RECENT DEVELOPMENT OF CORPORATION LAW BY THE SUPREME COURT OF THE UNITED STATES.

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II. RIGHTS OF STOCKHOLDERS AND CREDITORS IN THE PROPERTY OF THE CORPORATION.

In the May Number of the AMERICAN LAW REGISTER AND REVIEW[1] an attempt was made by the writer to state the result of recent decisions by the Supreme Court of the United States upon the subject of Corporate Power. The decision in *Central Transportation Company* v. *Pullman's Palace Car Company*[2] was examined, and attention was called to certain difficulties in the way of harmonizing some of the views expressed in that case with other decisions by the same Court. It is now proposed to give some consideration to the problems which, in constantly increasing numbers, are being presented to the Court for solution in cases concerning the rights of stockholders and creditors of insolvent corporations.

The ears of the American lawyer have grown accustomed to the assertion that the capital stock of a corporation is a trust fund for the payment of debts. He has heard this trust fund doctrine referred to with pride as an American doctrine and there are not wanting those who find in this circumstance a stimulus to patriotic sentiment and a reason for self-congratulation.[3] There seems to be something in the thought of a trust fund for the benefit of creditors which arouses within the lawyer's breast a feeling of legal chivalry; and more than one distinguished judge has become a knight-errant in the service

[1] 34 AM. L. REG., page 296.

[2] 139 U. S. 24.

[3] *E.g.*, Judge SEYMOUR D. THOMPSON: 27 Am. Law. Rev. 846. Judge THOMPSON to some extent modifies his expressions upon this subject in § 2953 *et. seq.* of his recently published Commentaries on Corporation Law.

of this honored doctrine—although in so doing he has laid himself open to the imputation on the part of less sentimental jurists of engaging in a somewhat Quixotic tilt at legal windmills. In the pages of this magazine[4] comments have appeared from time to time upon some of the more notable decisions which purport to be based upon the trust fund doctrine; and in the pages of the *American Law Review*, Mr. Thacher[5] of New York and the late Mr. McMurtrie[6] of Philadelphia have contributed valuable suggestions to the discussion of the general subject.

Whatever this trust fund doctrine may be, it is at any rate certain that the Supreme Court of the United States is definitely committed to it. In *Handley* v. *Stutz*,[7] Mr. Justice BROWN uses the following language:—"Ever since the case of *Sawyer* v. *Hoag*, 17 Wall. 610, it has been the settled doctrine of this court that the capital stock of an insolvent corporation is a trust fund for the payment of its debts; that the law implies a promise by the original subscribers of stock who did not pay for it in money or other property to pay for the same when called upon by creditors; and that a contract between themselves and the corporation, that the stock shall be treated as fully paid and non-assessable, or otherwise limiting their liability therefor, is void as against creditors. The decisions of this court upon this subject have been frequent and uniform, and no relaxation of the general principle has been admitted: *Upton* v. *Tribilcock*, 91 U. S. 45; *Sanger* v. *Upton*, 91 U. S. 56; *Webster* v. *Upton*, 91 U. S. 65; *Chubb* v. *Upton*, 95 U. S. 665; *Pullman* v. *Upton*, 96 U. S. 328; *County of Morgan* v. *Allen*, 103 U. S. 498; *Hawkins* v. *Glenn*, 131 U. S. 319; *Graham* v. *Railroad Co.*, 102 U. S. 148, 161; *Richardson* v. *Green*, 134 U. S. 30." In a case decided the same year[8] Mr. Justice HARLAN said:—"In *Sawyer* v. *Hoag*, 17 Wall. 610, 620, it was held that the capital stock of a corporation, especially its unpaid subscriptions, is a trust fund *sub modo* for the

[4] *E. g.*, 32 AM. LAW REG. & REV., 175.
[5] 25 Am. Law Rev., 940.
[6] 25 Am. Law Rev., 749.
[7] 139 U. S. 417. (1891).
[8] *Clark* v. *Bever*, 139 U. S. 96. (1891.)

benefit of its general creditors . . . . There is no dispute here as to the soundness of this general principle." In *Fogg* v. *Biair*,[9] decided upon the same day as the preceding case, the same learned justice says, "It is the settled doctrine of this Court . . . . that unpaid subscriptions to the stock of a corporation constitute a trust fund for the benefit of its creditors which may not be given away or disposed of by it, without consideration or fraudulently, to the prejudice of such creditors."

In *Camden* v. *Stuart*,[10] Mr. Justice BROWN reasserts the Court's adherence to the doctrine and says "Nothing that was said in the recent cases of *Clark* v. *Bever*, 139 U. S. 96; *Fogg* v. *Blair*, 139 U. S. 118; or *Handley* v. *Stutz*, 139 U. S. 417, was intended to overrule or qualify in any way the wholesome principle adopted by this court in the earlier cases, etc., etc." In *Potts* v. *Wallace*,[11] Mr. Justice SHIRAS reviews the cases and finds that the law of Pennsylvania is in accord with Federal doctrine upon this point and remarks "It is undoubtedly true that in Pennsylvania in the case of an insolvent corporation, its assets including unpaid capital stock constitute a trust fund." In the same year, in *Swan Land and Cattle Co.* v. *Frank*,[12] the Court per Mr. Justice JACKSON, gives its assent to the theory that the assets of the corporation "constitute a *trust fund* for the payment of all debts and demands." If any modification of the statement made above is required, it is as the result of the more guarded assertion of Mr. Justice BREWER in *Hollins* v. *Brierfield Coal and Iron Co.*,[13] where the learned judge says:—"While it is true language has been frequently used to the effect that the assets of a corporation are a trust fund held by a corporation for the benefit of creditors, this has not been to convey the idea that there is a direct and express trust attached to the property. As said in *2 Pomeroy's Equity Jurisprudence*, 1046, they "are not in any true and complete sense trusts, and can only be called so by way of analogy or

[9] 139 U. S. 118.
[10] 144 U. S. 104. (1891.)
[11] 146 U. S. 618. (1892.)
[12] 148 U. S. 603. (1892.)
[13] 150 U. S. 371. (1893.)

metaphor." The Profession has not had an opportunity to ascertain whether or not this suggestion that in dealing with the trust fund doctrine we are living in the domain of metaphor and hyperbole is to be adhered to by the court; for neither in 151, 152, 153, 154, 155 nor 156 U. S. are problems of this character presented to the judges for decision. Accordingly, in the absence of a definite repudiation of the trust fund doctrine, whatever that may be, it seems upon the whole to be justifiable to assert that the Supreme Court is committed to it.

In view of these considerations, it is a matter of no little interest to ascertain just what the trust fund doctrine is, and to determine what the commercial conditions are which seem to have driven the Supreme Court to declare its adherence to a metaphor as a rule of judicial decision.

There are at least three possible views of the true nature of the property of a corporation and of the consequent rights and liabilities of stockholders and creditors. In the first place, the courts might unite in holding that the corporation "is entitled to hold property (if not contrary to its charter) as absolutely as an individual can hold it," and that "its estate is the same, its interest is the same, its possession of the same." [14] If this view were to prevail, the corporation might deal with its property as an individual may do and might dispose of its property subject only to the limitations which obtain in the case of an individual with respect to the rights of creditors. If balances on stock remained unpaid and the corporation had in no way cut itself off from collecting those balances, creditors might reach them on the ground—and only upon the ground—that they were the property of the corporation in the same way that "bills receivable" are assets of a firm. A creditor's bill would be a mere equitable execution or a means of garnishment available for the creditor who had reduced his claim to judgment at law. The corporation could unquestionably prefer a creditor as an individual may do and it would make no difference whether the creditor happened to be a stranger to the corporation, a stockholder therein or a director thereof. If the stockholder whose balance was unpaid was also a creditor

[14] Mr. Justice BRADLEY in *Graham* v. *R. R.* 102 U. S. 148. (1880.)

of the corporation on another transaction, he could set-off his claim against the stock debt when called upon to pay either by the corporation or a creditor claiming through it. In short, there would be no such thing as a department of corporation law concerned with the rights of corporate creditors in the property of their debtor, for they would stand before the law in the same position as if they were seeking to enforce their rights against a natural person with no ground for asking for the application of equitable principles unless there was present in the case some such well-recognized basis of equitable relief as fraud upon creditors or a state of affairs calling for marshalling of assets, subrogation or the like. In this view of the case it would on principle be immaterial whether or not a contract to pay less than par for stock is regarded as a valid contract. If the courts regard it as valid, no difficulty would arise. If they treated it as impolitic and invalid, a right of rescission would exist in favor of the corporation. There would be either the contract which the parties made or none at all.

In the next place, the courts might agree in treating the property of a corporation as being, so to speak, the product of representations made by each and all of the stockholders to the public to the effect that for each share of stock one hundred per cent. of value had actually been paid into the treasury or had been conveyed to the corporation as property, or subsisted in the hands of the stockholder ready to be paid in upon demand. On this view, the rights of creditors would be both greater and less than upon the basis of the doctrine suggested above. A contract made in good faith between a stockholder and the corporation with terms different from those above outlined would not be enforced according to its terms against a creditor; for the latter would be entitled to invoke the doctrine of estoppel for the purpose of subjecting a stockholder to a liability of one hundred per cent. on the dollar, no matter what his actual agreement with the corporation might have been. In other words, this view involves the proposition of substantive law that a contract by which one becomes the owner of stock is necessarily and inevitably an undertaking upon the part of the stockholder to pay par and a representation to the public that if the par of the stock has not already been paid, the holder will pay it on demand. It would therefore be true, in a sense, that the courts in such a case would not be making a subscriber live up to a bargain entered into by him, but would be making a bargain for him and compelling him to live up to that.[15] On the other hand, as said above, the rights of creditors would be to some extent *less* upon this view. As the basis of the creditor's right is estoppel, it should seem that only those creditors would be entitled to compel payment of par value who become such after the occurrence of the transaction complained of and who give credit in ignorance of the real facts of the case. If the first view were to obtain, it should seem that prior creditors would be entitled to the same relief as subsequent creditors, the basis of their equity being in each case fraud. Nothing in this view of the nature of the creditor's right is inconsistent with the exercise by the corporation of the right of a natural person to set-off, in case of mutual debts, or of the right to prefer a creditor in case of insolvency.

A third possible view would be the view that the corporation is identical with the members that compose it and that it and they hold the corporate property in trust for the benefit of corporate creditors. This view, it will be observed, is entirely distinct from the doctrine based on estoppel and adverted to above. The theory of a trust for creditors necessarily involves the protection of prior and subsequent creditors alike: for otherwise we should have the anomaly of an equitable doctrine existing for the benefit of a class which conceivably might never come into existence to the exclusion of those whose meritorious claims had already accrued. Again, on any known definition of a trust we must have a specific *res* or subject matter, the legal title to which is in the trustee. In the case of a *bona fide* contract between corporation and stockholder that stock shall be treated as full paid when 50 per cent. only has been paid in fact, it is to be observed that no

[15] See the language of Mr. Justice BROWN (then District Judge) in *Flinn* v. *Bagley*, 7 Fed. Rep. 785. (1881.)

mere trust theory will enable a creditor to reach the unpaid 50 per cent. This follows from the fact that the limitation expressed in the contract is valid between the corporation and the stockholder,—which means that the corporation not only has no legal title to the property represented by the unpaid balance but can never acquire it. We should accordingly have the spectacle of a trustee without right or title to the trust property. On the other hand, no right of preference would exist; for if there is not enough to satisfy all *cestuis que trustent* in full, equality is equity and the trustee must settle with all *pro rata*. It should seem, however, that a right to set-off would exist in favor of a stockholder-creditor, even upon the trust theory: for in no intelligible sense can one individual stockholder be a trustee for those who are creditors of the corporation—that is (on this view) of the stockholders treated in the aggregate; and as far as an individual stockholder is concerned, it is the case of a claim against him and a claim in his favor. It should seem to be immaterial that the claim against him is a claim for the delivery to the corporation of trust property subsisting in his hands. If his obligation is merely to pay trust property to the trustee, and if at the same time the trust fund is liable for the satisfaction of a *bona fide* claim in his favor, why deny the applicability of the doctrine of set-off?

It is believed that these are the only three theories which, upon general legal principles, can be applied to the relations subsisting between the creditors of a corporation, the corporation itself, and its stockholders. It is nevertheless certain that no one of these theories corresponds to the so-called "trust fund doctrine" as recognized in the decisions of the Supreme Court of the United States. This becomes clear if we but glance at the cases already cited and at others which are inseparably connected with them. The Court, it should seem, would recognize the right of an insolvent corporation to prefer a creditor.[16] This is inconsistent with the theory of a trust.[17]

[16] *Hollins* v. *Brierfield Coal and Iron Co.* (150 U. S. 371. 1893) taken in connection with

[17] *Emerson* v. *Lester*, 118 U. S. 3. (1885.) See 2 N. W. Law Rev. 173.

The court permits a creditor to collect from a stockholder a balance unpaid on his subscription in spite of a contract between the stockholder and the corporation that nothing more shall be deemed due thereon.[18] This also is inconsistent with the theory of a trust. The court will not permit a creditor to file a bill to have the trust property applied to the satisfaction of his claim unless he has first obtained a judgment at law.[19] Here again is a result inconsistent with the theory that a trust exists for the benefit of creditors. The court compels a stockholder who has received a distribution of stock by way of gratuity to respond for the par value thereof, and that, too, only in favor of subsequent creditors; but in the same case refuses to reach a similar result with respect to the recipients of a stock bonus issued as an inducement to subscribe for the bonds of a "going concern" which had run into debt.[20] This result is inconsistent with the doctrine of estoppel as is also the decision long ago rendered in *Sawyer* v. *Hoag*,[21] and reiterated in *Handley* v. *Stutz*, (*supra*) that no set-off will be permitted in favor of a stockholder-creditor.

The refusal of set-off and the ignoring of the contract between stockholder and corporation when the rights of a creditor intervene are inconsistent with the property theory. Upon the property theory the liability of the stockholder would be a simple debt and might well be the subject of set-off; while in a case where the corporation has no contract rights against a stockholder, as far as that stockholder is concerned, the corporation has no property which a creditor can reach.

The result of our inquiry is to establish that the so-called Trust Fund Doctrine is a thing different from any one of these three theories—and they, we believe, represent the only possible ways in which general legal principles can be applied to corporate phenomena. If the question of the further development of a legal doctrine was to be settled upon the basis of

[18] *Hawley* v. *Upton*, 102 U. S. 314. (1880.)
[19] *Hollins* v. *Brierfield Coal and Iron Co.*, 150 U. S. 371. (1893.)
[20] *Handley* v. *Stutz*, 139 U. S. 417. (1891.)
[21] 17 Wall. 610. (1873.)

pure legal reasoning, these considerations would compel us to abandon further discussion of the "Trust Fund" and to cast aside every thing but the simple property theory since, upon principle, it is the only one to which courts should give their assent. The estoppel theory involves a serious piece of judicial legislation as to what the effect of a contract shall be. This alone is enough to condemn it. The trust theory is, strictly speaking, untenable. It involves a conception which (in the language of Mr. Justice BRADLEY)[22] "is at war with the notions which we derive from the English law with regard to the nature of corporate bodies." Followed to its logical conclusion, it would lead to results which could not be tolerated.[23]

In the judgment of the writer, however, the development of the law upon this subject is not to be settled upon the basis of pure legal reasoning and a consideration of the true nature of the Trust Fund Theory or Doctrine seems to make this plain. If it is permissible to answer the question as to the nature of this theory or doctrine by way of paradox, the answer is that it is neither a theory nor a doctrine. The name "Trust Fund" is a name given by American courts and American writers to the more or less systematic judicial recognition of a demand of the commercial world. That demand is, in substance, that the liability of a stockholder shall be unlimited up to the par value of his shares and that he shall not be entitled to the benefit of any legal principle which would normally entitle him to an advantage against corporate creditors. This is not a legal theory. It is a commercial condition struggling for recognition in the courts. If this fact had been perceived in the first instance, courts probably would never have undertaken the task of doing the legislature's work. But perceiving dimly the commercial necessity and charmed by the indefinite possibilities suggested by the word "trust," they entered upon the field and they have never been willing to quit it. Any criticism of the cases on this subject which ignores this fact seems to the writer to be perverse and unintelligent. The courts have been doing legisla-

[22] *Graham* v. *R. R.*, 102 U. S. 148. (1880.)

[23] *Hollins* v. *Brierfield Co.*, 150 U. S. 371. (1893).

tive work. They have reached their decisions upon the basis of practical necessity and they have called in sometimes one legal theory and sometimes another in an attempt to give the result a juristic aspect, Can anyone who reads the decisions of the Supreme Court of the United States doubt that this is the true explanation of their course ? In order to make good this point, it is only necessary to refer to the language of Mr. Justice MILLER in regard to set-off in *Sawyer* v. *Hoag*, (*supra*) to the opinion of Mr. Justice HARLAN in *Clark* v. *Bever*,[24] and to that of Mr. Justice BROWN in *Handley* v. *Stutz*.[25] The judges even talk about being "embarrassed" by previous decisions when they desire to reach a certain result. If that result can be best attained by invoking the theory of a trust, then the courts without hesitation adopt the trust theory for the purpose of that case. When it is attempted to make a trust decision the basis of an inductive argument, as in the case of *Hollins* v. *Brierfield Co.*, (*supra*), the court does not shrink from declaring that the use of the term trust in the earlier cases was metaphorical. If the doctrine of estoppel will enable the courts to accomplish an obviously just result, then the doctrine of estoppel is more or less distinctly enunciated. It by no means follows, however, that the doctrine of estoppel is to be applied in the next case which arises or even in a different branch of the same case. In *Handley* v. *Stutz*, (*supra*) the court affects to perform the impossible task of distinguishing on principle between the status of two sets of stockholders ; and holds one set liable and declares that the other set is entitled to immunity. Mr. Chief Justice FULLER and Mr. Justice LAMAR dissented. They were unable to see the distinction. There was no distinction in law but there seemed to be an exigency in fact which called for a distinction in result. Thus Mr. Justice HARLAN, in *Clark* v. *Bever*, (*supra*) uses the following language in support of the conclusion that a stockholder is not liable to a subsequent creditor for the par value of stock which had been disposed of at its actual value which was less than par—and he uses it with all

[24] 139 U. S. 96. (1891.)
[25] 139 U. S. 417 (1891).

the confidence which we are accustomed to associate with the enunciation of a principal of law:—"To say that a public corporation, charged with public duties, may not relieve itself from embarrassment by paying its debt in stock at its real value—there being no statute forbidding such a transaction—without subjecting the creditor, surrendering his debt, to the liability attaching to stockholders who have agreed, expressly or impliedly, to pay the face value of stock subscribed by them, is, in effect, to compel them either to suspend operations the moment they become unable to pay their current debts, or to borrow money secured by mortgage upon the corporate property." He follows this up immediately by a general protestation to the effect that the court is not to be understood as modifying "the principles laid down in the cases above cited." The same line of thought characterizes the opinion of the same learned Justice in *Fogg* v. *Blair*.[26] When the facts of the case require that stockholders should be held for the unpaid balance (as in *Camden* v. *Stuart*, *supra*) it becomes necessary to reassure the Profession that the earlier cases of *Handley* v. *Stutz*, *Clark* v. *Bever* and *Fogg* v. *Blair* are not to be regarded as having established a principle of immunity in favor of the stockholder.

If this view of the case is correct it seems too clear for argument that the mass of decisions is so great that a return to first legal principles is an impossibility. The only practical question is that which relates to the means of perfecting the work of judicial legislation which is at present in an unfinished condition. That it is in an unfinished condition scarcely admits of dispute. The impossibility of predicting the view which the court will take of a given commercial condition is admirably brought out by Mr. Edward Avery Harriman in some recent papers in the *Northwestern Law Review*.[27] He exposes the fallacy underlying the attempt of Judge SEYMOUR D. THOMPSON to overthrow *upon principle* the doctrine that

[26] 139 U. S. 118. (1891.)

[27] Vol. II, No. 6, page 167, "The Power of Corporations to prefer Creditors;" Vol. III, No. 4, page 115, "Corporate Assets as a 'Trust Fund for the benefit of Creditors;'" Vol. III, No. 7, page 206, "Corporate Assets as a 'Trust Fund for the benefit of Creditors.'"

an insolvent corporation can prefer its creditors. He also demonstrates that *upon principle* a right of preference exists as well in the case where the preferred creditor is a director as where he is a stockholder of the preferring corporation; and he aptly criticises the decision of Mr. Justice HARLAN in the Circuit Court of Appeals in *Mfg. Co.* v. *Hutchinson*,[23] as being inconsistent, *upon principle*, with the decision in *Hollins* v. *Brierfield Co.* which the learned Justice cites in support of his conclusion. No one who has had practical experience in the work of organizing or re-organizing a corporation will deny that there are serious difficulties and embarrasments to be encountered at every turn.

Is not the solution of the difficulty that which was suggested above? The courts have begun a work of judicial legislation and they have undertaken to develop a new status—hitherto but little defined by the law—the status of a "stockholder." It remains to recognize frankly that this is the truth of the matter and to decide boldly that the contract of membership in a corporation has, as an inseparable incident to it, the obligation to pay into the corporate treasury the par value, in money or property, of the stock of a new concern and the actual value, if less than par, of the stock of a "going concern;" and that the making of a contract of membership involves a waiver by the stockholder of the right to enforce any principle of law which would result in relieving him from his absolute liability actually to pay the amount thus determined into the coffers of the corporation. By becoming a stockholder he has waived his right to a set-off—no matter how clear that right may be. He has waived his right to a preference no matter how obvious it is that in the absence of waiver he would be entitled to it. He has undertaken to contribute a given amount for the benefit of creditors and he has agreed that he will remain passive until their claims are satisfied. It is believed that this is the result which the commercial world demands; and to obtain it nothing is needed but a frank avowal of the situation by the Court, coupled with an authorative announcement of the suggested rule of law.

[23] 63 Fed. Rep. 496.