EDITORIAL NOTES.

BY G. W. P.

THE "TRUST FUND THEORY" OF THE CAPITAL STOCK OF A CORPORATION.

IT is a matter of no small interest to trace a well-settled legal doctrine to the case in which it is said to have been first enunciated, with a view to discovering whether or not the germs of the doctrine are really to be found there. Such an investigation is peculiarly interesting in the case of the American doctrine that the capital stock of a corporation is a "trust fund" for the payment of its debts. Wood *v.* Dummer,[1] is said to be the first case in which the term "trust fund" was used in this connection. In the opinion of Mr. Justice STORY, in that case, occurs the following passage: "It appears to me to be very clear on general principles, as well as the legislative intention, that the capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank." The decision was merely that a court of equity would not sanction a gratuitous distribution of the capital stock of a corporation among the shareholders when the balance retained was insufficient to meet the claims of bill holders. Forty-nine years later, in Sawyer *v.* Hoag,[2] we find the Supreme Court of the United States declaring, *per* Mr. Justice MILLER: "Though it be a doctrine of modern date, we think it now well established that the capital stock of a corporation, *especially its unpaid subscriptions*, is a trust fund for the benefit of the general creditors of the corporation." In that case a stockholder and the corporation agreed that he should be called upon only for 15 per cent. of the par value of his stock, and that the remaining 85 per

[1] Mason, 308 (1824).
[2] 17 Wall, 610 (1873).

cent. should be treated as a loan from the corporation to the stockholder, evidenced by the note of the latter secured by the deposit of collateral. Upon the insolvency of the corporation the assignee demanded payment of the note, but the stockholder asserted his right to set off a claim against the company which he had bought up at 33 per cent. of its face value after the insolvency became known. The Court held (Mr. Justice HUNT dissenting) that the transaction between the stockholder and the corporation "was a fraud upon the public, who were expected to deal with them." It was an attempt to extinguish the stock debt by converting it into a debt for the loan of money to the prejudice of creditors. The shareholder, who was a party to this transaction, and had bought up a claim to relieve himself from liability, would seem to have been guilty of such technical "iniquity" as would deprive him of the aid of equity to enforce his set-off. But the Court preferred to say that "the debt which the appellant owed for his stock was a trust fund devoted to the payment of all the creditors of the company," and that, as the plaintiff claimed as an individual, the debts were not mutual or in the same right. The set-off was refused on this ground.

Seven years later, in Hawley *v.* Upton,[1] Mr. Chief Justice WAITE delivering the opinion, the same august tribunal went so far as to assert that a contract to pay 20 per cent. for stock was, in law, a contract to pay its par value, and permitted the assignee of the corporation to recover from the defendant the 80 per cent. which he had not contracted to pay. In the following year Mr. Justice BROWN, now of the Supreme Court of the United States, then sitting as a district judge, was called upon to decide a similar question in the case of Flinn *v.* Bagley,[2] and he felt himself compelled to follow the decision in Hawley *v.* Upton. In Flinn *v.* Bagley a corporation, being desirous of raising money by increasing its capital stock, found itself confronted by the fact that its existing stock was selling at

[1] 102 U. S., 314 (1880).
[2] 7 Fed. Rep., 785.

only sixty-six and two-thirds cents on the dollar. As no one could be found willing to pay par for what was worth but sixty-six and two-thirds per cent., there was no recourse but to issue the new stock at its real value. All the stockholders assented to this arrangement, and it was therefore no fraud upon them. Nor was it a fraud upon existing creditors, "since the assets of the debtor were increased by the amount of money actually paid in." A subsequent creditor, however, sought to hold the subscribers to the new stock liable for the difference between the price paid and the par value of the stock, although they had received their shares upon the understanding that the shares were to be treated as fully paid.

Judge BROWN reviewed the English authorities, especially Currie's Case, Carling's Case, DeRuvigne's Case and Anderson's Case, and showed that in England the consequence of making a contract to sell shares for less than par was to avoid the entire transaction, which the Court would undo and restore the parties to their original position, but that the court did not conceive itself justified in making a new contract for the parties and compelling them to perform it. Intimating that he sympathized with this position, and recognizing the hardship of the case before him, Judge BROWN used the following language: "I have sought to find a tenable ground upon which to base a distinction between this case and the one under consideration, but it seems to me that there is no substantial difference between them. Here is an agreement literally to subscribe a certain sum and to take in payment therefor a certificate, the par value of which was fixed by law representing a sum one-third larger than the amount of the subscription. How does this differ from the agreement in Hawley *v.* Upton by which the defendant acknowledged the receipt of ten shares of stock the par value of which was also fixed by law, and in consideration thereof promised to pay one-fifth of such par value?"

Subsequently Judge BROWN was elevated to the Supreme Court, and in 1891 was called upon to deliver the opinion of that tribunal in the case of Handley *v.* Stutz.[1] In this case there was an increase of capital by the issue of 800 shares of stock, 300 of which were distributed *pro rata* among stockholders, and the remaining 500 shares were given as a bonus to those who subscribed to the bonds of the corporation—it being in evidence that the bonds could not have been sold had not this additional inducement been offered. In this case, too, a subsequent creditor sought to hold the distributees of the 300 shares and the recipients of the bonus liable for the par value of the stock. But the Court drew a distinction—those who were the distributees of the 300 shares of stock and those who had taken the 500 shares as a bonus with the bonds—holding that the former were liable, but that the latter were not.

As to the precise extent of the liability of the former class the opinion leaves us in some doubt. As is pointed out in a suggestive note by Mr. THOMAS THACHER in the American Law Review for October, 1891, the court did not decide with very great clearness whether the distributees were liable for the par value of the stock or only for the "fair" value thereof. Mr. Justice BROWN, who had but a short time before bowed unwillingly to Hawley *v.* Upton, delivered the opinion of the court. In deciding that *subsequent* creditors, as distinguished from those creditors whose rights had accrued prior to the ordering of the increase of stock, were entitled to recover from the distributees, he used this language: "It is true they assume the risk of the stock not being taken at all, but the moment shares are taken they are supposed to represent so much money put into the treasury as they are worth, which becomes available for the payment, not only of future, but of existing creditors." He had in a previous portion of the opinion used this language: "With regard to the first class, namely, the original stockholders who voted for this increase of 800 shares and then distributed among themselves 300 of those shares without the shadow of right or consideration, *it is difficult to see why they should not be called upon*

[1] 139 U. S., 417.

to respond for their value." Upon this point, therefore, we are left in the dark as to whether Hawley *v.* Upton was followed to the letter, or whether the doctrine was modified.

As to the recipients of the bonus, the Court attempted a distinction between the taking of stock below par in the case of "a going concern" and the taking of stock below par at the inception of a corporation—holding in the latter case the transaction was a fraud upon creditors, but that in the former case the subscribers could be held liable for no more than they had agreed to pay—in this case nothing. The Upton cases were sought to be distinguished on the ground that the defendants were original subscribers to the increased stock or transferrees of such subscribers. The Court seems to have felt that there was in reality but a shadowy distinction between facilitating the operations of a going concern by raising money through an increase of stock, and accomplishing the same result by an issue of bonds with a stock bonus; and perhaps Mr. Justice BROWN (although, as Mr. THACHER points out, he said the Supreme Court was not *embarrassed* by previous decisions upon this point) was himself somewhat embarrassed by the recollection of Flinn *v.* Bagley. Accordingly, we find him struggling manfully with the problem as follows: "The liability of a subscriber for the par value of increased stock taken by him may depend somewhat upon the circumstances under which, and the purposes for which, such increase was made. If it be merely for the purpose of adding to the original capital stock of the corporation and enabling it to do a larger and more profitable business, such subscriber would stand practically upon the same basis as the subscriber to the original capital. But we think that an active corporation may, for the purpose of paying its debts and obtaining money for the successful prosecution of its business, issue its stock, and dispose of it for the best price that can be obtained." The distinction between the two transactions, however, was too fine for the Chief Justice and Mr. Justice LAMAR, who dissented upon this point from the decision of the majority.

This called forth from the pen of Mr. R. C. MCMUR-

TRIE an article entitled, "Is the Capital Stock of a Corporation a Trust Fund in any Proper Sense?" which was published by our esteemed contemporary the American Law Review in August, 1891. In that article the writer took substantially this position (to use the language in which he himself has since summarized it): "No one can legally destroy his assets if he does not retain enough to pay his debts. This applies to corporations as well as to private persons. Hence settlements on wife and children can be avoided; and, if the corporation is insolvent, so can contracts by stockholders to pay fifty cents in satisfaction of one dollar. *In other words, representations on which people are asked to rely must be made good in favor of those who have dealt on the faith of these statements.*" He further showed that the distinctive attributes of a trust fund were wanting in the case of the capital stock of a corporation, whether paid or unpaid; and that the use of the term was an abuse of it.

Following closely upon the publication of this article comes the able opinion of Judge MITCHELL speaking for the Supreme Court of Minnesota in the case of Hospes *v.* Car Co.[1] The same learned Judge in delivering the opinion of the court two years before in the Bank *v.* Gustin Mining Co.,[2] had recognized certain restrictions upon the so-called trust fund doctrine, but had admitted that the general proposition that the capital stock of a corporation is a trust fund for the benefit of its creditors could not be controverted. In Hospes *v.* Car Co., however, in an opinion of great vigor, he takes occasion to point out that "this 'trust fund' doctrine, commonly called the 'American doctrine' has given rise to much confusion of ideas as to its real meaning, and much conflict of decision in its application. To such an extent has this been the case that many have questioned the accuracy of the phrase as well as doubted the necessity or expediency of inventing any such

[1] 50 N. W. Rep., 1117, 1892. 5 Lewis Amer. R. R. & Corp. Reports, p. 562.

[2] 42 Minn., 327.