Michigan Law Review

Volume 47 | Issue 1

1948

CORPORATIONS-PARTICULAR LANGUAGE AND CIRCUMSTANCES MAKING PREFERRED DIVIDENDS CUMULATIVE

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CORPORATIONS—PARTICULAR LANGUAGE AND CIRCUMSTANCES MAKING PREFERRED DIVIDENDS CUMULATIVE—The Securities and Exchange Commission filed a plan and requested an order under the Public Utilities Holding Company Act of 1935 [1] to carry out the dissolution of the *X* company, a Delaware corporation, whose sole income-producing asset was the common stock of the *Y* company, a Kentucky corporation. The dissolution plan contemplated distributing to the shareholders of the Delaware company its holdings of the Kentucky company stock according to a pro-rata distribution ratio, based on the Class A Common [2] and Class B Common stock of the Delaware company. Certain holders of the Class A Common shares of the Delaware company objected to the plan, contending that the commission erred in considering the Class A Common to be noncumulative. The certificate of incorporation provided that dividends should be paid, ". . . when, as, and if declared by the Board of Directors, out of the net

[1] §§ 11(e), 18(f), 15 U.S.C. (1946) §§ 79k(e), 79r(f).

[2] Class A Common shares are, in effect, the preferred shares of the Delaware company.

profits or surplus of the corporation." The Delaware statute applicable provided that "preferred dividends shall be cumulative or non-cumulative as shall be so expressed [in the Certificate of Incorporation]." [3] *Held*, the Class A Common shares were cumulative under Delaware law, because the dividends were chargeable against surplus generally, and not merely against the net profits of a particular year. *In re Louisville Gas and Electric Co.*, (D.C. Del. 1948) 77 F. Supp. 176.

The principal case is in accord with the trend of the reported cases, which look to the shareholder's contract to ascertain the nature and extent of his rights.[4] Text writers have frequently asserted, however, that the English and American courts will presume preferred shares to be cumulative in the absence of an expressed contrary intention.[5] This presumption is supposedly derived from the leading case, *Henry v. The Great Northern Railway Company*,[6] where the court found the shares in question to be cumulative primarily upon an interpretation of Parliamentary intent as manifested in several special acts directed toward the corporation's capital structure. The court reasoned that if the shares were deemed non-cumulative the common shares would benefit to the detriment of the preferred, and, as company directors were usually common shareholders, a determination that the shares were noncumulative would be contrary to apparent legislative intent by tending to cause the directors to exercise their discretion in their own interest.[7] This argument has been cited with approval by a number of English and American courts,[8] and is largely responsible for several decisions holding that where preferred shares participate pro rata in the profits, after distribution of stated percentages to preferred holders and an equal amount to common holders, the shares are noncumulative.[9] Although some courts appear to cite the text writers' presumption approvingly,[10] all decided cases seem to be based upon an unprejudiced evalu-

[3] Del. Rev. Code (1935) § 2045, 36 Del. Laws (1929) c. 135, § 5.

[4] Warren v. King, 108 U.S. 389, 2 S.Ct. 789 (1883); American Hair and Felt Co., 21 Del. Ch. 380, 191 A. 887 (1937); Staples v. Eastman Photographic Materials Co., 2 Ch. Div. 303 (1896).

[5] 12 FLETCHER, CYCLOPEDIA OF CORPORATIONS, Perm. ed., § 5447 (1932); 1 COOK, CORPORATIONS, 8th ed., § 273 (1923); 2 CLARK & MARSHALL, PRIVATE CORPORATIONS, § 529 (d) (1901).

[6] 1 De G. & J. 606, 44 Eng. Rep. 858 (1857).

[7] Plaintiff's brief contended that a presumption declaring preferred dividends to be cumulative should be applied, but the court's opinion neither repeated nor decided upon this contention as a valid legal principal. Id. at 615.

[8] Fidelity Trust Co. v. Lehigh Valley R. Co., 215 Pa. 610, 64 A. 829 (1906); Boardman v. Lake Shore & M.S. Ry. Co., 84 N.Y. 157 (1881). Cf. Staples v. Eastman Photographic materials Co., 2 Ch. Div. 303 (1896), distinguishing the Henry case. See also, Lattin, "Is Non-Cumulative Preferred Stock in Fact Preferred?" 25 ILL. L. REV. 148 (1930), for an argument which might tend to weaken the basis for the decision in the Henry case.

[9] Englander v. Osborne, 261 Pa. 366, 104 A. 614 (1918); 6 A.L.R. 802 (1920); Continental Insurance Co. v. Minneapolis St. P. & S.S.M. Ry. Co., (C.C.A. 8th, 1923) 290 F. 87.

[10] Garrett v. Edge Moor Iron Co., 22 Del. Ch. 142, 194 A. 15 (1937); Warburton v. John Wanamaker Phila., 329 Pa. 5, 196 A. 506 (1938); and the prin-

ation of the facts of each case, uniformly reiterating that the rights of shareholders depend upon their contracts.[11] Thus, a provision that dividends be paid only out of the net earnings of a particular year has been held consistently to constitute the shares noncumulative,[12] while a stipulation that payment be made from net profits, or surplus generally, will merit an interpretation that the shares have cumulative rights.[13] In the principal case, the court required only that cumulative rights be set out with reasonable clarity, holding that the word, "preferred," is not a term of art under Delaware law. This was true although the applicable statute has been interpreted as requiring that some designation of the nature of the dividend be made.[14] Courts may also subordinate a description of shares as "cumulative" or "noncumulative" in favor of statements of the procedure for payment, purposes of the issue, or other such contractual expressions.[15] Thus, the conclusions stated by some widely-accepted text writers do not seem to be borne out by the cases. On the basis of the generally-recognized contract analysis, any application of a presumption which grants cumulative rights where none are expressly or impliedly provided for flatly contradicts the principle that common and preferred shareholders enjoy equal rights, subject only to the preferences and limitations set out in their contracts.[16]

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cipal case at 179. In Hazel Atlas Glass Co. v. Van Dyk & Reeves, Inc., (C.C.A. 2d, 1925) 8 F. (2d) 716 at 720, the court, obiter, seems to give full force to the presumption that preferred shares are cumulative, citing 1 COOK, CORPORATIONS, 7th ed., § 273 (1913). But cf. Englander v. Osborne, 261 Pa. 366, 104 A. 614 (1918), for a suggestion of a contrary presumption.

[11] ". . . Words ought to be construed with reference to the subject to which they apply, and not with reference to the meaning which may be attached to them as applied to a different subject." Turner, L.J., in Sturge v. Eastern Union Ry. Co., 7 De G.M. & G. 158 at 176, 44 Eng. Rep. 62 (1855); Boardman v. Lake Shore M.S.R. Co., 84 N.Y. 157 (1881); 18 C.J.S., Corporations, § 229. Courts usually look to the by-laws, articles of incorporation, resolutions pertaining to stock issues, and stock certificate provisions, Bailey v. Railway Co., 17 Wall. (84 U.S.) 96 (1872); Belfast & M.L.R. Co. v. Belfast, 77 Me. 445, 1 A. 362 (1885); Prouty v. Mich. S. & N.I. R. Co., 1 Hun (N.Y.) 655 (1874). But cf. Murphy v. Richardson Dry Goods Co., 326 Mo. 1, 31 S.W. (2d) 72 (1930), where it was held that cumulative rights must appear in the articles, not in the by-laws alone.

[12] 2 CLARK & MARSHALL, PRIVATE CORPORATIONS, § 529 (d) (1901); 98 A.L.R. 1526 (1935); 18 C.J.S., Corporations, § 229.

[13] 12 FLETCHER, CYCLOPEDIA OF CORPORATIONS, perm. ed., § 5447 (1932); Fidelity Trust Co. v. Lehigh Valley R. Co., 215 Pa. 610, 64 A. 829 (1906). The term "guaranteed" has also been held to render shares cumulative. Dickinson v. R. Co., 7 W. Va. 390 (1874).

[14] Garrett v. Edge Moore Iron Co., 22 Del. Ch. 142, 194 A. 15 (1937), cited with approval in principal case; 18 C.J.S., Corporations, § 220. But cf. Murphy v. Richardson Dry Goods Co., 326 Mo. 1, 31 S.W. (2d) 72 (1930).

[15] Warburton v. John Wanamaker Phila., 329 Pa. 5, 196 A. 506 (1938), noted in 36 MICH. L. REV. 1384 (1938); Foster v. Coles, 22 T.L.R. (Ch.) 555 (1906).

[16] Englander v. Osborne, 261 Pa. 366, 104 A. 614 (1918); 18 C.J.S., Corporations, § 227.