Amending the Articles of Incorporation—Chapter 1.9

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AMENDING THE ARTICLES OF INCORPORATION

CHAPTER 1.9

Common-law principles vest the general management of corporate businesses in the board of directors whose authority extends to every transaction relating to the ordinary business of the corporation. No direct power over ordinary corporate business can be exercised by the shareholders unless by their unanimous consent.\(^1\) However, amendment of the articles of incorporation is an extraordinary and unusual change, not relating to the ordinary business, and must be authorized by some specified majority vote or written consent of the shareholders with three exceptions:

1. The board of directors may amend the articles of incorporation with respect to the registered office or the registered agent unless otherwise provided by the articles themselves.\(^2\)

2. A court of competent jurisdiction may amend the articles under a plan of reorganization.\(^3\)

3. The incorporators may amend the articles prior to holding the organizational meeting.\(^4\)

The purpose of this law note is to analyze only those amendments which must be adopted by a specified majority\(^5\) of the shareholders thus altering the corporate set-up and varying the contract rights of the shareholders.

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3. In about 20 states, the articles of incorporation may be amended without a shareholders' vote where a plan of reorganization has been confirmed by the decree or order of a court of competent jurisdiction. E.g., S. C. Code §12-19.9 (Supp. 1962); II A. B. F., Model Bus. Corp. Act Ann. 263, §59A (1960). Amendments under court order generally take place in cases of receivership and bankruptcy and their primary purpose is to conserve the debtor-corporation's assets for the greater advantage of all creditors. Thus reorganization is largely administered under the Federal Bankruptcy Act and will not be further discussed in this law note. 11 U. S. C. §510 (1952).
4. S. C. Code §12-19.2 (Supp. 1962), similar to other modern corporation statutes, provides that "Prior to holding the organizational meeting, the articles of incorporation may be amended by the incorporator or if more than one incorporator, then by two-thirds of the incorporators, with the consent in writing of all subscribers, if any, for shares of the corporation. If any such amendment effects a material change in the articles of incorporation, non-assenting subscribers for shares may rescind their subscription without liability."

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I. BACKGROUND AND DEVELOPMENT OF THE DOCTRINE THAT A CORPORATE CHARTER IS A CONTRACT

The articles of incorporation (corporate charter) is a three-fold contract (1) between the state and the corporation, (2) between the corporation and the shareholders or members, and (3) between the shareholders among themselves. The Constitution of the United States declares that "No state shall . . . pass any law impairing the obligations of contracts." In Dartmouth College v. Woodward, the United States Supreme Court held that a corporate charter (articles of incorporation) is a contract within the meaning of the Constitution and consequently state legislative action impairing rights arising under a corporate charter is void unless the state has expressly reserved the power to alter such rights. Thus the state was barred from impairing the obligations of the original articles of incorporation and the shareholders could not change the articles without unanimous action at least in cases of major changes. The effect of Dartmouth College has been virtually nullified in every state except Louisiana by state constitutional provisions or state legislative enactments which reserve power to alter, amend, or repeal all general laws as well as special acts relating to incorporation.

In a state in which existing corporations are subject to the reserved power to amend, a new statute or even a comprehensive new corporation code may be made to apply to all corporations then existing as well as to those thereafter formed. Of course, neither a statute nor a constitutional provision reserving the power to amend or repeal applies to a corporation created before the reservation, unless the corporation expressly or impliedly submits to it. Fortunately, the great majority of states have ruled that the reserved power enables the state not only to alter its own

7. U. S. Const. art. I, §10, cl. 1.
8. 17 U. S. 518, 4 L. Ed. 629 (1819).
contract (the articles as a contract between the state and the corporation), but also to empower amendment of the contracts of others (the articles as a contract between the corporation and its shareholders and among the shareholders

inter se). However, some decisions, while recognizing that the reserved power enables the state to alter its own contract, do not recognize that the reserved power may permit less than all the shareholders to alter the contract between the corporation and its shareholders or the contract between the shareholders themselves. Today when a corporation is formed subsequent to an enactment reserving the power to amend or repeal, the great majority of courts consider the reservation of power a part of the shareholder's contract — a consent on his part that his contract is subject to change. No distinction is made between legislation which purports to amend directly and that which gives to a specified portion of the shareholders the right to amend.

In short, the majority view means that corporate charters issued prior to the reservation of the power to amend or repeal cannot be disturbed by state or shareholder action (unless unanimous); however, charters issued after the reservation of power can be altered by state action or by a specified majority of the shareholders under state regulatory provisions. However, where an amendment affects some right of a particular class of shares, the amendment, in most situations, must be adopted by a vote of the affected class regardless of whether or not such class would otherwise be entitled to vote in corporate affairs. Thus, the contractual relationships between state and corporation, between corporation and shareholders, and between shareholders

inter se may be reached through statutes authorized by the reserved power. But statutes are not always explicit on the matter of how far the designated majority might go in voting changes which are highly detrimental to some group of shareholders. Modern statutes frequently enumerate various specific changes which


13. E.g., Zabrinsky v. Hackensack & N. N. R. R., 18 N. J. Eq. 178 (1867); Wheatley v. A. L. Root Co., 147 Ohio St. 127, 69 N. E. 2d 187 (1944). But even in these states, other cases have recognized the right of shareholders to amend the articles when the amendment is fair, equitable, and in the best interest of the corporation. Franzblau v. Capital Sec. Co., 1 N. J. Super. 517, 64 A. 2d 644 (1949).

may be made by amendment and follow this enumeration by a blanket power of amendment as to any provision which might be lawfully contained in the articles. The following are illustrative of the most controversial amendments which have been challenged in the courts.

II. CANCELLATION OF ACCRUED CUMULATIVE DIVIDENDS

Cumulative dividends on shares of stock give the holder of such stock the right to be paid both his current and accrued dividends before any payment can be made upon shares having lesser preferences. It is generally agreed that a stockholder cannot sue his corporation for undeclared dividends; therefore, the only advantage that holders of cumulative preferred shares have over common shareholders is that no dividend can be paid on the common stock until all accrued dividends have been paid on the cumulative preferred. The problems which arise in this area can best be explained by way of illustration:

(1) X, a small corporation, had 10,000 shares of Class A cumulative preferred and 10,000 shares of Class B common stock.

(2) The Class A shares were entitled to an annual dividend of $10.00.

(3) The Class B shares were entitled to participate equally in excess profits after payment of both accrued and present dividends on the Class A stock.

(4) For a period of 10 years during the depression, X corporation managed to stay solvent but operated with little or no profits. No dividends were declared during this time.

(5) From the facts given thus far, it is clear that cumulative dividends of $100 per share ($10 × 10 years = $100) or an aggregate of $1,000,000 ($100 × 10,000 shares = $1,000,000) have accrued on the Class A stock. In other words, the Class B stock can receive no dividend until $1,000,000 in back dividends has been paid off to the Class A stock.

(6) X corporation now goes through a period of successful years in which it has an annual profit of $200,000 to be distributed in dividends each year.

(7) $10 per share or a total of $100,000 must be paid to the Class A shareholders as their annual current dividend—the other $100,000 of annual profit must also go to the Class A shareholders until all back dividends (totalling $1,000,000) are paid off. Thus, 10 years must pass before the Class B shareholders will be entitled to share in the profits.

(8) Query: May the right to back dividends of the Class A shareholders be eliminated so that Class B shareholders can participate in the distribution of the annual profits?

Numerous cases have arisen in this area, and any attempt to cover all of them extensively would be fruitless. Effort will be made to discuss only the leading cases and the principal questions which have plagued the courts. Various methods have been used in attacking accrued dividends. This discussion will center around compulsory amendments to the articles of incorporation which often fail, and will touch on the voluntary devices of merger and exchange of shares.

A. CANCELLATION BY AMENDMENT

Two questions must be answered where accrued cumulative dividends are cancelled by direct amendment. 1st — Does the state have power to authorize such an amendment? 2nd — If the state has such a power, has the power in fact been exercised?

1. Power of the State to Authorize Cancellation of Accrued Cumulative Dividends by Amendment

Some of the states which have adopted the majority view that the reserved power to amend the articles extends to amendments by the specified majority of shareholders have nevertheless, held that the reserved power does not authorize cancellation of accrued cumulative dividends by amendment. Delaware is the leading proponent of this legal paradox. In Keller v. Wilson, the shareholders passed a plan of recapitalization by which it was proposed to cancel the cumulative preferred shares and all dividends accrued thereon, the holders of the preferred to receive 5 shares of common stock for each share of preferred. The Delaware court held that the

16. 21 Del. Ch. 391, 190 Atl. 115 (1936).
right to accrued cumulative dividends is a vested right in
the nature of a debt or property right and to confer the power
of annulment upon a majority of the shareholders by appro-
priate charter amendment is repugnant to state and federal
constitutional prohibitions against impairment of contractual
obligations and deprivation of property without due process
of law. The statute purportedly authorizing the amendment
in the Keller case was passed in 1933 while the corporation
had been organized in 1925. The reserved power existed prior
to the formation of the corporation. However, any speculation
that the statute's being enacted subsequent to the formation
of the corporation might have been the real reason for in-
validating the amendment was quashed in 1937 by Consoli-
dated Film Indus., Inc. v. Johnson,\textsuperscript{17} in which the Delaware
court said "The case is exactly similar in principle in all but
one respect to [Keller]." The court went on to say that in
Keller the corporation was created before the legislation pur-
portedly authorizing cancellation of accrued cumulative divi-
dends whereas the corporation in Johnson was created after.
Nevertheless, the court found that it made no difference and
approved the holding of Keller.

Since Keller was settled, the question of the remedy to
which the plaintiff was entitled was not decided. Johnson
enjoined filing of the amendment certificate, thus leaving the
question of damages open in Delaware. In Dunn v. Wilson
& Co.,\textsuperscript{18} the federal district court interpreting the Delaware
Law held that the dissenting preferred shareholder whose
accrued dividends had been purportedly eliminated by amend-
ment of the articles was entitled to the dividends which had
accrued up to but only up to the time of the amendment.
In other words, where the amendment purports to cancel both
past and future cumulative dividends, a dissenting share-
holder may recover his accrued dividends, but his right to
future dividends is terminated. This simply means that no
dividends can be paid on the common shares until all accrued
dividends are paid on the preferred. Never having been de-
nounced by the Delaware court, the theory of the Dunn case
as to damages apparently prevails today in that state.

The Delaware view that the reserved power does not enable
the legislature to authorize cancellation of accrued cumulative

\textsuperscript{17} 22 Del. Ch. 407, 197 Atl. 489 (1937).
\textsuperscript{18} 53 F. Supp. 205 (D. Del. 1943).
dividends by amending the articles has been followed in Ohio, North Carolina, and New Jersey. In *Franzblau v. Capital Sec. Co.*, the New Jersey court distinguished its prior decision in the *Longsdale case* holding that it was limited to the situation in which the statute authorizing elimination of accrued dividends by charter amendment was enacted subsequent to the formation of the corporation. Disagreeing with the Delaware court, the New Jersey court held that where the statute is sufficiently explicit and in existence at the formation of the corporation, the right is conditioned from its inception and a charter amendment denying the right is not an elimination of an existing right (vested property interest) but a happening of the condition precedent which precludes the right from coming into existence. In *McNulty v. W. & J. Sloane*, a lower court in New York delivered a decisive opinion permitting elimination of accrued dividends under a statute enacted subsequent to the formation of the corporation. However, Ohio and North Carolina, which refuse to permit elimination of accrued dividends by direct amendment, have not been clear on whether the amendment could be justified under a statute in force at the time the charter was granted. The Pennsylvania Supreme court approved the Delaware view in *Schaad v. Hotel Easton Co.* The approval by the court in *Schaad* was apparently dictum, because the statute purportedly authorizing cancellation of accrued dividends by amendment contained a clause to the effect that the act would not impair rights arising prior to the effective date of the Act. The corporation was in existence prior to enactment and taking effect of the Act.

Many courts have not followed the Delaware view which immunizes accrued dividends from charter amendments. In *Harr v. Pioneer Mechanical Corp.*, the federal court interpreting the Delaware statute three years prior to *Keller v. Wilson* held that upon requisite vote, the corporation had

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22. 1 N. J. Super. 519, 64 A. 2d 644 (1949).
23. 54 N. Y. S. 2d 253 (1945).
25. 65 F. 2d 332 (2d Cir. 1933).
power to create new prior preference shares ahead of outstanding preferred stock, notwithstanding past due cumulative dividends thereon and to abolish rights of holders to receive accrued dividends before holders of other stock received either ordinary or liquidating dividends. In *McNulty v. W. & J. Sloane*, it was held that the general reserved power of the state to alter corporate charters gave the legislature power to provide for charter amendments which would eliminate accrued dividends. The court in *McNulty* took the position that "The right to accumulated dividends accrued by lapse of time but not declared, is not in the nature of a debt. There is no debt until the dividend has been declared." In *Western Foundry Co. v. Wicker*, the Illinois court held that the right to accrued cumulative dividends is no different from any other right of preferred shareholders, saying that it was nothing more than a simple contract right which could be eliminated by amending the contract which created it. Thus the trend of the more recent decisions is to the effect that the right to accrued cumulative dividends may be eliminated if adequate statutory authority exists.

2. Construction of Statutes

In those jurisdictions in which the vested rights doctrine has been abandoned and accrued cumulative dividends are deemed legally destructible, questions of statutory construction frequently arise in determining whether the state has in fact authorized the elimination of such dividends.

a. GENERAL AUTHORITY TO CHANGE OR RECLASSIFY

In *Morris v. American Pub. Util. Co.* a statute providing that a corporation could amend its articles in any way desired, including alteration of stock preferences, so long as the amendment contained only provisions that could have lawfully been contained in the original articles was held not to authorize cancellation of accrued cumulative dividends. In *Patterson v. Durham Hosiery Mills*, the North Carolina court held that statutes authorizing amendments of corporate charters for the purpose of reclassifying shares were not to operate retrospectively and not to authorize cancellation of

26. 54 N. Y. S. 2d 253 (1945).
29. 214 N. C. 806, 200 S. E. 906 (1939).
accrued cumulative dividends. The rule of Patterson was apparently approved two years later in Clark v. Henrietta Mills.\textsuperscript{30} The New York and Ohio courts have also held that statutory authority to reclassify stock does not by implication include authority to eliminate unpaid cumulative dividends.\textsuperscript{31} At this point, it must be pointed out that the Delaware, North Carolina, and Ohio courts are apparently committed to the view that no form of statutory language can authorize elimination of accrued cumulative dividends by direct amendment, while the New York court has held that adequate statutory language may authorize such an elimination.\textsuperscript{32}

*Western Foundry Co. v. Wicker*\textsuperscript{33} involved a somewhat unique situation. Here the statute existing at the formation of the corporation provided that the corporation might include in its articles provisions “Creating, defining, limiting, and regulating the powers of ... stockholders ... and might divide its capital stock into classes ... with such preferences, rights, values, and interests as may be provided in the articles of incorporation.” The articles of incorporation gave the prescribed majority of shareholders power to change the rights and preferences of the preferred stock. The Illinois court held that the language of the articles together with that of the statute was sufficient to authorize cancellation of accrued cumulative dividends by amending the articles.

b. **AUTHORITY TO CHANGE RIGHTS OR PREFERENCES**

In *Morris v. American Pub. Util. Co.*,\textsuperscript{34} statutory authority for an “Amendment which would alter or change the preferences given to any one or more classes of preferred stock” was held not to authorize cancellation of accrued cumulative dividends. The court, conceding that the right to change any preference was granted by this language, said that the right to accrued dividends was not a mere preference but a vested right. After *Morris*, the Delaware statute was amended to authorize amendment of the articles affecting the “relative,

\textsuperscript{30} 219 N. C. 1, 12 S. E. 2d 682 (1941).
\textsuperscript{32} See preceding section, supra on POWER OF STATE TO AUTHORIZE CANCELLATION OF ACCRUED CUMULATIVE DIVIDENDS BY AMENDMENT.
\textsuperscript{33} 403 Ill. 260, 85 N. E. 2d 722, 8 A. L. R. 2d 878 (1949).
\textsuperscript{34} 14 Del. Ch. 136, 122 Atl. 696 (1923).
participating, optional, or other special rights of the share." In Harr v. Pioneer Mechanical Corp. the federal court held that the amended Delaware statute was broad enough to authorize cancellation of accrued dividends. However, three years later, the Delaware court denounced the holding of Harr in Keller v. Wilson & Co. asserting that the statutory language did not authorize cancellation of accrued cumulative dividends by charter amendment. As has previously been pointed out, Keller apparently held that the state is incapable of cancelling accrued cumulative dividends by any form of statutory language.

In Davison v. Parke, Austin & Lipscomb, Inc., the New York court held that a statute authorizing charter amendments to alter preferences of outstanding shares of any class with appraisal rights for dissenting shareholders did not authorize cancellation of accrued cumulative dividends. Davison's holding led to a subsequent amendment of the New York statute expressly permitting charter amendments altering or abolishing "... any cumulative or non-cumulative dividends, whether or not accrued, which shall not have been declared. ..." In McNulty v. W. & J. Sloane, the New York court held that this language authorized the removal of accrued dividends and also upheld the constitutional validity of the amended statute.

In McQuillin v. National Cash Register Co. the Maryland statute permitted any amendment "Which changes the terms of any of the outstanding stock by classification, reclassification, or otherwise." The federal court interpreting the Maryland statute held this language to be sufficient authority for a charter amendment providing for a scheme of reorganization which cancelled accrued cumulative dividends.

c. SPECIFIC AUTHORIZATION TO DEAL WITH ACCRUED DIVIDENDS

In Franzblau v. Capital Sec. Co., a statute in effect at the time of incorporation provided that the right to dividend
arrearage could be satisfied by the issuance of stock therefor or otherwise. The New Jersey court held this language sufficient to authorize an amendment to the corporate charter providing for the surrender of the preferred stock and cancellation of the dividend thereon, in exchange for new preferred shares of stock and a small payment amounting to about 10 percent of the accrued dividend. It has already been pointed out that in McNulty v. W. & J. Sloane,\(^{42}\) a statute authorizing alteration of "... any cumulative or non-cumulative dividends, whether or not accrued which shall not have been declared ..." was held sufficient statutory authority for an amendment cancelling accrued cumulative dividends. In fact, the only issue involved where the statutory authority is explicit is whether or not the right is regarded as being protected by constitutional provisions. If the court is committed to the view that the right to accrued dividends is a vested right, no statutory language could authorize an amendment eliminating such dividends. On the other hand, where the right is not deemed a vested one, explicit language authorizing its elimination could hardly be questioned.

The South Carolina statute expressly provides that "A corporation may amend its articles of incorporation ... To cancel or otherwise affect the right of holders of shares of any class to receive dividends which have accrued but have not been declared."\(^{43}\) However, the lack of case law in this state leaves open the question of whether the South Carolina court will uphold the constitutional validity of this language.

B. CANCELLATION BY MERGER OR CONSOLIDATION

Theoretically, merger and consolidation are separate areas of corporate law from that of amending the articles of incorporation. However, the same problems which arise in amending the articles frequently arise in cases of merger and consolidation. In the area of accrued dividends, a corporation with cumulative dividends due but undeclared may be merged with or consolidated into another corporation and cumulative preferred shares exchanged for those carrying no right as to dividends already accrued. In those states which recognize the right to eliminate accrued cumulative dividends by direct amendment of the articles, no problem arises when such divi-

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42. 54 N. Y. S. 2d 253 (1945).
dividends are eliminated by the more indirect devices of merger or consolidation. However, in those jurisdictions in which a direct amendment cancelling the right to accrued cumulative dividends would be considered invalid, the question arises whether elimination of the right through an indirect device ought to receive judicial sanction.

As previously pointed out, the Delaware court has repeatedly held that the right to accrued cumulative dividends is a vested right which cannot be eliminated by direct amendment of the articles. However, in *Federal United Corp. v. Havender*, the Delaware court held that the elimination of accrued dividends could be affected by merging a parent corporation with its wholly owned subsidiary. Here cumulative dividends totaling $500,000 had accrued on the old preferred. The corporation had an existing capital surplus of $745,000. The plan of merger provided for conversion of each share of old preferred into one share of new preferred and six shares of common. Surrender of shares of the old preferred included surrender of the right to accrued dividends thereon. Practically all of the existing surplus ($745,000) was to be capitalized. The lower court invalidated the merger in so far as it eliminated accrued cumulative dividends, saying that this was merely a scheme to circumvent the long established policy of the Delaware court. However, the lower court's holding was reversed on appeal. The Delaware Supreme court distinguished mergers from amendments on the ground that under the Delaware merger statute, dissenting shareholders had the right of having their shares appraised and purchased by the corporation, while under the amendment statute, dissenting shareholders had no such right. Relying on a supposition that under the merger statute shareholders had constructive notice that accrued cumulative dividends might be eliminated in the event of merger, the court went on to say:

The shareholder has notice that the corporation whose shares he has acquired may be merged with another corporation if the required majority of the shareholders agree. He is informed that the merger agreement may prescribe the terms and conditions of the merger, the mode of carrying it into effect, and the manner of converting the shares of the constituent corporations into the shares of the resulting corporation. A well-under-

44. 24 Del. Ch. 318, 11 A. 2d 331 (1940).
stood meaning of the word "convert," is to alter in form, substance, or quality.

While scholars have questioned Havender's merits, it has been followed by most courts. In *Langfeider v. Universal Lab., Inc.*,46 the federal court interpreting the Delaware law carried Havender's holding one step further by permitting elimination of accrued cumulative dividends under a plan of merger despite a charter provision that the preferred should receive 110% of any reduction in capital plus its accrued dividends up to the time of reduction. A lower court in New York upheld the validity of a merger in which the admitted purpose was the elimination of accrued cumulative dividends.47 New Jersey has also recognized the elimination of cumulative dividend arrearages in plans of merger.48

In two of the earlier cases in this area, the Ohio and Pennsylvania courts refused to allow the elimination of accrued cumulative dividends through plans of merger.49 Refusal in these cases was based on the theory that a merger amounted to a dissolution, entitling the preferred shareholders to par and accrued dividends before anything was paid to the common stock. However, in both states, statutes subsequently altered the law on this point permitting elimination of accrued dividends in cases of merger.50 Thus, it may be stated as a broad general rule that in every state which has specifically dealt with the problem, there may be a compulsory elimination of accrued cumulative dividends in a plan of merger with the shareholder's only remedy being a statutory right of appraisal.51

45. 163 F. 2d 804 (3d Cir. 1947).
50. But see: Jones v. Missouri Edison Elec. Co., 144 Fed. 765 (8th Cir. 1906) (Majority's acts constituted fraud on minority); Opinion of the Justices, 261 Mass. 556, 159 N. E. 70 (1927) (Shares of public utility condemned under the power of eminent domain); Opelka v. Quincy Memorial Bridge Co., 335 Ill. App. 402, 82 N. E. 2d 184 (1948) (This decision did not permit elimination of accrued dividends upon sale of assets, and there is some speculation that the court's reasoning in this case might have bearing on merger cases in this state). Sale of assets is an indirect device sometimes used in attempting to eliminate accrued cumulative dividends; however, this device will not be further discussed in this article. Purchase of preferred stock by the corporation with a corresponding cancellation of accrued cumulative dividends might also be employed particularly where the articles or statute provide for redemption of preferred shares.
C. CANCELLATION BY EXCHANGE OF SHARES

A third device for eliminating accrued cumulative dividends is amending the articles to authorize the issuance of new prior preference stock thereby inducing shareholders on whose stock dividends have already accrued to exchange their shares for the new prior preferred. Those who refuse to exchange their stock find themselves holding shares on which they cannot insist upon payment of their accrued dividends until the new prior preferred shareholders have received all of their dividends. Theoretically, at least, this method does not have the oppressiveness of the compulsory amendment expressly eliminating the right to accrued cumulative dividends. Here, the exchange is voluntary or discretionary with the shareholder. The holder of the old preferred may keep his shares and insist upon payment of his dividends after the payment of dividends on the new prior preferred.

This device also had its inception in Delaware. In Morris v. American Pub. Util. Co.,51 the plaintiff had a 6% cumulative preferred stock on which dividends had accrued. An amendment created prior preferred, participating preferred, and preferred with priorities in that order. The old cumulative preferred was designated as the last of these, but could be exchanged for eight-tenths of a share of participating preferred plus a small payment or scrip. The right to accrued dividends was destroyed upon exchange. If the shareholder of the old preferred chose not to exchange his shares, dividends on the new preferred would be paid before either current or accrued dividends on the old preferred. The Delaware court refused to enjoin the amendment. Some doubt was cast on this decision thirteen years after it was handed down when Keller denied the right to eliminate accrued cumulative dividends by direct amendment. However, five years after Keller, the Delaware court in Shanik v. White Sewing Mach. Corp.52 again refused to enjoin an amendment providing for a voluntary exchange of shares with the consequent elimination of accrued cumulative dividends. Thus, it seems well established in Delaware that the issue of prior preference stock to induce the voluntary release of accrued dividends is not considered an unfair use of the amending power.

52. 25 Del. Ch. 371, 19 A. 2d 831 (1941).
Substantially the same result has been reached in New York and Ohio. Contrary to Delaware, both of these states give the dissenting shareholder the right to have his shares appraised and purchased by the corporation in the case of charter amendments. However, different results have been reached in these states on the question of whether the appraisal right extends to amendments which provide for a voluntary exchange of shares. The New York court has held that a shareholder may have an appraisal when the articles are amended to change his preferential rights; however, the issue of prior preference stock does not entitle the shareholder to an appraisal. In *Johnson v. Lamprecht*, the Ohio Supreme court sustained a plan which gave the preferred shareholder the option of retaining his old stock with accrued dividends thereon or of exchanging for a new prior class and releasing his accrued dividends, but it differed from the New York court by permitting the dissenter to have an appraisal if he so desired. The Ohio court seems to have followed the better view. If appraisal rights in the event of amendments affecting priorities exist under the state statute, courts should not deny such rights simply because the amendment itself provides an alternative for the dissenting shareholder. Other states have also recognized subordination of accrued cumulative dividends by issuance of prior preference stock.

New Jersey has limited the power of the majority to affect accrued cumulative dividends by the issuance of prior preferred stock but the extent of the limitation is uncertain. In *General Inv. Co. v. American Hide & Leather Co.*, two judges concurring specifically stated that, in their opinion, the corporation could not pay dividends on the new preferred stock until dividends on the old preferred had first been paid. It is not clear whether the majority of the court agreed with

53. Matter of Dresser, 247 N. Y. 553, 161 N. E. 179 (1928). In Matter of Duer, 270 N. Y. 343, 1 N. E. 2d 457 (1936), commented on in 85 U. Pa. L. Rev. 824 (1937), plaintiff neither exchanged his shares nor demanded an appraisal. Other shareholders exchanged for the new prior preferred. The corporation began to liquidate. The court refused to compel the corporation to issue new stock to the plaintiff for his old shares and held that the shareholders who had exchanged had priority over the plaintiff.

54. 133 Ohio St. 567, 15 N. E. 2d 127 (1938).


56. 97 N. J. Eq. 214, 127 Atl. 529 (1925).
these two judges. In the only subsequent case on this point, a New Jersey lower court held that, according to its interpretation of General Investment Co., the accrued dividends on the old preferred would have to be paid before dividends on the new preferred.57

North Carolina clearly prohibits subordination of accrued cumulative dividends by the issuance of prior preference stock.58 However, North Carolina does permit the issue of new stock on which dividends should be paid before payment of future dividends on the old stock.59 In other words, preferred stock may be subordinated as of the date of issue of new stock; however, the right to accrued dividends cannot be subordinated.

Thus we see that even in the states which preclude the elimination of accrued cumulative dividends by direct amendment, courts have generally permitted the issue of prior preference stock thereby inducing voluntary surrender of the right to accrued dividends or resulting in subordination of this right to dividends on the new class of stock. However, the North Carolina and New Jersey courts have seen the obvious result of indirectly destroying the vested right and have not recognized the preference of the new prior preferred shares.

The law as to accrued dividends may be summarized as follows:

(1) The jurisdictions are divided on whether the right to accrued dividends may be altered by amending the articles under any form of statutory language. One view is that the right to accrued dividends is a "vested right" protected by the state and federal constitutions from impairment. Under this view, no form of statutory language can affect the right to accrued dividends. A slight majority of states hold that the right to accrued dividends may be altered by compulsory direct amendment of the articles where adequate statutory authority exists. In these states, the question of whether accrued cumulative dividends may be eliminated by amending the articles becomes one of statutory interpretation.

Some states distinguish between statutes enacted prior to the formation of the corporation and statutes enacted after its formation. In these states, statutes enacted prior to the formation of the corporation are constitutional and may authorize the alteration of accrued dividends by amending the articles, while statutes enacted after the formation of the corporation are unconstitutional insofar as they authorize the alteration of the right to accrued dividends by amendment.

In states which hold that amendments affecting the right to accrued dividends are constitutional, the statutes fall into two broad categories. Direct removal of accrued dividends is legal when the statute expressly permits it. Where the statute grants only general authority to amend the articles, authority to change or reclassify stock, or authority to change the rights and preferences of the shareholders, most courts have applied a strict construction and denied the right to affect accrued dividends by charter amendment.

Mergers and consolidations, even if arranged with a subsidiary for the purpose of eliminating accrued dividends, will accomplish this purpose in most states. However, modern merger statutes do provide dissenting shareholders with the right of appraisal.

Indirect removal of accrued dividends by issuing prior preference stock, thereby inducing a voluntary exchange of shares with the accompanying elimination of accrued dividends, has been permitted in all states passing on the question except North Carolina and New Jersey.

The South Carolina statute expressly permits the elimination of accrued cumulative dividends by direct amendment. Thus, only two arguments, both constitutional, could be made in the event an amendment affecting accrued dividends is challenged in this state. One argument is that the state legislature had no authority to authorize alteration of the right to accrued dividends under any circumstances. The other argument is that the statute can only affect corporations formed after its enactment. Both these arguments are based on the theory that the right to accrued dividends is a "vested right" in the nature of a debt or property right. Should

a direct amendment altering accrued dividends be held unconstitutional in this state, the alternative devices of merger and voluntary exchange of shares would presumably still be available if the view adopted in most states which have ruled on the questions is followed. 61

III. ALTERING LIQUIDATION PREFERENCES

Liquidation preferences may include components of accrued dividends and capital. It seems that the capital component should be given as much weight as the dividend component; however, even in jurisdictions which refuse to apply retrospectively legislation permitting by direct amendment of the articles the elimination of accrued dividends, holdings have permitted by this direct method the elimination of liquidation preferences.

In Goldman v. Postal Tel. Inc., 62 the liquidation plan involved the sale of Postal Telegraph’s assets to Western Union. Under Postal’s charter, its preferred shareholders were to receive $60 per share upon liquidation. The charter was amended to provide that Postal’s preferred shareholders would receive Western Union stock in lieu of the $60 preference. The total of Western Union stock to be received by Postal’s shareholders had a value substantially less than the aggregate liquidation preference due. The court approved the amendment, stating that the rights of preferred stockholders to priority of return of capital in distribution of assets on liquidation are not such “vested rights,” “contract rights,” or “property rights” as are constitutionally beyond reach of alteration under the Delaware statute providing that preferences may be changed by requisite vote of a majority of those shareholders affected by the amendment.

In Williams v. National Pump Corp., 63 a statute in effect when the plaintiff obtained his shares authorized amendment of the charter by less than a unanimous vote and provided for a fair compensation for those shareholders who objected

61. S. C. Code §12-19.1(b) (9) (Supp. 1962) provides that “A corporation may amend its articles of incorporation ... to authorize new classes of shares having rights and preferences either prior or subordinate to the shares of any class then authorized, whether issued or unissued.” S. C. Code Chapter 1.10 (Supp. 1962) is the South Carolina statutory authority for mergers.
63. 46 Ohio App. 427, 188 N. E. 756 (1933).
to such amendment. The shareholders voted to amend the articles of incorporation so as to cancel and eliminate the existing convertible or preferred stock, and to convert the same into common stock without nominal or par value, without any of the preferences specified in said certificate of stock as to payment of dividends or distribution of assets in case of dissolution. The Ohio court held the statute constitutional, the amendment authorized, and the statutory remedy exclusive.

In *Transportation Bldg. Co. v. Daugherty*, reduction of liquidation and redemption price from $50 to $30 by charter amendment was permitted. The property of the corporation consisted of a thirteen-story building and lot, and the corporation's history was one of financial instability. The proposed amendment had three main purposes: First, the removal from the articles of certain restrictive provisions which were obstructing successful business management; second, to increase the number of common shares for the purpose of selling the additional shares to a management firm at ten cents per share as the principal consideration for an agreement by the firm to manage the corporation's property for a maximum term of seven years; and third, lowering the call price of the preferred shares. The California court, permitting the amendment, stated that where it clearly appeared from the evidence that the proposed plan would be fair, just, and equitable, that the corporation intended to honestly transact its business under the plan, and that carrying out the plan was in the best interest of the corporation and would not work a fraud upon the shareholders, it was not within the discretionary power of the Corporation Commissioner or the court to deny the change in the corporation's capital structure.

New York and New Jersey have distinguished between voluntary and compulsory amendments affecting liquidation preferences. The New Jersey court has enjoined an amendment affecting liquidation preferences through a compulsory exchange of shares, but the court indicated that the amendment would not have been enjoined had the exchange of shares been voluntary. The New York court has recognized the right to alter liquidation preferences by amending the

64. 74 Cal. App. 2d 604, 169 P. 2d 470 (1946).
articles, but denies even an appraisal if the amendment is voluntary. 66  

Thus it appears that the majority of courts allow liquidation preferences to be altered by amending the articles of incorporation, the only apparent limitation being the equitable one that the amendment must be honest, fair, not detrimental to the rights of creditors, and in the best interest of the corporation. Ohio imposes the additional limitation that dissenting shareholders be given an alternative course in the nature of an appraisal. New Jersey requires the amendment to be voluntary.

Section 9.5(d) (5) of the new South Carolina law makes clear by way of illustration that the authority to “change the designations, preferences, limitations, or relative rights of the shares” granted by section 9.1(b) (6) of the same act includes authority to reduce, alter, or abolish liquidation preferences. King v. Ligon 67 manifests a willingness by the South Carolina court to recognize the constitutional validity of a charter amendment altering liquidation preferences.

Many cases have held that liquidation preferences, like accrued dividends, may be eliminated or altered through the indirect devices of merger and voluntary exchange of shares. However, since the weight of authority permits direct amendments affecting liquidation preferences, these devices will not be further discussed in this law note. On the other hand, should a particular state court invalidate an amendment affecting liquidation preferences, the desired result could presumably be reached through a plan of merger or exchange of shares.

IV. REDEMPTION PREFERENCES

A redemption provision on a share of stock is a contract enforceable against the corporation. The Kentucky court has gone so far as to hold the redemption contract enforceable even though the corporation would be forced to sell its assets in order to discharge the obligation. 68 However, when per-

68. Westerfield Bonte Co. v. Burnette, 176 Ky. 188, 19 S. W. 477 (1917).
formance of the contract will result in preference of shareholders over creditors, the courts in most states will intervene and order that debts to creditors be paid prior to redemption preferences. The question of concern in this law note is whether redemption preferences may be eliminated for the benefit of other shareholders or the corporation itself by amending the articles.

Shares of a corporation may be redeemable in series. This generally means that the corporation has issued preferred stock under a contract to redeem different series (specified shares) at different specified dates. Modern statutes frequently provide that the articles may be amended to divide any preferred or special class of shares into series. Another question which may arise is whether the right to receive redemption preferences in series may be altered once the series have been established. No case is known in which the shareholder majority attempted to alter the series designation by amending the articles. However, in Miller v. Smith Bldg. Co., the corporation suffered losses, so that after the payment of debts, there were not sufficient assets to pay off the preferred shareholders whose stock provided for redemption in series. The court appointed a receiver to pay all the preferred shares equally from the remaining assets. The court reasoned that the earlier maturing stock had a preference over the other only in earnings, and therefore, equal sharing by all the series was required if payment were to be made from capital. The desired result was reached in this case without resorting to the cumbersome process of amending the articles and possibly having the validity of the amendment challenged in court.

A. Making Redeemable Shares Non-Redeemable

Varying views exist on the question of whether redeemable shares may be made non-redeemable by amending the articles. In Davis v. Louisville Gas & Elec. Co., the Dela-
ware court held valid an amendment that reduced the dividend rate on one class of stock and made the corporation's other class of stock non-redeemable. The court reasoned that the corporation should be permitted to raise money by making the redeemable class more attractive to prospective investors. The statute authorizing the amendment was enacted subsequent to the formation of the corporation; however, the court went on to say that such a statute and amendment were within the contemplation of the reserved power and consequently became a part of the original charter when and if passed.

On the other hand, the Michigan court has held that a dissenting shareholder can compel redemption of his shares where a majority of his class has voted not to enforce the redemption provision. The Michigan decision is weakened a great deal by the fact that the vote of the majority was not a formal amendment of the articles. The court also emphasized the fact that the vote of the majority was taken after the redemption contract had matured.

An 1899 Georgia case reached the same result where a majority of the shareholders voted not to enforce the redemption contract prior to maturity of such contract. Again, the vote did not take the form of a formal amendment. Here the plaintiff held stock subject to redemption. Plaintiff did not attend a shareholders' meeting at which all members of his class present voted not to enforce the redemption contract. Nevertheless, the court permitted the plaintiff to enforce his redemption contract individually. The court treated the plaintiff as a creditor rather than a shareholder reasoning that he had loaned the corporation money on which he was to draw 8% interest, and the corporation was to repay the face amount on a specified date. The court relied on the fact that plaintiff had no voting rights as further establishing a creditor-debtor relationship.

The Wisconsin court has indicated that an amendment changing a contract for redemption on a particular date to a contract for redemption at the option of the corporation was not binding on a dissenter, but the court refused redemption because it would have endangered creditors. However, some

76. Koepler v. Crocker Chair Co., 200 Wis. 476, 228 N. W. 130 (1930).
doubt has been thrown on the authority of this decision by the subsequent case of Johnson v. Bradley Knitting Co.,\textsuperscript{77} which sustained an amendment reducing the dividend rate and sinking fund provision.

In King v. Ligon,\textsuperscript{78} the South Carolina court held that statutory provisions authorizing the holders of two-thirds of any class of a corporation's stock to attach thereto additional conditions or penalties not contemplated at the time of its issuance authorized an amendment which removed a contract for redemption. However, this holding seems unnecessary, because the corporation was in receivership at the time of the action, and the same result could have been reached without affirming the amendment.

In a controversial case decided in 1936, the Michigan court held that the date of redemption could not be postponed under a statute enacted subsequent to the formation of the corporation and authorizing charter amendments with the express exception that such amendments could not affect vested rights.\textsuperscript{79} The court based its holding on the theory that the redemption provision was a definite contractual undertaking.

### B. Making Non-Redeemable Shares Redeemable

Divergent views also exist in this area. In Breslav v. New York & Queens E. L. & P. Co.,\textsuperscript{80} the New York court held that an amendment making non-callable preferred shares callable was not authorized by a statutory provision authorizing a corporation to classify or reclassify shares. The New York legislature immediately amended the statute, enlarging the definition of "classify or reclassify" to include the creation, alteration, or abolition of any provision or right concerning redemption of shares.\textsuperscript{81} No litigation has arisen under the amended statute although the American Metal Co. has reclassified its non-callable preferred into a class of callable preferred in reliance thereon.

In Yukon Grain and Mill Co. v. Vose,\textsuperscript{82} the plaintiff purchased preferred stock at a time when neither the charter

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\textsuperscript{77} 228 Wis. 566, 220 N. W. 683 (1923).
\textsuperscript{78} 180 S. C. 224, 155 S. E. 305 (1936).
\textsuperscript{80} 291 N. Y. S. 932 (1936), aff'd without opinion 273 N. Y. 593, 7 N. E. 2d 708 (1937).
\textsuperscript{81} N. Y. Stock Corp. Law §86 (1923).
\textsuperscript{82} 201 Okla. 376, 206 P. 2d 206 (1949).
nor the statutes made provision for its redemption. Shortly after the charter, the law was amended to permit redeemable preferred stock. An amendment to the articles was adopted which called the preferred stock for redemption. The court enjoined the amendment, holding that the statute indicated no intent to authorize amendments which would make non-redeemable shares redeemable. The court said that the statute merely authorized a new class of stock which could be created under proper authority and circumstances, but the legislature, even if it desired to do so, could not authorize interference with the private rights of shareholders under the reserved power.

In Cowan v. Salt Lake City Hardware Co., the corporation's charter provided that, on dissolution, preferred stock was entitled to be paid its par value plus a dividend of 6% per year. Five months prior to the expiration of the charter, the articles were amended to provide that non-callable preferred stock should be callable and redeemable at par plus interest. The amendment also included a provision to extend the life of the corporation. The court sustained the validity of the amendment on the theory that an amendment to extend the life of the corporation is the same as if the corporation had obtained a new charter. The only right the preferred shareholders were entitled to was that of receiving 6% interest until expiration of the charter, and this right was honored by the corporation.

Delaware corporations have reclassified their non-callable preferred by direct amendment under section 242 of the Delaware Law. Thus, in 1949 Hershey Chocolate Corporation reclassified non-callable preferred into callable preferred. It is interesting to note that a 2/3 class vote (instead of the usual majority) was required under the terms of the existing articles of incorporation. The Missouri statute also provides that all shares of non-callable preferred may be redeemed "at the par or stated value thereof" upon vote of 3/5 of all shareholders, but dissenting holders of preferred are entitled to an appraisal upon demand within a specified period; otherwise, a holder "shall be concluded presumably to have consented to the redemption of said preferred shares at their par or stated value."

83. 118 Utah 300, 221 P. 2d 625 (1950).
In *Clarke v. Gold Dust Corp.*, the federal court interpreting the New Jersey statute authorized the destruction of a redemption contract under a plan of merger. Plaintiff, who had purchased preferred, non-callable shares of the constituent corporation was offered either (a) a share for share exchange into 7% cumulative preferred of the surviving corporation, callable at $115 plus dividends, or (b) 2 3/4 shares of no-par common of the surviving corporation. Plaintiff refused both alternatives and did not ask for an appraisal. The court sustained the plan under statutory authority of the corporation to provide for a decrease in its capital stock by retiring or reducing classes of stock. However, prior to *Clarke*, the New Jersey court had enjoined a merger on the ground that the shares for which the dissenter would have to exchange were redeemable in three years. New York has sustained a merger of a parent corporation with its subsidiary, although the old non-callable preferred was exchanged for a new preferred callable at $115.

Both New Jersey and Ohio have approved the exchange device as a method of inducing the voluntary surrender of redemption preferences. The New Jersey court has sustained under a subsequent statute, an amendment which permitted preferred shareholders to exchange 40% of their holdings for bonds. The Ohio court sustained an amendment providing for a new prior stock, retirable at $105 and exchangeable for the old preferred at the option of the holder. As in the case of accrued dividends, the exchanges seem to put pressure on dissenters because the new issues are generally given certain priorities over the old preferred. Nevertheless, no case is known which has invalidated an amendment providing for a voluntary exchange with the consequent subordination of redemption preferences of dissenting shareholders. The situation is therefore analagous to that of accrued dividends. Some states authorize the creation, alteration or elimination of redemption preferences by direct amendment, and in the states which do not permit this type of direct amendment, the de-

84. 106 F. 2d 598 (3d Cir. 1939), cert. denied 309 U. S. 671, 84 L. Ed. 1017 (1940).
sired result may be reached through the indirect devices of merger and exchange of shares.

C. REDUCTION OF CALL PRICE

The few courts which have passed on the question have sustained direct amendments providing for alteration of the call price in redemption contracts. These decisions can hardly be reconciled with those which do not permit removal of the redemption feature, postponement of the date of redemption, making non-redeemable shares redeemable, and alteration or elimination of the right to accrued dividends by direct amendment.


In *Bowman v. Armour & Co.*, the preferred shares were redeemable at $115 plus accruals. There were $18.50 in accruals. The Illinois lower court validated an amendment converting the preferred shares into debentures at $120 plus warrants.

The California court has also indicated that it would sustain an amendment reducing the call price from $50 to $30 on the theory that the higher price was based on an overevaluation.

The following generalizations may be made concerning alteration of redemption preferences:

(1) The majority view is that redemption preferences cannot be altered by direct amendment so as to make redeemable shares non-redeemable, or to make non-redeemable shares redeemable.

(2) Every state which has dealt with the problem has permitted reduction of the call price by direct amendment.

(3) As in the case of accrued dividends and liquidation preferences, virtually any change in redemption preferences can be affected through the indirect devices of merger and voluntary exchange of shares.

Section 9.5(d) (4) of the new South Carolina statute makes clear by way of illustration that the authority to “change the

89. 14 Del. Ch. 136, 122 Atl. 696 (1923).
90. Ill., Cook Cty. Super. Ct.
designations, preferences, limitations, or relative rights of the shares" granted by §9.1(b)(6) of the same act includes authority to reduce, alter, or abolish redemption preferences. Thus, the only grounds on which an amendment altering redemption preferences could be challenged in this state are constitutional. It might be argued that redemption preferences are constitutionally protected "vested rights" which no form of statutory language can affect, or alternatively, that a statute cannot affect corporations organized prior to its enactment.

V. SINKING FUND PROVISIONS

Preferred stock may be issued under an agreement that the corporation will set aside a certain amount annually for the protection or redemption of the preferred stock. These agreements are known as sinking fund provisions and are considered by all courts as contractual obligations which bind the corporation to set aside the specified amount. As in the case of dividends, liquidation preferences, and redemption preferences, these provisions will not be permitted to impair creditors' rights. Absent creditors' rights, there is a split of authority as to whether or not the articles of incorporation may be amended so as to eliminate or reduce sinking fund provisions.

The only case found dealing with the constitutionality of a statute authorizing elimination of a sinking fund provision is Yoakam v. Providence Biltmore Hotel Co.92 In this case, it was argued that the amendment was authorized by two statutes alternatively. One statute existed prior to the formation of the corporation and authorized the alteration of "preferences." The other statute was enacted subsequent to the formation of the corporation and authorized amendment of the "relative, participating, optional, or other special rights of the shareholders." The court concluded that the reserved power did not extend to matters such as sinking fund provisions in which the state had no interest. The court further reasoned that the state could not authorize the abrogation of a corporation's commitment to its shareholders and that no form of statutory language could alter the impairment of constitutionally protected contract rights. The court made no distinction as to constitutional validity between the prior

92. 34 F. 2d 533 (D. R. I. 1929).
and subsequent statutes. In the court's opinion, neither statute, regardless of language or time of enactment, could authorize impairment of sinking fund provisions.

Two cases have struck down amendments altering sinking fund provisions on the ground that the statutory language relied on did not authorize such an amendment. In Davison v. Park, Austin & Lipscomb, the New York court held that statutory authority to "classify and reclassify" stock did not include authority to alter sinking fund provisions. The New Jersey court has held that a statute authorizing the "change of preferred to common stock and such other amendments as might be desired" does not authorize the elimination of a sinking fund.

While no decision has been found authorizing the complete elimination of sinking fund provisions, at least two states have recognized the validity of amendments reducing such provisions. In Johnson v. Bradley Knitting Co., the Wisconsin court held that the general amending power authorized reduction of a sinking fund provision and justified the decision on the theory that the amendment was necessary to the welfare of the corporation. The Kentucky court has recognized the validity of an amendment which reduced the sinking fund, with a contract to partially rebuild it, meanwhile making dividends available to the common stock.

From the few decisions which have dealt with the problem, it appears that the courts have tended to immunize sinking fund provisions from impairment by amendment of the articles. On the other hand, there is little doubt that such provisions could be eliminated by the indirect devices of merger and voluntary exchange of shares.

Section 9.5(d) (9) of the new South Carolina statute makes clear by way of illustration that authority to "change the designations, preferences, limitations or relative rights of the shareholders" granted by §9.1(b)(6) of the same act includes authority to alter or abolish sinking fund provisions.

95. 285 N. Y. 500, 35 N. E. 2d 618 (1941).
97. 228 Wis. 566, 280 N. W. 688 (1938).
99. No case directly in point has been found. However, there is no reason to think that courts will distinguish this situation from that of accrued dividends, liquidation preferences, and redemption preferences where such indirect devices are generally recognized.
Thus the only challenge that could be made to an amendment affecting sinking fund provisions in South Carolina is one of constitutional validity. It might be argued (1) that the state cannot authorize such interference with shareholder rights under any terms, or (2) even if the state has power to grant such authority, it does not apply to corporations formed prior to the enactment of the statute.

VI. ALTERING FUTURE DIVIDENDS

It is generally agreed that future dividend rights may be altered by amending the articles of incorporation if adequate statutory authority exists. The constitutionality of statutes authorizing a specified majority of shareholders to alter dividend rates has seldom been questioned. Two early cases discussed the problem of constitutionality; however, neither decision has value as precedent because of peculiar circumstances in each case.98 The leading case concerning the constitutionality of amendments affecting the dividend rate is *Davis v. Louisville Gas & Elec. Co.*99 In this case, the corporation was organized in 1913. In 1927 the Delaware statute was amended to provide that any previously organized corporation could readjust participation in dividends. In 1928 the corporation amended its charter to eliminate a dividend preference of its Class B stock. The court sustained the constitutionality of the amended statute and charter amendment on the theory that the shareholders should be permitted to alter their intracorporate, and, in a sense, private powers in the interest of a public policy which coveted the corporation's successful progress. There is a tendency to accept the holding of the *Davis* case;100 therefore, the only argument which is generally made against amendments affecting future dividends is one of statutory construction.

Express powers to alter dividend rates have generally been accepted as a valid exercise of the reserved power. In *Harbine v. Dayton Malleable Iron Co.*,101 a power to "... change the express terms and provisions of any class of shares" was held to authorize reduction of the dividend rate on preferred stock. Statutes authorizing amendments af-

99. 16 Del. Ch. 157, 142 Atl. 654 (Ch. 1928).
100. Note, 29 COLUM. L. REV. 88 at 89 (1929).
fecting the "preferences" of the various shareholders have also been held to authorize alteration of the dividend rate. 102

On the other hand, the great majority of courts have held that general powers to amend the articles do not authorize amendments affecting dividend rates. 103 This rule is grounded on the theory that a general power to amend authorizes only incidental changes and altering the right to future dividends is much more than an incidental change. This line of reasoning treats the right to future dividends as being "in the nature of a vested right" constitutionally protected from vague statutory language.

Section 9.5(d) (2) of the new South Carolina statute ascertains by way of illustration that the authority to change the designations, preferences, limitations or relative rights of the shares granted by §9.1(b) (6) of the same act includes authority to alter dividend preferences. There is no case law in this state directly in point; however, the constitutional validity of such a grant has been settled in other states, and there is no foreseeable question of statutory construction under these provisions.

VII. VOTING RIGHTS AND PRE-EMPTIVE RIGHTS

Despite the importance of voting rights, charter amendments altering voting rights have been permitted in the great majority of states. Every state which has dealt with the problem has adopted a rule which precludes constitutional objections to charter amendments impairing voting rights with the possible exception of New Jersey. 104

102. In Johnson v. Bradley Knitting Co., 228 Wis. 566, 280 N. W. 688 (1938), a statute prohibiting changes in shareholder preferences without a three-fourths vote of the class affected was held by implication to permit such changes if the requisite three-fourths approved. Similarly, in Peters v. United States Mortgage Co., 13 Del. Ch. 11, 114 Atl. 598 (Ch. 1921), the court held that where the statute prohibited amendment of preferences without a class vote, the dividend rate could be altered if the class voted approval.


As in the case of future dividends, the principal argument which is made against charter amendments affecting voting rights is one of statutory construction where express authority to alter voting rights is not granted by the statute. In Faunce v. Boost,\textsuperscript{105} the statute enumerated certain permissive amendments. The enumeration did not include voting rights. However, the statute concluded the enumeration by authorizing "such other change, amendment, or alteration as may be desired." From the time of its formation, the corporation had consisted of only one class of voting stock. An amendment to the articles was passed which reclassified the corporation's shares into Class A and Class B. Class A shares were given the exclusive right to dividends and liquidation preferences; however, exclusive voting rights were vested in the Class B, all of which was issued to the defendant as consideration for the cancellation of a certain royalty agreement entitling him to one and one-half shares of stock for every share issued to others after the original issue. The New Jersey court invalidated the amendment, and one of the grounds for the decision was that the amendment was not authorized by the statutory language.

However, the weight of authority is contrary to the New Jersey view. Thus, general statutory authority to amend the articles has been held by the Delaware court to authorize the corporation to take away the voting rights of its preferred shareholders.\textsuperscript{106} The Delaware court has also held that general statutory authority to amend the articles authorized the corporation to transfer the right to vote from the common stock to the preferred,\textsuperscript{107} and to change its voting system from cumulative to straight voting.\textsuperscript{108} In Metzger v. George Washington Memorial Park\textsuperscript{109} the Pennsylvania court sustained an amendment giving preferred shareholders voting rights against the contention of the common shareholders that their exclusive right to vote was a "vested property right.”

\textsuperscript{105} 16 N. J. Super. 534, 83 A. 2d 649 (1951).
\textsuperscript{107} Topkis v. Delaware Hardware Co., 23 Del. Ch. 129, 2 A. 2d 114 (1939).
In a few states, the right to cumulative voting is unalterably conferred by constitutional provision. In these states, the right to cumulative voting cannot be affected unless the constitutional provision guaranteeing such right is repealed.

Closely allied to voting rights are pre-emptive rights whose primary purpose is to protect the voting power of the shareholders. It stands to reason that the courts which permit alteration of voting rights by direct amendment also permit the elimination of pre-emptive rights by direct amendment. Thus, the shareholders' voting power may be decreased by the indirect device of a new stock issue accompanied by an amendment denying pre-emptive rights. Voting rights may also be affected indirectly by a plan of merger or an exchange of shares.

There is virtually no doubt that an amendment affecting voting rights and/or pre-emptive rights would be upheld in South Carolina unless it applied to cumulative voting.

VIII. OTHER AMENDMENTS

Numerous other corporate changes may be affected by amending the articles in most states.

The California court has upheld the validity of amendments shortening the terms of corporate existence, so as to bring about dissolution, even though the existing statute provided means for voluntary dissolution. Virtually all state statutes authorize amendments extending the term of corporate existence, and the validity of such amendments has never been challenged. Similarly, no state statute has been found which does not provide for voluntary dissolution.

110. E.g., S. C. CONST. art. IX, §11.
111. The Draft Version of the S. C. BUS. CORP. ACT of 1962 contained a proposed section which made cumulative voting permissive rather than mandatory. However, the necessary repeal of the constitutional provisions was not accomplished, and the proposed section was excluded from the final version of the Act.
113. This is the combined effect of S. C. Code §12-16.11(b), §12-19.1(b) (6), §12-19.5(d) (7), §12-16.21, §12-19.5(b) (Supp. 1962); S. C. CONST. art. IX, §11.
A corporation's right to increase its authorized shares by charter amendment is generally recognized in most jurisdictions.\(^\text{117}\) In some states this right may be subject to the limitation that the increase may not seriously impair "vested rights" of the shareholders.\(^\text{118}\)

Other generally recognized charter amendments include change of corporate name,\(^\text{119}\) enlarging or limiting the corporate purpose, changing the par value of shares, and recapitalization.\(^\text{120}\)

**IX. CONCLUSION**

The law on amending the articles of incorporation has gone through five stages in this country.

The first stage immediately followed the *Dartmouth College* case in point of time. During this brief period, no amendments to the articles were allowed either through direct action of the state legislature or by majority vote of the shareholders. The theory behind this view was that the articles of incorporation is a contract, constitutionally protected from change without unanimous assent of all parties thereto.

A loophole was found in the *Dartmouth College* holding, and from this loophole developed the second stage. As part of the contract embodied in the articles of incorporation, the state reserved the power to subsequently amend the articles. This view concedes that the articles of incorporation is a contract; however, embodied in the contract is a consent on the part of the shareholder that his rights arising thereunder may be subject to change. However, during this stage, it was held that the articles could be amended only through direct action by the state legislature and not by a majority vote of the shareholders.

The third stage logically followed. Here, it was held that the state legislature, which had reserved power to amend the articles, could delegate this power of amendment to a specified majority of the shareholders. However, the majority's right to amend the articles was limited to incidental changes.


\(^{118}\) Berger v. Amana Soc'y, 250 Iowa 1060, 95 N. W. 2d 909, 70 A. L. R. 2d 830 (1959).


“Vested rights” of the minority shareholders could not be affected.

The rigid protection of “vested rights” proved commercially and economically inexpedient. Furthermore, it was often difficult to determine which rights were “vested” and which were not. It is therefore not surprising that plans of merger and voluntary exchange of shares were recognized as legally effective devices through which “vested rights” could be altered or eliminated. This is the present position of the Delaware and New Jersey courts.

The fourth stage evolved during the depression of the thirties. During this period, the courts in the large corporation states recognized the validity of direct amendments affecting vested rights if:

1. the statute authorizing the amendment existed prior to the formation of the corporation, and
2. the statute contained specific and express language authorizing the amendment in question.

This view apparently still prevails in most states.

Under this view, equitable limitations on the amending power are imposed by some courts in the guise of the “vested rights” doctrine. Where a particular amendment is fraudulent, is obviously unfair, or unduly shifts the wealth of the corporation from one class of shareholders to another, some courts have invoked the “vested rights” doctrine to invalidate the amendment and protect the minority shareholders. This explains the diverse decisions on amendments involving vested rights in the large corporation states. These courts have applied constitutional reasoning in order to reach equitable results. Although this line of decisions has generally reached satisfactory results, it is somewhat confusing and does not provide a satisfactory guide for future decisions.

The fifth stage is still in embryonic form. A few of the recent decisions have permitted amendments affecting “vested rights” subject only to the equitable limitation that the amendment be fair and just to all shareholders and creditors. Without expressly saying so, these decisions have imposed a fiduciary duty on the majority shareholders — a duty to disregard self interest and act in the best interest of the corporation. Clearly, this is the best result. Because of the complexity of the problems and the numerous situations which
arise in this area, equitable restrictions on the majority's power can much more adequately protect minority rights than can rigid constitutional restrictions based on the theory of vested rights.

In addition to equitable limitations on the majority's power, all modern corporation statutes protect the minority's rights by providing for class voting.121 Class-voting provisions specify that amendments adversely affecting the rights of shareholders of a particular class must be adopted by a vote of the shareholders of such class, whether or not such shareholders are entitled to vote generally in corporate affairs.

Four states have adopted statutory provisions entitling shareholders who dissent to a particular charter amendment to have their shares appraised and purchased by the corporation.122 However, in most states, appraisal statutes apply only to certain fundamental changes such as merger, consolidation, and sale of all or a substantial portion of the corporate assets.123 Appraisal rights provide a very satisfactory remedy. Not only do they benefit the dissenting shareholder, but they also aid the corporation and the majority shareholders, because the proceeding for appraisal does not delay the change, but the change will take place subject to the claim of dissenting shareholders.124

Thus it seems that the most satisfactory rule, and the one which is most likely to evolve from the trend of recent statutes and decisions, is to permit any amendment of the articles subject only to three limitations:

(1) Dissenting shareholders must have a right of appraisal.
(2) The shareholders affected by the amendment must be entitled to a class vote.
(3) The amendment must be fair to all shareholders and creditors, and it must be in the best interest of the corporation.

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121. S. C. Code §12-19.5 (Supp. 1962) not only provides for class voting but also enumerates certain types of changes calling for a class vote.
123. This is the situation in South Carolina. E.g., S. C. Code §12-20.9, §12-21.4 (Supp. 1962).