ARREARAGES ON CUMULATIVE PREFERRED STOCKS LISTED ON THE NEW YORK STOCK EXCHANGE: AN ANALYSIS OF EXPERIENCES, 1935-62

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ABSTRACT

ARREARAGES ON CUMULATIVE PREFERRED STOCKS LISTED ON THE NEW YORK STOCK EXCHANGE: AN ANALYSIS OF EXPERIENCES, 1935-62

by Ronald M. Horwitz

When a preferred stock is cumulative, the unpaid portion of the stated annual dividend accumulates in favor of the cumulative preferred shareholder, in most cases even if it is not earned. These accumulated unpaid dividends are called arrearages and must be paid or otherwise legally eliminated before any dividends can be paid to subordinate preferreds or common stocks.

The easiest way to eliminate the arrearages is with a cash payment or an outright retirement of the preferred issue. Frequently, however, the firm does not have the working capital to afford such payments or it chooses not to make cash payment. In these instances, management must resort to non-cash settlements, the most common of which have been recapitalizations and mergers.

The objectives of this study are twofold--to examine the historical role which preferred stock arrearages have had and the value placed on the arrearages when the accrued dividends are settled. To achieve these objectives most effectively the study is organized in the following

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Chapters I and II lay the legal framework which surrounds the preferred stock contract. In Chapter I the legal development of the contract is traced. Chapter II examines the various alternatives which boards of directors can employ to remove the accrued dividends, thus satisfying the claims of the preferred shareholders.

Chapter III discusses the economic and social significances of the arrearages. The preferred issues listed on the New York Stock Exchange were examined at five year intervals from December 31, 1935 to 1950 and then annually to December 31, 1962. Tabulations were made of the number of arreared issues and the dollar amount of the arrearages on each of these dates. The data were analyzed to extract trends and explanations of their behavior. The chapter concludes with a discussion of the discretionary power of boards of directors to declare dividends and its relationship to cumulative preferreds.

Chapter IV focuses its attention on the economic behavior of preferred stocks which became arreared from 1950 to 1962. The dividend policy on these preferreds is scrutinized with regard to the level of annual earnings and the working capital position of the individual firms.

In Chapter V each of the preferred issues on which the arrearages were settled by corporate recapitalizations or mergers from 1951 to 1962 are examined. In each instance the value of the securities in the settlement which the arreared pr

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the arreared preferred shareholders received is compared to the price which should have been paid to retire the arreared shares. The purpose of these comparisons is to determine if the cumulative feature of preferred stocks had any value in corporate reorganizations in which arreared preferred stock was eliminated.

The major findings of the study include:

1. The greatest historical cause of arrearages on preferred stocks was the losses incurred by most firms in the 1930-33 depression. Since that time short-run variations in the amount of arrearages were caused by cyclical recessions and recoveries.

2. Arrearages are most likely to be cleared when substantial earnings reappear.

3. The chances of a non-cash settlement increase, on the average, the longer the dividends are in arrears.

4. Unlike common dividends, the burden of proof should properly fall upon the board of directors to show that an earned cumulative preferred dividend should not be paid.

5. The problem of the long and large accumulation of arrearages both as to the number of issues and the dollar amount seems to be a thing of the past.

6. In general, the cumulative feature failed to have any value in arrearage settlements effected by recapitalizations or mergers from 1951 to 1962.

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ARREARAGES ON CUMULATIVE PREFERRED STOCKS
LISTED ON THE NEW YORK STOCK EXCHANGE:
AN ANALYSIS OF EXPERIENCES, 1935-62

By

Ronald M. Horwitz

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INTRODUCTION

Cumulative preferred stocks have played an important role in corporation finance since the middle of the nineteenth century. Together with bonds, common stocks and non-cumulative preferreds, they have been one of the most popular methods of raising corporate capital. Preferred stocks, both cumulative and non-cumulative, presently constitute over 25% of the total issues listed on the New York Stock Exchange and pay over $300,000,000 of dividends annually.[1]

From the standpoint of dividends, with which this study is primarily concerned, the term "preferred stock" is generally understood to mean stock which is entitled to receive a predetermined amount of corporate distributions of earnings per year before any dividends can be paid on junior securities. When a preferred stock is cumulative, the unpaid portion of the stated annual dividend accumulates in favor of the cumulative preferred shareholder, in most cases even if it is not earned. These accumulated unpaid dividends are called arrearages

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[1]New York Stock Exchange Fact Book (New York: New York Stock Exchange, 1963), p. 47.

and must be paid or otherwise legally eliminated before any dividends can be paid to subordinated preferreds or common stocks.

Holders of cumulative preferred stock may--or may not--eventually receive all back dividends due them. Each of the following possibilities also exists:

1. Some, but not all, of the arrearage may be paid off.
2. The cumulative preferred share owners may be given the opportunity to exchange their holdings for some other security issued by the same corporation.
3. No part of the arrearage may ever be paid off.

Arrearages on cumulative preferreds can become substantial both in dollar amount and the number of issues involved. The ultimate effects of the accumulations can have both economic and social consequences. Large accumulations tend to depress market values of both the preferred and common issues because dividends have been passed on each.

Most preferred stocks have sturdy dividend records; where large arrearages occurred, the majority of stocks in that group date their accumulations back to the Great Depression of the 1930s. Generally prosperous business of the 1940s enabled management to pay off back dividends in many cases. In other situations, arrears have been reduced. Progre

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reduced. Progress has, however, been far from uniform. Although earnings per share of preferreds have in some years been substantial, sufficient to eliminate back dividends, management has often proceeded cautiously.

The social consequences of preferred arrearages are of a moral or ethical nature. The major issue is the refusal by a board of directors to declare a cumulative preferred dividend when it has been earned and when the working capital position is such that the dividend can be paid without financial detriment. This discretionary power held by boards of directors to declare or pass dividends is especially crucial with cumulative preferreds since the investor, in most cases, was willing to pay a premium for the cumulative feature. The passing of an earned dividend in particular dilutes the value of the cumulative feature and should subject the board of directors to close scrutiny.

When a corporation with arreared preferreds reaches the position when it is prepared to resume common dividends, it must seek a feasible method to eliminate the arrearages. The easiest way is to pay all of the accumulated dividends in cash or as part of an outright retirement of the preferred issue. Frequently, however, the firm does not have the working capital to afford such payments or it simply chooses not to make cash payment. In these instances, management must resort to non-cash settlements, the most common of whic

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common of which have been recapitalizations and mergers.

The investor should have some appreciation for the historical value, if any, of the cumulative feature in preferred stocks should he be considering such an investment. For example, it is difficult to understand how the following statement could be made if full recognition of the cumulative feature was standard operating procedure in arrearage settlements: "The great majority of the issues (preferred stocks with dividend arrears in 1962) seem far removed from a worth-while pay-off point. We believe that funds can be invested elsewhere to better advantage" (parentheses mine).[1] Clearly, if it can be shown that the cumulative feature has had little or no value in arrearage settlements, this would tend to reduce the premium that an investor would be willing to pay for cumulation, in arreared issues particularly.

Research on cumulative preferred arrearages has been sadly neglected on a long-term macro sense. Prior studies have considered arrearages at only one point in time.[2] A comprehensive consideration of total arrearages over time, their raison d'etre, their characteristics, and their means of settlement has been noticeably missing in financial

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[1] "Preferred Stocks with Dividend Arrears," The Outlook, May 28, 1962, p. 786.

[2] See for example, the annual tabulations appearing annually in The Exchange from 1952 to 1961.

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literature. This study was undertaken as an attempt to fill this gap. In it, it is hoped that the above questions will be answered and the more salient points which have highlighted the historical record of cumulative preferred stocks uncovered.

Chapters I and II lay the legal and theoretical framework of the study. The legal characteristics of preferred stocks and their corresponding influence on the financial management of the firm are reviewed in Chapter I. The body of the chapter will consist of a discussion of the rights to dividends, when both earned and not earned, of cumulative and non-cumulative preferred stockholders. Special emphasis will be placed on the several facets of the cumulative feature in reorganization or dissolution and their financial implications.

Chapter II will focus upon the various alternatives which boards of directors can employ to remove the accrued dividends, thus satisfying the claims of the preferred shareholders. The most important points to be discussed are: (1) the legal nature of the arrearages under each of the elimination methods; and (2) the related power which management has under each either to completely or partially eliminate the claims of the preferred and the related stockholder remedies.

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amined at length in Chapter III. The discussion is developed from a comprehensive historical review of preferred arrearages as to dollar amounts and periods outstanding. The preferred issues are analyzed to discover if there are some generalizations that can be made covering the economic causes of the occurrence and elimination of the arrearages. If, by examining the historical fluctuations of arrearages for a wide group of preferreds over time, a pattern of dividend action can be uncovered, it can then be used as a guide for future cumulative preferred stock purchases. The stocks will also be analyzed by general industrial categories.

A similar analysis is applied to contemporary preferred arrearages in Chapter IV. This chapter, however, contains a much more intensive examination than that in Chapter III. It is here that an attempt will be made to draw some conclusions regarding the behavior of the arreared preferreds which have not been affected by economic events prior to 1950, thus eliminating the effects of the 1930-33 depression and World War II. In this manner contemporary arreared preferreds can be more objectively evaluated in light of current times. The dividend policy on these preferreds will be scrutinized with regard to the level of earnings and the working capital position of the firm.

In Chapter V the cumulative feature is subjected to tests to determine if cumulation has had any value in recent arrearag

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cent arrearage settlements. The tests will be performed on those preferreds which had their arrearages eliminated during the period 1951-62. The objective of the testing is to determine the degree of compensation received for the arrearages. Three representative case studies will be presented to illustrate the types of problems encountered when attempts are made to settle arrearages.

After evaluating the findings of Chapters III-V the role that the cumulative feature has had in the payment of dividends on preferred stocks will be summarized. In particular, it will be determined whether today's investor can purchase a share of cumulative preferred and still have a reasonable degree of assurance that the cumulative feature will be honored by the firm.

CHAPTER I

THE PREFERRED STOCK CONTRACT

Contemporary business corporations seeking to raise original capital or additional external funds through the issuance of corporate securities may choose from three general forms: (1) bonds, or corporate debt; (2) common stock, or corporate ownership; or (3) preferred stock, a hybrid between the two.

Preferred stock has been the most recent form of the three securities which corporations have used to raise capital. Its history began in the United States in 1836 when the Baltimore and Ohio Railroad Company and the Chesapeake and Ohio Canal Company received statutory authority to issue preferred shares.[1] However, it was not until the middle of the 19th century that preferred stock came into general use, with the railroads issuing the majority of the shares. The laws governing preferential rights have consequently had a relatively short period of development.

Capital stock becomes preferred when it has claims or

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[1]Donald Kehl, Corporate Dividends (New York: The Ronald Press Co., 1941), p. 187.

rights which are higher ranking than the outstanding common issue. The preferential status may take the form of a prior claim on earnings for dividend purposes, a prior claim on assets in the event of liquidation, or both. The extent of the preference is governed by the certificate of incorporation, by-laws, stock certificate, and applicable statutory provisions. All leading states of incorporation have statutes which, in broad general language, authorize corporations to issue preferred shares designating usually in the certificate of incorporation the dividend and liquidation preferences and priorities which such shares shall have over other classes of stock.

Preferred Dividends and the Law

The investment incentive behind the purchase of the vast majority of preferred stock issues is the promise of greater regularity of dividends than would be possible with common stock. Preferred shares are generally entitled to receive distributions of corporate earnings, either cumulatively or non-cumulatively, before any dividends can be paid on the outstanding common shares or any other subordinate stocks. When a dividend of a fixed amount per year is to be paid,[1] an express provision for this

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[1]In return for the dividend preference, the preferred shareholder is ordinarily limited in the amount of his dividends so that if the corporation is unusually successful he may not claim any share of the earnings beyond the fixed rate. Should the preferred stock be given the right

amount should appear in the certificate of incorporation or some other duly authorized corporate instrument. The amount of the annual dividend can be shown as either a given amount of dollars per year or per quarter or as a percentage of the par or stated value of the stock. Even these provisions, however, are only conditional guarantees. For in order to pay preferred dividends two prerequisites must be met: (1) earnings or capital otherwise legally available for dividends must be present,[1] and (2) the board of directors must officially declare the dividends payable.

The problem of defining the rights of the preferred shareholders to their dividends if one or both of these two conditions are not met has been one of the most controversial issues in preferred stock financing. If this situation is not specifically covered in the proper corporate documents, as was often the case with the early preferred issues, the question arises as to whether: (a) the passed dividends will accumulate over the years in favor of the preferred shareholders and must be paid in

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to share in additional earnings, the stock is said to be "participating" preferred.

[1]Legal capital available for earnings distributions as dividends is defined by the corporation statutes of each state. See Harry Buttimer, "Dividends and the Law," Accounting Review, XXXVI (July, 1961), 435 for an excellent summary.

total before any dividends can be declared on the common, or (b) the shareholder's claim expires at the close of the fiscal year of the corporation. If the claim accumulates beyond the close of the fiscal year as in (a), the shares are said to be cumulative. If the claim expires as in (b), they are non-cumulative.

In the absence of a specific provision as to accumulation, the stock is nevertheless, as a general rule, treated as cumulative.[1] A plain provision stating only that dividends shall be preferred in a certain amount or per cent each year at a minimum means that if there are sufficient earnings in any given year, a claim for payment of the unpaid dividends for that year becomes fixed, even though actual payment may be postponed to some other date. Any other interpretation would make the dividend preference specifically non-cumulative.

However, if the dividend for a given year is not earned a question arises as to whether the dividend preference is cumulative in the broad sense of having pre-

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[1]See for example Fidelity Trust Co., v. Lehigh Valley R. R. Co., 64 A. 829 (1906) in which it was stated (p. 831): "There is no provision in the statute bearing directly upon the question of cumulation, and in the absence of any specification to the contrary the general rule would seem to be that the preferred stock is entitled to arrears"; and Hazel Atlas Glass Co., v. Van Dyk & Reeves, 8F. (2d) 716 (1925) where the opinion read (p. 720): "For in any case unless a contrary intention appears, dividends on preferred stock are cumulative and arrears in one year are payable in a subsequent year when there are sufficient profits before dividends can be paid on the common stock."

viously passed unpaid dividends being payable out of later earnings. Any language which might be construed to indicate that the preference was to be from the earnings of a particular year would be sufficient to bar this type of cumulation. To hold otherwise would burden the corporation with unearned fixed charges, similar to debt contracts. There has been a tendency in recent issues to counter this problem by expressly providing that dividends shall be cumulative only to the extent earned.[1,2]

While it is important to clarify the rights of preferred shareholders it should be remembered at this point that rights to passed (accrued) dividends are only a measure of the preferred stock's priority over the common stock in the firm's retained earnings and nothing more. Regardless of the amount which preferred dividends are in arrears, a preferred shareholder cannot sue for payment of an accrued dividend just as he cannot sue for any undeclared dividend.[3] The term "accrued" clearly here does

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[1]For example, Lehigh Valley Coal Corp. $3 1st preferred and Chicago and Eastern Illinois Railroad $2A.

[2]It is possible to conceive of a preferred stock stipulation so strong that it would require directors to declare a preferred dividend whenever earnings were sufficient. Payment of the dividend may however present an acute financial problem and thus would deprive the directors of flexibility in their management of the firm.

[3]The leading case here is New York, Lake Erie Railroad v. Nickals, 119 U.S. 296 (1886).

not mean the same as in the law of debt. The existence of profits creates the potential existence of dividends, while the declaration of the dividend creates the legal liability.

The legal differential between cumulative and non-cumulative preferred stock contracts, where the contract itself was vague as to the rights of its holders, presented a tangle in the courts until the Wabash Railway case of 1930.[1] Until the Wabash decision each case concerning (non)cumulative dividends was settled on its own particular merits, and the courts adroitly managed to sidestep the basic problem of setting forth a general rule to cover all situations.

Before the Wabash case boards of directors deemed that they had the discretion not merely to postpone payments of earnings attributable to preferred stock but also to determine whether or not such stock should be entitled to share in the earnings, even where the earnings were adequate to satisfy the dividend requirements of the stock. This belief stemmed from a fundamental common law right permitting the directors to determine the time when the dividends should be paid and to refrain from declaring dividends when, in their judgment, corporate purposes could best be served by retaining earnings in the business. The right of a stockholder to receive a participation in income could

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[1]Wabash Railway Co. v. Barclay, 280 U.S. 197 (1930).

be made to depend upon the time when it was payable, and thus management could acquire a very real power to steer earnings.

The best known power to route earnings arises when non-cumulative shares are a part of the corporation's capital structure. The most disputed use of this power occurs when there are earnings in any year which could be applied to the payment of preferred dividends (especially on non-cumulative shares) and the directors choose to withhold declaration of the dividends. Should the shares be cumulative or if no stipulation is made as to the effect of passed dividends upon the rights of the shareholders, the preferred shareholder has a claim to the earnings up to the extent of his preference. The controversy had centered around preferred shares specifically entitled "non-cumulative."

The legal questions surrounding the cumulative or non-cumulative nature of preferred shares most often arise in years subsequent to the original passing of the preferred dividends, when the corporation seeks to pay dividends on common stock or second preferred. Such declarations by boards of directors, prior to the Wabash case, were met with the claims of the non-cumulative holders that they were entitled to payment of previously earned but unpaid dividends before any distributions could be made to the common or second preferred holders.

A group of leading cases prior to the Wabash decision[1] held that such earnings, even though withheld, must ultimately be applied to the holders of the non-cumulative preferred, thus giving the non-cumulative stockholders a specific claim on profits not paid to them as dividends. Therefore, a mere failure of the directors in any year to declare earned dividends on non-cumulative preferred did not mean that the holder of that stock thereby had his rights forfeited to dividends for that year. A contrary view insisted that the claim of the non-cumulative shareholders to dividends for any year simply ceased to exist if the directors chose to declare none--leaving the rights of the preferred shareholders at the mercy of the board of directors.

These two views were reconciled in the Wabash Railway case. Wabash had outstanding an issue of preferred "A" stock entitled to receive dividends in each fiscal year up to 5% before any dividends could be paid upon any other stock, but the dividends on the 5% preferred were non-cumulative. There were also outstanding issues of convertible "B" preferred and common stock. No dividend

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[1]See for example: Basett v. U.S. Cast Iron Pipe and Foundry Co., 74 N.J. Eq., 668 (1908); Day v. U.S. Cast Iron Pipe and Foundry Co., 96 N.J. Eq., 736 (1924); Moran v. U.S. Cast Iron Pipe and Foundry Co., 95 N.J. Eq., 389 (1924); Collins v. Portland Electric Power Co., 7 F. (2d) 221 (1925).

was paid on the Class A preferred from October, 1913, until January 29, 1917. Then one per cent was paid quarterly until and including April 30, 1918. From then until May 25, 1925, no dividends were paid on any class of stock. During this period, the corporation had earned the Class A stock's dividend, but rather than declare any dividends, management chose to use some $16,000,000 (which closely approximated the undistributed profits during the arrearage period) for working capital purposes.

On April 1, 1927, Wabash paid a dividend on its second preferred and proposed to pay regular dividends upon the Class B and common stocks without first making good and paying out of surplus the earned but unpaid dividends upon the Class A preferred.

A first preferred holder sought to enjoin both the payment to the other classes out of current earnings and any future dividends until the corporation had first paid the earned but undistributed dividends of prior years on the first preferred. The majority of the Circuit Court of Appeals held that no dividend, even out of current earnings, could be paid on the subordinate stocks until the prior preferred had been paid in full the earned but unpaid dividends.[1]

> Recognizing that no dividend, other than in liquidation may be paid except out of earnings

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[1] Barclay v. Wabash Railway Co., 30 F. (2d) 262 (1929).

> . . . cumulative dividends must be paid regardless of the year in which they are earned, while non-cumulative dividends paid any year are dependent upon the earnings of that year. If not earned in the particular year, the stockholders are not entitled to dividends for that year and the deficiency cannot be made up out of surplus earnings of a subsequent year.[1]

The Court referred to the Norwich Water Co. v. Southern Railway Co. case[2] which held that failure to declare non-cumulative preferred dividends within a year resulted in a loss to preferred stockholders of the right to demand that dividend but not a loss to the directors of their right to pay it.[3] The Court then summarized by stating that a failure by the board of directors to declare dividends on the non-cumulative preferred stock in years when money was earned resulted in giving the plaintiff stockholders a dividend credit entitling them to receive such dividends, and the board may not pay out dividends upon junior stocks until after these earned dividends of the preferred A are first paid and satisfied.[4]

The majority decision of the Appeals Court was written by Judge Manton. Learned Hand vigorously dissented, taking the view that if the dividend was not declared on

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[1] Ibid., p. 262.

[2] Virginia Law Register (N.J.) 203 (1925).

[3] Barclay v. Wabash Railway Co., 30 F. (2d) 266 (1929).

[4] Ibid., p. 267.

non-cumulative preferred shares, it was forever lost, even though it may have been earned.[1]

Wabash appealed the Circuit Court decision and the last word on the subject was written by Mr. Justice Holmes, writing for the Supreme Court, who found for the Railway:

> When . . . the dividends in each fiscal year were declared to be non-cumulative and no net income could be so applied within the fiscal year . . . the right for that year was gone.[2]

There was one important consideration underlying the Supreme Court's decision in the Wabash case--that was the use of prior year's earnings for business improvement purposes to avoid having to pay non-cumulative preferred dividends. Justice Holmes stated that it was the common understanding of lawyers and businessmen that if directors justifiably apply the earnings of non-cumulative preferred stock for any one year to improvements in the business rather than paying a dividend the right to claim the dividend is gone and cannot be asserted later.

It therefore has been the general interpretation of the Wabash decision that in order to stir a court to some sort of remedial action non-cumulative preferred shareholders must at least prove that earnings were retained in

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[1]Ibid., pp. 267-68.

[2]Wabash Railway Co. v. Barclay, 280 U.S. 204 (1930).

conflict with the "wise administration of a going concern."[1] However, since most boards of directors can readily discover some contingent liability or expansionary plan to justify the retention of earnings, this conclusion would be, as a practical matter, ineffective. The Wabash Rule would thus tend to check only the unimaginative common stockholder's board.

An outstanding example of recent interpretations of this issue appears in the New Jersey Courts.[2] Early interpretations of the New Jersey statutes concerning non-cumulative dividends, even after the Wabash case, held to bar non-cumulative dividend accruals for only those years without corporate earnings. The New Jersey Courts themselves, however, have apparently shifted towards the Wabash rule which wipes out non-cumulative claims for earned but undeclared dividends unless the action of the directors was arbitrary or unreasonable.

In the leading New Jersey case[3] the Second Circuit Court held the Wabash case to mean that the board of directors could defeat non-cumulative claims by retaining earnings for any appropriate corporate purpose. More sig-

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[1]Ibid., pp. 197 and 204.

[2]Most court cases involving corporate questions have originated in New Jersey and/or Delaware, which are the two most important states of incorporation.

[3]Guttman v. Illinois Central Railroad, 189 F. (2d) 927 (1951).

nificantly, the court went on to hold that once non-cumulative preferred dividends had been reasonably retained, directors had no power to distribute them to preferred shareholders in later years. As a result, undeclared, non-cumulative preferred dividends are truly forever lost even though the directors, at a later date, might deem it reasonable to compensate non-cumulative stockholders for earlier withholdings.[1]

It has been charged that the Supreme Court confused the issue in the Wabash case by failing to distinguish between: (a) the discretionary power of the directors to determine the time of distribution and division of earnings; and (b) the contractual claim of preference (even if non-cumulative) to precede the common stock undiminished by the failure of the directors to declare dividends each year.[2]

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[1]This finding of the Second Circuit Court is rarely followed. American Car and Foundry made payments of their non-cumulative preferred after 1930 and in 1950 in the form of previously passed dividends. In Diamond v. Darvis, 38 N.Y.S. (2d) 103 (1942), the directors were permitted to pay a previously earned dividend to non-cumulative stock. It has been observed that nothing in the Wabash decision expressly prohibits a board of directors that had decided to withhold dividends for reasons of conservative financial policy, sound at that time, from re-examining and revising its policy in light of later events.

[2]Clifford M. Hicks, "The Rights of Non-Cumulative Preferred Stock--A Doubtful Decision by the United States Supreme Court," Temple Law Quarterly, V (June, 1931), 552.

The only real solution to the problem seems to be to have clear and explicit preferred and common stock contracts which would cover all possible situations. Only when this condition would prevail could the market price of the shares accurately reflect their relative rights. And stockholders would no longer need to resort to costly and time consuming court battles to learn just which rights they acquired when they purchased their stock.

Based on the decision of the Supreme Court in the Wabash case the relative rights of preferred shares regarding dividend distributions can now be summarized. The general rule is that no dividend may be declared upon outstanding common shares until the rights of preferred holders to past and current dividends have been settled. The relative rights of different classes of preferreds are as follows:

1. Cumulative: Dividends accrue to the credit of the cumulative preferred shares at the stated dividend rate each fiscal period, regardless of whether they are earned or declared.[1]

2. Non-cumulative: Dividends accrue to the credit of

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[1]Many preferred shares are cumulative only to a stated maximum (usually lower than the annual dividend rate) per year or in total. Examples of this are two issues of the Curtis Publishing Co. One is a $4 prior preferred on which $3 is cumulative and an additional $1 is cumulative to the extent earned, the second is their $0.60-$1.60 prior preferred issue.

the non-cumulative preferred shares only when the board of directors chooses to declare them. Should directors pass non-cumulative preferred dividends during any fiscal period, the claim of the shareholders to those dividends is gone.

3. Cumulative-When-Earned: Dividends accrue to the credit of the cumulative-when-earned preferred shares only to the extent that they are earned per fiscal period, regardless of whether they are declared. The maximum accumulation per period is the stated dividend rate.[1]

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[1]The importance of the basic differences between the three types of preferred is illustrated by examining how alternative accounting treatments can affect the relative dividend claims. Non-cumulative or cumulative-when-earned can suffer when profits are shifted from one year to the next so that the preferred can be cut off in year I and forced to share with the common in year II.

For example, assume a corporation is capitalized with 1,000 shares of $5 preferred and 1,000 shares of common. During a given fiscal year it earns $3,000 but also incurs research and development costs amounting to $3,000. The board of directors is faced with two accounting options for these costs; it can capitalize them for 10 years or write them off against current income. If the net income for the next fiscal year is $8,000, the claims of the preferred under each alternative accounting method, if no dividends are declared, are as follows:

Type of Preferred	Capitalize		Expense	
	Year I	Year II	Year I	Year II
Non-cumulative	- 0 -	- 0 -	- 0 -	- 0 -
Cumulative-when-earned	$2.70	$5.00	- 0 -	$5.00
Cumulative	5.00	5.00	$5.00	5.00

The Cumulative Feature in Preferred Shares[1]

The cumulative feature usually appears or disappears respectively in new preferred contracts as business conditions become favorable or slacken. During the last stages of the industrial revolution the dividend was more frequently non-cumulative as the promoters of these enterprises had serious doubts of their promised success. From 1897 to the present preferred issues have tended to be cumulative with lower dividend rates due to a greater confidence in the economics of large-scale production as a buffer against the abrupt fluctuations in earnings which fixed charges against the net income of the common (e.g., bond interest) or quasi-fixed charges (e.g., cumulative preferred dividends) can cause.[2]

It is common, particularly in corporations not recently organized, to vest sole voting power in common shareholders with a provision shifting the exclusive vote to the preferred shareholders upon the passing of a certain number of preferred dividends. While this provision was originally thought to satisfy the preferred holders,

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[1]The balance of this study will be concerned with cumulative preferred and the rights and priorities which attach to this security.

[2]Arthur Stone Dewing, A Study of Corporate Securities (New York: The Ronald Press, 1934), pp. 169-170.

it is no longer popular or effective for two reasons:

1. The shift of voting power brings the preferred into the picture too late to save the corporation from reorganization, and these provisions tempt the directors elected by the common stockholders to declare doubtful dividends from a financial management point of view in order to maintain their share of the capital and control.

2. In actual practice these provisions are of dubious value. The common stock management is usually able to perpetuate itself in control by the proxy solicitation mechanism at its disposal. The preferred shareholders do the voting but they, in essence, decide on the same proxies that would be presented to the common stockholders, had they the voting power.

The effect of passed preferred dividends, which in practice is nothing more than the retention of annual earnings, tends to hit non-cumulative preferred stock the hardest. Passing of a common stock dividend merely deprives that stock of its present investment return while its aliquot property interest in the corporation appreciates correspondingly. Though this investment gain is subject to continuing business risk, common shareholders can theoretically realize their capital appreciation by the sale of some shares at presumably enhanced market prices. The non-cumulative stock, however, usually has the opposite market effect, and its price drops when its dividends are passed.

On the other hand, it is often thought that the cumulative preferred shareholders fare even worse than the non-cumulative when dividends are passed. The reasoning is as follows: Presumably investors in cumulative preferred shares were willing to pay some type of "premium" when purchasing their shares in return for the cumulative feature of their security. If cumulative dividends are passed, this retention of earnings permits corporate use of back dividends without payment of an additional return to the preferred shareholders.[1] This has the effect of lowering the return on the cumulative vis a vis the return anticipated, bargained and paid for by the shareholder when the investment was made.

The effect of accrued dividends upon the financial management of the firm can be very serious. When there are arrearages the corporation usually cannot raise additional capital by the issuance of ordinary preferred or common shares. Even attempts to pay the arrearages may result in forcing the common shareholders to go without dividends for many years even after corporate earnings increase due to the drain on working capital and available

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[1]There are some preferred contracts which provide for the accrual of interest on passed cumulative dividends.

legal surplus for dividend declarations. The passing of the dividends will affect the market for the common and may make it difficult for the company to borrow money, or if it can secure debt capital, it most probably will be at a relatively high interest rate.

Should the firm resort to debt financing, it must turn to short term unsecured loans or float mortgage bonds or prior preferred. The first alternative is only temporary; the second involves the risk of insolvency through additional fixed charges against net income. The third method, prior preferred, is the most practical, and if the corporation has reserved the power by majority vote to issue prior stock, this method is apt to be chosen. However, if the new issue is subject to the accrued dividends on the old, then it would be no more saleable than the old.

Cumulative Rights in Reorganization or Dissolution

The last, and perhaps the most important, area of study in cumulative preferred contracts is the rights of cumulative preferred shareholders with dividend arrearages at the time of corporation reorganization or dissolution. Since reorganization or dissolution is most often the result of having accrued preferred dividends on the books for a lengthy period of time which prompted the common to attempt some sort of "fresh start," the rights of the cumulative preferred holder are vital.

If in addition to a provision for payment of capital on liquidation, there is also a clause for priority payment of dividends, the majority of cases permit preferred shareholders to recover in the absence of undistributed earnings, in addition to their capital, the equivalent of what would have been the amount of dividends had there been earnings.[1]

If the preferred stock contract grants only a preference to dividends, the preferred stock is not entitled to a preference in the distribution of capital upon liquidation.[2] It is entitled to share ratably with the common stock in surplus accumulation prior to dissolution which, had the directors chosen to do so, might have been previously completely distributed to common shareholders.[3] If, however, there exists a provision for preference as to capital upon dissolution, the provision will define the full extent of the preference and thus preclude the pre-

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[1]The normal purpose of the rule against payment of dividends from capital, that of protecting creditors in the amount of "legal" capital, would no longer exist since upon dissolution creditors' claims would have to be met in full before any attention can be directed to the distribution between preferred and common stockholders.

[2]Lloyd v. Pennsylvania Electric Vehicle Co., 75 N.J. Eq. 263 (1909).

[3]Continental Insurance Co. v. U.S., 259 U.S. 156 (1922).

ferred from sharing in surplus available after payment of the liquidation value on the preferred shares and the par or stated value of the common.

The cumulative preferred shareholder, entitled to dividends irrespective of earnings, is interested in keeping a failing concern in existence until his dividends wholly exhaust the firm's common capital. On the other hand, a common stockholder is interested in forcing a dissolution or reorganization as early as possible because then the capital assets will be divided, giving him an opportunity to share therein. Consequently, when the dividends of the cumulative preferred shares begin to accrue, the affairs of the corporation would be placed at the mercy of the conflict between the preferred and common shareholders.

The most serious question confronted here is the use of common capital to pay accrued but unearned preferred dividends. The nucleus of the discussion centers around the legal nature of the claim of the cumulative preferred stockholders to undeclared and unearned dividends with and without the presence of undistributed income as of the date of the reorganization or dissolution. The rights and priorities which the cumulative preferred holders have under various alternatives will be examined in the next chapter.

CHAPTER II

ALTERATIONS OF THE CUMULATIVE PREFERRED STOCK CONTRACT

When cumulative dividends are not paid or declared in accordance with the preferred stock contract, these dividends form a type of contingent liability to the firm. Because of the adverse impact of these arrearages upon the financial management of the firm, boards of directors most often seek to eliminate or adjust these claims to give the corporation a quasi "fresh start." Such a move is necessary because it may be the only one left which management can employ to place the company's capital structure on a basis that can be consistently supported by its new earnings pattern.

Rights of Arreared Preferred Stockholders

The position of the creditor when his legal rights to receive payment of his claims are not satisfied is vastly different from that of the cumulative preferred shareholder. The creditor can bring suit to force the corporation into reorganization or liquidation. But the preferred stockholder has no similar recourse when the corporation either fails to earn or pay preferred dividends.

At the same time, however, the common shareholder sees the corporation continuing to operate with the burden of preferred arrearages hanging over its head, thus preventing the prospect of any common dividend declaration.

Arrearage elimination plans are generally put forth at a time when the retained earnings begin to show a credit balance after periods of unprofitable operations. It is often desirable to offer a plan creating a "stockholder reorganization." It will usually subordinate or entirely abolish the claim of the preferred holders to their accrued dividends. These plans have the dual function of brightening the future of the corporation for possible additional financing and offering the common shareholders some prospect for future dividends.

By the time the corporation recognizes the need to settle its arrearage accumulation, the interests of the preferred and the common shareholders may have become diametrically opposed. The preferred holder seeks payment in full of the accrued dividends together with no changes in his rights or priorities. On the other hand, the common holder is interested in convincing the preferred holder to accept an adjustment of his arrearages so that the common will be able to participate in future earnings distributions more rapidly. However, if the corporation is still short of insolvency, the only way for the corporate structure to be reorganized is through an adjustment between the conflicting claims of the preferred and common shareholders.

Methods of Settling Preferred Stock Arrearages

An easy way to resolve the conflict is for the corporation to purchase the arreared preferred shares on the open market. By the purchase the corporation automatically diminishes the possibility that the accrued dividends will ever be paid on the still outstanding shares by reducing the fund of monetary assets from which the dividend payments would be made. Conversely and paradoxically, a withholding of dividends helps to provide an asset fund for the purchase of the arreared shares while at the same time reducing the market price of the shares. Common shareholders can, in effect, accomplish the same result themselves by purchasing the arreared shares.

While the preferred shareholders have the opportunity to stand upon their contingent right to a claim, in full, of the accrued dividends, as a practical matter the majority may be expected to take a somewhat less adamant position. Because the consent of the common[1] must be had for all adjustments, preferred shareholders must rely upon their cooperation. Thus the common, through

[1]Because the common stockholders usually control the board of directors via their voting control, they have virtually all say regarding dividend declarations and the method of reorganization.

and with the assistance of management, has the effective power to force the preferred to surrender many of their priorities and rights.

Intuitively, such a situation may be difficult to accept since the preferred shareholders would be giving up their legal claims and priorities. However, the common, usually in voting control, will have considerable latitude under their discretionary powers in declining to pay even earned dividends. Further, if there are no earnings but an actual impairment of capital, the common may well be reluctant to approve a "quasi-reorganization" or reduction of capital. Preferred stockholders are, to this extent, dependent upon cooperation from the common stock interests. Thus, the preferred holders may be "casually coerced" into accepting plans under which claims to past accumulations will be given up in the hope of receiving some future return in the form of dividends, no matter how small.

Cash Payment

The simplest method of arrearage elimination is cash payment in full of the accrued dividends. Certainly under this method there should be no charges of inequity from the preferred holders for they are receiving in dollars precisely what they bargained for when their investment was made. It is interesting to note, however, that no case could be uncovered where a preferred shareholder has sued for payment of implicit interest or opportunity costs over and above the stated dividend payment.[1]

Other Methods

Any other method of settling dividend arrearages involves changing the relative or absolute rights of the existing preferred shareholders with almost always a correspondingly lower future dividend rate. The most popular techniques employed in adjustments are the charter amendment and the merger, consolidation or sale of all assets. As an important part of these methods issues of prior preferred are created which modify the interests of the older preferred.

Before any of these methods is effectuated management must be sure that there is a strong enough corporate need to call for such a drastic action as arrearage elimination. Certainly if the corporation is beginning to prosper the financial strait jacket which arrearages place on it in the money and capital markets is virtually *prima facie* evidence that some sort of capital adjustment is necessary.

No matter which method is selected there is always

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[1]Some preferred contracts, however, do provide for the accrual of interest on preferred dividends in arrears (e.g., as in *Roberts* v. *Roberts-Wick Co.*, 77 N.E. 13 (1906).

present the problem of the dissenting shareholder who insists that he has a vested contractual right which cannot be cancelled or changed without his approval, even though the majority or two-thirds of his fellow stockholders agreed to the adjustment. His only redress can be had in court.

Many legal authorities feel that in addition to the stockholders, the state has a decided interest in the welfare of corporations to which it has granted charters. Thus, there is a strong belief that the state need not wait for a dissident stockholder to take action but should institute suit as an interested party. Professor Arno Becht has questioned the role of the state in cases of this nature and he raises some interesting issues:

> To prove a public interest, one has to find some way in which the accrued dividends interfere with the corporation's discharge of its functions. Obviously, it can go on rendering service and collecting the price without being affected by the accruals. It is only when the corporation needs more money for its purposes that a public interest becomes even faintly discernible. . . . It has been argued that accrued dividends make management over-eager to pay dividends to the common stock and tempt it to engage in too risky enterprises, and answered that the fact that accruals can be removed will make the management more willing to engage in risky enterprises from the first. If the corporation wishes to borrow money it seems that accrued dividends should not stand in the way because they are subject to creditors' claims anyway. (There is the possibility of) issuing stock for cash, prior to all the old classes, which is subject to the perhaps valid criticism that it further complicates the capital structure of the corporation and opens the road to future accruals on the new

class. But these doubtful claims of the majority and the corporation are offered in face of the certain fact that the common stock is getting present dividends at the expense of the preferred.

Finally, even if it were true that preferred accruals hamper financing, there is no vestige of reasons why a sacrifice necessary to get money should not come out of the senior class. The preferred stockholders presumably pay more for a smaller return, bargaining for security. Such amendments keep the money and give the security to the class that neither paid nor bargained for it.[1]

Direct Removal

When a corporation is burdened with preferred arrearages and at the same time does not have either the legal capital or funds from which to make a settlement, it may seek to effect a direct removal of the accrued dividends. The courts quickly made their feelings known regarding this method of arrearage settlement in the Roberts-Wick Co. case of 1906.[2]

The original capital structure of the Roberts-Wick Co. consisted of common shares and 6% cumulative preferred shares which bore interest at 6% in the event of nonpayment of the preferred dividends. Because of a subsequent capital impairment amounting to $91,000, a reorganization took place which reduced total capital by one-third. The necessary legal plurality approved the

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[1]Arno C. Becht, "Alteration of Accrued Dividends," Michigan Law Review, IL (January, 1951), 379-80.

[2]Roberts v. Roberts-Wick Co., 77 N.E. 12 (1906).

plan which left a surplus of $9,000. The plaintiff stockholder, who originally held 250 preferred shares, voted against the reduction of the capital stock. However, she nonetheless surrendered her old shares, reducing her holding to 167 new shares.

After the reorganization the company had profits of $15,000. The board of directors then ordered payment of a one per cent dividend on the common and payment of all accrued cumulative preferred dividends and the associated accrued interest. However, payment was to be based upon the number of preferred shares held after the reorganization, thus having the effect of wiping out, without consideration, the dividends and interest on the shares eliminated by the reorganization. Mrs. Roberts sued for payment of the dividends and interest on her original holding of 250 shares.

The court first established the point that the preferred holders with dividends in arrears were not entitled to be paid from the surplus arising directly from the reduction of the capital stock, vis a vis subsequent earnings. But, more importantly, the court ruled that when a corporation has preferred stock with cumulative and interest bearing dividends and has reduced its capital stock and afterwards earned "surplus profits," the holders of the preferred stock had a prior right to a sufficient amount of the surplus profits to pay the arrears of dividends on the shares held by them prior to the reduction of the stock and the interest on such dividends. In so doing the court became the first to attach the "vested rights" stigma to accrued dividends, saying:

> Preferred stockholders . . . would still be "creditors" (quotation marks mine) for the arrears of dividends. . . . They may not have been creditors of the corporation in a technical sense; but as between themselves and other stockholders they were as creditors, with demands to be fully paid certain arrears of dividends before any of the surplus profits should be appropriated to a dividend upon the common stock.[1]

As a result of this wording, the Roberts-Wick case has become one of the most celebrated references for the vested rights theory of accrued dividends. Further, it seems correct to say, based upon case study, that the Roberts-Wick case has led to the conclusion that the direct removal of accrued dividends, whether or not accompanied by an exchange of shares, has been for the most part a failure.

Charter Amendment

Next to the straight cash payment of the arrearages the simplest method to effect an adjustment is through amendment of the articles of incorporation or the by-laws. The amending procedure is meant to function as a device for preventing what a corporate reorganization is supposed to cure--business difficulties and failures--without

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[1] *Ibid.*, p. 15.

waiting for insolvency and the drastic and expensive procedure of reorganization.

As a matter of legal analysis it seems that an accrued dividend is not different from a dividend rate. A simple amendment to the corporate charter or by-laws changing or removing the accrued dividends it is not different in kind from one reducing a dividend rate, say, on the preferred. If this be true, the problems presented by accrued dividends are not different legally from those of an amendment of the dividend rate. While there seem to be some shreds of logic in this analogy, these reflections have not prevailed with the courts. Early decisions show an extreme judicial reluctance to permit any tampering with arrearages. Subsequent cases reveal a continuous search by corporations for the means to avoid the pitfalls present in the earlier cases. This search has become so successful that, as will be seen in the discussion below, it may be said that accrued dividends are no longer as safe as they were although the old concept of their legal status still prevails.[1]

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[1]In contrast to earlier cases, modern statutes permitting classification and reclassification of shares authorize very complex amendments. In more recent cases, the amendments may abolish the old preferred stock altogether replacing it with another class or classes. Sometimes the old preferred is replaced in part by new preferred and in part by common. The possible variations are infinite.

Most amendments affecting preferred shares are made under the state's reserved power to alter, amend, or replace corporation laws. Any proposed amendment must first be critically examined from three points of view to be sure that it will meet all legal requirements. The first is one of construction to be sure that the power to make the amendment has been reserved or conferred by the language of the corporation charter or by-laws or the statutes of the states of incorporation. The second examines the constitutionality of the amendment under the due process of law and contract right clauses.[1] A critical problem here is the enactment of corporation statutes subsequent to the granting of the charter and its effect on the interests of the dissenting stockholders. The third is a question of equity--are the dissenters being treated unfairly.

Charter amendments may be either direct or indirect. The direct charter amendment changes the corporate charter by a majority vote (or whatever plurality is necessary)

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[1]Becht (op. cit., p. 374) also remarks that relatively few of the cases involving arrearages have raised questions of constitutionality: "Considering the number of cases involving accrued dividends it is surprising how seldom constitutional questions concerning them have been raised. When a subsequent statute authorizes interference with them, the stockholders can claim that it impairs the obligations of his contract and also that it takes his property in the corporation without due process of law. The argument seems to have been made in relatively few of the cases in which it could have been."

to provide for an exchange of the old preferred for some other class. However, this type of amendment, with but few exceptions, has been held to be not valid since it is compulsory with respect to all stockholders.

In the benchmark Dartmouth case[1] it was held that the corporate charter is a contract and thus cannot be changed without the unanimous consent of the stockholders, unless some power to effect the change is in the charter itself. So, if the authority to eliminate accrued dividends by a direct charter amendment is specifically conferred upon the majority or other required number, the amendment would be held to be valid.

Wessel v. Guantanamo Sugar Co.,[2] heard in the New Jersey Court of Chancery, was the precedent setting case on direct charter amendments. The complainants owned some 8% cumulative preferred stock with a $100 par value which had arrears of $112 per share. A plan of compulsory reorganization was offered which retired all of the preferred and cancelled the arrearages by giving the preferred holders a $40 principal, 5%, 12-year debenture and fourteen shares of a new $5 par value common for each share of preferred held. The plan was approved by 75%

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[1]Trustees of Dartmouth College v. Woodward, 4 Wheaton (U.S.) 518 (1819).

[2]Wessel v. Guantanamo Sugar Co., 35 A. (2d) 215 (1944).

of the common shareholders and 74.14% of the preferred. The complainant opposed the plan on the grounds that it was inequitable as to him and illegal.

The court held that since the plan was mandatory, the recapitalization is illegal and invalid as against the complainants. It drew the distinction with cases of merger or consolidation of corporations where the terms are not mandatory and preferred stockholders have the right to decline the offered terms and instead have their stock appraised and receive cash in payment therefor.[1]

Two years after the court rejected this plan the company offered the preferred holders the voluntary choice between full payment of the arrearages and call price or an exchange for a new preferred stock. About one-third elected to receive the payment, amounting to $227 per share.

The indirect charter amendment most often calls for the creation of a new preferred stock prior in preference to the outstanding preferred shares with respect to dividends and assets.[2] "Sister" amendments are then enacted which give the holders of the old preferred an opportunity to exchange their shares, dependent on a release of their

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[1] _Ibid_., p. 217.

[2] See, for example, the method used in the Armour and Company 1954 recapitalization, _infra_, p. 111.

claim to the accrued dividends, partially or in full.[1] This is technically different from the direct charter amendment since here any exchange and/or release of the arrearages is done voluntarily by the stockholders.

The indirect charter amendment originates if the corporation does not have, or care to use, the power to remove accrued dividends directly. By assenting to the exchange of the old for prior preferred, the old preferred shareholders thus move ahead of the dissenters to the plan, making the old stock a less desirable investment. If the old shares are listed on an exchange, they will be removed in favor of the new preferred and thus lose their liquidity. While the amendment does not affect or change the absolute priorities of the old preferred, it does change the capital structure so that the relative priorities are affected. The effect of sustaining these amendments is to condone their use to induce the surrender of the accrued dividends. Also, the dissenters face the danger of losing out if liquidation is in view because the prior preferred would have first preference to assets

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[1]Often the old preferred is convertible into prior preferred plus some common shares. If this arrangement prevails, the holders of the old preferred are made to bear part of the risks originally allocated to the common while the latter is compelled to share its chance of unusual profits with a class of stock which did not bargain for that privilege.

after the claims of the creditors.

There are two leading cases which illustrate the general position the courts have taken regarding amendments involving arrearage eliminations.

Keller v. Wilson & Co. was settled on November 10, 1936.[1] The original capitalization of Wilson included a 7% cumulative preferred, a 2d convertible, $5 cumulative preferred and the common. On February 1, 1935, the 7% preferred had arrearages totalling $26.25 per share while the 2d preferred arrearages were $21.25. On December 14, 1934, the board of directors voted to submit to the stockholders a recapitalization plan converting the 7% cumulative into 6% cumulative (ratio of 1.4292:1) and the 2d preferred into common with both conversions including cancellation of all accrued dividends. The plan and the charter amendment were approved by the stockholders with greater than a 99% plurality. Keller was the holder of some 2d preferred and sought to void the conversion of it and the cancellation of the arrearages and further to enjoin a 12 1/2¢ dividend on the common declared on February 26, 1935, before the accrued dividends were paid. The case centered around the right of a corporation to cancel accrued and unpaid dividends without the consent of each stockholder by amendment.

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[1]Keller v. Wilson & Co., 190 A. 116 (1936).

The court ruled that the right of a holder of cumulative preferred when the law did not permit cancellation of accrued and unpaid dividends without the consent of a holder is a "substantial right." This right constitutes a "vested right of property." The statute authorizing amendments of a corporation's charter for the purpose of reclassifying stock did not authorize cancellation by charter amendment of cumulative dividends already accrued, since these were "vested rights of property."

The court went on to conclude that:

> Property rights may not be destroyed; and when the nature and character of the right of a holder of cumulative preferred stock to unpaid dividends which have accrued through the passage of time is examined in a case where that right was accorded protection when the corporation was formed and the stock was issued, a just public policy . . . demands that the right be regarded as a vested right of property. The cancellation of cumulative dividends is not an amendment of a charter. It is the destruction of a right in the nature of a debt. When the necessary corporate action is taken the status of the shares may be changed and the right thereafter to claim the dividends as originally stipulated may be cancelled, but the amendment statute ought not to have a retroactive effect.[1]

A similar situation arose in the Consolidated Film Industries case of 1937.[2] On October 1, 1936, the company had $2 cumulative participating preferred outstanding

[1]Ibid., p. 125.

[2]Consolidated Film Industries, Inc. v. Johnson, 197 A. 489 (1937).

with accrued dividends of $4 per share. On August 31, 1936, the board of directors proposed an amendment to the certificate of incorporation to change all preferred and the rights thereof to all accrued and unpaid dividends for 1 1/4 shares of a new $1 cumulative preferred and 1/4 share of common for each share owned. The necessary stockholders approved the plan.

The complainant maintained two grounds for his suit: (1) that accrued dividends could not be cancelled by charter amendment (relying on the Wilson & Co. case), and (2) that the corporation did not have the power under the certificate of incorporation to amend its charter in the manner proposed.

Both Consolidated and Wilson & Co. were incorporated under the Delaware General Corporation Law. However, the two charters were different because when Consolidated was organized the law read that the corporation can change, by amendment, in its certificate of incorporation the relationship or other special rights of the shares. This provision did not exist when Wilson & Co. was organized. Another difference between the two cases is that Consolidated's cumulative dividends had actually been earned while in the Wilson case the corporation had a surplus but it was insufficient to meet the accrued dividends on both the first and second preferred shares. It should be noted, however, that the court did not consider it material on the question of vested rights whether the dividends were earned or not.

The court held in the Consolidated case that the owner of cumulative preferred shares was entitled to rely on his contractual rights until the accomplishment of the reclassification of the shares and the change of their status by the necessary legal corporate action. It was held again, as in the Wilson case, that the cancellation of cumulative dividends already accrued through the passage of time was not an amendment of a charter.[1]

It seems clear from these two cases that in Delaware there is a decided reluctance on the part of the courts to approve plans for cancellation of earned dividends. Also, the courts, with rare exception, do not inquire whether there are economic facts which make an amendment necessary even though it may adversely affect the property interests of the stockholders. The inquiry is rather directed towards a question of corporate power to act.

Contrasting with Delaware are the New Jersey courts where the focal point is the existence of earned surplus at the date of the arrearage settlement. As long as the surplus is composed of earnings, no matter when they came into being, the New Jersey courts will hold any adjustment plan unfair and inequitable which makes available to the

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[1] Ibid., p. 493.

common stock any part of a dissenting preferred shareholder's proportionate share of the earnings. The courts have held that the corporation must provide for the accrued dividends of the dissenting shareholders to the extent of the available earned surplus, in cash or its equivalent. Since the relief granted is usually an invalidation of the plan with respect to the dissenter, no problem arises as to payment of dividends from future earnings on the new stocks even if they are prior preferred.[1]

The general power to amend the articles of incorporation or the by-laws has thus been held not to authorize the removal of the claims of cumulative preferred holders with respect to accrued dividends in the absence of unanimous consent since it interferes with the "vested rights" of the preferred shareholders.

It is rather noticeable that if one desires to determine the basic reason why courts have refused to permit charter amendments eliminating or adjusting arrearages little aid is found in the "vested rights" claim, for the courts have generally tended to use the term "vested right" as that in the nature of a debt, which in fact accrued dividends are not.

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[1] John F. Meck, Jr., "Accrued Dividends on Cumulative Preferred Stock: The Legal Doctrine," Harvard Law Review, LV (1942), 110-11.

The vested rights argument of accrued dividends has been vigorously attacked by E. R. Latty when he stated, "besides begging the question it doesn't stand analysis despite the apparent acceptance by the courts. Accrued dividends are not debt and can't be enforced against the will of the directors. Vestedness is a legal conclusion rather than a reason."[1]

The proposed charter amendments which involve voluntary exchanges of the old preferred together with full or partial release of the accrued dividends have three effects: (1) It is in the interest of the common stockholders to reduce the present and future claims of the old preferred as drastically as possible because the change would not affect them and serves to increase the pressure on the dissenting preferred holders. (2) The amendment can create a time limit for the exchange, and after the expiration date the dissenters must keep the old shares subject to all of their disabilities. (3) The dissenters are hurt even more because the old preferred will generally fall substantially in market value.

One question which results from the decisions involving charter amendments concerns these so-called

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[1]E. R. Latty, "Fairness--The Focal Point in Preferred Stock Arrearage Elimination," Virginia Law Review, XXIX (August, 1942), 3.

"voluntary" plans. That question involves the relief that should be given to the dissenters. Enjoining the entire amendment and thus keeping the status quo would most effectively prevent any interference with the rights of the dissenter. However, if the amendment is executed it binds those who consented to it as well as those dissenters who are unable to assert their objections through legal means. Moreover, in many cases the amendment is illegal only so far as it affects accrued dividends.[1] Old stock no longer would be listed on exchanges and the new would take its place. It appears that the courts have given relief against compulsory plans just as they have against the direct removal of the accrued dividends; but in only one state, New Jersey, do the courts enjoin the entire plan. In others, dividends on the common stock have been enjoined until the accrued dividends have been paid, but the remainder of the plans has otherwise been left operative.[2]

Immediately after the prior preferred is issued in an arrearage adjustment the dividend rights of the new stock must be settled, most particularly with respect to the accrued and current dividends on the old preferred.

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[1]See the discussion of the Wilson and Consolidated cases, supra, pp. 43-46.

[2]The leading case here is Harbine v. Dayton Malleable Iron Co., 61 Ohio App. 1 (1939).

The general position of the courts has been to permit payment of the dividends on the new preferred even before any payment is made on the accrued dividends of the old. At the same time courts have generally given dissenters only an injunction against dividends on the common stock until the accrued dividends have been paid.[1]

The courts are thus placing great pressure on the dissenters to exchange their shares. No case could be found where the courts enjoined payment of dividends on the new until the old preferred had been paid both the accrued and current dividends. This may seem strange since this last alternative would give the fullest possible measure of protection to the old preferred holders. However, the courts have seemed to be most eager to assist corporations in removing the restraint of the accrued dividends, provided that the plan put forth is equitable.

An example of the position of the courts in this matter appears in the American Public Utilities case of 1923.[2] The plaintiff held 6% cumulative preferred stock on which a 4 1/2% dividend scrip had been issued while

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[1] Brickley v. Cuban American Sugar Co., 19 A. (2d) 820 (1940).

[2] Morris v. American Public Utilities Co., 14 Del. Ch. 136 (1923).

24% of dividends had accrued on each share.

An amendment was adopted which created a prior preferred, participating preferred and preferred stock, with the relative priorities in that order. The old preferred was the last but it could be surrendered with a cash payment or dividend scrip totalling $7.50 for 8/10 of a share of participating preferred. The amendment apparently, but not explicitly, also destroyed the accrued dividends. The company, after the amendment was approved and exchanges made, declared a dividend on the two prior stocks before payment of the accrued dividends on the old preferred.

The court held that the company had no power in the amendment to destroy accrued dividends but it also refused to enjoin the payment of dividends on the two prior stocks before payment of the accrued dividends was made, saying:

> The corporation has neither declared nor set apart from earnings any sum for a dividend on the common stock, nor is it threatening to do so. The payment of dividends to the two preferred classes created by the amendment which come in ahead of the class which the complainants hold is not in violation of the rights secured to them by their contract with the corporation.[1]

After reviewing the cases involving charter amendments, the following generalization can be made about the method which the courts would be most likely to sustain: "If the

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[1] Ibid., p. 154.

power exists to issue stock prior to the old preferred, an amendment should be drafted offering such new stock in exchange for the old. If the power also exists to reduce future rights of the old stock, make its dividends non-cumulative, take away its voting power and otherwise convince its holders that keeping it would be a bad bargain, these features should also be included in the amendment. It should then provide that the exchange of the new stock for the old be conditional upon the release of the accrued dividends. Finally, there should be a statement that if the dissenters wish to keep their old stock with its accrued dividends, they may do so."[1]

Merger, Consolidation or Sale of All Assets

The use of a merger, consolidation, or sale of all the corporate assets is the most recently developed technique employed to eliminate or adjust dividend arrearages. Because mergers and consolidations necessarily involve consideration of the capital structure of the new corporation, the provisions for modification of the rights of stockholders of the constituent corporations are much broader than those of the amendment technique. The relative stockholder rights depend primarily on the prevailing

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[1]Arno C. Becht, "The Power to Remove Accrued Dividends by Charter Amendment," Columbia Law Review, XL (April, 1940), 639.

state statutes. In effect, these methods are similar to compulsory amendments which eliminate accrued dividends.

In almost all states, statutes require approval of the merger or consolidation by some percentage of the shareholders. No statute was found requiring 100 per cent approval. Unlike early amendment statutes, many merger and consolidation statutes provide for appraisal and payment to dissenting stockholders.

As a component part of the merger plan, a provision is made for compulsory exchange of the preferred stock and the accumulated accrued dividends for a new security. It is here that the courts, recognizing that legislation has long sanctioned such reorganizations to strengthen the financial position of a corporation and being aware of the appraisal remedy afforded a dissenting stockholder, are more likely to relegate the individual interests of the preferred stockholder to a position secondary to that of the corporation.

There is one important limitation to the successful operation of merger plans. If the plan of the merger is unfair or inequitable (i.e., it is merely a fraudulent scheme to enrich the common or other group of stockholders at the expense of the preferred) or amounts to cancellation of arrearages without adequate consideration, equity, usually via appraisal, will aid a dissenting preferred stockholder to upset such a plan. Nonetheless it does seem strange that while the states and courts have moved to protect accrued dividends from cancellation by amendment, they have permitted the equally easy method of merger.

The leading case concerning this method is Havender v. Federal United Corporation.[1] The company was incorporated on January 25, 1932, with a $6 cumulative preferred and Class A and B common. Federal subsequently merged with a wholly-owned subsidiary, Corporation Bond and Share Company. Under the merger plan, the preferred would be converted into one share of a new $3 preferred and six shares of common for each share of the old preferred and all of the cumulative dividends in arrears, totalling $29 per share. The stockholders voted in the proper legal plurality for the merger but some preferred holders did not convert. Havender, a preferred holder who did not convert, brought suit to prevent the corporation from forcing the conversion. There was no charge of unfairness or illegality regarding the merger plan.

The decision was handed down by the Delaware Supreme Court, which was the same court which has repeatedly refused to sanction compulsory elimination of accruals by direct charter amendment, as in the Keller and Johnson cases. The court stated that:

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[1] Havender v. Federal United Corporation, 11 A. (2d) 331 (1940).

> The average intelligent mind must be held to know that dividends may accumulate on preferred stock and that in the event of a merger of the corporation issuing the stock with another corporation the various rights of the shareholders, including the right to dividends on preference stock accrued but unpaid, may be the subject of reconcilement and adjustment. . . . While their right to dissent is admitted, public policy does not permit a dissenting stockholder, as against an affirmative vote of two-thirds, to veto a merger agreement if its terms are fair and equitable in the circumstances of the case. Within the time and in the manner provided by the statute, the dissenting stockholder if he so desires, may demand and receive the money value of his shares as that value has been determined by an impartial appraisal. In such a situation, the shareholder is not confronted, as was the complainant in the Keller case, with a proposed alteration of rights attached to preference stock and with no alternative right to demand and receive the value of his stock in money.[1]

Thus the court refused to uphold Havender's claim that the merger was effective to terminate claims of dissenting preferred shareholders to accrued unpaid dividends, claimed to be vested rights under the doctrines of the Keller and Johnson cases.

Summary

The various ways by which the dividend rights of cumulative preferred holders can be modified or cancelled based upon court decisions and state statutes can now be summarized:

1. Direct removal of accrued dividends is legal only when the statutes expressly permit it.

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[1] _Ibid._, pp. 338-39.

2. Indirect removal by issuing prior preferred and making other alterations damaging to the dissenters is sustained in most states.

3. Plans offering securities for the accrued dividends and the old stock are sustained if voluntary and enjoined if compulsory.

4. Mergers, consolidations, and the sale of all assets legally accomplish compulsory removal in most states.

CHAPTER III

THE SIGNIFICANCE OF PREFERRED STOCK ARREARAGES

It has been a distinct contribution of American corporate jurisprudence to vest the power to declare dividends in the corporate directors. This is in sharp contrast, for example, to the English custom where for many years the distribution of corporate earnings was under the control of the shareholders. The practice of having directors function for the corporation in declaring dividends, impliedly sanctioned by statutory provisions rendering them liable for illegal distributions, began in America in the 1870s and became the basis of the law on the subject.

The rule that declaration of dividends normally is within the discretion of directors may be limited in the case of preferred stock. The dividend rights of common shareholders are most often dependent upon the general statutes and court decisions. The rights of preferred holders, however, are in general dependent upon the specific provisions in the articles of incorporation, by-laws, and stock certificates. Amounts of the preferred dividend are stipulated in these corporate documents together with what should be, but often is not, a definitive listing of the exact nature of the dividend preference as to participation and accumulation in addition to a statement of the extent of the preference over the common as to assets. Despite all of these precise characteristics, directors still have under their discretionary control the most important feature regarding preferred dividends--the right to determine the timing of the dividend declarations.

The remainder of this study will consider those instances where boards of directors have exercised this discretionary power regarding the timing of cumulative preferred dividend declarations and have chosen to pass the dividends so that at the calendar year end a company's cumulative preferred shares had dividends in arrears.

History of the Arrearages

The cumulative preferreds to be analyzed were taken from those listed on the New York Stock Exchange. The listed preferred issues were examined at five-year intervals from December 31, 1935, to December 31, 1950. From that point to December 31, 1962, annual examinations were made. The study began with the 1935 date because it is the end of the first five-year period after the Wabash decision which first differentiated between cumulative and non-cumulative preferreds.

Tabulations included only those preferreds listed on the Exchange when they first became arreared.[1] Once in arrears a stock remained in the tabulations even though it may have been suspended from trading on the Exchange before settlement due to market prices lower than requirements, lack of trading volume, or voluntary delisting. Thus many preferreds first become arreared on the New York Stock Exchange and then were delisted and traded elsewhere, most usually over the counter. The listings which were compiled here are by no means complete since there were many issues which became arreared and were cleared during the interim period between the tabulation dates.

For purposes of this study only those issues specifically bearing cumulative dividends[2] either cumulative in full, to a stated maximum, or when-earned have been included. The tabulations reveal a total of 180 companies with 248 issues of cumulative preferreds in arrears. Seven of the 248 issues went into arrears, were cleared, and then went into arrears again, all within the study period. In Table 1 is a listing of the number

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[1]A complete listing of all of the issues included in the study together with their dollar arrearages is in Appendix A.

[2]Cumulative dividends on both preferreds and Class A common were included.

Table 1.--Schedule of Arrearages on Preferred Stocks For the Years 1935, 1940, 1945, 1950-62

Year Ending December 31,	Number of Issues in Arrears					Amount of Arrearages (000s of dollars)
	Beginning of Period	Added	Removed	End of Period In Arrears 10 Yrs.	End of Period In Arrears 10 Yrs.	
1935	- -	- -	- -	18	161	$ 984,726
1940	179	28	86	25	96	1,079,978
1945	121	1	69	44	9	1,097,019
1950	53	6	29	23	7	968,301
1951	30	1	3	16	12	975,664
1952	28	1	8	11	10	473,515
1953	21	5	5	7	14	359,255
1954	21	3	5	6	13	353,191
1955	19	2	2	6	13	241,638
1956	19	2	4	4	13	195,752
1957	17	4	2	3	16	158,596
1958	19	2	9	2	10	27,405
1959	12	1	3	3	7	29,508
1960	10	3	2	3	8	29,921
1961	11	8	0	3	16	36,735
1962	19	2	3	2	16	23,472

Source: Appendix A.

of issues in arrears for each point of tabulation together with their corresponding dollar amount of accumulated dividends.

Table 2 has been compiled as a first step in analyzing the causes of preferred arrearages and their settlements. In the table is a listing of the number of arreared issues by the year in which the cumulative preferred dividend was first passed.

Not surprisingly, the greatest concentration of issues is found from 1931 to 1933 and in 1938. In the 1931-33 period, during the depths of the 1930-33 depression, 124 issues, or exactly 50% of the issues in this study became arreared. In 1938, during which there was a mild recession, fifteen issues or 6% had their dividends passed for the first time. These figures would lead one to attribute the lack of after-tax corporate earnings together with the need to conserve working capital, especially during times of a sluggish economy, as the foremost causes of the passing of preferred dividends. This conclusion is supported by Table 3 which lists corporate net income after taxes for the years covered by the study. There is a definite similarity in the year-by-year pattern of original preferred dividend passing and periods of low corporate net income.

A second reason put forth to explain original arrearages was the desire to reduce the burden of the old

Table 2.--Year Dividends First Passed on Preferred Stocks in this Study

Year	Number of Issues	Year	Number of Issues	Year	Number of Issues
1890	1	1931	50	1949	1
1905	1	1932	46	1950	1
1916	1	1933	28	1951	1
1918	1	1934	5	1952	1
1919	1	1935	7	1953	5
1920	2	1936	3	1954	3
1921	4	1937	4	1955	2
1923	2	1938	15	1956	2
1924	4	1939	1	1957	4
1926	6	1940	5	1958	2
1927	6	1941	1	1959	1
1928	2	1946	2	1960	3
1929	6	1947	1	1961	8
1930	6	1948	1	1962	2

Source: Appendix A.

Table 3.--Corporate Net Income After Taxes For the Years 1931-62

Year	Amount (In Billions)	Year	Amount (In Billions)
1931	$(0.9)	1947	$20.4
1932	(3.8)	1948	22.5
1933	(1.1)	1949	18.4
1934	2.5	1950	25.4
1935	4.8	1951	21.6
1936	6.5	1952	19.5
1937	6.5	1953	19.9
1938	3.3	1954	19.8
1939	6.0	1955	26.1
1940	6.9	1956	23.5
1941	9.5	1957	22.3
1942	11.1	1958	18.8
1943	12.2	1959	24.5
1944	11.7	1960	23.0
1945	10.5	1961	23.3
1946	16.3	1962	. .[a]

Sources: 1931-55: U.S. Department of Commerce, Historical Statistics of the United States, 1960, pp. 580-81; 1956: U.S. Department of Commerce, Statistical Abstract, 1960, p. 492; 1957-61: Ibid., 1963, p. 495.

[a]Data not available.

excess profits taxes.[1] There was excess profits taxation during three periods in our nation's history: 1917-21, 1940-45 and from July 1, 1950 to December 31, 1953. The excess profits tax, which was a surtax in addition to the regular corporate income tax, was applied to the excess profits of a corporation earned during the duration of the excess profits tax legislation.

In general, excess profits were defined as those profits in excess of one of two amounts: (1) a "normal" amount of earnings, usually the average earnings of a base period which was comprised of the years immediately prior to the enactment of the excess profits act, or (2) a stated percentage of the invested capital at the beginning of the taxable year.[2]

It is the use of the "invested capital" method which may have caused the passing of some preferred dividends. The World War I tax generally permitted a return of 20% on invested capital before the excess profits tax applied. The 1941 law permitted an 8% return (graduated from 5% to 8% from 1942 to 1945), while the Korean War legislation allowed returns from 8% to 12%.

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[1]"Tabulation of Preferred Stocks in Arrears," Magazine of Wall Street Manual, 1941, p. 44.

[2]For a detailed description of the law see, Standard Federal Tax Reporter, Volume VI (Hillside, N.J.: Commerce Clearing House, Inc., 1964), paragraph 6100.

Under the excess profits tax law, the advantage which accrued to a corporation that had passed its preferred dividends was the avoidance of the dilution of the invested capital base which would have taken place had the preferred dividends been declared. By so doing, the amount of excess profits tax could be reduced or possibly eliminated. The importance of this reason for original arrearages however, seems to be relatively minor, since only a total of twenty issues went into arrears during the periods of excess profits taxation. However, the excess profits tax may have been very instrumental in decisions not to pay any of the accumulated dividends on the preferred, thus causing the total dollar amount of arrearages to rise, while not affecting the number of arreared issues.

Some interesting conclusions can be made by observing the relative dollar make up of the arrearages by industrial classification. The arreared preferreds will be divided into four categories: railroads, utilities, industrials and other (usually financial corporations). The 248 arrearages included here were distributed among the industries as follows:

Railroads:	28 issues or 11.3%
Utilities:	25 issues or 10.1%
Industrials:	189 issues or 76.2%
Other:	6 issues or 2.4%

In Table 4 is the industrial breakdown of the number of issues in each set of arrearages, while Table 5 shows the relative dollar amount of each industry to the total dollar amount of arrearages for each period.

The steady climb of the proportion of arreared preferred shares of railroads from 1935 to 1950 illustrates the financial problems which confronted that industry during those years. Although the dollar amounts are a high percentage of the total, the ratios are somewhat misleading since the total railroad arrearages were primarily due to two issues: the Missouri Pacific 5% preferred which was recapitalized in 1955 dropping the proportionate dollar amount 16.1% and the Missouri-Kansas-Texas 7%A preferred which was exchanged in 1958, cutting the relative arrears by 58.8%. Nonetheless, the railroads have, except for three years (1951, 1959 and 1960) always had a higher percentage of arrearages in dollars than in the number of issues. Even this is not too surprising since both the railroads and utilities could be expected to have, on the average, more preferred financing per company than the other two classifications because of their asset structure.

A situation similar to that of the railroads is found in the history of the utility preferreds, with relatively few companies with several issues accounting for most of the dollar arrearages. Still, every period in which there were arreared utility preferreds the proportionate dollar

Table 4.--Preferred Stock Issues in Arrears by Industrial Classification For the Years 1935, 1940, 1945, 1950-62

Year	Railroads		Utilities		Industrials		Others		Total	
	Number	P. C.[a]	Number	P. C.[a]	Number	P. C.[a]	Number	P. C.[a]	Number	P. C.[a]
1935	19	10.6%	25	14.0%	131	73.2%	4	2.2%	179	100.0%
1940	16	13.2	20	16.5	84	69.4	1	0.9	121	100.0
1945	13	24.6	12	22.6	28	52.8	-0-	-0-	53	100.0
1950	12	40.0	8	26.7	10	33.3	-0-	-0-	30	100.0
1951	10	35.7	8	28.6	9	32.1	1	3.6	28	100.0
1952	9	42.9	3	14.3	8	38.1	1	4.7	21	100.0
1953	6	28.5	1	4.8	13	61.9	1	4.8	21	100.0
1954	4	21.0	1	5.3	13	68.4	1	5.3	19	100.0
1955	3	15.7	1	5.3	14	73.7	1	5.3	19	100.0
1956	4	23.5	1	5.9	11	64.7	1	5.9	17	100.0
1957	4	21.0	-0-	-0-	14	73.7	1	5.3	19	100.0
1958	3	25.0	-0-	-0-	8	66.7	1	8.3	12	100.0
1959	4	40.0	-0-	-0-	6	60.0	-0-	-0-	10	100.0
1960	4	36.4	-0-	-0-	7	63.6	-0-	-0-	11	100.0
1961	5	26.3	-0-	-0-	13	68.4	1	5.3	19	100.0
1962	5	27.8	-0-	-0-	12	66.7	1	5.5	18	100.0

Source: Appendix A.

[a]Percentage.

Table 5.--Annual Proportion of Dollars of Preferred Stock Arrearages in each Industry For the Years 1935, 1940, 1945, 1950-62

Year	Railroads	Utilities	Industrials	Others
1935	24.6%	21.7%	52.4%	1.3%
1940	27.0	42.4	29.8	0.8
1945	29.3	51.7	19.0	-0-
1950	31.1	60.6	8.3	-0-
1951	28.9	63.0	8.0	0.1
1952	58.6	24.7	16.6	0.1
1953	66.9	10.4	22.6	0.1
1954	68.2	11.0	20.6	0.2
1955	52.1	16.8	30.8	0.3
1956	67.5	21.7	10.5	0.3
1957	86.5	-0-	13.0	0.5
1958	27.7	-0-	69.6	2.7
1959	27.9	-0-	72.1	-0-
1960	31.3	-0-	68.7	-0-
1961	30.9	-0-	68.7	0.4
1962	56.1	-0-	41.0	2.9

Source: Appendix A.

amount of arrears exceeded the number of issues.

The opposite circumstance is found in the industrial classification. Until 1958, the proportionate number of issues exceeded the dollar amounts. From 1958 to 1961 the percentage of dollar amounts was greater than the number of issues. However, this too is somewhat misleading since one issue, the Virginia-Carolina Chemical 6% participating preferred, which was exchanged in 1962, accounted for over 75% of the industrial dollar arrearages in the 1958-61 period. The industrial issues in arrears remained in a relatively stable proportion from 1935 to 1940 and from 1953 to 1962. From 1940 to 1951, however, there was a decided decline in the proportion of industrials, falling from 69.4% in 1940 to a low of 32.1% in 1951, rising again annually until 1953. The major reason for the increasing proportion of industrial arrearages is the recent elimination of preferred shares which has taken place in many railroad and utility reorganizations.

The "other" classification of preferred contains only six issues and reached its maximum relative dollar amount of arrearages of 2.9% in 1962 when the relative significance of the $678,168 of Atlas Corporation's 5% preferred arrearages was magnified due to the overall drop in the total amount of arrearages.

One last observation of interest is that at the end of 1962, railroad preferreds were 9.5% of all preferreds listed on the New York Stock Exchange but were 27.8% of the number of preferreds in arrears; the industrials were 59.8% of the listed preferreds and 66.7% of those in arrears; others were 3.1% of the listed preferreds and 5.5% of the arreared; the balance of the listed preferreds were utilities.[1]

History of the Arrearage Settlements

The pressure on boards of directors to somehow remove the accrued dividends on the cumulative preferreds becomes greatest when the earnings of the corporation improve to a point where the common shareholders believe that they should begin to share in the prosperity. As a result, it is not unexpected to find that as corporate profits increase, arrearages are settled.

However, the fact that earnings have recovered to levels which of themselves would have permitted sizable arrearage payments is no indication that the payments will occur. One reason is the need to build working capital to a level commensurate with the current and prospective volume of business. In addition there may be senior corporate obligations which have matured or are nearing maturity and require cash outlays before it would be prudent to make any substantial distributions to preferred

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[1]Data from The New York Stock Exchange Fact Book (New York: New York Stock Exchange, 1963), p. 14.

stockholders, thus leaving a comparatively narrow margin for the preferred.

The size of the preferred issue is another important consideration in determining the eventual treatment of the accrued dividends. Recapitalizations, for example, are quite common to large arrearages where cash payment would be financially prohibitive. Recapitalizations are usually undertaken in good times when earning power is high and when the price of the common stock is also high. Offers to pay preferred arrears in common stock are usually made nearer the top than the bottom of bull markets. And in order for the preferred holder to realize his accrued dividends in cash, he must be able to sell the stock he received in exchange for the arrearages at the equivalent of the dividend accrual, which would mean selling out at the top of the market.[1]

Another consideration in the settlement of accrued dividends is the prevailing money rates. At a time when money is "cheap" the high dividend rates on many of the preferred issues become a real financial burden. This suggests that when dividend arrearages are cleared up an attempt will be made to convert the outstanding preferreds into issues bearing lower interest or dividend rates, if this has not already been done in the process

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[1]Herbert Lawrence, "37 Preferreds with Dividend Arrears," Barrons (December 18, 1939), 20.

of the arrearage settlement.

A last consideration is the tightening of the undistributed profits tax in 1936. The Revenue Act of 1932 first provided for a surtax to be levied on a corporation's undistributed income that has been accumulated beyond the reasonable needs of the business. The surtax rates were raised sharply in 1936 which lead many to assume that many companies which had arreared preferreds would shortly resume the payment of preferred dividends. By resuming the dividends the amount of undistributed earnings would be reduced thereby reducing or avoiding the surtax.

Nonetheless, there is no evidence that avoidance of this surtax was the motivating factor in most arrearage payments. Improved earnings and adequate finances seem to be the governing factors in guaging dividend prospects.

Although the dollar amount of arrearages showed no significant drop until 1952 when two utilities with five preferred issues with arrearages totaling $503,877,000 were exchanged[1] the number of preferred issues in arrears that were settled each period was substantial:

From 1936 to 1940:	86 of 179 or	48.0%
1941 to 1945:	69 of 121	57.0%

[1]American and Foreign Power's $7, $6, and $7A 2d, preferreds and Standard Gas and Electric's $7 and $6 prior preferreds.

1946 to 1950:	29 of 53 or	54.7%
1951 to 1962:	46 of 64	71.9%

Of the 248 instances of preferreds going into arrears, only eighteen were still in arrears as of December 31, 1962. Only two of these have been in arrears for over ten years with the average period for the other sixteen issues being 2.7 years and for all eighteen issues, 4.8 years.

As discussed in Chapters I and II, there are five major methods of settling accumulated dividend claims on cumulative preferred stocks:

1. Recapitalization--including for the purposes of this study a corporate reorganization, recapitalization, or a simple exchange of the old preferred and accumulated dividends for a new preferred issue.

2. Cash payment of the accrued dividends.

3. Corporate merger.

4. Retirement of the old preferred at its call price plus payment of the accumulated dividends.

5. Liquidation.

All five of these methods were used in the settlement of the 230 issues of arrearages which were cleared. In Table 6 is a listing of the methods employed by each industrial classification. The most significant factor in this table is the comparatively high percentage of full cash settlements which appeared in the industrial category _vis a vis_ the other three. On the other hand, also of

Table 6.--Methods Used to Settle Preferred Stock Arrearages in each Industry From 1935 to 1962

Method	Railroads		Utilities		Industrials		Others		Total	
	No.	P. C.[a]	No.	P. C.[a]	No.	P. C.[a]	No.	P. C.[a]	No.	P. C.[a]
Recapitalization	13	56.5%	14	56.0%	74	41.8%	2	40.0%	103	44.8%
Cash Payment	6	26.1	3	12.0	67	37.9	1	20.0	77	33.5
Merger	3	13.0	3	12.0	13	7.3	2	40.0	21	9.1
Retirement	-0-	-0-	-0-	-0-	19	10.7	-C-	-0-	19	8.3
Liquidation	1	4.4	5	20.0	4	2.3	-0-	-0-	10	4.3
Totals	23	100.0%	25	100.0%	177	100.0%	5	100.0%	230	100.0

Source: Appendix A.

[a]Percentage.

significance is the relatively high proportion of recapitalizations found among the utility and railroad preferreds.

These findings would tend to lead the potential investor in arreared preferreds to turn first to industrial preferreds. The preferred stockholders in this category seem to have come out the best since most of the arrearage settlements here were in the form of cash or retirements, where the investor cannot lose any of the accumulated dividends except for the opportunity cost involved in having to wait for his funds.[1] With a recapitalization, the preferred investor benefits or suffers depending upon the market action of the new securities he holds. In general however, the arreared preferred investor whose securities are exchanged in a recapitalization cannot expect to match the degree of success to be had in a cash settlement.[2] It stands to reason that if a corporation cannot meet its old preferred obligations in cash the chances of its meeting the greater obligations that virtually always accompany a recapitalization are slim.

More insight into the settlement of arrearages is had by considering the average length of time that a given

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[1]An exception to be found in this study is the Pittsburgh Coal 6% preferred which provided for interest on the arrearages.

[2]Examples of these types of settlements will be studied in Chapter V.

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issue is in arrears before a settlement is made. This is done in Table 7.

Table 7.--Average Time Taken to Settle Preferred Stock Arrearages for Each Method Used, 1935-62

Method	Issues Involved	Settlement Time (In Years) Mean	Mode	Range
Recapitalization	103	9.7	3	2-37
Cash	77	5.5	4	1-30
Merger	21	12.1	14	1-29
Retirement	19	6.4	2	1-19
Liquidation	10	13.1	. .[a]	1-23

Source: Appendix A.

[a]No uniquely identifiable mode.

Not surprisingly, the seventy-seven arreared preferreds that were settled by cash payments were in arrears, on the average, the shortest period of time. Both cash payments and retirements (which, in essence, are the same as cash payments except that the preferred issue is called and retired at the same time that the accumulated dividends are paid) have taken place in relatively short time. And only under these two methods is the preferred holder <u>guaranteed</u> of complete satisfaction of his claims.

Based upon the information in this table, the preferred investor should be alert when a corporation gets into such di

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dire financial straits that it passes cumulative preferred dividends for more than 6 1/2 years. For, when this occurs the stockholders will, more often than not, be confronted with an arrearage settlement plan of either a recapitalization, merger, or an outright liquidation. As discussed earlier, under any of these three methods, the stockholder has a greater difficulty of realizing his accrued dividends in cash.

Financial Significance of Preferred Stock Arrearages

Comparative Macro-Analysis of Preferred Stock Arrearages

The relative importance of preferred shares on the New York Stock Exchange, as measured by the number of listed issues, is shown in Table 8. Does the slight decrease in both the absolute number of preferred issues and the number of preferreds relative to the total issues listed imply that preferred financing is becoming passe?

Table 9 shows that the dollar total of new preferred financing registered with the Securities and Exchange Commission during the study period levelled off in the last three years to about one-quarter billion, approximately one-half the amount registered annually in the early fifties. What caused this drop? Two outstanding reasons appear:

Table 8.--Number of Stocks Listed on the New York Stock Exchange, for the Years 1935, 1940, 1945, 1950-62

Year End	Number of Total Issues	Number of Preferred Issues	Percentage of Preferred Issues
1935	. .[a]	. .[a]	- -
1940	. .[a]	. .[a]	- -
1945	1,269	395	31.1%
1950	1,472	433	29.4
1951	1,495	441	29.4
1952	1,522	455	29.9
1953	1,530	461	30.1
1954	1,532	456	29.8
1955	1,508	432	28.6
1956	1,502	425	28.3
1957	1,522	424	27.9
1958	1,507	421	27.9
1959	1,507	415	27.5
1960	1,528	402	26.3
1961	1,541	396	25.7
1962	1,559	391	25.1

Source: New York Stock Exchange Fact Book (New York: New York Stock Exchange, 1963), p. 47.

[a]Data not available.

Table 9.--Annual Amount of New Preferred Financing Registered with the Securities and Exchange Commission Compared to the Annual Amount of Preferred Stock Arrearages For the Years 1935, 1940, 1945, 1950-62

Year Ending June 30,	Annual Amount of New Preferred Financing (in millions of dollars)	Arrearages Outstanding at Year End (in millions of dollars)	Percentage of Arrearages to New Preferred Financing
1935	$ 28[a]	$ 985	3,517.86%
1940	110	1,080	981.82
1945	407	1,097	269.53
1950	468	968	206.84
1951	427	976	228.57
1952	851	474	55.70
1953	424	359	84.67
1954	531	353	66.48
1955	462	241	52.16
1956	539	196	36.36
1957	472	159	33.69
1958	427	27	6.32
1959	443	30	6.77
1960	253	30	11.86
1961	248	37	14.92
1962	253	23	9.09

Sources: U.S. Securities and Exchange Commission, Annual Report: 1962, p. 171; Table 1., *supra*, p. 60.

[a]For ten months only.

1. The dollar amount of new preferred financing has dropped presumably due to the impact of the 52% marginal corporate tax rate. Because preferred dividends are not deductible for tax purposes while interest payments on debt are many firms turned to funded debt for new financing to obtain this tax advantage.
2. For the same reasons old preferreds are also disappearing via sinking fund arrangements, outright retirements or exchanges for other securities.

The significance of the dollar amount of the preferred arrearages can be seen in Tables 9 and 10. Prior to 1956 the amount of preferred arrearages was greater than half of the total funds raised via new preferreds.[1] Likewise, until 1958 the arrearages alone amounted to at least 47% of the total preferred dividends paid on the New York Stock Exchange.

While the $23 billion of arrearages as of December 31, 1962, is small relative to the amount in as recent as 1951, the 1962 arrearages still represent 9.09% of the new preferred stock financing for that year and almost

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[1]The percentage of arrears to new preferred issues on the New York Exchange would be even higher since SEC registration is required of all companies whose securities are publicly held, not just those listed on the Exchange.

Table 10.--Annual Dividends Paid on Preferred Stocks Compared to the Annual Amount of Preferred Stock Arrearages For the Years 1935, 1940, 1945, 1950-62

Year	Estimated Aggregate Preferred Dividends[a] (in thousands of dollars)	Arrearages	Percentage of Arrearages to Dividends Paid
1935	. .[b]	$ 984,726	--
1940	. .[b]	1,079,978	--
1945	$337,203	1,097,019	325.33%
1950	379,315	968,301	255.28
1951	380,367	975,664	256.51
1952	377,664	473,515	125.38
1953	383,323	359,255	93.72
1954	367,806	353,191	96.03
1955	335,632	241,638	71.99
1956	332,998	195,752	58.78
1957	334,554	158,596	47.41
1958	331,414	27,405	8.27
1959	336,644	29,508	8.77
1960	330,983	29,921	9.04
1961	340,925	36,735	10.78
1962	336,283	23,472	6.98

Sources: New York Stock Exchange Fact Book (New York: New York Stock Exchange, 1963), p. 47; Table 1., supra, p. 60.

[a]Dividends paid on preferreds listed on New York Stock Exchange only.

[b]Data not available.

7% of the total preferred dividends paid. Real progress has been made in reducing the dollar amount of the arrearages. How much this progress has aided or harmed the preferred shareholder will be looked at in Chapter V.

It is evident that despite the presence of large amounts of arrearages that were present in the early fifties investors were continuing to put their money into new preferred issues. Presumably then investors do not direct their attentions to what can happen to the preferred if business turns bad or if the directors choose to withhold their dividends, even though earned. It seems that investors, if they consider anything at all, would more probably direct their attentions to what is likely to happen or what has happened most frequently in the past.

Effect of Other Preferred Stock Features on Arrearages

However, notwithstanding these considerations, there are two ways by which preferred investors can protect themselves against future events, both of which offer a potential sharing in residual profits after the stipulated preferred dividends have been paid. The first, the participating feature, offers the preferred an opportunity to share in some predetermined ratio with the common in any earnings distributions made after the common has received the same amount per share as the preferred.

The terms of participation may take on different variations of this form. Participating preferred are relatively rare with only six issues appearing in this study.

The second feature, convertibility, is a more popular added inducement of preferred issues which may operate in favor of the preferred shareholders both when preferred dividends are being paid and not. There are forty-six convertible issues in this study. The conversion privilege permits the preferred shareholder to convert his stock into a stipulated number of common shares whenever he believes that it is to his advantage to do so within the time specified. Of course the corporation can force conversion by exercising its call privilege if the conversion value of the preferred has risen substantially above its call price. The chief difference between the participating and conversion privileges is that under the latter the preferred stockholder is forced to give up his preferred position in order to enjoy the increased income.

When a preferred issue becomes arreared, both the participating and most usually, the conversion features cease to have value. Clearly the participating privilege is worthless, since while the preferred is in arrears no dividends can be paid to the common, hence no participation. With the conversion privilege however, it is difficult to make a flat statement. Usually the cause of a preferred going into arrears is the lack of earnings, and this in itself would usually drive down the price of the common enough so that conversion would be unwise. However, it is not too difficult to visualize a company permitting its preferred to go into arrears when there are enough earnings to pay the preferred dividends, but where working capital is in a tight position and where there is a small proportion of preferred stock in the total capitalization. Here there is a distinct probability that the conversion value of the preferred may warrant exercising because the market may well view the situation as temporary and ignore it.

Arrearages and Investor Reaction

It would be interesting to know the proportion of preferred investors who realize that, with respect to their investment in cumulative preferred stocks having no guarantee of dividends, the majority of cases have held that directors have the discretionary power to refuse payment.[1] At first blush, cumulative preferred shareholders may feel that they have little cause for alarm and complaint if the directors should pass a current dividend, even though earned, because this dividend will have to be

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[1]See for example: Hastings v. International Paper Co., 175 N.Y.S. 815 (1919); Fernald v. Frank Ridlon Co., 140 N.E. 421 (1923).

paid before distributions can be made to the common shareholders or at liquidation if the stock certificate provides for a preference as to dividends as well as capital. Actually there is the possibility of serious damage to the preferred.

Non-payment actually subjects the accumulated earnings not yet distributed to the cumulative preferred holders to the general risks of the business. Subsequent bad times for the particular corporation or a general depression may erode the undistributed profits entirely, preventing any future dividend payments. If not actually lost by business reverses, the accumulation of large preferred arrearages will, as discussed in Chapter II, frequently result in pressure from management and common shareholders for a recapitalization to wipe out the arrearages so that the barrier to future common dividends will be removed.

With the great number of the preferred which have ended in recapitalizations, mergers and liquidations, one may wonder why any investor would be interested in acquiring preferreds with accrued dividends. Yet arreared preferreds often present a distinct opportunity for profit. The average investor has a habit of overlooking this potential. When he thinks of monetary safety his first thought is of a high grade bond; when he thinks of participation in the improving earning power of some business he naturally turns first to common stocks. Thus preferreds have become a kind of no-man's land of investments--neglected by investors and speculators alike. As a result of this one can many times find a high grade preferred that affords a return higher than that which can be obtained from a bond of equivalent quality.

For speculation on natural business recovery or active inflation arreared preferreds offer opportunity for profit. The news that preferred dividends will be resumed or just that the corporation is attempting to find some means of settling the arrearages is usually enough stimulus to cause an increase in the market price of the preferred.[1]

Further, the investor in an arreared preferred stands to better his rate of return when the arrears are paid, provided that the market price at the time of acquisition had not already been discounted on the basis of the outstanding arrearages. For example, assume a share of $5 preferred was acquired at a price of $80 several years ago when there were $10 of arrearages attached. Provided the price of $80 does not reflect the probability of a rapid clearing of the arrearages, the investor's cost would be reduced to $70 when the arrearages were paid--thus viewing them as a return of capital, as in the case of a bond purchased in default. After the $10 recovery

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[1]Cases of this will be observed in the next chapter.

the preferred shareholder's annual rate of return would rise to 7.1% (\$5/\$70) from the 6.25% (\$5/\$80) received before the recovery. The Treasury Department however, does not recognize the \$10 as a return of capital but taxes amounts received in discharge of accumulated unpaid dividends as income in the year received.[1]

Social Significance of Preferred Stock Arrearages

The second aspect of preferred arrearages is their effect upon society, mainly as a question of equity or fairness. It is here that the discretionary power of the directors regarding dividend declarations should come under close scrutiny. As Johnson points out:

> If the financial manager has the interest of the common stockholders at heart, he will recognize that failure to pay preferred dividends also means failure to pay common dividends. Consequently, contentment on the part of the common stockholders depends upon prior satisfaction of the preferred shareholders. Moreover, many corporate directors believe that the terms of their agreement with the preferred stockholders carry a moral commitment to treat the obligation to pay preferred dividends with almost the same respect as they view the interest requirements on a bond issue.[2]

Even where the preferred dividend is non-cumulative it has been held that directors have the usual discretion

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[1]U.S. Treasury Department, Internal Revenue Service, Special Ruling, January 29, 1951, 515 Commerce Clearing House.

[2]Robert W. Johnson, Financial Management (2d ed.; Boston: Allyn and Bacon, Inc., 1962), pp. 485-486.

in refusing to declare dividends from earnings.[1] In addition, in those jurisdictions following the Wabash decision,[2] if directors are given the same type of discretion as they have with respect to common stock, serious injustice to non-cumulative preferred shareholders may result. Under the broad application of the Wabash Rule, the non-cumulative preferred dividend, though earned, is lost forever if not paid. Often, however, non-cumulative preferred stock will be issued upon a reorganization when it definitely is not the purpose to impose anything resembling a compulsory charge upon the corporation. During the period of rehabilitation, sufficient latitudes should be accorded the directorate in declining to declare dividends. However, after the recovery period a considerably closer scrutiny of the directors' actions in withholding dividends on non-cumulative preferred when earned is necessary.

Usually a non-cumulative preferred stock is not a desirable investment holding because of this discretionary power. Its existence is a standing inducement to the

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[1]See McLean v. Pittsburgh Plate Glass Co., 28 A. 211 (1893); and Morse v. Boston & Me. R. R. Co., 160 N.E. 894 (1928).

[2]Wabash Railway Co. v. Barclay, 280 U.S. 204 (1930), discussed here at supra, pp. 15-19.

improper passing of dividends. It is a standing invitation to the directors, unless their ethical standards are high, to administer the corporate finances to the advantage of the common shareholders.

It is now easier to see and appreciate why preferred contracts are written as cumulative-when-earned. By having preferred of this type the stockholder is partially able to overcome the directors' discretionary right to omit dividends when they have been earned. The crucial question is that even without this legal requirement, do corporate directors feel a strong enough moral obligation to pay any kind of preferred dividend at least, as a minimum, to the extent that the dividend is earned in any one year?

The problem of the cumulative preferred shareholder is even more acute. Given a company having two issues of preferred outstanding bearing the same contractual rights, except that one is fully cumulative while the other is non-cumulative, it would be expected that the fully cumulative issue would command a higher market price because the risk of non-payment of dividends is less since the claim to the dividends is more certain. Because of paying this "premium" the cumulative preferred holder anticipates a return commensurate with the security he obtained.

However, here again, even though the claim to the dividends may be more certain, it is only more certain in a relative sense. As we have seen, the discretionary power of the directors continues in effect with cumulative preferreds as well.

We have already discussed the two practical limitations on dividend payments of lack of available earnings and lack of cash. However, when earnings are present and there is available cash to pay the cumulative dividends, if the directors still choose to pass the dividends, they are, in effect, depriving the preferred shareholders of their bargained-for return. The directors are using funds which should have been distributed to the preferred holders without paying the shareholders an additional return for the use of their capital.

There can be no doubt that in the typical investor's mind incidents of favor, preference and priority are ordinarily associated with preferred stock. However, the directors have the power to ignore these preferences and deny them all. When is the exercise of this power fair to the preferred shareholders? As will be seen when some case histories are examined in Chapter V there are many cases where directors chose to use funds for working capital purposes which, had the preferred stock been bonds, would have been distributed as interest.

Should this discretionary power of the directors, of withholding earned dividends, be subjected to some sort of test in order to determine the equity of the situation? It seems that some standard must be established to apply to directors' actions when they withhold earned dividends on preferred. The traditional rubber stamping by the courts of every action of the directors which does not harm the corporation on the theory that it is an exercise of "business judgment" appears to be basically unsound with respect to the preferred stockholder. Certainly when arrearages of 207% of the total new preferred financing can be present in a given year as was the case in 1950--a year of substantial business improvement--it seems that some new theory which transcends that of "business judgment" must be devised.

If business judgment means judgment which benefits the stockholder or the corporation, nearly every withholding of income and every reduction of investor's rights in favor of the corporation becomes good business judgment. The only limitation would be the need to make future preferred stock issues attractive to investors. But the more money that a company retains, the less need it has to attract preferred stock investors, in particular due to the inherent tax disadvantage. In almost all cases observed where the cumulative dividend could have been continued but instead was withheld "for the sake of the stockholder's future advantage," the quoted price of the preferred suffered a severe decline, indicating that the investment market did not agree with the directors as to what was really sound "business judgment" regarding the preferred investor.[1]

The respective claims to dividends of preferred and common shareholders are hardly on a parity. The entire history of common stock is the theory of venture capital and primary risk, with the distribution of profits dependent upon business expediency as the directors see it; whereas the purpose underlying preferred stock, as far as dividends are concerned, is the desire for greater regularity of time and certainty in amount of the dividends than would be true with the common stock.

The stipulation upon issuance of preferred stock to pay dividends out of earnings very much resembles a fixed charge; it is like common in that no payment can be made until creditors are satisfied--that is, the distributions of dividends must be out of earnings; but it is like a bond in fixing precisely the amount to be paid. Like common, the right of preferred shareholders to dividends should be subject to the discretion of the directors to retain the earnings in the business <u>when there is a real need</u>. Unlike common, the presumption should be in favor of the preferred shareholder when he shows that the corporation has earnings sufficient to pay a dividend. The

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[1]Benjamin Graham, D. L. Dodd, and Sidney Cottle, <u>Security Analysis</u> (4th ed.; New York: McGraw-Hill Book Co., Inc., 1962), p. 380.

burden of proof should properly fall upon the corporation and its directors to show that a dividend should not be paid.

Summary

The great power which boards of directors have over the steering of corporate earnings with respect to their preferred shareholders is demonstrated in Table 1 showing the total arrearages of those cumulative preferreds listed on the New York Stock Exchange and in Table 9 comparing the dollar amount of arrearages to the total funds raised from new preferred financing. In addition to this financial aspect of arrearages there is the question of soundness from an ethical and equitable point of view of directors withholding earned cumulative dividends.

The central issue in this problem is how many preferred investors realize that the security is subject to the above discussed discretionary action together with the relative ease of amending the preferred contract, as discussed in Chapter II? Becht suggests that this problem can be overcome by having the preferred stock certificate bear on its face a statement that it is subject to alterations in a great variety of ways, most of which are to its detriment, and that if business is bad losses will be forced upon the stockholders regardless of the liquidity and other paper preferences. It seems not unlikely that the corporation will find that the temporary expedients it adopts will make it more difficult to attract that part of the market which prefers security to speculation, the very thought behind preferred stock.[1]

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[1]Arno C. Becht, "Alteration of Accrued Dividends," Michigan Law Review, IL (February, 1951), 594.

CHAPTER IV

ARREARAGES ON CONTEMPORARY PREFERRED STOCKS

We shall now turn from the overall significance and trends of preferred arrearages and concentrate on the more recent experiences of cumulative preferred stocks from 1950 to 1962. The purpose of this investigation is to see if there are any indications in this period of the future trend of preferred arrearages.

From 1950 to 1962 thirty-five issues of cumulative preferred stocks went into arrears.[1] Among these were thirty corporations; two issues went into arrears twice.[2] There were four railroads, no utilities, twenty-nine industrials and two "other" preferred issues in the group. Of the thirty-five preferreds, sixteen were still in arrears on December 31, 1962; fifteen were cleared with cash payments, one issue was retired, two corporations were recapitalized and one merged.

The very high proportion of cash arrearage settle-

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[1]Table 2, <u>supra</u>, p. 62.

[2]A complete listing of the thirty-five issues, their arrearages, earnings and working capital position is in Appendix B.

ments together with the relatively few recapitalizations is indicative of the fact that by the fifties most firms had "put their houses in order" and found their present capital structures satisfactory. Therefore, the lapses in dividends on contemporary cumulative preferreds should not be viewed as the result of awkward capitalizations but rather, in general, as nothing more than temporary withholdings of the dividends until the firm had both the earnings and the working capital to pay the preferred dividend requirements.

Arrearages and Preferred Earnings

The original arrearage in thirty-two of the thirty-five issues occurred during fiscal years when there were net losses. Of the three cases where there were earnings, in one, the Lehigh Valley Coal Corporation, $3 first preferred, cumulative to the extent earned, the dividend was not earned in full. In the other two instances, the 4 1/2% Cudahy preferred in 1953 and the Van Norman $2.28 convertible preferred, the earnings of the preferreds were more than the preferred dividend requirement.

Thus continuing evidence is uncovered to support the lack of earnings as the prime reason for the passing of cumulative dividends. In fact, among the sixteen issues still in arrears at the end of 1962, only one has earned enough since the stock went into arrears to cover the arrearages--Endicott-Johnson Corporation's 4% preferred earned $8.58 per share in 1962, over four times the $2.00 arrearage. This company, however, has paid half of the preferred dividend requirements during both years of its arrearages. Three issues, General Baking's $8 preferred and Pittsburgh Steel's 5% and 5 1/2% all earned part of their total arrearages in 1962. But in all three cases, no dividends were paid.

When there were corporate earnings during this period it was noticeable that boards of directors did make some effort to pay at least part of the preferred dividend requirement. Ten companies made payments on the accumulated dividends of their preferreds when current earnings were present. A good example of this practice is the experience of the Gar Wood 4 1/2% convertible preferred. Here the corporation paid out at least part of the preferred dividend requirement whenever earnings were present. Just the opposite situation is found in the Spear & Co. $5.50 preferred where full dividend payments were made for three years although there were no preferred earnings. Fourteen issues, including twelve still in arrears, had no earnings while they were in arrears and likewise paid no dividends.

Viewed from the other side, that of settlement, the relationship between earnings and arrearages appears to continue. Eleven of the fifteen arrearages cleared with cash payments were settled only when preferred earnings were present. One of the other four, the Van Norman $2.28 preferred, first merged, then had the arrearages paid and finally was exchanged for the stock of the new company, Universal American Corporation. Only Minneapolis Moline Company and Spear & Company paid their arrearages when there was no preferred earnings. However, one may speculate that the small dollar size of these two arrearages, $98,000 and $26,000 respectively, both less than one per cent of their company's working capital, may have influenced the decision for payment.

On the other hand, of the four issues with non-cash settlements, in only two cases, the recapitalization of the Lehigh Valley Coal Corporation and the retirement of the Amalgamated Leather 6% convertible preferred, were there any preferred earnings during the arrearage period. The other two issues had no preferred earnings up to the date of settlement.

Other Considerations

While we have seen that the expected pattern between earnings and dividends exists for contemporary preferreds in arrears, it was difficult to extract any type of pattern between the dividends and the working capital. In many cases, the amount of the arrearages was less than one per cent of working capital. In five corporations[1] the working capital was less than the arrearages and at times was negative (i.e., current liabilities were greater than current assets). This situation was present in three companies at the end of the first year of arrearages, which may well have been a contributing factor in the decision to pass the dividend.

The absence of utility shares among the current preferreds which were in arrears and the relatively few railroad stocks, both in number of issues and dollar amount, stands out. It is difficult to attribute any one cause to this other than that by the fifties most of the firms in these two industries had been relieved of the burdensome roles which cumulative preferred stocks formerly played in their capitalizations via prior mergers or recapitalizations.

However, probably the most outstanding feature of the thirty-five issues being reviewed is the general tendency of boards of directors to treat cumulative preferreds as cumulative only when enough is earned to cover all of the prior arrearages. It appears that no matter how the preferred contract is written boards of directors will still, in general, declare cumulative

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[1] J. I. Case Co., United States Hoffman Machinery Corporation, Chicago and Eastern Illinois Railroad, New York, New Haven and Hartford Railroad, and the Hotel Corporation of America.

preferred dividends only when there are current earnings to support them.[1]

This of course, aside from the element of timing, has no effect on those preferreds settled by cash payments or retirements. But, to those preferreds settled by recapitalizations, the effect may be severe. As we have seen, times for recapitalizations have not depended upon the presence of earnings as have cash payments. Because boards of directors are reluctant to declare cumulative preferred dividends without the presence of earnings, and because capitalizations usually take place after periods of extended losses, the preferred shareholder is unlikely to receive any dividends even if his shares are cumulative. This, of course, has the effect of converting cumulative preferreds into non-cumulative shares. Thus, the value of

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[1]There are, however, some notable exceptions. During the period 1950-62, there were eight cumulative preferreds listed on the New York Stock Exchange on which dividends were paid every year even though the dividends were not always earned. The stocks and the years in which the dividends were not earned are:

1. Colorado Fuel and Iron, 5 1/2% B (1960 and 1962).
2. Columbia Pictures Corp., $4.25 (1958, 1959 and 1961.
3. Continental Copper, 5%, (1961 and 1962).
4. Kroehler Manufacturing, 4 1/2% A (1961).
5. Publicker Industries, $4.75 (1954, 1955, 1957-59, and 1961-62).
6. U.S. Industries, Inc., 4 1/2% A (1959 and 1960).
7. United States Smelting, 7% (1953, and 1957-60).
8. Ward Baking Co., 5 1/2% (1961 and 1962).

the cumulative feature is lost. This problem will be studied at depth in the case studies of the next chapter.

Conclusion

The problem of the long and large accumulations of arrearages on cumulative preferreds both as to number of shares and dollar amount seems to be a thing of the past. Most indicative of this trend is the fact that contemporary preferred arrearages have existed for shorter periods of time than in the past. This is supported by:

1. The short time it has taken to settle contemporary arrearages compared to the average time for all of the issues included in Appendix A of this study. Current cash settlements took only 3.7 years on the average versus 5.5 overall; the two issues recapitalized were in arrears for three and five years versus the overall average of 9.7 years.[1] While there is a natural bias for the averages of the contemporary preferreds to be lower since the sample was taken from a set of fewer years than the overall set, the bias is not as severe when the second indicator is considered:
2. Contemporary preferreds with accumulated dividends

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[1]From Table 7, <u>supra</u>, p. 76.

as of December 31, 1962 have been in arrears for a relatively short time. Their average is only 2.7 years and none has been in arrears for more than seven years.

It was during the 1930-33 depression that the problem of preferred arrearages became acute. Because of depressed earnings boards of directors passed preferred dividends and forced cumulative issues into arrears. Since that time, however, the economy of our country has not been so tested.

It is unlikely that arrearages as large as those encountered in the thirties and forties will ever reappear. There are two major considerations which lead to this conclusion:

1. The reduction in the absolute number of old cumulative preferred shares in corporate capitalizations because of retirements and/or recapitalizations within the last twenty-five years.

2. The decline in popularity of new preferred financing.

CHAPTER V

THE VALUE OF THE CUMULATIVE FEATURE IN RECENT ARREARAGE SETTLEMENTS

Introduction

In his classic work on corporate securities Arthur Stone Dewing makes the following statement: "Considerable stress is usually laid by the banker and his salesmen upon the fact that the dividends on a preferred stock are cumulative. Practically, this is of little value."[1] Although Dewing's statement was made during the depression of the thirties, preferred stocks are still very much an active security for both financing and investment. And the cumulative feature has been very popular.[2] Because the cumulative feature always has value if regular dividends are paid, the time to question its worth is when dividends are not paid and an arrearage settlement is made. The purpose of this chapter is to determine if Dewing's claim is still valid when considered in light of

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[1]Arthur Stone Dewing, A Study of Corporate Securities (New York: The Ronald Press, 1934), p. 171.

[2]In a recent study of 72 preferred stocks issued in the period 1946-1950, all were found to be cumulative. D. A. Fergusson, "Recent Developments in Preferred Stock Financing," Journal of Business, XXV (September, 1952), 447-62.

recent arrearage settlements.

The gain or loss of an individual investor in an arrearage settlement is dependent upon (1) his purchase price for the preferred, and (2) the dividends received and the value of the settlement. However, in this study we are not interested in how any one investor prospered but rather in how the entire issue of preferred fared when the arrearage settlement was made. If the cumulative feature of a preferred share is worth anything, the value of the arrearage settlement must reflect it. If it does not, it becomes apparent that the cumulative feature is simply a facade--an addition to "sweeten" the preferred contract but without value.

To determine the value of the cumulative feature we shall examine those cumulative preferred issues which had arrearage settlements from 1951 to 1962. In particular, we are interested in determining if the cumulative feature was given adequate consideration when the settlements were made. In other words, was the value of the settlement enough to compensate in full for the accumulated but unpaid dividends.

In arrearage settlements made with cash payments or by retirement of the preferred the problem of adequate compensation for accrued dividends is not present because aside from the delay of payment, the arrearages are paid in full. Therefore, only the nineteen settlements which involved recapitalizations (fifteen) or mergers (four) shall be evaluated. These represent 41.3% of the settlements made from 1951 to 1962. One company from each industrial group (except "others") will be examined in depth to see how the mechanics of non-cash settlements operate.[1]

Methodology

The value of the cumulative feature in each arrearage settlement is a matter of opinion and negotiation. In almost all recapitalization and merger cases there is an infinite scope for speculation and dispute on every element of valuation. However, in order objectively to measure the extent of the value of the cumulative feature 100% recognition of the unpaid dividends in our measuring stick will always be assumed. The test to be applied to measure the value of the cumulative feature must also be objective and so will be in terms of money received or obtainable in the market.

The first problem is to analyze the market value of the cumulative preferred shares. Because preferred stocks

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[1]These nineteen issues differ from the nineteen issues discussed at p. 95. Chapter IV dealt only with those issues which became arreared from 1950 to 1962. This chapter is concerned with those arrearages which were settled from 1951 to 1962, regardless of the year in which the arrearages first began.

are in most cases arranged to resemble closely a bond issue as far as practicable, their yields follow a pattern similar to that of bond interest rates. The return for preferred shares is typically higher than that for bonds (see Table 11) because preferred dividends and any related sinking funds are contingent rather than fixed payments as are bond requirements. Usually the protection of the preferred consists of contingent voting rights rather than the creditor's right to throw a defaulting corporation into bankruptcy.

However, once a preferred share goes into arrears the usual yield relationship collapses. The market price of the stock will fall below its normal yield price reflecting the market's discounting of the probability of the payment of the preferred arrearages plus resumption of the regular dividends. Should full dividends be resumed, the market price should theoretically rise to its normal yield relationship plus a discounted premium for the yet unpaid arrearages.[1] The discount rate is dependent upon the probability of payment.

The market price of the preferred will also rise when a non-cash settlement is announced. The amount of the rise depends upon the value of the securities received in

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[1]A good example of this pattern was found in the American and Foreign Power $7 first preferred, which will be analyzed later in this chapter.

Table 11.--Comparative Yields on Industrial Bonds and Preferred Stocks, for the Years 1940-62

Year	Composite Average of Yields on Industrial Bonds	Average Preferred Stock Yields High Dividend - Industrial Series Medium Grade	Speculative Grade
1940	3.10%	5.74%	9.79%
1941	2.95	5.53	7.86
1942	2.96	5.74	9.28
1943	2.85	5.16	7.72
1944	2.80	4.89	6.43
1945	2.68	4.49	5.19
1946	2.60	4.31	4.62
1947	2.67	4.59	4.96
1948	2.87	4.97	5.58
1949	2.74	4.94	5.81
1950	2.67	4.79	5.45
1951	2.89	4.82	5.42
1952	3.00	4.83	5.53
1953	3.30	5.12	5.74
1954	3.09	4.75	5.40
1955	3.19	4.49	5.14
1956	3.50	4.74	5.39
1957	4.12	5.28	5.91
1958	3.98	5.14	5.77
1959	4.51	4.99	5.58
1960	4.59	5.18	5.77
1961	4.54	4.82	5.41
1962	4.47	4.81	5.34

Source: Moody's Industrial Manual, 1963 (New York: Moody's Investors Service, Inc., 1964).

the settlement. The value of these securities is the result of negotiation between the various groups of stockholders involved and the board of directors. If the negotiations give full recognition to the value and claim inherent in the cumulative feature of the preferred shares, the value of the settlement should be equal to the sum of the normal yield price of the preferred plus the discounted present value of the accrued dividends.

There is a practical limitation, however. If the preferred shares are callable, as most are, it is highly unlikely that the market price will rise over the call price. Any investor who purchases a callable security at a price higher than the call price is taking the risk that his security will be called. However, in the case of cumulative preferred shares, since virtually all call provisions provide for the payment of any accumulated dividends together with the call price, the risk is not as great as it first appears.

In evaluating non-cash settlements, these market actions and the call price feature will be taken into consideration. In measuring the value of the cumulative feature the settlement will be viewed on an "as if" basis. It will be assumed that the retirement of the old preferred shares in the recapitalization was paid for by issuing the new securities arising in the settlement. Therefore, the market price of the securities received in the settlement will be compared with the sum of the call price of the old preferred plus the amount of the accrued dividends which would have been payable had the old preferred been called. This method is the call price test.

The theory underlying this method is that the call price plus the accumulated dividends is what the preferred shareholders could have expected had their stock been retired in accordance with the terms of their contract. Thus the value of cumulation can be measured by the difference between what the shareholders should have gotten had outright retirement taken place and what they actually got in terms of the market value of the exchange package. The settlement value of both alternatives should theoretically be the same since they both accomplish the same thing--retirement of the old preferred and the settlement of the outstanding arrearages.

Should a preferred not be callable, then an alternative measure will be used--the difference between: (a) the sum of the "normal yield" price of the preferred and the preferred arrearages (without adding an amount for the compound interest element), and (b) the market value of the securities in the settlement package on the date of the settlement. This method is the market price test.

This method is based upon the theory that if the stock were paying its regular dividend its market price should follow the usual yield pattern. Further, if the stock has claim to accumulated dividends, the price should rise over the normal yield price by the amount of the dividend claim. The yield rate that will be used to calculate the "normal yield" price is the average preferred stock yield on speculative grade high-dividend industrials in the year of settlement as compiled in Table 10.[1]

In making the comparisons it will be assumed that the proceeds were first a recovery of the call price (or "normal yield" price) of the preferred and then a recovery of the accrued dividends--exactly the same accounting treatment that is applied to payments on defaulted corporate bonds. Applying this methodology each test of the cumulative feature will have one of the following results:

1. Full value to cumulation--when the value of the settlement package was equal to or greater than the call price (or "normal yield" price) plus the accrued dividends (without compounding interest) but greater than the call price (or "normal yield" price).

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[1]One may argue that it would be more reasonable to add a premium to the required yield to reflect the additional risk of investing in an arreared preferred. While it is true that arreared preferreds do sell at a discount, reflecting this risk differential, it would be double counting to add this yield premium in these computations. What is trying to be measured here is the value of the cumulative feature and to do this the arreared preferred must be compared with a like investment completely ignoring the arrearage factor for yield determination.

2. Some value to cumulation--when the value of the settlement package was less than the call price (or "normal yield" price) plus the accrued dividends (without compounding interest) but greater than the call price (or "normal yield" price).

3. No value to cumulation--when the value of the settlement package was equal to or less than the call price (or "normal yield" price).

It must be remembered, however, that the value of the cumulative feature is being measured solely in comparison with the call or "normal yield" price plus the accrued dividends. And that while on the basis of this test it may be concluded that there was no value to the cumulative feature in a given arrearage settlement, it cannot be concluded what the value of the settlement package would have been if the preferred dividends were not cumulative. It may well be that the cumulative feature helped to increase the consideration given to the holders of the arreared preferred even though this increase would not be revealed in the tests used in this study.

Case Study--Armour and Company

Description of Stock

Stated value of $100 per share. Preferred as to assets and dividends. Entitled to cumulative dividends of $6 per share. Each share convertible into six shares of common stock. Could be redeemed at the option of the company at a price of $115 per share plus accumulated dividends. Each share had one vote in corporate matters.

History

This case study of the Armour $6 convertible prior preferred is of particular interest because of the litigation which ensued from the recapitalization to remove the preferred arrearages. The Armour stock went into arrears twice, once for ten years, from fiscal 1938 to 1947, and then for six years from 1949 to 1954 (see Table 12). The stock was exchanged in a recapitalization on December 21, 1954.

The company's annual reports for 1938, 1940, 1942, 1945, 1949 and 1953 all contained explanations of the causes of the preferred arrearages and the intentions of management to clear them. Much of the comment was caused by the presence of large earnings per share of preferred and the reluctance of management to declare preferred dividends in those years. In eighteen of the twenty-one years examined the stock earned more than its dividend requirement, but in ten of these years management chose not to declare any preferred dividends. This policy seems strange, especially when viewed together with the president's statement in the 1938 annual report that it was the policy of the company not to pay any

Table 12.--Earnings, Dividends and Price Record of the Armour and Company $6 Prior Preferred Stock For the Years 1934-54

Year Ending	Per Share Earnings	Per Share Dividends	Per Share Arrearages	Market Price at Calendar Year End
10/31/34	$13.11	$ 1.50	$- 0 -	67 3/4
35	10.51	6.00	- 0 -	65 3/8
36	12.08	6.00	- 0 -	82
37	10.81	6.00	- 0 -	57
38	- 0 -	1.50	4.50	45
39	6.13	- 0 -	10.50	46 1/4
40	9.49	- 0 -	16.50	49
41	23.56	1.50	21.00	62 1/2
42	22.95	4.50	22.50	45 1/2
43	21.47	- 0 -	28.50	74
44	21.11	6.00	28.50	104
45	17.21	6.00	28.50	123 3/4
46	39.01	9.50	25.00	129
47	45.90	31.00	- 0 -	103
48	- 0 -	6.00	- 0 -	71 3/4
49	1.12	3.00	3.00	71 1/2
50	38.08	- 0 -	9.00	86
51	32.06	6.00	9.00	92 3/4
52	14.28	3.00	12.00	83
53	20.68	6.00	12.00	86 1/2
54	3.11	- 0 -	18.00	--
12/20/54	--	--	18.50	98

Source: Moody's Industrial Manuals, 1935-55 (New York: Moody's Investors Service).

dividends unless they were earned.[1]

The very large increase in earnings in the forties and early fifties found Armour unable to pay any common dividends because of the large accumulation of accrued dividends on the preferred. Unwilling to pay $66,750,000 to retire the preferred ($9,250,000 of arrearages plus $57,500,000 call price for the 500,000 outstanding shares) and/or reduce whatever favorable financial leverage was afforded by the preferred, the company offered its shareholders the following compulsory recapitalization plan as an amendment to the articles of incorporation:

Each share of preferred and the corresponding accrued dividends were to be redeemed at $120 payable in 5% subordinated income debentures of like principal maturing November 1, 1984, and one warrant for the purchase of one share of the company's common stock at the following prices:

$12.50	from redemption	to	12/31/57
15.00	1/1/58		12/31/59
17.50	1/1/60		12/31/61
20.00	1/1/62		12/31/64

The plan was approved by the necessary plurality on December 7, 1954. The entire issue of the $6 preferred (except for 4,715 shares held by dissenters to the plan) plus the $18.50 of accrued dividends per share was retired

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[1]Armour and Company, Annual Report: 1938, President's Letter.

on December 21, 1954.

The recapitalization had two distinct favorable financial advantages for Armour: (1) conservation of working capital by not redeeming the shares for cash, and (2) retention of a favorable degree of financial leverage by converting the preferred into debentures. The company estimated a resulting annual tax saving of $1,560,000 due to the tax deductibility of the debenture interest.

One of the preferred shareholders who voted against the plan, Johnston A. Bowman, instituted suit in January, 1955, to void the plan, alleging that the amendment to the articles of incorporation authorizing the redemption of the $6 preferred was an impairment of his contractual rights. The case was heard in January, 1958, in the Superior Court of Cook County, Illinois. The court found for Armour and Bowman appealed. On May 22, 1959, the Illinois Supreme Court ruled on the appeal.[1]

Bowman's appeal asserted that the 1954 amendment operated to deprive him of rights and privileges as a holder of preferred stock contrary to constitutional inhibitions. Questions relating to the necessity of the recapitalization, the tax advantages to the corporation, the fairness of the plan, the financial consequences of

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[1] Bowman v. Armour & Co., 160 N.E. (2d) 753 (May 22, 1959).

its adoption on the preferred holders and the infringement of "contractual" or "vested rights" were all tossed aside by the court, who chose only to examine the statutory interpretation of the Illinois Business Corporation Act as it applied to the amendment.

The particular article of the Act upon which the court focused its attention read:

> In particular, and without limitation upon such general power of amendment, a corporation may amend its articles of incorporation from time to time, so as:
>
> (g) To change the designation of all or any part of its shares, whether issued or unissued, and to change the preferences, qualifications, limitations, restrictions, and the special or relative rights in respect of all or any part of its shares, whether issued or unissued.[1]

Appearing in the court's opinion is one of the clearest expositions of the rights of a preferred stockholder and the nature of any arrearages which may have accrued.[2] The court attacked the "vested rights" theory, first found in the Roberts-Wick case,[3] and threw out any question of vestedness as it related to the Bowman case.

The court stated that the problem at hand was not one of power to amend or the power to divest certain

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[1]Section 52 (g) Business Corporation Act, Ill. Rev. Stat., 1957.

[2]The text of this section appears in Appendix C.

[3]See pp. 35-37, *supra*.

rights and privileges. Rather it was a question of whether or not the Corporation Act gave Armour the right to amend its charter to the extent that holders of the prior preferred were required to surrender their ownership in stock and accept in lieu thereof, the debentures:

> The amendment, whether it is viewed as effecting a purchase of the preferred stock with bonds or as a compulsory redemption thereof, obviously contemplates that the fundamental relationship of stockholder . . . will be changed and the preferred stockholders will become mere creditors of the company.[1]

Rather than being a modification of ownership, the plan was a liquidation of ownership status in exchange for creditorship status.

The Articles of Incorporation of Armour expressly provided that the preferred stock could be redeemed at a price of $115 per share plus accrued dividends. The attention of the court centered around the word "price." It ruled that "price" meant money and not bonds or other evidences of debt. The court recognized the right, subject to legal restrictions, of a corporation to purchase its own stock, with the consent of the shareholder.[2] It held that the effect of the amendment was in fact a purchase with bonds without the consent of the owners of

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[1] Bowman v. Armour & Co., 160 N.E. (2d) 757 (1959).

[2] Ibid., p. 757.

the stock. Therefore, Armour could only reacquire its preferred when an individual stockholder was willing to sell and no amendment passed with the approval of a two-thirds vote of the shareholders can force him to sell.[1]

The Supreme Court reversed the Superior Court and found for Bowman. The basis of the reversal was that the redemption of the preferred was not in legal accord with the provisions in the preferred stock certificate and the articles of incorporation.

On December 2, 1959 the Superior Court entered a decree stating that the preferred shareholders who did not vote for the amendment and did not surrender their certificates were entitled to receive, instead of the debentures and common stock warrants, 7.26 shares of common for each share of preferred and the accrued dividends plus total damages of $208,000. These shares of common had a total market value of $98.01 on December 20, 1954, the date of the exchange, and $263.18 on December 2, 1959.

Test for Value of Cumulative Feature

Exchange

Those shareholders who accepted the exchange offer became the holders of a warrant for the purchase of one share

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[1]*Ibid.*, p. 758.

of common at varying prices plus a cumulative income debenture bearing 5% interest, maturing in 1984, and callable for sinking fund purposes at 100. The opening market quotations of these securities on their first trading date after the exchange were:

Debenture	(February 18, 1955)	- 80 1/2
Common	(December 21, 1954)	- 13 1/2

The value of the exchange package was $97.60.[1]

The call price of the Armour preferred should have been $133.50 ($115.00 call price plus the accrued dividends of $18.50). Under the call price test the cumulative feature failed to have any worth because the new securities had a value of $35.90 less than the call price of the old preferred.

Dissent

Surprisingly, it was the dissenters to the 1954 exchange who had the most profitable experience. This was due to the rise in the market price of the common between the dates of the original exchange offer and the end of the litigation. Here we can use two dates to evaluate the worth of the cumulative feature. It is not difficult to see how the number of common shares awarded to the dis-

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[1]Calculated as follows: $120 principal of debentures X 80 1/2 plus the value of the common warrant of $1.00 (market price of the common of $13.50 less the warrant cost of $12.50).

senters was determined. Apparently the court attempted to make payment in common stock of equivalent value to that of the exchange package on the date of exchange. Thus the values of the 7.26 shares of common on December 21, 1954 ($98.01) and the exchange package ($97.60) were virtually the same.

However, the court decision was handed down on December 2, 1959, and both the judge and the plaintiff had the advantage of hindsight, for on that date the common was selling at 36 1/4, well above the 13 1/2 on the exchange date. Thus the plaintiffs could have asked for payment in common stock knowing full well that the market value of their package had appreciated substantially over that on the date of the exchange.

Conclusion

Quite clearly, the non-dissenters to the Armour exchange offer did not receive fair value for their cumulative preferreds on the date of the recapitalization. This conclusion is supported by the call price test. The ultimate gain or loss to be had by the participants in the exchange offer depends on the market action of the common stock and the common dividend policy of the company now that the preferred has been removed from the capital structure. However, as of the date of the exchange, the preferred shareholders were not compensated in any degree for the cumulative feature of their shares.

On the other hand, the dissenters would argue that they did receive value for their cumulation and that the non-dissenters were too hasty. However, the argument of the dissenters is not convincing since it is based upon events that occurred subsequent to the date of the exchange.

Case Study--Missouri-Kansas-Texas Railroad (Katy)

Description of Stock

Series A. Par value of $100 per share. Entitled to cumulative dividends of 7% per share beginning January 1, 1925. Preferred as to assets and dividends. Callable at $110 plus dividends. No preemptive rights. One vote per share, equal with the common.

History

The history of Katy's 7% preferred was very unsteady. After paying some cash dividends in the late twenties, the losses suffered during the thirties prompted the directors to halt dividend payments until 1953 when the railroad paid its first dividend in twenty-one years (see Table 13). Additional dividends were paid through 1957. The 7% preferred was retired in a compulsory recapitalization which was effective January 1, 1959.

The indenture agreement of an issue of outstanding 5% Adjustment Bonds prohibited any dividend payments until all interest arrearages on the bonds were cleared. This was not done until 1952 and it was this clearing which

Table 13.--Earnings, Dividends and Price Record of the Missouri-Kansas-Texas Railroad 7%A Preferred Stock For the Years 1930-58

End of Year	Per Share			
	Earnings	Dividends	Arrearages	Market Price at Calendar Year End
1930	$10.62	$7.00	$ - 0 -	80
1931	1.01	5.25	1.75	12 1/8
1932 - 1941	- 0 -	- 0 -	8.75 - 71.75	11 3/8 - 1 1/4
1942	8.82	- 0 -	78.75	3 3/8
1943	7.67	- 0 -	85.75	8 3/8
1944	9.16	- 0 -	92.75	18 1/2
1945	8.80	- 0 -	99.75	45 3/4
1946	2.57	- 0 -	106.75	22 3/4
1947	4.23	- 0 -	113.75	16
1948	9.75	- 0 -	120.75	21 3/4
1949	7.30	- 0 -	127.75	22 3/8
1950	9.52	- 0 -	134.75	50 3/4
1951	6.26	- 0 -	141.75	51
1952	11.32	- 0 -	148.75	67
1953	9.51	5.00	150.75	61 5/8
1954	6.03	6.00	151.75	77 1/4
1955	4.66	4.25	154.50	81 3/8
1956	2.91	2.00	159.50	62 1/2
1957	- 0 -	0.50	166.00	31
1958	- 0 -	--	166.00	66 1/4

Source: Moody's Transportation Manuals, 1930-59 (New York: Moody's Investors Service).

prompted the 1953 resumption of preferred dividends. The current status of the Adjustment Bonds also marked the onset of a series of four recapitalization plans which were put to the stockholders and the Interstate Commerce Commission for approval. As the president of the railroad explained:

> This constructive step (the 1953 preferred dividend) was made possible by the payment during the year of the remaining interest arrearages on the Company's Adjustment Bonds. It then became practicable, with the bond interest on a current basis, to offer a plan of recapitalization of the Company.[1]

This first recapitalization plan was filed with the Inter-State Commerce Commission in 1952 and was subsequently withdrawn from consideration. Later, in 1955 an important change in the common stock ownership took place. The estate of E. N. Claughton sold 525,000 shares of common (about 65% of the outstanding shares). Three investment corporations purchased 450,000 of these shares and succeeded in placing four new directors on the board.

A second plan was then filed with the ICC late in 1955. It was withdrawn because of the opposition of the four new directors. The third plan met a similar fate after the ICC examiner recommended that the application for a recapitalization be denied.

On October 31, 1957 an ICC examiner gave approval to

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[1]Missouri-Kansas-Texas Railroad, Annual Report: 1952, p. 3.

the fourth plan. This recapitalization, to be effective January 1, 1959, called for the exchange of the preferred shares and their respective accumulated dividends for: (1) a $110 non-interest bearing certificate, (2) a 5 1/2%, $100 income debenture maturing in 2033, and (3) one share of a $5 par value common. By supplemental order dated November 26, 1958, Finance Docket No. 19760, the ICC approved the plan as amended. The recapitalization was approved by 77.32% of the outstanding shares.

As a result of the exchange, arrearages totaling $110,722,830 or $166.00 per share, were cancelled and the following securities issued:

a. Subordinated Income Debentures--$66,700,500 face value

b. Certificates at $110 --$73,370,550 face value

c. Common Stock --667,005 shares

Test for Value of Cumulative Feature

In the 1958 recapitalization, the preferred stockholders received the income bond whose opening market value was $42.00; one share of common worth $7.875 and the certificate which was traded on the American Stock Exchange at $17.75. The total market value of these securities was $67.625.

The call price for the 7% preferred was $276.00 (call price of $110.00 plus arrearages of $166.00). Under the call price test the theoretical shortage in the exchange was $208.375.

Conclusion

This seems to be another case of "shall we at least take something or stick with our nothing." It is obvious that the preferred shareholders chose at least to raise their position in liquidation one notch, up to that of an unsecured creditor, at least to the extent of their bonds and certificates. Unfortunately the exchange did little else for them. For by agreeing to the exchange offer they completely gave up any claim to their arrearages. There is no doubt that they were not compensated to any degree for their accumulated dividends in the exchange. The Katy preferred, for all intents and purposes, may just as well have been non-cumulative.

The resumption of dividends and the attempts at a recapitalization brought about a sharp increase in the market price of the preferred, but not nearly enough to recover the cumulative dividends that were in arrears. In fact, the stock had not even risen to a point commensurate with the average yield. This, of course, reflects the pessimism of the investors as to the future prospects of the company. The accuracy of their judgment can only be evaluated by the future of the company's financial history.

Case Study--American & Foreign Power Company, Inc.

Description of Stocks

(1) $7 preferred, cumulative. Entitled to $100 plus accrued and unpaid dividends upon liquidation. Redeemable at $110 plus dividends. Ranks pari passu with the $6 preferred.

(2) $6 preferred, cumulative. Same provisions as the $7 preferred.

(3) $7 second preferred, cumulative. Junior in all respects to both classes of first preferred. Liquidation price of $100 plus accrued dividends. Redeemable at $105 plus accrued dividends.

History

American & Foreign Power is a subsidiary of Electric Bond and Share Company, both of which are registered holding companies. Foreign Power's financial difficulties began in the early thirties when its earnings began to fall. In 1933 the company failed to earn the dividends on its first preferreds and from that date to 1939 did not declare dividends on any class of the outstanding preferred.

Because of the lack of earnings, the non-payment of preferred dividends, and the resulting large accumulations of arrearages, the company was ordered to simplify its capital structure by the Securities and Exchange Commission in 1940. A plan for recapitalization was filed in 1947 under Section 11 (e) of the Public Utility Holding Company Act of 1935. It called for the exchange of the preferreds for new 4 1/4% debentures, cash and shares of a new common stock. However, after the SEC gave its approval to the plan, as amended, a substantial need for cash arose and the company found itself having to float a larger bond issue than originally anticipated. After a discussion with institutional investors it was concluded that the sale of the debentures could not be effected within the framework of the plan. As a result, the SEC withdrew its order but directed the company to reorganize on a single common stock basis and such debt securities that would meet the existing circumstances.

Before the 1947 plan was withdrawn a group of $6 preferred shareholders asked for SEC rejection of the plan because $59,000,000 of arrearages on the first preferreds would be cancelled without any compensation to the preferred shareholders. The group asked for issuance of 4% notes or dividend certificates convertible into the new common in exchange for the arrearages. The entire plan was withdrawn before the Commission gave a ruling on this proposal. It is unfortunate that the SEC did not have the opportunity to give an opinion on this matter for then it would have been compelled to take a stand on the value of the cumulative feature in this recapitalization.

Foreign Power filed a subsequent plan of reorganization dated January 15, 1951. At that date the capital structure of the company was:

$8,750,000 of short term bank notes.
$49,500,000 of 3.75%--4.20% notes all owned by Bond and Share.
$50,000,000 of 5% gold debentures all held by the public.
478,995 shares of $7 preferred, 2.88% held by Bond and Share.
387,026 shares of $6 preferred, 17% held by Bond and Share.
2,547,761 shares of $7 second preferred, 84.71% held by Bond and Share.
2,281,138 shares of common stock, 38.64% held by Bond and Share.
6,444,595 common stock warrants, 90.2% held by Bond and Share.

The plan was approved by the SEC on November 7, 1951, and ordered enforced by the United States District Court for the District of Maine on January 15, 1952.[1] The effective date of the plan was February 29, 1952. Substantially all of the persons and all of the committees who were in opposition to the 1947 plan participated in the negotiations on the 1951 plan and were in accord with its provisions. However, the enforcement decree was appealed by three stockholder groups, two of which were affirmed and one dismissed.[2]

The 1951 plan provided for the following new capital structure:

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[1] In re American & Foreign Power Co., Inc., 102 F. Supp. 331 (1952).

[2] Kantor; Zucker et al.; and Silver v. American & Foreign Power Co., Inc., 197 F. (2d) 307 (1952).

1. $8,750,000 of the short term bank notes
2. $50,000,000 of 5% Gold debentures
3. $67,564,600 of 4.8% Junior debentures
4. 7,152,711 shares of new no-par common stock.

The debentures and common stock were distributed as follows:

Outstanding security of Foreign Power	Security to be Issued
1. Each share of publicly held $7 Preferred Stock	$90 principal amount of 4.8% debentures and 4.0021 shares of new common.
2. $6 Preferred Stock	$80 principal amount of 4.8% debentures and 3.2032 shares of new common.
3. $7 Second Preferred Stock	.85 share of new common.
4. Common Stock	.02 share of new common.
5. To Electric Bond and Share for all of its holdings of notes, preferred, common and common warrants.	3,902,956 shares of new common stock.

In determining the allocations of the new securities as between the various classes of stocks the Securities and Exchange Commission extensively reviewed the history of the transactions betweem Foreign Power and its parent Electric Bond and Share, considering in detail various claims of mismanagement and over-reaching on the part of Bond and Share. The Commission concluded that it was appropriate to settle these alleged claims as part of the allocations; that Bond and Share was therefore not entitled to treatment on a parity with the public security holders on the basis merely of its relative holdings in Foreign Power; but that in the allocation of the new securities there should be an appropriate reduction of Bond and Share's participation and an increase in that of the public security holders. On the basis of the evidence the Commission concluded that a net "give-up" of annual earnings of about $4,500,000 on the part of Bond and Share fell within the range of a fair settlement of the claims. As a result of the recapitalization, Electric Bond and Share's position as a creditor was eliminated and its proportion of the common stock rose from 38.64% to 54.57%.

The division of the new securities between the various classes of the old stock was done primarily on the basis of their seniority and the relative dividend rates. As a result, the $7 second preferred, even though its per-share arrearages were almost 80% of the total of the arrearages on both of the first preferreds,[1] failed to receive interest and earnings on its new shares equal to either of the first preferreds.

The following chart was constructed comparing the re-

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[1]As of December 31, 1950 arrearages were $141.75 on the second preferred and $89.425 and $76.65 on the two first preferreds.

turn to each share of the old classes of stock based upon the new securities to be distributed.[1] Annual net income was assumed to be $15,700,000, the same amount used in the SEC hearings.

	Total	Per Share
$7 Preferred Stock		
Interest on Debentures	$ 2,010,000	$ 4.32
Earnings on Common	2,373,000	5.10
	$ 4,383,000	$ 9.42
$6 Preferred Stock		
Interest on Debentures	$ 1,233,000	$ 3.84
Earnings on Common	1,312,000	4.08
Total	$ 2,545,000	$ 7.92
Second Preferred Stock		
Earnings on Common	$ 450,000	$ 1.16
Common Stock		
Earnings on Common	$ 38,000	$ 0.027
Electric Bond and Share		
Earnings on Common	$ 5,246,000	$ --
Total	$12,662,000	
Interest on Gold Debs and Bank Loans	3,038,000	
Total Earnings	$15,700,000	

One $6 preferred shareholder sued, challenging the SEC's use of the relative dividend rates as the basis of allocation.[2] The suit requested a greater participation in earnings than was provided for in the plan via an

[1]Table taken from: In re American & Foreign Power Co., Inc., 102 F. Supp. 335 (1952).

[2]Kantor v. American & Foreign Power Co., Inc., 197 F. (2d) 307 (1952).

allocation based upon liquidation values. In the above chart the ratio of the projected earnings of the two issues of first preferred after the exchange is \$9.42 : \$7.92 or 100 : 84.08. This ratio is very close to the ratio of the respective dividend rates of \$7 and \$6 or 100 : 85.71. The court rationalized the slight discrepancy between 85.71 and 84.08 by pointing out the higher quality of the earnings of the \$6 preferred because of the greater proportion of debentures in the settlement. On the other hand the liquidation price on the date of the exchange for the \$7 preferred (\$100 plus dividend arrearages) was \$196.425. The liquidation price of the \$6 preferred (\$100 plus dividend arrearages) was \$182.65. The ratio between the two was 196.425 : 182.65 or 100 : 92.99, decidedly more in favor of the \$6 preferred than the ratio of the dividend rates.

The Court, however, rejected the use of liquidation values. It held that the possibility of liquidation or redemption was considered by the SEC to be too remote to warrant consideration and that the Commission properly viewed the company as a going concern. This conclusion was consistent with the other findings--in particular, the large scale capital equipment construction program of the company from 1946 to 1950 which caused the 1947 Plan to be set aside.

The liquidation value of the \$7 second preferred was higher than that of either issue of the first preferred because of its large dividend accumulation. But its share of the earnings after the recapitalization on a per share basis is just slightly more than 1/7 of that of the $6 preferred. The Court supported this relationship by pointing out that there is no guarantee to any class of junior investors of a participation in a reorganized enterprise. The principle of absolute priority implies a sacrifice, if such be necessary, by those at the bottom of the investment ladder.[1]

Test for Value of Cumulative Feature

The respective market values that were first available for the securities which the holders of the preferred shares received in the recapitalization were:

Common Stock	-	$10.875
4.8% Debentures	-	71.375

The total market value of the packages received by each class of preferred was (including accrued interest on the debentures):

$7 first preferred stock	-	$ 113.86
$6 first preferred stock	-	97.35
$7 second preferred stock	-	9.24

The deficiencies for all three issues under the call price test were computed as follows:

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[1] Kantor et al. v. American & Foreign Power Co., Inc., 102 F. Supp. 338 (1952).

Stock	Call Price	+	Arrearages	-	Value of Exchange Package	=	Deficiency In Exchange
$7 1st Pfd.	$110.00		$96.425		$113.86		$92.565
$6 1st Pfd.	110.00		82.65		97.35		95.30
$7 2d Pfd.	105.00		148.75		9.24		244.50

Conclusion

In only one instance did a share of American & Foreign Power preferred recover a portion of its accumulated dividends, and that was the $7 first preferred. Therefore, in general, the 1952 recapitalization failed to give any recognition to the claim of the preferred holders to the accumulated and unpaid dividends. Indeed, the deficiencies in each case bore a similar resemblance to the ratio of the arrearages. Clearly, if the recapitalization gave full effect to the arrearages, an acute overcapitalization would occur, either in the form of debt or equity. In addition, the common shareholders and probably the second preferred holders would have received none of the new stock, and thus would have had their equities wiped out. Certainly, if cumulation is to have full value, should not all subordinate claims be eliminated if such a step is called for? If a preferred is truly preferred as to assets and dividends it seems that an affirmative answer is called for. This, however, was not the case with Foreign Power and, as a result, the cumulative feature was virtually ignored in the recapitalization.

Summary

The same methodology as was used in the analysis of the three previous cases was applied to the other fourteen exchanges of arreared preferred stocks. The findings of all of these analyses are summarized in Table 14.

In only four of the nineteen issues was full accumulation of dividends realized in the exchange of the old preferreds. The remainder of the stocks, except for the Alleghany $5.50 and the Virginia-Carolina Chemical Corporation 6% where the arrearages were substantially realized, were, in essence, treated entirely as non-cumulative in the recapitalizations. While one may feel that only fifteen cases in twelve years is not substantial enough to refute Dewing's statement that introduced this chapter, the fact remains that in these cases the preferred contracts were fundamentally violated when the shareholders were not compensated for their cumulative rights.

However, it does not appear sound to condemn the cumulative feature as worthless for contractual reasons only. What should also be considered, although not quantifiable, is the number of instances where the mere pres-

Table 14.--Summary of Tests to Determine the Value of the Cumulative Feature in Preferred Stock Arrearage Settlements Effected by Recapitalizations or Mergers from 1951 to 1962

Stock	Per Preferred Share: Call Price	or Normal Yield Price	Arrearages	Total	Value of Settlement Package	Value to Cumulation: None	Some	All
Alleghany Corp., 5½% A	$105.00		$147.13	$252.13	$170.63		X	
Alleghany Corp., $2.50 pr. cv.	50.00		29.38	79.38	81.00			X
American & For. Power, $7	110.00		96.43	206.43	113.86		X	
American & For. Power, $6	110.00		82.65	192.65	97.35	X		
American & For. Power, $7 2d.	105.00		148.75	253.75	9.24	X		
Armour and Company, $6 pr. cv.	115.00		18.50	133.50	97.60	X		
Consolidated R.R. of Cuba, 6%	110.00		124.00	234.00	. .[a]	-	-	-
Internat'l Hydro-El., $2 part.	. .[b]	$33.84	50.50	84.34	33.25	X		
Lehigh Valley Coal, $3 1st.	55.00		5.29	60.29	40.50	X		
Long Bell Lumber Corp., $4A	60.00		89.52	149.52	76.15		X	
Mo.-Kansas-Texas R.R., 7%A	110.00		166.00	276.00	67.63	X		
Missouri-Pacific R.R., 5%	107.50		164.50	272.00	100.51	X		
Robbins Mills, 4.5% cv.	52.50		2.25	54.75	39.25	X		
Std. Gas and Electric, $7 pr.	115.00		102.90	217.90	266.50			X
Std. Gas and Electric, $6 pr.	110.00		88.20	198.20	238.03			X
Std. Gas and Electric, $4	. .[b]	69.69	80.33	150.02	181.00			X
Thompson-Starrett, $3.50 cv.	55.00		. .[c]	55.00	28.00	X		
United Wallpaper, 4% cv.	50.00		6.50	56.50	30.63	X		
Va.-Carolina Chemical, 6% part.	105.00		96.00	201.00	141.83		X	

[a]Data not available.

[b]Security not callable.

[c]No dividends payable when stock is called.

ence of the cumulative feature was enough to persuade the directors to declare preferred dividends where had the preferred been non-cumulative, they would have passed the dividends. Also, if one wishes to evaluate the cumulative feature in contemporary arrearages, it is essential to note that thirteen of the fifteen issues found to be without value as cumulatives, went into arrears prior to 1950.

Therefore, there does not appear to be sufficient evidence to make a blanket condemnation of the cumulative feature in contemporary preferred financing as Dewing did in 1934. There have been cases where the cumulative feature failed to have value, most particularly in those cases where the arrearages were eliminated by recapitalizations. It seems however that these cases are still repercussions of the 1930-33 depression. It does appear that contemporary preferred experiences point to a real value for the cumulative feature--especially when considered in light of the high proportion of recent cash settlements. What the analyses of this chapter do prove is that if preferred arrearages are subjected to elimination via recapitalization, the chances are very high that the preferred will fail to realize any value for their cumulative feature.

CHAPTER VI

CONCLUSION

The experiences of cumulative preferred stocks listed on the New York Stock Exchange with dividends in arrears have been examined over a twenty-seven year period (1935-62). Their role in corporate finance has been analyzed with respect to the economy, a firm's board of directors and its stockholders.

The Economy

The dollar amount of arrearages from 1935 until 1952 was close to the $1 billion level. It was not until 1952 that arrearages showed a substantial decrease, dropping to below $500,000,000. In 1958, arrearages dropped under $100,000,000 for the first time. They have since not exceeded that amount. Arrearages in 1951 were as high as 325% of the preferred dividends paid on preferreds listed on the New York Stock Exchange.

By far the most important historical cause of the large dollar amount of arrearages present in the 1930s and 40s was the severe losses incurred by most firms in the 1930-33 depression. During that time 50% of the arrearages first began to accumulate. A similar relationship between arrearages and corporate net income has been found to exist since the depression.

Another cause of preferred arrearages was the desire to reduce the burden of excess profits taxes computed by the "invested capital" method. However, only twenty issues went into arrears during periods of excess profits taxation.

Settlements of arrearages have been analyzed by the five major methods used. It was found that the longer the arrearage was outstanding the greater the chances were that the arrearages would be settled by a non-cash method. The settlements have been attributed to three factors:

1. The fact that the earnings of the firm had recovered to a level where the common stockholders believed that they should begin to share in the new prosperity. However, sizable earnings proved to be no guarantee that a cash settlement will occur.

2. When interest rates have fallen it could be advantageous for a firm to retire its arreared preferred issue and raise the required funds by floating a bond issue or new preferred stock at the lower interest or dividend rates.

3. An attempt to reduce the amount of retained earnings to avoid any undistributed profits tax.

In summary, it appears as though the problem of long and large accumulations of arrearages on preferred stocks both as to the number of issues and the dollar amount seems to be a thing of the past. There are four reasons for this conclusion:

1. Recent arrearages have been settled, on the average, faster than they were prior to 1950.

2. Tabulations on December 31, 1962 show that the preferreds with accrued dividends on that date had been in arrears, on the average, only 2.7 years.

3. The reduction in the number of outstanding preferred issues due to their elimination in corporate reorganizations and mergers.

4. The decline in the popularity of new preferred financing.

A Firm's Board of Directors

The power to control the distribution of corporate earnings that is held by a firm's board of directors was subjected to close scrutiny. Despite the inferences of preference and priority usually conveyed by a preferred stock, boards of directors have the power to treat, in essence, cumulative preferred stocks virtually the same as common. For regardless of the level of earnings and working capital a board of directors can refuse to declare dividends on cumulative preferred stocks. This, however, does not stop the undeclared dividends, whether earned or not, from accumulating as a contingent claim of the preferred stockholders in accordance with their contract.

It is strongly recommended that all cases where boards of directors have passed earned cumulative preferred dividends be subjected to some sort of objective test in order to determine the equity of each individual withholding. Otherwise the firm will have the use of funds which should have been distributed to the preferred shareholders without paying them an additional return for the use of their capital.

The Stockholder

From the standpoint of the stockholder the cumulative feature in the majority of arrearage settlements in recent times (1951-62) has proven to have full value. Of the forty-five settlements that occurred in this period, twenty-one that were effected by full cash payments, three by retiring the preferred and four by recapitalizations or mergers proved to have fully compensated the preferred shareholders for the amount of the arrearages that had accumulated on their stocks.

Of the forty-five cases there were fifteen recapitalizations and two liquidations in which there was little or no value to the cumulative feature in the settlement. Clearly in the case of the liquidations it was a situation of a hopeless investment choice. But what protection, if any, should have been given to the investors in the fifteen other situations?

Should an individual stockholder who does not agree with a settlement proposal put forth by a corporation consent to sacrifice his claims for the good of the whole as long as the majority is convinced that a settlement is needed? The question becomes especially poignant when one considers how the majority of the preferred stockholders approve corporate amendments for settlement of their arrearages. In almost all cases the approval is not so much an exercise of intelligent judgment as the result of an efficient functioning of the proxy machinery.

Court decisions examining arrearage settlements are too often based upon the legal power to remove accrued dividends without examining the fairness of the plan in light of its facts. Orschel has raised the question of whether the final authority to judge the fairness of settlement plans should rest with the courts. He advocates setting up a special administrative agency to pass on the equity of all questioned arrearage settlement plans.[1]

Becht, on the other hand, sets forth certain propositions based on the assumption that if there is a real

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[1]Albert K. Orschel, "Administrative Protection for Stockholders in California Recapitalizations," Stanford Law Review, IV (1952), 217.

need for the plan the corporation can prove it. And in the absence of such proof it is better to keep the status quo than to force the stockholders into an expensive inquiry whose outcome is likely to be inconclusive. He advocates:

1. Requiring dissenters to prove that the plan alters their interests in the property of the corporation.

2. Requiring the corporation to prove a specific need which justifies the amendment.

3. If proof is given, let the majority further sustain the burden of proving that there is no other solution to the difficulties which would not affect the relative priorities of the classes of stock.

4. If the majority fails to sustain the burden of proof of these issues, let the court enjoin the plan entirely or so much as puts pressure on the dissenters.[1]

The worst possible result of Becht's proposal would be a continuation of the status quo. Is this undesirable? It seems that any redefinition of a security holder's rights should call for a show cause--a cause that is something vital and specific. The courts should insist that senior security holders receive substantially the equivalent in value for what they give up in the plan; and that this value is primarily a question of the claim upon earnings. If this is not possible, then a status quo situation seems to be the only other alternative--one that should

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[1]Arno C. Becht, "Alteration of Accrued Dividends," Michigan Law Review, IL (1951), 592.

be in effect at least until the cumulative preferred shareholders can be sure of getting their bargained-for return in the arrearage settlement plan--one which fully recognizes the value of the cumulative feature.

If these measures are not adopted it seems as though all cumulative preferred shares would have to bear a statement on the face of their certificates warning the preferred shareholder that although his share is cumulative with respect to dividends, it is possible that should the dividends on his stock go into arrears, he will never receive full value for them in an ultimate settlement of the arrearages--thus completely negating any positive feature which accumulation may have had.

APPENDIX A

LIST OF COMPANIES WITH PREFERRED STOCKS IN ARREARS AS OF DECEMBER 31, 1935, 1940, 1945, 1950-62

RAILROADS

Name of Company	Description of Stock	Year of First Arrearage	Type of Settlement	1935	1940	1945	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
				Arrearages in thousands of dollars as of December 31:															
Alleghany Corp.	5½%A	1931	Recapitalization	$ 17,136	$ 35,491	$ 53,848	$ 26,452	$ 26,910	$ 16,307	$ 17,059	$ 17,800	$ 18,484	$ 19,315	$ 20,056					
Alleghany Corp.	$2.50 pr.cv.	1934	Recapitalization	411	1,683	3,135	1,363	1,149	796										
Bangor and Aroostook	5% cv.	1940	Cash		48	48													
Central of Georgia	5%B	1946	Cash				2,222	2,222	2,222	2,491									
Central of Georgia	5%B	1961	--															$ 850	$ 1,700
Chi. and Eastern Illinois	6%	1924	Recapitalization	15,873															
Chi. and Eastern Illinois	$2A	1947	Cash				766	768											
Chi. and Eastern Illinois	$2A	1958	--												$ 151	$ 151	$ 151	150	150
Chicago Great Western	4%	1919	Recapitalization	35,016	36,859														
Chicago Great Western	5%	1946	Cash				2,746	1,236	751										
Chi-Rhode Is. and Pacific	7%A (5% cum)	1931	Recapitalization	6,325	13,679														
Chi-Rhode Is. and Pacific	6%B (5% cum)	1931	Recapitalization	5,525	11,804														
Consolidated R.R. of Cuba	6%	1932	Recapitalization	6,668	14,396	23,488	36,218	38,036	39,854										
Denver and Rio Grande	6%	1924	Recapitalization	11,830	16,762	21,692													
Erie Lackawanna	5%	1959	--													157	783	1,410	1,880
Gulf, Mobile and Northern	6%	1923	Recapitalization	5,308															
Internat'l R.R. of Cent. Am.	5% part.	1931	--	2,125	2,475	3,725	3,225	3,725	4,100	4,225	4,600	4,600	4,475	4,475	4,975	5,475	5,975	6,475	6,975
Missouri-Kansas-Texas	7%A	1931	Recapitalization	19,835	43,181	66,526	89,870	94,540	98,372	99,041	100,375	102,710	106,044	110,380					
Missouri-Pacific	5%	1918	Recapitalization	49,901	67,851	85,801	103,751	107,341	110,931	114,521	118,111								
N.Y.-Chicago-St. Louis	6%A	1931	Cash	9,734	20,553	30,829	21,635												
N.Y.-New Haven-Hartford	7%	1932	Recapitalization	8,581	12,226	12,226													
N.Y.-New Haven-Hartford	5% cv. A	1948	Cash				5,820	5,870	4,305	2,861									
N.Y.-New Haven-Hartford	5% cv. A	1956	--										2,350	2,350	2,454	2,454	2,458	2,458	2,458
Pere Marquette	5% prior	1931	Merger	2,380	1,773	4,013													
Pere Marquette	5%	1931	Merger	2,641	5,852	8,959													
Rutland R. R.	7%	1890	Merger	31,234															
Western Pacific R.R. Corp.	6% cv.	1927	Liquidation	6,655	6,655	6,655	6,655												
Wheeling and Lake Erie	4%	1916	Recapitalization	4,159															
Totals				$241,337	$291,288	$320,945	$300,723	$281,797	$277,638	$240,198	$240,886	$125,794	$132,184	$137,261	$7,580	$8,237	$9,367	$11,343	$13,163

UTILITIES

Name of Company	Description of Stock	Year of First Arrearage	Type of Settlement	1935	1940	1945	1950	1951	1952	1953	1954	1955	1956
American & Foreign Power	$7	1932	Recapitalization	$ 13,412	$ 29,506	$ 35,290	$ 42,834	$ 46,187					
American & Foreign Power	$6	1932	Recapitalization	9,288	20,435	24,441	29,665	31,987					
American & Foreign Power	$7 2d	1932	Recapitalization	96,388	186,326	274,333	361,143	378,979					
American Power and Light	$6	1933	Recapitalization	11,308	17,617								
American Power and Light	$5	1933	Recapitalization	11,619	18,101								
Brooklyn & Queens Transit	$6	1934	Liquidation	1,204									
Commonwealth & So. Corp.	$6	1935	Liquidation	4,498	31,500	43,340							
Electric Power & Light	$7	1932	Merger	11,398	29,213	46,129							
Electric Power & Light	$6	1932	Merger	4,853	12,439	19,642							
Engineers Pub. Service	$5 cv.	1933	Cash	1,778									
Engineers Pub. Service	$5.50	1933	Cash	2,437									
Engineers Pub. Service	$6	1933	Cash	1,013									
Federal Water Service	$2A	1931	Recapitalization	4,923	10,617								
General Gas & Electric	$8	1933	Recapitalization	338	840								
General Gas & Electric	$7	1933	Recapitalization	429	1,208								
General Gas & Electric	$6A cv.	1933	Recapitalization	6,045	15,699								
Internat'l Hydro-Electric	$2 part.	1932	Merger	6,354	17,119	23,560	32,127	33,840	$ 35,554	$ 37,267	$ 38,981	$ 40,694	$ 42,408
Laclede Gas	5%	1933	Liquidation	271	896								
Market Street Railway	6% prior	1924	Liquidation	8,888	13,071	16,556	20,042	20,739	21,436				
Market Street Railway	6%	1924	Liquidation	4,114	5,909	7,405							
Philadelphia Rapid Transit	7%	1932	Recapitalization	3,920									
Standard Gas and Electric	$7 prior	1933	Recapitalization	2,450	17,920	30,812	37,903	37,903					
Standard Gas and Electric	$6 prior	1933	Recapitalization	570	4,170	7,170	8,820	8,820					
Standard Gas and Electric	$4	1933	Recapitalization	5,555	23,733	38,882	54,031	57,061	60,075				
Twin City Rapid Transit	7%	1932	Recapitalization	840	1,260								
Totals				$213,893	$457,579	$567,560	$586,565	$615,516	$117,065	$ 37,267	$ 38,981	$ 40,694	$ 42,408

OTHER

Name of Company	Description of Stock	Year of First Arrearage	Type of Settlement	1935	1940	1945	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
Atlas Corp.	5%	1961	--															$ 170	$ 678
General Realty & Utility	$6	1931	Recapitalization	$ 6,141	$ 9,177														
Hotel Corp. of America	5% cv.	1951	Cash					$ 147	$ 344	$ 540	$ 737	$ 784	$ 656	$ 770	$ 742				
Second Nat'l Investors	$5 cv.	1930	Recapitalization	1,343															
Sterling Securities	$3 cv. 1st	1931	Merger	2,356															
Sterling Securities	$1.20	1931	Merger	2,750															
Totals				$ 12,590	$ 9,177			$ 147	$ 344	$ 540	$ 737	$ 784	$ 656	$ 770	$ 742			$ 170	$ 678

INDUSTRIALS

Name of Company	Description of Stock	Year of First Arrearage	Type of Settlement	Arrearages in thousands of dollars as of December 31:															
				1935	1940	1945	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
Amalgamated Leather	$7	1920	Recapitalization	$ 5,096															
Amalgamated Leather	6% cv.	1938	Cash		$ 399	$ 177													
Amalgamated Leather	6% cv.	1956	Retired										$ 19	$ 93	$ 167	$ 241	$ 315	$ 371	
American Chain	7%	1931	Recapitalization	2,008															
American Crystal Sugar	7%	1926	Recapitalization	2,918															
American Hide & Leather	7%	1905	Cash	21,775															
American Locomotive	7%	1932	Recapitalization	8,007	15,046														
American Metal	6% cv.	1931	Cash	1,433															
American Steel Foundry	7%	1933	Retired	801															
American Type Founders	7%	1932	Recapitalization	1,116															
American Woolen	7%	1927	Recapitalization	22,514	27,913	20,563													
American Writing Paper	$6	1930	Recapitalization	2,678															
American Zinc	$6	1920	Recapitalization	6,075															
American Zinc	$5 pr. cv.	1937	Cash		85														
Armour and Company - Del.	$6 pr. cv.	1931	Recapitalization	1,180															
Armour and Company - Ill.	7%	1938	Retired		649	1,888													
Armour and Company - Ill.	$6 pr. cv.	1938	Recapitalization		8,794	16,311	$ 4,500	$ 4,875	$ 6,750	$ 6,750									
Artloom Corp.	7%	1932	Cash	31															
Associated Dry Goods	6% 1st.	1932	Cash	806															
Associated Dry Goods	7% 2d.	1932	Cash	1,394	1,735														
Austin-Nichols & Co.	$5 pr. A	1933	Recapitalization	64	643	878													
Barker Bros.	6½%	1932	Recapitalization	686															
Beck Shoe Corp.	4 3/4%	1962	--																$ 35
Bethlehem Steel	7%	1932	Recapitalization	17,977															
S. Blumenthal Co.	7%	1933	Cash	292	365														
Botany Consolidated	$4A	1926	Recapitalization	3,800															
Bucyrus Erie	7%	1932	Recapitalization	1,042															
Budd Manufacturing	7%	1928	Recapitalization	2,084	4,167														
Burns Bros.	7%	1932	Recapitalization	633															
Burns Bros.	$8A part.	1931	Recapitalization	3,974															
Bush Terminal Bldgs.	7%	1933	Cash	1,470	1,960	3,640	2,999	2,999	569	325									
A. M. Byers	7%	1933	Cash	1,007	2,158														
J. I. Case Co.	7%	1933	Cash	916															
J. I. Case Co.	7%	1960	--														163	813	1,463
J. I. Case Co.	6½% 2d.	1960	--														136	682	1,227
Certainteed	7%	1929	Cash	3,087	1,644														
Chi. Pneumatic Tool	$3.50	1931	Recapitalization	3,803															
Consolidated Film Ind.	$2	1932	Merger	1,600	3,600														
Continental Baking	8%	1932	Recapitalization	5,613	2,005														
Crown Williamette Paper	$7 1st.	1931	Recapitalization	2,200															
Crown Williamette Paper	$6 2d.	1931	Recapitalization	1,169															
Crucible Steel	7%	1932	Recapitalization	6,188															
Cuban American Sugar	7%	1929	Cash	3,868	4,440														
Cudahy Packing	4½%	1953	Cash							450	$ 900	$ 1,350	675						
Cudahy Packing	4½%	1962	--																338
Curtis Publishing	7%	1933	Cash	7,200	1,288	1,628													
Curtis Publishing	$3 - $4	1961	--															753	1,756
Curtis Publishing	$.60 - $1.60	1961	--															108	251
Cushman's Sons	7%	1936	Cash		234														
Cushman's Sons	$8	1936	Recapitalization		1,457														
Deere & Co.	7%	1930	Cash	4,629															
Durham Hosiery	6%	1932	Recapitalization	1,015															
Endicott-Johnson Corp.	4%	1961	--															72	145
The Fair Dept. Store	7%	1938	Retired		731														
Fairbanks Co.	8% 1st.	1921	Recapitalization	968	1,314														
Fairbanks Co.	8% 2d.	1921	Recapitalization	2,320	3,160														
Federal Mining & Smelting	7%	1931	Recapitalization	897															
Foster Wheeler Corp.	$7	1933	Recapitalization	368	937														
Franklin-Simon	7%	1934	Retired	121	805	1,406													
Fuller Co.	$6 1st. part.	1932	Recapitalization	816															
Fuller Co.	$6 2d. part.	1932	Recapitalization	788															
Gar Wood Industries	4½% cv.	1950	Cash				71	142											
Gar Wood Industries	4½% cv.	1955	Cash									35	137	137	103				
General Amer. Industries	6% cv.	1952	Cash						109	182	328	185	188	232					
General Baking	$8	1961	--															493	1,013
General Cable	7%	1931	Recapitalization	4,988	7,875	7,875													
General Cable	$4A	1941	Recapitalization			1,227													

Name of Company	Description of Stock	Year of First Arrearage	Type of Settlement	1935	1940	1945	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
				Arrearages in thousands of dollars as of December 31:															
General Outdoor Advertising	6%	1931	Cash	$ 383															
General Outdoor Advertising	$4A	1933	Retired	2,027	$ 1,200														
General Steel Casting	$6	1931	Cash	2,700	5,700	$ 6,150	$ 2,000	$ 900											
Gimbel Bros.	7%	1932	Recapitalization	4,183															
Goodrich Tire	7%	1931	Cash	8,829															
Goodyear Tire	$7	1933	Recapitalization	6,776															
Gotham Silk Hosiery	7%	1935	Cash	143	128														
Grand Union	$3	1934	Cash	239															
Guantanamo Sugar	8%	1929	Recapitalization	968	1,660														
Gulf States Steel	7%	1931	Merger	595															
Hamilton Watch	6%	1931	Cash	745															
Hat Corp. of America	6½%	1932	Cash	196															
International Minerals	7% pr.	1926	Merger	5,600	8,600														
International Paper	7%	1931	Recapitalization	29,695	10,417														
International Silver	7%	1932	Cash	951															
Jones-Laughlin	7%	1932	Recapitalization	13,504	26,421														
Keith-Albee	7%	1931	Liquidation	1,913	1,001														
Kelsey Hayes	$1.50 A	1936	Cash		1,016														
G. R. Kinney	$8	1931	Cash	1,918	323	143													
Kresge Dept. Store	8%	1927	Recapitalization	1,224															
Lehigh Portland Cement	7%	1932	Recapitalization	1,385															
Lehigh Valley Coal Corp.	6% cv.	1931	Recapitalization	2,718	6,308	9,662													
Lehigh Valley Coal Corp.	$3 1st.	1955	Recapitalization									$ 827	$ 887	$ 779	$ 753	$ 1,403			
Long Bell Lumber Corp.	$4A	1927	Merger	19,597	31,475	43,091	47,266	47,771	$48,989	$50,361	$51,833	52,605							
Louisiana Oil Refining	6½% cv.	1933	Merger	803															
Ludlum Steel	$6.50 cv.	1931	Merger	864															
Manati Sugar	7%	1926	Recapitalization	2,328															
Maytag Co.	$3	1932	Cash	642															
McKesson and Robbins	$3 cv.	1938	Recapitalization		4,088														
Mead Corp.	$6	1932	Cash	650															
Mengel	7%	1931	Recapitalization	980															
Mengel	5% cv.	1939	Cash		195														
Minneapolis-Moline	$6.50	1931	Merger	2,967	3,874	3,393													
Minneapolis-Moline	$5.50 1st.	1957	Cash											50					
Minneapolis-Moline	$1.50 2d. cv.	1957	Cash											38					
Mullins Manufacturing	$7	1938	Cash		403														
National Dept. Stores	6%	1940	Retired		82														
National Supply Co.	7%	1931	Recapitalization	4,945															
National Supply Co.	6% pr.	1938	Recapitalization		631														
National Supply Co.	5½% cv.	1938	Recapitalization		2,023														
National Supply Co.	$2	1938	Recapitalization		1,258	699													
New York Shipbuilding	7%	1935	Retired	70															
Norwalk Tire & Rubber	7%	1935	Cash	11															
Otis Steel	7% pr.	1931	Merger	3,624	1,885														
Panhandle Producing	8% cv.	1923	Recapitalization	1,683															
Paramount Pictures	6% 1st.	1935	Cash	750															
Paramount Pictures	6% 2d.	1935	Cash	193															
Peabody Coal Co.	5% pr. cv.	1953	Cash							352	1,055	456							
Penn-Dixie Cement	7%	1929	Recapitalization	5,303	9,423														
Penn-Texas Co.	$1.60 cv.	1957	Cash											164	740	444			
Phillips-Jones	7%	1933	Recapitalization	41	282	261													
Phoenix Hosiery	7%	1931	Recapitalization	411	822														
Pierce Oil	8% cv.	1921	Liquidation	16,800															
Pittsburgh Coal	6%	1926	Recapitalization	26,079	43,050	56,339													
Pittsburgh Steel	7%	1931	Retired	3,300	2,349	699	3,068												
Pittsburgh Steel	5%	1937	Recapitalization		1,215	4,094													
Pittsburgh Steel	5½%	1937	Recapitalization		962	83													
Pittsburgh Steel	5%	1961	--															$ 226	$ 451
Pittsburgh Steel	5½%	1961	--															1,083	2,165
Pittsburgh Terminal Coal	6%	1927	Liquidation	1,645	2,597														
Pittsburgh United Corp.	7% cv.	1931	Liquidation	1,732															
Porto-Rico American Tobacco	$3.50A	1931	Recapitalization	3,464															
Pressed Steel	7%	1931	Recapitalization	4,046															
Pressed Steel	5% 1st. cv.	1938	Retired		102														
Pressed Steel	5% 2d. cv.	1938	Retired		144														
Pure Oil Co.	6%	1933	Cash	4,982															
Pure Oil Co.	8% cv.	1933	Retired	1,801															
Radio Corp. of America	$5B	1931	Cash	16,297															

Name of Company	Description of Stock	Year of First Arrearage	Type of Settlement	Arrearages in thousands of dollars as of December 31: 1935	1940	1945	1950	1951	1952	1953	1954	1955	1956	1957	1958	1959	1960	1961	1962
Radio Keith Orpheum	6% cv.	1940	Cash		$ 769														
Real Silk Hosiery	7%	1931	Cash	$ 660	775														
Republic Steel	6% pr. cv.	1935	Cash	1,612															
Republic Steel	6% cv.	1930	Cash	4,328															
Revere Copper	7%	1931	Retired	2,665	1,248														
Revere Copper	5¼%	1937	Retired		1,235														
Revere Copper	$4A	1940	Recapitalization		827														
Robbins Mills	4.5% cv.	1954	Merger								$ 282								
Robert Reis	7% 1st.	1921	Recapitalization	1,624	2,388	$ 3,126													
Robert Reis	$1.25 pr. cv.	1949	--				$ 284	$ 426	$ 568	$ 710	852	$ 994	$ 1,137	$ 1,279	$ 1,420	$ 1,563	$ 1,242	$ 492	$ 441
Schulte Retail Stores	8%	1932	Recapitalization	2,594															
Servel Inc.	$4.50	1954	Cash								154	359	564	770					
Shell Union Oil	5½% cv.	1931	Cash	9,177															
Skelly Oil	6%	1931	Cash	1,856															
Alexander Smith Inc.	4.20%	1953	Cash							97	290	483	676	655					
Alexander Smith Inc.	3½%	1953	Cash							76	229	382	535	516					
A. J. Spalding	7% 1st.	1932	Merger	811															
Spang Chalfant	6%	1932	Merger	1,884															
Spear & Co.	7%	1932	Recapitalization	504															
Spear & Co.	7%	1932	Recapitalization	446															
Spear & Co.	$5.50	1954	Cash								27	27	27	26					
Symington	$2A	1927	Recapitalization	3,574															
Thompson-Starrett	$3.50 cv.	1931	Merger	895	2,069	3,187	4,305	4,529	4,752	4,976									
United Dye & Chemical	7%	1940	Retired		102	766	861	903	1,072	1,276	871	826							
U. S. Distributing	7% cv.	1931	Merger	3,497	6,994														
U. S. Hoffman Machinery	5% cv.	1960	--														39	192	346
U. S. Leather	7% pr.	1933	Cash	1,236	1,433														
U. S. Steel	7%	1932	Cash	54,042															
United Stores	$6	1929	Cash	2,265	1,244	574													
United Wallpaper	4% cv.	1953	Recapitalization							36	107	178							
Universal Pictures	8% 1st.	1932	Retired	464	1,100														
Universal Pictures	4¼%	1958	Cash												141				
Universal Pipe & Radiator	7%	1931	Recapitalization	868															
Vadsco Sales	7%	1930	Recapitalization	829	1,525														
Van Norman Industries	$2.28 cv.	1957	Cash											167	100	682	443	443	
Va.-Carolina Chemical	6% part.	1929	Recapitalization	9,816	15,872	19,068	15,659	15,659	15,659	15,659	15,659	15,659	15,659	15,659	15,659	16,938	18,216	19,494	
Va. Iron Coal & Coke	5%	1931	Recapitalization	397	918	1,022													
Ward Baking	$7	1934	Recapitalization	4,672	9,721														
Warner Bros. Pictures	$3.85	1932	Retired	1,489	3,356														
Warren Bros.	$1 1st.	1932	Recapitalization	64	144														
Warren Bros.	$3 cv.	1932	Recapitalization	478	1,094														
Webster - Eisenlohr	7%	1931	Cash	229	360														
Weston El. and Imp.	$2A	1933	Retired	14															
Wheeling Steel	6%	1932	Recapitalization	9,154	466														
White Sewing Machine	$4 cv.	1930	Retired	2,200	472	564													
Willys Overland Motors	6% cv.	1938	Recapitalization		358														
Wilson & Co.	$6	1938	Cash		2,424														
Worthington Pump	7%A	1932	Cash	1,504	356														
Worthington Pump	6%B	1932	Cash	2,192	468														
Worthington Pump	4½% cv.	1938	Cash		589														
Worthington Pump	4½% pr.	1938	Cash		589														
Yellow Truck	7%	1928	Cash	8,400															
Yellow Truck	75¢ B	1926	Cash	1,463															
Youngstown Sheet	5½% A	1932	Cash	2,888															
Totals				$516,906	$321,934	$208,514	$81,013	$78,204	$78,468	$81,250	$72,587	$74,366	$20,504	$20,565	$19,083	$21,271	$20,554	$25,222	$9,631

APPENDIX B

LIST OF EARNINGS, ARREARAGES, AND WORKING CAPITAL OF COMPANIES WHOSE PREFERRED STOCKS HAD ORIGINAL ARREARAGES FROM 1950 TO 1962

Year Ending	Earnings Per Share		Arrearages Per Share		Total Arrearages	Working Capital
Amalgamated Leather, 6% cv., $50 par						
1956	$ - 0 -		$ .75		$ 18,500	$ 2,400,000
1957	- 0 -		3.75		93,400	2,300,000
1958	- 0 -		6.75		166,800	1,900,000
1959	6.25		9.75		240,800	2,200,000
1960	- 0 -		12.75		314,900	2,100,000
1961	- 0 -		15.75		371,400	1,700,000
			(Retired in 1962)			
Atlas Corporation, 5%, $20 par						
1961	$ - 0 -		$ .25		$ 169,800	$ 59,000,000
1962	- 0 -		1.00		678,200	35,000,000
Beck Shoe Corporation, 4 3/4%, $100 par						
1962	$ - 0 -		$ 1.19		$ 34,900	$ 9,300,000
J. I. Case Co.						
	6½% 2d, $7 par		7%, $100 par			
1960	$ - 0 -	$ .11	$ - 0 -	$ 1.75	$ 299,000	$ 10,800,000
1961	- 0 -	.57	- 0 -	8.75	1,494,800	(26,000,000)
1962	- 0 -	1.02	- 0 -	15.75	2,690,600	(21,400,000)
Central of Georgia Railway Co., 5%B, $100 par						
1961	$ - 0 -		$ 5.00		$ 850,200	$ 6,200,000
1962	- 0 -		10.00		1,700,400	6,500,000
Chicago and Eastern Illinois Railroad, $2A (Cumulative if earned)						
1958	$ - 0 -		$ 2.00		$ 150,800	$ (70,000)
1959	- 0 -		2.00		150,800	(1,300,000)
1960	- 0 -		2.00		150,800	(600,000)
1961	- 0 -		2.00		150,200	(2,000,000)
1962	- 0 -		2.00		150,200	(1,900,000)
Cudahy Packing Co., 4½%, $100 par						
1953	$ 5.43		$ 4.50		$ 450,000	$ 25,700,000
1954	- 0 -		9.00		900,000	16,000,000
1955	27.03		13.50		1,350,000	17,200,000
1956	52.68		6.75		675,000	21,600,000
			(Cash paid in 1957)			
1962	- 0 -		3.75		337,500	8,100,000

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital
Curtis Publishing Co.				
	$3 - $4 Pfd.*	$.60-$1.60 Pfd*		
1961	$ - 0 - $ 2.25	$ - 0 - $ .30	$ 860,400	$ 32,200,000
1962	- 0 - 5.25	- 0 - .90	2,007,400	13,700,000
Endicott-Johnson Corp., 4%, $100 par				
1961	$ - 0 -	$ 1.00	$ 72,400	$ 47,100,000
1962	8.58	2.00	144,800	50,800,000
Erie-Lackawanna Railroad, 5%, $100 par (Cumulative to 15% maximum)				
1959	$ - 0 -	$ 1.25	$ 156,700	$ 8,300,000
1960	- 0 -	6.25	783,300	11,400,000
1961	- 0 -	11.25	1,410,000	2,900,000
1962	- 0 -	15.00	1,880,200	4,000,000
Gar Wood Industries, 4½% cv., $50 par				
1950	$ - 0 -	$ 1.13	$ 70,900	$ 8,100,000
1951	48.02	2.25	141,700	11,100,000
		(Cash paid in 1952)		
1955	- 0 -	.56	35,300	11,200,000
1956	16.54	2.25	137,100	11,600,000
1957	8.45	2.25	137,100	12,000,000
1958	8.28	1.69	103,000	12,200,000
		(Cash paid in 1959)		
General American Industries, 6% cv., $50 par				
1952	$ - 0 -	$ 2.25	$ 109,200	$ 2,500,000
1953	12.55	3.75	182,000	3,100,000
1954	- 0 -	6.75	327,600	2,200,000
1955	- 0 -	9.75	185,300	1,400,000
1956	- 0 -	12.75	187,900	3,200,000
1957	138.64	12.75	232,100	4,600,000
		(Cash paid in 1958)		
General Baking Co., $8				
1961	$ - 0 -	$ 6.00	$ 493,400	$ 16,000,000
1962	3.79	14.00	1,013,100	16,300,000

*Cumulative to the second amount only if earned.

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital

Hotel Corporation of America, 5% cv., $25 par

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital
1951	$ - 0 -	$ .94	$ 147,200	$ (85,000)
1952	- 0 -	2.19	343,900	36,000
1953	- 0 -	3.44	540,200	(300,000)
1954	- 0 -	4.69	736,500	800,000
1955	4.14	5.94	784,300	2,000,000
1956	19.46	7.19	655,800	150,000
1957	8.85	8.44	769,800	- 0 -
1958	5.31	8.13	741,500	9,700,000

(Cash paid in 1959)

Lehigh Valley Coal Corp., $3 1st. (Cumulative to the extent earned)

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital
1955	$ 1.53	$ 3.72	$ 826,700	$ 5,700,000
1956	4.61	3.98	886,900	6,900,000
1957	2.79	3.49	778,500	6,700,000
1958	- 0 -	3.38	753,100	6,100,000
1959	2.91	6.29	1,403,000	7,300,000

(Recapitalized in 1960)

Minneapolis-Moline Company

Year Ending	$5.50 1st.		$1.50 2d cv.		Total Arrearages	Working Capital
1957	$ - 0 -	$ 2.75	$ - 0 -	$ .75	$ 88,400	$ 38,000,000

(Cash paid in 1958)

New York, New Haven & Hartford Railroad, 5%A cv., $100 par (Cumulative if earned)

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital
1956	$ - 0 -	$ 5.00	$2,350,000	$ (900,000)
1957	- 0 -	5.00	2,350,000	500,000
1958	- 0 -	5.00	2,453,600	1,400,000
1959	- 0 -	5.00	2,453,600	(7,400,000)
1960	- 0 -	5.00	2,457,700	(21,500,000)
1961	- 0 -	5.00	2,457,700	(5,500,000)
1962	- 0 -	5.00	2,457,700	37,000,000

Peabody Coal Company, 5% prior cv., $25 par

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital
1953	$ - 0 -	$ .31	$ 351,600	$ 5,500,000
1954	1.99	1.56	1,054,900	8,800,000
1955	5.62	.81	456,100	12,200,000

(Cash paid in 1956)

Penn-Texas Corporation*, $1.60 cv.

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital
1957	$ - 0 -	$ .40	$ 163,700	$ 23,000,000
1958	- 0 -	2.00	739,600	63,000,000
1959	8.65	1.20	443,600	75,000,000
		(Cash paid in 1960)		

Pittsburgh Steel Company

Year Ending	5½%, $100 par: Earnings Per Share	5½%, $100 par: Arrearages Per Share	5%, $100 par: Earnings Per Share	5%, $100 par: Arrearages Per Share	Total Arrearages	Working Capital
1961	$ - 0 -	$ 5.50	$ - 0 -	$ 5.00	$1,308,100	$ 39,000,000
1962	7.54	11.00	8.88	10.00	2,616,300	44,000,000

Robbins Mills, 4.5% cv., $50 par

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital
1954	$ - 0 -	$ 1.69	$ 282,000	$ 9,400,000
	(Merged with Textron American in 1955)			

Servel Inc., $4.50

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital
1954	$ - 0 -	$ 3.38	$ 153,900	$ 11,800,000
1955	- 0 -	7.88	359,100	9,100,000
1956	- 0 -	12.38	564,300	9,400,000
1957	- 0 -	16.88	769,500	12,100,000
1958	- 0 -	- 0 -	- 0 -	10,600,000
1959	84.40	- 0 -	- 0 -	4,200,000
		(Cash paid in 1958)		

Alexander Smith Inc.

Year Ending	Earnings Per Share	Arrearages Per Share 3½%	Arrearages Per Share 4.2%	Total Arrearages	Working Capital
1953	$ - 0 -	$ 1.75	$ 2.10	$ 173,100	$ 19,100,000
1954	- 0 -	5.25	6.30	519,200	13,100,000
1955	- 0 -	8.75	10.50	865,300	12,900,000
1956	42.10	12.25	14.70	1,211,400	31,400,000
1957	39.21	12.25	14.70	1,171,200	31,800,000
		(Cash paid in 1958)			

Spear & Co., $5.50 preferred

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital
1954	$ - 0 -	$ 2.75	$ 26,800	$ 7,400,000
1955	- 0 -	2.75	26,800	6,900,000
1956	- 0 -	2.75	26,800	5,500,000
1957	- 0 -	2.75	26,000	3,000,000
		(Cash paid in 1958)		

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*Formerly Fairbanks - Whitney Corporation.

Year Ending	Earnings Per Share	Arrearages Per Share	Total Arrearages	Working Capital
United States Hoffman Machinery Corp., 5% cv., $50 par				
1960	$ - 0 -	$ .63	$ 38,800	$ 135,000
1961	- 0 -	3.13	192,300	89,000
1962	- 0 -	5.63	346,100	(1,500,000)
United Wallpaper, Inc., 4% cv., $50 par				
1953	$ - 0 -	$ 1.00	$ 35,600	$ 13,700,000
1954	- 0 -	3.00	106,800	10,200,000
1955	- 0 -	5.00	178,000	7,400,000
		(Recapitalized in 1956)		
Universal Pictures Co., Inc., 4½%, $100 par				
1958	$ - 0 -	$ 3.19	$ 141,400	$ 31,500,000
1959	113.00	- 0 -	- 0 -	32,600,000
		(Cash paid in 1959)		
Van Norman Industries, $2.28 cv.				
1957	$ 2.77	$ .64	$ 166,900	$ 20,500,000
1958	- 0 -	.39	99,600	18,600,000
1959	3.92	2.67	681,700	19,000,000
1960	5.15	2.85	442,600	19,000,000
1961	- 0 -	2.85	442,600	19,900,000

(Cash paid in 1962 after merging with Universal American)

APPENDIX C

OPINION OF THE ILLINOIS SUPREME COURT ON ACCRUED DIVIDENDS[a]

We hold that defendant acquired his shares of the preferred stock of the plaintiff corporation subject to a contractual condition investing a two-thirds majority of the preferred shareholders with the right to adopt a charter amendment eliminating unpaid accrued dividends on the preferred stock. . . . We are further satisfied that the right of a preferred shareholder to receive unpaid accumulated dividends, regardless of how characterized, is no different from the many other rights possessed by preferred shareholders. Notwithstanding its frequent description as a "vested right" or a "vested property right" or "right in the nature of a debt," in the final analysis it is nothing more than a simple contract right. The same contract creating the right to accrued cumulative dividends may, by other terms and conditions, render the right defeasible by appropriate action of the majority of the members of the corporation. Furthermore, although an amendment cancelling accrued dividends appears to have

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[a] Bowman v. Armour & Co., 160 N.E. (2d) 756-57 (1959).

a retroactive effect, its actual operation is prospective only. The accrual of dividends by the mere lapse of time does not alter the nature or character of the dividend rights of preferred stock. Where a corporation fails to declare a dividend on its preferred stock, the only change effected is an enlargement of the size or quantity of the right to dividends. The character of the right remains unchanged and continues to be prospective.

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