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CORPORATIONS - RECEIVERS - RIGHTS OF CREDITORS OR RECEIVER TO RAISE AN OBJECTION TO CORPORATE ACTION WHICH WOULD BE OPEN TO SHAREHOLDERS

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CORPORATIONS — RECEIVERS — RIGHTS OF CREDITORS OR RECEIVER TO RAISE AN OBJECTION TO CORPORATE ACTION WHICH WOULD BE OPEN TO SHAREHOLDERS — The United States Circuit Court of Appeals for the First District held in *Greene v. Reconstruction Finance Corporation*,[1] that a receiver could not defend the foreclosure of a mortgage which was given by the corporation without the necessary two-thirds assent of the shareholders required by statute.[2] In reaching this conclusion, the court reasoned that the statute must have been intended by the legislature for the sole benefit of the shareholders, since the mortgaging of property has to do with the management of the corporation—a matter with which the creditors or their representative, the receiver, have no concern. There have been sweeping dicta to the effect that creditors have no control over corporate

[1] (C. C. A. 1st, 1938) 100 F. (2d) 34.

[2] *Accord*, Westerlund v. Black Bear Mining Co., (C. C. A. 8th, 1913) 203 F. 599. *Contra:* Leffert v. Jackman, 227 N. Y. 310, 125 N. E. 446 (1919); In re James, (D. C. N. Y. 1927) 30 F. (2d) 551, reversed on different grounds in (C. C. A. 2d, 1929) 30 F. (2d) 555, but the court seemed to think the creditors could attack the transaction. The court in Commerce Trust Co. v. Chandler, (C. C. A. 1st, 1924) 295 F. 241 at 244, held a receiver entitled to contest the validity of an alleged mortgage on the ground that it did not comply with the Massachusetts Business

management except where there is proof of fraud or breach of trust.[3] It appears to the writer that these dicta, based on fictions, are only partially true. A careful analysis leads to the conclusion that the answer to the problem of creditors' suits would be a better one if the courts would recognize that under certain conditions, once the condition precedent of insolvency has been complied with,[4] the creditor or his receiver can, regardless of true fraud or breach of trust, enforce certain corporate rights of action.[5]

These attempts to enforce corporate rights of action generally come about in the following manner: The corporation having become insolvent, a judgment creditor with a sheriff's return of nulla bona on his judgment comes into equity for a creditor's bill asking that a receiver be appointed to reach the corporate assets, and a receiver is then appointed.[6] The receiver, in attempting to liquidate all the assets, may challenge or enforce certain transactions of the corporation entered into while solvent. However, as the receiver is supposed to stand in the corporation's "shoes," he is faced with a doctrine which arose early in the law of receivership to the effect that the power of a receiver to sue is limited to causes of action which the corporation could have asserted but for his appointment.[7] This doctrine is still applied in some states even today. What is the receiver to do in situations where the corporation has precluded itself, by fraud or otherwise, from attacking? The majority of courts soon recognized the harshness of this rule (which had probably been influenced by the law of wills, where the executor stands in the "shoes" of the testator), and the receiver was allowed to attack transactions in fraud of creditors though the corporation was

Law Statute—Mass. Acts & Resolves (1903), c. 437, § 40—requiring the assenting vote of 2/3 of the shareholders though the shareholders did not contest the validity. Judge Hale, in handing down the decision, said "that which is of benefit to the stockholders is primarily for the benefit of the creditors." This same court, in deciding Greene v. Reconstruction Finance Corp., (C. C. A. 1st, 1938) 100 F. (2d) 34, which involved a quite similar Delaware statute, did not mention this case.

[3] Sweet v. Lang, (C. C. A. 8th, 1926) 14 F. (2d) 762; Gay v. Hudson River Electric Power Co., (C. C. A. 2d, 1911) 187 F. 12; Pond v. Framingham to Lowell R. R., 130 Mass. 194 (1881).

[4] This condition would prevent the creditors from intervening while the corporation is an active solvent concern, but once the corporation is insolvent the objection to the effect that creditors' suits hamper the management would be done away with.

[5] See Berl, "The Vanishing Distinction between Creditors and Stockholders," 76 UNIV. PA. L. REV. 814 (1928).

[6] The methods of appointing receivers are many and are regulated by statute in many states. For more detailed discussions of the appointment of receivers, see Judge Learned Hand's opinion in Luhrig Collieries Co. v. Interstate Coal & Dock Co., (D. C. N. Y. 1922) 281 F. 265.

[7] Republic Life Insurance Co. v. Swigert, 135 Ill. 150, 25 N. E. 680 (1890); Moise v. Chapman, 24 Ga. 249 (1858); Folsom v. Smith, 113 Me. 83, 92 A. 1003 (1915).

estopped so to do.[8] This rule has become more and more liberalized, the concept being stretched to include suits on unpaid stock subscriptions not maintainable by the corporation because of fraud in the inducement,[9] suits to set aside unrecorded conditional sales,[10] unlawful preferences,[11] unfiled chattel mortgages,[12] and causes of action given to the creditors by statute.[13] It would appear that the liberal view is by far the better, for it prevents a multiplicity of suits among the creditors, the shareholders and the insolvent. It also makes a receivership better serve its purpose of saving the rights which accrue to creditors in consequence of their relation with the insolvent corporation. In the discussion of the cases to follow, the corporation's management refused to enforce these causes of action, and the creditor or his representative was allowed to sue.

The writer will attempt to show that the courts, in spite of their language of fraud and breach of trust, are not applying the legal rules of fraud and trust relationship in allowing recovery to the creditor. The cases brought by the receiver for the benefit of creditors can be roughly divided into three broad groups: (1) instances where the court speaks of a trust relationship, holding that the corporation has breached the duty of trust to the ceditors; (2) situations where the court speaks of some hazy principle of "fraud"[14] on the creditors; (3) cases where the court forgets this broad basis and speaks neither of "fraud" nor of breach of trust, but holds that the creditor has certain rights which must be protected. It must be remembered at the outset that these groups blend into each other and that it is impossible to segregate a case into just one group, but for the convenience of the discussion the aforementioned classification will be used.

I.

The courts which speak of a trust relationship in substance say that the assets of a corporation representing the capital stock constitute a trust fund for the benefit of its creditors. This theory is used in connection with the rule that shareholders may be compelled in equity at the suit of creditors to follow and subject to the payment of their claims the assets wrongfully taken from the capital stock and distributed

[8] Sweet v. Lang, (D. C. Minn. 1928) 14 F. (2d) 758; Franklin National Bank v. Whitehead, 149 Ind. 560, 49 N. E. 592 (1898).

[9] Lex v. Selway Steel Corp., 203 Iowa 792, 206 N. W. 586 (1925).

[10] Craig & Co. v. Uncas Paperboard Co., 104 Conn. 559, 133 A. 673 (1926).

[11] Industrial Mutual Deposit Co.'s Receiver v. Taylor, 118 Ky. 851, 82 S. W. 574 (1904).

[12] Cornelius v. C. C. Pictures, Inc., (C. C. A. 2d, 1924) 297 F. 444.

[13] Rockwood v. Foshay, (C. C. A. 8th, 1933) 66 F. (2d) 625.

[14] Quotation marks are put around "fraud" to differentiate it from the fraud known by our common-law concepts.

among or withdrawn by the shareholders or paid or conveyed to third persons without consideration. Thus the United States Supreme Court in *Sanger v. Upton*[15] held that a resolution of the corporation to the effect that no further call for money due on subscription agreements should be made was void as to creditors, the capital stock being a fund set apart for the payment of its debts. Then, there are situations where the courts, going beyond the capital stock fund, say that *all* the assets of the corporation are impressed with a trust for the creditors in that these assets cannot be wasted in such a manner as to injure the creditor.[16] In *Rouse v. Merchants' National Bank*[17] the court declared that a corporation does not own property like a natural person because it cannot, without restriction, dispose of its property, that as soon as corporate property is acquired it becomes impressed with the character of a trust fund for the purpose of carrying on the corporate business, and that shareholders and creditors are able to interpose to prevent its diversion from the charter purposes.

This doctrine is also applied in reorganization cases. In *Railroad Company v. Howard*[18] a transfer of the assets of a corporation by agreement between mortgage bondholders and its shareholders left unsecured corporate creditors unpaid while the old shareholders were given a new interest in a new corporation which acquired the old corporate assets. The Supreme Court held the transfer could not be solemnized by foreclosure. In those cases involving merger and consolidation when the creditors are not provided for by the old corporation, they can bring suit and follow the assets of the old corporation into the new corporation, these assets being impressed with a trust for their benefit.[19]

Upon analysis, it is difficult to see how one could call the capital stock or all the assets a trust fund for the benefit of creditors, for there are many essentials of a good trust which are lacking. There is no deed, and no consideration for a deed, setting up a trust naming trustees or

[15] 91 U. S. 56 (1875).

[16] Kearns v. Leaf, 1 H. & M. 681, 71 Eng. Rep. 299 (1862); Bradshaw v. Weber, 161 La. 789, 109 So. 492 (1926).

[17] 46 Ohio St. 493, 22 N. E. 293 (1889).

[18] 7 Wall. (74 U. S.) 392 (1868).

[19] American Ry. Exp. Co. v. Fleishman, Morris & Co., 149 Va. 200, 141 S. E. 253 (1928); Cole v. Millerton Iron Co., 133 N. Y. 164, 30 N. E. 847 (1893); Swing v. Empire Lumber Co., 105 Minn. 356, 117 N. W. 467 (1908). Reorganization is now generally regulated by statute and generally a creditor, if given a fair offer, cannot prevent the merger and consolidation, but can follow the assets of the old corporation into the new one to satisfy his debt. 17 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 8329 (1932). For a discussion of reorganization, see Frank, "Some Realistic Reflections on Some Aspects of Corporate Reorganization," 19 VA. L. REV. 541 (1933).

beneficiaries. Secondly, a trust is void if the beneficiaries are not certain, and the creditors of a corporation change every day. Third, instead of the trustee distributing the income from the res (which is very difficult to ascertain) among the beneficiaries, the trustee distributes the income among its stockholders. There is no need to carry this analysis any further, for from this perfunctory criticism it becomes apparent that the trust theory is simply a device based on the standards of fair play and decency to protect the creditors against injury. In reality, it seems that it is applied to allow the creditors or the receiver to enforce corporate rights of action which the corporation refused so to enforce.

2.

Many courts have either replaced the trust fund doctrine by, or combined it with, a fraud doctrine. The courts in substance say that the capital stock issued by a corporation is a representation of a fund which the creditors can look to for payment of their claims, and since the creditor relies on this, the disposition or impairment of this fund is a fraud on them. Thus, when the corporation declares dividends out of capital,[20] does not collect the balance of a debt owed by the shareholder on a subscription agreement,[21] buys overvalued property,[22] or gives capital stock as a bonus, there is a disposition of the capital assets of the corporation which is a fraud on the creditors and they may recover against those responsible.

On analysis, this "fraud" doctrine will not stand up under our legal concept of fraud.[23] To hold a party liable for fraud, there must be false representations fraudulently made under circumstances which entitle the plaintiff to rely thereon. If as a result of the plaintiff's reliance he suffers damage, the defendant is liable. Once that definition is applied, it becomes apparent that this "fraud" dictum is just another fictional device used by the courts in the interest of fair play. When a creditor extends credit to a corporation he probably never thinks of the capital stock, much less relies on it. The average creditor looks to the reputation of the firm and its current assets and liabilities, not to some figure set up in the charter which is on file at some state office. Assuming that the filing of the charter with the secretary of the state is a representation by the corporation to the public and that the creditor does rely on the statement, it would be impossible for a creditor to show his reliance was the proximate cause of his damage. The natural and proximate cause of his injury is the insolvency and the multiple

[20] Bottlers' Seal Co. v. Rainey, 243 N. Y. 333, 153 N. E. 437 (1926) (here the recipient of the capital had to return the money to the creditors).

[21] Ogilvie v. Knox Ins. Co., 22 How. (63 U. S.) 380 (1859).

[22] Rapids Grocery Co. v. Grant, 165 La. 593, 115 So. 791 (1928).

[23] See FRANK, LAW AND THE MODERN MIND (1930).

factors that lead to it. It would seem that this practice of calling a thing "fraud" or kindred names has resulted in stretching our legal ideas to the point where their application is decidedly out of line with our present concepts of such a doctrine.

3.

Contrary to the broad dicta enunciated by many cases there have been cases where the courts do not speak of a trust fund or fraud. There is a respectable body of authority holding that a duty of carrying on the business affairs of the corporation with due diligence is owed the shareholders and creditors by the management. The creditors and shareholders are placed in the same category as far as this duty is concerned.[24] The Wisconsin court in *Whitford v. Mohlenpah*[25] said,

> "as to stockholders and creditors the directors of a corporation stand in the relation of a fiduciary, and a breach of their duty as such, by means of which corporate assets are lost and dissipated to the damage of stockholders and creditors, makes the directors participating therein personally responsible."

Thus, when the director votes himself an exorbitant salary,[26] knowingly declares dividends out of capital,[27] negligently invests the corporate assets,[28] engages in ultra vires acts which result in insolvency,[29] or obtains preference for himself over other creditors of the insolvent corporation,[30] he commits a breach of duty to the creditors and is personally liable. Generally these misdeeds of the director are committed while the corporation is a solvent going concern and the theory of the action is that, since the corporation had a cause of action against the director for his breach of duty, the receiver can come in and liquidate this corporate asset. Many of the courts, in considering these cases, have declared that the gross negligence is such as to amount to constructive fraud on the creditors.[31] However, as the Virginia court in *Anderson v.*

[24] The court in Dresdner v. Goldman Sachs Trading Corp., 148 Misc. 541, 265 N. Y. S. 913 (1933), said that the management owes the shareholders and creditors a duty of due diligence and that the right to hold the directors for a breach of this duty is a derivative suit of the corporation which can be enforced by the shareholder or the receiver. This case was reversed in 240 App. Div. 242, 269 N. Y. S. 360 (1934), but on the ground that there was no proof of lack of due diligence on the part of the director.

[25] 196 Wis. 10, 219 N. W. 361 (1928).

[26] McKey v. Swenson, 232 Mich. 505, 205 N. W. 583 (1925).

[27] Guaranty Trust Co. v. Grand Rapids, G. H. & M. R. R., (D. C. Mich. 1931) 7 F. Supp. 511.

[28] Williams v. McKay, 40 N. J. Eq. 189 (1885).

[29] Wells v. Neill, 162 Miss. 30, 138 So. 569 (1931).

[30] Richards Co. v. The Mayfair, 287 Mass. 280, 191 N. E. 430 (1934).

[31] Swentzel v. Penn Bank, 147 Pa. St. 140, 23 A. 405, 415 (1892).

Bundy[32] said in holding a director liable for mismanagement, "It is plain the term 'gross negligence' is loosely used in many of the judicial decisions, and that it is sometimes used as the mere antithesis of a 'want of ordinary care.'" Here again we see the courts are finding liability so as to protect the creditors under a standard of fair play.

The reason for the application of these fictions by the courts is not hard to understand. Although the common-law doctrines of fraud and trusts were well-settled before the advent of this new creature of the state, abuses arose which had to be corrected. The protection of creditors being essentially a question of policy, the legislature was the first to put down safeguards for the creditors' benefit. Thus, we see the legislatures passing statutes forbidding issue of shares of par stock for overvalued property, forbidding watered stock, holding directors personally liable for declaring dividends out of capital stock, requiring that annual reports be open to public inspection and making officers signing such reports liable for all debts incurred while they were officers if there was any material misrepresentation in the report, and regulating reorganization proceedings.[33] The courts followed the spirit of these laws and, guided by a "due process" standard of decency and morality, undertook to circumvent the actions of this new legal being. It seems that the best solution to this problem of corporate creditors' rights would be for the courts to rely upon legislative policy as a guide.

Jerome J. Dick

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[32] 161 Va. 1 at 16, 171 S. E. 501 (1933). The same sentiments were uttered by the court in McEwen v. Kelly, 140 Ga. 720, 79 S. E. 777 (1913).

[33] For a history of this legislation, see Warren, "Safeguarding the Creditors of Corporations," 36 HARV. L. REV. 509 (1923).