"important only in so far as deciding whether the dividend decision was intrinsically fair."

The plaintiff claimed that the dividends were unfair on the theory that, given prevailing interest rates in the late 1970s, the rate of return on reinvested funds exceeded the rate of arrearage accruals, permitting Eurgasco to reinvest the funds so as to cause the eventual payment of arrearages on both issues of preferred. The court rejected the claim and ruled that the dividends were intrinsically fair, and that the plaintiff's case against the dissolution proceeding accordingly was moot. The court gave two reasons. First, high returns on reinvested funds were not certain at the time the decision to make the dividends was made in 1977. At the rate levels prevailing in 1977, it would have taken until 2024 to pay down all the arrearages. That the higher rates prevailing in 1978–1983 would have brought forward the payoff date to 1991 did not change matters. Second, the board owed fiduciary duties to the first preferred as well as the second preferred. Had the board decided to retain the funds, the first preferred might have successfully claimed a breach of fiduciary duty. Citing *Baron v. Allied Artists,* the court stated that "[i]n keeping with prudent business management, the board of directors does have a fiduciary duty to see that preferred dividend arrearages are brought up to date as soon as possible."

Suppose you were the judge presiding over Exxon's Delaware proceeding to dissolve Eurgasco. How would you rule?

(B) BY MERGER

Bove v. The Community Hotel Corporation of Newport, Rhode Island

Supreme Court of Rhode Island, 1969.
105 R.I. 36, 249 A.2d 89.

■ JOSLIN, J.

[The plaintiffs held shares of $100 par value, 6 percent cumulative preferred stock of The Community Hotel Corporation of Newport, Rhode Island. Dividends on the 4,335 outstanding shares of the stock had not been declared for 24 years; dividend arrearages totaled $645,000, or $148.75 per share.

[The board of Community Hotel organized a shell corporation called Newport Hotel Corp. and caused Community Hotel to agree to merge into it. Under the merger, each of Community Hotel's outstanding 6 percent preferred shares, together with all accrued dividends, would be converted into 5 shares of Newport common; each share of Community Hotel's outstanding 2,106 shares of common stock would be converted into one share of Newport common. Under section 7–5–3 of the Rhode Island statute, the merger required the approval of the holders of two thirds of each class of stock.

[The court affirmed a judgment denying the issuance of an injunction against the accomplishment of the merger.]

It is true, of course, that to accomplish the proposed recapitalization by amending Community Hotel's articles of association under relevant provisions of the general corporation law would require the unanimous vote of the preferred shareholders, whereas under the merger statute, only a two-third vote of those stockholders will be needed. Concededly, unanimity of the preferred stockholders is unobtainable in this case, and plaintiffs argue, therefore, that to permit the less restrictive provisions of the merger statute to be used to accomplish indirectly what otherwise would be incapable of being accomplished directly by the more stringent amendment procedures of the general corporation law is tantamount to sanctioning a circumvention or perversion of that law.

The question, however, is not whether recapitalization by the merger route is a subterfuge, but whether a merger which is designed for the sole purpose of cancelling the rights of preferred stockholders with the consent of less than all has been authorized by the legislature. The controlling statute is § 7–5–2. Its language is clear, all-embracing and unqualified. It authorizes any two or more business corporations *which were or might have been organized* under the general corporation law to merge into a single corporation; and it provides that the merger agreement shall prescribe "* * * the terms and conditions of consolidation or merger, the mode of carrying the same into effect * * * *as well as the manner of converting the shares of each of the constituent corporations into shares or other securities of the corporation resulting from or surviving such consolidation or merger,* with such other details and provisions as are deemed necessary."[2] (italics ours) Nothing in that language even suggests that the legislature intended to make *underlying purpose* a standard for determining permissibility. Indeed, the contrary is apparent since the very breadth of the language selected presupposes a complete lack of concern with whether the merger is designed to further the mutual interests of two existing and nonaffiliated corporations or whether alternatively it is purposed solely upon effecting a substantial change in an existing corporation's capital structure.

Moreover, that a possible effect of corporate action under the merger statute is not possible, or is even forbidden, under another section of the general corporation law is of no import, it being settled that the several sections of that law may have independent legal significance, and that the validity of corporate action taken pursuant to one section is not necessarily dependent upon its being valid under another. * * *

We hold, therefore, that nothing within the purview of our statute forbids a merger between a parent and a subsidiary corporation even under circumstances where the merger device has been resorted to solely for the purpose of obviating the necessity for the unanimous vote which would otherwise be required in order to cancel the priorities of preferred shareholders. * * *

A more basic problem, narrowed so as to bring it within the factual context of this case, is whether the right of a holder of cumulative preferred stock to dividend arrearages and other preferences may be cancelled by a

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2. The quoted provision is substantially identical to the Delaware merger statute (Del.Rev.Code (1935) C. 65, § 2091) construed in Federal United Corp. v. Havender, 24 Del.Ch. 318, 11 A.2d 331.

statutory merger. That precise problem has not heretofore been before this court, but elsewhere there is a considerable body of law on the subject. There is no need to discuss all of the authorities. For illustrative purposes it is sufficient that we refer principally to cases involving Delaware corporations. * * *

* * * [The Court contrasted the Delaware Supreme Court's decision in Keller v. Wilson & Co., 21 Del.Ch. 391, 190 A. 115 (1936), which ruled that the statutory power authorizing stockholders to amend charters did not permit an amendment cancelling accrued dividends on preferred stock, with its 1940 decision in Federal United Corp. v. Havender, 24 Del.Ch. 318, 11 A.2d 331 (1940), which ruled that the Delaware merger statute did authorize cancellation of such accruals by merger with a wholly-owned subsidiary, even though the effect of the merger was identical to that of a prohibited charter amendment. The Court then continued:]

The *Havender* approach is the one to which we subscribe as being the sounder, and it has support in the authorities. * * *

The plaintiffs do not suggest, other than as they may have argued that this particular merger is a subterfuge, that our merger statute will not permit in any circumstances a merger for the sole reason that it affects accrued, but undeclared, preferred stock dividends. Rather do they argue that what should control is the date of the enactment of the enabling legislation, and they point out that in *Havender,* Federal United Corp. was organized and its stock was issued subsequent to the adoption of the statute authorizing mergers, whereas in this case the corporate creation and the stock issue preceded adoption of such a statute. That distinguishing feature brings into question what limitations, if any, exist to a state's authority under the reserved power to permit by subsequent legislation corporate acts which affect the preferential rights of a stockholder. More specifically, it raises the problem of whether subsequent legislation is repugnant to the federal and state constitutional prohibitions against the passage of laws impairing the obligations of contracts, because it permits elimination of accumulated preferred dividends by a lesser vote than was required under the law in existence at the time of the incorporation and when the stock was issued.

The mere mention of the constitutional prohibitions against such laws calls to mind Trustees of Dartmouth College v. Woodward, 17 U.S. 518, 4 Wheaton 518, 4 L.Ed. 629, where the decision was that a private corporation charter granted by the state is a contract protected under the constitution against repeal, amendment or alteration by subsequent legislation. Of equal significance in the field of corporation law is Mr. Justice Story's concurring opinion wherein he suggested that application of the impairment clause upon acts of incorporation might be avoided if a state legislature, coincident with granting a corporate charter, reserved as a part of that contract the right of amendment or repeal. With such a reservation, he said, any subsequent amendment or repeal would be pursuant, rather than repugnant, to the terms of the contract and would not therefore impair its obligation.

not necessarily constitute an improper exercise of the right of amendment reserved merely because it was subsequent.

* * * [P]laintiffs also contend that [the merger] is unfair and inequitable to them, and that its consummation should, therefore, be enjoined. By that assertion they raise the problem of whether equity should heed the request of a dissenting stockholder and intervene to prevent a merger notwithstanding that it has received the vote of the designated proportions of the various classes of stock of the constituent corporations.

* * *

This case involves a merger, not a recapitalization by charter amendment, and in this state the legislature, looking to the possibility that there might be those who would not be agreeable to the proposed merger, provided a means whereby a dissatisfied stockholder might demand and the corporation be compelled to pay the fair value of his securities. G.L.1956, §§ 7–5–8 through 7–5–16 inclusive. Our inquiry then is to the effect of that remedy upon plaintiff's right to challenge the proposed merger on the ground that it is unfair and inequitable because it dictates what shall be their proportionate interests in the corporate assets. Once again there is no agreement among the authorities. Vorenberg, ''Exclusiveness of the Dissenting Stockholder's Appraisal Right,'' 77 Harv.L.Rev. 1189. See also Annot. 162 A.L.R. 1237, 1250. Some authorities appear to say that the statutory remedy of appraisal is exclusive. Beloff v. Consolidated Edison Co., 300 N.Y. 11, 87 N.E.2d 561; Hubbard v. Jones & Laughlin Steel Corp., D.C., 42 F.Supp. 432. Others say that it may be disregarded and that equity may intervene if the minority is treated oppressively or unfairly, Barnett v. Philadelphia Market Co., 218 Pa. 649, 67 A. 912; May v. Midwest Refining Co., 1 Cir., 121 F.2d 431, cert. denied 314 U.S. 668, 62 Sup.Ct. 129, 86 L.Ed. 534, or if the merger is tainted with fraud or illegality, Adams v. United States Distributing Corp., 184 Va. 134, 147, 34 S.E.2d 244, 250, 162 A.L.R. 1227; Porges v. Vadsco Sales Corp., 27 Del.Ch. 127, 32 A.2d 148. To these differing views must also be added the divergence of opinion on whether those in control or those dissenting must bear the burden of establishing that the plan meets whatever the required standard may be. Vorenberg, supra; 77 Harv.L.Rev. 1189, 1210–1215.

In this case we do not choose as between the varying views, nor is there any need for us to do so. Even were we to accept that view which is most favorable to plaintiffs we still would not be able to find that they have been either unfairly or inequitably treated. The record insofar as it relates to the unfairness issue is at best sparse. In substance it consists of the corporation's balance sheet as of September 1967, together with supporting schedules. That statement uses book, rather than the appraised, values, and neither it nor any other evidentiary matter in any way indicates, except as the same may be reflected in the surplus account, the corporation's earning history or its prospects for profitable operations in the future.

Going to the figures we find a capital and surplus account of $669,948 of which $453,000 is allocable to the 4,530 issued and outstanding shares of $100 par value preferred stock and the balance of $216,948 to surplus.

Obviously, a realization of the book value of the assets in the event of liquidation, forced or otherwise, would not only leave nothing for the common stockholders, but would not even suffice to pay the preferred shareholders the par value of their stock plus the accrued dividends of $645,000.

If we were to follow a rule of absolute priority, any proposal which would give anything to common stockholders without first providing for full payment of stated value plus dividend accruals would be unfair to the preferred shareholders. It could be argued that the proposal in this case violates that rule because an exchange of one share of Community Hotel's preferred stock for five shares of Newport's common stock would give the preferred shareholders securities worth less than the amount of their liquidation preference rights while at the same time the one to one exchange ratio on the common would enrich Community Hotel's common stockholders by allowing them to participate in its surplus.

An inherent fallacy in applying the rule of absolute priority to the circumstances of this case, however, is its assumption that assets would be liquidated and that nothing more than their book value will be realized. But Community Hotel is not in liquidation. Instead it is a going concern which, because of its present capitalization, cannot obtain the modern debt-financing needed to meet threatened competition. Moreover, management, in the call of the meeting at which it was intended to consider and vote on the plan, said that the proposed recapitalization plan was conceived only "* * * after careful consideration by your Board of Directors and a review of the relative values of the preferred and common stocks by the independent public accountants of the Corporation. The exchange ratio of five new common shares for each share of the existing preferred stock was determined on the basis of the book and market values of the preferred and the inherent value of the unpaid preferred dividends." Those assertions are contained in a document admitted as an exhibit and they have testimonial value.

When the varying considerations—both balance sheet figures and management's assertions—are taken into account, we are unable to conclude, at least at this stage of the proceedings, that the proposed plan is unfair and inequitable, particularly because plaintiffs as dissidents may avail themselves of the opportunity to receive the fair market value of their securities under the appraisal methods prescribed in § 7–5–8 through § 7–5–16 inclusive.

The plaintiffs argue that due consideration will not be given to their dividend accruals under the appraisal. We do not agree. Jeffrey v. American Screw Co., 98 R.I. 286, 201 A.2d 146, requires that the securities of a dissident invoking the statute must be appraised by a person "versed in the intricacies of corporate finance." Such a person will find when he looks to *Jeffrey* for guidance that the evaluation process requires him to consider "* * * all relevant value factors including market value, book value, asset value, and other intrinsic factors probative of value." Certainly, unpaid dividend arrearages fall within that directive and are a relevant factor to be considered in arriving at the full and fair cash value of the plaintiffs' preferred stock. While we make no decision one way or the other on the exclusiveness of appraisal as a remedy for a dissident, we do decide that its availability is an element or a circumstance which equity should weigh before intervening. When that is done in this case, we find no ground for intervention.

For the reasons stated, the judgment appealed from is affirmed.

NOTE: THE INVESTMENT VALUE DOCTRINE

The *Bove* court rejects the proposition that liquidation value should be taken as a measure of the value of the rights of the preferred. This gives rise to a problem, whether in the context of an appraisal proceeding or a determination whether good faith or fiduciary duties owed to the preferred have been violated. How, from a valuation perspective, is a court to determine whether a reallocation of rights (and hence of value) is or is not fair? It is often asserted that the allocative problems attending equity recapitalization are intractable when reviewed for fairness *ex post*. Historical precedent arguably falsifies that claim.

The Public Utility Holding Company Act of 1935 called for a breakup of the huge public utility holding companies which had been assembled during the previous two decades. Generally speaking, it sought to restrict their operations to one or more systems whose operations were integrated and confined to a single State and States contiguous thereto. It also had as one of its major objectives the simplification of the corporate and capital structures of holding company systems and the redistribution of voting power among security holders on a fair and equitable basis.

The volume and complexity of the corporate and capital structures which were required to be simplified and the nature and scope of the geographical dispersion of the properties required to be integrated presented difficult and novel problems. The SEC had the task of resolving these problems. Opponents of the legislation had asserted that the law would cause dumping and forced liquidation of securities, demoralizing the trading markets. They characterized the integration and simplification requirements as a ''death sentence.'' The Congress, on the other hand, contemplated that this program should not and need not destroy any legitimate investment values. It gave the SEC a mandate to bring about the required integration and simplification in keeping with that objective.

Compliance with the integration and simplification requirements took various forms. They included liquidations, mergers and consolidations, separation of large systems into smaller, integrated systems, divestment of nonutility properties unrelated to the utility business, sale of nonretainable utility properties to other systems with whose properties they could be integrated, sale of the securities of nonretainable subsidiaries to the public at competitive bidding or pursuant to a rights offering to stockholders of the parent company and distribution of securities pro rata among stockholders.

The Commission was authorized to approve a simplification plan under Section 11(e) of the Act only if, *inter alia,* it found the plan to be ''fair and equitable'' (15 U.S.C. § 79k), the same formula which Congress had formerly embedded in Section 77 (11 U.S.C. § 205) and Section 77B (48 Stat. 912) of the Bankruptcy Act, and later inserted in Chapter X of the Bankruptcy Act. In ruling upon simplification plans, the Commission developed a so called ''investment value'' doctrine to implement the ''fair and equitable'' standard contained in Section 11. That doctrine was designed to meet the problem created by the disparity—often substantial—