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PREFERRED STOCK: ITS AUTHORIZATION BY AMENDMENT OF THE CORPORATE CHARTER.

Gurney Edwards

To what extent may a corporation rightfully issue preferred stock without the unanimous consent of its existing stockholders when the corporation was organized with one class of stock and under a charter or general statutes which contained no provisions authorizing the issuance of preferred stock?

Happily modern corporation statutes with their express and detailed provisions regarding the issuance of preferred stock are gradually obviating the need of answering this question. But in the case of older corporations, which were either organized under general statutes which contained no such express provisions or were established by special charters which alike were silent on the subject, the problem is one of decidedly more than academic interest.

In connection with this problem, two types of cases have most frequently arisen: (1) where the state, either by amending the general statutes under which the corporation was organized or by amending the corporate charter (under its reserved power to amend), has sought to grant to the corporation legislative authority to issue preferred stock; or (2) where the stockholders of the corporation, under a power to amend the articles of association or governing by-laws, have sought, without the aid of legislation, to achieve the same result. These two typical situations may conveniently be considered separately in the order stated.

I. LEGISLATIVE AUTHORIZATION TO ISSUE PREFERRED STOCK.

At the threshold of the problem is, of course, a question as to the extent of the state's reserved power to amend, alter or repeal existing charters or general corporation statutes insofar as they relate to established corporations. It is not the purpose of

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Although it seems that a distinction might be made as to whether the reserved power relates to a special charter or general statutes, the tendency of the courts has been to treat the two cases alike. See for instance Looker v. Maynard, 179 U. S. 46, 21 S. Ct. 21 (1900). Many of the cases hereinafter referred to involved corporations organized under general laws.
this article to enter into an elaborate discussion of this question. It is sufficient to point out very briefly the general limitations on the exercise of this power. Ever since the famous case of Dartmouth College v. Woodward and Mr. Justice Story's intimation in his opinion in that case that its doctrine might, in part at least, be avoided by a reservation, in the corporate charter, of the power to alter, amend, or repeal the charter, the states have, of course, increasingly sought to maintain their control of newly created corporations. The extent of the reserved power has become an important judicial problem, and has resulted in a multitude of diverse and not readily reconcilable decisions. The divergence in the decisions has no doubt been due to several causes:—in part, to the different facts of the cases presented; in part, to the extent of the particular reservation of power in question; in part, to conflicting constructions of the reserved powers of alteration, amendment and repeal, even where they are expressed in very much the same language; and finally in part, perhaps, to different theories as to the nature of the contractual relations involved in the corporate charter.

It is clear, however, in this confusion of authority that the re-

2 For an extensive discussion of this question, see Stern, The Limitation of the Power of a State under a Reserved Right to Amend or Repeal Charters of Incorporation (1905) 53 Am. L. Rev. 73, 145. It is to be noted that in many respects the author reaches conclusions that are decidedly at variance with the judicial decisions on the subject.

3 Wheat. (U. S.) 518 (1819).

4 For a discussion of that case, see for instance Looker v. Maynard, supra n. 1.


7 Wright v. Minnesota Mutual Life Insurance Company, supra n. 6.

8 See for instance the theory held at least at one time in New Jersey and still held in other states that the reserved power can only be exercised to promote a public interest, Zabriski v. The Hackensack & N. Y. R. Co., 18 N. J. Eq. 178 (1867).

So also it is held in Utah that the reserved power extends only to changing so much of the charter as is a contract between the state and the corporation, Garey v. St. Joe Mining Company, 32 Utah 487, 91 Pac. 369 (1907).

9 For instance it is said quite generally that the charter constitutes a triple contract: (a) between the state and the corporation; (b) between the corporation and the stockholders; and (c) between the stockholders inter se, or as it is sometimes said, the stockholders and the corporation. See Somerville v. St. Louis Mining and Milling Company of Montana, supra n. 5; Garey v. St. Joe Mining Company, supra n. 8.

However, for a case criticising this doctrine and holding that the rights of stockholders under the charter are not to be regarded as original but merely as derivative, see Durfee v. Old Colony & Fall River R. R. Company, 5 Allen (Mass.) 230 (1862).
served power of amendment is not without its limitations.\textsuperscript{10} As a matter of construction, quite apart from any constitutional question, the power to amend is not the power to substitute a radically and fundamentally different charter for the old charter.\textsuperscript{11} Moreover, the power is, of course, subject to constitutional limitations in the Federal Constitution other than the contract clause, such as the "Due Process" and "Equal Protection" clauses of the Fourteenth Amendment.\textsuperscript{12} Accordingly the United States Supreme Court though entertaining a liberal view of the reserved power has set bounds to the exercise of this power by the state.

Thus in Holyoke v. Lyman\textsuperscript{13} the Court had occasion to say:

"Power to legislate, founded upon such a reservation is certainly not without limit, but it may be safely affirmed that it reserved to the legislature the authority to make any alteration or amendment in a charter granted, subject to it, that will not defeat or substantially impair the object of the grant, or any rights which have vested under it, which the legislature may deem necessary to secure either the object of the grant or any other public right not expressly granted away by the charter."\textsuperscript{14}

The term, "vested rights", in this connection is of course not an entirely happy phrase and is rather the name for a legal result than the description of the right secured by that result. It has indeed been pointed out that any modification of corporate charters or corporate rights, involves, at least in a degree, an interference with vested rights.\textsuperscript{15} The Supreme Court, however, has by its own decisions somewhat clarified the meaning of this phrase, and has pointed out that rights depending for their existence upon the granting clauses of the charter are not protected\textsuperscript{16}, but that rights and interests acquired by the company in the course of its existence and not constituting a part of the contract of incorpora-

\textsuperscript{10} Holyoke Company v. Lyman, 15 Wall. (U. S.) 500 (1872); Miller v. The State, 15 Wall. (U. S.) 478 (1872); Shields v. Ohio, 95 U. S. 319 (1877).

\textsuperscript{11} Zabriski v. Hackensack & N. Y. R. Co., supra n. 8; Durfee v. Old Colony & Fall River R. R. Co., supra n. 9.

\textsuperscript{12} Shields v. Ohio, supra n. 10; The Railroad Tax Cases, 13 Fed. 722 (1882); County of Santa Clara v. Southern Pacific Railroad Co., 18 Fed. 385 (1888).

\textsuperscript{13} Supra n. 10.

\textsuperscript{14} For other decisions of the Supreme Court which used very similar language, see Close v. Glenwood Cemetery, 107 U. S. 466 (1882); Looker v. Maynard, supra n. 1.

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\textsuperscript{16} 2 Morawetz on Private Corporations (2d ed. 1886) § 1103, p. 1066.

\textsuperscript{17} Greenwood v. Freight Company, 105 U. S. 13 (1881); Hill v. Glasgow Railroad Company, 41 Fed. 610 (1888).
tion" (such as property acquired under the operation of the charter or contracts entered into thereunder)\textsuperscript{18} are properly beyond the power of the states to disturb.

Within the limitations of these principles, therefore, the question is: Does and should the state's reserved power to alter or amend extend to authorizing the issuance of preferred stock? More specifically, does such an exercise of power amount either (a) to a radical and fundamental change in the corporate business or (b) to an impairment of "vested rights" as this phrase is used in the foregoing Supreme Court decisions.

(a) The issuance of new preferred stock may of course be regarded in one of two ways, either as a transaction for the raising of money, not without analogy to a corporate loan or mortgage, or as an increase simply in the capitalization of the company. If it be regarded as a raising of money, then clearly on the basis of even the least liberal authorities, the legislative authorization would not constitute a fundamental departure from the business of the company.\textsuperscript{19}

If it be regarded as an increase in the capitalization of the company, then too on principle and authority alike, the legislative amendment should be regarded as valid. If the issuance of new preferred stock is to be regarded as a fundamental change in the corporate constitution, it is hard to escape the conclusion that any increase in the capitalization of a company would be fundamental and that any reduction in its capitalization would likewise be fundamental. But in the decisions the courts do not regard an increase in capital as a fundamental change in the corporate business or as an alteration in the original object and purpose of the

\textsuperscript{17} Railroad Company v. Maine, 96 U. S. 499 (1877); Hill v. Glasgow Railroad Company, supra n. 16. See also Miller v. The State, supra n. 10.

\textsuperscript{18} Sinking Fund Cases, 90 U. S. 700 (1878). As to the protection of contracts between a corporation and a third party, see also Durfee v. Old Colony & Fall River Company, supra n. 9. For a further discussion of this general question, see Lord v. Equitable Life Assurance Society, 194 N. Y. 212, 87 N. E. 443 (1909).

\textsuperscript{19} See Zabriski v. The Hackensack N. Y. R. Company, supra n. 8, holding even under the narrow New Jersey doctrine then maintained that a legislative amendment to the corporate charter authorizing a mortgage would be valid. See also Joy v. Jackson & Mich. Flank Road Co., 11 Mich. 165 (1863), to the effect that an amendment to a corporate charter authorizing a corporate mortgage, even where the state had not reserved the power to amend, became effective upon its acceptance by a mere majority of the stockholders.
A charter amendment authorizing a reduction of stock has thus been held not to be fundamental. Somewhat analogously, one court has sustained a legislative change authorizing the conversion of par-value stock into non-par stock.

(b) Neither should the legislative authorization of a preferred stock issue be regarded as objectionable on the ground that it impairs the vested rights of existing stockholders.

Of course, there is some constitutional limit beyond which the state cannot go in upsetting the rights of existing stockholders. It cannot for instance take the property in their stock and transfer it to other owners. Moreover, inasmuch as the value of the stock may in large measure depend on its voting control over the corporate management, the state probably cannot deprive the existing stockholders completely of their voting rights. The issuance of preferred stock, however, involves, generally speaking, a far less serious encroachment upon the existing stockholders’ rights.

The issuance of preferred stock may, of course, affect the rights of the existing stockholders in a number of ways. (a) If the preferred stock carries full or limited voting rights, its issuance may qualify the voting rights of the existing stockholders. (b) If the preferred stock has, as rarely would in fact be the case, the right to share with the common stock in the surplus of the company in the event of its liquidation, its issuance would diminish the share of the existing stockholders in the surplus assets of the company. (c) The issuance of preferred stock would defer the right of the existing stockholders to receive dividends. (d) Insofar as the preferred stock is preferred not only as to dividends, but as to assets, it would defer the right of the existing stockholders to the assets of the company in the event of its liquidation. But

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20 The Buffalo & New York City R. R. Co. v. Dudley, 14 N. Y. 336 (1856); however, for a case which reaches a contrary result, but in which it does not appear what, if any reserved power existed, see Macon Gas Co. v. Richter, 143 Ga. 397, 85 S. E. 112 (1915).


23 Hill v. Glasgow Railroad Company, supra n. 16; Lord v. Equitable Life Assurance Society, supra n. 18.

24 Lord v. Equitable Life Assurance Society, supra n. 18. But cf. In re Sharood Shoe Corp., 192 Fed. 945 (1912), where the court sustained an amendment to the articles of association passed by the corporation under its reserved power to amend which conferred exclusive voting rights upon prior preferred stockholders who had been the creditors of the corporation.
should the modification of the rights of the existing stockholders in any of these respects be regarded as such a serious invasion of their rights as to prevent the state from authorizing the changes in question?

(a) and (b) In these respects it is obvious that an increase of the existing common stock of the company would involve exactly the same difficulties as an issue of preferred stock. The difficulty is not, however, met by denying the right to effect the increased capitalization but by insisting upon the granting of pre-emptive rights ratably to the existing stockholders."

Whether the state in authorizing a preferred stock issue carrying full voting rights and a right to share in the corporate surplus could at the same time validly deprive the existing stockholders of their right to subscribe to the new stock is, in the absence of precise authority, not at all clear." Insofar as the preferred stock upon its issue might be entitled to share in the then existing surplus of the company, it would seem that the legislative action would be invalid as amounting to a transfer of a portion of the property of the existing stockholders to other persons. If, however, the new preferred stock possesses no such rights to share in the corporate surplus but carries voting rights, whether general or limited, it seems likely that the legislature could under such circumstances deny the right of pre-emption to the existing stockholders. Indeed in the case of Lord v. Equitable Life Assurance Society, the Court, though denying the power of the legislature to deprive existing stockholders completely of their voting rights and though specifically denying by dictum the legislative right to provide that henceforth the existing stockholders could vote for only a minority of the directors, did apparently feel that a statute conferring the right to vote on other classes of persons was a valid exercise of the state's power to amend. In other cases also it has been recognized that the state in the exercise of its reserved power

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26 City of Covington v. Covington & Cincinnati Bridge Co., 10 Bush (Ky.) 69 (1873), pointing out that existing stockholders' rights would be protected by giving them a right to subscribe to the preferred stock.

27 See County Judge of Shelby County v. Shelby R. Co., 5 Bush (Ky.) 225 (1868) for a case sustaining, under the state's reserved power to repeal, a corporate amendment increasing the corporation's capital stock and conferring the right to subscribe to the increased stock on the citizens of a certain district through which the corporation was to extend its railroad line. The original stockholders who were thus deprived of the right to subscribe to the new stock were not, however, the ones that were contesting the validity of the amendment.

27 See supra n. 18.
to amend may affect existing voting rights in the corporation. Thus in Miller v. The State, the Court sustained a legislative amendment to a charter which conferred upon a municipal stockholder the right to elect a majority rather than a minority of the directors and in Chase v. Glenwood Cemetery, another Supreme Court case, the Court sustained the right of the state, under its reserved power, to transfer the management of a cemetery corporation from a board of managers chosen by the original proprietors to a board of trustees, a majority of whom were selected by the lot owners. By the weight of authority, moreover, the courts sustain as valid a legislative change permitting cumulative voting, thus facilitating the election of directors representing minority interests.

On the basis of these authorities, there is, therefore, at least a reasonable ground for the contention that the legislature in an enactment authorizing an issue of preferred stock carrying voting rights may deny a pre-emptive right to existing stockholders. If this result may be true as to preferred stock carrying general voting rights, it would be true a fortiori of course as to preferred stock carrying more limited voting rights.

(c) It is undeniable that the preferred stock issue affects the rights of existing stockholders as to dividends. Their priority is gone. If the new capital represented by the preferred stock issue does not earn its dividend rate, the return on their own stock

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28 See supra n. 10.
29 In this case the special facts were that the corporation did not issue all of its originally authorized stock, so that in fact the municipally subscribed stock bore a larger ratio to the issued stock than to the originally authorized stock. The change in directors corresponded exactly to this change in ratio.
30 Supra n. 14.
31 For other cases cf. Commonwealth v. Bousell, 3 Whart. (Pa.) 559 (1838); Hyatt v. Esmond, 37 Barb. (N. Y.) 601 (1862); Jackson, Gov. v. Walsh, 75 Md. 304, 23 Atl. 773 (1892); contra, Matter of Election of Directors of Newark Library Association, 64 N. J. L. 217, 43 Atl. 435 (1899).
32 Looker v. Maynard, supra n. 1; Gregg v. Granby Mining & Smelting Co., 164 Mo. 616, 65 S. W. 312 (1901); Cross v. West Virginia, Central & Pacific Ry. Co., 35 W. Va. 174, 12 S. E. 1071 (1891); contra, Smith v. Atchison, Topeka & Santa Fe R. Co., 64 Fed. 272 (1894): Further in Tucker v. Russell, 82 Fed. 263 (1897), and Orr v. Bracken County, 81 Ky. 593 (1894), the courts denied the legislative right to substitute a method permitting one vote per share for a sliding voting scale. It is perhaps possible to distinguish these cases from the cumulative voting cases on the ground that in the latter type of case the majority are not deprived of their control; the minority are simply assured of a representation on the board of directors.
33 For instance the right to vote generally in the event of a default in preferred stock dividends or the right to vote upon any project for a prior stock issue or a bond issue.
will suffer. But the lessening of the value of the old stock is not an objection to the legality of the authorization of the issue of the new.

Moreover, even if the proposed new issue of stock was of the same class as the existing stock, the same lessening in value might also occur for obviously the capital represented by the new stock might not yield as great a return as the capital represented by the old stock. But such a fact would hardly be a valid objection to the increase.

Furthermore, an even more conclusive answer to the alleged invalidity of the preferred stock issue is that a corporate mortgage would subordinate the dividend rights of existing stockholders very much more than would a preferred stock issue, but as shown above the courts would universally regard the legislative authorization of a mortgage as valid. It is indeed on the strength of this analogy that the courts have most frequently sustained the legislative power to authorize a preferred stock issue.

(d) If the preferred stock, as is of course usually the case, is preferred not only as to dividends, but also as to assets, the existing stockholders will suffer a further diminution of their existing rights. If the new capital represented by the preferred stock is of a sort that rapidly diminishes in value, the book value of the existing common stock will be apt to suffer an actual loss. But as has already been pointed out, the possible loss of value is not a fatal objection.

A similar loss might also occur, of course, if the new stock was of the same class as the old. Moreover, many courts without misgivings have reached a result which indirectly may impair the value of the existing stock, when they hold that the state under its reserved power may amend the charter or the general laws under which the corporation was organized so as to impose a new or increased liability on stockholders for corporate debts or for corporate assessments.

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46 See supra n. 34.

47 See Buffalo & New York City R. R. Co. v. Dudley, supra n. 20.

48 Sherman v. Smith, 1 Black (U. S.) 587 (1861), (articles of association
But in this connection also, the really decisive argument in favor of the validity of the preferred stock is that it will prejudice the rights of the existing stockholders far less than a corporate mortgage; which admittedly would be valid. A default in the fulfillment of the terms of the mortgage would result in a probable foreclosure and the possible obliteration of all the equity of the stockholders in the corporate assets. A default in the payment of the dividends on the new preferred stock would be attended by no such dire consequences for the existing stockholders.

There is, of course, also a practical argument of great weight in favor of permitting the legislature to authorize a preferred stock issue under its reserved power to amend. As it is pointed out in the cases already cited, the financial needs of a company may imperatively require financial expansion, a corporate mortgage may not be feasible, and raising money by the increase of the existing capital stock may also be impracticable. A preferred stock issuance becomes the readiest if not the only method. But if the state's reserved power to legislate in such a case is denied, a single dissenting stockholder may prevent the preferred stock issue, however desirable it may be. The temptation open to the litigious stockholder is enormous. The stage is set for the financial hold-up of the company by a predatory investor or even by a business competitor who may have purchased his stock with this purpose in view.

Influenced by all these various considerations, but particularly by the analogy of the case of a corporate mortgage, the majority of the courts, in the relatively few decisions in which they have had occasion to pass upon the precise question, have accordingly recognized the legislative power to authorize a preferred stock issue without the unanimous consent of the existing stockholders.

provided expressly against individual liability); South Day Meadow Dam Co. v. Gray, 30 Me. 547 (1849), (liability of stockholders increased); Gardner v. Hope Insurance Company, 9 R. I. 194 (1869), (limitation of liability of stockholders to assessments not exceeding the value of their stock removed); Somerville v. St. Louis Mining & Milling Company of Montana supra n. 5, (stock made liable to assessments, though expressly exempt from liability, when the corporation was organized); contra, Garey v. St. Joe Mining Company, supra n. 8; but for a possible explanation of this case see that foot note.

See the cases cited, supra n. 35, and in particular, City of Covington v. Covington & Cincinnati Bridge Company.

This argument is advanced in the case of Salt Lake City Automobile Co. v. Keith O'Brien Co., 45 Utah 218, 143 Pac. 1015 (1914).

West Chester & Philadelphia R. Co. v. Jackson, supra n. 35; City of Covington v. Covington & Cincinnati Bridge Co., supra n. 35; Burlington R. Co. v. Thrall, supra n. 35; Curry v. Scott, 54 Pa. 270 (1867). In all these
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As a corollary of this proposition, it has been held that although a unanimous vote was requisite at the time of the organization of the corporation for the issuance of preferred stock, a state statute which permits by a two-thirds vote amendments to the articles of association authorizing a preferred stock issue is valid. The courts have perhaps been prone to single out features of the preferred stock issue such as redeemability which most closely resemble those of a loan; but as such features were not present in most of the cases, they cannot be considered to be decisive.

Only two cases have been found in conflict with the cases supporting the proposition that a legislative amendment authorizing a preferred stock issue is valid without unanimous consent. In Einstein v. Raritan Woolen Mills, the corporation proposed under the authority of a statute, passed subsequent to the creation of the corporation, to issue preferred stock and additional common stock and to require the exchange of existing common stock into this preferred stock. The court enjoined the proposed corporate action. It would seem that the court might well have invalidated the corporate action on the ground of the objectionable features of the compulsory exchange of existing common stock into new preferred stock. This the court did not do, however, but rested its decision on the broad ground that the charter constituted, with respect to the corporate stock, a contract between the stockholders inter se, which could not be modified except by the unanimous consent of all the stockholders. Logically, therefore, the decision goes the length of denying the right even to increase the existing capital stock by the issuance of stock of the same kind. Although on the facts of the case it does not clearly appear what if any power to amend was reserved at the time of the organization of the corporation and although the absence of such a reserved power conceivably may explain the case, its explanation

cases as a matter of fact the stockholders by a majority vote accepted the legislative amendment. As the effect of the corporate acceptance by a majority vote was the same as if the state had exercised its reserved power to amend, it was unnecessary for the courts to rest their decision upon the existence of this power. Accordingly it does not appear in these cases whether the power existed or not. The cases are, of course, in point on the proposition that the legislative change does not require unanimous acceptance.

42 Hinckley v. Schwarzchild, supra n. 34.

43 See for instance Westchester & Philadelphia R. Co. v. Jackson, supra n. 35, emphasizing the fact that the preferred stock was redeemable after a certain period like a loan.

44 74 N. J. Eq. 634, 70 Atl. 295 (1908).
very probably lies in the peculiar New Jersey doctrine which then obtained as to the extent of the state's reserved power to amend. The unfortunately hampering character of this doctrine is sufficiently evident, perhaps, without any further criticism of this case.

The only other minority decision is Atlanta Steel Company v. Mynahan. The report gives merely an abstract of the decision. The facts do not appear, but the holding as shown by the abstract is that an amendment to the corporation charter increasing its capital stock, whether common or preferred, is fundamental and requires the unanimous consent of its existing stockholders. It does not appear whether the state had reserved the power to modify the corporate charter.

It would seem that the case is either attributable to the peculiar doctrines of the courts of the state, or else that it is untenable.

Up to this point the problem has been dealt with on a single assumption of facts. The issuance of one class of stock at the time of the organization of the corporation; the absence of any legislative provision at the time permitting the issuance of preferred stock; and a subsequent legislative enactment authorizing such a preferred stock issue. But manifold variations of these facts are obviously possible. The corporation may have been organized with preferred and common stock without provision for any other class of stock, and the state may authorize a new prior preferred stock issue. Such a new issue may be preferred over the old preferred stock either as to dividends, or as to assets or as to both; or the new preferred stock may not be preferred as to either but may be entitled to a higher dividend rate than the old preferred stock. It is submitted, however, that these variations do not really alter the problem if the arguments already advanced are sound. The complete lack of judicial authority makes an answer based on the decisions impossible. It would seem indeed that legislative authorization of new classes of preferred stock would be less difficult to sustain than authorization of preferred stock where none existed before. Where preferred stock is provided for at the time of the organization of the corporation, it is apparent that the stockholders contemplated stock inequality from the start, and is-

45 See supra n. 8.
46 138 Ga. 608, 75 S. E. 980 (1912).
47 Cf. Macon Gas Co. v. Richter, supra n. 20.
issues of new preferred stock would hardly therefore constitute a radical departure from the original corporate framework.

There is only one conceivable difference between the two situations that might make it more difficult to sustain the validity of the issuance of a new class of preferred stock than to sustain an initial issuance of preferred stock. Preferred stock, of course, unlike common stock, is entitled to dividends at a fixed rate. The issuance for the first time of preferred stock may possibly diminish the dividends theretofore paid on the existing common stock, but it is at least not diminishing them below any stated return. Now the new class of prior preferred stock, if the capital represented thereby proves a poor investment, may possibly have the effect of making impossible the payment of a dividend on the outstanding preferred stock at its regular dividend rate. If the legislature passed an amendment to the corporate charter decreasing the preferred stock dividend rate theretofore established, it is very doubtful whether such an amendment would be valid.48 The issuance of a non-productive prior preferred stock might not have a very different practical effect upon the existing preferred stockholders' rights, particularly if their dividend rights were non-cumulative. But a distinction would seem to exist between the case of a reduction for all purposes of the dividend rate on the outstanding preferred stock and the case where the payment of that dividend rate may simply be interfered with by the issuance of new stock, a distinction sufficient to justify a different legal conclusion in the two cases.

A further and final question analogous to those already considered should perhaps claim brief attention. Where a corporation already has several classes of stock outstanding, it may desire from time to time through legislative authority to increase or decrease the existing classes of stock and thereby to change the ratio between the respective amounts of these stocks. In view of

48 See Pronick v. Spirits Distributing Company, 58 N. J. Eq. 97, 42 Atl. 586 (1899), holding that, under a power to amend the certificate of incorporation, the majority might not reduce the dividend rate on preferred stock. The force of this case as a precedent for the precise question at hand is probably not decisive (a) because of the narrow doctrine that in the past at least as already noted (supra n. 8) has obtained in New Jersey; (b) because the change had not been authorized directly by legislative action. Cf. Allen v. White, 103 Neb. 256, 171 N. W. 52 (1919), holding that, where the articles of association of the company had provided for the payment of profits on a dividend basis, a legislative amendment authorizing the distribution of earnings in proportion to the amount of property bought from, or sold to, members was invalid.
what has already been said, it would seem that such a legislative change would *a fortiori* be valid. A preferred stockholder can hardly object to an increase in a deferred class of stock. Furthermore, if a deferred stockholder has no standing to object to the issuance of a new class of preferred stock, he, all the more clearly, cannot object to an increase of an existing class of preferred stock. Legal objections to a reduction in any class of stock would also scarcely be possible. Thus accordingly, a legislative modification of the existing ratio of the classes of stock through the authorization of the exchange of one class of stock for another would also probably be valid,¹⁴ in the absence at least of elements of unfairness in the particular case.

Finally it must again be emphasized that the public interests in the functioning of corporations require for the corporation a free opportunity to enjoy a normal corporate growth and a ready ability to meet financial needs. If it be true that the very purpose of the state's reserved power to amend is to permit corporate changes which the corporate business may require²⁰ and to carry into effect the purposes of the corporate grant²¹ any limitation upon the state's reserved power which prevents the legislature from authorizing new issues of corporate stock to meet the corporate exigencies as they arise will have an unfortunately hampering effect. Although it is assuming the question, of course, to argue that the existing stockholder took his stock subject to the state's express right to amend, he was at least put upon notice as to the possible scope of this power; and whatever hardship may fall upon the stockholder is after all only incidental to the furthering of corporate interests in legitimate growth and financial adaptability.

¹⁴ A federal court has virtually so held. Venner Co. v. U. S. Steel Corp., 116 Fed. 1012 (1902). The corporation was organized with common and preferred stock and corporate bonds. A statute subsequently passed permitted the exchange of some of the preferred stock for bonds. It was argued that the statute impaired the obligation of the contract between the stockholders in that this contract had fixed the relation *inter se* of the different stock and security holders. The court denied the force of the argument and sustained the legislation.

²⁰ It is so stated in Wright v. Minnesota Mutual Life Insurance Company, *supra* n. 6.

II. Authorization of Preferred Stock Issues Through Amendments to Articles of Association or Governing By-Laws.

The second situation to which reference has already been made arises as follows: A corporation having a general power to amend its articles of association or governing by-laws but no specific statutory or other authority to amend its articles or by-laws for the purpose of issuing preferred stock provides by such an amendment for new preferred stock. Is this issue of preferred stock valid?

One of the leading cases on the subject and a case very frequently cited in later decisions is Kent v. Quicksilver Mining Company. By the provisions of its charter the company had in that case "power to make such by-laws as it may deem proper to enable it to carry out the objects of the corporation, and the same to alter, amend, add to or repeal at their pleasure, provided that such by-laws are not contrary to the statute or to the charter". In pursuance of this provision, the company passed by-laws authorizing the issuance of capital stock. Subsequently by a vote of approximately three-fourths of the outstanding stock, the corporation amended its by-laws so as to allow the conversion of the capital stock into preferred stock upon the payment of five dollars.

The new stock was to enjoy a seven per cent. dividend rate, payable prior to any dividends on the unconverted capital stock and was also to share pro rata with the common stock in any surplus of earnings. The court said that the power to amend the by-laws did not carry with it the power to impair vested rights and that the issuance of the preferred stock did impair vested rights and was therefore illegal.

It is to be noted that the court admits that there would have been no legal obstacle in the way of issuing preferred stock at the time that the corporation first issued stock, that circumstances conceivably might exist under which a corporation could at a subsequent date provide for preferred stock (though the court does not specify what these circumstances might be), and finally that, if in the present case the power to amend the by-laws had been expressly reserved so as to provide for the issuance of preferred stock, the issuance of it thereafter in pursuance of the exercise of that power would have been unexceptionable.

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78 N. Y. 159 (1879).
Accordingly in the last analysis the decision does not involve so much any question of constitutional limitation as a question of the construction in this particular case of a general power to amend. The decision, however, undoubtedly has this unfortunate effect: It gives an unnecessarily narrow construction to the general power to amend, and such a narrow construction is open to all the same objections as a narrow construction of the state’s reserved power to amend corporate charters or general corporation laws.

The result of the decision, moreover, is to suggest that there is one criterion for the valid exercise by the corporation of its power to amend its articles of association or governing by-laws but another and different criterion for the valid exercise by the state of its power to amend. The court indeed suggested that, had the state directly authorized the preferred stock issue, the issue would have been valid. Although there are perhaps no a priori reasons why the two kinds of powers of amendment should receive the same construction, it is, of course, practically convenient for the purpose of avoiding confusion that they should. Moreover, there is no very compelling and convincing reason why, if the state’s reserved power to amend may be exercised to authorize a preferred stock issue, the corporation may not exercise its own general power of amendment for the same purpose. The existing stockholders suffer no more seriously in the second case than in the first.

The New York courts have followed the Kent case in two other cases involving rather similar facts.

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The court in fact distinguishes Rutland v. Thrall, supra n. 35, on the express ground that in that case a legislative enactment had authorized the preferred stock issue in question.


In the Campbell case the stockholders voted to surrender forty per cent. of their shares to permit them to be issued as preferred stock. In the Ernst case the corporation proposed to increase its capital stock by the issuance of preferred stock. As a matter of fact in neither case does it appear from the facts, what if any, power the duly constituted authorities of the corporation had to amend the articles of association or by-laws of the corporation, but in neither case does the court suggest the absence of such a power, and in each case the court places great emphasis on the Kent case. Of course, it seems that subsequent cases might have distinguished the Kent case on its facts. In the Kent case the proposition was to issue 7% preferred stock in exchange for the existing common stock which it did not appear was
PREFERRED STOCK

The Tennessee court has also handed down a decision in a fairly recent case very analogous in part to the Kent case.\textsuperscript{25}

In general, however, the more modern tendency expressed by the few cases that have been decided seems to be away from the Kent case. Indeed, one may perhaps entertain the feeling that, had the court decided that case twenty-five years later, its decision might well have been otherwise.

The courts in fact seem inclined to apply the same test to the problem as to that of the exercise of the state’s reserved power and ask whether the proposed change is fundamental or not.\textsuperscript{5} It has been held that, in the exercise of a general power to amend, a corporation can reduce its capital stock;\textsuperscript{47} and one court has even gone so far as to intimate by dictum that in exercising the same power the corporation could deprive its preferred stockholders of the right to share in surplus dividends over and above the stated dividend rate.\textsuperscript{a} Accordingly in two comparatively recent cases the courts have sustained the right of the corporation to issue preferred or a new class of preferred stock by providing therefor through an amendment to its articles of association. In one of these, \textit{In re Sharood}\textsuperscript{26}, the court sustained an amendment which authorized prior preferred stock and conferred the exclusive voting privilege on the holders of this stock. It is true that there was an express power conferred by statute upon the corporation to dividend paying, on the payment of $5.00 per share. The court apparently regarded this scheme as somewhat unconscionable but did not choose to rest its decision on this fact alone.

Another possible distinguishing ground might be suggested. At the present time by-laws ordinarily do not establish the corporate framework but merely contain regulations for the management of the corporate business, and hence the power to amend by-laws would not confer the power to issue a new class of stock. This suggestion hardly seems well-founded, however, in view of the fact that it was the provisions of the by-laws that authorized the originally issued stock, and apparently therefore in the case of this particular corporation by-laws subserved a much wider purpose than they generally do today.

\textsuperscript{25} Railroad v. Knoxville, 98 Tenn. 1, 37 S. W. 882 (1896). The charter of the corporation authorized it to fix the amount of its capital stock by its by-laws. In pursuance of this authority the corporation fixed the amount of its stock which was to consist of only one class. Later the corporation increased the amount of such stock and still later provided for a further increase through an issue of preferred stock. It was held that the preferred stock was illegal.


\textsuperscript{27} Perry v. Bank of Commerce, \textit{supra} n. 21 and 56.

\textsuperscript{28} Peters v. U. S. Mortgage Company, 14 Del. Ch. 11, 114 Atl. 598 (1921).

\textsuperscript{29} \textit{Supra} n. 24 and 56.
amend its articles of association so as to provide for preferred stock. The court, however, relied only on a general power of amendment of the articles; and although this latter provision contained broad language, the court placed no emphasis on its particular language.

In the other case, Salt Lake City Automobile Company v. Keith O'Brien Company, the decision was squarely in point to the effect that a corporation under a general power to amend its articles of association could provide for an issue of preferred stock though its articles had provided for no such stock when the corporation came into being and first issued its capital stock.

It is also interesting to note that the same general judicial tendency holds true in England as in this country and that in England the courts have now overruled an earlier decision which denied the right of a corporation, under its power to amend its articles of association, to provide for a preferred stock issue.

Indeed, all the arguments already advanced for a liberal construction of the state's reserved power to amend are equally applicable to the corporation's power to amend. The analogy of borrowing money or the corporate mortgage is also equally pertinent.

The cases discussed furthermore show that no distinction is to be taken between the case of issuing preferred stock for the first time and issuing a new class of preferred stock. Very properly no distinction should be taken.

Conclusion.

It is fair to predict that the courts insofar as they continue to face the problem discussed will face them with an increasingly liberal attitude. Although the courts cannot afford to neglect the

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References:

“Supra” n. 40.

For another case recognizing a very similar proposition, see Hoffman v. The Pennsylvania Warehouse and Safe Deposit Co., 1 Pa. Co. Ct. (Phil. Co. Ct.) 598 (1886). The decision of the court is contained in one line, but from the syllabus it appears that the holding of the Court was that a power given by charter to directors to increase the capital stock conferred the power to issue preferred stock.

“See, Andrews v. Gas Meter Co., (1897) 1 Ch. 361 overruling Hutton v. Scarborough Cliff Hotel Co., 2 Dr. & Sm. 521 (1865).

This analogy is relied upon in each of the cases discussed supra; In re Sharpood Shoe Corp. and Salt Lake City Automobile Company v. Keith O'Brien Company.
interests of individual stockholders, they equally cannot afford to neglect the important collective interests of the stockholders as a whole in the healthy financial growth of corporations. The authorization of preferred stock by legislative or corporate amendment without seriously jeopardizing the rights of any existing stockholders may greatly facilitate the financial progress of the corporation as a whole. In striking a proper balance between the conflicting interests involved, the courts, therefore, should not hesitate to sustain the validity of such preferred stock issues.