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CORPORATE RECAPITALIZATIONS AND THE ELIMINATION OF PREFERRED DIVIDEND ARREARS: THE AMERICAN LESSON[1]

This paper attempts a critical analysis of the reasons which are often advanced and those which may be advanced to justify the elimination of accumulated preferred dividend arrears through corporate recapitalization schemes. It will also develop an argument based primarily on fundamental legal and economic principles to support the need for greater protection of preferred stockholders from such recapitalization schemes. The paper also explains why in the writer's opinion, the existing legislation in many of the American states and in Singapore are inadequate for this purpose.

I. INTRODUCTION

THE status of the preferred stockholder[2] remains somewhat of an enigma even to this day. It is usual to consider common stockholders as insiders of the corporation while creditors generally as outsiders. The preferred stockholder, however, defies this dichotomous characterization. For instance, the preferred stockholder is usually entitled only to a fixed return on his investment. He would also in the usual case, have priority to the return of capital invested over the common stockholder in the event of liquidation. He is usually not accorded voting rights save in very limited situations. To this extent, he is very much like a creditor of the corporation. On the

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[1] This paper is adapted from a seminar paper, originally entitled "A Case for Affirmative Legal Protection of Preferred Dividend Arrearages", presented by the writer at Columbia Law School, Columbia University, New York in 1990. The writer wishes to acknowledge the many helpful suggestions made by Professor D.D. Prentice of Pembroke College, Oxford University. The views expressed in this paper are, however, those of the writer alone and the writer accepts sole and complete responsibility for them.

[2] Although there is a technical difference between stocks and shares, as this paper takes on an American legal perspective, the American preference for the terms "stock", "stockholder" and "preferred stockholder" will generally be used in this paper save in part HI where the focus of the discussion is on Singapore law. The reader should note that for the purpose of this paper, the terms "share", "shareholder" and "preference shareholder" could easily have been substituted in place of the terms "stock", "stockholder" and "preferred stockholder" respectively without affecting the essence of the paper.

other hand, the preferred stockholder is unlike the usual creditor in several important respects. For instance, the preferred stockholder's priority to return of capital and to dividends is subordinated to the rights of the corporation's creditors. His voting rights although limited are often accorded by statute. Creditors on the other hand usually have no statutory right to vote in the debtor corporation and would have to resort to powers of attorney in their favour should they wish to vote at any meeting of the debtor corporation's stockholders. The preferred stockholder has no absolute right to be paid dividends in any particular year. Like the common stockholder, the receipt of dividends in any particular year is subject to the discretion of the board of directors. The creditor on the other hand is contractually guaranteed payment of interest and principal on a fixed and pre-agreed schedule which is not subject to the discretion of the board of directors.

It is difficult to define a preferred stockholder other than one with some preferential right over and above those which are generally enjoyed by the common stockholders of the corporation. The main reason why the typical preferred stockholder is so difficult to define and characterize is because in a sense, there is no "typical" preferred stockholder. The rights of the preferred stockholder are established by contract. Although some of the terms of the preferred stock contract are statutorily provided, most corporate law statutes do not contain very much by way of defining a preferred stockholder's rights. Most of the preferred stockholder's rights are therefore contained in the individual articles of incorporation[3] of each corporation. Hence the rights of one preferred stockholder may vary substantially from those of another preferred stockholder, and varying not only across corporations but also within corporations (where there is more than one class of preferred stock in the corporation).

Generally, preferred stocks enjoy a preference over dividends, that is, dividends on preferred stock must be paid before any dividends may be paid on the common stocks. There is, however, no right to be paid any dividend until a dividend is declared by the corporation's board of directors. This right to a fixed dividend in priority over the common stockholders is also often cumulative in nature. This means that if the fixed preferred dividend is not paid in any one year, it would first have to be made up in any year that a dividend is declared before the common stockholders may be paid any dividend. Some preferred stocks are also participating,

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[3] For those more familiar with English-based company law, the term "articles of incorporation" of a company under American corporation law is akin to the "memorandum and articles of association" of a company incorporated under most English-based company law. Again for the purposes of this paper, the term "articles of incorporation" will be used. Sometimes the term "corporate charter" or "certificate of incorporation" is used in place of the term "articles of incorporation", depending on the term chosen by the courts in any particular case. For the purposes of this paper, the three terms should be read as interchangeable.

that is, the holders are entitled to a share in the normal dividends, like the common stockholders, after receiving their fixed preferred dividends. This, however, is not a usual feature of preferred stocks. Most preferred stocks are also given a preference in the return of capital upon liquidation of the corporation. For the purpose of this paper, it is assumed, unless otherwise stated, that the preferred stockholder is one holding preferred stock with a fixed cumulative preferred dividend and priority in the return of capital in the event of liquidation, over the common stockholders but with no further right of participation in the profits of the corporation beyond the fixed dividend.

This paper is an attempt to bolster the case for the introduction of affirmative legal protection of cumulative preferred dividend arrears against schemes employed by corporations to eliminate them. It is not the aim of this paper to recanvass arguments which other writers[4] have already made. Instead, it seeks to take a fresh look at the problem of preferred dividend arrears elimination and to advance only certain arguments, which this writer deems compelling for the protection of such arrears.

Part II of this paper will state the problem for which this paper seeks to advance an argument for redress and the usual context in which it arises. It will first introduce some of the schemes that have been used by corporations to eliminate preferred dividend arrears without adequate compensation to the preferred stockholders. Since these schemes have been most prevalent in the American states, this paper will undertake a broad survey of the American courts' development of the law in this area.

Part III looks at the implications of the American experience on Singapore-incorporated companies. In particular, it will consider the possibility of effecting the recapitalization schemes which have been used in the American jurisdictions to eliminate accumulated preferred dividend arrears in the context of the laws in force in Singapore.

Part IV focuses, *inter alia*, on a contractual analysis of the preferred stock contract. First, it will suggest a partial reconciliation of prevailing judicial views. Secondly, it will examine the contractual justifications often advanced for the legal stance the American courts have adopted in this problem. In particular, two usual contractual justifications for the courts' tolerance of management's elimination of preferred dividend arrears will be examined. An attempt will then be made to reveal the fallacies behind these justifications. In the process, the paper hopes to reveal the reasons why the approach taken by the American courts to address this problem is far from satisfactory. It will also develop, at the same time, an argument

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[4] See for example, Stamler, "Arrearage Elimination and the Preferred Stock Contract: A Survey and a Proposal for Reform" (1988) 9 Cardozo L. Rev. 1335 (1988); Brudney, "Standards of Fairness and the Limits of Preferred Stock Modifications" (1973) 26 Rutgers L. Rev. 445.

that the case for the protection of accumulated preferred dividend arrears is not only not inconsistent with the basic accepted principles of contract law, but is, on the contrary, positively affirmed by them. Thirdly, it will address other non-contractual arguments in favour of affirmative legal measures to prevent the elimination of accumulated preferred dividend arrears without adequate compensation to the preferred stockholder.

Finally, Part V will look at some possible means of protecting the preferred stockholder against the elimination of accumulated preferred dividend arrears.

In view of the host of case authorities from the American courts in this area of the law, this paper by necessity, takes on an American perspective. References will therefore be made to basic American contract and corporation law. Readers conversant with English and Singapore law will however find much similarity in American, English and Singapore contract and corporation law insofar as the basic legal principles are concerned. Therefore, in order to avoid confusion, unless the American legal position is radically different from the position in Singapore, only American case authorities will be cited except in Part III where the focus is on Singapore law.

II. THE ELIMINATION OF PREFERRED DIVIDEND ARREARS

A. *The Common Devices Employed*

The phenomenon of eliminating preferred dividend arrears was most prevalent in the late 1930s and the 1940s as corporations started to pull themselves out of the Great Depression of the 1930s. During the Depression, many corporations could not generate enough profits to pay the accumulated preferred dividends on their preferred stocks, let alone dividends on common stock. Consequently, as these corporations started to experience profit making operations once again in the years after the Depression, they found themselves face to face with huge arrears in preferred dividends which had accumulated over the lean years. Meanwhile, as the financial outlook of these corporations improved, the common stockholders (among whom, in many cases, were members of the management of these corporations) began to feel restless in anticipation of receiving some return at last on their investments in the form of dividends. However, under the terms upon which the preferred stocks were issued, dividends on common stocks, could not be paid so long as the arrears in preferred dividends remained outstanding. This obstacle led to the invention of various devices to eliminate instantaneously, either in form or effect, all the accumulated preferred dividend arrears thereby clearing the way for the declaration of dividends on the common stocks.

There were basically three devices used to eliminate preferred dividend arrears. The first, and most direct approach was to amend the articles of

incorporation by abrogating the preferred stockholders' rights to the accumulated preferred dividend arrears. This would typically take the form of a cancellation of the existing preferred stocks (together with all accumulated preferred dividend arrears attached thereto) and replacing them with either an existing security or a newly created security. The security given in replacement of the cancelled security could be either preferred stocks or common stocks, but in either case, it would not carry any dividend arrears.

The second device came in the guise of a merger or consolidation whereby the surviving or new entity after the exercise would be devoid of the class of preferred stocks which previously carried the accumulated preferred dividend arrears.

The third device commonly used was a subtle refinement of the first. This entails the creation of a new class of preferred stocks ranking in priority over the existing preferred stocks in respect of dividend payments. Both the existing preferred and common stockholders would be encouraged to surrender their stockholdings in exchange for these new preferred stocks. However, while the existing preferred stockholders could exchange their existing preferred stocks together with the accumulated preferred dividend arrears thereon for the new preferred stocks, they would also be given the option not to do so. Should they decide not to participate in the exchange, they would retain their existing preferred stocks including the accumulated preferred dividend arrears thereon but would then be subordinated to the new class of preferred stocks in respect of dividend payments. In the meantime, dividends would usually be declared by management in respect of the newly created preferred stocks. In this paper, devices of this nature will for convenience be referred to as "voluntary exchange schemes".

The common denominator of all these devices was that they invariably took on the form of a recapitalization scheme. With the emergence of these schemes to eliminate accumulated preferred dividend arrears, it was inevitable that the courts would be called upon to rule on their validity. The experience of the American courts has borne this out.

B. *The Evolution of the Law in this Area*

Any attempt to discern some pattern arising from the courts' decisions in this realm of corporate law inevitably meets with some difficulty when one remembers that the preferred stockholder's rights are primarily defined by contract. Hence judicial decisions tend to turn on the particular terms governing the particular issue of preferred stocks brought before the court in each particular case. This of course varied according to the provisions of the articles of incorporation of the issuer and the applicable statutory instruments prevailing at the relevant time in the relevant jurisidiction. However, some

general trends may be gleaned from this melange of judicial authorities.

At the outset, it should be noted that certain basic legal principles are well established under American corporation law. First is the principle that the corporate charter is a contract between the corporation and the state of incorporation, a contract between the corporation and its stockholders and finally a contract between the stockholders of the corporation *inter se.*[5] Secondly, since the case of *Dartmouth College* v. *Woodward*[6] in 1819, it has been accepted by later cases that a corporation may amend its corporate charter so long as a power to do so is properly reserved within the statute under which the corporation was incorporated or within the charter itself. Hence, it was held in *Peters* v. *U.S. Mortgage Co.*[7] that a corporation could amend its charter to eliminate the existing participating-preferred shareholders' right to share in the surplus profits of the corporation so long as the prescribed statutory procedures for such an amendment were complied with. The Chancellor in that case stated the applicable legal principle succinctly as follows:

> A corporation in a sale and issuance of its stock assumes a contractual relation to the stockholder. For the terms of the contract, the rights of the stockholder and the obligations of the corporation, reference is to be made to the appropriate provisions of the certificate of incorporation and the laws of the sovereign conferring the corporate franchise. Unless there be some provision in either the law or the corporate certificate reserving the power to do so, there can be no alteration in the terms of the contract under which the stockholder, as such, possesses his rights, without his consent. If, however, the right to change or alter the stockholder's contract be reserved in a proper way, then no stockholder can complain against a proposed change therein, for the very plain reason that one of the terms by which he holds his contract is that the same may be altered.[8]

The American courts in the earlier cases tended to adopt what for ease of reference would be referred to as the "vested right view". This view treats the preferred stockholder's right to accumulated but unpaid dividends as a vested right which cannot be abrogated either by corporate or legislative action. *Morris* v. *American Public Utilities Co.*[9] was decided on this ground. It distinguished the earlier case of *Peters* v. *U.S. Mortgage Co.*[10] on the

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[5] *Morris* v. *American Public Utilities Co.* 14 Del. Ch. 136.

[6] 17 U.S. [4 Wheat.] 518.

[7] 13 Del. Ch. 11.

[8] 13 Del. Ch. 11 at 14.

[9] See above, note 5.

[10] See above, note 7.

basis that the latter only involved the elimination of the right to participation in future dividends and not the elimination of dividend arrears. In *Morris's* case, a proposed amendment to the corporate charter would have left the existing preferred stocks junior to two new classes of preferred stocks. In addition, the amendment purported to change several rights then attached to the preferred stocks to the stockholders' disadvantage and to cancel all accumulated dividend arrears on the existing preferred stocks. The court held that the accumulated dividend arrears on the existing preferred stocks were accrued through the lapse of time and were more than a mere preference. The court viewed it as a present vested right postponed in enjoyment on a contingent event. This was so notwithstanding that the dividends had not been declared by the board of directors.

The leading case on the vested right view is perhaps the Delaware decision of *Keller* v. *Wilson & Co.*[11] In *Keller's* case, the complainant held 500 shares of Class A stock which carried a 5% cumulative dividend. On liquidation, each share was entitled to receive $75 plus accrued dividends after full payment was made to a prior class of preferred stocks but before any common stockholder could receive a return of his capital. A recapitalization was proposed which would have forced the complainant to surrender each of his Class A stocks in exchange for five shares of common stocks. This would have eliminated the accumulated arrears in the cumulative dividend on the Class A stocks. Authority for the amendment was based on section 26 of the General Corporation Law (as amended after the date the Class A stocks were issued). Layton C.J., delivering the opinion of the court, said that while there was no question that the corporation could amend the rights of the preferred stockholders as to future dividends, the attempt to eliminate accumulated dividend arrears on the Class A stocks was impermissible, the dividends having "accrued through the lapse of time".[12]

Another school of thought is that a preferred stockholder's right to

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[11] 21 Del. Ch. 391.

[12] A similar result was arrived at in *Wiedersum* v. *Atlantic Cement Products Inc.* (25 N.Y.S. 2d. 496). In that case, the preferred dividend arrears sought to be eliminated by charter amendment amounted to $56.29 per share. Each existing 7% cumulative preferred stock with dividend arrears was to be exchanged for 4 shares of a new 50-cent per annum cumulative dividend preferred stock, in satisfaction of all accrued unpaid dividends on the existing preferred stock. The court held that section 36 of the Stock Corporation Law only allowed prospective changes to a corporation's capital stock and did not authorise expressly nor impliedly a cancellation of a non-assenting stockholder's right to accrued dividends. In *Roberts* v. *Roberts-Wicks* Co. (184 N.Y. 257), the court held that a preferred stockholder's right to accrued cumulative preferred dividends was a vested right and the accumulated dividend arrears was equivalent to an unsatisfied indebtedness of the corporation payable when the corporation made sufficient profits from its business to discharge it. The statutory provision relied upon by the corporation to effect the charter amendment was held not to authorise an amendment which would have deprived the preferred stockholders of accrued dividends.

preferred dividend arrears is merely a contractual right and not a vested property right. Therefore, like all other contractual rights, it is subject to amendment in accordance with the terms of the contract. This, for convenience, will be referred to as the "contractual right view". In *Western Foundry Co.* v. *Wicker*,[13] there were outstanding 7% cumulative preferred stocks with a preference in the distribution of assets on liquidation. Arrears in preferred dividends had accumulated to $71.75 per stock when an amendment to the charter was proposed, *inter alia*, to cancel all unpaid accumulated preferred dividends. The preferred stocks were also to be made non-cumulative as to future dividends after the amendment and a $2 dividend was to be paid to the existing preferred stockholders. The corporate charter provided that the rights and preferences of the preferred stocks could be amended by the written consent or the affirmative vote of two-thirds of the preferred stockholders. Every preferred stockholder, except the defendant, approved the amendment. The corporation then brought an action for an order declaring the amendment binding on the defendant. The defendant in return, counterclaimed for the dividend arrears. The defendant conceded that he was bound by the changes to the rights attached to his preferred stocks but contested the cancellation of the accumulated dividend arrears on his stocks. The Supreme Court of Illinois was unsympathetic to the defendant's argument that he had a vested right in the dividend arrears. Instead it held that if the articles of incorporation so provided, there was nothing to forbid members of a corporation from giving a majority of a class of stockholders the right to cancel obligations which the entire class might hold against the corporation, even though some stockholders in the class might refuse to assent to such a cancellation. In its view, the right to receive unpaid accumulated preferred dividends was just like any other contractual right and possessed no special quality of indefeasibility.

The Supreme Court of Minnesota in *Sherman* v. *Pepin Pickling Co.*[14] took a similar stand and refused to enjoin an amendment to a corporation's articles of incorporation which cancelled an existing class of 7% cumulative preferred stock of $ 100 par value together with the dividend arrears attached to these stocks and substituting in its place, a new class of 5% non-cumulative preferred stocks of $70 par value. The court held that an undeclared dividend was not a debt and that the cumulative feature of the preferred stocks merely prevented the board of directors from paying a dividend to common stockholders until the cumulative preferred dividends had been paid. It went on to hold that statutory corporation law provisions then existing were part of the contract between the corporation and the preferred stockholder. Having said this, the court then found, but not without some adroit judicial gymnastics, that the statutory provisions authorised the cancellation of the dividend

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[13] 403 Ill. 260; 85 N.E. 2d. 722.

[14] 230 Minn. 87; 41 N.W. 2d 571.

arrears on the preferred stocks. The relevant statute then allowed a corporation to make amendments to its certificate of incorporation "... to change the number and par value of shares of its capital stock or in respect of *any other matter which an original certificate of incorporation of the same kind might lawfully have contained...."* (emphasis mine). The statute further allowed the corporation to make amendments to its certificate of incorporation to issue stocks and to give such preference to preferred stocks as it deemed best. The court then reasoned that since a provision that dividend arrears could be cancelled by the corporation was "a matter which an original certificate of incorporation of the same kind might lawfully have contained" and this was something which the corporation deemed best for itself, the cancellation of dividend arrears in the present case was therefore authorised by the preferred stock contract.

This view that the preferred stockholder invested in his stock on the implied understanding that the rights thereunder could be amended in accordance with the prevailing statutory law and the corporation's articles of incorporation, was carried over into recapitalizations using the vehicle of a merger or consolidation. In *Anderson* v. *Cleveland-Cliffs Iron Co.*,[15] the Court of Common Pleas of Ohio approved a consolidation of two companies which in effect eliminated accumulated preferred dividend arrears amounting to $26.16 per share on $5 per annum cumulative preferred stock. These existing preferred stocks with dividend arrears were each to be exchanged under the consolidation for one new $4.50 per annum cumulative preferred stock plus one common stock. The court clinically held that the consolidation was perfectly legitimate as the prevailing statutory law allowed it and the requisite vote thereon had been obtained.

In the context of a merger, the case of *Federal United Corporation* v. *Havender*[16] held that a merger which would eliminate the accumulated dividend arrears on preferred stocks was perfectly legitimate so long as the prescribed statutory procedures were followed. The court reasoned that a preferred stockholder took his stock on the implied understanding that in the event of a merger, which was allowed under the prevailing statutory law, the various rights of stockholders including the right to dividends on preferred stock accrued but unpaid, may be the subject of reconcilement and adjustment. It was therefore not reasonable for a preferred stockholder to insist that his right to dividends was a fixed contractual right in the nature of a debt and in that sense vested. The preferred stockholder, in the court's opinion, was not a creditor of the corporation nor did he have a lien over its assets.

The contractual right view was pushed to its outer limits in the case

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[15] 54 Ohio L.Abs. 65; 87 N.E. 2d. 384.

[16] 24 Del. Ch. 318.

of *Hottenstein* v. *York Ice Machinery Corp.*[17] While again rejecting the vested right view, the court in that case went further to hold that its decision did not consider of importance the fact that the merger party was a wholly-owned subsidiary of the defendant corporation, incorporated specifically for the purpose of the merger and the elimination of the preferred dividend arrears (which had accumulated to the sum of $88.25 per share). The decision was also arrived at despite the fact that 50% of the common stockholders who stood to gain from the merger comprised two of the defendant corporation's directors and their family members.[18]

The co-existence of the vested right view and the contractual right view, increased the uncertainty of litigation in this area of the law. To steer clear of this minefield, corporations later devised the voluntary exchange schemes described earlier. This effectively precluded the plaintiff preferred stockholder from raising the "vested right" argument. Such a scheme was effectively upheld by the Ohio Supreme Court in *Johnson* v. *Lamprecht.*[19] In that case, the plaintiffs represented 5% of a corporation's preferred stockholders, holding 8% cumulative preferred stocks of $100 par value. A new class of 6% preferred stocks was created by the corporation having priority in dividends over the existing preferred stocks. The holders of the existing preferred stocks were entitled to exchange their stocks for the new preferred stock at the rate of one existing preferred stock for one and one third new preferred stock plus three quarters of a common stock. The exchange was however optional and those who preferred to were allowed to retain their existing preferred stocks, together with all the accumulated dividend arrears thereon. The plaintiffs' grievance was the creation of a class of preferred stocks senior to their existing stocks. The plan left them with two unpalatable options. One was to accept the exchange of their existing preferred stocks with accumulated preferred dividend arrears for preferred stocks without preferred dividend arrears and which were in that sense inferior to the stocks they were holding. The other option was to retain their existing preferred stocks with accumulated dividend arrears but which would thereafter take on a subordinated status with respect to future dividend payments. The court refused to enjoin the recapitalization scheme on the grounds that the corporation had the power under its charter to issue superior preference stock with the consent of two-thirds of the existing preferred stockholders and more than two-thirds of the existing preferred stockholders had voted

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[17] 136 F.2d. 944 (3rd. Cir.).

[18] *Havender's* case was again followed and the vested right view rejected in the case of *Bove* v. *Community Hotel Corp.* (105 R.I. 36; 249 A.2d. 89 (1969)) where the court refused to enjoin an elimination of accumulated preferred dividend arrears through the process of a merger, by the exchange of the preferred stocks on which these dividends had accrued, for common stocks of a newly created corporation.

[19] 135 Ohio St 567; 15 N.E. 2d. 127.

in favour of the plan. *Keller* v. *Wilson & Co.*[20] and another case, *Lonsdale Corporation* v. *International Co.*,[21] were both distinguished on the ground that the stocks substitution plans in those cases were not optional so that the preferred dividend arrears would inevitably be cancelled if the plans had been condoned. Another case, *Yoakam* v. *Providence Biltmore Hotel Co.*[22], was also distinguished on the ground that while the exchange of existing preferred stocks for new preferred stocks in that case was optional, the rights of existing preferred stocks which were not exchanged would have been adversely modified. In this case, the court found it significant that the existing preferred stocks not exchanged retained their existing rights including their preference over the common stockholders and their accumulated dividend arrears.

A similar scheme was approved by the Delaware Supreme Court in *Shanik* v. *White Sewing Machine Corp.*[23] despite the state's historically strong stand in favour of the vested right view. Later, in *Johnson* v. *Fuller*,[24] approval of a similar device to reduce accumulated preferred dividend arrears and to effectively eliminate the impact of what remained thereafter, was obtained at Circuit level. The Third Circuit court in this case was however influenced to some extent by the fact that the corporation had been doing well financially in its operations and it was likely that in the near future it would have been able to make sufficient profits to pay off the accumulated preferred dividend arrears even notwithstanding that a new strata of preferred stocks had been created in priority over the existing preferred stocks.[25]

In *Kamena* v. *Janssen Dairy Corporation*[26] however, the court enjoined a recapitalization plan that would have forced preferred stockholders to exchange every 10 of their 5% cumulative preferred stock with accumulated dividend arrears thereon for 4 new 5% Tpreferred stocks without dividend arrears. This was notwithstanding that the corporation had complied with all legal procedural requirements necessary to effect the recapitalization.

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[20] See above, note 11.

[21] 101 N.J. Eq. 554; 139 A. 50.

[22] 34 F.2d. 533.

[23] 25 Del. Ch. 371; 19 A.2d. 831 (S.Ct. 1941).

[24] 121 F.2d. 618 (3rd Cir.).

[25] A later Third Circuit case, *Barrett* v. *Denver Tramway Corp.* (53 F.Supp. 198 (D. Del 1943), affirmed, 146F.2d. 701 (3d Cir. 1944)), however expressed much more reluctance in arriving at a similar decision. At the District Court level, Judge Leahy lamented that "[W]here a plan of reclassification fails to call on the junior stock to contribute pari passu with the preferred stock.... I fail to see, in the face of objection, why a state or federal jural dichotomy should sit idly by and sentence the preferred shares to make the exclusive contribution when all rights should be whittled proportionately. Regardless of fraud and bad-faith questions, I believe it inequitable to allow the lower class to benefit to the detriment of the higher, in view of the traditional contract between preferred and common stockholders." Nonetheless the court felt bound to follow prior Delaware cases, it being a diversity action.

[26] 133 N.J. Eq. 214.

The court held that the defendant corporation's position might have been less assailable if some provision had been made to fairly compensate the preferred stockholders for the loss they were called upon to sustain under the plan. However, cases like *Kamena* v. *Janssen Dairy Corporation* where the American courts have struck down schemes to eliminate accumulated preferred dividend arrears on the ground that they reek of inequity and injustice are few and far in between. Instead, the courts have been more inclined to show deference to management's business judgment as to what is best for the corporation, at least in the absence of proof of bad faith or something akin to fraud.

III. THE LEGAL POSITION IN SINGAPORE

Companies incorporated under the Companies Act[27] are allowed to issue preference shares.[28] The term "preference share" is defined in section 4(1) of the Act to mean: "a share, by whatever name called, which does not entitle the holder thereof to the right to vote at a general meeting ... or to any right to participate beyond a specified amount in any distribution whether by way of dividend, or on redemption, in a winding up, or otherwise."[29] This definition of a "preference share" in section 4(1) of the Act is expressly stated to be "in relation to sections 5,64 and 180". It seems therefore possible, as a matter of strict statutory construction, for there to be other forms of preference shares outside the context of these sections.[30] As far as the rights of preference shareholders are concerned, outside the context of the aforementioned sections 5, 64 and 180, the Companies Act prescribes very few requirements. Certain rights of preference shareholders must, however, be expressly set out in the company's memorandum or articles of association.[31]

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[27] Cap. 50, Singapore Statutes, 1990 Rev. Ed.

[28] *I.e.*, the equivalent of "preferred stock" under American nomenclature. Hence, in this part of the paper, the terms "share", "shareholder" and "preference shareholder" would be used instead of the terms "stock", "stockholder" and "preferred stockholder" respectively.

[29] Preference shares issued after 15 August 1984 must however be entitled to at least one vote on a poll at any general meeting of the company in three specified situations, namely: (a) during such period as the preferential dividend or any part thereof remains in arrear and unpaid, such period starting from a date not more than 12 months, or such lesser period as the articles may provide, after the due date of the dividend; (b) upon any resolution which varies the rights attached to such shares; or (c) upon any resolution for the winding up of the company. See s. 4(1) and s. 180(2) of the Companies Act, Cap. 50 Singapore Statutes, 1990 Rev. Ed.

[30] As to the problems of interpretation associated with this definition of a "preference share", see Lee Beng Tat, "Equity and Preference Shares – A Problem of Definition" [1992] S.J.L.S. 127.

[31] S. 75(1), Companies Act.

There are limited safeguards under Singapore law against the three recapitalization schemes or devices[32] which have been used in the American jurisdictions to eliminate accumulated preferred dividend arrears. These schemes have exhibited certain key features. For instance, all of them involve either a direct or indirect variation of the rights of the existing preference shares to future or accumulated (and unpaid) preferred dividends. This may in turn, require an alteration to the constitutional documents of the company. In the process, some of these schemes also involve the issuance of new shares either of an existing class or of an entirely new class. This part of the paper will examine the effectiveness of these schemes in Singapore through an analysis of the impact of Singapore law on these key features of the recapitalization schemes.

A. *Variation of Shareholder Rights and the Alteration of the Memorandum or Articles of Association*

Recapitalization schemes which seek to vary the rights of preference shareholders with respect to dividends in Singapore-incorporated companies would almost inevitably involve an alteration to the company's memorandum or articles of association or both. This is because section 75(1) of the Companies Act prohibits a company from allotting any preference shares or converting any issued shares into preference shares "... unless there are set out in its memorandum or articles the rights of the holders of those shares with respect to repayment of capital, participation in surplus assets and profits, cumulative or non-cumulative dividends, voting and priority of payment of capital and dividend in relation to other shares or other class of preference shares."[33]

If any of these rights are contained in the company's memorandum or articles, then any attempt to vary them would call for an alteration to the memorandum or the articles as the case may be.[34] There is, however, nothing

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[32] Described earlier in Part IIA of this paper.

[33] There is nothing in s. 75 which invalidates any of these rights if they are not laid out in the company's memorandum or articles. Non-compliance with s. 75(1) would, however, render the company and every officer in default guilty of an offence under the Act. In the case of a public listed company, Art. 901(6) of the Listing Manual of the Stock Exchange of Singapore Limited requires certain other rights of preference shareholders to be set out in the company's articles of association.

[34] In the case of a company publicly listed with the Stock Exchange of Singapore Limited, Art. 310 of the Listing Manual of the Exchange makes it a continuing listing requirement that the Exchange be informed of any proposed alteration of its memorandum or articles. In addition, companies so listed would in the ordinary case be required (by Art. 912 of the Exchange's Listing Manual) to provide in its articles that the articles as approved by the Exchange may not be deleted, amended or added to without the prior written approval of the Exchange.

explicit in section 75(1) which requires the company to state whether its preference shareholders would be entitled to preserve any accumulated preferred dividend arrears attached to their shares. Hence, while any alteration to the rights of preference shareholders to future cumulative dividends would probably require an alteration to the company's memorandum or articles, the elimination of accumulated preferred dividend arrears may not be subject to such a constraint. As such, any elimination of existing preferred dividend arrears alone without a prospective cancellation of the right to receive future cumulative preferred dividends may not require any alteration to the company's memorandum or articles unless an express right to preserve such dividend arrears is set out therein. Nonetheless, as these two measures tend to be implemented together in the recapitalization schemes under consideration, an alteration to the memorandum or articles would usually be necessary.

The memorandum and the articles of a company operate at law as a legally binding contract between the company and its members and a contract between the members *inter se.*[35] Hence, it is possible for any preference shareholder who is a registered member of the company to bring an action to require the company and the other members to respect any right accorded to him by the memorandum or articles of association, at least where the right he seeks to enforce is one accorded to him in his capacity as a member of the company.[36] In the context of the subject under discussion, the right of a preference shareholder to cumulative dividends in the future and his right to accumulated preferred dividend arrears would clearly be "member's rights", that is, rights accorded to him in his capacity as a member of the company. Therefore, such a shareholder would have no problem establishing his *locus standi* to bring an action to enforce such rights if the company attempts to alter the memorandum or the articles of the company in such a way as to prejudice his rights to such dividends.

However, whether a preference shareholder is entitled to legal protection of such rights depends on two other considerations. Firstly, any purported recapitalization scheme which involves an alteration of the memorandum or articles of a company must be carried out in accordance with the legal procedural requirements set out in the company's memorandum and articles themselves and the Companies Act. The legal procedural requirements under Singapore law for the alteration of the memorandum and articles of a company will be dealt with subsequently in this part of the paper.

Secondly, in order for a preference shareholder to challenge any proposed recapitalization, he must establish that he has a legitimate right to protect in the first place. It would usually be clear from the terms of issue of the

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[35] S. 39(1), Companies Act.

[36] *Hickman* v. *Kent* [1915] 1 Ch. 881; *Eley* v. *Positive Government Life Assurance Co.* (1876) 1 Ex.D. 88; *Ling Beng Hui* v. *Ling Beng Sung* [1990] 2 M.L.J. 186.

preference shares that holders of such shares would be entitled to cumulative dividends and hence the *right* to accumulate such dividends should they be unpaid in any year. These are therefore likely to be indisputable rights of the preference shareholder. However, being rights to be enjoyed only in the future, it is likely that the Singapore courts would follow the practice of the American courts and hold that they may be cancelled prospectively so long as all the legal procedural requirements are satisfied.

Whether a preference shareholder who has already accumulated preferred dividend arrears attached to his shares is entitled to preserve them notwithstanding any proposed recapitalization scheme which would eliminate them, is not entirely clear. The arguments raised in some of the American courts have suggested that a case may be made that the preference shareholder does indeed have such a right and that it is indefeasible notwithstanding that the company may have complied with all the legal procedural requirements to alter its constitutional documents. As pointed out earlier, other judicial pronouncements in the American courts have suggested that the preference shareholder's claim to preserve his accumulated preferred dividend arrears is not a vested right which merits protection at all. This second school of thought argues that while the preference shareholder may have a right to accumulate preferred dividend arrears, the right has always been subject to the company's paramount right to effect any recapitalization scheme which may eliminate them altogether so long as all legal procedural requirements to alter the company's constitutional documents have been satisfied. Under this view, the preference shareholder therefore has no absolute right to preserve his accumulated preferred dividend arrears (save in cases where such a right is an express term of the share issue). The law, as it presently stands in Singapore, offers no clear answer to this question. An attempt to formulate an acceptable answer will be made in Part IV of this paper.

Where the rights of preference shareholders are set out in a company's articles of association, the articles may always be varied through an amendment of the articles provided four conditions are satisfied.[37] First, any alteration to the articles must be subject to any conditions set out in the company's memorandum.[38] Secondly, it must be carried out by means of a special resolution.[39] Thirdly, members who voted for the alteration

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[37] Apart from these conditions, private companies are subject to further restrictions in their ability to alter their articles. For instance, a private company may not alter certain necessary attributes of private companies contained in its articles if it is to remain a private company. See s. 18(1) and 32(2)(c), Companies Act.

[38] S. 37(1), Companies Act.

[39] S. 37(1), Companies Act. It is arguable whether this provision allows the company's memorandum to dispense with the need for a special resolution to amend the articles.

of the articles must have acted *bona fide* in the interest of the company.[40] Fourthly, any alteration to the articles may not require a member to take or subscribe for more shares in the company than the number held by him at the date of the alteration or in any way increase his liability to contribute to the share capital of the company or to otherwise pay money to the company unless the member has agreed in writing to be bound by such alteration.[41]

Where shareholders' rights are set out in the memorandum of a company, it should be noted that section 26(1) of the Companies Act states that the memorandum of a company may be altered only to the extent and in the manner provided by the Act and not otherwise. There appears to be very little provision in the Companies Act allowing for the alteration of the memorandum of a company for the purposes of altering the rights of shareholders (including those of preference shareholders) which may be set out in the memorandum. Section 71 of the Act appears to allow alterations to the form the interests of a company's shareholders takes rather than alterations to the substantive rights of the shareholders. The cancellation of shareholders' rights set out in the company's memorandum may be possible under a formal reduction of capital exercise carried out in accordance with section 73 of the Companies Act.[42] Subsection (1) of section 73 allows a company to alter its memorandum: "so far as necessary ... by reducing the amount of its share capital and of its shares accordingly." While this would appear literally to allow only an alteration to the amount of a company's share capital reflected in its memorandum pursuant to a capital reduction exercise, it could be argued that this power to alter the memorandum should be read to include a power to *delete* altogether, provisions in the memorandum relating to the rights attached to a class of shares where that class of shares will cease to exist after the capital reduction. If not there would be redundant verbiage in the memorandum which would be impossible to remove. Whether the court has the power to order such a tidying-up exercise is not significant since no shareholders' rights would be prejudiced and it is unlikely that anyone would bring any action over it. However, section 73 on its literal reading would not sanction a *variation* of the rights of a class of shares, where the class continues to exist after the capital reduction exercise. There is in fact case authority to the effect that a reduction of capital under a provision like section 73 does not involve a 'variation' of shareholders' rights.[43]

Even in the case where the articles of a company may be altered to eliminate

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[40] *Allen* v. *Gold Reefs of West Africa Ltd.* [1900] 1 Ch. 656; *Peters American Delicacy Co. Ltd.* v. *Heath* 61 C.L.R. 457. As to what would be deemed "bona fide in the interest of the company", see *Greenhalgh* v. *Arderne Cinemas* [1951] Ch. 286.

[41] S. 39(3), Companies Act.

[42] See in particular, subsection (1) of s. 73.

[43] *Re House of Fraser plc.* [1987] B.C.L.C. 293.

the right of preference shareholders to preferred dividend arrears (that is, assuming that such a right is set out in the company's articles in the first place), the company may also have to contend with any backlash from the preference shareholders invoking the provisions of section 74 of the Companies Act. Section 74 allows holders of in the aggregate at least 5% of the issued shares of that class of preference shares to apply to court for an order to cancel the variation or abrogation of their rights. On such an application, the court may after considering all the circumstances of the case decide either to disallow or confirm the variation or abrogation.

For this purpose, section 74(6) of the Companies Act provides that any issue of preference shares ranking *pari passu* with existing preference shares issued by the company would be deemed to be a variation of the rights attached to the existing preference shares unless the issue of the new preference shares was authorised by the terms of issue of the existing preference shares or by the articles of the company in force at the time the existing preference shares were issued.[44] The creation of a new class of preference shares having priority in the receipt of dividends over existing preference shares, which is a feature of the "voluntary exchange schemes", would therefore, in the ordinary case, involve a variation of the rights attached to the existing preference shares within the meaning of section 74.

There are, however, at least two instances where the mere issue of a class of preference shares with a higher dividend priority than the existing preference shares would still not amount to a variation of the existing preference shareholders' rights. First, even where there is a variation of rights clause like Article 4 (in Table A Fourth Schedule of the Companies Act) in a company's articles, there may still be no requirement to call for a separate class vote to approve recapitalization schemes which take on the "voluntary exchange" format where the issue of the new preference shares with a higher dividend priority than the existing preference shares is authorised by the terms of issue of the existing preference shares or by the company's articles in force at the time the existing preference shares were issued. This is because, the issue of the new preference shares under such conditions would not *per se* amount to a variation of the existing preference shareholders' rights[45] and a clause like Article 4 would protect shareholders against a variation of their rights, not against a variation in the enjoyment of their rights.[46] Therefore, in the voluntary exchange schemes which allow the existing preference shareholders the option to retain their shares with the accumulated preferred dividend arrears and where the issue

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[44] Where Table A in the Fourth Schedule of the Companies Act applies, Art.5 thereof extends this principle to any class of shares.

[45] S. 74(6), Companies Act.

[46] *Greenhalgh* v. *Arderne Cinemas Ltd.* [1946] 1 All E.R. 512; *White* v. *Bristol Aeroplane Co. Ltd.* [1953] Ch. 65.

of the additional preference shares would not *per se* be considered a variation of the existing preference shareholders' rights, it would be likely that a court would rule that there would be no variation to these shareholders' rights but merely a variation in the enjoyment of their rights. Section 74 of the Companies Act would therefore have no application in such a scenario. It is true that it would be highly unlikely that the articles of a company or the terms of an issue of preference shares would authorise a subsequent issue of preference shares ranking in priority over the existing preference shares. It is, nonetheless, a theoretical possibility which ought to be pointed out. The second instance, which incidentally is not unlikely to arise, is where the existing preference shareholders are given the option to exchange their shares for new preference shares created in *another* company as part of a merger exercise. Section 74 of the Companies Act would again have no application since the issue of these new shares, being outside the scope of section 74(6), would not *per se* amount to a variation of the existing preference shareholders' rights.

It should further be noted that section 74 does not authorise the alteration of shareholders' rights if these are set out in the memorandum of the company. The default rule in section 26(1) of the Companies Act that the memorandum is not alterable except as allowed by the Act, is therefore not displaced. In addition, the protection accorded by section 74 of the Companies Act is not automatically available to any preference shareholder of every company. The recourse to the courts for relief under the section only applies if the company has provision in its memorandum or articles authorising the variation or abrogation of the rights attached to any class of shares in the company subject to the consent of any specified proportion of the holders of the issued shares of that class or the sanction of a resolution passed at a separate meeting of the holders of those shares. Article 4 of Table A in the Fourth Schedule of the Companies Act is an example of such a provision which would, apply to every company incorporated under the Act unless it has been expressly excluded or modified by the company's articles.[47]

Where there is a provision like Article 4 requiring a separate class vote whenever the rights of a class of shareholders are to be altered or abrogated, two legal implications arise. First, such a separate class vote must be carried out and the requisite percentage of votes must be obtained to sanction the variation or abrogation of these rights.[48] Secondly, there is case authority holding that preference shareholders of the class voting in a separate class vote are required to exercise their votes in the interest of the class as a

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[47] S. 36(2), Companies Act.

[48] *Crumpton* v. *Morrine Hall Pty. Ltd.* (1965) 82 W.N. (N.S.W.) 456.

whole and may not take into account their interest, if any, as holders of the company's common shares.[49]

It is the common practice for companies incorporated under the Companies Act to exclude the application of Table A completely in a company's articles although there may still be a clause similar to Article 4 in the articles which the company registers with the Registrar of Companies. It is foreseeable that a company may exclude the application of Table A without installing in its articles a clause similar to Article 4 of Table A. The default application of Table A is also inapplicable to companies incorporated before 30 December 1967, or for that matter to any company other than those limited by shares. For instance, it would not apply to an unlimited company. In any of these cases, the protection of section 74 would not be available to any shareholder of the company. Companies incorporated before 30 December 1967, and unlimited companies are admittedly in the minority of companies presently existing in Singapore. There may however be companies which were originally incorporated only with one class of shares so that a clause like Article 4 would obviously have been unnecessary. On a subsequent issue of another class of shares, the necessity to amend its articles to include such a clause may not have been apparent to the company. It is particularly in such cases that the investor of preference shares in a company may be vulnerable to the abuses highlighted by this paper.

B. *Cancellation, Creation and Exchange of Shares*

Where the recapitalization scheme takes on a form which involves the cancellation of the existing preference shares with preferred dividend arrears and replacing them with a new issue of shares (either of a new or existing class of shares), several other legal considerations come into play. First, the Companies Act does not allow for the reduction of existing share capital (which is what a cancellation of preference shares would entail) unless it is pursuant to a capital reduction exercise sanctioned by the court under section 73 or one of the statutory exceptions thereto.[50] Hence the cancellation of existing preference shares would have to be part of a capital reduction scheme complying with the requirements of section 73 or as part of a larger reorganisation exercise, in which case, sections 210, 211 and 212 of the Companies Act would apply. Under section 73, the proposal to reduce the existing share capital must be approved by a special resolution of the company. In the case of section 210, the proposed arrangement[51] with the

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[49] *Re Holders Investment Trust Ltd.* [1971] 1 W.L.R. 583. Apart from this exception involving a class vote, shareholders are generally entitled to vote in their own selfish interests.

[50] For instance, see ss. 70 and 71(l)(e) of the Companies Act.

[51] This term clearly includes a reorganisation of a company's share capital as is evident from

preference shareholders involving the cancellation of their shares will have to be approved first, by at least three-fourths in value of the preference shareholders present and voting at a meeting called to approve the arrangement, and secondly, by the court. In both cases, the additional approval of the court for the capital reduction exercise or the arrangement as the case may be, will be required. Schemes employed to eliminate preferred dividend arrears which are similar to those highlighted thus far, will therefore, if employed in Singapore, be subject to the scrutiny of the courts. This, however, as will be seen from subsequent arguments raised in this paper, is not so secure nor so desirable a safeguard as it would appear at first sight.

Where new shares are to be issued in place of the existing preference shares, the company must have enough unissued authorised share capital for this purpose. If not, any allotment of shares in excess of the company's authorised capital would be void.[52] In such instances, it is arguable whether recourse may be had to section 72 of the Companies Act to obtain a court order to validate the issue. The words of section 72 would, on a literal reading, appear to be wide enough to empower the court to validate even an over-allotment. It would however be unlikely that the court would make a validation order without making a corresponding order requiring the company to amend its memorandum of association to effect the necessary increase to its authorised share capital under section 71(l)(a) of the Companies Act. To avoid the necessity for such a validation order, a company with insufficient unissued authorised capital should first increase its authorised capital by amending its memorandum,[53] invoking section 71 (1)(a) of the Companies Act.[54] Thereafter, and before the issue of the shares, the directors of the company must, in addition, ensure that they have the company's approval at a general meeting to exercise any power[55] vested in them to issue the shares, in the absence of which the issue would be void.[56] Preference shareholders would in most cases have no way of influencing either any

the non-exhaustive definition provided in s. 210(11) of the Companies Act.

52 *Bank of Hindustan, China & Japan* v. *Alison* (1871) L.R. 6 C.P. 222.

53 S. 22(l)(c) of the Companies Act requires the authorised capital of a company to be set out in its memorandum of association.

54 In the case of a company publicly listed with the Stock Exchange of Singapore Limited, the articles of the company would in the ordinary case contain additional limitations on the ability of the company to issue preference shares in view of the requirements of Art. 901(3) of the Listing Manual of the Exchange.

55 An example of a clause conferring such a power on the directors is Art. 2 of Table A, Fourth Schedule, Companies Act.

56 S. 161, Companies Act. This approval may be a one-off approval or an unexpired standing approval from the company at a general meeting. S. 161 deals only with the issue of shares. There is no indication whether the prior allotment of the shares would be within the ambit of the section. In any event, the court is empowered under s. 72 to validate, on an application being made, not just defective issues of shares but defective allotments as well.

alteration of the memorandum to increase the company's authorised capital or the approval to issue the new shares[57] since preference shareholders would usually not be entitled to vote at any general meeting of the company on these issues. These legal requirements therefore do not serve as effective forms of protection for the preference shareholders.

Taking the foregoing statutory provisions into consideration, one must conclude that the likelihood of the abuses highlighted herein arising in Singapore through the implementation of the recapitalization schemes as described in this paper, is less than that in the American states. The danger is, nonetheless, still present and could be exploited by those aware of this possibility and who are so minded to exploit it. For instance, although preference shareholders would in the ordinary case be entitled to vote on any resolution which would vary the rights attached to their shares,[58] the requirement under sections 73 and 210 of the Companies Act for shareholder approval, is nonetheless not much of a safeguard. After all, the requisite majority of votes required in each case is computed based only on those present (either in person or by proxy) and voting. The requisite percentage of votes to carry any special resolution to alter a company's articles so as to vary the rights of preference shareholders, is also computed in the same way. Due to the "free-rider" problem which will be explained later, such a safeguard would often be illusory to small shareholders, who tend to form the majority of a company's shareholders. Such "safeguards" based on a separate class vote, have proven to be ineffective in the American jurisdictions. An example at hand is the case of *Western Foundry Co.* v. *Wicker*, the facts of which were raised earlier in Part IIB of this paper.

Although it is true that preference shareholders' rights are relatively immutable if they are set out in a company's memorandum, there is no statutory requirement that they be incorporated in the memorandum. Even in respect of the rights of preference shareholders listed in section 75(1) of the Companies Act, the company issuing the preference shares is given the option to express these rights in its articles and not in its memorandum. In fact, the usual practice of Singapore-incorporated companies is to set out the rights of their shareholders (preference and otherwise), in their articles and not in their memorandums of association.

Finally, the very root of the abuses highlighted has not been dealt with under Singapore law. In particular, the nature and extent of a preference shareholder's rights to accumulated preferred dividends have not, like in many of the American jurisdictions, been clearly addressed. Furthermore,

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[57] Unless the new shares to be issued are preference shares ranking *pari passu* (and presumably also those ranking ahead) of the existing preference shares, in which case, s. 74 of the Companies Act may apply to make a class vote of the preference shareholders necessary to approve the issue of the new preference shares.

[58] S. 180(2) and s. 4(1)'s definition of "preference share" in the Companies Act.

as pointed out earlier, there is no clear statutory requirement that this right be spelt out by the company in either its memorandum or its articles. Hence, the practice of Singapore-incorporated companies is not to address this issue in writing at all.

Of course if a company is incorporated or if its business is carried on with a view to using it as a vehicle of fraud, then the incorporators would be guilty of an offence under section 340 of the Companies Act. Fraud, however, is not something that is easy to prove as it involves an element of *mens rea.* Apart from criminal liability, preference shareholders prejudiced by any of the recapitalization schemes highlighted in this paper would probably attempt to apply for relief under section 216(1) of the Companies Act which reads as follows:

> Any member or holder of a debenture of a company or, in the case of a declared company under Part IX, the Minister may apply to Court for an order under this section on the ground –
>
> (a) that the affairs of the company are being conducted or the powers of the directors are being exercised in a manner oppressive to one or more of the members or holders of debentures including himself or in disregard of his or their interests as members, shareholders or holders of debentures of the company; or
>
> (b) that some act of the company has been done or is threatened or that some resolution of the members, holders of debentures or any class of them has been passed or is proposed which unfairly discriminates against or is otherwise prejudicial to one or more of the members or holders of debentures (including himself).

This provision would certainly give the Singapore courts jurisdiction to give relief to an applicant shareholder if they deem it fit to do so in cases where the directors or other shareholders in the applicant's class have acted unfairly in any way towards the applicant. Determining whether any of the recapitalization schemes highlighted in this paper would be "oppressive", "in disregard" of the applicant's interest, "unfairly discriminatory" or "prejudicial" to the applicant is however, far from a cut and dried affair. This is evident from the host of arguments for and against the protection of preference shareholders from these recapitalization schemes presented in the multitude of conflicting cases from the American courts. It would be interesting to see how the Singapore courts would react to such re-capitalization schemes in the face of some of these arguments.

To complicate matters, recapitalizations are often motivated by a perception that the company would in the long run and as a whole (including preference shareholders) be better off with a new capital structure. Such perceptions are often based on business arguments which the courts are not equipped to evaluate. Such a long term perspective of the company may, however, be inconsistent with the investment aspirations of individual preference shareholders. In such cases, even the protection of a separate class vote of the preference shareholders in the form of a clause like Article 4 in Table A of the Fourth Schedule to the Companies Act, may not satisfy some of the shareholders in that class who have no long term investment designs on the company. These preference shareholders may be outvoted by the rest of those in the class who honestly believe that voting in favour of the recapitalization would indeed be in their long term interest. While it could legitimately be argued that these preference shareholders took their shares on the understanding that they would be bound by the will of the majority in their class, the question whether the majority of the class had indeed voted in the best interest of the class would always remain to haunt any court hearing such a dispute. Again, this is a question which the court is not properly equipped to answer.

It is likely that, to avoid the need to evaluate any business arguments in support of a capital restructuring and to prevent the thwarting of what would *prima facie* appear to be a move for the overall benefit of the company, the Singapore courts would decide to invoke the express power accorded the court in section 216(2)(d) of the Companies Act, that is, to make an order for the dissentient preference shareholders to be compulsorily bought out by the other shareholders or by the company itself.[59] This would in effect, amount to a forced sale of a proprietary interest, which is something a court should be very reluctant to order. Such a course of action would also make all the more pressing, the need to establish a means to appraise fairly, the value of the preference shares to be transferred. The valuation of preference shares, especially those with accumulated preferred dividend arrears is much more complicated and difficult than the valuation of common shares as the usual established methods of share valuation (such as those based on earnings, asset values, future cash flows, dividends or gross revenues) would have to make special provision for the uncertainty of both the payment and the time of payment of the preferred dividend arrears. This difficulty in the valuation of shares with preferred dividend arrears will be revisited in Part V of this paper. At the same time, it should be noted that there is at present, no statutorily prescribed formula for the valuation of such shares under Singapore law.

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[59] In the latter case, the court would be required to make a corresponding order for a reduction in the company's share capital.

Therefore, while the statutory scheme in Singapore is tighter than that existing in many of the American states so that the scope for the exploitation of preference shareholders through creative recapitalization schemes is substantially narrowed, the lot of the cumulative preference shareholder in Singapore is still not altogether secure from the abuses which have plagued their American brethren.

IV. The Case for the Protection of Preferred Dividend Arrears

Notwithstanding that a corporation may have complied with all the legal procedural requirements which must be followed in any recapitalization scheme which seeks to eliminate existing accumulated preferred dividend arrears, any jurisdiction before which a challenge against such a scheme is brought needs to consider if the right of a preferred stockholder to accumulated preferred dividend arrears is something which the law ought to protect. The American courts have tried to resolve this by examining the nature of this right. In particular, they have tried to determine if it is in the nature of a vested proprietary right or a mere contractual right.

A. *Contractual Analysis of the Preferred Stock Contract*

1. *Partial reconciliation of the vested right and the contractual right views*

This writer is of the view that the 'contractual right' view and the 'vested right' view propounded by the American courts are not totally incompatible. It is submitted that to the extent that the earlier cases suggest that undeclared preferred dividend arrears are a vested property right in the nature of an unsatisfied debt, these cases cannot withstand legal scrutiny. The preferred stockholder's right to dividend arrears certainly resembles an accrued debt that is not immediately payable but payable only on the occurrence of a contingent event. In both cases, the preferred stockholder and the creditor are not in a position to enforce immediate payment under the right that they hold. The analogy is, however, not perfect. While the creditor of an accrued debt not immediately payable may be able to prove the debt on the bankruptcy[60] of a corporation, it is unlikely that the bankruptcy court would allow a similar proof to be filed for preferred dividend arrears that have not been declared by the corporation where the preferred stock contract does not expressly provide that the preferred stockholder is to receive payment of preferred dividend arrears on his stock in the event of the

[60] While in some common law jurisidictions, the term "bankruptcy" is reserved for individuals and the term "winding up" is usually used in the context of a corporation, under American legal terminology, the term "bankruptcy" may be applied to both corporations and individuals.

corporation's liquidation. In the absence of such express provision, the preferred stockholder only has a right to be paid the preferred dividend arrears on the materialisation of an expectancy that a dividend would be declared in the future.

It is an established principle of American corporation law that, in the absence of any provision to the contrary, a stockholder is not entitled to payment of dividends until they have first been declared by the board of directors, even if there are surplus profits from which such dividends could be paid.[61] This is provided the non-declaration of dividends was done in good faith and in the interest of the company. On the same reasoning, preferred stockholders would not be entitled to payment of arrears in preferred dividends until they have been declared. Only upon a declaration of dividends is a corporation's profits segregated from the property of the corporation so as to become the property of the stockholders. It is only at this point in time that the dividend arrears become a debt of the corporation owing to the stockholder, upon which payment is immediately enforceable by legal action. Until then, the preferred stockholders have no cause of action to demand payment of the dividend arrears. However, in many of the earlier cases which purported to use the vested right view, it was not altogether clear that the courts were claiming that the preferred stockholder had a vested property right as opposed to a binding contractual right. To this extent, the vested right view may still be defensible.

The courts which rejected the vested right view seemed to have confused the *certainty* of the preferred stockholder's right to be paid his preferred dividend arrears before any common dividend is paid should a dividend be declared in the future and the *expectancy* of there being such a declaration. The former is certainly a vested right postponed in enjoyment on a contingency, that is, on the contingency that the corporation generates enough profits to justify the declaration of a dividend and a declaration is in fact made. The right to receive cumulative dividends does not abate simply because they were not promptly declared.[62] In fact, it is precisely because dividends may not be regularly and promptly declared that dividends on preferred stocks are often stipulated to be cumulative. There is no reason why such a present right postponed in enjoyment on a contingency should not be enforceable. A simple example should make this point clear:

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[61] *Hunter* v. *Roberts, Thorp & Co.* 83 Mich. 63, 47 N.W. 131; *Park* v. *Grant Locomotive Works* 40 N.J.Eq. 14. Indeed, the position is the same under English law. For example see *Bond* v. *Barrow Haematite Steel Co.* [1902] 1 Ch. 353. The Singapore position is likely to be the same although it has never been really challenged in the courts. This is especially likely since other countries which have adopted the common law like Singapore, have taken the same position. A case in point is New Zealand. See for instance the case of *Re Holben, Hubbard & Co. Ltd.* [1938] N.Z.L.R. 54.

[62] *Patterson* v. *Durham Hosiery Mills* (below, note 72).

> Assume that *Cl* and *C2* are not on good terms and *D* is indebted to *C2*. *D* then approaches *Cl* for a loan. *Cl* makes the loan on the condition that should *D* come into enough money to repay his debts he would repay *C1* before he repays *C2*. *Cl* states that he does not mind even if *D* cannot repay him. His only condition to advancing the loan however is that should *D* decide to repay *C2*, he must first repay *Cl*.

There is no reason why a promise given on such terms by *D* to *Cl* in consideration of *Cl*' s agreement to extend the loan should not be enforceable against *D*. *D*'s position is akin to that of a corporation which has issued preferred stocks on the understanding that dividends thereon would be cumulative and have priority over dividends to the common stockholders. Both *D* and the corporation are not obligated to repay *Cl* or to declare preferred dividends respectively. However if *D* wishes to repay *C2*, *Cl* must be repaid first. Similarly, if the corporation wishes to pay dividends to the common stockholders, the preferred stockholders must be paid first. The preferred stockholder has as much a vested right as *Cl* in the example.

Hence, unless there is very clear and unequivocal language in the terms of the preferred stock contract authorizing the corporation to do so, the preferred stockholders should not be deprived of their dividend arrears without adequate compensation. The vested right view should therefore not be totally rejected save to the extent that it equates the preferred stockholder to a creditor and his right to receive preferred dividend arrears to a corporate debt.

In certain cases, a preferred stockholder's right to preferred dividend arrears may in a true sense be a vested right akin to an accrued debt. This would be so where the board of directors having declared a dividend, then failed to pay it. The dividend would then be a debt owing by the company to its shareholders enforceable immediately by legal action. Alternatively, the board of directors may be compelled by the terms of the preferred stock contract to pay out dividends on preferred stocks every year. For instance, in *Pennington* v. *Commonwealth Hotel Construction Corp.*,[63] the certificate of incorporation stated that the preferred stockholders were: "*entitled* to receive and *the company shall be obligated to pay* thereon out of the surplus or net profits of the business of the corporation in each year, a dividend at the rate of seven per centum (7%) per annum..." (emphasis mine). In such a case, any preferred dividend arrears would again be an accrued debt immediately enforceable by legal action.

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[63] 17 Del. Ch. 394. See also, *Lydia E. Pinkham Medicine Co.* v. *Grove* (303 Mass. 1,20 N.E.2d 482 (1939)), *Crocker* v. *Waltham Watch Co.* (315 Mass. 397, 53 N.E.2d 230 (1944)) and *Arizona Western Insurance Co.* v. *L. L. Constantin & Co.* (247 F.2d 388, 391 (3d Cir. 1957)).

2. *The preferred stock contract and the protection of preferred dividend arrears*

A preferred stockholder is deemed to have taken his stocks on the terms embodied in the corporation's articles of incorporation and the prevailing statutory law. To this extent the contractual right view cannot be faulted. However, it is this writer's opinion that the courts should be slow to apply contractual principles to decimate a preferred stockholder's expectation of receiving payment of his preferred dividend arrears unless they are constrained into doing so. On the contrary, in the absence of very clear and unequivocal terms allowing a corporation to eliminate such dividend arrears, the courts should be able to preserve such an expectation of the preferred stockholder and yet remain faithful to the precepts of contract law.

The two common justifications for the elimination of accumulated preferred dividend arrears are, what would for convenience be referred to as the "consent" and "voluntary variation" arguments. The consent argument claims that the preferred stockholder took possession of the preferred stock knowing that the certificate of incorporation of the corporation or the statutory corporate law then prevailing empowered the board of directors to implement schemes whose effect would be to eliminate accumulated preferred dividend arrears. They must therefore be deemed to have consented to the assumption of such a risk and the price they paid to hold the stock would accordingly have been discounted to reflect this risk.

The "voluntary variation" argument is a variant of the "consent" argument. It draws on the fact that preferred stockholders are, in the voluntary exchange schemes described earlier, not compelled to exchange their existing stocks with accumulated preferred dividend arrears for those offered by the corporation without any dividend arrears. Therefore, to the extent that they "voluntarily" exchanged their stocks with dividend arrears for those without such arrears, they must be deemed to have agreed to vary their original contract with the corporation with respect to their existing preferred stocks.

Consent to assume the risk of a particular loss is indeed a very strong argument at law. However, it is arguable that in reality, a preferred stockholder investing in preferred stocks does not consent to the unilateral action of the corporation to eliminate accumulated preferred dividend arrears. It is after all, not unreasonable to assume that two of the major attractions of preferred stocks are the priority they accord to the holder over common shareholders in respect of dividends and the certainty of the fixed return that they promise. The cumulative feature of most preferred stocks is simply an appendage of the latter feature. It gives the preferred stockholder some assurance that should a dividend not be declared in any year, his desire for a fixed and certain return on his investment would still be preserved

to the extent that the arrears would be made up in future years when a dividend is in fact declared. It would therefore be a major, if not a total, failure of consideration if these rights are taken away without the consent of the preferred stockholder. The preferred stockholder who has invested his money for years in a corporation without receiving a cent in dividends makes a sacrifice in the loss of use of the money invested. While he consents to have his money tied up in the corporation while it is undergoing difficult times, he does so on the understanding and expectation that should the corporation's operations experience an upturn, the board of directors would some day deem the time ripe for a distribution of profits to the common stockholders. When that moment arrives, the preferred stockholder would also be paid his preferred dividends including all arrears thereon. He would foreseeably be very aggrieved should the corporation suddenly decide to eliminate the preferred dividend arrears attached to his stocks without adequate compensation just as the corporation was on the verge of declaring a dividend.

Such action on the part of the corporation runs so clearly counter to one's intuitive sense of fairness that no judicial support of it ought to be required to substantiate it. Nonetheless, if such support is required, the court in *Keller* v. *Wilson &* Co.[64] clearly expressed the view that it might reasonably be supposed that one who invests his money in cumulative preferred stocks relies largely upon the right to receive the stipulated dividends at some time, that is, the investor seeks certainty as against a speculative increase in price. This serves both as an inducement to buy the stock and an inducement to retain it.

Proponents of the Efficient Capital Market Hypothesis (ECMH) who see it as a panacea of all the investor's ills, would argue that the preferred stock investor would be fully compensated *ex ante* in the form of a discount in the market price of the stock. Unsophisticated investors would "free ride" on the expertise of sophisticated ones who, being the larger investors in the market, would determine the appropriate market price for the risk attendant on the preferred stocks.

This writer concedes that the ECMH may work very well to protect the sophisticated investor and indeed such an investor may realistically be viewed as having taken the stocks with a full awareness of the risks attendant on such stock, including the possibility that in the future, any accumulated dividend arrears may be eliminated by corporate action. The ECMH is, however, no comfort to the unsophisticated individual investor who may not be apprised of this risk. This is notwithstanding the fact that the corporation may have the power to do so according to its corporate charter and the prevailing statutory law. (Why this risk may not be brought to his attention is addressed subsequently in this paper.) To such an investor, the

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[64] See above, note 11.

fact that the market may have priced the preferred stocks "fairly" by market standards given the level of risk inherent in the stocks is irrelevant if he would not have invested in the stock in the first place (or at least not without a much higher return) if he knew that it was subject to the risk that his accumulated dividend arrears might be eliminated by subsequent corporate action. The point is that an individual investor may be more risk adverse than the big players in the market (who by and large are those who have the biggest influence on the market price). What is a fair price to the market and the sophisticated investor may, therefore, not be a fair price to the individual unsophisticated investor due to their different degrees of risk aversion. Even if a substantial bulk of preferred stocks investors are sophisticated institutional investors, the fact that preferred stocks are still being sold to the unsophisticated individual investors makes the issue far from moot.

Furthermore, the fact that the certificate of incorporation of the issuer corporation or the prevailing statutory law may allow its board of directors to implement schemes whose effect would be to eliminate accumulated preferred dividend arrears, does not of necessity lead to the conclusion that the preferred stockholder agreed to assume the risk of such action by the board of directors. There are several reasons why this is not so. First, no corporate management issuing preferred stocks would in its right mind play up the existence of this power. The attractive aspects of the preferred stocks, for example, the "guaranteed" fixed return from the cumulative quality of the dividends, and the priority of such return over the dividends of common stockholders would be highlighted instead. Whether the law deems the investor to have constructive notice of this corporate power or not is one thing. Whether it is equitable on the one hand, to tell the unsophisticated individual investor (at the time when he is being induced to purchase the stock) that he will be receiving cumulative dividends and then on the other, to reserve in some clause buried in the dense text of the corporation's charter or the prevailing statutory law, a power to take away the same right from him, is quite another matter altogether. In other words even what the law allows may not necessarily be right and if it is not, some thought ought to be given to changing it.

Secondly, even if the preferred stockholder was aware of the existence of the legal powers of the corporation, he may not be aware that they could be used to eliminate accumulated preferred dividend arrears. After all, in many of the earlier cases, neither the "corporate powers clause" in the certificate of incorporation nor the applicable statutory law stated explicitly that the corporation could at its will eliminate accumulated preferred dividend arrears. In fact, the schemes used by corporations to eliminate such dividend arrears have been rather subtle and indirect in most cases. The inexperienced preferred stock investor would therefore in all likelihood, be unapprised

of this risk. Some recognition of this was made in passing by Layton C.J. in *Consolidated Film Industries, Inc.* v. *Johnson*[65] when he said that:

> ... the statute informed *[the preferred stock investor]* that the corporation was granted a power only. He was not informed that the exercise of the power not only would change the character of his stock and the rights incident thereto in the future, but also, by retrospection, would cancel his fixed, contractual right to dividends accrued through time, and which, as against common shareholders, he was entitled by virtue of his contract to have paid before distribution of earnings among them. He therefore was justified in the belief that he would be protected in his right to cumulative dividends accrued through time up to the time when, by corporate action, the status of his shares should be changed.[66]

In *B. & H. Warehouse, Inc.* v. *Atlas Van Lines, Inc.*,[67] an attempt was made to amend a corporation's certificate of incorporation in such a way as to impose restrictions on the transferability of certain Class A common stocks. The certificate of incorporation itself reserved a general right in the corporation to amend the certificate and further stated that all rights conferred on stockholders were granted subject to this right in the corporation to amend the certificate. Notwithstanding the foregoing, the court held that the plaintiff, a holder of Class A stock, only agreed to the general right to amend the certificate of incorporation which was included in virtually every corporate charter in Delaware. This, in the court's opinion, was insufficient notice to the plaintiff that an amendment such as the one before the court would be reasonably within the contemplation of the provision.

Similarly, it is submitted that from a purely legal standpoint, any attempt to eliminate preferred dividend arrears should be allowed only if the prevailing statutory law or the corporate charter expressly and clearly reserves to the corporation a right to do so. While the preferred stockholder takes his stock based on the general terms of the prevailing statutory law and the issuing corporation's certificate of incorporation, there is no true bargaining in a sense with respect to these terms. The intricacies of corporate statutory law and corporate charters are not foremost in the investor's mind when he decides to invest in a stock, save to the extent of any provisions therein which clearly relate to his rights as a stockholder. On the other hand, the ability to enjoy accumulated dividend arrears through the cumulative feature of the preferred stock would be a major consideration in

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[65] 22 Del. Ch. 407.

[66] 22 Del. Ch. 407 at 415.

[67] 490 F.2d. 818 (5th Cir. 1974).

an investor's decision to invest in cumulative preferred stocks. Therefore as between a general right reserved by the corporation to amend its corporate charter and the specific right of a preferred stockholder to preferred dividend arrears, courts should give more weight to the latter when an attempt is made by a corporation to use such a general right of amendment to eliminate accumulated preferred dividend arrears. In any event, it is an accepted rule of construction that an ambiguous contract term should be construed *contra proferentem,* that is, against the party who drafted the term.[68] In this case, any ambiguity as to whether the scope of a right to amend a corporation's charter, would encompass an amendment which would eliminate accumulated preferred dividend arrears should be construed against the corporation.

Thirdly, even if the preferred stockholder was aware of the possibility that the corporation may exercise its powers to implement schemes to eliminate any accumulated preferred dividend arrears, it would not be unreasonable for him to expect that such a power would only be exercised in good faith and with adequate compensation to the preferred stockholders. Surely, he could not have agreed that one party to the preferred stock contract, that is the corporation, could unilaterally, abrogate a very fundamental advantage of the preferred stock upon which he consented to hold the stock. Hence, if recapitalization is in the best interest of the corporation and this would necessitate the elimination of accumulated preferred dividend arrears, then the preferred stockholders ought to be duly compensated for such loss. Contract law recognises that the rights of the parties to a contract cannot be so amorphous that in effect there is no contract at all. If one party can in effect choose at will, without incurring any penalty, to perform or not to perform any fundamental term of a contract, then there cannot be a true contract at law. The right to payment of accumulated preferred dividend arrears in priority over common stockholders must surely be a fundamental term of the cumulative preferred stock contract.

It is a fundamental rule of construction that "[w]hen parties have entered into a contract, it is to be presumed that their intention was to make an effective, rather than a nugatory, agreement, and therefore, unless such construction is wholly negatived by the language used, the agreement should be construed in such a way as to make the contract effective and the obligations imposed by it binding upon the parties."[69] Therefore, to avoid making nonsense of the corporation's promise to pay cumulative preferred dividends on the preferred stocks, it should be read as not entitling the corporation to eliminate accumulated preferred dividend arrears at will without adequate compensation to the preferred stockholder. Again there

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[68] 17 *American Jurisprudence* 2d. – *Contracts, S.* 276.

[69] 17 *American Jurisprudence* 2d. – *Contracts,* S. 254.

is some judicial support for this argument. In *Wildermuth* v. *Lorain Coal & Dock Co.*[70] the court in the course of interpreting the scope of the statutory authority granted to corporations to amend their corporate charters said that:

> ... it never was the intention of the Legislature that corporate management might secure capital upon the representation that the investment was to be safeguarded by provisions acceptable to the investor and then, after the investment had been made, that the corporate management or a majority of its shareholders might repudiate any part of the contract through which it had secured a part of its capital.[71]

If such corporate action is condoned, the preferred stockholder would not only find the rules of the ballgame completely changed but would find himself in a different ballpark altogether.

The "voluntary variation" argument is also flawed because, in most instances, the preferred stockholder is forced either to surrender his preferred dividend arrears and accept a new class of preferred stock without dividend arrears or to hold on to his existing preferred stock with dividend arrears and be subordinated to the new preferred stocks with respect to future dividends. Being caught between a rock and a hard place, it would be collectively rational for the preferred stockholders faced with such a dilemma, not to agree to the exchange, but individually irrational for any particular preferred stockholder not to do so. Since the preferred stockholders are unlikely to be an organised group, most preferred stockholders would agree to the exchange for fear of being left holding subordinated preferred stock with accumulated preferred dividend arrears which may never be paid. The problem is aggravated when the new preferred stocks are also to be issued to persons other than the existing preferred stockholders. In such a case, even if the preferred stockholders were to agree collectively not to exchange their stocks for the new preferred stocks, they would still be left holding stocks with huge accumulated preferred dividend arrears which may never be paid.

In short, when such a scheme of recapitalization is presented to the preferred stockholders, their agreement to exchange their existing preferred stocks with dividend arrears for a new class of preferred stock without such arrears is not one which they arrive at with a real freedom of choice. In traditional contract law, a contract obtained under duress of one party would be unenforceable. So would any variation of an existing contract, as would be the case here, secured under duress. There appears to be no difference in principle between a contract variation secured by duress and the case

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[70] 138 Ohio St. 1; 32 N.E. 2d. 413.

[71] *Per* Turner J., 138 Ohio St. 1 at 19; 32 N.E. 2d. 413 at 422.

of a preferred shareholder left with no real choice but to agree to the elimination of the accumulated preferred dividend arrears which he would otherwise be entitled to. While commercial *pressure per se* would not amount to duress in law, the preferred shareholder in such situations would be subjected to much more than pure commercial pressure. His decision to surrender his accumulated preferred dividend arrears will not be a calculated and considered decision based on an appreciation of the attendant risks involved. He is simply not given any real choice in the matter. In essence, what is involved is a coercion of his will which vitiates any true consent on his part. This would be tantamount to duress at law. Therefore the argument that a preferred stockholder in surrendering his existing stocks with accumulated preferred dividend arrears for new stocks without such arrears, thereby consents to the surrender of the arrears by taking on a new stocks contract with the corporation in place of the existing preferred stock contract, cannot hold any water. A North Carolina court has in fact enjoined such a seemingly "voluntary" recapitalization on the grounds that it was unduly coercive on the existing preferred stockholders.[72]

If contract law is to be used to interpret the rights of the preferred stockholder with accumulated preferred dividend arrears, then a closer analogy to such a preferred stockholder's status would be that of a person who has started to perform the requirements of a unilateral offer. Once such person has begun to perform what is prescribed by the offer, the offer may no longer be revoked by the offeror either on the ground that there is an implied promise by the offeror not to withdraw the offer once such performance has commenced or, alternatively, on the ground that the commencement of the performance itself, albeit incomplete, would be an acceptance of the offer in the eyes of the law.[73] The preferred stockholder has put his money in the corporation and waited for a declaration of dividends.

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[72] *Patterson* v. *Durham Hosiery Mills* 214 N.C. 806; 200 S.E. 906 (1939). This case involved a proposed recapitalization under which the corporation would offer to purchase one third of the plaintiff's holding of 112 shares of 6% cumulative preferred stock in the defendant corporation at $30 per share plus two Class B stock and to receive in exchange for the remainder of his holdings, a new class of 6% cumulative preferred stock. All preferred dividend arrears on the existing preferred stocks would be cancelled in the process. Although the recapitalization plan was approved by more than three-quarters of the votes of the preferred stockholders in accordance with legal procedure, and the preferred stockholders remained free to retain their old preferred stocks if they so desired, the court held that the preferred stockholders were subject to undue coercion under the recapitalization plan. In essence, they were made either to accept a less attractive common stock in exchange for some of their existing preferred stock or see their stock relegated in priority to a new issue of preferred stock.

[73] 17 *American Jurisprudence* 2d. – *Contracts, S.* 37; *Mooney* v. *Daily News Co.* 116 Minn. 212; 133 N.W. 573. For English authority on this point, see for example *Errington* v. *Errington* [1952] 1 K.B. 290 and *Daulia, Ltd.* v. *Four Millbank Nominees, Ltd.* [1978] Ch. 231.

While his wait may not be complete so as to entitle him to immediate payment of the accumulated preferred dividend arrears, the corporation on the other hand should not be allowed to prematurely terminate his wait if he wishes to continue waiting.

A fortiori, it would be highly inequitable to allow one party to a contract to unilaterally abrogate the terms of a contract without fair compensation after the other party has substantially performed his part under the contract. The preferred stockholder has substantially performed his part of the contract, that is, he has advanced money to the corporation on the expectation that he would receive a fixed dividend in priority over common stockholders. While he is not entitled to dividends until the board of directors has declared them, having waited for such a declaration over the years, he should not be deprived of what he has waited for without due compensation. Even if the investment has turned out to be an unmitigated disappointment from the perspective of dividend generation, the preferred stockholder should be given the right to sit on his accumulated preferred dividend arrears with the hope, however slim, that dividends may be declared someday in the future. He should not be forced to accept an alternative to the original contract he entered into. There is no reason why, having received the consideration (in the form of a cash investment in the corporation) for its promise to give the preferred stockholder cumulative dividends in priority over any dividends to the common stockholders, the corporation should not be compelled to honour its promise. In fact, the whole scenario is reminiscent of cases involving promissory estoppel.[74] The preferred stockholder has certainly been induced to rely upon a representation of the corporation to his detriment.

It is true that rights under a contract tend to be fixed while those of a stockholder are generally recognised to be defeasible. Even so, the only reason why stockholders' rights are generally defeasible stems from terms, express or implied, upon which the stockholders agreed to hold their stocks. Any right the company may have to defeat the rights of its stockholders are still based on the rules of contract. In other words, the defeasibility of the stockholders' rights is not something which is inherent in the nature of the stockholders' interest. It is therefore ultimately a question of construction whether it was contemplated by the company and its preferred stockholders that the terms of the contract between them included a stipulation that the preferred stockholders' interest in the accumulated

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[74] 17 *American Jurisprudence* 2d. – *Contracts,* S. 9. The doctrine of promissory estoppel is well established under English law. Some notable cases on promissory estoppel include the following: *Central London Property Trust* v. *High Trees House Ltd.* [1947] K.B. 130; *Hughes* v. *Metropolitan Railway Co.* (1877) 2 App. Cas. 439; *Birmingham & District Land Co.* v. *London and Northwestern Railway Co.* (1888) 40 Ch.D. 268; *Emmanuel Ayodeji Ajayi* v. *R.T. Briscoe (Nigeria) Ltd.* [1964] 3 All E.R. 556; *The Post Chaser* [1982] 1 All E.R. 19.

preferred dividend arrears was an interest which was to be defeasible by any particular recapitalization scheme. It is submitted that such a term of defeasibility cannot be implied into the contract between the company and its preferred stockholders. It would defeat the reasonable and legitimate expectations of the preferred stockholders. Instead, if any term is to be implied at all, it would be a term to the effect that in all such relationships between companies and their preferred stockholders, unless there is clear and express provision to the contrary, companies issuing preferred stocks with cumulative dividends would not do anything to deprive the preferred stockholders of any accumulated preferred dividend arrears without adequate compensation.

B. *Non-Contractual Arguments for the Protection of Preferred Dividend Arrears*

If a corporation is not making enough profits to pay the preferred stockholders, the worst that could happen is the insolvency of the corporation. In the event that the corporation goes into bankruptcy, the preferred stockholder would in most cases be entitled, under the terms of the preferred stock contract, to receive the par value of his stock or the issue price plus any dividend arrears thereon, in priority over the common stockholders.[75] As such, it would be ironical that the preferred stockholder should lose his priority and the accumulated preferred dividend arrears should the corporation he invested in continue to survive, but would preserve them should the corporation be liquidated. Something is clearly amiss here. This anomaly takes on even greater significance when one bears in mind that the ability of a corporation in liquidation to pay preferred dividend arrears is not constrained, unlike the case of an on-going corporation, by the absence of profits.[76]

In the case of a preferred stockholder without a preference to the return

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[75] Under English law, while the rule is that accumulated preferred dividend arrears *are prima facie* not payable upon a liquidation of the company unless previously declared, much really depends on the way the preference shareholders' right to dividends is phrased in the company's memorandum or articles and case law suggests that the rule is very easily displaced. If the memorandum or articles clearly state that the preference shareholders are to receive a "preferential" dividend and that they are to "rank both as regards dividends and capital in priority to the ordinary shares", then the courts have read the latter provision as referring to a case where the company is being wound up. In addition, the courts have been prepared in such situations to read the word "dividends" to mean arrears of dividends on the preference shares even though such dividends had not been declared before the commencement of the company's winding up. See *Re Crichton's Oil Co.* [1902] 2 Ch. 86; *Re Roberts & Cooper* [1929] 2 Ch. 383; *Re Wood, Skinner & Co. Ltd.* [1944] Ch. 323; *Re Walter Symons Ltd.* [1934] Ch. 308; *Re F. de Jong & Co. Ltd.* [1946] Ch. 211; *Re E. & W. Savory Ltd.* [1951] 2 All E.R. 1036; *Re Wharfedale Brewery Co.* [1952] Ch. 913.

[76] *Pennington* v. *Commonwealth Hotel Construction Corp.* (above, note 63).

of capital and dividend arrears upon a liquidation of the corporation, his right to the preferred dividend arrears resembles to some extent, an out-of-the-money call option. So long as the corporation continues as a going concern, there is every possibility, however slim, that a dividend may be declared in the future. There is therefore some option value in the stock. The analogy is admittedly not perfect as the preferred stockholder does not, in a sense, have the power to exercise the option, and his right to receive payment on the dividend arrears is still subject to the discretion of the corporation's board of directors. Nonetheless, the existence of some kind of "option value" in the stock should be clear.

One possible argument against legal intervention to protect preferred stockholders is that the market has not demanded for it. The argument is that since most issues of preferred stocks do not contain such protection, the parties must have agreed not to include such protection in their agreement. The problem with this argument, as explained earlier, is that many preferred stockholders may subscribe to the stocks without realising the potential loss of dividend arrears they would be exposed to. It is the writer's opinion that corporate law should step in to protect such *ex post* opportunism on the part of issuers of preferred stocks.

Another argument against legal intervention to protect accumulated preferred dividend arrears, is that if the arrears are so large as to preclude any dividend from being paid out to the common stockholders, the corporation would be driven to the pursuit of high risk, high return ventures in the hope of paying off the arrears. Recapitalization with the elimination of accumulated preferred dividend arrears would remove the attraction of such conduct on the corporation's part. One response to such an argument is that such a risk would at least be one which the preferred stockholders had agreed to assume. Even in the worst scenario, where the corporation becomes insolvent and goes into bankruptcy, they would in most cases still had their priority over the common stockholders in the return of capital and dividend arrears under the terms of the preferred stock contract. To allow recapitalization to eliminate accumulated preferred dividend arrears would be to allow common stockholders to benefit at the expense of preferred stockholders. To preserve such arrears would ensure that no common stockholder gets anything before the preferred stockholders have received in full what they had contracted for.

Choosing not to protect arrears in preferred dividends from elimination would also expose directors to a "conflict of interest". In most cases where directors hold stocks in the corporation, they would be in the form of common stocks. There are several reasons why this is so. First, directors understandably prefer to hold common stocks as common stockholders are usually the only ones entitled to vote in the election of directors. Secondly, common

stocks are often the subject of tender offers[77] which have the potential of ousting the incumbent management. Control of the common stocks therefore also gives the directors some control over the security of their own jobs. Thirdly, common stocks, rather than preferred stocks, would be more effective in aligning the directors' interest with those of the corporation's stockholders, since preferred stocks usually do not include a right to participate in the profits of the corporation beyond a fixed return. Common stocks on the other hand share in the total wealth of the corporation and would therefore enjoy a greater chance of capital appreciation than preferred stocks. This would give the directors who manage the company the requisite incentive to maximise the profits of the corporation.[78]

If executive directors hold a substantial stake in the common stocks of the corporation, it follows that it would be in their interest to eliminate accumulated preferred dividend arrears in order that dividends may be paid to the common stockholders (which would include themselves). This "conflict of interest", however, may not be illegal as the conflict may not be one between the company's interest and the directors' interest. Indeed, the recapitalization and the consequent elimination of accumulated preferred dividend arrears may actually be in the interest of the company. Cases such as *Hottenstein* v. *York Ice Machinery Corp.*[79] which condone schemes to eliminate accumulated preferred dividend arrears without giving due weight to the financial stake of the corporation's management in the securities which stand to gain from the whole exercise, only highlight the plight of the preferred stockholder.

Many statutes and corporate charters do provide that in the event that the rights of any class of stock are to be affected by a proposed charter amendment, a separate class vote of holders of that class of securities would be required. Under American law, this may not be as effective in protecting the preferred stockholders against abuse as it may first appear. After all, many preferred stockholders may also be common stockholders. It is not uncommon for dividends in the form of preferred stock to be issued to existing common stockholders. Therefore, even if a separate class vote is conducted to approve the proposed recapitalization which would eliminate accumulated preferred dividend arrears, the vote may be tainted by this overlapping membership of the preferred and common stockholders. It may be worthwhile for those preferred stockholders who also hold common stock to approve the recapitalization in view of the larger common dividends that could be declared in view of the savings realized from the elimination of

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[77] This is the American equivalent of a take-over offer in England or Singapore.

[78] Often, the same objective is achieved by giving the directors stock options in the company's stock.

[79] See above, note 17.

the accumulated preferred dividend arrears. This would work to the detriment of preferred stockholders who are not also common stockholders and who acquired their preferred stock not by way of a pro-rata stock dividend. A standard immutable rule preventing the elimination of accumulated preferred dividend arrears without appropriate compensation would avoid these conflict of interest situations. It should be noted however that this danger of a tainted vote from such overlapping stockholding is not present under English or Singapore law in view of the rule that a member of a class of shareholders may only vote in the interest of the class as a whole where a separate class vote is taken and may not, in such instances, take into account his interest (if any) as a member of another class of shareholders.[80] Also, where the alteration to preferred rights is done by way of a scheme of arrangement under a provision like section 210 of the Singapore Companies Act, there is case authority[81] to suggest that the court has discretion in determining the appropriate definition of a "class" for the purposes of the class vote required under section 210. It is therefore open to the court to exclude from a class, preference shareholders with overlapping shareholdings in the ordinary shares of the company in order to prevent the class vote from being tainted by any possible conflict of interests.

There is also the "free-rider" problem, that is, even if a preferred stockholder wishes to apply for a court order to enjoin the corporation from proceeding with the plan of recapitalization, it may not be worthwhile for him to do so if he does not have a sufficiently large stake in the corporation. It would then be left to the large investors to pursue any legal action against the corporation. If there is no single preferred stockholder with a substantially large stake in the corporation, there may be nothing to stop the corporation from running roughshod over the accumulated preferred dividend arrears. Only the large investors would be moved to pursue legal action but not the small ones. However the large investors would often be sophisticated institutional investors. It would therefore appear that those who need protection most would be the ones least protected.

V. PROTECTIVE MEASURES

Before suggesting any form of protection for preferred stockholders, it should be made clear at the outset, that this writer is of the view that from a purely legal perspective, a corporation should be allowed to eliminate preferred dividend arrears if, and only if, such a power is clearly set out in either the prevailing corporate legislation or the corporation's certificate of in-

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[80] *Re Holders Investment Trust Ltd.* [1971] 1 W.L.R. 583.

[81] *Sovereign Life Assurance Co.* v. *Dodd* [1892] 2 Q.B. 573; *In re Hellenic & General Trust Ltd.* [1976] 1 W.L.R. 123.

corporation. It is submitted that general equivocal powers to amend a corporation's charter such as those in the case of *Sherman* v. *Pepin Pickling Co.*[82] should not suffice.

An example of a case in which a statutory provision clearly authorising a corporation to eliminate preferred dividend arrears by charter amendment was relied upon by a corporation to effect a plan of recapitalization which eliminated accumulated preferred dividend arrears was *O'Brien* v. *Socony Mobil Oil* Co.[83] In that case, section 55 of the Virginia Stock Corporation Act allowed corporations to amend their articles of incorporation to "cancel or otherwise affect the rights of holders of shares of any class to receive dividends which have accrued but have not been declared (whenever accrued and whether or not earned)". Several states in the United States have since adopted statutory provisions to give corporations incorporated within the state a clear authority to eliminate accrued dividends.[84]

While such statutory provisions may clarify the legal status of a recapitalization to eliminate accumulated preferred dividend arrears in such states and make the job of the courts much easier, they may not be the most desirable means of resolving the problem. Instead, they may only serve to legitimize the abuses which this paper has highlighted. This is certainly not the course this writer would encourage the Singapore legislature to take. Rather than protecting the corporations against suits of preferred stockholders in respect of its elimination of accumulated preferred dividend arrears, legislation should instead move towards the protection of such arrears. In jurisdictions where the elimination of accumulated preferred dividend arrears has now been legitimized by statute, these statutes should go on to require that investors of preferred stock should, prior to their investment in the stocks, be given written notice of this risk that they are deemed to have assented to. In addition, for the benefit of investors in the secondary market, a mandatory legend should be placed on all preferred stock certificates issued by corporations within such jurisdictions highlighting this risk attendant on the stock.

In jurisdictions where there is no clear statutory authority for the elimination of accumulated preferred dividend arrears by corporate action (which would include Singapore), courts should adopt a more conservative attitude against schemes to eliminate such arrears where the corporate charter does not clearly and unequivocally reserve a right in the corporation to do so. This paper has attempted to show that traditional contract principles should be sufficient to fend off criticisms against taking such a stand. It would also be expedient to enact laws in such jurisdictions preventing corporations

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[82] See above, note 14.
[83] 207 VA. 707; 152 S.E. 2d. 278.
[84] Del. Gen. Corp. Law s. 242(a)(4); N.Y. Bus. Corp. Law s. 801; Calif. Corp. Code s. 903(a)(7).

with charter provisions that clearly give the corporation the power to eliminate accumulated preferred dividend arrears, from relying on the power against any preferred stockholder unless it is shown that such charter provision was brought to the attention of the preferred stockholder prior to his agreement to invest in the stock.

In many of the cases which approved the elimination of accumulated preferred dividend arrears, this was effected through a merger or consolidation.[85] Legislation in many of the American states do provide a stockholder who does not consent to a merger or consolidation with a right to demand that the corporation redeem his stock at a judicially appraised "fair value". The preferred stockholder who has his accumulated preferred dividend arrears eliminated through a merger or consolidation is therefore not totally without a remedy. However, voluntary exchange schemes resembling those in *Johnson* v. *Lamprecht*[86] and *Shanik* v. *White Sewing Machine Corp.*[87] do not involve mergers or consolidations. Preferred stockholders who disagree with such schemes of recapitalization would therefore not be entitled to any appraisal remedy. This has led at least one commentator to suggest that appraisal rights be given in all cases to the preferred stockholder who is not in favour of any recapitalization which would eliminate his accumulated preferred dividend arrears, whatever form the vehicle used to effect the recapitalization may take.[88]

While according appraisal rights to the preferred stockholder whose accumulated preferred dividend arrears are to be eliminated is a step in the right direction, the effectiveness of the appraisal right as a remedy to the problem would depend very much on the appraisal formula used. For instance, if appraisal means that the preferred stockholder is to be paid what the market then values his preferred stocks, it would not be fair to him since the market would probably reflect a discount in the price for the fact that the directors of the corporation had chosen not to declare a dividend in the past. To make matters worse, such a no-dividend policy could have been prevalent in the company for many years. In other words, the market would value the stock on the assumption that the directors would continue to take this stand in the immediate foreseeable future. To be equitable, the appraisal remedy should require that the price paid to buy out the preferred stockholder include all the accumulated preferred dividend arrears.

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[85] *Hottenstein* v. *York Ice Machinery Corp.* (above, note 17); *Anderson* v. *Cleveland-Cliffs Iron Co.* (above, note 15); *Federal United Corporation* v. *Havender* (above, note 16).

[86] See above, note 19.

[87] See above, note 23.

[88] Jeffrey S. Stamler, "Arrearage Elimination and the Preferred Stock Contract: A Survey and a Proposal for Reform" (1988) 9 Cardozo L. Rev. 1335.

On the other hand, even a receipt of the accumulated preferred dividend arrears may not be totally fair to the preferred stockholder. This is because he would in effect be forced to sell his interest in the corporation unless he would be prepared to accept a new security interest in the corporation and the consequent elimination of his accumulated preferred dividend arrears. Such a stockholder may in fact be prepared to wait and sit out the lean periods of the company if he is optimistic that the company would be able to pay the dividend arrears in the near future. To receive cash in lieu of his right to a fixed accumulated dividend may not be in his best interest where the fixed dividend rate is much higher than the existing interest rate at which he would be able to reinvest the cash received. After taking into account the time value of money, it may still be more worthwhile for the preferred stockholder to wait for the corporation to declare a payment of the accumulated preferred dividend arrears than to sell out his interest under an appraisal remedy. In addition, where there is a capital gains tax in force, an individual preferred stockholder may not wish to realize a gain from his preferred stock investment as yet.[89] To force him to do so may therefore not be fair to him. Even in the absence of a capital tax, this would in effect, amount to a forced sale of a proprietary interest, a very drastic action indeed. If a corporation foresees the contingency that it may in the future wish to redeem the preferred stock it issues, it should be clearly stated at the outset as one of the terms of the issue.[90] Only in such cases would it not be unfair to the preferred stockholder if he is forced to sell out his interest for fair value.

It is tempting to run to the conclusion that in the case of an insolvent company, the value of the company's stocks, including its preferred stocks is simply zero. While this may be true of an insolvent company which has gone into liquidation or which has voluntary ceased its business, it is not true of all insolvent companies. The dangers posed by the recapitalization schemes raised in this paper do not take place when the company has gone into liquidation or when the company has voluntarily ceased to conduct its business. We are therefore not concerned with the valuation of preferred stocks under such circumstances. In all other cases, the fact that a company is insolvent merely means that it is unable to meet its financial obligations as they fall due. It does not necessarily mean that its total liabilities exceed its total assets. Hence on a liquidation, the preferred stockholders would still be returned some of their capital investment in the company. Even if the company's total liabilities do exceed its total assets, so long as the company has not been put into liquidation and the company has not ceased

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[89] It should be noted that under Singapore tax statutes, as a general rule, capital gains are not taxable.

[90] Under s. 70 of the Companies Act, Singapore-incorporated companies may, if they are so authorised by their articles, issue redeemable preference shares.

its business operations for good, there is still the possibility, however remote that the company may experience an upturn in its fortunes in the future. This 'option value' of the preferred stock must be worth something. The preferred stocks are therefore still not valueless in such circumstances.

In summary, to be fair to the preferred stockholder, any appraisal formula used must compensate him for the arrears in accumulated dividends discounted for uncertainty as to when they would actually be paid but for the recapitalization, any tax losses and (in the case of preferred stock not expressly stated to be callable by the corporation) any loss from the difference in the fixed dividend rate and the existing market rate at which the funds received from the appraisal could be reinvested after taking into account the time value of money. The appraisal should be supported by a valuation report from an independent competent and suitably qualified valuer appointed by the preferred stockholders as a class and agreeable to the issuer corporation (which agreement should not to be unreasonably withheld). Statutory provisions providing appraisal rights of this nature would in the opinion of this writer be a more equitable way of dealing with the problem than those simply legitimising the elimination of accumulated preferred dividend arrears.

In addition, legislatures could also consider statutorily imposing the automatic vesting of preferred dividend arrears once they are in arrears for a prescribed number of years and turning it into an ordinary debt which is immediately due and payable by the company to the preferred stockholder.[91] (If a preferred dividend is paid within this prescribed period, then a fresh statutory period would begin to run.) In such a case, the preferred stockholders would be able to bring an action to enforce payment of the preferred dividends once the arrears have been continuously outstanding beyond the prescribed number of years. This would prevent the accumulation of preferred dividend arrears to such a magnitude that it would be unforeseeable for the common stockholders to receive any dividends unless the preferred dividend arrears are eliminated by way of a recapitalization, merger or consolidation.

Such action would be useful where the company has accumulated profits which it has been holding back for years. Although both English and

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[91] The writer acknowledges with gratitude this suggestion made by Professor Lewis Kornhauser, New York University School of Law. Such a scheme could be contractually provided for under a corporation's constitution but seeing the often disparate bargaining strengths between the investor and the corporation, it would be unlikely that such provisions would become commonplace without statutory intervention. Even with the introduction of such legislation, it should be noted that under Singapore law [s. 250(1)(g) of the Companies Act], the dividend debt would still rank, priority-wise, after the debts of general creditors on a winding up of a company incorporated under the Companies Act. This preserves the notion that preference shareholders are equity-holders and not creditors of the company.

Singapore case law[92] suggest that where there is a chronic failure to pay dividends over an extended period of time, relief from the courts is available, litigation brought on such premises often centres on an allegation of bad faith on the part of the company's management. As such, litigation has rarely been the best solution in these circumstances. The costs of litigation (both monetary and in the form of managerial time lost) are often very prohibitive and unproductive. The acrimony involved and the bad publicity generated in the course of such litigation is also something few (but the very malicious) would look forward to. In addition, to qualify for relief, the plaintiffs in the English and Singapore cases had to show that what they suffered was a harm which was intended to be addressed by the relevant statutory provision. The cases where the courts have granted relief for a company's failure to pay dividends also tended to involve only small closely-held companies often run very much like quasi-partnerships. Relief under the automatic vesting mechanism would meet with none of these impediments. While legal action would still be required to enforce the dividend arrears which have now been converted into a debt, it should not be too difficult to secure summary judgment against the company.

By converting the dividend arrears into a debt, the automatic vesting mechanism is even more useful where the company has no profits to declare a dividend. The debt would then have to be paid by the company regardless of the availability of profits. For heavily cash-strapped corporations, this may even mean borrowing to pay the dividend arrears once they are vested. This is a contingent cost which the corporation could factor into the price of the preferred stocks at the time of its issue. To ensure that such a mechanism would not remove the distinction between equity (a description which preferred stocks answer to) and debt, the minimum statutory period before automatic vesting would take effect should not be made too short.

Some American companies have used innovative formulae in their corporate charters to ensure that dividends are declared fairly regularly. For instance, a corporation could provide in its constitutional documents that its retained earnings be capped at a pre-determined level so that any surplus beyond this level must be declared as a dividend to the shareholders.[93] Legislation could be drafted along the same lines to require corporations issuing preferred shares to set limits on their retained earnings in excess of which, preferred dividends on the preferred shares (not necessarily ordinary dividends) should be paid. Alternatively, corporations issuing preferred shares could be required by legislation to design for themselves and thereafter to keep

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92 *Re Sam Weller and Sons Ltd.* (1989) 5 B.C.C. 810; *Re Gee Hoe Chan Trading Co. Pte. Ltd.* [1991] 3 M.L.J. 137.

93 *Lydia E. Pinkham Medicine Co.* v. *Grove* (above, note 63).

strictly to, an earnings-based formula upon which decisions on the declaration of preferred dividends would be based.[94]

The remedies outlined in the two immediately preceding paragraphs allow the preferred stockholder a greater likelihood of retaining his interest in the corporation than the provision of an appraisal remedy alone. However, the problem with these proposed remedies is that the preferred stock contract becomes very much like a loan agreement, with less flexibility given to a corporation's management to utilize the free cash flow of the corporation.

A more flexible mechanism could be to statutorily require corporations to appropriate on paper, the requisite proportion of their net profits to a sinking fund for the future payment of accumulated preferred dividend arrears. In years where no net profit is generated, no appropriation to the fund need be carried out but the obligation to do so, nonetheless, remains and any arrears in appropriation are to be made up in subsequent years when net profits are generated. This fund would not be payable to the preferred stockholder until a dividend is actually declared by the board of directors. Money in the fund may in the meantime be used for any legitimate business purpose for the benefit of the corporation. In such a case, while the preferred stockholder would not be able to bring legal action to enforce payment of dividends to them immediately out of this fund, they should have sufficient standing to request a court to enjoin any attempt by a corporation to eliminate the fund. There is some judicial pronouncement in support of this although it was made only in passing.[95] In such instances, the courts may even be prepared to imply a constructive trust on the fund in which the corporation is the trustee and the preferred shareholders the beneficiaries. Such a scheme has the advantage over the automatic vesting mechanism in that at no point in time would the preferred stockholders have a vested right to sue for immediate payment of the preferred dividend arrears. This reserves in the board of directors, the full discretion to determine when dividends ought to be paid. It therefore clearly preserves the notion that the investment of the preferred stockholder is not by way of a loan to the corporation payable under a pre-determined schedule.

Only when some form of the abovementioned protective measures has been adopted, should a corporation be allowed to eliminate accumulated preferred dividend arrears in the course of a recapitalization which is in the best interest of the corporation, subject however to mandatory judicial review in all cases, to ensure that the preferred stockholders are adequately compensated. The preferred stockholders should be paid fair value for their stocks should they choose, or be forced to exit the corporation on the

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[94] For an example of such an earnings-based formula for the declaration of dividends in general, see the case of *Crocker* v. *Waltham Watch Co.* (above, note 63).

[95] *Sherman* v. *Pepin Pickling Co.* (above, note 14).

consummation of such a recapitalization plan, determined in accordance with the factors listed above. The burden of proving that the recapitalization would be in the best interest of the corporation as a whole and that the preferred stockholders would receive fair value for their stocks under the plan should however, rest solely on the corporation.

VI. CONCLUSION

One commentator believes that "a rigid application of the *Keller* theory that accruals are indestructible vested rights would make corporate capital structures undesirably inflexible. But the enrichment of a junior class of security holders at the expense of a senior class is too high a price to pay for flexibility."[96]

A preliminary observation flowing from this remark is that flexibility did not seem to be a problem in many of the cases that went to the American courts (and they were not few in number). The requisite percentage of votes legally required for the corporation to proceed with the scheme of re-capitalization, merger or consolidation sought to be enjoined, was in all the cases obtained by the corporation. Due to the dispersed nature of stockholders, the "free-rider" problem explained earlier and the fact that management in effect control the proxy machinery by default, it is not surprising that shareholders may as a class vote in favour of a recapitalization scheme which may not be totally in their interest. Even in a statutory framework like the one existing in Singapore, not every preferred shareholder will find it worth his while to contest the recapitalization through an application to court under section 216 of the Companies Act. The management in a corporation would usually also add a sweetener to the proposed recapi-talization plan, which may take the form of a promise to immediately declare dividends on the new stocks to be exchanged for the old preferred stocks (with the dividend arrears), to induce the preferred stockholders to vote in favour of the plan. In addition, the trade-off that appears to be implicit in the statement quoted above may not be necessary after all. This paper has attempted to show that the vested right view and the contractual right view need not be totally incompatible.

It is this writer's view that the case for some affirmative legal protection of accumulated preferred dividend arrears overwhelms the arguments for non-intervention. As has been shown, principles of contract law, rather than supporting a case for non-intervention, suggest that the law should step in to prevent the elimination of such dividend arrears at least in cases where no adequate compensation is given to the preferred stockholders for such

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[96] E.M. Dodd, "Accrued Dividends in Delaware Corporations – from Vested Right to Mirage" (1943-44) 57 Harv. L. Rev. 894.

action. While some steps of statutory intervention have been taken in several American states, this writer submits that these have been steps in the wrong direction. It is hoped therefore that the Singapore legislature would not go down the same path. It is also worth noting that while cases of preferred dividend arrears elimination may be few and far in between even in the American jurisdictions today, corporations are still armed with this trap to snare the unwary preferred stock investor in these jurisdictions and in Singapore. The legislature in Singapore should in the meanwhile, not wait for a major economic recession before taking any action to defuse this trap.

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