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NOTES

PARTICIPATION OF PREFERRED SHAREHOLDERS BEYOND STATED PREFERENCE

In the absence of express provision, may preferred shareholders participate in dividends beyond the stated preference? In the recent case of *Tenant v. Epstein*,[1] the Supreme Court of Illinois was called upon to answer this question under rather unusual circumstances. The corporation was organized with capital stock of $160,000, consisting of 2000 shares of $5 par value common stock, and 30,000 shares of $5 par value 7% cumulative preferred. Tenant owned 500 shares of common and 2000 shares of preferred stock, while the Epsteins[2] had 1500 shares of common and 28,000 shares of preferred stock. Both common and preferred carried one vote per share. Cash dividends of 7% on the preferred stock had been paid annually during the seven year period of the

[1] 356 Ill. 26, 189 N.E. 864 (1934), noted in 83 Univ. Pa. L. Rev. 91 (1934).

[2] The Epstein family were directors of the corporation and owned all stock except that owned by Tenant.

corporation's existence. At the end of this period, no dividends having been declared on the common stock, an "equalizing"[3] dividend of 49% was paid on the common. Subsequently a stock dividend was declared of one share of $5 par value common stock for each share of outstanding stock, common and preferred.[4] In connection with the stock dividend $160,000 of the accumulated surplus was capitalized. A cash dividend was thereafter declared on all common stock.

Tenant objected to the sharing of the preferred in the stock dividend and the subsequent cash dividend asserting that the surplus belonged only to the common shareholders either as dividends or as surplus on liquidation. He contended that since the articles of incorporation contained no express provision allowing the preferred to participate[5] and the certificates of stock expressly limited the preferred to the 7% preference,[6] the preferred stockholders had no right to share in this dividend, which was admittedly in excess of the 7% preference. The Epsteins sought to justify the action of the corporation on the following grounds: (1) Since the articles of incorporation did not expressly limit the preferred to the stated preference, preferred shareholders should participate equally with the common in all dividends.[7] (2) To protect the preferred shareholders' proportionate interest on the assets of the corporation on dissolution[8] they should be permitted to participate in stock dividends. (3) Likewise, to protect the preferred shareholders proportionate voting strength, they should share in all stock dividends.

[3] This was called "equalizing" because the total dividends paid on the preferred stock before that time had been 49%. It was the theory of the Epsteins that this 49% to the common would put both classes of stock in a position to share in a stock dividend.

[4] Tenant received 2500 shares, making his holding 3000 shares of common and 2000 shares of preferred stock. The Epsteins received 29,500 shares so they then held 31,000 shares of common and 28,000 shares of preferred stock.

[5] The articles of incorporation provided: "The preferred stock shall be seven per cent (7%) cumulative dividend preferred, and shall be a first lien on the assets of the company in event of dissolution, over the common stock of the company, and shall be entitled to payment of seven per cent (7%) cumulative dividend annually before any dividend shall be declared and paid upon the common stock of the company." 356 Ill. at 30.

[6] The certificates were similar to the articles except that they included the provision, "The holders of the capital preferred stock shall receive from the surplus or net earnings of the corportation dividends at the rate of seven per cent (7%) per annum at the par value of such stock, *and no more*, payable quarterly." (Italics supplied.) 356 Ill. at 31.

[7] See the article and certificate provision, *supra* notes 5, 6. The Epsteins relied entirely on the articles and contended that the certificate provision "and no more" should not be considered because such was antagonistic to the articles of incorporation.

[8] The contention was that even though the court decided the preferred was limited to its preference as a going concern, it was not so limited on liquidation, but rather was participating. Since a stock dividend merely redistributes the units of corporate ownership, the preferred necessarily had to share in the stock dividend to maintain its pro rata ownership in the company.

The Supreme Court held that the rights of the preferred shareholders were limited to the stated preference and the stock dividend was set aside.[9]

As to whether a stated preference limits the right of preferred shareholders to participate in current[10] dividends, the authorities do not agree.[11] Early text writers[12] and a series of Pennsylvania cases[13] take the view that, in the absence of express provision, preferred shareholders may participate in current dividends. Such a view is predicated upon the premise that all stock is basically equal; preferences add to the rights of certain shares but subtract none of the already existing rights. Thus a 7% preference would entitle the preferred shareholders to receive a 7% dividend first, but once the common shareholders had received a like amount, further dividends in the same period would be shared equally. The right to participate could of course be expressly denied.[14]

The contrary and majority view[15] has been accepted in Maryland,[16] Maine,[17] Ohio,[18] a federal court,[19] and England.[20] In support of this view it is said that preferred shareholders should have only those rights that common understand-

[9] 356 Ill. 26, 189 N.E. 864 (1934).

[10] By current dividends is meant the dividends declared in the going concern. From a standpoint of decreasing surplus, stock or cash dividends could be considered current.

[11] See Thompson, The Respective Rights of Preferred and Common Stockholders in Surplus Profits, 19 Mich. L. Rev. 463 (1921) for an analysis of the conflicting views.

[12] 6 Fletcher, Corporations (1st ed. 1919), 6030 ff., § 3634. Conyngton, Corporate Organization and Management (1917), 84, "Unless expressly provided, preferred stock participates equally with the common after both common and preferred have received an equal dividend." 1 Cook, Corporations (4th ed. 1898), § 269, "It seems that unless the corporate contract expressly provides otherwise, preferred stockholders participate in surplus profits remaining after the proper dividend has been declared, on the preferred and an equal dividend on the common." But see note 15 *infra*.

[13] Fidelity Trust Co. v. Lehigh Valley R. Co., 215 Pa. 610, 64 Atl. 829 (1906); Sternbergh v. Brock, 225 Pa. 279, 74 Atl. 166 (1909); Englander v. Osborne, 261 Pa. 366, 104 Atl. 614 (1918).

[14] The Appellate Court in Tenant v. Epstein did in fact conclude that the phrase "and no more" in the certificates expressly negatived equal participation as to cash dividends, but the Supreme Court held that the articles of incorporation alone would have limited the preference, "It was not necessary in the stock certificates to use the words 'and no more' to limit the payment to 7 per cent per annum." 356 Ill. at 38.

[15] 12 Fletcher, Cyclopedia of the Law of Corporations (perm. ed. 1933), § 5448. The author recognizes both views but seems to favor the majority; 1 Cook, Corporations (8th ed. 1923), § 269; Thompson, *supra* note 11, 483 ff. (1921); 11 Corn. L. Quar. 234 (1925); 79 Univ. Pa. L. Rev. 466 (1931); 20 Ill. L. Rev. 288 (1925). But see Christ, Rights of Holders of Preferred Stock, 27 Mich. L. Rev. 731 (1929).

[16] Scott v. Baltimore & Ohio Ry. Co., 93 Md. 475, 49 Atl. 327 (1901); Powers Foundry Co. v. Miller, 171 Atl. 842 (Md. 1934).

[17] Stone v. U.S. Envelope Co., 119 Me. 394, 111 Atl. 536 (1920).

[18] Shiminon v. Screw & Tack Co., 18 Ohio N. P. (N.S.) 569 (1916); Duwelius v. Champion Fibre Paper Co., 25 Ohio N. P. (N.S.) 107 (1924), affd. in 22 Ohio L. Rep. 600.

[19] Niles v. Ludlow Valve Co., 202 Fed. 141 (C.C.A. 2d 1913).

[20] Will v. United Lankat Plantations Co., Ltd., [1912] 2 Ch. 571.

ing and business usage give them, that ". . . . the phrase 'preferred stock' holds out to the ear of the ordinary investor no promise of participation in earnings beyond his preferential dividends."[21]

But granting that the majority view[22] as to cash dividends is the preferable and hence that the stated preference limits participation, stock dividends involve additional problems. For a stock dividend by increasing the number of units of ownership[23] decreases the proportionate interest each share would carry in the assets of the corporation in the event of dissolution.[24] Thus it may be argued that any shareholder whose rights in dissolution are not limited should also share in the stock dividend in order to maintain his proportionate interest.[25] But since a stated preference as to dividends is held to limit the right to dividends, a stated preference on dissolution should be held to limit the participation at dissolution to the amount of the preference. A class of stock limited as to current dividends but carrying unlimited rights to participate in surplus on dissolution is an anomaly giving rise to a number of almost insoluble problems.[26] As held in *Tenant v. Epstein,* charter provisions should not be construed to contemplate this combination of rights unless the language clearly so requires.[27] But even in a case where the preferred shareholders have unlimited participation at dissolution, while that fact may make improper the distribution of a stock dividend among holders of common stock alone, it does not necessarily follow that the preferred shareholders may share in a stock dividend, for such

[21] Stone v. U.S. Envelope Co., 119 Me. 394, 398, 111 Atl. 536 (1920). The court in Tenant v. Epstein adheres to this view completely, "we think the results reached . . . . are more nearly in accord with business usage and the expectations of investors when they purchase preferred shares of stock." 356 Ill. at 35.

[22] *Supra* notes 16, 17, 18, 19, 20.

[23] Gibbons v. Mahon, 136 U.S. 549 (1890); Graves v. Graves, 94 N.J. Eq. 268, 120 Atl. 420 (1923). Montgomery, Income Tax Procedure (1918), 188, 215. The author compares a stock dividend to the process of changing a $5 bill into "ones." The total value is the same before and after.

[24] This argument is frequently advanced when a new issue of stock is declared for the purpose of raising funds. The courts hold that the existing stockholders have a "pre-emptive" right to subscribe for the new shares before it is offered to the public in order to protect their proportionate interest in the dividends and assets of the corporation and their voting power. Stokes v. Continental Trust Co., 186 N.Y. 285, 78 N.E. 1090 (1906); Jones v. Concord & M. R. R., 67 N.H. 119, 38 Atl. 120 (1892).

[25] This was the argument on which the Appellate Court based its decision, 271 Ill. App. 204 (1933). See also Riverside & Dan River Cotton Mills, Inc. v. Thomas Branch & Co., 147 Va. 509, 137 S.E. 620 (1927).

[26] See Continental Ins. Co. v. U.S. Reading Co., 259 U.S. 156 (1922).

[27] If the participation of certain stock was different in current dividends and final dissolution, the stock in control would either declare all the surplus out as current dividends or save it until final distribution, according to its own participation rights. This should clearly be avoided in absence of express provision to the contrary.

sharing would really give the preferred shareholders more than the 7% current dividends to which they are limited.[28]

Since each share of common and preferred stock in *Tenant v. Epstein* carried one vote,[29] the relative voting strength of the common and preferred would be fixed by the number of shares of the two types. In support of the claim of the preferred shareholders to participate in the stock dividend it was urged that if they did not, their proportionate voting strength would be lessened.[30] But unless the limitation on the preferred dividend rights is to be overridden,[31] the preferred shareholders' right to maintain their proportionate voting strength would only be a reason for denying a stock dividend to the common shareholders alone.[32]

Thus, regard for preferred voting rights and participation rights on dissolution (if such exist) may make improper any stock dividend on common stock alone, while regard for dividend limitations may forbid the issuance of a stock dividend to the preferred shareholders. Unless complicated solutions[33] are resorted to, the result is that the corporation may be prevented from declaring *any* stock dividend. And that result seems justified when the relatively small utility of the stock dividend practice is weighed against the injury which is bound to occur to certain shareholders' proportionate rights to dividends, assets on liquidation, or proportionate voting strength when a stock dividend is distributed by a corporation with more than one type of stock.

[28] This is apparent in Tenant v. Epstein, for a cash dividend was immediately declared upon the newly issued stock, which in effect gave the preferred not only a stock dividend but also a cash dividend in excess of their limited 7%.

[29] All stock in Illinois corporations must have one vote per share. Ill. Constitution, Art. XI, § 3.

[30] Eidman v. Bowman, 58 Ill. 444, 447 (1871); Stokes v. Continental Trust Co., 186 N.Y. 285, 78 N.E. 1090 (1906).

[31] This suggestion was rejected in Tenant v. Epstein with the following words: "It is strenuously argued that the stock dividend be allowed to stand because, if declared pro rata, it would effect no change in voting control. While this is true, it very materially effects a more important right, viz., the right to dividends if and when declared." 356 Ill. at 38.

[32] Since the stock dividend was one share for each existing share and all was voting stock, the actual issue of a change in control was not before the court.

[33] A possible but very impractical way to issue a stock dividend in this situation would be to declare the dividend only on the common stock and offer a proportionate number of shares to preferred shareholders at value less an amount equal to any value attributable solely to voting rights. The preferred shareholders would thus be paying for any dividend or asset rights to which they were not entitled as preferred shareholders but would be getting for nothing the voting rights to which they were entitled as preferred shareholders. The obvious objection to such a solution is that it would be nearly impossible to evaluate voting rights.