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the wrong that would have gone unremedied had the common law been followed, the court heeded the dictates of common sense as well as basic morality. In the language of the court, a rule of law carried to its extreme conclusion is often extreme injustice.

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PREFERRED'S RIGHT TO SURPLUS IN ABSENCE OF AN EXPRESS LIQUIDATION PROVISION

Priorities as between classes of stock are creatures of contract.[1] If one class of stock has a priority to dividends over another class of stock, it is commonly referred to as "preferred stock". Preferred stock can, by express provision, be given a priority as to return of the capital investment on dissolution. It quite often is also preferred on dissolution to an amount equal to the unpaid and accrued dividends. The articles of incorporation may state or deny many other priorities or rights to preferred stock.

In the absence of an express provision in the articles of incorporation, creating a priority or right for preferred stock on dissolution, several problems can arise. It has been generally accepted that if on dissolution *capital* remains to be distributed, the so-called "equality rule" is applied in the absence of an express provision for capital distribution on dissolution.[2] Under the "equality rule" all classes of stock share in the distribution in proportion to their investment. However, if on dissolution, after payment of the corporate debts, and after return of the capital investment to all classes of stock, assets remain to be distributed, the question arises as to the respective rights of each class of stock to such *surplus* in the absence of an express provision covering *surplus* distribution on dissolution.

Four variations of this problem can arise:

FACT SITUATION NUMBER 1:

a) Preferred has a prority as to dividends, but none accrued or unpaid.
b) Preferred has a liquidation preference as to *capital*, but there is no provision for the distribution of *surplus* on dissolution.
c) Assets to be distributed on dissolution, after payment of debts, are greater than capital, therefore *surplus* remains to be distributed as well as *capital*.

1. Hamlin v. Toledo, St. L. & K.C. R. Co., 78 Fed. 664, 36 L.R.A. 826 (6th Cir. 1897); Llovd v Pennsylvania Electric Vehicle Co., 75 N.J. Eq. 263, 72 Atl. 16, 21 L.R.A. (N.S.) 228, 138 Am. St. Rep. 557, 20 Ann Cas. 119 (1909); Williams v. Renshaw, 220 App. Div. 39, 220 N.Y.S. 532 (1927); Drewry, Hughes Co. v. Throckmorton, 120 Va. 859, 92 S.E. 818 (1917). See also 1 COOK ON CORPORATIONS sec. 269 7th ed. 1913); 11 FLETCHER CYCLOPEDIA CORPORATIONS sec. 5295 (per. ed. 1932); and 1 MACHEM sec. 525 (1st ed. 1908).
2. Guaranty Trust Co. v. Galveston City R. Co., 107 Fed. 311 (5th Cir. 1901); Teller v. Wilcoxen, 110 Iowa 565, 81 N.W. 772 (1900); Coltrane v. Baltimore, etc. Assoc., 110 Fed. 281 (1901); People v. New York, etc., Co., 50 N.Y. Misc. Rep. 23 (1906). See also 5 THOMPSON ON CORPORATIONS sec. 6590 (2d ed. 1910); 1 COOK ON CORPORATIONS sec. 278 (7th ed. 1913); 1 MACHEN, MODERN LAW OF CORPORATIONS sec. 564 (1st ed. 1908).

FACT SITUATION NUMBER 2:
a) No accured or unpaid dividends.
b) No liquidation provision for either capital or surplus.
c) Surplus.

FACT SITUATION NUMBER 3:
a) Dividends accrued and unpaid.
b) Liquidation provision only as to capital.
c) Surplus.

FACT SITUATION NUMBER 4:
a) Dividends accrued and unpaid.
b) No liquidation provision for either capital or surplus.
c) Surplus.

In situation number 1 the English courts have recently adopted the "exhaustion rule", which is merely a restatement of the canon of construction: *expressio unius est exclusio alterius.*[3] Under this rule an expression in the articles of incorporation of one liquidation right of priority (such as to return of capital investment) excludes or exhausts the possibility of any other participation on dissolution (such as to surplus). This rule was approved by the House of Lords as the proper rule for fact situation number 1 in the 1949 case of *Scottish Insurance Corporation v. Wilsons & Clyde.*[4] Prior to this case and since 1932 the "equality rule", as set out in *In re William Metcalfe,*[5] had been applied to fact situation number 1. It was held in the *Metcalfe* case that:

> ". . . when there are surplus assets left over they are to be dealt with as between the members on the basis of equality, whatever were the original and limited rights of the preference shareholders earlier."[6]

The *Metcalfe* case, however, was expressly overruled by the *Scottish Insurance* case. Which of these two rules is the more desirable solution for situation number 1 will be later discussed, but the important fact to note is that the "exhaustion rule" is the law of England today for fact situation number 1.

The American authority on fact situation number 1 is weak but seemingly in line with the present English view. Only two cases are to be found: a New York decision, *Williams v. Renshaw,*[7] and a Missouri case, *Murphy v. Richardson Dry Goods Co.*[8] In the *Williams* case the the majority of the court construed what seemed to be an ambiguous dissolution provision to be preference only as to par return. The court then went on to say:

3. Scottish Insurance Corporation v. Wilsons & Clyde, 1949 A.C. 462. In re Isle of Thanet Electricity Supply Co., Ltd., 1949 2 All E. R. 1060, 1950 Ch. 161.
4. 1949 A.C. 462.
5. 1933 Ch. 142.
6. Id. at 155.
7. 220 App. Div. 39, 220 N.Y.S. 532 (1927).
8. 326 Mo. 1, 31 S.W.2d 72 (1930).

"The language in the instant case provides for the 'winding up' and specifies the amount to be received. *This is exclusive of other amounts.*"[9] (Italics supplied)

The *Murphy* case was decided along much the same line of reasoning and cites the *Williams* case with approval. However, whether either of these cases is authority, even in its own jurisdiction, for the proposition that the "exhaustion rule" should be applied to fact situation number 1, is open to question. There is language in the *Williams* case to suggest that the holding, as set out above, was based on an implied restriction in the preferred share contract, rather than by applying the "exhaustion rule" to an express liquidation provision:

"When the second preferred stock is paid at 'par', it no longer exists. It is automatically eliminated. . . . The meaning to be ascribed to such language is that second preferred stockholders should be paid 'in full' and that '*payment in full*' means that they should receive payment 'at par', and that payment made to them, when made at *par*' shall be in *full.* This conclusion eliminates necessity of discussion of the English authorities cited by the appellant. . . ."[10]

Whether such language is sufficient to distinguish the *Williams* case and the *Murphy* case from any application of the "exhaustion rule", is open to question. However, both of these cases cite with approval the English case of *In re National Telephone Co.* in which it was held that:

". . . attachment of preferential rights to preferential shares on their creation, is, primae facie, a definition of the whole of their rights . . . and negatives any further or other right. . . ."[11]

This approach certanly would indicate that the New York courts and the Missouri courts are inclined toward the application of the "exhaustion rule" to fact situations where there is a provision for return of capital, but no provision for the distribution of surplus on dissolution. Added authority for the "exhaustion rule" might also be found in the dictum of an Ohio case which indicated that one provision for liquidation might exclude an implication of any other.[12]

In situation number 2, where there are no unpaid dividends and no provision for distribution of either surplus or capital, both the American and English case law is extremely weak In the American case of *Continental Insurance Co. v. Reading Co.*,[13] the court held that preferred and common should share equally in the distribution of assets on dissolution. The court based its decision upon construction of the articles of incorporation, but went on to say:

"it (meaning their construction of the articles) is, however,

9. Supra note 7, at 536.
10. Ibid.
11. 1914 1 Ch. 755, 774.
12. Hatch v. Newark Telephone Co., 34 Ohio App. 361, 376, 170 N.E. 371, 376 (1930).
13. 259 U.S. 156, 42 S. Ct. 540 (1922).

in accord with the general common law rule that stockholders, common and preferred, share alike in the assets of a liquidating corporation, if the preference is only as to divididends."[14] (Italics supplied)

Thus it would seem that situation number 2 is covered by the "equality rule". However, the rule as set out in the *Continental* opinion does not state whether all the assets of a dissolving corporation are distributed by the "equality rule" or just the assets representing *capital.* An analysis of the cases cited supporting the so-called "common law rule" seems to indicate that the "rule" is limited to *capital* distributions. Two of the cases cited make such a distinction, *Lloyd v. Pennsylvania Electric Vehicle Company*[15] and *Birch v. Cropper.*[16] In the *Lloyd* case no surplus actually existed and the funds being distributed on dissolution actually represented return of the capital investment; however, the court, by way of dictum, approved *Birch v. Cropper* and the application of the "equality rule" to fact situation number 2, where there is no liquidation provision whatsoever.[17] *Birch v. Cropper,* an early English case, held that assets representing surplus and due to the sale of assets pursuant to dissolution are to be "distributed among the shareholders in proportion to their shares."[18] Thus, by the *Lloyd* case's approval of the English case, it might be said that this dictum is some authority in the United States in support of the "equality rule". Further authority favoring the application of the equality rule to situation number 2 might be found in *Williams v. Renshaw,* in which the concurring opinion refers to the *Continental* case as "a case in which a preference was confined to dividends only, and the court held that, in distribution of capital assets, the two stocks stood equal."[19] It would at first appear that the use of the word "capital" in his quotation would limit the rule of the *Continental* case to *capital* distributions, but by reading on in the opinion of the *Williams* case it will be noted that the term "capital assets" is used very loosely and probably would include *surplus* distributions.

All that can be said for the case law concerning fact situation number 2 is that it is weak, ambiguous and consists mostly of dictum.

Situations number 3 and 4 present an interesting variation of situations number 1 and 2. Here, to the lack of an express liquidation provision, is added the additional problem of dividends being accrued and unpaid on the preferential shares.

In situation number 3, where there is a liquidation provision as to capital but not as to surplus, there seems to be no case law. It might be

14. Id. at 548.
15. 75 N.J. Eq. 263. 72 Atl. 16, 21 L.R.A. (N.S.) 228, 138 Am. St. Rep. 557, 20 Ann. Cas. 119 (1909).
16. 14 A.C. 525 (1889).
17. 72 Atl. 16, 18 (N.J. 1909). See note 15, supra.
18. Supra note 16, at 548.
19. Supra note 7, at 537.

presumed that the "exhaustion rule" should be applied here inasmuch as it was applied to parallel situation number 1. It would follow here, also, that an expression of one liquidation right would exclude any further participation on liquidation.

Situation number 4 is parellel to situation number 2 in that there is surplus to be distributed, but there is no liquidation provision in the articles of incorporation to control either capital distribution or surplus distribution. The variation between situation number 2 and situation number 4 lies in the fact that in situation number 2 there are dividends accrued and unpaid on the preferred stock. The question arises as to how this additional fact affects the application of the "equality rule", which it seems has had more favor with the law in situation number 2. The basic philosophy of the "equality rule" is that a share of stock is the same as any other share of stock unless there is an express provision taking away the innate equality.[20] Inasmuch as there is no express liquidation provision in situation number 4, it would seem to follow that the "equality rule" would require that all shares take rateably and thus, preferred would not take its accrued dividend plus a proportionate share of the surplus, but would only take a per cent of the surplus, based on total capital of both classes.

From the foregoing discussion of each fact situation it may be noted, with the exception of situation number 1, that the law has not crystalized into absolute rules. It must be remembered that the solutions set out above in the discussion of fact situations number 2, 3, and 4 are in the most part mere speculations and conjectures as to the rules some courts might be inclined to follow, and that they are adopted mainly from dictums and English cases. However, it is not because of the inadequacy of the case law, but rather due to the unfairness of the rules that a court might follow, that a more equitable theory of surplus distribution is here submitted.

Such a theory of surplus distribution might be evolved from a series of English cases involving the dissolution of the Bridgewater Navigation Company. In 1888, the first *Bridgewater* case was decided.[21] The Court of Appeal there applied the "equality rule" to surplus distribution and the case was affirmed by the House of Lords in the case of *Birch v. Cropper*,[22] in which the rule of equality was modified so that both classes of stock shared in proportion to their capital investment. But in applying the "equality rule", the court made an important distinction:

> ". . . the assets of the company remaining undistributed other than the reserve fund, which is not the subject of this application, ought to be distributed among the shareholders in proportion to their shares."[23]

20. 1 MACHEN, MODERN LAW OF CORPORATIONS secs. 517-523 (1st ed. 1908). 1 COOK ON CORPORATIONS sec. 278 (7th ed. 1913).
21. 39 Ch. 1 (1888).
22. 14 A.C. 525 (1889).
23. Id. at 548.

Thus, it must be noted that only a part of the surplus of the Bridgewater Navigation Company was distributed by the "equality rule". The remainder of the surplus, representing a reserve fund accumulated out of withheld earnings, was adjudicated upon and distributed according to the ruling of the third *Bridgewater* case, *In re Bridgewater Navigation Co.*, decided in 1891 by the Court of Appeal:

> ". . . if it appears that some of those assets consist of undrawn profits of one of these classes, such undrawn profits ought to be distributed amongst the members of that class. . . ."[24]

Thus, it is submitted that the *Bridgewater* cases will support a general theory of surplus distribution in absence of an express provision to the effect that the "equality rule" is only applied to funds, other than capital, if such funds would not have been available for distribution if the corporation were still a going concern; that if the surplus fund was such that it *could have been* distributed as dividend *just prior* to dissolution, then such funds should be distributed in dissolution according to the dividend scheme set out in the articles. *Birch v. Cropper* supports the first part of this general theory. There the surplus fund represented realized appreciation of assets. Such surplus would not have been available for distribution while the Bridgewater Navigation Co. was still a going concern because the articles of this company limited payment of dividends only "out of the profits of the company arising from the business".[25] Thus, by analysis of the source of the surplus fund it can be seen that at no time did either common or preferred have a contingent claim against the surplus adjudicated in that case. However, the surplus fund considered in the third *Bridgewater* case[26] did represent accumulated earnings and could have been distributed as dividends just before dissolution. It was held that since this surplus fund would have been available to the common stock for dividends after payment of preferred's set rate, the mere fact that dissolution had intervened did not change the fact that the surplus actually belonged to the common shareholders and, therefore, should be distributed to them on dissolution. This holding supports the second part of the general theory set out above.

Whether this group of English cases would be authoritative, even in England, is open to question. It has been over sixty years since the House of Lords decided *Birch v. Cropper*. In a recent case before the House of Lords the third *Bridgewater* case was criticized:

> "I have to doubt that this was a correct decision, and there was no appeal."[27]

In the same case Lord Simonds inserted a possible protest against the general theory evolved from the *Bridgewater* cases:

24. 2 Ch. 317, 329 (1891).
25. Supra note 21, at 2.
26. See note 24, supra.
27. Supra note 4, at 482.

"... the profits though undrawn, belong, subject to the payment of the preference dividend, to the ordinary stockholders and in so far as surplus assets are attributable to undrawn profits, the preference stockholders have no right to them. This appears to follow from the decision of the Court of Appeal in *In re Bridgewater Navigation Company* (*1*), in which the judgment of the House of Lords in *Birch v. Cropper* (2) is worked out. This again is not decisive of the construction of the particular articles, but *I am unwilling to suppose that the parties intended a bargain which would involve an investigation of an artificial and elaborate character into the nature and origin of the surplus assets.*"[28] (Italics supplied)

Thus, it would seem that the Bridgewater cases might be doubtful authority in England today. However, this is not to say that the theory of surplus disribution evolved from these cases is without support.[29] A dictum in an American case, *Niles v. Ludlow Valve Mfg. Co.*,[30] might be persuasive authority for such a theory. There the court was faced with the problem of surplus distribution of a going concern in absence of an express provision. The court based its reasoning on what rights preferred would have on dissolution as to surplus. The court reasoned that if the surplus were due to an unearned increment attaching to the corpus of the corporation, the preferred might have an interest in the surplus: but if the fund were due to accumulated annual profits, "such profits when and as earned, belonged to the common shareholders (after paying 8 per cent to the preferred), they did not cease so to belong by failure to pay them out in annual dividends."[31]

The proposed theory for surplus distribution might be restated as follows:

In absence of an express provision govering the distribution of surplus on dissolution, such surplus should be distributed in accordance with the dividend scheme if the surplus is such as would have been available for dividend distribution if the concern had not gone into dissolution; but if the surplus fund would not have been available for dividend distribution, then such surplus should be distributed according to the "equality rule".

Applying this theory to the four fact situations set out above, it will be noticed that the results in each situation will usually vary from the results of the application of the rules it was believed that some courts might be inclined to follow . Application of this theory, however, requires knowledge of additional facts from those set out in each fact situation. It requires an investigation of the source of the surplus and an examination of the statutes and articles of incorporation for restrictions on declaration of dividends.

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28. Supra note 4, at 488.
29. See 81 U. Pa. L. Rev. 875, also suggesting application of the theory set out in this article.
30. 196 Fed. 994 (S.D.N.Y. 1912), affirmed in 202 Fed. 141 (2d Cir. 1913).
31. Id. at 996.

Thus, in situation number 1 the doctrine of *expressio unius est exclusio alterius* or the "exhaustion rule" has no application, since the capital will be distributed according to the express provision of the articles and the surplus will be distributed by the provisions governing dividends if such surplus were available just before dissolution for dividend distribution; and if the surplus were such that it would not have been available for dividends if dissolution has not intervened, then it will be distributed according to the "rule of equality".

In situation number 2, where there is no liquidation provision for distribution of either capital or surplus, the "equality rule" is applied also, only of the surplus fund would not have been available for dividends if there had been no dissolution.

In fact situations number 3 and 4, the accrued dividends on the preferred shares would be paid on dissolution and common would be entitled to the remainder, if the articles so provided and the surplus was derived from a legal source for the declaration of dividends. If the surplus, however, was not such as would have been available for dividends, then the "rule of equality" would be applied and the surplus fund would be divided rateably among the classes of shares.

Although the direct authority for the surplus theory proposed in this article is limited to the *Bridgewater* cases and the dictum of the *Niles* case, the logic and the fairness of the rule should be convincing enough to overcome the deficiency of authority. It should also be pointed out that the direct authority for any other rule is also very limited and weak. Thus, it is submitted that the theory of surplus distribution herein evolved should be applied to all four fact situations. This results in a more fair and equitable distribution on dissolution.

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