Michigan Law Review

Volume 55 | Issue 1

1956

Corporations - Dividends - New Jersey Dividend Credit for Non-Cumulative Preferred Stock

John A. Beach S.Ed.
University of Michigan Law School

CORPORATIONS—DIVIDENDS—NEW JERSEY DIVIDEND CREDIT FOR NON-CUMULATIVE PREFERRED STOCK—Defendant, a New Jersey corporation, paid no dividends on its non-cumulative preferred stock after 1933, although it had annual earnings exceeding the total amount of the preference in each of the years 1941 through 1948, and again in 1951 and 1952. In 1955 defendant had earned surplus exceeding $12,000,000. Plaintiffs, holders of non-cumulative preferred shares, brought this action asking for a declaratory judgment as to the nature of their preference rights over the common holders. On appeal from a summary judgment for defendant, *held,* affirmed. In the absence of any impending or threatened declaration of dividends to common shareholders, there was no actual controversy between the parties and the trial court acted within its discretion under the declaratory judgment statute[1] in refusing to grant declaratory relief. The court reaffirmed obiter, however, its disposition to protect preferred shareholders by continued application of the "dividend credit" doctrine. *Sanders v. Cuba R. Co.,* (N.J. 1956) 120 A. (2d) 849.

Although the defendant at one time had refused to admit any duty toward the preferred shareholders arising from the passed dividends,[2] the supreme court's unwillingness to reverse the trial court's exercise of discretion in refusing a declaratory judgment is not open to serious question.[3] The interesting aspect of the court's opinion is the careful discussion of the present scope of New Jersey's "dividend credit" doctrine. In the absence of detailed provisions in the charter spelling out the preference rights of preferred stock, there is some disagreement among the courts as to what these rights are, particularly as to the meaning of the adjective "non-cumulative." Outside New Jersey, *Wabash Ry. Co. v. Barclay*[4] is the leading case for the prevailing view holding "non-cumulative" to mean that once the directors have lawfully refrained from declaring a dividend on such shares in any year in which earnings would have allowed a dividend, the non-cumulative preferred holders have lost any right to demand a preference based on the passed dividend in future distributions of earnings.[5] However, the New Jersey courts have extended a "credit" to the preferred holders to the extent of preferences earned but unpaid in any fiscal year. Such credits must be paid before any distribution of surplus is made to junior stock in later years.[6] The gap between these two posi-

[1] N.J. Stat. Ann. (1952) §§2A:16-50 to 16-62 (substantially the Uniform Declaratory Judgments Act).

[2] In a circular letter to preferred shareholders in 1951, defendant stated that it did not admit that the preferred holders had "any equity with respect to the Company's past earnings." Principal case at 850.

[3] N.J. Stat. Ann. (1952) §2A:16-61. Cf. 62 HARV. L. REV. 787 at 795 (1949).

[4] 280 U.S. 197, 50 S.Ct. 106 (1930).

[5] See Guttmann v. Illinois Central R. Co., (2d Cir. 1951) 189 F. (2d) 927, cert. den. 342 U.S. 867 (1951), holding that directors not only cannot be forced to declare, but are also precluded from declaring, a non-cumulative preferred dividend once it has been legitimately passed in the year when earnings were made. *Contra:* Diamond v. Davis, 38 N.Y.S. (2d) 103 (1942), affd. 265 App. Div. 919, 39 N.Y.S. (2d) 412 (1942), affd. 292 N.Y. 552, 54 N.E. (2d) 683 (1944) (applying New Jersey law); 27 A.L.R. (2d) 1073 (1953).

[6] Bassett v. United States Cast Iron Pipe & Foundry Co., 75 N.J. Eq. 539, 73 A. 514 (1909); Moran v. United States Cast Iron Pipe & Foundry Co., 95 N.J. Eq. 389, 123 A. 546 (1924), affd. 96 N.J. Eq. 698, 126 A. 329 (1924); Day v. United States Cast Iron Pipe & Foundry Co., 96 N.J. Eq. 736, 126 A. 302 (1924); Cintas v. American Car & Foundry Co., 131 N.J. Eq. 419, 25 A. (2d) 418 (1942), affd. 132 N.J. Eq. 460, 28 A. (2d) 531 (1942). Cf. Berle, "Non-Cumulative Preferred Stock," 23 COL. L. REV. 358 at 363 (1923). Some have argued that New Jersey's rule is grounded upon particular charter language and/or upon a statute existing at the time the Cast Iron Pipe charter was drawn. See Lich v. United

tions had arguably been narrowed by dicta in two recent New Jersey cases to the effect that no dividend credit arises when the undistributed earnings are used for normal and "legitimate corporate purposes."[7] It has been pointed out elsewhere that these cases, while purporting to follow the traditional New Jersey interpretation, seriously weaken the rule by engrafting on it the "legitimate corporate purpose" qualification.[8] No such qualification is to be found in the original formulation,[9] and clearly this modification would allow directors to escape the non-cumulative preferences with little more difficulty than would be experienced under the *Wabash* rule. For example, annual earnings could be plowed back into the business through the purchase of new assets (the legitimate corporate use of such funds negating any dividend credit), and in later years the surplus arising from the reinvested earnings would be available for dividends to junior stock.[10] The court in the principal case expressly recognized the clash in the policies underlying the traditional New Jersey rule and the rule as qualified by the above-mentioned dicta. While it reserved the ultimate choice between these conflicting policies, the court saw fit to emphasize that departure from the unqualified dividend credit rule would put the preferred shareholders "substantially at the mercy of others who will be under temptation to act in their own self-interest,"[11] and further to announce that "there does not seem to be any present disposition in this court to reject it [the dividend credit rule] or limit its sweep in favor of the Supreme Court's approach in the Wabash Railway case."[12] Such carefully considered dicta should give pause to anyone who would argue that dividend credit is dead, and that *Wabash* reigns supreme even in New Jersey. The principal case appears to be a rather pointed forecast of continued protection of non-cumulative preferred shareholders under New Jersey's traditional dividend credit rule.

John A. Beach, S.Ed.

States Rubber Co., (D.C. N.J. 1941) 39 F. Supp. 675, affd. (3d Cir. 1941) 123 F. (2d) 145; BALLANTINE, CORPORATIONS, rev. ed., 522-523 (1946). However, the principal case assumes no such limitation. See, generally, Frey, "The Distribution of Corporate Dividends," 89 UNIV. PA. L. REV. 735 (1941).

7 Dohme v. Pacific Coast Co., 5 N.J. Super. 477 at 491, 68 A. (2d) 490 (1949). The notion that use of earnings for some corporate purposes would defeat a dividend credit was apparently derived from Agnew v. American Ice Co., 2 N.J. 291 at 303, 66 A. (2d) 330 (1949), where the court said: "Dividends earned but withheld and retained as surplus, *and not utilized in the corporate business,* are required to be paid on the preferred stock before there can be a dividend distribution on the common stock" (emphasis added). See also Lich v. United States Rubber Co., note 6 supra.

8 See Ashley, "The Future of the Law of Non-Cumulative Preferred Stock in New Jersey: A Raid on the Inarticulate," 5 RUTGERS L. REV. 358 (1951).

9 See cases cited note 6 supra.

10 This was substantially the technique employed by the directors in the principal case.

11 Principal case at 852.

12 Ibid.