Reducing Rate of Dividend on Preferred Stock

William Q. de Funiak

Follow this and additional works at: http://scholarship.law.nd.edu/ndlr

Part of the Law Commons

Recommended Citation
William Q. de Funiak, Reducing Rate of Dividend on Preferred Stock, 14 Notre Dame L. Rev. 23 (1938).
Available at: http://scholarship.law.nd.edu/ndlr/vol14/iss1/3
REDUCING RATE OF DIVIDEND ON PREFERRED STOCK

It must be stated at the outset that it is not the purpose of this discussion to treat of such matters as the reduction of the preferred stock of a corporation to be distributed ratably among the preferred stockholders, the cancellation of accrued dividends, the priority rights of preferred stock, or similar questions.

In the treatment of such a question as that of the right of a corporation to reduce the dividends on preferred stock, and the rights of the preferred stockholders where such an attempt is made, many factors are involved. Contract rights between the stockholders and the corporation, varying provisions of state statutes, reservations in the articles or certificate of incorporation or in the certificates of stock, all come into play. The dogmatic statement of principles or rules of law is not always possible.

However, certain principles sufficiently established require recognition as a foundation for discussion of the question.

The right to dividends on preferred stock rests partly, at least, in contract and is on an entirely different footing from the right of the common stockholder. The contract may have its foundation in a by-law, or in the provisions in the certificate of incorporation and in the stock certificate.

The preferred stockholders are entitled to such dividends as are provided for in the terms of the contract, so long as there are funds rightfully available for payment, and the
right is not waived. Such rights are inviolable and the preferred stockholders cannot be deprived of them by any action of the directors or common stockholders to which they do not consent.

However, let us consider briefly the question of consent by the preferred stockholders themselves, permitting changes in relation to the preferred stock. Such a change must generally be effected by amendment of the articles or certificate of incorporation which usually, pursuant to statute, authorize the issuance of the preferred stock, prescribe the rate of dividend, etc. Since consideration of the amendment of the articles or certificate of incorporation leads us into a complex and diverse subject, we refer only briefly to the fact that the statutes of the several states now generally reserve a blanket or general power of amendment, or the articles of incorporation may reserve such right.

The statutes themselves vary as to what proportion of the stockholders must agree to an amendment. Where all the stockholders must agree to any amendment, it would seem that a unanimous agreement to a change in relation to the preferred stock could effectively accomplish a reduction in dividends. However, under statutes permitting merely a general or blanket right of amendment upon a vote of a specified majority of each class of stock, it would seem extremely doubtful that a vote of the specified majority of preferred stockholders, assenting to an amendment in relation to the

---

8 In Keith v. State ex rel. Mills, 113 Ohio St. 491, 149 N. E. 866 (1925), it appears that an increase in the rate of dividend of preferred stock was agreed to by all the preferred and common stockholders.
preferred stock, could affect the contractual right of the minority non-assenting preferred stockholders to a definite rate of dividend.\(^9\)

If the statute provides not only as to amendment but specifically as to amendment in relation to the preferred stock upon a vote of assent by a specified majority of the preferred stockholders,\(^{10}\) it may reasonably be argued that anyone thereafter acquiring preferred stock takes such stock subject to the provision, as part of his contract.\(^{11}\) But it appears extremely questionable to the writer that a preferred stockholder’s contractual right to a specified rate of dividend can be altered by an amendment of the articles of incorporation under authority of a statute enacted after he acquired his preferred stock.\(^{12}\)

In the text encyclopaedia *American Jurisprudence* it is said,

---

\(^9\) See Keller v. Wilson & Co., 190 Atl. 115 (Del. 1936), rev’g 180 Atl. 584 (Del. Ch.).

\(^{10}\) In Wisconsin, for example, the statutes provide that no change in relation to preferred stock once issued can be made except by amendment of the articles of incorporation adopted by a three-fourths vote of both preferred and common stockholders. *Henderson’s Laws of Wisconsin Corporations* § 93, p. 106.

And the Wisconsin Supreme Court, by a four to three decision in the recent case of Johnson v. Bradley Knitting Co., 280 N. W. 688 (Wis. 1938), has declared that such Wisconsin statutes are as much a part of the stock certificates as though printed therein, and that anyone taking such stock certificates takes them subject to the right of amendment in relation to the preferred stock, including amendment to reduce the rate of dividend on such stock.


\(^{12}\) A course of action which if pursued would deprive minority stockholders of dividends to which they were entitled under their contract as original stockholders and would destroy their contractual rights could neither be done by the legislature nor by the majority stockholders. Allen v. White, 103 Neb. 256, 171 N. W. 52 (1919).

"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 the 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 . . . demands that the right be regarded as a vested right of property secured against destruction by the Federal and State constitutions." Keller v. Wilson & Co., (Del.) 190 Atl. 115 (1936), rev’g 180 Atl. 584 (Del. Ch.).
"In the absence of any reservation, the obligation to pay dividends on the preferred stock at the rate contracted may not be altered without the assent of the preferred stockholders." 13

This statement, of course, implies the converse that if there is a reservation, the rate may be altered. This language, unfortunately, is too broad and general to be of much value. 14

For example, what sort of reservation would permit of a change in the dividend rate? What must its phraseology be? If the reservation is one expressly permitting a change in the dividend rate by a majority vote of preferred stockholders, it might very well be that any preferred stockholder acquired his stock subject to such reservation as part of his contract. But if the reservation is merely one of a general or blanket nature, providing for amendment upon a majority vote of preferred stockholders, we are faced, as has been seen, with the situation that an amendment reducing the dividend rate, although ostensibly validly adopted by a majority vote, would affect non-assenting stockholders' contractual rights to a definite rate of dividend.

While a Kentucky case 15 has declared that a statute of the state, permitting a corporation to change or amend its articles of incorporation upon a two-thirds majority vote of the capital stockholders, was a part of the charter of every corporation, so that an amendment was valid which changed preferred stock with a par value of $100 a share and entitled to an annual dividend of 6½ per cent, to stock with a par value of $25 a share and entitled to annual dividends of $6.50, it will be noticed that there was actually no change in the rate of dividend to which each share of stock was entitled.

A number of cases have, of course, determined that a corporation may change par value stock to stock of no par value,

14 The authorities cited to support the text statement are Annotations in 6 A. L. R. 832; 67 A. L. R. 780; 98 A. L. R. 1530.
where power to do so existed under express statutory authority. In considering those of the cases involving preferred stock, it is either impossible to discover what effect, if any, such change had upon the rate of dividend, or else it expressly appears that the change did not affect the dividend rate, there being the same proportionate return in dividends after the change. In one of the cases, in enumerating the many instances in which a corporation has the power of amendment, the court included power to fix or alter the dividend rate "in respect to unissued or treasury shares of any class or series". This would seem to imply, in spite of the court's recognition of a wide range of subjects as to which amendment might exist, that no right of altering the dividend rate existed in the case of stock already in the hands of a stockholder.

While the case of Pronik v. Spirits Distributing Co. was decided some 40 years ago, it is very pertinent to the scope of this inquiry. The preferred stock of the corporation had been issued under a statute then in force, authorizing corporations to create and issue two kinds of stock, general and preferred. The preferred could be made subject to redemption at par at a fixed time, to be expressed in the stock certificate. The statute further provided that the holders of the preferred stock should be entitled to receive, and the company bound to pay thereon, a fixed yearly dividend, to be expressed in the certificate, not exceeding 8 per cent per annum, before any dividend should be set apart or payable on the common stock. Unless otherwise provided in the organization certificate, the preferred stock was not to be created, or certificate issued therefor, except by authority to the

---

16 See cases cited in FLETCHER CYC. CORPORATIONS (Perm. Ed.) §§ 3696, 5151, 5152; Annotation 105 A. L. R. 1452, at p. 1462.
17 See, for example, Randle v. Winona Coal Co., 206 Ala. 254, 89 So. 780, 19 A. L. R. 118 (1921).
20 58 N. J. Eq. 97, 42 Atl. 586 (1899).
board of directors, given by two-thirds vote of the stockholders at a meeting called for the purpose.

In the case under discussion, the original certificate of incorporation authorized the creation and issuance of two classes of preferred stock, the first preferred providing for 7 per cent cumulative dividends, the second, 6 per cent non-cumulative dividends, both with an ultimate participation in further dividends along with the common stock. There was no express reservation in the certificate of incorporation of any right in the stockholders to alter, amend or modify the provisions as to the dividends. Certificates of both classes of stock, duly issued, signed and delivered to the stockholders, contained the same provisions as to the rights of the holders of preferred stock, and did not contain any reservation of right in the corporation to alter, amend or modify the amount of dividends payable.

It was said that under that method of providing for the issue of preferred stock there was a contract, not only among the stockholders themselves under the organization certificate, but a contract, in addition, between the stockholders and the company, created by the certificate itself, as to all those matters which the statute directed to be expressly determined by the certificates. A contract so issued under the statute and containing the provisions as to the rate of dividend, which the statute expressly authorized the holder to receive and obliged the company to pay, created a direct obligation or contract between the stockholders and the company as to the rate of dividend, which could not be altered without the stockholders' consent.

It also appeared that at the time the company was organized the statute then in force authorized corporations, with the assent of a majority in interest of the stockholders, to amend its original certificate of incorporation, and providing that the amended certificate should take the place of the original certificate of incorporation and should be deemed
to have taken effect as of the date of the filing and recording of the original certificate.

It was held that such general powers of amendment of the certificate of incorporation, originally fixing the relation among the stockholders *inter sese*, did not confer the power of altering the previous contract of the company itself with the stockholder as to the rate of dividend created by a stock certificate required by statute to express the rate of dividend, and which reserved no power in the company to change such rate. Such an alteration, it was said, would have the effect of impairing the obligation of the contract created by the stock certificate issued under the company's charter.  

In contrast with this older case may be considered the very recent decision of the Wisconsin Supreme Court in *Johnson v. Bradley Knitting Co.* In that case a stockholder sought to restrain the corporation and its officers from carrying out a plan of reorganization through certain amendments of its articles of incorporation which, among other things, would have reduced the rate of dividend on the first preferred stock. The stockholder contended that general or blanket language in a statute or charter authorizing amendment of the articles upon a vote of the prescribed majority should not be construed as relating to changes impairing contractual obligations or taking away vested rights of the stockholders.

The Wisconsin statute, in part, provides:

"Any corporation may, in its original articles, or by amendment thereto, adopted by a three-fourths vote of stock, provide for preferred stock; for the payment of dividends thereon at a specified rate before dividends are paid on the common stock. . . ."

"Certificates of preferred stock and common stock shall state, on the face thereof, or on the reverse side of such certificates with an appropri-
ate reference thereto on the face thereof, all privileges accorded to and all restrictions imposed on preferred stock.”

“No change in relation to such preferred stock shall be made, except by amendment to the articles adopted by a vote of three-fourths of the preferred and three-fourths of the common stock.”

The court declared that those statutes were as effectively a part of the stockholder’s certificates of stock and of the corporate charter as though printed therein, and that at the time the stockholder purchased his stock from the corporation the right to amend the articles of incorporation was reserved both by the articles of incorporation and the statutes above quoted. Accordingly, the proposed amendments, having been adopted by the required statutory vote, were valid and binding upon the stockholder, who was said to have consented thereto in advance when he became a member and stockholder of the corporation.

It is to be noted that the decision was by a four to three vote of a divided court. In a strong dissenting opinion it was pointed out that under the common law rule the contract between the corporation and the preferred stockholders cannot be impaired without their consent by any subsequent action of the corporation, and that statutes in derogation of this common law rule must be strictly construed. It was argued that the language of the statutes in question was blanket language which should not be so interpreted as to affect or destroy valuable rights.

The case of Farrier v. Ritzville Warehouse Co. is also of interest. The by-laws of the company permitted their own amendment by a vote of the majority of the stockholders. As originally adopted they provided for an equal division of 50 per cent of the dividends among the stockholders, and a division of 50 per cent among those stockholders dealing with the corporation. In 1912 the by-laws were amended to

26 As to this rule see supra, text and note 5.
27 116 Wash. 522, 199 Pac. 984 (1931).
provide that each stockholder should receive a 10 per cent dividend from the company's earnings, the remainder of the earnings to be divided among stockholders dealing with the corporation. Again in 1919 the by-laws were amended, reducing the 10 per cent dividend to 7 per cent. While stockholders were said to be estopped by the passage of time and the acceptance of dividends from protesting the change of 1912, as to the latter change it was held that the majority stockholders could not compel the minority stockholders to submit to such a change.

While the constitutional safeguards set up in this country against impairing the obligation of contracts do not exist in England, nevertheless attention may be called to at least one English case in point. Therein, a plan to change existing preference shares for new preference shares with a lower rate of dividend was declared to be prejudicial to the interests of the shareholders and could not be adopted without their consent.

A case open to some question, decided in the Delaware Court of Chancery, merits some consideration. The facts show that the certificate of incorporation provided that preferred stock was entitled to receive 7 per cent dividends, which were cumulative, and thereafter the common stock might receive 7 per cent from the surplus. After those dividends were declared and became payable, a certain portion of any remaining surplus was divisible among preferred and common stockholders. The directors called a special meeting at which they proposed to submit for consideration an amendment which, while not affecting the right of the preferred stock to its 7 per cent cumulative dividend, would deprive it of its opportunity to share in the surplus with the common stock. One of the stockholders sought relief against

---

28 Re Neath and Brecon etc., R. Co. (1892) 1 Ch. 349.
the holding of such meeting, but the court discharged a rule requiring the corporation to show cause why preliminary injunction should not issue, and vacated a restraining order previously issued.

While the specified rate of dividend was not reduced, it will be noted that the right to share in the surplus was as much a right of the preferred stock as was the right to the 7 per cent dividend. The court apparently believed that the general right of a corporation to amend its certificate of incorporation, reserved by the statutes, was part of the stockholders' contract, to the extent of warranting the proposed amendment. It further cited the statute allowing the altering of preferences given to any one or more classes of preferred stock.

Before concluding this discussion it may be of interest to call attention to Section 77B of the Bankruptcy Act, providing for reorganization of corporations. It is there said, among other things, that "A plan of reorganization within the meaning of this section . . . (2) may include provisions modifying or altering the rights of stockholders generally, or of any class of them, either through the issuance of new securities of any character or otherwise." While this apparently permits reduction in the rate of dividends on preferred stock, further discussion of the matter is not undertaken as the writer considers it not within the strict scope of this article.

The conclusions of the writer from the available authorities may be briefly summarized: Where power to amend the articles or certificate of incorporation in relation to the rate of dividend is expressly reserved, or where power to make amendments in relation to preferred stock generally can reasonably be construed to include reduction of the dividend rate, such reduction can be made as to preferred stockholders thereafter acquiring their stock. But a mere general power to amend articles of incorporation cannot be so exercised as to
affect vested contractual rights, including that of receiving a specified rate of dividend on preferred stock. And no statutory enactment, subsequent to acquisition of preferred stock, can validly authorize an amendment affecting the dividend rate on such stock.

William Q. de Funiak.

Chicago, Illinois.