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CORPORATIONS-RIGHT OF CORPORATION TO PAY DIVIDENDS TO COMMON SHAREHOLDERS TO EQUALIZE PRIOR WRONGFUL PAYMENT TO PREFERRED SHAREHOLDERS

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COMMENTS

CORPORATIONS—RIGHT OF CORPORATION TO PAY DIVIDENDS TO COMMON SHAREHOLDERS TO EQUALIZE PRIOR WRONGFUL PAYMENT TO PREFERRED SHAREHOLDERS—As a general proposition, payment of dividends may be made only out of surplus and not out of the capital stock of a corporation.[1] Though the cases evidence considerable confusion as to the meaning of "surplus" and "capital," it is clear that these terms do not indicate a res. Rather, they are convenient designations for legislatively prescribed limits as to when dividend payments are proper.[2] The capital stock rule, that the aggregate consideration received for no par stock plus the aggregate value of issued par stock may not be tapped for shareholder distribution, is founded, loosely speaking, on the notion that that amount should be "pledged" for the payment of corporate debts, since creditors of a corporation may look only to corporate assets for payment.[3]

If the directors of a corporation do pay dividends out of capital, they are subject to common law and statutory redress for their action.[4] Usual remedies for wrongful dividend payment are of three varieties:[5] (1) injunction to restrain the illegal declaration of dividends,[6] (2) damage suit against the directors for their breach of fiduciary obligations,[7] or (3) suit against the shareholders who have received payment to compel them to return the dividends. The obligations and liabilities of shareholders who have received wrongful dividend payments are the primary concern of this comment.

[1] 18 C.J.S. § 460 (1939).

[2] Ballantine and Hills, "Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws," 23 CALIF. L. REV. 229 at 233 (1935).

[3] "The function of legal or stated capital is threefold: (1) the protection of creditors against the shareholders; (2) the protection of senior shareholders against junior shareholders; and (3) the protection of all shareholders against mismanagement and the impairment of their investment and its earning power." Id. at 233. 18 C.J.S. §460 (1939); cf. Salina Mercantile Co. v. Stiefel, 82 Kan. 7, 107 P. 774 (1910).

[4] 12 FLETCHER, CYC. CORP., perm. ed., §§5431-5442 (1932); 35 YALE L. J. 870 (1926).

[5] See, generally, on wrongful payment of dividends and remedies therefor: 55 A.L.R. 8 (1928), supplemented in 76 A.L.R. 885 (1932) and 109 A.L.R. 1381 (1937); Fuld, "Recovery of Illegal and Partial Liquidating Dividends from Shareholders," 28 VA. L. REV. 50 (1941).

[6] Coquard v. The National Linseed Oil Co., 171 Ill. 480, 49 N.E. 563 (1898) (dictum in suit brought by shareholders); Reid v. Eatonton Mfg. Co., 40 Ga. 98 (1869) (dictum that suit brought by creditors for injunction would be proper when the corporation is insolvent).

[7] At common law, directors who acted in good faith and without negligence were not responsible for losses which resulted from their acts, although there was much confusion

A. *Agnew v. American Ice Co.*[8]

Agnew v. American Ice Co. involved a corporation's adoption of what is apparently a unique and previously untried remedy. The corporation concerned had a class shareholding structure of "cumulative-non-cumulative" (cumulative if earned) preferred stock, and common stock. "The articles of incorporation provided for the payment 'out of the surplus or net earnings of each fiscal year . . . as and when declared by the Board of Directors,' of a non-cumulative dividend upon the company's outstanding preferred stock 'at the rate of but never exceeding six per cent. per annum, payable yearly, half-yearly or quarterly, before any dividend shall be set apart or paid on the common stock for such year,' and the distribution, in the discretion of the directorate, of 'the remainder of the surplus or net earnings of each fiscal year . . . as dividends among the holders of the common stock, as and when the Board of Directors shall determine.'[9] . . . Annual dividends at the established rate of $6 per share were paid on the preferred stock from the year 1917, when the issue was authorized, to and including the year 1934. . . . At times, the annual earnings exceeded the dividends paid on the preferred stock; *and in other years, the reverse was true.*[10] In 1945, payment of the full dividend on the preferred stock was resumed; and on September 24, 1946, a dividend of 50¢ on each share of the common stock was declared, payable 'out of the surplus or net earnings of the Company.' It is this dividend that is under attack. The . . . preferred shareholders [insist in suit to restrain the payment on the com-

over the degree of care required for immunity. 35 YALE L. J. 870 at 871 (1926). But negligence might readily be found. See Fell v. Pitts, 263 Pa. 314, 106 A. 574 (1919).

Today, there are commonly statutes on directors' liability for improper payment of dividends. Often, these statutes are ambiguous as to the degree of care required. 35 YALE L. J. 870 at 870 (1926). Insolvency at the time of the dividend declaration may be a factor in fixing liability. 12 FLETCHER, CYC. CORP., perm. ed., §5432 (1932). But under these statutes the cause of action belongs only to the statutory class designed to be protected. Fleisher v. West Jersey Securities Co., 84 N.J.Eq. 55, 92 A. 575 (1914). However, if the corporation has the right and the directors refuse to sue, then shareholders may sue in the right of the corporation. Siegman v. Electric Vehicle Co., (C.C. D. N.J. 1905) 140 F. 117.

[8] (N.J. 1949) 66 A. (2d) 330.

[9] The type of preference expressed here has been construed in a series of New Jersey cases, of which the leading case is Day v. United States Cast Iron Pipe & Foundry Co., 96 N.J.Eq. 736, 126 A. 302 (1924), to entitle the preferred to priority of payment over common—if and when dividends are declared—of dividends at the stated rate for all years in which a corporation has showed a profit, but only for those years. This provision is distinguished from that of the usual cumulative preferred grant of priority for all past years, without regard to earnings in any year.

[10] Emphasis added.

mon] that dividends are not payable on the common stock until the shortage in the preferred dividends for the years 1935 to 1944 [has] been paid."[11] Notwithstanding the charter provisions cited, the court held that the prior payment to the common shareholders to equalize prior wrongful payment to the preferred shareholders was justified. The court reasoned that the statement of preferences in the articles was but a contractual grant of priority, not a guarantee of dividends. Being but an "incident of ownership of the stock,"[12] the preference could therefore be subjected to a "set-off" for overpayments, "for otherwise the one class would benefit at the expense of [the funds available for dividends on the common stock]."[13] The court recognized that it was confronted with a novel problem; in the light of past decisions on analogous matters, it is submitted that the decision is questionable.[14]

B. *Recovery of Illegally-Paid Dividends*

The recovery of illegally-paid dividends from shareholders is not usually predicated on any theory that the shareholders have themselves committed a wrong, for the fundamental wrong in the picture is deemed that of the directors.[15] Yet when dividends are paid from impaired capital at a time when the corporation is also insolvent, all courts will allow recovery of the payments.[16] Some courts sustain this result on the "trust fund" theory[17] that the assets of a corporation which is insolvent constitute a trust fund for creditors and, therefore, shareholders take the payment impressed with a trust in favor of these creditors. Other courts speak of a conveyance of assets in fraud of creditors,[18] which assets may be recovered. Lack of notice of wrongful payment is deemed immaterial when the corporation is insolvent, because, it is usually explained, the shareholder is a mere donee, who has not given value.[19] Some writers have vigorously questioned this last proposition and prefer to sustain recovery in all fact situations when

11 Principal case at 332-333.

12 Id. at 334.

13 Id. at 333.

14 The conclusions of this comment are not based on facts or statutes peculiar to the principal case.

15 Wood v. National City Bank, (C.C.A. 2d, 1928) 24 F. (2d) 661.

16 Ibid.; Bartlett v. Smith, 162 Md. 478, 160 A. 440 (1932); Ulness v. Dunnell, 61 N.D. 95, 237 N.W. 208 (1931).

17 Hayden v. Thompson, (C.C.A. 8th, 1895) 71 F. 60.

18 Detroit Trust Co. v. Goodrich, 175 Mich. 168, 141 N.W. 882 (1913).

19 Bartlett v. Smith, 162 Md. 478, 160 A. 440 (1932); Mackall v. Pocock, 136 Minn. 8 at 13, 161 N.W. 228 (1917).

payment was made during insolvency on the basis of statutory mandate.[20]

There is considerable conflict in the cases as to right of recovery from shareholders when the wrongful payment was made by a solvent corporation. If the shareholder took with notice, recovery is always allowed, for here, it is felt, the shareholder is an accomplice of the directors in the commission of the wrong; nor can the shareholder offer equities to overcome this complicity.[21] But when the shareholder takes without notice, the cases are in conflict. Many courts do allow recovery. Some, again, justify this result on the trust fund analysis (an approach inapplicable as to a going concern);[22] some speak of fraudulent conveyance (though prior to insolvency, the creditor cannot question the transaction).[23] The Minnesota court, pursuing a line of reasoning it had hitherto adopted in the "watered stock" cases, has rejected the trust fund doctrine as to a going corporation, but has accepted the equally doubtful "holding-out" or "fraud" theory,[24] as has the Michigan court.[25] A few courts have said that the wrong is solely, or in part, to the corporation, thereby neatly dispelling the objection that a creditor is not wronged by an improper dividend payment made by a corporation

20 BALLANTINE, CORPORATIONS, rev. ed., §255 (1946); 2 GLENN, FRAUDULENT CONVEYANCES, rev. ed., §604 (1940). These writers argue that for this purpose the shareholder is a "kind of creditor" who had earlier made a money investment. Cf. Fuld, "Recovery of Illegal and Partial Liquidating Dividends from Shareholders," 28 VA. L. REV. 50 (1941).

21 Wood v. National City Bank, (C.C.A. 2d, 1928) 24 F. (2d) 661.

22 Williams v. Boice, 38 N.J.Eq. 364 (1884) (dictum, since the shareholders here took with notice. It is not clear just what emphasis the court attaches to that fact).

23 Lexington Life, Fire and Marine Insurance Co. v. Page & Richardson, 17 B. Mon. (56 Ky.) 412 (1856).

24 Mackall v. Pocock, 136 Minn. 8, 161 N.W. 228 (1917), relying on Hospes v. Northwestern Manufacturing and Car Co., 48 Minn. 174, 50 N.W. 1117 (1892), where the court said that takers of "watered stock" should pay up to par in behalf of subsequent creditors who "rely" in innocence on apparent capitalization. In the Mackall case the court logically argued at p. 12: "Is there a sound distinction between a case where a corporation disposes of its capital by issuing bonus stock, or stock but partly paid for, and one where it disposes of its capital by paying dividends out of it? . . . [T]hey are all forms of . . . the same thing . . ., a disposition of corporation assets. . . . In each case the right of a creditor to question the transaction depends wholly on whether he dealt with the corporation on the faith that its capital was as represented."

Once conceding the "fraud" theory or any other rationale as a basis for compelling shareholders to pay to par, one must accede to the court's view that there should be no distinction in the recovery-of-dividends action from that of action to compel payment of full par value. The good faith of the shareholder is immaterial in both situations. "It is surely no defense that the beneficiary of a voluntary conveyance which is fraudulent as to creditors, is himself innocent of any wrong." Mackall v. Pocock, 136 Minn. 8 at 13, 161 N.W. 228 (1917).

25 American Steel and Wire Co. v. Eddy, 130 Mich. 266, 89 N.W. 952 (1902) (dictum. The decision rests primarily on a statute).

that continues solvent.[26] There is apparently no authority to sustain the simple position that legislative mandate, implicit in the maintenance of capital requirement, holds foreign the notion of capital impairment and demands that the shareholders pay upon insolvency.[27] There is some legislation in the field to this effect, however, which legislation apparently takes no account of good faith.[28]

Many courts vehemently reject recovery as to payments taken in good faith from a solvent firm. Most of these courts follow the leading federal case of *McDonald v. Williams*,[29] which rested chiefly on the basis that there can be no trust fund as to the assets of a going corporation. The court argued that there is no res set aside as the subject of a trust and pointed out that the going corporation has freedom in the disposition of its assets, unbound by a "lien" of creditors.[30] Implicit in the opinion is rejection of a corporate cause of action. The Maryland court emphasized the practicality of modern business conditions, finding it objectionable to require a shareholder who is one of a vast number in a large enterprise to question the authority under which his dividends have been declared or to give up those payments many years later.[31]

C. *Analysis of the "Set-off" Remedy*

What does this authority suggest as to the conclusion of the *Agnew* case? The court implicitly assumes that the wrong which has been done is only to the common shareholder since the corporation was solvent at the time of the first dividend declaration and still remains so. And since that wrong is only to the junior shareholder, simple adjustment will correct the wrong. Nor does the court make inquiry as to the good faith of the preferred shareholders who received dividends, for the

[26] Salina Mercantile Co. v. Stiefel, 82 Kan. 7 at 10, 107 P. 774 (1910); Detroit Trust Co. v. Goodrich, 175 Mich. 168 at 173, 141 N.W. 882 (1913); Irving Trust Co. v. Gunder, 234 App. Div. 252, 254 N.Y.S. 630 (1932).

[27] However, the logic of the Minnesota court in drawing a parallel between liability to pay full par value and the liability to repay dividends (see note 19, supra) would suggest that those courts which find the duty in the former situation on the basis of legislative mandate inherent in the par value clause might properly find a duty in the second situation on a theory of legislative mandate inherent in the capital stock clause. See Ooregum Gold Min. Co. of India v. Roper, [1892] A.C. 125, 66 L.T. 427.

[28] 15 Mich. Stat. Ann. (1937) §21.48.

[29] 174 U.S. 397, 19 S.Ct. 743 (1899).

[30] But compare with other federal cases which do find a "trust fund" as to the assets of a going corporation when the problem is as to liability to pay par value. Sawyer v. Hoak, 17 Wall (84 U.S.) 610, 21 L. ed. 731 (1873); Scovill v. Thayer, 105 U.S. 143, 26 L. ed. 968 (1881). The views of these cases in the context of the Minnesota court's reasoning (supra, note 19) would effect a different result in the McDonald case.

[31] Bartlett v. Smith, 162 Md. 478, 160 A. 440 (1932).

court's remedy cannot adjust itself to that element; and as it cannot adjust itself to the presence or absence of good faith, so it cannot take account of a far more basic fact: whether the preferred shareholders who are now being penalized are the very same preferred shareholders who once benefited by the wrongful payment. The latter severe shortcoming of the remedy here employed is recognized by the court, yet the objection is dismissed lightly.[32]

Various possibilities suggest themselves to test the "set-off" or "double-payment" remedy in the light of precedent and logic. Assume first that the *second* dividend payment is made at a time when the corporation is insolvent. It may readily be granted that no court would sustain any adjustment of this sort on those facts, for a payment in those circumstances would be the clearest case of a second wrong—added to a first in the hope of making a right.. The remedy has meaning, then, only when the common shareholder is paid at a time when the corporation still remains solvent; and if that is so, it will likely follow that the first payment was also made during solvency. Two questions are raised: who is entitled to recovery and who should be compelled to re-pay?

1. *Who is entitled to recovery?* Are creditors presently being hurt by the later dividend declaration by a solvent corporation, or is it the corporation, or the latter's common shareholders? In fact, though capital is impaired, the creditor is not endangered so long as the corporation remains solvent, or rather, so long as there is a reasonable relationship of security between the assets and liabilities (current or permanent, depending on this creditor) of the corporation.[33] Yet, it must be remembered that there is a legislative mandate, apart from practical business facts: the mandate requiring the maintenance of capital stock. Those courts following the *McDonald* case[34] would reject that contention, on these facts of a solvent concern, saying that as to creditors no wrong was done by prior payment. And, a fortiori, there is even less basis for objection by creditors on the facts of the principal case than on those of the usual case involving an attempt to recover dividends

[32] "No matter what the rule, individual shareholders will suffer some inequity; but it is generally the preferable policy to sustain the equity of set-off for overpayments rather than to deny it, for the transferee may by inquiry safeguard himself against the former, while the latter course would unjustly enrich the preferred stockholders at the expense of the holders of the common stock." Principal case at 335.

[33] Ballantine and Hills, "Corporate Capital and Restrictions upon Dividends under Modern Corporation Laws," 23 CALIF. L. REV. 229 at 233 (1935); 2 GLENN, FRAUDULENT CONVEYANCES, rev. ed., §604 (1940).

[34] McDonald v. Williams, 174 U.S. 397, 19 S.Ct. 743 (1899).

from shareholders, for here, not only was there solvency at the time of the wrongful payment, but the corporation is *still* solvent. It is therefore unlikely that even those courts which on the usual facts of the recovery-of-dividends action would allow recovery by creditors, though payment was taken in good faith from a solvent firm, would on *these* facts of present corporate solvency find any present right in the creditor to complain.[35]

Any actionable wrong which exists, therefore, must be to the corporation or its shareholders. There is some authority for the former proposition and at least one well-reasoned case has gone so far as to say that the corporation, though presently solvent, may yet recover dividends also paid out during solvency, despite the fact that there have at no time been creditors in the picture.[36] But the writer has found no authority which would sustain the contention of a legal wrong to the remaining shareholders. To recognize such a wrong is to disregard the fact of corporate entity, for the corporation had owned the distributed assets and it would logically seem that pursuit of those assets should be the right of the owner.[37] The court in the principal case thinks other-

[35] However, it is interesting to speculate on what would happen should a corporation on the facts of the principal case become insolvent at a later date. Would those courts which allow recovery of dividends which were made by a solvent corporation to a bona fide shareholder still allow recovery at that subsequent date if the second dividend transaction has intervened? The answer logically would depend on whether the set-off was really deemed a "recovery of dividends" by the corporation so that there was no longer a wrong outstanding. The following argument might be made: declaration of dividends from surplus is discretionary with directors (subject to limitations on excess accumulation of surplus). Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919). This is so even as to cumulative preferred or "cumulative-non-cumulative" stock; there is no duty to pay dividends, the preference merely establishing priority if and when there should be a declaration. But when the dividend is declared, a debt is established from the corporation to the shareholder. Staats v. Biograph Co., (C.C.A. 2d, 1916) 236 F. 454. If, then, the corporation declares a dividend out of surplus for the preferred (as in the principal case), it creates a debt for that amount. If the corporation then sets-off that debt (as in the principal case), it has diminished its obligations by the amount of the set-off and has thus recovered the prior wrongful payment. The reasoning, perhaps, is strained, but may offer a proper analytical approach for wiping out the wrong to the corporation: when a dividend is later declared on behalf of the common, after the set-off transaction, the creditor has no remaining complaint, any dispute which remains existing only between the various shareholder classes.

The principal case, of course, does not accept this reasoning, saying that the set-off which exists is only between classes of shareholders and not between the preferred and the corporation.

[36] Salina Mercantile Co. v. Stiefel, 82 Kan. 7, 107 P. 774 (1910). With skillful reasoning the court rejects the defendants' contention, at p. 8 that the no-dividend-out-of-capital rule is solely for the protection of creditors, and that, therefore, if a corporation owes no debts, its directors may without doing a wrong divide any or all of its assets among the stockholders, "since this would merely be restoring the property to its real owners."

[37] Gager v. Paul, 111 Wis. 638, 87 N.W. 875 (1901). And if the corporation refuses to sue, a shareholder may do so in its name, but, "when he does so, he merely enforces the right which the corporation has, and the relief granted must be measured by that right." At p. 652.

wise, for the theory of adjustment between classes that the court adopts is predicated on the finding of an original wrong to the junior shareholders at the time of wrongful payment, which wrong is now held to justify a second flouting of charter terms. Nor, unless the wrong is solely to the junior shareholders, has any earlier harm to the corporation ever been cured. And, further, the court finds critical to its decision a discussion of whether the set-off violates the Uniform Stock Transfer Act ban on secret liens in favor of a corporation;[38] the court concludes that it does not, not merely because this set-off is not a "lien," but, further, because the set-off is not in favor of the corporation.

If one does not accept the court's conclusion as to whose right was invaded, as apparently no other court has, the payment to the common ahead of the preferred shareholders seems merely a second wrong, which not only does not "right" the previous wrong, but exists independently of it. An analytical rationalization might be offered for the result; namely, that the corporation in the second dividend declaration first declares a dividend for the preferred shareholders, creating a debt as to the latter. It then diminishes that debt by a set-off measured by the previous wrongful overpayment. Then, it may be argued, subsequent payment to the common shareholders is not in advance of payment to the preferred, but rather a later exercise of the director's discretion to declare dividends on the common.[39] This, of course, is not the approach of the New Jersey court.

2. *From whom may recovery be made?* There remains what is probably the most serious objection to the remedy employed in the *Agnew* case. That objection is that the corporation, in employing the remedy, can take no account of the identity of those who did receive prior wrongful payment and those who did not. Whereas in the usual recovery-of-improper-dividends suit, apart from the theory on which it is based, the corporation may pursue only those shareholders who did actually receive the questioned payments, the remedy of set-off-in-favor-of-common-shareholders cannot be adapted to a set-off penalty against only those who in-fact had previously shared. Thus indiscriminately, the blanket class penalty strikes all the class members. Those who received the prior wrongful payment and those who bought shares yesterday are equally punished. And, while totally innocent parties may suffer, their predecessors in title go free, having pocketed and retained the wrongful payments with impunity. Also, common shareholders who became such subsequent to the wrongful payment now enjoy a

[38] N.J. Rev. Stat. (1937) § 14:8-41.
[39] See note 29, supra.

windfall, since their advance payment violates their expressly conceded subordinate standing in the receipt of dividends. Waiving all other objections, one could find the New Jersey remedy sound only if the persons who were shareholders at the time of the wrongful payment continued to be so. That situation will not probably exist, in which event the dynamic existence which is characteristic of most bodies of shareholders would militate against the remedy of the *Agnew* case.[40]

D. *Conclusion*

It is difficult to ascertain the motivations prompting the unusual corporate conduct in the principal case. A closed corporation which has experienced no intervening stock transfers between the time of a wrongful dividend declaration and the time of the subsequent "set-off" might justifiably apply the remedy, assuming it would base such action on the strength of the rationalization earlier suggested.

But in what is undoubtedly the setting of most corporations, the set-off approach appears neither analytically correct nor fundamentally fair. The remedy faultily presupposes a group of shareholders which is unchanging in membership; and since the supposition must generally be incorrect, so, recent, innocent purchasers of the stock class which had previously enjoyed the wrongful payment are subjected to penalties in violation of their dividend contract, while their predecessors who did receive payment need not account for those payments. Further, what must properly be viewed as a wrong to the corporation remains uncorrected—unless, of course, one denies the problem by denying the premise, as did the court in the principal case.

These objections carry still further meaning since recovery of dividends would seem possible as an alternative remedy, at least in some states.[41]

Theodore Sachs, S.Ed.

[40] The court was aware of the difficulty, but did not think it damaging. See note 26, supra. There is an additional problem, that of the mathematics involved. Do the common shareholders now receive an aggregate payment equal to the wrongful overpayment, or a per-share dividend equal to those formerly given, or what alternative measure is employed?

A final question which might be asked deals with the matter of directors' liability. Would liability, if present, be extinguished by the imposition of a "set-off"? The answer would logically be in the negative, unless the earlier-mentioned "rationalization" of the corporation's conduct is employed.

[41] Those finding a wrong as to the corporation. Salina Mercantile Co. v. Stiefel, 82 Kan. 7, 107 P. 774 (1910).