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Stockholders as General Creditors

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STOCKHOLDERS AS GENERAL CREDITORS

May one occupying the legal status of a stockholder ever be permitted to change his status to that of a creditor and compete with ordinary creditors in the assets of an insolvent corporation?

It is the purpose here to briefly discuss the principles which should govern the right of a stockholder to share with creditors, or to state it another way, to consider the elements which must exist in order to enable corporate creditors or their legal representatives to prevent stockholders from decreasing the fund out of which their claim would otherwise be paid in full.

Whenever a corporation contracts for the cancellation of a stock subscription or contracts for the repurchase of its stock the execution of such contract results in a withdrawal of corporate assets and may injuriously affect the rights of creditors or other stockholders.[1] The general rule is that there can be no withdrawal of the assets of a corporation by the stockholders until all of the debts of the corporation have been paid and there can be no cancellation of a subscription for capital stock without the consent of other stockholders.[2]

Some courts have said that the corporate assets are a trust fund for the satisfaction of creditors.[3] Other courts have denied the trust fund theory and have worked out the rights of creditors to the corporate assets as against stockholders by applying strictly equitable principles based upon actual or presumed re-

[1]When a subscription for capital stock is unpaid the subscriber is regarded as a debtor of the corporation. *Edwards* v. *Schillinger*, 245 Ill. 231, 91 N. E. 1048.

[2]*Potts* v. *Wallace*, 146 U. S. 689; *Scottish Security Company, Receiver*, v. *Starkes*, 117 Ky. 609, 78 S. W. 455; *Gaithright* v. *Oil City Land Company*, 56 S. W. 163, (Ky.).

[3]*Sawyer* v. *Hoag*, 84 U. S. 610; *Handley v. Stutz*, 139 U. S. 417 on page 427; *Spencer* v. *Smith*, 201 Federal 647.

liance by creditors upon the stockholders' apparent relationship to the corporation and upon the apparent corporate assets.[4]

The "trust fund theory" is merely a rule of equity.[5] Regardless of any labeled theory, it appears that just as a member of a co-partnership cannot contract away any of his personal liability as a member of the firm, so are the officers and members of a corporation forbidden to contract away, either directly or indirectly, any portion of the capital stock which takes the place of personal liability in the case of a private co-partnership.[6] As, however, co-partners may, as among themselves, limit their liability or responsibility for the debts of the co-partnership, so likewise may stockholders, as among themselves, or with the corporation, contract for a preference, limit their liability, or provide for a resale of their stock.[7]

But such contracts may not be permitted to affect other stockholders who subsequently purchase stock in reliance upon

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[4] *Shaw et al.* v. *Robinson-Stokes Co.*, 50 Neb. 403, 669 N. W. 947; *First National Bank* v. *Guston Company*, 42 Minn. 327, 44 N. W. 198; *Coyt* v. *Gold Amalgamating Company*, 119 U. S. 343. In the case last cited Justice Bradley said:

> "That trust (in favor of creditors) does not arise absolutely in every case, where capital stock has been settled for by arrangement with the company. It is not as if stockholders had given their notes for that amount; these notes being in the treasury of the company; but there are other equities to which the stockholders are entitled . . . . on which they are to stand."

In case of *Koutze* v. *Blockman*, 284 Federal 962, the Court said:

> "The rule that the subscribed and unpaid stock of an insolvent corporation becomes a trust fund for the payment of claims to creditors is not an inflexible one. It has its exceptions. It will not be applied in a case where the result will be inequitable. It will be released where its operation will result in injustice. *Clark* v. *Beaver*, 139 U. S. 96. We think the court below properly held that as between appellant and appellee the equities of the latter prevailed."

[5] 25 American Law Review, 749.

[6] *Sanger* v. *Upton*, 91 U. S. 56.

[7] *Porter* v. *Plymouth Gold Mining Company*, 29 Mont. 347, 74 Pacific 938; *Rides* v. *Delker Sons Company*, 145 Ky. 634, 140 S. W. 1011. But the court in the last case said:

> "If the purpose in providing for these peculiar shares was to arrange matters so that, under any circumstances, a part of the principal of the stock might be withdrawn before the full discharge of all corporate debts, the devise would be contrary to the nature of capital stock, opposed to public policy and void as to creditors affected thereby."

the apparent status as stockholders of those who have contracted for the right to resell or withdraw their interest in the corporate enterprise.[8] Reliance on the part of other stockholders is not presumed but must be affirmatively shown.[9] On the other hand such contracts may be permitted to affect creditors who deal with the corporation with a knowledge of them.[10] Where credit has been extended to a corporation after the stock subscription or after the making of a contract pertaining to its resale or cancellation, those extending such credit as ordinary creditors are presumed to have done so on the faith of such asset.[11] Where credit has been extended before such contracts are made no such presumption can arise.[12]

ARE CONTRACTS FOR WITHDRAWAL VOID AB INITIO?

It has often been stated that these contracts or 'arrangements are contrary to public policy.[13] This kind of language implies that these contracts are void ab initio whereas the authorities show them to be merely unenforcible under certain circumstances.[14] "Public policy" is a wonderfully flexible term. The test as to whether or not a contract is contrary to public policy as far as its validity as distinguished from its enforceability is concerned, is its evil tendency and not its actual injury to the public in a particular instance.[15] It may well be that with this

[8] *Randall Printing Company* v. *Sanitas Mineral Water Company*, 120 Minn. 268, 139 N. W. 606; *Jones* v. *Johnson*, 86 Ky. 530, 6 S. W. 582.

[9] *Walradt* v. *Barkley*, 111 Neb. 67, 196 N. W. 928.

[10] *Hospes* v. *Northwestern Manufacturing Company*, 48 Minn. 174, 50 N. W. 1117; *Great Western Mining Company* v. *Harris*, 128 Federal 321; *Coyt* v. *North American Gold Amalgamating Company*, 14 Federal 12, affirmed in 119 U. S. 343.

[11] *Scott* v. *Abbott*, 160 Federal 573, where the creditors had made loans to the company after the increase of its stock, the court saying:

> "Indeed, if it had not been proved the law would indulge the presumption that credit was given to the Shoe Company in reliance upon the increased capital."

[12] *Handley* v. *Stutz*, 139 U. S. 417, where the court said:

> "Only subsequent creditors are entitled to enforce their claims against these stockholders, since it is only they who could by any legal presumption have trusted the company upon the faith of the increased stock."

[13] *Spencer* v. *Smith*, 201 Federal 647; *Ellsworth* v. *Lyons*, 181 Federal, 55, on page 58; *Guaranty Company* v. *Galveston City Railway Company*, 107 Federal 311.

[14] *Sham* v. *Robertson and Stoker*, 50 Neb. 403, 69 N. W. 947.

[15] *Gordon* v. *Gordon*, 168 Ky. 409, 182 S. W. 220, and cases cited in note 23, Volume 13, Corpus Juris, page 425.

meaning of public policy in mind that some arrangements for the withdrawal of capital—whether such arrangements be for the cancellation of stock subscriptions or for the repurchase of stock—should be regarded as void ab initio. Such an arrangement would be one made in secret for the purpose, primarily, of benefitting the stockholder rather than the corporation, in advance of credit by others and with the very contemplation of a competition between the holder of such an arrangement and creditors. But where such an arrangement is made for the repurchase of corporate stock or for the cancellation of a stock subscription and made openly, regularly, for the benefit of the corporation, and in good faith, it would seem that it might be enforcible except as against those who have actually been prejudiced thereby.

There is no rule of positive law in most states which arbitrarily forbids a stockholder, either expressly or by necessary implication, from assuming to affect the position of a creditor. The Bankruptcy Act as such contains no such provision except as it may require the claim as against the corporation to have accrued before the petition in bankruptcy is filed. It has often been assumed that upon the dissolution of an insolvent corporation, especially in bankruptcy court, that the claims of corporate creditors always have a priority over the claims of stockholders regardless of the character of the relationship between the particular stockholder and the corporation. It is submitted that if equitable rules and principles govern that competition rather than some arbitrary rule of public policy or trust fund theory that a stockholder might, in a given case, prove himself entitled *to share with* general creditors, but it would seem that he should not in any case be permitted to have priority over them.

ELEMENTS AFFECTING STOCKHOLDERS' RIGHTS

It seems material to consider, in determining the position of a stockholder who has arranged with a corporation for the repurchase of his stock, the preferring of his stock, or the cancellation of his subscription, to note when the contract was made with reference to the time of the formation of the corporation in order to determine whether or not he was in reality dealing with an organized entity; to note whether the cancellation of the obligation or the withdrawal of the assets is to take place at a time when the corporation is in a failing condition; to note whether the contract is intended merely for the purpose of securing a priority by one stockholder over another upon dissolution; to note whether the arrangement is a secret one or one to be spread upon the corporate records or to be recorded in a public office; to note whether the contract for withdrawal is deliberately calculated and intended to withdraw assets from the reach of creditors such as the arrangement in the federal case of *Spencer* v. *Smith*,[16] (if the arrangement in that case was anything more than a provision for a preference among stockholders themselves); to note whether in the case of a contract for the repurchase of stock, such contract was made at the time of the issuance of the stock and in consideration thereof or was given to the stockholder after he had become such; to note whether the contract provides for the taking up of the stock or the cancellation of the relationship at a time certain or at the option of the stockholder; to note whether or not at the time when the option was actually exercised by the stockholder to change his status from that of a stockholder to a creditor, the corporation was solvent or insolvent; to note whether the contract is predominantly in the nature of a loan transaction whereby money is advanced to the corporation with the stock issued as collateral; to determine whether or not the contract or arrangement actually benefited the corporation; to note whether the creditors or stockholders who are objecting to the performance of such a contract were in existence at the time the contract was made; to note whether or not the contract provides for a priority over creditors or provides only for the right to share with creditors; to note whether the contract specifically contemplates the incurring of debts after its execution and the securing of a preference over creditors as in the case of *Guaranty Trust Company* v. *Galveston City Railway*,[17] to determine whether or not the stock really issued was issued contrary to law and to determine whether or not the stockholder was induced to purchase his stock as a result of the fraud of the corporation.

Where a corporation is just being formed and where one of the members of the corporate enterprise stipulates for the right to withdraw from the undertaking upon certain contingen-

[16] 201 Federal 647.
[17] 107 Federal 311.

cies and at his option, such a contract should be regarded as contrary to public policy and void from its inception as being a contract which, by reason of its inherent character and necessary tendency, is calculated to mislead those likely to extend credit to the corporation. Such a contract cannot be regarded as having been made for the corporation's benefit but can only be regarded as having been made for the benefit and protection of one of the organizers.[18]

In the case of such a contract by a corporation that is just being formed, the corporation as an entity being entirely in the hands of its formers, the contract is not in reality two-sided and might not be enforcible even as against the corporation itself and even at a time when the corporation is solvent and when the rights of creditors and other stockholders could not possibly be affected.

It is submitted that where a contract for the repurchase of stock is made after the issuance of the stock and after the stock transaction with the particular stockholder has been fully executed, such a contract should be deemed to be against public policy and void.[19] Such a contract has all the vices of any contract for the withdrawal of corporate assets and does not have any of the counterbalancing advantages such as being for the

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[18] *Sarbach* v. *Kansas Fiscal Agency*, 86 Kan. 734, 122 Pacific 113. The court in this case said, relative to a stockholder who had such an arrangement:

> "Were he an ordinary creditor whose money had gone to enhance the value of the corporate shares there might be reason why he should prevail; but the very agreement by which he became a creditor was unconscionable as between himself and the other unwilling and unconsenting stockholders and therefore one which equity will not enforce."

[19] *Matthew Brothers* v. *Pullen*, 268 Federal 827; *Keith* v. *Kilmer*, 261 Federal 733, where the court said:

> "But it is entirely clear that the transaction out of which the alleged contract grew was entered into not for the benefit of the corporation itself, but for the benefit of certain stockholders. In brief, junior and minority stockholders desired to buy out the senior and majority stockholders and having no money with which to buy, the parties agreed not for the benefit of the corporation, but for the benefit of the trading stockholders to have the corporation, in form at any rate, agree to buy and pay for a large part of the stock intended thus to pass ultimately from the seniors to the juniors thus giving them control of the corporation and its offices and emoluments. The corporation was, so to speak, rather an accommodation purchaser for the benefit of certain vending and purchasing stockholders."

benefit of the corporation itself. If, on the other hand, the contract is made at the time of the issuance of the stock and after the corporation has been formed and as an inducement to the stock sale, then it might well be considered to have been a sale for the benefit of the corporation in that it might have been intended for the raising of ready money needed by it.

At any rate, by the weight of authority, such contracts are held not to be ultra vires and void but enforcible except as against those creditors and stockholders who have been actually prejudiced thereby.[20] As before pointed out, prejudice on the part of *other stockholders* must be affirmatively established and reliance of *creditors* will not be presumed except on the part of those *becoming such subsequently*.[21] Therefore it is submitted that such contracts are not void ab initio but unenforcible only as against those creditors who have become creditors subsequently to the contracts and who have had no knowledge of them[22] and as against those subsequent stockholders who can affirmatively show that they did not know of their existence and that their existence has misled them to their detriment.

Where the contract to repurchase stock even though made at the time of the stock sale as an inducement thereto and in consideration thereof provides that the option to resell the stock rests with the holder, such contract should be regarded as subject to more question for the reason that it puts it in the power of the stockholder to speculate upon the outcome of the venture without taking all the risks thereof and contemplates a withdrawal only in case of the failing condition of the enterprise.

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[20]*Ophir Consolidated Mines* v. *Brynston*, 143 Fed. 829; *Porter* v. *Plymouth Gold Mining Company*, 29 Mont. 347, 74 Pacific 938; *Griffin* v. *Bankers Realty Company*, 105 Neb. 419, 181 N. W. 168; *Walradt* v. *Barkley*, 111 Neb. 67, 195 N. W. 928; Vol. 14 Corpus Juris 575, Par. 858 and cases cited; *Mulford* v. *Torrey Exploration Co.*, 45 Colo. 81, 100 Pac. 596.

[21]*Walradt* v. *Barkley*, cited supra; *Handley* v. *Stutz*, cited supra.

[22]Volume 14 Corpus Juris 571, Par. 850, supported by cases in note 40, lays down the proposition:

> "Where a creditor deals with the corporation with knowledge of the agreement that only a certain percentage of the par value of each share of stock subscribed is to be paid, he relies only on that amount and has no equitable right to insist on the collection of any greater sum from the stockholder than the corporation itself could claim as a part of its assets."

The arrangement thus appears to have some elements of bad faith and to have been made more for the benefit of the stockholder than for the purpose of aiding the corporation.

If such a contract to repurchase stock is to be placed on record as a notice to all persons subsequently dealing with the corporation and is in fact so placed of record under a statute providing for constructive notice, certainly no one could be deemed to have been misled by the appearance of the stock issuance, and therefore, unless the contract is unenforcible on the grounds of public policy as an *absolute rule of law* the holder thereof should be permitted to prove it as a claim even in a court of bankruptcy.[23]

It is well settled that a corporation may issue its capital stock as collateral for a loan to the corporation.[24] But certainly a bona fide loan arrangement might still mislead creditors subsequently doing business with the company and, if so, those misled by the apparent stock issuance should be protected, if such situations are to be governed by flexible equitable rules.

By the weight of authority, a contract made with a going corporation for the repurchase of its stock as an inducement to and in consideration of the sale thereof is enforcible as against even subsequent stockholders in the absence of a showing on their part to the effect that they were misled by the appearance of the stock transaction.[25] It has been held that a preferred stockholder cannot be a creditor.[26]

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[23] *Allen* v. *Commercial Bank*, 191 Federal 97; *Durand* v. *Brown*, 236 Federal 609, the court in this case saying:

> "No creditors could reasonably have given credit actually or constructively on the supposition that the stock was not paid for . . . . The corporate records showed the making of the contract and the subsequent acts and conveyances. . . . The contract itself was recorded in full in the record of the articles of association kept by the County Clerk."

[24] *Wright* v. *Johnston*, 183 Iowa 807, 167 N. W. 680, and cases cited in note 32, page 416, Volume 14 C. J.

[25] *Jones* v. *Johnson*, 86 Ky. 530, 6 S. W. 582; *Walradt* v. *Barkley*, cited supra.

[26] *Smith* v. *Southern Foundry Company*, 166 Ky. 208, 179 S. W. 205; *Armstrong* v. *United Trust and Savings Bank*, 248 Federal 268; *Warren* v. *King*, 108 U. S. 398, where the court said:

> "The language of the certificate is entirely satisfied by referring it to a priority in rank of the preferred stock over the *common stock*, to a first claim of the preferred stock on the property of the corporation after its indebtedness should be paid when there should be money to be divided among the stockholders."

As further evidence of the fact that contracts for the repurchase of stock made as an inducement to and in consideration of the sale of stock and providing for a definite term of performance, are not unenforcible as an absolute rule of law, it is only necessary to point out that the holders of such contracts have been permitted to prove their claims in bankruptcy subject to the claims of other creditors.[27]

In the case of *Durand* v. *Brown*,[28] a stockholder, at the time of the issuance of his stock, reserved the right to turn it back and withdraw his money. True it is that he elected to turn back the stock while the company was solvent. The fact remains that at the time of the adjudication in bankruptcy about $5,000 of principal together with interest remained to be paid to him by the company on his stock.

If the contention is true that a contract made for the return of stock is void on the grounds of public policy and that a stockholder can never compete with creditors, then this case of *Durand* v. *Brown* is in conflict, for the court said:

> "Appellee is not attempting to get anything but his advances and reasonable interest. The corporation has apparently had the benefit of every dollar of his advances and has been able to operate about eight years presumably at least in a large measure as a result initially of the advances made by appellee and his associates. No creditors could reasonably give credit actually or constructively on the supposition that the stock in question was not paid for. The stock was issued in the name of Tildens as paid for; the corporate records showed the making of the contract and the subsequent acts and conveyances including not only the bill of sale from the Tildens to the corporation but the bill of sale to secure the repayment of advances given by the corporation to the trustees, upon the exercise of the option to receive back the money. . . . . The contract itself was recorded in the record of Articles of Association kept by the County Clerk. The existing creditors became such subsequent to this time and the alleged overvaluation was thus not to the detriment of other interested parties."[29]

In the case of *Allen* v. *Commercial Bank*,[30] the reports of the corporation listed the stockholder who was seeking to compete with creditors as a holder of stock to the extent of $10,000, and it was shown that practically all of the corporate indebtedness was incurred after the publishing of this list. The court there held that this stockholder could not be permitted to com-

[27] *In Re Morris Brothers Company*, 282 Federal 670; *Re Fecheimer Fishel Company*, 212 Federal 357.

[28] 236 Federal 609.

[29] See also the case of *Seubert v. Scott*, 39 S. D. 278, 169 N. W. 75.

[30] 119 Federal 97.

pete with creditors because it would be inequitable and unjust to permit him who had thus been held out as a stockholder to compete with those who had extended credit on the faith of his position.

If the stock of a corporation has been issued contrary to law, that is, without a license or in other respects in contravention of statute, it would seem that the stock issuance was absolutely void and the persons who would otherwise have been stockholders should be permitted to recover back their money as general creditors.[31]

It is well settled that a "Blue Sky" statute of a state providing for a penalty for the lack of a license is not a statute for revenue purposes but one purely for the protection of the public against fraud and imposition and that, therefore, the penalty provided for failure to secure a permit makes any contract for the sale of stock attempted without such permit absolutely void.[32]

Of course a claimant could, with knowledge of the invalidity of the stock issuance, voluntarily benefit by accepting dividends, attending meetings, etc., and act in such a way as to mislead creditors and thus be held to be estopped to set up such illegality.[33]

If a stockholder has been induced by fraudulent misrepresentations as to the condition of the company or other material fact to purchase his stock he may rescind.[34] But creditors may

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[31] An agreement founded on the doing of an act penalized by statute is void where the penalty is not for revenue purposes. 13 C. J. 421, pars. 352-353, and many cases there cited; *Reichardt* v. *Hill*, 236 Federal 817.

[32] *Edward* v. *Ioor*, 205 Mich. 617, 172 N. W. 620; *Rhines* v. *Skinner Packing Company*, 108 Neb. 105, 187 N. W. 874; *Pruitt v. Oklahoma Steam Baking Company*, 390 Oklahoma 509, 135 Pacific 730; *American Tubing Works* v. *Boston Machine Company*, 139 Mass. 5, 29 N. E. 63. In *Pruit* v. *Oklahoma Steam Baking Company*, just cited, the court said:

> "Where the issuance of shares is illegal for the want of power in the company to issue them and where the shares cannot legally exist, the person taking them cannot be estopped or otherwise become a member in respect to them. . . . . The money paid plaintiff could not, in fact, have been paid him as dividends as he was not a stockholder."

Where the statute prohibiting the stock transaction is a prohibition upon the seller only, the parties cannot be deemed to be in pari delicto, 13 C. J. 499, par. 443.

[33] *Madson* v. *Smith*, 290 Federal 939; *Allen* v. *Commercial Bank*, 191 Federal 97.

[34] *In Re Morris Brothers Company*, 282 Federal 670; *Newton National Bank* v. *Newbegin*, 74 Federal 135, 20 C. C. A. 339.

have extended credit in reliance upon the defrauded stockholder's investment in the corporate enterprise. In such a case the court, in *Scott* v. *Abbott*,[35] said:

> "The rights of innocent general creditors are superior to those of deceived stockholders. When one of two innocent persons must suffer by the fraud of another, the one who has enabled such third party to commit the fraud ought to sustain the loss."

Again, if a stockholder, because of misrepresentation on the part of corporate officers did not know that he was purchasing stock outright but considered himself to be making a loan to the corporation, such belief would seem to be of material assistance in helping him to the position of a general creditor for it would have a direct bearing upon his good faith and in the absence of a showing that his appearance had caused a change of position on the part of other stockholders or creditors, should give him good standing in a court of equity. Of course it is true that such a mistake on the part of stockholders would not be sufficient of itself to relieve them from liability on their stock purchase, for the mere fact that a person is misinformed as to the effect of his contract does not relieve him from its obligations.[36]

It is therefore submitted that no general rule can be arbitrarily laid down to the effect that when a corporation is insolvent in the sense of not having sufficient assets to actually pay its general creditors, that a stockholder can, under such circumstances, never change his status from that of a stockholder to a general creditor. It is submitted that a stockholder may have rights as against general creditors even in a bankruptcy court when the status of the stockholder is such that he has not actually or presumably misled those creditors. On the other hand a stockholder should not be permitted to have priority even as against other stockholders, if the arrangement whereby such priority is stipulated has actually misled such stockholders in their dealing with the corporation. It is submitted that where the predominant purpose of the issuance of the stock and the giving of the right to turn the same back to the corporation is to aid the corporation in the enterprise and where the contract provides that the stock is to be taken back at a definite time and further where such a contract is given in good faith it should not

[35]160 Federal 573, at 582.
[36]*Upton* v. *Tribelcock*, 90 U. S. 45.

be regarded as being against public policy and therefore necessarily unenforcible, but such a contract should enable the holder thereof to establish himself in the position of a creditor even in a court of bankruptcy and such holder should be permitted to compete with all claimants except those who can show equities in their favor.

In a close case the rule that in a court of bankruptcy any doubt as to the probability of a claim is resolved in favor of the claimant, might be of assistance.[37]

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[37] *Dycus* v. *Brown*, 135 Ky. 140, 121 S. W. 1010.