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Accounting Questions

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DIVIDENDS ON CUMULATIVE PREFERRED STOCK

Question: A corporation was formed in 1925, with an authorized capital stock of $1,000,000 described in the charter as follows:

"The said ten thousand shares of one hundred dollars each are preference shares and shall confer upon the holders thereof the right to a fixed cumulative preferential dividend at the rate of seven per centum per annum on the amount paid up thereon from time to time—etc."

There was sold in 1925, $500,000 of this stock entirely paid up.

There was sold in 1928, $100,000 of this stock fully paid up.

There was sold at December 15, 1931, $100,000 of this stock fully paid up.

There remains $300,000 of this stock unissued.

There have never been any profits out of which the directors could legally pay dividends and therefore no dividends have ever been declared (December 31, 1931).

If in 1932 this corporation has a substantial profit out of which the directors legally may declare and do declare dividends, do the holders of certificates of original issue in 1931 and 1928 share equally with the holders of certificates originally issued in 1925 and with each other, or do the dividends accrue only from the date of original issue of each individual certificate?

Please cite court cases where possible.

From the viewpoint of the corporation it would seem unjust that it should have to pay dividends accrued for seven years upon money that has only been invested in the business for a few months.

On the other side of the question it may be held that when the corporation sold stock in 1931 it received as part of the purchase price consideration for the accrued dividends, and since there is only one class of stock, every certificate will draw identical dividends.

Some lawyers take one view of the question, while other lawyers' viewpoint is the opposite. Similarly stockbrokers have divergent views. No authoritative decision has as yet been pointed out to us.

Answer No. 1: In the case submitted by your interrogator, the charter provides that the preferential dividend shall be "at the rate of 7 per cent. per annum on the amount paid up on the preferential shares from time to time."

In order to comply with this provision, it would appear that the dividend would have to be calculated from the respective dates on which the shares were paid up, as otherwise the payment would not be "at the rate of 7 per cent. per annum on the amount paid up from time to time."

The rights of holders of cumulative preferred stock, however, depend upon the agreements relating thereto, including the charter and by-laws of the company in question. Therefore, the answer to the question raised depends upon the interpretation of those agreements. While various courts have, from time to time, passed upon several matters relating to cumulative preferred stocks, we have not found a case which deals with the precise point now raised. However, in the department of "Practical points in accountancy law" in *The Accountants' Magazine* for July, 1928 (volume 32, no. 317, page 437), the following discussion, under the heading of "Recipients of arrears of cumulative dividends" appears and may be of interest in dealing with the question now raised:

"In the well-known case of *In re Walkley* (1920), the principle was definitely laid down that when a company has for several years passed its preference (cumulative) dividend, and then finding itself in funds declares a dividend for the past years, plus a dividend for the year then current, such a declaration is not a declaration of three dividends but of one, and that for the year in which it is declared, although its amount is conditioned by the fact that in previous years no dividends had been paid. The principle of that decision is that a shareholder has no right to a dividend whether cumulative or otherwise till there are profits available.

The recent case of *First Garden City* v. *Bonham Carter* is a further and somewhat unexpected application of the judgment in Walkley's case. In that instance the articles of the company provided for the payment upon all its ordinary shares of a cumulative dividend not exceeding 5 per cent., but no provision was made as to how any arrears would be dealt with. The ordinary shares had been issued in blocks from time to time over a number of years, and the question arose as to the rights of the holders of such shares to participate in the paying off of a certain portion of accumulated arrears. It was contended for the holders of shares issued on the earliest dates that they were entitled to a priority over the holders of shares issued on later dates, and that they were entitled to exhaust the fund available for paying off arrears. It was found, however, that no such priority existed, and that the fund available for paying off arrears must be ratably divided amongst the holders of all the shares in proportion to the amount of arrears owing to them.

In his opinion *In re Walkley*, Lord Justice Younger expressed the view that the principle of that decision would not deprive the holders of shares which might have been issued on earlier dates of their right to receive the whole fund available for dividend, but Tomlin, J., in giving judgment in the *First Garden City* case, observed: 'I can find nothing in the nature of a priority. The dividend, having regard to *re Walkley*, is quite clearly a dividend for the current year, and it seems to me consistent with the decision of the court that I should hold that, in the absence of something which gives an express priority to one year over another, all the shares have to rank pari passu in regard to their total claim in respect of all the years'."

This decision may not, of course, apply as a precedent in the jurisdiction your correspondent has in mind.

Answer No. 2: In this problem it is set forth that a corporation was formed in 1925, with an authorized capital stock of $1,000,000 consisting of 10,000 shares of $100 par stock said to be preference shares conferring upon the holders the right to a fixed cumulative preferential dividend at the rate of 7 per cent. per annum on the amount paid up thereon from time to time. This problem emphasizes the fact that ridiculous situations are created by carelessness at the formation of corporations.

The authorization of "preference" shares carries with it the implication of another or other classes of shares against which the preference is exercised, but here it is stated that the entire 10,000 shares are "preference" shares and it can not be considered that it was intended that the preference should operate merely within this one class of stock in respect to groups of shares issued at different dates. It must be concluded, therefore, that the term "preference" is meaningless and by the same reasoning that the term "cumulative" is also meaningless.

If the above be conceded, it must then appear that the situation is precisely the same as though the stock in question had been called common stock and that all stock outstanding at the date of a dividend would be entitled to the same treatment.

It would be interesting to know under what conditions the issues of 1928 and 1931 were marketed. Was it suggested that stock previously issued would have preferential treatment in the matter of dividends over that to be accorded to new stock? If the new stockholders were advised of such a limitation on the value of their stock, they would doubtless be bound. If they were not advised except through the imprint of the dubious paragraph on stock certificates, it seems to me they have a right to expect parity with all stock previously issued.

The suggestion that the stock sold in 1931 carried in its purchase price consideration some value for accrued dividends does not seem to be tenable. On the other hand, the suggestion which is advanced from the viewpoint of the corporation that it would seem unjust to pay dividends accrued for seven years upon money that had been invested only for a few months seems to be entirely valid.

The common sense view of the situation is that the original capital contribution of $500,000 had not earned any profit up to December 31, 1931, and was, therefore, not entitled to any dividends up to that time. The same is true of the stock issued in 1928, so that at December 31, 1931, none of the stock outstanding had earned or was entitled to any dividend. Therefore, unless the charter specifically provided for preference as between the respective issues, all stock outstanding at December 31, 1931, was entitled to the same treatment in subsequent periods.

This narrows the discussion to an interpretation of the phrase "on the amount paid up thereon from time to time." It certainly is not clear that this phrase was meant to distinguish between groups of shares but rather was meant to care for the possibility of shares being issued with provision for part payment at various dates.

The problem submitted does not, of course, involve any accounting principles but merely calls for an interpretation of a vague declaration in the charter. It is not surprising that lawyers differ on it.

You ask me to cite court cases where possible. It does not seem to me that you could obtain any court cases which would fit.

I venture the opinion, however, that if the matter were brought before a court, it would be decided that these shares were in effect common stock and that dividends after December 31, 1931, should be distributed equally to all shareholders.