The Right to Accrued Cumulative Preferred Dividends

INTRODUCTION

One writer stated over twenty years ago that "few branches of corporation law are in a more confused and unsatisfactory state than that relating to the right of minority stockholders to prevent amendments to the corporate charter, to which they have not given their assent, from being operative."[1] Unfortunately, the statement is still *apropos* today.

An Ohio corporation lawyer recently remarked that Ohio law was in such an uncertain condition that he suggests the capitalization of new corporations, which he represents, make no provision for preferred stock. This type of action makes a discussion of the general situation a timely one.

The historical and background material will be taken up in the following subdivisions:

1. impairment of contracts,
2. reserved power,
3. restrictions on reserved power,
4. illusory concept of "vested rights,"
5. "good faith" and "fairness" tests,
6. effect of policy;

and then a survey of Ohio law will conclude the article.

IMPAIRMENT OF CONTRACTS

The Constitution of the United States declares that "no state shall . . . pass any Law impairing the obligation of Contracts."[2] The guiding light for construction of this clause is, and has been for 130 years, *Trustees of Dartmouth College v. Woodward,* where it was held that when the legislature of a state grants a charter to a private corporation, the charter involves a contract between the state and the corporation. Marshall, C.J., stated in his opinion:[3]

> It is more than possible, that the preservation of rights of this description was not particularly in the view of the framers of the Constitution, when the clause under consideration was introduced into that instrument. It is probable, that interferences of more frequent occurrence, to which the temptation was stronger, and of which the mischief was

[1] Dodd, *Dissenting Stockholders and Amendments to Corporate Charters,* 75 U. OF PA. L. REV. 585 (1927).

[2] ART. I, §10.

[3] 4 Wheat. 518, 643 (U.S. 1819).

> more extensive, constituted the great motive for imposing this restriction on the state legislatures. But although a particular and a rare case may not, in itself, be of sufficient magnitude to induce a rule, yet it must be governed by the rule, when established, unless some plain and strong reason for excluding it can be given.

Since this well articulated opinion, no court has questioned the application of the contract clause to corporate charters, except as affected by the reserved power.

A similar provision appears in the Constitution of the State of Ohio which declares: "the General Assembly shall have no power to pass retroactive laws, or laws impairing the obligation of contracts; . . ."[4]

It has been said that a corporation charter is, in addition to a contract between the state and the corporation,[5] also, a contract between the corporation and the stockholders, and one between the stockholders themselves.[6] The Ohio courts have adopted the relationship between the corporation and the stockholders, and, as other courts have done, refined the concept to include stock certificates.[7] Needless to say, the stock certificate merely reiterates what is already defined in the corporate charter. This contract relationship is a complex one and nice problems have arisen therefrom as to how far the majority and/or management can coerce dissenting minority stockholders to submit to changes in their rights and liabilities under this contract.[8]

RESERVED POWER

Story, J., stated in the *Dartmouth College* case:[9]

> When a private eleemosynary corporation is thus created, by the charter of the crown, it is subject to no other control on the part of the crown, than what is expressly or implicitly reserved by the charter itself. Unless a power be reserved for this purpose, the crown cannot, in virtue of its prerogative, without the consent of the corporation, alter or amend the charter, or divest the corporation of any of its franchises, or add to them, or add to, or diminish, the number of trustees, or remove any of the members, or change or control

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[4] ART. II, §28.

[5] Note 3, *supra*; 2 MORAWETZ, CORPORATIONS §§1045, 1050, 1054, 1062 (2d ed. 1886).

[6] Morris v. Amer. Pub. Util. Co., 14 Del. Ch. 136, 122 Atl. 696 (1923); Graeser v. Phoenix Finance Co., 218 Iowa 112, 254 N.W. 859 (1934); 2 MORAWETZ, CORPORATIONS §§1047, 1059, 1064 (2d ed. 1886); 1 FLETCHER, CORPORATIONS §164 (1931); 13 AM. JUR., CORP., §§73, 76, 77 (1938).

[7] Geiger v. Seeding Mach. Co., 124 Ohio St. 222, 177 N.E. 594 (1931); Harbine v. Dayton Malleable Iron Co., 14 Ohio Op. 276, 22 N.E. 2d 281 (1939); Knight v. Shutz, 141 Ohio St. 267, 47 N.E. 2d 886 (1943).

[8] BALLANTINE ON CORPORATIONS §274 (1946).

[9] 4 Wheat. 518, 674 (U.S. 1819).

> the administration of the charity, or compel the corporation to receive a new charter.

It was not long after this until almost all the states had made provision for the reserved power either by inserting changes into their constitutions or by passing an appropriate statute. The Constitution of the State of Ohio declares, "Corporations may be formed under general laws; but all such laws may, from time to time, be altered or repealed."[10] The general incorporation laws now enacted in almost all the states contain such a reservation *to make clear* the retention of legislative control over corporations.[11] In 1927, when Ohio adopted a corporation act, Section 8623–14, Ohio General Code, declared:

> A corporation for profit organized under the provisions of this act or of any previous corporation act of this state may alter or add to its articles or change issued shares in any respect by the adoption of an amendment in the manner hereinafter provided in this act; . . .

In a state, such as Ohio, in which existing corporations are subject to the reserved power to amend, a new statute or even a comprehensive new corporation code may be made to apply to all those corporations then existing as well as to those thereafter to be formed.[12]

Restrictions on Reserved Power

The power reserved to the legislature to alter or amend the corporate charter is not without limitations or restrictions. However, the limits do not seem capable of any precise or intelligible definition.[13] The reservation does not permit the legislature to deprive a corporation, or its stockholders, or its creditors of rights of contract or property without due process of law.[14] Corporations and stockholders are entitled to protection of their "vested rights" under the due process and equal protection clauses, and to other rights guaranteed by state and federal constitutions.[15]

The reserved power is held to enter into and form an integral part of the "charter contract" of any corporation formed subsequent to the reservation—constitutional or legislative. The more

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[10] Art. XIII §2.

[11] *But see* as to Louisiona, 3 La. L. Rev. 481 (1941), 9 Tulane L. Rev. 292 (1934).

[12] Ohio Gen. Code §§130, 135 (1946); 131 A.L.R. 725, 734; 1 Davies, Ohio Corporation Laws 1152, 1160 (1942), 4 U. of Cin. L. Rev. 129, 150 (1930).

[13] Phillips Petroleum Co. v. Jenkins, 297 U.S. 629 (1935); 75 U. of Pa. L. Rev. 585, 729, 737 (1927), 7 Fletcher, Corporations §§3679–3688 (1931).

[14] Superior Water, Light & Power Co. v. Superior, 263 U.S. 125, 137 (1923); *In re* Mt. Sinai Hospital, 250 N.Y. 103, 164 N.E. 871 (1929); 7 Fletcher, Corporations §§3681, 3688 (1931).

[15] 57 Harv. L. Rev. 852, 872, 890 (1944); 31 Col. L. Rev. 1163 (1931); 13 Geo. Wash. L. Rev. 372 (1945).

widely accepted, but not necessarily better, view extends to: (1) the power to make mandatory changes by amendment of the corporation laws, and, (2), to permissive changes authorized to be made by a specific majority of the stockholders in accordance with a statute enacted after the formation of the corporation, and after the contract between the corporation and its stockholders was made, even if a particular class of shares must suffer to a material extent.[16] In a few states, such as Utah and Idaho, a strict view reserves the power to the state to make changes only in the public interest and does not authorize permissive amendments changing the contract rights of the stockholders among themselves.[17] Had Ohio and other jurisdictions adopted this interpretation at the beginning, the litigation would have been reduced considerably, but this same litigation makes it, for all intents and purposes, impossible to revert to that point.

ILLUSORY CONCEPT OF "VESTED RIGHTS"

Once a court decides a certain contractual right is a "vested right," then the legislature in the exercise of its reserved power cannot authorize changes by amendment.[18]

Some of the rights which frequently have been supposed to be vested[19] and so to be immune from the power of amendment are the following: (1), the right to arrears of accrued dividends on cumulative preferred shares; (2), the right to vote for the election of directors; (3), the right to have stock remain noncallable; (4), compulsory redemption rights to resell shares at the option of the holder; (5), pre-emptive rights to subscribe for new issues of shares; and (6), sinking fund provisions for the accumulation of a fund for the retirement of preferred stock.[20]

Voting rights are generally no longer within the realm of sanctity.[21] Thus, a majority of the stockholders may be authorized to

[16] Looker v. Maynard, 179 U.S. 46 (1900); Goldman v. Postal Tel. Inc., 52 F. Supp. 763 (Del. 1943); Davis v. Louisville Gas & Elec. Co., 16 Del. Ch. 157, 142 Atl. 624 (1928).

[17] Garey v. St. Joe Mining Co., 32 Utah 497, 91 Pac. 369 (1907); Frost & Co. v. Coeur d'Alene Mines Corp., 60 Id. 491, 92 P. 2d 1057, 1061, 1063 (1939); 32 MICH. L. REV. 743, 771, 772 (1934).

[18] Wheatley v. Root, 147 Ohio St. 127, 69 N.E. 2d 187 (1946); Lonsdale Securities Corp. v. Int'l Mercantile Marine Co., 101 N.J. Eq. 554, 139 Atl. 50 (1927); Craddock-Terry Co. v. Powell, 181 Va. 417, 25 S.E. 2d 363 (1943); 31 COL. L. REV. 1163, 1168 (1931); 44 MICH. L. REV. 659 (1945); FLETCHER, CORPORATIONS §§3696, 3697 (1931).

[19] The list is not necessarily to be considered complete in all jurisdications today but is merely descriptive.

[20] BALLANTINE ON CORPORATIONS §277 (1946).

[21] Lord v. Equitable Life Assur. Soc., 194 N.Y. 212, 87 N.E. 443 (1909); Lowenthal v. Rubber Reclaiming Co., 52 N.J. Eq. 440, 28 Atl. 454 (1894).

restrict, create, or endanger the voting rights of certain classes of stockholders.[22] Amendments changing the name or place of business of a corporation have invariably been sustained.[23] There is a diversity of opinion as to whether a sale of all the assets can be authorized by an amendment of the charter under the reserved power.[24]

Almost all courts are in accord on the proposition that a holder of stock, upon which a cumulative dividend has accrued and which remains unpaid, has a vested interest or present property right, which may not be extinguished by amendment, in an *existing surplus* which might be lawfully applied to the payment of such accrual to the extent of the arrears upon his stock.[25]

The court in *Roberts v. Roberts-Wickes Co.*[26] made one of the first pronouncements on this subject when it stated:

> The stock corporation law . . . authorized the reduction to be made; but that statute and the proceedings under it could not affect any vested right nor impair the force of any corporate obligation. Nor was it intended to accomplish any such thing; or anything more than to authorize the holders of a majority of the stock, when the circumstances seemed to them to justify it, to increase, or to reduce, the amount of the capital stock. . . . Its agreement to pay dividends on the preferred stock had not been fulfilled, and, so long as the corporation was a going concern, *this default created an indebtedness*, which was payable whenever, in the future, it should accumulate surplus profits from the conduct of the business. The preferred stockholder, as the result of the reduction of the capital stock, would hold a less number of shares; but they would still be *creditors* for the arrears of dividends due by the company on the shares of preferred stock, which they had previously held. They may not have

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[22] Morris v. Amer. Pub. Util. Co., 14 Del. Ch. 136, 122 Atl. 696 (1923); Topkis v. Del. Hardware Co., 23 Del. Ch. 125, 2 A. 2d 114 (1938); 54 HARV. L. REV. 1368, 1372 (1941).

[23] Clark v. Monongahela Nav. Co., 10 Watts 364 (Pa. 1840); Phinney v. Trustees, 88 Md. 633, 42 Atl. 58 (1898); Buffalo & N.Y.C.R.R. v. Dudley, 14 N.Y. 336 (1856); Park v. Modern Woodmen of Amer., 181 Ill. 214, 54 N.E. 932 (1899); Bryan v. Board of Educ., 151 U.S. 639 (1894).

[24] *Invalid*: Dow v. Northern R.R., 67 N.H. 1, 36 Atl. 510 (1887); Allen v. Francisco Sugar Co., 92 N.J. Eq. 431, 112 Atl. 887 (1921). *Valid*: Story v. Road Co., 16 N.J. Eq. 13 (1863); Elec. Lighting Co. v. Sabre, 50 R.I. 288, 146 Atl. 777 (1929).

[25] Wheatley v. A. I. Root Co., 147 Ohio St. 127, 69 N.E. 2d 187 (1946); Schaffner v. Standard Boiler & Plate Iron Co., 150 Ohio St. 454 (1948); Morris v. Amer. Pub. Util. Co. 14 Del. Ch. 136, 122 Atl. 696 (1923); Gen'l Inv. Co. v. Amer. Hide & Leather Co., 97 N.J. Eq. 214, 127 Atl. 529 (1925), *aff'd* 98 N.J. Eq. 326, 129 Atl. 244 (1925); Lonsdale Sec. Co. v. Int'l Mercantile Marine Co., 101 N.J. Eq. 554, 139 Atl. 50 (1927); Yoakam v. Providence Biltmore Hotel Co., 34 F. 2d 533 (R.I. 1929). *Contra*: Thomas v. Laconia Car Co., 251 Mass. 529, 146 N.E. 775 (1925).

[26] 184 N.Y. 257, 264, 77 N.E. 13, 15 (1906).

> been creditors of the corporation in a technical sense; but, as between themselves and other stockholders, they were as creditors, with demands to be fully paid certain arrears of dividends before any of the surplus profits should be appropriated to a dividend upon the common stock. (Emphasis supplied.)

The effect of the *Roberts* case has been substantially removed in New York,[27] but its effect has been noted in other jurisdictions.

In *Harr v. Pioneer Mechanical Corp.*,[28] the federal court construed the Delaware law as authorizing the removal of accrued dividends by majority vote of the stockholders; in *Keller v. Wilson & Co.*[29] the Delaware court of last resort subsequently held that that construction was erroneous and refused to follow it. The *Keller* case[30] is probably the most widely cited case for the proposition that accrued dividends are a "vested right." The court expressed itself in this language:

> The right of a holder of cumulative preferred stock, issued at a time when the law did not permit of the cancellation of accrued and unpaid dividends against the consent of the holder, to such dividends, is, and ought to be regarded as a substantial right. . . . If, . . . , that the right to have paid at some future time the accumulation of dividends on preferred stock, was, as between the shareholders, a fixed and vested right, *having the nature and character* of a debt, postponable in enjoyment until the creation of a fund from which payment legally could be made, it is difficult to perceive the justice of permitting the corporation to destroy the opportunity to create the fund by action under a subsequent amendment to the law which, when the corporation was formed and the stock issued, did not permit of such destruction. (Emphasis supplied.)

In several states, including Ohio, New York, New Jersey, and Virginia, specific statutory provisions have been adopted giving every corporation the broad power to eliminate the claim to accrued cumulative dividends by charter amendment or at least to refund or satisfy it by exchange of shares or otherwise.[31] Constitutionality of such statutes, and specifically that of Ohio, will be discussed *infra*.

One of the first cases sanctioning the elimination or subordination of accrued preferred dividends seems to be *Johnson v. Bradley Knitting Co.*[32] Other inroads have been made on the "vested rights"

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[27] *In re* Duer, 270 N.Y. 343, 1 N.E. 2d 457 (1936).

[28] 65 F. 2d 332 (2d Cir. 1933).

[29] 21 Del. Ch. 391, 190 Atl. 115 (1936).

[30] *Supre*, note 29, 190 Atl. at 124.

[31] OHIO GEN. CODE §8623–14(3)(i) (1938); STOCK CORP. LAW (N.Y.) §36E (b) (1943); 1 N.J. REV. STAT. §14–11–1 (1937); VA. CODE ANN. §3780 (1942).

[32] 228 Wis. 566, 280 N.W. 688 (1938).

theory of limitations on charter amendments.[33] One view is that any *preferential* right may constitutionally be eliminated if a statute permits it.[34] That the constitutional protection of vested rights in dividends is not altogether outmoded is shown by the most recent Ohio cases.[35]

When dealing with a merger, the Delaware decisions have reached an altogether different result. The court in *Federal United Corp. v. Havender*[36] upheld a merger with its resulting cancellation of accrued dividends, distinguishing the *Keller*[37] case on its facts. The vested rights doctrine in this situation was expressly repudiated in *Hottenstein v. York Ice Machinery Corp.*[38] Approval of this merger with a subsidiary, created solely for the purpose, is going to the verge of the law.

"Good Faith" and "Fairness" Tests

In those jurisdictions that have expressly repudiated the "vested rights" theory, certain equitable limitations have been placed upon charter amendments. Except in New Jersey, the courts have not generally reviewed the "fairness" of amendments even in case of substantial prejudice, short of fraud. The others have adopted the position that the discretionary power of the controlling or specified majority is untrammeled by any restriction other than the duty of exercising good faith.[39]

The dictum in the *McNulty* case[40] that the power of a court of equity would be limited to a "test of good faith," which is the same test that has been applied to justify non-interference by the courts in the Delaware cases, indicates that the preferred stockholder probably cannot look for a judicial requirement of objective fairness to protect him under these statutes. This conclusion is sup-

[33] Hottenstein v. York Ice Mach. Corp., 135 F. 2d 944 (D.C. Cir. 1943); Goldman v. Postal Tel. Inc., 52 F. Supp. 763 (Del. 1943); Barrett v. Denver Tramway Corp., 53 F. Supp. 198, 204 (Del. 1943); Berle & Means, Modern Corporation and Private Property 217 (1932); 1 Davies, Ohio Corporation Law 323, 324 (1942).

[34] Federal United Corp. v. Havender, 24 Del. Ch. 318, 11 A. 2d 331 (1940); McNulty v. Sloane, 184 Misc. 835, 54 N.Y.S. 2d 253, 260–262 (1945).

[35] Wheatley v. Root, 147 Ohio St. 127, 69 N.E. 2d 187 (1946); Schaffner v. Std. Boiler & Plate Iron Co., 150 Ohio St. 454 (1948).

[36] 24 Del. Ch. 318, 11 A. 2d 331 (1940).

[37] 21 Del. Ch. 391, 190 Atl. 115 (1936).

[38] 135 F. 2d 944 (D.C. Cir. 1943).

[39] Barrett v. Denver Tram. Co., 53 F. Supp. 198 (Del. 1943); McNulty v. Sloane, 184 Misc. 835, 54 N.Y.S. 2d 253 (1945); for an administrative opinion see Report S.E.C., Reorganization Committee, Part VII, 519–525 (1938).

[40] *Supra*, note 39.

ported by *Anderson v. Int'l Minerals & Chemicals Corp.*,[41] where the court states:

> If, proceeding in accordance with the statute, the consolidation is duly consummated, there are but *two* alternative rights which survive to the holders of the old shares: to take the new shares upon the terms and conditions of consolidation or to take the value of the old shares determined in accordance with Section 21 (the appraisal section). (Emphasis supplied.)

In New Jersey, by contrast with Delaware and New York, an analysis and synthesis of the cases will show equitableness plays a *real* part in determining the validity of such amendments. The "test of fairness" would appear to be primarily whether the corporation had an earned surplus at the time of proposing abolition of arrearages.[42]

While Ohio courts are apparently willing to stand or fall with the "vested rights" theory, there are intimations in some of the cases that other equitable limitations could be used. The syllabus of *Johnson v. Lamprecht*[43] states:

> 3. When there is a change in the terms and conditions of stock by reason of an amendment to the articles of incorporation, dissenting shareholders have a remedy under the provisions of §8623–72. If fraud or illegality is found in the enactment of the amendment, the remedy under that section is not exclusive.

and in *Ohio Nat. Life Ins. Co. v. Struble*[44] the syllabus reads:

> 4. In the absence of fraud, an optional plan of mutualization of a domestic stock life insurance corporation will not be enjoined at the suit of dissenting minority shareholders who are remitted to their statutary right to obtain the fair cash value of their shares.

Effect of Policy

Letts, J., in the *Yoakam* case[45] succinctly states the effect of "policy" on this phase of the law:

> Special circumstances relating to corporate needs, expediency, the plaintiff appearing as a professional obstructionist, a dominant public interest, all have played a part in creating a seemingly hopeless confusion of the law.

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[41] 295 N.Y. 343, 350, 67 N.E. 2d 573, 576 (1946).

[42] Day v. U.S. Cast Iron Pipe & Foundry Co., 96 N.J. Eq. 736, 126 Atl. 302 (1924); Gen'l Inv. Co. v. Amer. Hide & Leather Co., 97 N.J. Eq. 214, 127 Atl. 529 (1925); Windhurst v. Central Leather Co., 101 N.J. Eq. 543, 138 Atl. 772 (1927); Lonsdale Sec. Co. v. Int'l Mer. Marine Co., 101 N.J. Eq. 554, 139 Atl. 50 (1927); Kamena v. Janssen Dairy Corp., 133 N.J. Eq. 214, 31 A. 2d 200 (1943). *But see* Clark v. Henrietta Mills, 219 N.C. 1, 12 S.E. 2d 682 (1941).

[43] 133 Ohio St. 567, 15 N.E. 2d 127 (1938).

[44] 82 Ohio App. 480, 81 N.E. 2d 622 (1948).

[45] 34 F. 2d 533, 546 (R.I. 1929).

Another reason for the fame of the *Keller* case[46] is its open recognition of the part policy plays in such determinations, as shown by this excerpt from the opinion:

> It may be conceded, as a general proposition, that the State, as a matter of public policy, is concerned in the welfare of its corporate creatures to the end that they may have reasonable powers wherewith to advance their interests by permitting adequate financing. It may also be conceded that there has been an increasing departure from the conception which formerly prevailed when the right of individual veto in matters of corporate government operated as a dangerous obstruction to proper functioning. . . . the State is concerned also with the welfare of those who invest their money, the very essence of generation, in corporate enterprises. Some measure of protection should be accorded them. While many interrelations of the State, the corporation, and the shareholders may be changed, there is a limit beyond which the State may not go. Property rights may not be destroyed; and when the nature and character of the right of a holder of cumulative preferred stock, to unpaid dividends, which have accrued thereon through passage of time, is examined in a case where that right was accorded protection when the corporation was formed and the stock was issued, a just public policy, which seeks the equal and impartial protection of the interests of all, demands that the right be regarded as a vested right of property secured against destruction by the Federal and State Constitutions.

One writer has used "overriding public interest" in lieu of "public policy." He then considers it as a "judicial criteria," which is a "current limitation on governmental power to expropriate private property."[47]

OHIO LAW

"The Wheatley-Schaffner Dilemma"

In order that the reader will have a typical fact situation at hand and as a point of departure for a review of the Ohio law in this regard, the facts of the most recent case reaching the court of last resort in Ohio will be stated.[48] The plaintiffs sued to recover from defendants the amount of dividends which had accumulated on their preferred shares of stock and to enjoin defendant corporation from paying dividends to the holders of common shares until all the unpaid cumulative dividends on the preferred shares shall have been paid. It was alleged that the directors were attempting to do what plaintiffs sought to enjoin. Plaintiffs' stock was cre-

[46] 190 Atl. 115, 124 (1936).

[47] For complete discussion see STRONG, MATERIALS ON AMERICAN CONSTITUTIONAL LAW, Part II, 321 (1949).

[48] Schaffner v. Std. Boiler & Plate Iron Co., 150 Ohio St. 454 (1948).

ated December 26, 1928, and the pertinent part of the Articles of Incorporation, as amended, provided:

> Such dividends shall be cumulative from the first day of January, 1929, and no dividends shall be declared on the second preferred stock or the common stock on any year (. . .) until all such cumulative dividends on the first preferred stock for such year and all previous years have been paid or declared and surplus appropriated to the extent thereof.

On February 2, 1939, more than two-thirds of the stockholders approved a charter amendment, now being questioned, that provided in part:

> That the present issue of the first preferred and second preferred stock shall be cancelled; that all indebtedness now due and owing to the holders thereof by way of dividends which have accrued and would in the future accrue to them . . . is waived; . . .

The plaintiffs did not consent thereto and now question its legality to affect their contracts. The defendants admitted the then state of the law, as expressed in *Wheatley v. A. I. Root Co.*;[49] but alleged it did not apply to these facts since defendant corporation was insolvent and the defense of laches and estoppel was applicable. *Held,* plaintiffs could not be deprived of their accured dividends.

As stated *supra* the Ohio courts are still wedded to the "vested rights" theory. Whether this is a "marriage of convenience" and the extent to which it is actually believed will not be questioned for the moment. However, it should be noted that the use of "indebtedness" in the amendment, as done in the "Schaffner" amendment, makes a "vested rights" result easier.

In order that the reader may better get the significance of forthcoming observations, pertinent portions of the *Wheatley* and *Schaffner* syllabi will be excerpted. *Wheatley* case syllabi include:

> 1. A provision giving *preferential rights* to the holders of preferred shares in a private corporation incorporated in their stock certificates and in the articles of incorporation, constitutes a definite contractual undertaking between such shareholders and the corporation and *such rights* are protected by the constitutional safeguards prohibiting retroactive legislation or legislation impairing the obligation of contracts.
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> 2. . . .
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> 3. The provisions of Section 8623–14(3)(i), General Code, . . . may not be applied retroactively to permit an alteration of the *terms* of a contract made by a private corporation with its shareholders prior to the date of the enactment of such statute.
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> 4. . . . *Held*: The *plan of recapitalization* adopted im-

[49] 147 Ohio St. 127, 69 N.E. 2d 187 (1946).

> pairs *vested contractual rights* of shareholders protected by the Constitution of Ohio, which rights are thereby violated by the retroactive application of Section 8623–14(3)(i), General Code. (Emphasis supplied.)

Notice that the court in no place spells out just what "preferential rights" are involved. At first blush, one thinks that under the Ohio contract clause *all* contract rights are sanctified and the reserved power under this same constitution (referred to in syllabus 2, which is omitted) is of no effect. As indicated by a perusal of Ohio and other jurisdictions this is not true. Notice, also, that the court does not state the date, up to which the corporation may not divest the stockholders of their "vested rights." In view of the fact that the court of appeals permitted recovery only up to July 24, 1939 (date of statutory change), it would seem that this was a significant issue to be decided. Notice, also, no mention of the general corporation act adopted in 1927, which was, so far as Section 8623–14, Ohio General Code, is concerned, a legislative delegation of the right to make amendments under the reserved power, contained therein.

Two years later the *Schaffner* case[50] was before the court. The facts were comparable except that this amendment was made prior to the 1939 amendment, not after as in the *Wheatley* case.[51] This appeared to be the ideal time to rectify the confusion of the latter case, and to correctly state the law of Ohio in this regard. With all due respect to the members of the Ohio Supreme Court, it appears that in their effort to relieve the confusion, the law became further uncertain. The court very meticulously covered all the points mentioned in the previous paragraph. As to the date to which recovery is permitted, the court states, in syllabus 3:

> . . . , but such plan is ineffective to cancel unpaid cumulative dividends which had accrued prior to the date of the adoption of the plan of recapitalization.[52]

It might be pertinent to mention at this juncture that in Ohio it has been established, since the adoption of Rule 6 of the Rules of the Supreme Court in 1858, that the syllabus of a supreme court decision states *the law*.[53] However, it has been held that the rules stated in the syllabus must be interpreted with reference to the facts of the case and the questions presented to the court . . . .[54] Does this justify reading into the end of the statement quoted from

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[50] 150 Ohio St. 454 (1948).

[51] 147 Ohio St. 127, 69 N.E. 2d 187 (1946).

[52] This phraseology seems to have been taken from Harbine v. Dayton Malleable Iron Co., 14 Ohio Op. 276, 22 N.E. 2d 281 (1939).

[53] 11 O. JUR., COURTS, §§144, 145 (1930); Reporter's note, 94 Ohio St. ix, 116 N.E. xii (1916) .

[54] Miller v. Eagle, 96 Ohio St. 106, 117 N.E. 23 (1917).

the Schaffner syllabus "if before July 24, 1939, or if covering stock purchased before July 24, 1939?"

Assume for the moment that the stock in question was purchased in 1940 and the amendment date is 1943. *Quaere*: whether the court meant the law to be that the accrued dividends from 1940 to 1943 represented a "vested right" but that the court would not protect the stockholder after 1943. This may be an equitable approach but hardly seems appropriate in view of the fact that in "syllabus 1" of the *Schaffner* case the court indicated that laws in effect when the stock was issued became a part of the contract. In any event it is *not* exactly *clear* what was meant and could give rise to meritorious contentions.

In the light of the facts of the *Wheatley* case.[55] the court must make in the future a close scrutiny of the surplus of the corporation at the time of amendment to protect the innocent dissenter from the perpetration of a fraud.

Constitutionality of Section 8623–14(3)(i)

While the constitutionality of the prospective effect of this section was not an issue in the *Wheatley* case.[56] the court left the question open by stating, "It should be observed that no question relative to the prospective application of these statutes is presented, and, therefore, is not considered or decided."

The section of the Code, in question, states a corporation by adoption of an amendment may:

> i. change any or all of the express terms and provisions of designations of issued or unissued shares of any class or series; which change, if desired, may include the discharge, adjustment or elimination of rights to accrued undeclared cumulative dividends on any such class; . . .

It has been said that the purpose of specification of particular amendments is to avoid doubtful questions of construction which have arisen under general powers of amendment.[57] Prima facie it is true that the powers given in such amending statutes are absolute and unlimited. The courts are left without guidance. It ought to be obvious, however, that the purpose of granting these broad powers is to confer adequate authority for legitimate changes. One writer thinks that it can hardly have been the purpose contemplated by the legislators that a majority vote may *arbitrarily* and *capriciously* reduce or take away the stipulated rights of preferred shares as against a dissenting minority merely for the

[55] 147 Ohio St. 127, 69 N.E. 2d 187 (1946).

[56] *Supra*, note 55.

[57] Johnson v. Bradley Knitting Co., 228 Wis. 566, 280 N.W. 688 (1938); Breslav v. N.Y. & Queens Elec. Light & Power Co., 249 App. Div. 181, 291 N.Y.S. 932 (1936), *aff'd* 273 N.Y. 593, 7 N.E. 2d 708 (1937); 7 FLETCHER, CORPORATIONS §3718 (1931).

benefit of the common shares. If the statutes, such as the one in Ohio, are to be construed as conferring such arbitrary power, they might well be held to be unconstitutional.[58]

A careful reading of the section in question reveals no mention of the "lack of surplus" as a prerequisite for such an amendment. Assuming for the moment that Ohio courts abandon the "vested rights" theory when faced with the issue of the prospective effect of the section, the mere fact that a corporation with an abundant surplus could destroy the accrued dividends by amendment thereunder would amount to such an arbitrary, capricious, and even fraudulent abuse of the reserved power, that the section should be stricken down as violative of the due process and equal protection clauses of the federal and state constitutions.

Present Redemies to the Dissenter

First, he may accept whatever is offered to him in the reorganization as satisfaction of his accrued dividends and other preferential rights that may be sacrificed, for the "good of the corporation."

Second, he may resort to the privilege to withdraw with the appraised value of his stock, as provided in Ohio General Code, Section 8623-72 (1938).

Finally, assuming stock issued after 1939, he may test the constitutionality of sub-section 14(3) (i) in the state courts. This is dangerous because if the Supreme Court finds the statute constitutional *only* on state grounds, as was done regarding another statute in *Direct Plumbing Supply Co. v. Dayton*,[59] the United States Supreme Court *may* be precluded from ever taking jurisdiction.

Consolidation Cases

In a recent case in an inferior court,[60] the court reached a result which overthrows the "vested rights" doctrine in consolidation cases. While the *Havender*[61] and *Hottenstein*[62] cases were distinguished upon the facts, the result is the same. Special handling of these cases seems odd in the light of Ohio's long adoption of the "vested rights" doctrine. No doubt this problem will be scrutinized closely if and when it is carried to higher courts of Ohio.

CONCLUSION

Although the majority stockholders do not have the benefit of the reserved power, as in Ohio, to remove accrued dividends on

[58] BALLANTINE ON CORPORATIONS, §278 (1946).
[59] 138 Ohio St. 540, 38 N.E. 2d 70 (1941).
[60] Anderson v. Cleveland-Cliffs Iron Co., 54 Ohio Abs. 65 (Ohio C. P. 1948).
[61] 24 Del. Ch. 318, 11 A. 2d 331 (1940).
[62] 135 F. 2d 944 (D.C. Cir. 1943).

cumulative preferred stock, they can, by the use of prior issues of stock and by reducing future rights of the old stock, exert such pressure as to compel the dissenter to exchange and release his accrued dividends "voluntarily." "The apple that cannot be picked can, nevertheless, be shaken down."[63] The use of pressure has been effectively prohibited in some cases.[64]

As his defense against oppression, the dissenter has usually relied upon such concepts as constitutional protection of vested rights, as we have in Ohio, or lack of corporate power, and where these have failed him—either because of judicial decisions or legislation—he has been left almost entirely unprotected, as the *Hottenstein* and *Barrett* cases[65] demonstrate.

If a requirement of fairness were to be acknowledged, what would be the test of an equitable reorganization? The most reasonable tests probably are: (1), corporate necessity for the amendment, and (2), the substantial equivalence between what the preferred stockholder gives up and what he receives.[66] Such *necessity* will be a matter of proof to be offered to a court or administrative body depending on the procedures established by an appropriate statute.

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[63] Becht, *The Power to Remove Accrued Dividends*, 40 COL. L. REV. 633 (1940).

[64] Lonsdale Sec. Co. v. Int'l Merc. Marine Co., 101 N.J. Eq. 554, 139 Atl. 50 (1927); Patterson v. Durham Hosiery Mills, 214 N.C. 806, 200 S.E. 906 (1939).

[65] Hottenstein case, 135 F. 2d 944 (D.C. Cir. 1943); Barrett case, 53 F. Supp. 198 (Del. 1943).

[66] Latty, *Fairness—The Focal Point in Preferred Stock Arrearage Elimination*, 29 VA. L. REV. 1 (1942); Becht, *supra*, note 64. *But see* Dodd, *Fair and Equitable Recapitalizations*, 55 HARV. L. REV. 780 (1942).