditors and costs of winding-up usually exhaust the assets. Dewing, Financial Policy of Corporations, 49, 50.
III

The owner of stock preferred only as to dividends may enjoin the issue of dividend stock to common shareholders on a showing of injury to his power of control, or to his capital interest.

By stock preferred only as to dividends is meant a stock which is in all other respects equal in rights with common stock. Holders of such stock have voting rights and rights in the assets of the corporation similar to those of common shareholders.

This being true, it follows that these interests must be protected by the directors in their management of the corporation and that any discrimination against one class of shareholders in favor of another would be a breach of the directors' fiduciary duties. A preferred stockholder who can show that a proposed stock dividend to common shares exclusively will damage either his voting influence or his capital interests to an amount requiring relief should be able to require the dividend to be declared in non-voting stock if only the plaintiff's voting influence is being threatened, or in cash, if injury to his capital interest is shown.

Two queries in all probability immediately come to mind at the statement of this proposition.

(a) If the preferred stockholder is not injured enough by the issue to grant him a preemptive right, how may we find injury enough to ground a right to an injunction?

The answer to this is two-fold. In the first place, it was not contended above that no preemptive right should be given the preferred stockholder, but only that a preemptive right at a price below the actual value of the stock should not be given. Accordingly, if the preferred is given, and satisfied with, a preemptive right to buy his share of the dividend stock at its actual value, no injunction against the issue of the dividend should be granted.

But, second, the preferred shareholder may not be satisfied

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1. "It is the duty of directors as fiduciary agents . . . to exercise a power to issue additional shares, as well as all their other powers, in good faith for the benefit of the shareholders who constitute the corporation. If there are different classes of shares, this power must be exercised with impartial regard for the rights and interests of the shareholders of each class . . . . It is a breach of duty on the part of directors to issue additional shares or to sell treasury shares, not to benefit the shareholders, but to benefit themselves, or to enable particular shareholders or others to acquire voting control of the corporation." Morawetz, (1928) 42 Harv. L. Rev. 186, 188. See also Borg v. International Silver Co., (C.C.A. 2d Cir. 1925) 11 F. (2d) 147, 151-2.

2. If the plaintiff delays until after the stock is issued, he should be awarded damages representing the value of the voting or capital rights lost.
with such a preemptive right. And his dissatisfaction is well founded if the injury he complains of is dilution of his capital interest. Such an interest may not be given away, but must be preserved regardless of the stockholder's financial ability to make new purchases of stock. It is believed, therefore, that the issue of stock for no fresh contribution to capital should be subject to an injunction on the complaint of the preferred stockholder.

(b) If the dividend could be declared in cash to the common stockholders exclusively, why may not stock certificates representing that cash be so issued?

This argument points out that the right of the preferred to participate in surplus on dissolution may always be given a barren field on which to operate, by simply declaring that surplus out in cash dividends before the wind-up or reorganization. Why then, it may be asked, may the right not be diluted to nothing by putting more shares in competition with it?

Aside from the fact that this reasoning completely ignores practical considerations in the way of declaring a surplus all out in dividends, it must be seen that the declaration of a stock dividend is a direct invasion of the right, while a cash dividend merely makes the right of no value. The right is to share pro rata in surplus assets, if any, without further competition with shareholders who did not contribute their share of those assets by paying full value for their stock. A cash dividend has no effect on this right, although it may remove the fund on which the right can operate. A stock dividend, on the other hand, emasculates the right.

The Riverside Mills Case dealt with the type of stock considered here—that preferred only as to dividends. It is submitted,

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48This would seem to follow from the fiduciary relation between shareholder and director, where the preemptive right is limited, as the writer contends it should be, to a right to buy only at actual value. Financial inability to take up shares cannot be pleaded where the stock was offered to stockholders at less than its value, as the rights could have been sold and the value of the dilution of assets thus recovered. Upton v. So. Produce Co., (1926) 147 Va. 937, 133 S. E. 576.

44Common stockholders may enjoin the issue of common stock below its actual value to holders of stock preferred as to dividends and assets, on the ground that the interest of the common stockholders in surplus will be diluted by the issue. Borg v. International Silver Co., (D.C. N.Y. 1924) 2 F. (2d) 910. A sale to the highest bidder is unobjectionable if bona fide. Borg v. International Silver Co., (C.C.A. 2d Cir. 1925) 11 F. (2d) 147.

46It furthermore ignores the possibility that a reorganization price may be inflated by expectation of future earnings. See Hatch v. Newark Telephone Co., (1930) 34 Ohio App. 361, 170 N. E. 371.
in conclusion, that the case is correct as to its analysis of the problems involved but mistaken in the solution found for them.

IV

The owner of stock preferred both as to dividends and assets may, on a showing of injury to his power of control, enjoin the issue of voting dividend stock, or, in the alternative, demand a right to share in the dividend by paying actual value.

By stock preferred both as to dividends and assets is meant stock which still retains one right equally with the common—the right to vote.\(^4\) A distribution of stock as a dividend exclusively to common shareholders cannot be objected to by the holder of such preferred stock on the ground that his capital interest is being impaired. It is, rather, being strengthened, as what was before surplus and capable of being distributed in cash has now become capital, to add to the security of the preferred stockholder.

The preferred shareholder's voting rights can, however, be injured by such a dividend. He should be given a right to enjoin the issue of any but non-voting stock, or cash. The Niles Case\(^7\) dealt with stock of this type and refused relief to the preferred stockholder. A case offering a solution more nearly that proposed here is Russell v. American Gas and Electric Co.,\(^8\) in which a holder of stock preferred both as to dividends and assets brought a bill to enjoin the issue to common stockholders, at par of $50, of common stock worth $80, unless preferred stockholders were

\(^4\) In England, strangely enough, another right is retained. While the English courts hold that the giving of a preference as to dividends impliedly negatives any right to dividends in excess of the preference, they hold nevertheless that the giving of a preference as to assets does not preclude the preferred shareholder from sharing ratably in any surplus assets remaining after the common shareholder has been paid the amount of his capital contribution (paid up or promised). Re John Dry Steam Tugs, Ltd., [1932] 1 Ch. 594, 101 L. J. Ch. 271, 147 L. T. 493; Anglo-French Music Co., Ltd. v. Nicoll, [1921] 1 Ch. 386, 90 L. J. Ch. 183; In re Fraser and Chalmers, Ltd., [1919] 2 Ch. 114, 88 L. J. Ch. 343, 121 L. T. 232; In re Espuela Land and Cattle Co., [1909] 2 Ch. 187, 78 L. J. Ch. 729, 101 L. T. 13. Decisions in the United States are to the contrary. Murphy v. Richardson Dry Goods Co., (1930) 326 Mo. 1, 31 S. W. (2d) 72; Hatch v. Newark Tel. Co., (1930) 152 App. Div. 136, 220 N. Y. S. 532. The rights of such a stockholder should be held to be similar to those of holders of participating stock, if the English view is taken—for the stock is participating after the common has been made equal.


given a chance to subscribe on the same terms. The plaintiff based his bill on a plea that his “interest” in the corporation would be decreased. As the only “interest” possible of dilution by the issue was a voting interest, we may infer that the preferred stock carried voting rights.

The bill was dismissed, subject to the condition that the plaintiff be given a right to subscribe to preferred stock, par $50, value at $47, to preserve his “interest.” The proviso was a sorry one for the hopeful plaintiff to swallow, but the case at least shows an attempt to search for a manner of protecting voting rights of preferred stockholders without giving them a “windfall” dividend.

The case illustrates, too, the other remedy besides an injunction for the holder of this class of stock—a preemptive right to buy stock at its actual value. The right should apply as well to the new stock as to other stock.\(^4^9\) Furthermore, the owner of such stock must be satisfied with this remedy if it is offered, for the preservation of voting control is subject always to the shareholder’s financial ability to keep his pro rata share in the enterprise. More than this, it must be admitted that in the case of stock preferred as to assets as well as to dividends—and thus under the American cases precluded from further sharing in the assets\(^5^0\)—no objection can be taken to the issue of stock directly to common shareholders for no fresh contribution, provided a preemptive right to buy at actual value is given. As the corporation might have declared a cash dividend, and then credited that cash dividend toward the purchase of new stock, it may do this in shorter fashion by transferring that surplus to capital and issuing stock representing the funds transferred to the common shareholders for no new cash. The preferred stockholders had no right to that surplus.\(^5^1\) They can merely insist on a right to subscribe to the new stock on the same terms as it is issued to any one else.\(^5^2\)

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49 See quotation from Morawetz, supra, p. 416.
50 See cases cited supra note 46.
51 The same cannot be said of stock preferred only as to dividends. The holders of such stock have equal rights to a surplus not declared in dividends. Continental Co. v. United States, (1922) 259 U. S. 156, 42 Sup. Ct. 540, 66 L. Ed. 871.
which in this case would mean paying in cash from their own pockets an amount equal to that paid in cash by the common stockholders out of their "pocket" in the custody of the corporation.

This may be illustrated from the facts of the *Niles Case*. The Ludlow Mfg. Co. had outstanding, it will be remembered, 4,000 shares of preferred stock and 3,000 shares of common stock—both issued at pars of $100. The corporation had accumulated a surplus of $500,000. Table I represents the capital set-up before the stock dividend of 3,000 shares of common was declared.

<table>
<thead>
<tr>
<th>Table I</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares</td>
<td>Total</td>
<td>Value per Share</td>
</tr>
<tr>
<td>Pfd. — 4000</td>
<td>$400,000</td>
<td>$100</td>
</tr>
<tr>
<td>Com. — 3000</td>
<td>$300,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$500,000 (surplus)</td>
<td>$266.66</td>
</tr>
</tbody>
</table>

As the common stockholders are to pay no new value for their shares, a little figuring indicates the proper issue price of the new stock as $186.66. Table II shows the result of the issue, assuming that a preemptive right is given the preferred shareholders at $186.66 a share, and that all the stock is bought by the shareholders.

<table>
<thead>
<tr>
<th>Table II</th>
<th></th>
<th>Value per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Shares</td>
<td>Total Value</td>
<td></td>
</tr>
<tr>
<td>Orig. Com. ....... 3000</td>
<td>$300,000 (orig. cap.)</td>
<td></td>
</tr>
<tr>
<td>Bought by pfd..... 1714.3</td>
<td>$320,000 (cash by Pfd.)</td>
<td></td>
</tr>
<tr>
<td>Bought by Com... 1285.7</td>
<td>$239,988 (out of surplus by com.)</td>
<td></td>
</tr>
<tr>
<td>Total Com........ 6000</td>
<td>$859,988 (new cap.)</td>
<td>$186.66</td>
</tr>
<tr>
<td></td>
<td>$260,012 (remaining surplus)</td>
<td></td>
</tr>
<tr>
<td></td>
<td>$1,120,000</td>
<td></td>
</tr>
</tbody>
</table>

This table shows that the preferred shareholders have spent $320,000 in order to retain their position in voting control—an expense of $80.00 to each share of preferred. Common shareholders have likewise spent $80.00 per share out of the surplus fund. Each shareholder, preferred and common, has purchased .429—of a share.

Under the actual facts of the *Niles Case*, however, the entire issue of stock went to the common shareholders. The court reasoned that, as a cash dividend could have been declared, no objection could be made to the issue of stock certificates representing that
 rights of preferred shareholders

... Utterly forgotten was the fact that each certificate also represented a voting right, in addition to a share in the assets.

Had the corporation been a large one with shares easily obtainable on the market, perhaps no objection can be found to the result of the case. In view of the difficulty of purchasing shares in small corporations at their actual value, and of wholesale purchase of shares in large corporations, it is submitted that the preferred shareholders in the Niles Case should have been given a preemptive right, or, in the alternative, an injunction against the issue of voting stock.

The remedy of injunction is rendered all the more necessary at the present time, as new state legislation is tending either to abolish preemptive rights or to allow the corporation to abolish them by appropriate provisions in the charter. Furthermore, it is clear that the same objections to allowing preemptive rights in general do not militate against allowing them in these cases, or against allowing an injunction. Corporations which properly issue stock dividends are not under a financial pressure forcing them to procure new capital speedily, without the bother of submitting rights to shareholders in advance. Also it must be noticed that

In the Niles Case the $50,000 accumulated by the defendant prior to the time the stock dividend was declared. If the common stockholders were entitled to have the amount distributed to them as cash, they were clearly entitled to certificates of stock representing that cash. (C.C.A. 2nd Cir. 1913) 202 Fed. 141, 142-3.

Although it can readily be seen what price the preferred shareholders would have had to pay on the market, had they all desired to buy.

Unless otherwise provided in the articles, the board of directors may issue shares, option rights, or securities having conversion or option rights, without first offering the same to shareholders of any class or classes. See also Indiana, Burns' Ann. Stats. (Burns' 1929 Supp.) Sec. 4827 (i), and Illinois, Rev. Stats. (Cahill, 1933) Bus. Corp. Act, Ch. 32, Sec. 24; Minnesota Business Corporation Act, Minn. Laws 1933, ch. 300, Sec. 31 (i), discussed in Hoshour, The Minnesota Business Corporation Act, (1933) 17 Minnesota Law Review 689, 698.

Practical considerations of marketing securities have led many to regard the judge-made necessity of submitting issues to the procrastinating option of shareholders as more trouble than the right is worth. See, e.g., Drinker, The Preemptive Right of Shareholders, (1930) 43 Harv. L. Rev. 586. See also Berle and Means, Modern Corporation and Private Property, 146, 176-179, 258, 259.

The stock dividend should not be declared, even when the invested profit and loss surplus is ample, if the credit position is not fundamentally sound. The declaration of a stock dividend implies that the stockholder's capital has been invested in the business, and that it would be unwise to withdraw this capital. The company should not, therefore, represent that it has capital to divide in the form of a stock dividend, if it seeks to secure at the same time more capital from outside sources. Dewing, Financial Policy of Corporations, 568.
a corporation issuing stock dividends has seen fit to accord a preemptive right of the surest kind to one class of its shareholders. Equal treatment requires that the same rights be given to all classes.

V

The owner of common stock, in a "Pennsylvania Rule" jurisdiction, may enjoin the issue of voting stock as a dividend to holders of preferred stock without voting rights.

Heretofore we have been solicitous of the rights of the preferred stockholder. Now we come to a situation in which the common stockholder has a grievance. The owner of stock preferred both as to dividends and assets (and with no further participation rights), but deprived of voting power, has no grounds for objection to a dividend declared to the common shareholders exclusively. None of his rights will be touched.

The common stockholder, however, in a jurisdiction giving such a preferred stockholder a right to stock dividends, is in a position to object. His voting interest in the corporation is being given away with the dividend to the preferred stockholder. Suppose, for example, a corporation having 100 shares of preferred and 100 shares of common, which shares sold for $100. The corporation starts, then, with a capital of $20,000. Upon the accumulation of a surplus of $10,000 it proposes to issue a dividend of 100 shares of common stock pro rata to the preferred and common shareholders. As a result of the dividend, one who owned fifty shares of common stock and who thus had fifty per cent. of the voting control would come out with seventy-five out of 200 shares of common stock—or 37.5 per cent. of the voting control.

It has been held in Pennsylvania that holders of preferred stock having voting rights are entitled to a dividend of common stock in excess of their expressed preference, after the common shareholders have received a dividend equal to the preferred dividend.58

Mr. Christ, in the law review article referred to above,59 suggests that if the preferred stock had not had voting rights it should not be entitled to a stock dividend which would "shift the equilibrium of control" from the common stockholders as a class.

to the preferred stockholders as a class. It is the position of this paper that a more equitable solution, in view of the objections taken here to Mr. Christ's argument, would be to give the common shareholders a right to enjoin the issue of the dividend, unless the stock were made non-voting, or unless the dividend were declared to the preferred shareholders in cash.