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Robert Schaus

known legal meaning.[117] Nevertheless, it is only fair to add that the aim of the default procedures of Article 9 is to promote disposition of collateral at the highest possible price, both for the benefit of the secured party and the debtor, by providing for sale through regular market channels rather than through public sale where collusive agreements are not uncommon.

It is felt that the advantages of the Secured Transactions Article of the Code outweigh its disadvantages. What is lost in new and revolutionary terminology, and in spelling out too minutely the rights and obligations of the parties, is gained in certainty, simplicity and uniformity.*

Sheldon Hurwitz
Ralph L. Halpern
Robert S. Gottesman

ELIMINATION OF ACCRUED DIVIDENDS—COMPARISON OF NEW YORK AND DELAWARE LAW

Introduction

Corporations emerging from a general economic depression or the profitless first years of business are confronted with the problem of heavy arrearages on cumulative preferred shares. To the corporate management these arrearages constitute a millstone: they drag down the market price of the corporation's stock, thereby undermining any attempted venture to raise new capital by sale of stock; they depreciate the corporation's credit status; and lastly, the aggravate the impatience of the common shareholders. Is there any legal way the corporation can shake off this dead weight? The answer given by the courts of New York and of Delaware is the scope of this comment.[1]

117. But see U. C. C. § 9-507 (2): "The term commercially reasonable includes, among other things, obtaining approval of the secured party's place of disposition in a judicial proceeding or by a bona fide creditors' committee or representative of the creditors." The fact that a better price could have been obtained is not in itself sufficient to establish that the sale was not commercially reasonable.

* The New York State Law Revision Commission will undertake a study of the proposed Code before it is presented to the New York legislature. N. Y. Times, Feb. 9, 1953, p. 37, col. 5. It is contemplated that this study will be divided into three phases: a comparison with present law, public hearings, and a recommendation to the legislature. It is understood that this will not be completed for the 1954 session of the New York legislature.

1. The historical background of this problem began in 1819. In that year the U. S. Supreme Court, per Chief Justice Marshall, decided that a corporate charter was a contract, protected by the Constitution from impairment in its essential form. *Trustees of Dartmouth College v. Woodward,* 4 Wheat. 518 (U. S. 1819). Story, J., added that

New York

The first case on the subject presented to the New York Court of Appeals was *Roberts v. Roberts-Wicks Co.*, in 1906.[2] The Roberts-Wicks Co. was chartered in 1895. The law then existing permitted a corporation to increase or reduce its capital stock by vote of the stockholders;[3] there was no other statutory authority which could be interpreted to allow a cancellation of accrued dividends. The plaintiff was the holder of cumulative preferred shares. From 1901 to 1904, the Roberts-Wicks Co. paid no preferred dividends. In 1904 it reduced its preferred stock. The plaintiff voted against reduction but the requisite percentage was attained. New certificates were issued to represent the reduced preferred stock. Six months later the corporation declared a dividend, dated from the exchange of the old certificates for the new. It also declared a dividend payable to the common shares. Plaintiff claimed that before any dividends could be paid to the common, he was first entitled to the arrearages that had built up from 1901 to 1904. The Court of Appeals declared that the accumulation provision in plaintiff's old certificates was a binding contract between the company and the preferred stockholders; that the law authorizing the corporation to increase or decrease its capital stock was not intended to allow the cancellation of arrearages, but only increases or decreases in the capital stock; and that even if the statute did authorize an elimination of arrearages, it could not affect any vested rights, nor impair the force of any corporate obligation. The two important points to be extracted from *Roberts v. Roberts-Wicks Co.* are: the New York corporate law then existing did not authorize a corporation by vote of its stockholders to directly cancel accrued dividends; and if the statute did authorize such a cancellation, it would be unconstitutional, as a violation of a vested right.

About the same time the Court of Appeals was considering *Roberts v. Roberts-Wicks Co.*, the Appellate Division was hearing *Hinckley v. Schwarzchild and Co.*[4] There, defendant corporation

a corporation was subject to no control other than that expressly or impliedly reserved by the charter itself *Id.* at 675, 712. The decision had two effects: it conferred constitutional protection upon corporate charters; and it initiated state activity to insert reserved clauses. N. Y. CONST. Art. 10, § 1; N. Y. GEN. CORP. LAW § 5; DEL. CORP. LAW § 82. Theoretically speaking, the reserved clause would seem to enable a state, as one party to the "contract", to amend or repeal the charter at will, or to delegate that power to the stockholders. See note, 29 CORNELL L. Q. 114 (1943). But the courts were quick to limit this apparently absolute theoretical authority. See *Coombs v. Getz*, 285 U. S. 434 (1932).

2. 184 N.Y. 257, 77 N.E. 1073 (1906).

3. L. 1890, c. 564, as amended by L. 1892, c. 588.

4. 107 App. Div. 470, 95 N.Y. Supp. 357 (1st Dep't 1905).

was organized in 1893. Only common stock was authorized and issued. The corporation law then existing required the unanimous consent of all common stockholders to the issuance of preferred stock.[5] It was amended in 1901 to require only a two-thirds vote.[6] Shortly afterward, with the requisite two-thirds vote, the corporation issued a new class of preferred stock. The plaintiff, a common stockholder, sued to restrain the new issue on the ground that the statutory authority on which the corporation acted was unconstitutional as to corporations organized prior to the amendment. The Court refused the injunction, declaring that the amendment was a valid exercise of the reserved power of the Legislature. The result of the decision was to establish the principle that a corporation could legally issue new preferred stock by a two-thirds vote of its stockholders. Implicit in this principle was the corollary that if a corporation could legally issue new preferred prior to old common, it could also legally issue new preferred prior to old preferred. The implications were momentous. A corporation, with the ostensible purpose of raising new capital by a public sale of stock, could issue prior preferred shares. But instead of offering the stock to the public for cash, the corporation proposes to the old preferred shareholders an exchange of their stock with arrearages for the new preferred. To secure the requisite two-thirds vote, the corporation cloaks the exchange with various attractions, such as a liberal exchange rate, voting rights, or a cash dividend. And if there is any anxiety that a few preferred shareholders who voted against the exchange will stand adamant and demand their arrearages before the common shares receive any dividend, the corporation may impose sanctions, such as excerpting whatever preferential rights it can from the old preferred stock,[7] and setting a time limit for the exchange.[8] Realizing that the existence of the new preferred stock will depreciate the market value of his present holdings, and that it will sink even lower when it is removed from listing on the Stock Exchange,[9] the recalcitrant preferred shareholder generally submits to the exchange. This device for adjusting accrued dividends was first accomplished in *Matter of Dresser,*[10] in 1936, and has been frequently and successfully used since then.[11] No right of appraisal is granted to the dissenting

5. L. 1892, c. 688.

6. L. 1901, c. 354.

7. See 40 COL. L. REV. 633 (1940).

8. For an illustration of the disastrous consequences of this sanction, see *Matter of Druer,* 270 N.Y. 343, 1 N.E. 2d 457 (1936).

9. See 26 MINN. L. REV. 387 (1942).

10. 247 N.Y. 553, 161 N.E. 171 (1928).

11. *Matter of Druer, supra* n. 8; In re *Kinney,* 279 N.Y. 423, 18 N.E. 2d 645 (1939); In re *Woodruff,* 175 Misc. 819, 26 N.Y.S. 2d 679 (Sup. Ct. 1941).

shareholder.[12] The net result of this practice is to allow a corporation to accomplish indirectly what could not be achieved directly under the decision of *Roberts v. Roberts-Wicks Co.* And while it might be argued that there is no cause for complaint by the dissenting preferred shareholder, since he willingly surrenders his arrearage right, the counter argument might be made that this surrender is far from voluntary.[13]

To return to the subject of direct cancellation, in 1923 § 36 of the Stock Corporation Law was enacted,[14] which authorized a corporation to effect changes in respect to preferential rights by a two-thirds vote of the shareholders adversely affected.[15] However, which preferential rights might be legitimately altered were not specifically defined. In 1941, *Davidson v. Parke, Austin and Lipscomb, Inc.*,[16] came before the Court of Appeals. The defendant corporation was organized in 1914, and had issued cumulative preferred shares on which dividends were in arrears. In reliance upon § 36, a resolution was passed by two-thirds of the preferred shareholders to cancel the arrearages. Plaintiff, a preferred shareholder, dissented and sued to have the resolution declared void. The Court of Appeals declared that the issue to be decided was not whether the right of the plaintiff was vested or not, but rather whether § 36, which spoke in general terms of reclassification, included the specific power to reclassify so as to eliminate arrearages. The Court reasoned that there was no express statement of intent in the statute; that when the Legislature enacted the section it must have known of the decision in *Roberts v. Roberts-Wicks Co.*, and by failing to include an express statement on the matter, it implied that it did not intend it. The decision was greeted favorably for its rejection of the "vested rights" argument, which assumes its own conclusion, and for stating the problem in its basic simplicity: Has the Legislature authorized the cancellation of accrued dividends by a less than unanimous consent of the preferred shareholders? And if so, is such procedure constitutional?[17]

Shortly afterward, a second indirect method of adjusting arrearages was achieved in *Zoebel et al. v. American Locomotive Co.*

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12. *Matter of Dresser, supra* n. 10; In re *Kinney, supra* n. 11; *cf. Matter of Silberkraus*, 250 N.Y. 242, 165 N.E. 279 (1929).

13. For a decision disallowing this device solely on this point, see *Patterson v. Durham Hosiery Mills*, 214 N.C. 806, 200 S.E. 906 (1939); and see 55 HARV. L. REV. 1196 (1942).

14. L. 1923, c. 787; its provisions are now found in N. Y. Stock Corp. Law § 35.

15. While § 36 itself spoke of "classification or reclassification," §§ 37 and 38, as then existing, implied that § 36 included alterations of preferential rights.

16. 285 N.Y. 500, 35 N.E. 2d 618 (1941).

17. See 26 MINN. L. REV. 387 (1942); 19 N.Y.U. L. Q. 196 (1942); 29 CORNELL L. Q. 114 (1943).

et al.[18] The defendant corporation had issued cumulative preferred stock in 1901, dividends on which were in arrears in 1943. In that year a merger was proposed with a wholly owned subsidiary, by the terms of which preferred shares with arrearages would be exchanged for other stock plus cash. The merger was approved, but certain minority holders of preferred stock objected, and sued to enjoin the merger on the grounds that it was not in reality a true merger, but a recapitalization brought about through the mechanism of a merger with a wholly owned subsidiary. The Supreme Court refused to grant the injunction prohibiting the merger. It reasoned that the rights of the plaintiffs were contractual, and as such were subject to statutes in existence at the time the stock was issued; that the law at the time the stock was issued allowed a merger with a wholly owned subsidiary, and that consequently plaintiff had no cause to object.[19] The Court added that the fact that the motivating cause of the proposed merger was to wipe out the preferred shareholders' first call upon earned surplus and future profits to the extent of the accumulated arrears of their stock was not relevant, there being no showing that the exchange was so unfair as to amount to fraud or bad faith. When contrasted with the first indirect device,—the issuance of prior preferred—, the second indirect method has, from the viewpoint of the preferred shareholder, one redeeming quality: the dissenting preferred shareholder has the right of appraisal.[20]

While the above case was being heard, the Legislature amended § 36 to read that a "reclassification" under § 36 included the specific power to abolish accumulated dividends.[21] The amendment unequivocally opened the door to the direct method of elimination. The only question remaining was whether it was constitutional. A test case arose in 1945, in *McNulty v. W. & J. Sloane.*[22] The defendant corporation was organized in 1891, long before the amendment. In 1944 its preferred stock was in arrears. A resolution was passed abolishing all the old stock, common and preferred, and creating new common and preferred, with a ratio of exchange of old for new. The plaintiff, who voted against the resolution, applied to the Court to determine whether it was constitutional for § 36 to allow this reclassification. The late Judge Shientag

18. 182 Misc. 323, 44 N. Y. S. 2d 33 (Sup. Ct. 1943); the same device was later used in *Anderson v. International Minerals and Chemicals Corp.,* 295 N. Y. 343, 67 N. E. 2d 573 (1946).

19. The Court advanced another rationale: the state's reserved power to alter or amend was comprehensive enough to allow it to insert a merger provision even *after* the stock was issued. The Court declined to state on which rationale it rested its decision.

20. N. Y. Stock Corp. Law § 85 (7).

21. L. 1943, c. 600.

22. 184 Misc. 835, 54 N. Y. S. 2d 253 (Sup. Ct. 1945).

said it was. He declared that by reason of the reserved power of the State, the Legislature could authorize any alteration of preferential rights, subject only to the fundamental mandate that property should not be taken without due process of the law; that the test of due process was whether there was a reasonable basis for the law; that the problem involved was a very knotty one, containing questions of public policy, such as the interest in permitting corporations a certain flexibility in their capital structure to meet business and financial need, as against the interests of small investors; that in balancing these interests, he could not say that the Legislature had acted unreasonably, especially since the preferred shareholder has the protection of the good judgment of his fellow shareholders, the right of appraisal if they disagree with him, and the underlying safeguard of a court of equity.

No appeal was taken. The decision has been followed by the Appellate Division,[23] and cited with approval by the Court of Appeals.[24] Consequently, it is rational to say that *McNulty v. W. & J. Sloane* represents the New York law. However, the ultimate word on its constitutionality in each particular case rests with the Supreme Court of the United States.

The effect of *McNulty v. W. & J. Sloane* is to allow direct elimination of accrued dividends in New York by resolution of two-thirds of the preferred shareholders. Accordingly, it will probably bring to an end the vitality of the two indirect methods, relegating them to the position of historical landmarks in the field of New York corporate law.

Delaware

The first case on the subject presented to the Delaware Courts was *Morris v. American Public Utilities Co.*, in 1923.[25] The defendant corporation was incorporated in 1912, and had issued cumulative preferred stock. The Delaware law existing at that time allowed a corporation to alter the preference rights of any class of stock by a majority vote of the stockholders affected.[26] Arrearages accumulated on the preferred shares. In 1923, an amendment to the charter was passed which was designed to affect a cancellation of preferred arrearages through the creation of new prior preferred stock and a compulsory exchange plan. The effect of the latter amounted to a direct cancellation. The plaintiff, a protest-

23. *Liebschultz v. Shaeffer Store Co.*, 270 App. Div. 1, 93 N.Y.S. 2d 125 (3d Dep't 1949).
24. *Anderson v. International Mineral and Chemicals Corp., supra* n. 18.
25. 14 Del. Ch. 136, 122 Atl. 696 (1923).
26. 25 LAWS OF DELAWARE c. 155, § 1.

ing preferred shareholder, sued to have the amendment declared void. The Chancellor declared that the charter was a contract, one of the terms of which was the statutes of Delaware at the time it was made, and reasoned that since an alteration of preferences was allowed by statute, the plaintiff could not complain as to the issuance of the prior preferred stock; but as to the cancellation of the accrued dividends, he declared that part of the amendment void, reasoning that the right to arrearages was not a preference right within the meaning of the statute, but a vested right. The effect of the decision was twofold: it incorporated the vested right doctrine into Delaware law, thus barring the direct elimination of arrearages; but it allowed indirect elimination by means of a voluntary exchange plan through the creation of prior preferred stock.[27]

Following *Morris v. American Public Utilities Co.*, the next case to be heard by the Delaware Courts was *Keller v. Wilson and Co.*,[28] in 1936. Wilson and Co. was incorporated in Delaware in 1925, and had issued cumulative preferred stock. In 1927, § 26 of the Delaware Corporation Law was amended to allow alteration of preferential or "other special rights" of stock. By 1935 the arrearages on the preferred shares were more than twelve million dollars. A recapitalization plan was voted by the stockholders which, by compelling an exchange of stock, attempted to directly cancel the accrued dividends. The plaintiff, a holder of preferred stock who had not approved the resolution, sued, claiming that the law existing at the time the corporation was formed did not permit the direct cancellation of accrued shares, and that if the subsequent amendment were construed to allow it, it would violate the contract clause and due process of law. The Supreme Court of Delaware upheld this contention, stating that the plaintiff had a vested right which was immune from subsequent state action; *and* that the amendment of § 26 was not intended to permit accrued dividends to be cancelled. Focusing solely on the constitutional argument, the decision seemed to leave the implication that a corporation organized *after* 1927, the year § 26 was amended, could alter its charter so as to eliminate accrued dividends.[29]

That precise point was argued before the Supreme Court of Delaware one year later, in *Consolidated Film Industries v. Johnson*.[30] The defendant, Consolidated Film Industries, was organized

27. This device was availed of as such for the first time in *Yoakam v. Providence Biltmore Hotel Co.*, 34 F. 2d 533 (R. I. 1929).
28. 21 Del. Ch. 391, 190 Atl. 115 (1936); the decision in effect overruled *Harr v. Pioneer Mechanical Corp.*, 65 F. 2d 332 (2d Cir. 1933), which had given an opposite construction to § 26.
29. That this was generally conjectured, see 31 ILL. L. REV. 661 (1937).
30. 22 Del. Ch. 407, 197 Atl. 489 (1937).

in 1928, and had issued cumulative preferred stock, which by 1936 was in arrears. In 1936, an amendment was passed which provided for a compulsory stock exchange, the effect of which was to directly cancel the accumulated dividends. The plaintiff, a preferred shareholder, sued to enjoin carrying out the amendment, relying on *Keller v. Wilson and Co.* The defendant argued that since the corporation was formed after 1927, § 26 (which authorized direct elimination of arrearages) was a part of the stock contract and could validly be used. The Supreme Court agreed, but it granted the injunction nevertheless, relying on its reasoning in *Keller v. Wilson and Co.* that there was no indication that the Legislature intended § 26 to apply retroactively, *i. e.*, to dividends already accrued. The effect of this decision was effectively to prohibit the elimination of accrued dividends in Delaware by a compulsory stock exchange plan.

In 1940, the Delaware Supreme Court was presented with the question whether accumulated dividends could be cancelled indirectly, through the device of a merger. Indirect cancellation, by means of an issuance of prior preferred stock, had been tolerated in *Morris v. American Public Utilities Co.* But there was some doubt whether present Delaware sentiment, as expressed so strongly in *Keller v. Wilson and Co.* and *Consolidated Film Industries v. Johnson,* would condone it in the new merger situation. The case in which it was submitted for adjudication was *Federal United Corporation v. Havender.*[31] Federal United was incorporated in 1932. By 1936 the cumulative preferred stock was in arrears. At that time a proposal was made to merge with a wholly owned subsidiary, and an exchange ratio adopted, whereby new stock would be given for the surrender of old preferred with arrearages. The plaintiff, a preferred shareholder, sued in equity to have the merger declared void. The Supreme Court of Delaware was of the view that a merger with a wholly owned subsidiary was allowed by the Delaware Law.[32] The Court reasoned that the substantial elements of the merger provision had existed from the inception of Delaware corporation law; that these provisions were written into every charter; that every shareholder has notice that the corporation whose shares he has acquired might be merged with another if the required number of shareholders agree; that as an incident to the merger, preference and accrual rights may, and perhaps, must be the subject of readjustment; that plaintiff has no fixed or vested rights as far as a merger is concerned; and that

31. 24 Del. Ch. 318, 11 A. 2d 331 (1940).

32. Del. Gen. Corp. Law § 59; a two-thirds vote of all capital stock is required.

consequently he must either exercise his right of appraisal,[33] or show that the terms of the merger were unfair or inequitable. The Court found the exchange was fair. The reasoning of the case has been criticized; the argument made is that it was fallacious for the Court to base its holding on the premise that a merger necessitated an adjustment of conflicting interests between two separate sets of shareholders, because where the merger was with a wholly owned subsidiary, no such conflict existed.[34] The effect of the decision was to open the door to the adjustment of accrued dividends by merger, subject only to the limitation of the equitable principle of fairness, and the right of appraisal. The same device was used, and sustained, where it was effected with a wholly owned subsidiary created for the specific purpose of the merger.[35]

It was also followed in *Porges v. Vadsco Sales Corp.*,[36] a subsequent Delaware decision. The case is interesting to examine for the light it sheds on the force of the words "fair and equitable", the words of judicial protection that were expressed by the Court in *Federal United Corp. v. Havender.* The Vadsco Sales Corp. was contemplating a merger with its wholly owned subsidiary for the purpose of bringing about an adjustment of its preferred arrearages, which at the time amounted to approximately one million, eight hundred thousand dollars. The company had approximately twenty-one thousand shares of 7% cumulative preferred outstanding (liquidation value, one hundred dollars; redemption value, one hundred and ten dollars), and one million shares of common, of no par value. Both classes were voting. At the time the merger was proposed, the company had a deficit of two and one-half million dollars. The new stock consisted of preferred, cumulative at two dollars and fifty cents per year, with a liquidation value of fifty dollars, and a redemption value of fifty-two dollars and fifty cents, and the right to elect a majority of directors if the arrearages reached six dollars and twenty-five cents a share. The exchange ratio was one share of old preferred with arrearages for one share of new

33. DEL. GEN. CORP. LAW § 61. But see § 59a, which applies specifically to a merger of a parent corporation with a wholly owned subsidiary, and states that § 61 is not applicable to a merger under its provisions, but excepts any other changes with respect to the parent corporation. The writer assumes that the exception includes recapitalization, but has found no express adjudication sustaining his assumption. *Porges v. Vadsco Sales Corp.*, 27 Del. Ch. 127, 32 A. 2d 148 (1943), by allowing appraisal, has implied it.

34. 24 MINN. L. REV. 992 (1940).

35. *Hottenstein v. York Ice Machinery Corp.*, 136 F. 2d 944 (3d Cir. 1943), which points out the fallacy in the reasoning of the *Federal United Corp. v. Havender,* which was regarded as standing for an express reversal of *Keller v. Wilson and Co.* and *Consolidated Film Industries v. Johnson.* However, research fails to show that any Delaware court or federal court has seen fit to adopt the dictum.

36. *Supra* n. 33.

preferred and five shares of new common.[37] The plaintiff sued, charging that the exchange was inequitable, and consequently that the merger should be enjoined. He introduced the company balance sheet to show that the net worth of the company was approximately two million, two hundred and twenty thousand dollars, and the sum of par value or fixed liquidation value of the preferred stock was two million, one hundred thousand dollars, which when added to the arrearages due, gave a sum of three million, nine hundred thousand dollars. From that the plaintiff argued the interest of the preferred stockholders was greater than the net worth, and consequently the common stock should not participate in the exchange, for it had no equity left. The Court denied the injunction; it declared that the unfairness which is actionable must be so clear as to impel the conclusion that it emanates from acts of bad faith or a reckless indifference to the rights of others, rather than from an honest error of judgment. Applying the test, the Court could find no such unfairness; book values were not evidence of the going concern value, and the preferred stock now had voting control plus a sinking fund. The effect of the decision is to indicate that only brazen unfairness will be enjoined by Delaware Courts.

In 1941, the case of *Shanik v. White Sewing Machine Corp.*[38] was decided. In brief, it was an attempt to adjust accrued dividends by the issuance of prior preferred stock. The Court sustained it, thus reaffirming the decision in *Morris v. American Public Utilities Co.*, which almost twenty years before had upheld a similar plan.

In the light of these decisions, Delaware law will allow the elimination of accrued dividends whether by the issuance of prior preferred stock or by merger. A dissenting shareholder has the right of appraisal, plus the protection of equitable safeguards. But accumulated dividends cannot be directly eliminated.

Conclusion

It appears that the only major difference between New York and Delaware as regards the elimination of accrued dividends lies in the subject of direct cancellation. Assuming that there is a rational basis for allowing the elimination of accrued dividends, the position of the Delaware Courts is inconsistent. Looking at the substance of things, what basis of distinction can be pointed out so as to permit the indirect methods yet prohibit the direct

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37. Since nothing was said by the Vice-Chancellor as to the character of the new common, the writer has assumed it was identical to the old common.
38. 25 Del. Ch. 371, 19 A. 2d 831 (1941).

method? It is naive to say that, as between a direct exchange and the indirect exchange by issuance of prior preferred, the former is compulsory and the latter is voluntary. Similarly, it is naive to say that, as between a direct exchange and an indirect exchange by merger, the former is the product of relentless force while the latter a compromise of conflicting interests. In the opinion of the writer, it is submitted that the Delaware Courts should reexamine their present position, and eliminate its incongruity.

As for the basic assumption, that the elimination of accrued dividends rests on a rational foundation, it should be conceded that the problem is a knotty one, and only the test of time can evaluate the truth of the arguments for and against it.[39]

Robert Schaus

39. For rational opposition, see 55 HARV. L. REV. 1196 (1942); 50 HARV. L. REV. 488 (1941); 57 HARV. L. REV. 894 (1944), where it is pointed out that corporations with heavy arrearages have successfully raised new capital, thus destroying the merit of the argument that economic necessity requires the elimination of arrearages.