

Michigan Law Review

Volume 40 | Issue 8

1942

CORPORATIONS - RIGHTS OF ACTION BY THE REPRESENTATIVE OF CORPORATE CREDITORS - EFFECT OF CORPORATE ASSENT

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Recommended Citation

Edward W. Adams, *CORPORATIONS - RIGHTS OF ACTION BY THE REPRESENTATIVE OF CORPORATE CREDITORS - EFFECT OF CORPORATE ASSENT*, 40 MICH. L. REV. 1213 (1942).

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CORPORATIONS — RIGHTS OF ACTION BY THE REPRESENTATIVE OF CORPORATE CREDITORS — EFFECT OF CORPORATE ASSENT — By various acts the directors and officers of a corporation—its agents for the conduct of corporate business—may wrong the corporation or make possible a wrong to the corporation or to the body of corporate stockholders. When the corporation becomes involved in insolvency proceedings, in order to make available to creditors as many assets as possible, the receiver or trustee in bankruptcy¹ determines whether some cause of action will lie to recover damages or property, or whether he may successfully defend to preserve assets. If the corporation itself could have been successful in the litigation, the solution would be easy because he will have succeeded to the rights and defenses of the corporation. The question whether such receiver or trustee may be successful in litigation becomes acute in a situation where the corporation could not have been successful because corporate assent or some substitute therefore would have barred the corporation.² The purpose of this comment is to cast some light on this problem—what are the rights

¹ "Trustee in bankruptcy" is used in the broad sense including a trustee for bankruptcy upon insolvency and the trustee in reorganization proceedings. In general the powers of the reorganization trustee and the trustee in bankruptcy are the same. 52 Stat. L. 892 (1938), 11 U. S. C. (1940), § 586.

² For the purposes of this comment, "corporate assent" includes what may be properly called substitutes for express assent—for example laches, acquiescence, statute of limitations, waiver or estoppel.

of the representative of creditors where the corporation is barred from pursuing a cause of action because of its assent? The writer will discuss: first, the rights of the representatives of creditors in general; second, the rights of the representative as to various causes of action where there has been corporate assent; and third, what is necessary to effect corporate assent.

I.

The trustee and receiver are the two most important representatives in cases of corporate insolvency proceedings.³ Any rights they may have are derivative.⁴ The trustee derives his authority and his rights of action from the Bankruptcy Act. Under section 70(a)(5) and (6)⁵ the trustee succeeds to the rights of action that the corporation might have pursued, and as to those he stands in the shoes of the corporation, subject to section 70(b) and (c).⁶ Concerning acts fraudulent as to creditors, his rights are derived from creditors under sections 70(e)⁷ and 67(d).⁸ Where a certain creditor has been given a preference, sections 60⁹ and 67(a)¹⁰ give the trustee original rights of action.¹¹ On the whole, the rights of the trustee are derived by means of the Bankruptcy Act either from the corporation or from its creditors.

Traditionally, it has been stated that a receiver stands in the shoes of the corporation, and as to litigation is subject to the defenses and limitations operative against the corporation.¹² This result seems to have been reached because the position of the receiver was considered analogous to that of the executor or administrator of a decedent's estate.¹³ However, the courts made some exceptions; thus, the rights of the

³ While other representatives, such as the assignee for the benefit of creditors, may exist, yet the receiver and trustee are much more important because of common usage.

⁴ The rights of the representative can come from three places: (1) they may be derived from the debtor; (2) they may be derived from the creditors; and (3) they may be rights originating in the representative, created by law, frequently by statute.

⁵ 52 Stat. L. 879 (1938), 11 U. S. C. (1940), § 110(a).

⁶ 52 Stat. L. 879 (1938), 11 U. S. C. (1940), § 110(b), (c).

⁷ 52 Stat. L. 879 (1938), 11 U. S. C. (1940), § 110(e).

⁸ 52 Stat. L. 875 (1938), 11 U. S. C. (1940), § 107(d). Sec. 70 (c) is also applicable.

⁹ 52 Stat. L. 869 (1938), 11 U. S. C. (1940), § 96.

¹⁰ 52 Stat. L. 875 (1938), 11 U. S. C. (1940), § 107(a).

¹¹ At common law preferences were deemed legal and proper. *Grover v. Wakeman*, 11 Wend. (N. Y.) 187 (1833). Under the Bankruptcy Act this has been changed.

¹² *HIGH, RECEIVERS*, 4th ed.; § 315 (1910); *Republic Life Ins. Co. v. Swigert*, 135 Ill. 150, 25 N. E. 680 (1890); *Rockwood v. Foshay*, (C. C. A. 8th, 1933) 66 F. (2d) 625; *Bostwick v. Young*, 118 App. Div. 490, 105 N. Y. S. 607 (1907). See also 34 *MICH. L. REV.* 1196 (1936).

¹³ 34 *MICH. L. REV.* 1196 at 1200 (1936); 38 *MICH. L. REV.* 689 at 690 (1940).

receiver rose higher than those of the debtor where there had been a fraud on the creditors or where an act was done which was illegal as to creditors.¹⁴ In these cases the receiver derived his rights from the creditors and could sue even though the debtor could not. As applied to corporations, there had to be a fraud as to corporate creditors upon which they could have an independent cause of action as distinguished from a mere fraud on the corporation or its stockholders that in no wise affected creditors' rights.¹⁵ Thus, as in the case of the trustee, the receiver derived rights both from the corporation and from the creditors.

Since the rights of the trustee and the receiver seem analogous for most purposes, no attempt will be made in the succeeding discussion to differentiate between them.

2.

There are many types of wrongs that may give rise to a corporate cause of action. Typical examples will be examined to ascertain whether the representative could have rights which override the supposed corporate assent. From an examination of these various wrongs, an attempt will be made to deduce more accurately the essential elements of a wrong which the representative may pursue.

There are certain types of transactions that are illegal because of some policy of law which favors creditors, and as to these the representative can prosecute a cause of action. Such are the cases where there has been an illegal dividend¹⁶ or illegal withdrawal of funds by stockholders,¹⁷ or where the stockholder has subscribed for par value stock at less than par.¹⁸ While the rights of creditors may not ripen until insolvency, yet in a suit by the representative the corporate assent is a nullity.¹⁹ A transaction frequent in connection with the banking business

¹⁴ HIGH, RECEIVERS, 4th ed., § 315 (1910); 34 MICH. L. REV. 1196 at 1198-1199 (1936); Franklin Nat. Bank v. Whitehead, 149 Ind. 560, 49 N. E. 592 (1898); Stone v. Young, 210 App. Div. 303, 206 N. Y. S. 95 (1924); McCandless v. Furlaud, 296 U. S. 140, 56 S. Ct. 41 (1935).

¹⁵ Sweet v. Lang, (D. C. Minn. 1924) 14 F. (2d) 758, affirmed (C. C. A. 8th, 1926) 14 F. (2d) 762; Verder v. American Loan Society, 1 Cal. (2d) 17, 32 P. (2d) 1081 (1934). See 34 MICH. L. REV. 1196 at 1198-1199, notes 11 and 12 (1936).

¹⁶ Hamor v. Taylor-Rice Engineering Co., (C. C. Del. 1897) 84 F. 392; Mackall v. Pocock, 136 Minn. 8, 161 N. W. 228 (1917). See 55 A. L. R. 8 at 113 et seq. (1928) for cases on recovery of dividends. As to the liability of directors, see 109 A. L. R. 1381 at 1395 (1937). McDonald v. Williams, 174 U. S. 397, 19 S. Ct. 743 (1899), presents the "good faith" view.

¹⁷ Hoyt v. Hampe, 206 Iowa 206, 214 N. W. 718, 220 N. W. 45 (1927); Gillet v. Moody, 3 N. Y. 479 (1850).

¹⁸ Sawyer v. Hoag, 17 Wall. (84 U. S.) 610 (1873); Beach v. Beach Hotel Corp., 117 Conn. 445, 168 A. 785 (1933); Peterson v. Darelius, 168 Minn. 365, 210 N. W. 38 (1926). See 71 A. L. R. 103 (1931).

¹⁹ See cases cited in notes 16, 17, and 18, supra.

is the use of accommodation paper executed by a third party under an agreement with the corporation that he will not be liable. Such an arrangement does not bind the representative.²⁰ In all of these cases, admittedly not entirely analogous, the reason seems to be that the transaction is voidable as to the representative because of the inherent potentiality of fraud on the creditors.

While the corporation will be frequently wronged by the taking of profits by promoters—possibly less frequently now than formerly²¹—yet by means of a carefully laid scheme the corporation may be barred from recovery. Nevertheless, the representative was allowed to recover in *McCandless v. Furlaud*,²² where the promoters, assenting to the transactions as the sole stockholders, took sufficient profits to leave the corporation in a state of nascent insolvency. Against a strong dissenting opinion based on the principle that the rights of the receiver could rise no higher than the rights of the corporation,²³ the majority permitted recovery on the theory that a fraud was perpetrated on the creditor bondholders, in a manner analogous to a fraudulent conveyance.²⁴ In *Bovay v. H. M. Byllesby & Co.*,²⁵ the same result was reached on similar facts. From these cases it would seem that insolvency at the inception of the corporation or the time of the taking of profits must result in order that there can be recovery. However, if the corporation were left in such a perilous financial condition that insolvency must follow, the result might be the same. But just because there are creditors at the time profits are taken it does not follow that creditors or their representative have a cause of action without the other facts being present.

Where excess salaries or excess compensation is taken, the corporation has suffered a wrong which gives it a cause of action.²⁶ Yet just

²⁰ *Iglehart v. Todd*, 203 Ind. 427, 178 N. E. 685 (1931); *Shaw v. Borchers*, (Tex. Comm. App. 1932) 46 S. W. (2d) 967.

²¹ "Blue sky" laws and the Securities Act have attempted to control the profits of promoters. See McGowan, "Legal Controls of Corporate Promoters' Profits," 25 GEO. L. J. 269 (1937).

²² *McCandless v. Furlaud*, 296 U. S. 140 at 168, 56 S. Ct. 41 (1935).

²³ *Id.*, 296 U. S. 140 at 173-174. Note the criticism of Justice Roberts that the Court is grouping individual wrongs into the hands of the receiver.

²⁴ *Id.*, 296 U. S. 140 at 163. There has been much periodical literature on this case. See 34 MICH. L. REV. 1189 (1936); 45 YALE L. J. 511 (1936); McGowan, "Legal Controls of Corporate Promoters' Profits," 25 GEO. L. J. 269 (1937); 3 UNIV. CHI. L. REV. 484 (1936).

²⁵ (Del. Ch. 1941) 22 A. (2d) 138. Here plaintiff was trustee in bankruptcy. See 85 A. L. R. 1262 (1933).

²⁶ *Rogers v. Hill*, 289 U. S. 582, 53 S. Ct. 731 (1933); *Buell v. Lanski*, 232 Ill. App. 500 (1924). In this latter case the trustee was not allowed to recover from directors and officers who had taken excessive salaries at a time when there were no creditors, all stockholders assenting. See BALLENTINE, CORPORATIONS 408 et seq. (1927).

how great an excess must result before there is anything more than a fraud on the corporation or the stockholders is hard to ascertain. Unless there has been a substantial impairment of the creditors' security so that their rights have become endangered, the creditors probably should have no right to complain. If in taking the salaries or compensation the directors or officers leave the corporation insolvent or almost insolvent, the creditors have been injured, and their representative should be able to recover.

A transaction somewhat similar to those mentioned is effected where corporate assets are diverted to pay personal debts.²⁷ Here again it is difficult to decide whether there is a mere wrong to the corporation or whether there is an overriding wrong to the creditors. If the corporation is left insolvent by these manipulations, the creditors have been injured; but if the rights of the creditors are substantially intact, it is difficult to see why they should have cause to complain and why their representative at some future insolvency proceedings should have a cause of action.²⁸

By hypothesis, creditors²⁹ are injured by a fraudulent conveyance by the corporation such as a gift of corporate assets or an incomplete pledge or mortgage. Insolvency is usually prerequisite in order that the conveyance may be termed fraudulent, and since the dividing line between solvency and insolvency may be very fine, it may be difficult to discover whether the corporation is insolvent or not. While these transactions may divert corporate assets, yet that of itself is not sufficient to give the creditors a cause of action.³⁰ If a conveyance is fraudulent according to legal standards, then the creditors and in insolvency proceedings the representative should be able to recover.

Analysis of the examples presented³¹ shows that difficult questions

²⁷ Hoyt v. Hampe, 206 Iowa 206, 214 N. W. 718, 220 N. W. 45 (1927); Sweet v. Lang, (D. C. Minn. 1924) 14 F. (2d) 758, affirmed (C. C. A. 8th, 1926) 14 F. (2d) 762.

²⁸ See cases cited in note 27, supra. In Sweet v. Lang, (D. C. Minn. 1924) 14 F. (2d) 758, affirmed (C. C. A. 8th, 1926) 14 F. (2d) 762, the court could find no creditors at the time of the transaction in question.

²⁹ Although the same type of transaction which gives rise to a fraud on creditors may cause the stockholders to be defrauded, yet unless there is clearly a fraud on the creditors, there is no fraudulent conveyance as to them. As to the rights of creditors, see 119 A. L. R. 1339 (1939).

³⁰ Fletcher American Nat. Bank v. McDermid, 76 Ind. App. 150, 128 N. E. 685 (1920); Franklin Nat. Bank v. Whitehead, 149 Ind. 560, 49 N. E. 592 (1898); Smith v. Commercial Credit Corp., 113 N. J. Eq. 12, 165 A. 637 (1933), affirmed sub nom. Morrow v. Smith, 115 N. J. Eq. 310, 170 A. 607 (1934). In most of these fraudulent conveyance cases of incomplete pledge or gift, there may be no wrong to the corporation.

³¹ Further examples of actionable corporate wrong might be suggested: where there is misconduct in office, an officer or director may be held liable to the creditors. BALLENTINE, CORPORATIONS 371 (1927), and see 50 A. L. R. 462 (1927). At least in

arise concerning the financial condition of the corporation. A transaction which results in a diversion of assets to the point where the corporation is clearly insolvent gives a cause of action to creditors. Likewise if there is actual fraudulent intent by the parties involved, the creditors have a cause of action. When either of these can be found, then the creditors have such rights against the recipient of the diverted assets or the parties supervising the diversion as may be derived by a representative in insolvency proceedings.

3.

That a corporation may assent to certain wrongs and thereby bar itself, and the representative deriving rights solely from it, is clear.³² Assuming that a wrong has been committed which may be assented to, it then becomes important to decide the question what constitutes corporate assent. Expressed assent by all the stockholders clearly would ratify the wrong.³³ In most instances this cannot be found, and difficulties then arise. Since certain wrongs may be ratified by the directors,³⁴ or by less than all stockholders,³⁵ the first problem is to decide what assent is necessary in order that the wrong be ratified.³⁶ Once this has been decided, then the question whether there has been the requisite assent is of primary importance. If the wrong is such that directors can

some cases the representative of creditors can recover. *Bates v. Dresser*, 251 U. S. 524, 40 S. Ct. 247 (1920); *Emerson v. Gaither*, 103 Md. 564, 64 A. 26 (1906). See 2 A. L. R. 867 (1919).

³² *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 203 Mass. 159, 89 N. E. 193 (1909); *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U. S. 206, 28 S. Ct. 634 (1908); *Mercer v. Steil*, 97 Conn. 583, 117 A. 689 (1922). See also STEVENS, CORPORATIONS 607 et seq. (1936).

³³ *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*, 210 U. S. 206, 28 S. Ct. 634 (1908). In *Old Dominion Copper Mining & Smelting Co. v. Bigelow*, 203 Mass. 159 at 178, 89 N. E. 189 (1909), Justice Rugg cites four ways in which promoters may get approval of the profits they seek to take: (1) by an independent board; (2) by disclosure to and approval from the subscribers to shares; (3) after the profits are taken by ratification of all the shareholders; (4) by the promoters' subscribing to all the stock and themselves approving as stockholders.

³⁴ Such would be a case where an officer acted within the powers which the corporation could use, but without authority given to him to do such an act. The board can approve of promoters' profits. See note 33, supra.

³⁵ Statutes may provide what percentage of shareholders would have to assent to some act. The percentage of shareholders necessary to assent might be stated in the corporate charter. An example where less than all shareholders can approve is in the case arising when an officer or director enters into a contract with the corporation or is interested in such a contract. See *North-west Transportation Co. v. Beatty*, 12 App. Cas. 589 (1887); BALLENTINE, CORPORATIONS 395 (1927).

³⁶ As to certain wrongs, there must be unanimous consent of all the shareholders in order that they can be ratified. Such a wrong arises when an ultra vires act is committed. See 3 MINN. L. REV. 206 (1919); *Steiner v. Steiner Land & Lumber Co.*, 120 Ala. 128, 26 So. 494 (1898); BALLENTINE, CORPORATIONS 367 (1927).

ratify it, then whether certain directors are disqualified to act in the ratification because of interest or some other reason is important. If less than all the stockholders can ratify, whether some will be disqualified from voting must be determined. These and many other problems are presented by the various types of situations, but the main problem in this comment is to determine the substitutes for the expressed assent of all possible stockholders.³⁷

Acquiescence by stockholders is treated as assent.³⁸ Whether there is acquiescence will depend on the facts of the instant case. If the stockholders have full knowledge of all the facts and do not signify their dissent within a reasonable time, they will be deemed to have ratified the wrong by acquiescence.³⁹ If benefits have been accepted which were derived from the wrong, the case is even stronger.⁴⁰ A long series of past dealings without dissent may be evidence of acquiescence as to the present wrong.⁴¹ Encouraging the parties to commit the wrong is also evidence of acquiescence.⁴² Whether the stockholders are said to have acquiesced or are said to be estopped to question the action is merely a distinction in terminology, since the net result is the same.

Where an unreasonable time has passed, the doctrine of laches which acts as a substitute for assent is applied; but there must be knowledge of the facts or laches will not attach.⁴³ In a legal action the same result is reached where a statute of limitations is held applicable,⁴⁴ and

³⁷ To a certain extent there will be similar problems as to unanimous assent as there is to assent by less than all stockholders or the directors. But in those cases usually the management will have sufficient strength so that no great questions will be raised other than those here presented.

³⁸ *Santos v. National Bank of Glen Falls*, 130 Misc. 348, 223 N. Y. S. 817 (1927); *Bashford-Burmister Co. v. Hammons*, 36 Ariz. 173, 283 P. 926 (1930); *Kent v. Quicksilver Mining Co.*, 78 N. Y. 159 (1879).

³⁹ *Mercer v. Steil*, 97 Conn. 583, 117 A. 689 (1922); *Kent v. Quicksilver Mining Co.*, 78 N. Y. 159 (1879).

⁴⁰ *Alexander v. Searcy*, 81 Ga. 536, 8 S. E. 630 (1889); *Post v. Beacon Vacuum Pump & Electrical Co.*, (C. C. A. 1st, 1898) 84 F. 371; *Towers v. African Tug Co.*, [1904] 1 Ch. 558; *Wormser v. Metropolitan Street Ry.*, 184 N. Y. 83, 76 N. E. 1036 (1906).

⁴¹ *Sweet v. Lang*, (D. C. Minn. 1924) 14 F. (2d) 758, affirmed (C. C. A. 8th, 1926) 14 F. (2d) 762.

⁴² *McGeorge v. Big Stone Gap Improvement Co.*, (C. C. Va. 1893) 57 F. 262; *Bashford-Burmister Co. v. Hammons*, 36 Ariz. 173, 283 P. 926 (1930).

⁴³ *Rabe v. Dunlap*, 51 N. J. Eq. 40, 25 A. 959 (1893); *Pigeon River Ry. v. Champion Fibre Co.*, (C. C. A. 4th, 1922) 280 F. 557; *Southern Pacific Co. v. Bogert*, 250 U. S. 483, 39 S. Ct. 533 (1919).

⁴⁴ *Mencher v. Richards*, 256 App. Div. 280, 9 N. Y. S. (2d) 990 (1939); *In re Cass' Estate*, 228 Iowa 957, 291 N. W. 855 (1940). See 26 IOWA L. REV. 334 at 344 (1941) where some suggestions as to the problem of the effect of the statutes of limitations are presented. It might be well if the legislatures would deal more directly with the various corporate wrongs setting forth limitations periods. New York has

this statutory period may by analogy be the measure in an equity action.⁴⁵

In sum and substance, these are all but a part of the same thing. If the stockholder knows of the wrong, having full knowledge of the facts, and then fails to act within a reasonable time, he is going to be in no position to question the wrong, and it makes but little difference which label is applied to the result.

The difficulty presented to one claiming assent or its substitute is proving it. If the corporation is closely held, the solution may be easy. But where there are many stockholders and they are scattered over a large area, it is difficult to prove that they had knowledge of the facts. Of course if the ratification does not require unanimous assent, then this difficulty will be substantially lessened.

The reason why corporate assent plays a part in the determination of rights of the representative is obvious, for if, by hypothesis his rights are derived solely from the corporation, at least as to certain wrongs, then corporate assent may be the decisive issue in the case. Because of this, the problem of corporate assent looms large in insolvency proceedings, and counsel for the representative should keep this constantly in mind.

To summarize, the rights of a representative of creditors are in general derivative. They may be derived from the debtor (the insolvent corporation) or from creditors. As to the latter, it seems that the representative must find a flesh and blood creditor or creditors who could have had a cause of action if the representative had not been appointed. Unless some injured creditor who had individual rights could be found, the representative would have no rights derived from creditors.⁴⁶ As to rights derived from the corporation, the representative stands in the shoes of the corporation and can prosecute a cause of action only if the corporation could have. It is only in such a case that the question of corporate assent becomes important at all. The reason for allowing the creditors' representative to sue where the creditors have an individual cause of action is sound, for it cuts out much litigation on the same

done so to some extent. See New York Civil Practice Act (Cahill, 1937), §§ 48(3), 49(4), 53.

⁴⁵ *Emerson v. Gaither*, 103 Md. 564, 64 A. 26 (1906). Most of the suits are in equity since stockholders are pursuing derivative actions because the corporation will not sue. Because of this it is hard to tell whether the statutes of limitations apply directly or by analogy.

⁴⁶ A further problem that will be present in such a case is whether the representative of creditors sues for and recovers for all creditors even though the rights of but a small class may be involved. This problem becomes very acute at the time when a division of the assets is to be made, if it has not been raised before. However, the writer feels that discussion of this would expand the scope of this comment too much, and therefore merely raises the problem as a warning.

issues, and courts that do not follow this example could profit by treating the representative as a true representative of creditors, vested with their rights.⁴⁷

Edward W. Adams

⁴⁷ It is admitted that this would provoke the same sort of criticism made by Justice Roberts in the *McCandless* case, note 23, *supra*, but the result would be desirable and would be an aid to diminishing the litigation in the courts. This is especially so since there are the same issues and the same evidence in the numerous cases. It would seem that convenience would be sufficient justification for extending such principles.