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CORPORATIONS - STATUTES DECLARING WATERED STOCK VOID - EFFECT UPON THE STOCKHOLDER'S LIABILITY TO CREDITORS

CORPORATIONS — STATUTES DECLARING WATERED STOCK VOID — EFFECT UPON THE STOCKHOLDER'S LIABILITY TO CREDITORS — Prior to the present era of "blue sky" laws providing for the careful scrutiny by the state of the issuance of stock, the evil of watered stock was sought to be curbed by constitutional and statutory provisions of a prohibitory and often penal nature.[1] These statutes and constitutional provisions very generally take one of two forms. The Colorado and the Arizona provisions are typical. The Colorado statute provides:

> "No corporation shall issue stock or bonds except for money paid, labor done or property actually received. . . . All fictitious issues of stock shall be void." [2]

[1] For example, the issuance of fictitious stock is a felony in Wisconsin. 1 COOK, CORPORATIONS, 8th ed., 287, note (1923).

[2] Colo. Stat. (Courtright 1930), c. 34, § 995. This act copies verbatim the provisions of Art. 15, § 9 of the state constitution.

The Arizona constitution provides:

> "No corporation shall issue stock except to bona fide subscribers therefor or their assignees . . . all fictitious increases of stock or indebtedness shall be void." [3]

In practical effect the two types of provisions are indistinguishable. The phrase "bona fide subscribers" in the Arizona form is construed to mean one who actually turns something of value over to the corporation in lieu of the stock issued to him.[4] Although in many states today the issuance of stock is carefully scrutinized and the manner of liability thereon is carefully spelled out by statute, constitutional and statutory provisions like the ones quoted above still remain the law of the land in some twenty-seven states.[5] Hence the problem of interpreting them properly is very much alive today.

Before proceeding to a discussion of the effect of such provisions upon the liability of stockholders to *creditors* as it existed at common law, let us first glance at the effect upon the rights of the corporation as against the *holder* of such stock. At common law a corporation was bound by the contract it made with its stockholders. If it agreed to take fifty per cent of the par value of the stock and issue it as full paid, it was bound by this agreement. If it received property in exchange for stock at a valuation far in excess of its real value, it was bound by such acceptance.[6]

The situation is very different under our typical statute or constitutional prohibition. The legislature has specified what may be the consideration for which valid stock may be issued. It has said that a fictitious issue is void. It would therefore appear that if stock is issued in violation of such provision that the corporation itself or bona fide stockholders thereof would be in a position to assert that such stock was void and conferred no rights. Is this not in accord with the public policy of the state as declared in these provisions? Courts have very generally

[3] Art. 14, § 6 (1910).

[4] Frame v. Mahoney, 21 Ariz. 283, 187 P. 584 (1920).

[5] See Ettlinger v. Collins, 25 Ariz. 115, 213 P. 1002 (1923), wherein the court names the following: Pennsylvania, Oklahoma, Illinois, California, Nebraska, Kentucky, Alabama, Arkansas, Missouri, Texas, Louisiana, Colorado, Massachusetts, South Dakota, Ohio, New York, Wisconsin, Maine, Utah, Indiana, Mississippi, New Jersey, Tennessee, Washington, Oregon, Iowa, and Arizona. See 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 5209, p. 490 (1932), for citation and reference to the statutes in this question; also PARKER, CORPORATION MANUAL, ANNUAL SUBJECTS 19 and 22; DODD, STOCK WATERING 30, note (1930).

[6] 1 COOK, CORPORATIONS, 8th ed., § 30, p. 151 (1923); DODD, STOCK WATERING 29 (1930). In Horton v. Sherrill-Russell Lumber Co., 147 Ky. 226 at 231, 143 S. W. 1053 (1912), the court said: "While the contract stands unimpeached, the courts . . . will treat that as a payment which the parties have agreed should be a payment."

taken this view although the decisions under such statutes are in considerable confusion. Thus, holders of such shares have been denied the right to sue in the name of the corporation,[7] and stock issued for services to be performed has been held void in a suit by objecting stockholders.[8] In *Meir v. Eaton* the South Dakota court said: "Even with full knowledge of the facts, a South Dakota corporation is powerless to bind itself to assent to a fictitious issue of corporate stock. . . ." [9] Many other cases could be cited wherein it has been recognized that as between the corporation and the holder of stock issued in violation of constitution or statute, or as between such holder and a bona fide holder, the stock wrongfully issued is void.[10] There may be situations in which the stock will be considered voidable only,[11]

[7] Arkansas River Land, Town & Canal Co. v. Farmers' Loan & Trust Co., 13 Colo. 587, 22 P. 954 (1889).

[8] Thompson v. Commonwealth Finance Co., 46 S. D. 141, 191 N. W. 447 (1922).

[9] 46 S. D. 286 at 290, 192 N. W. 721 (1923).

[10] Lepanto Gin Co. v. Barnes, 182 Ark. 422, 31 S. W. (2d) 746 (1930) (holding stock issued for a note void because promissory note was not property received); Bank of Dermott v. Measel, 172 Ark. 193, 287 S. W. 1017 (1926); Axford v. Western Syndicate Investment Co., 141 Minn. 412, 168 N. W. 97 (1918) (action to cancel stock issued to X without consideration); Anderson v. Scandia Mining Syndicate, 26 S. D. 558, 128 N. W. 1016 (1910); Clarke v. Lincoln Lumber Co., 59 Wis. 655, 18 N. W. 492 (1884) (denying to plaintiff right to recover back money paid defendant corporation on a contract to issue stock as full paid for one half value, on ground contract was illegal and parties in pari delicto); Lee v. Cameron, 67 Okla. 80, 169 P. 17 (1917) (stockholders suit to cancel shares issued to D at 40% of real value); Altenberg v. Grant, (C. C. A. 6th, 1898) 85 F. 345; Garrett v. The Kansas City Coal Mining Co., 113 Mo. 330, 20 S. W. 965 (1892); Ettlinger v. Collins, 25 Ariz. 115, 213 P. 1002 (1923); Mackie Pine Products Co. v. Frederick, 148 La. 687, 87 So. 712 (1921); Overlock v. Jerome Portland Copper Co., 29 Ariz. 560, 243 P. 400 (1926) (action to compel transfer of certificates representing bonus shares on books of company); Frame v. Mahoney, 21 Ariz. 282, 187 P. 584 (1920). In Rice v. Thomas, 184 Ky. 168, 211 S. W. 428 (1919), the court held that corporation creditors could not before insolvency enjoin the corporation from cancelling stock issued without consideration.

First Avenue Land Co. v. Parker, 111 Wis. 1 at 6, 86 N. W. 604 (1901), held that stock issued without consideration is void even in hands of a bona fide transferee without notice. "His certificate is so much waste paper, and he is not a stockholder," said the court. However, the court cites a number of cases that point out that innocent purchasers of void certificates may sue the corporation for misrepresentation and deceit and recover damanges.

[11] 1 COOK, CORPORATIONS, 8th ed., § 30, p. 151 (1923); Bankers Trust Co. v. Rood, 211 Iowa 289, 233 N. W. 794 (1930). In this case, the court in interpreting a related statute said (211 Iowa 289 at 296): "The purpose of the legislators in enacting the statute was to secure to the corporation payment for its stock in money or its equivalent to an amount equal to the par value of the stock. That object will be attained more successfully and certainly if the stock issued in violation of the statute is held to be voidable than if adjudged to be absolutely void. If it is held to be voidable

but in general it is held to be absolutely void, conferring no rights and subjecting the holder to no liabilities.[12]

Just how great will be the effects of such provisions will depend to a large extent upon the interpretation give the word "fictitious." Here the courts are not in harmony. In a substantial number of states it has been held that the stock is not fictitious if any real value has been given therefor.[13] If, on the other hand, the shares have been issued for little or no consideration they are held to be void.[14] This distinction leads to an absurd result when it is carried over and applied to the case of a bill by a corporate creditor against the stockholders. The holder of shares issued as a bonus will get off entirely free, while the holder for whose shares some consideration has been given will be liable for full par value.[15] In some states the distinction is not made and the stock is considered fictitious if issued for less than its par value.[16]

the corporation may avoid it, if its full value is not paid when demanded, and on the other hand may secure that value if the purchaser is willing to pay it. If it is held to be utterly void, it can recover nothing for the stock it has sold, and must return that which it has received."

[12] The courts have very generally taken this view with regard to stock issued in violation of other requirements set up for an issue of stock. For example, in Walton v. Standard Drilling Co., 43 S. D. 576, 181 N. W. 96 (1921), the state code provided: "When property is taken by the corporation in consideration for capital stock, the judgment of the directors made in good faith and entered in the minutes of the corporation shall be conclusive as to the value of such property." The court held void stock issued for property on the value of which the board never passed. In Northwest Mfg. & Milling Co. v. French, 44 S. D. 195, 183 N.W. 117 (1921), stock was held void under the same code provision because there was no notation in the minutes of the judgment of the directors. See also, Attorney General v. Massachusetts Pipe Line Gas Co., 179 Mass. 15, 60 N. E. 389 (1901) (stock issued without approval of board of commissioners as required by statute); Cecil B. DeMille Productions v. Woolery, (C. C. A. 9th, 1932) 61 F. (2d) 45.

[13] Stein v. Howard, 65 Cal. 616, 4 P. 662 (1884); Beitman v. Steiner Bros., 98 Ala. 241, 13 So. 87 (1892); Lake St. Elevated Ry. v. Zeigler, (C. C. A. 7th, 1900) 99 F. 114; Memphis & Little Rock R. R. v. Dow, 120 U. S. 287, 7 S. Ct. 482 (1887); 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 5309, p. 495 (1932). In California Trona Co. v. Wilkinson, 20 Cal. App. 694 at 703, 130 P. 190 (1912), the court said: "If there is a consideration of some sort and the transaction is one intended to redound to the benefit of the corporation in the prosecution of its corporate purposes, the consideration is sufficient [to satisfy the statute]. . . . "

[14] Cortelyou v. Imperial Land Co., 156 Cal. 373, 104 P. 695 (1909); Lucey Co. v. McMullen, 178 Cal. 425, 173 P. 1000 (1918).

[15] Yet this is the result the California court appears to reach. See infra in this comment.

[16] Lee v. Cameron, 67 Okla. 80, 169 P. 17 (1917); Pfister v. Milwaukee Electric Ry., 83 Wis. 86, 53 N. W. 27 (1892) (bonds issued for less than 75 per cent of value); Overlock v. Jerome Portland Copper Mining Co., 29 Ariz. 560, 243 P. 400 (1926); Altenberg v. Grant, (C. C. A. 6th, 1898) 85 F. 345; Garrett v. Kansas City Coal Mining Co., 113 Mo. 330, 203 S. W. 965 (1892); Anderson v. Scandia Mining Syndicate, 26 S. D. 558, 128 N. W. 1016 (1910).

Having decided that for most purposes stock issued in violation of one of these provisions is void as between corporation and holder, and creates no rights or liabilities, we must now face the problem of the effect of such provisions upon the rights of corporate creditors as they existed at common law. This was the problem presented to the court in the recent case of *Hirschfield v. McKinley*.[17] In this case the trustee in bankruptcy of a corporation was suing one of the original subscribers for the balance alleged to be unpaid on his stock subscription. Stock of the par value of $24,900 had been issued to the defendant for services valued at $350 at the most. The court denied recovery and indicated that the constitutional provision quoted above was to be given full effect. It was pointed out that: [18]

> "the issuance of stock by a corporation for which no sufficient consideration has been paid is contrary to public policy and the stock so issued is void. . . . It appearing from the record that the contract on which the plaintiff seeks to recover was by the public policy of the state declared to be void, no recovery can be had thereon as against any person. . . .
>
> "The decisions in the *Bruce Bros.* cases [19] made it clear that the supreme court of Arizona has adopted the 'blank piece of paper' doctrine in force in California and other jurisdictions. . . .
>
> "Stock issued without authority and in violation of law is void and confers no rights upon the person to whom it is issued and subjects him to no liabilities."

If we assume the premise that the only basis for the rights of the creditor against the stockholder is the contract between the latter and the corporation, this result is perfectly logical. The express contract of the stockholder is only that he will pay the price agreed upon, whether this be the par value or not. Nor can a contract to pay full par value be implied logically in the face of such a statutory declaration. If the certificate of stock is void, if it amounts to no more than a "blank piece of paper," it is difficult to see how its receipt can be the consideration for any sort of implied promise.[20] Yet in Fletcher on *Corporations* it is stated:

[17] (C. C. A. 9th, 1935) 78 F. (2d) 124.

[18] 78 F. (2d) 124 at 131 ff.

[19] National Union Indemnity Co. v. Bruce Bros., Inc., (Ariz. 1934) 38 P. (2d) 648; Scott v. Bruce Bros., Inc., (Ariz. 1934) 38 P. (2d) 654.

[20] Yet the Supreme Court of Washington in Gordon v. Cummings, 78 Wash. 515 at 524, 139 P. 489 (1914), in interpreting the Washington constitutional provision (Art. 12, § 6), which is the exact duplicate of the Arizona provision, in an action brought by receivers to recover for creditors the balance alleged to be due on stock issued as a bonus made this statement: "The defendants were charged with a knowl-

"If stock is issued at a discount for cash, in violation of an express statutory prohibition, the issue of the stock is not void, but the agreement that it shall be paid for at less than its par value is illegal and void, and cannot be enforced. In such a case the subscriber or purchaser is liable for the full par value." [21]

However desirable such a result may be from the point of view of policy, its logic is hard to follow. The general rule of the early common law was to the effect that an illegal contract was absolutely unenforceable. Later this rule was ameliorated to the extent of recognizing that the part of such a contract for which the consideration is not illegal may be enforced. But such part was never enforceable unless the contract was severable.[22] In the case of a contract for the purchase of stock, the contract is entire and inseverable. If the illegality goes to the type of consideration or to the amount of consideration received, it goes to the entire contract. To hold the provision as to consideration bad, and yet enforce the contract, is to make a contract for the parties, one that they never agreed upon and probably would not have agreed upon. It seems highly technical and requires considerable syllogistic prestidigitation to say that in fact the agreement as to price was severable and separate from the agreement to take the stock. However, there seems to be some little support for this view as set forth by Fletcher in the above quoted paragraph.[23]

The above logic is in accord with the former English view on the subject of stockholder liability. The English courts held that if there was any fraud or illegality in the picture the contract could be rescinded. But it had to be rescinded in toto or accepted and adopted in toto.[24] The English courts and a small minority of American courts have apparently always insisted that the only liability of stockholder to

edge of the law and that as against creditors, the acceptance of the bonus stock carried an implied promise to pay for it if it became necessary to do so."

How can we explain this logically except to say that this "implied promise" theory is just a method of stating the fact that the courts feel the stockholder should be liable?

[21] 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 5224, p. 546 (1932).

[22] 3 WILLISTON, CONTRACTS, § 1780, pp. 3090-3091 (1920).

[23] Such seems to have been the reasoning of the court in the case of Dupont v. Ball, 11 Del. Ch. 430, 106 A. 39 (1918). In this case the court interpreted the transaction as a stock subscription plus an agreement on the part of the corporation to issue stock as fully paid and subject it to no further assessment. The latter agreement was void, the court held, and that leaves valid only the stock subscription from which is implied a promise to pay full par value. There is no Delaware statute declaring such stock to be void, however. See also, DODD, STOCK WATERING 29, note (1930).

[24] 1 COOK, CORPORATIONS, 8th ed., § 46, p. 295 (1923); 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 5232, p. 566 (1932); 8 CENT. L. J. 142 (1879).

creditor must be upon the basis of some statute or upon his contract with the corporation. In *Christensen v. Eno* [25] a corporation issued new stock and credited defendant with a payment of forty per cent which was in fact pure gratuity. The court held that as between the corporation and the stockholder the corporation had no right to object that the stock was not full paid, and that the plaintiff, a creditor, had no better rights than the corporation. In the words of the court:

> "There are unquestioned evils growing out of the creation and multiplication of shares of stock in corporations not based upon corporate property. The remedy is with the legislature. But the liability of a stock holder to pay for stock does not arise out of his relation, but depends upon his contract, express or implied, or upon some statute; and in the absence of either of these grounds of liability, we do not perceive how a person to whom shares have been issued as a gratuity has by accepting them committed any wrong upon the creditors or made himself liable to pay the nominal face of the shares as upon a subscription or contract."

If this view of a stockholder's liability be accepted, it would seem that the logical effect of our statutory prohibition would be that given by the federal court in *Hirschfield v. McKinley*, quoted above. The contract being void, no suit could be maintained upon it. The rights of creditors would be unaffected where the stock is not fictitious, but creditors might be in a worse position than at common law if the stock is held to be fictitious. Suppose, for example, that the court is one that demands that full par value be paid to satisfy the statute. Suppose further that stock has been issued for less than par, but a part of the price agreed upon still remains unpaid. If such a contract is void the creditors could not logically enforce the stockholder's liability for the unpaid balance he had agreed to pay. Probably a court faced with such a situation would say that for this purpose the stock is only voidable,[26] or work out some sort of an estoppel.

But if the basis of the stockholder's liability upon his watered stock is not ex contractu but ex delicto, the situation is vastly different. Although courts do not always seem to have been too sure of their fundamental premises, they seem to have based the two majority theories of stockholder liability upon an ex delicto foundation. The basis of both the trust fund and the fraud theories is reliance—presumed or proved in fact—by a creditor upon the representation made by the corporation and participated in by the stockholder, that the stock is all

[25] 106 N. Y. 97 at 101, 12 N. E. 648 (1887).

[26] See analogous holding in Bankers Trust Co. v. Rood, 211 Iowa 289, 233 N. W. 794 (1930), a part of which is quoted supra, note 11.

paid in at full par value.[27] The California court points this out very clearly in the case of *Spencer v. Anderson.*[28] The court draws a distinction between an action upon an unpaid subscription which does sound in contract and an action by creditors to recover from stockholders who had received watered stock. In the latter case, says the court, the gist of the action is tort. Both are enforced by a creditor's bill in equity, but in the former case the creditor sues in the right of the corporation. In the second case he sues in his own right and the gist of the action is fraud and deceit. He may recover whether the corporation has a claim or not. His right "is to recover compensation for a wrong done directly to him by the corporation, acting for the stockholder and participated in by the latter." [29]

A long line of cases in California, which until recently had a constitutional provision identical with that of Colorado, recognizes this distinction in the situation where a transferee of the original subscriber is sued for the unpaid balance on his watered stock. As the court said in *California National Supply Co. v. O'Brien*:[30]

> "It follows that because fraud, actual or constructive is the basis of stockholder's liability, one who did not participate in the original fraudulent transaction, or who acquired his stock in ignorance of that transaction and who is not fairly chargeable with knowledge thereof, taking stock in the bona fide belief that it had been fully paid for, cannot be held liable."

If, then, the basis of the stockholder's liability upon his watered stock is ex delicto, what is the effect of a provision rendering watered stock void? Logically, such provision would seem to have no effect whatever. There is just as much holding out by the stockholder, just as much reliance by the creditor, just as much injury to the creditor, where the stock is void as where it is perfectly valid. We may have serious doubts as to the logic of the creditor-reliance theories. We may argue that creditors do not rely upon the authorized capital of a corporation. But if we assume, as upon authority we must, that this is the basis of stockholder liability, then the voidness of the stock itself is immaterial.

This appears pretty generally to be the result reached by the cases,

[27] 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 5233, p. 577 (1932); 49 CENT. L. J. 284 (1899); Rhode v. Dock-Hop Co., 184 Cal. 367, 194 P. 11 (1920).

[28] 193 Cal. 1 at 6, 222 P. 355 (1924).

[29] Spencer v. Anderson, 193 Cal. 1 at 6, 222 P. 355 (1924).

[30] 51 Cal. App. 606 at 613, 197 P. 414 (1921). Other California cases: Rhodes v. Dock-Hop Co., 184 Cal. 367, 194 P. 11 (1920); Sherman v. S. K. D. Oil Co., 185 Cal. 534, 197 P. 399 (1921).

at least where the only irregularity in the stock issue is the failure to exact full par value.[31] In fact it is sometimes expressly recognized that at least one of the purposes of such provisions is the protection of creditors, and that any interpretation that would tend to decrease their rights would do violence to this purpose. The Arizona Supreme Court, in reference to the identical constitutional provision on which the federal court relied in the *Hirschfield* case, said: "The evident purpose of the clause . . . was to prevent the issuance of stock except to parties who paid for it at its full face value and [it] was intended more for the protection of the creditors than otherwise." [32]

The Washington court said that if the Washington constitutional provision[33] meant anything, it was that one who took the stock of a corporation was liable for its value.[34] The *Hirschfield* case itself is no authority for any contrary position. The authority of that case is expressly limited to actions ex contractu. The court expressly stated that, if by some freak interpretation the action of the plaintiff could be considered as sounding in tort, he would have to show that all of the creditors whom he represented as trustee had been defrauded by misrepresentation of the actual stock of the company. There was no such proof forthcoming in that case.[35]

The writer has been able to discover only two states in which the statutory or constitutional voidness of a stock issue has been held to affect the liability of a stockholder as it existed at common law. In North Dakota there is a constitutional provision typical of the class under discussion.[36] In the case of *Lavell v. Bullock*,[37] the court was faced with the problem of interpreting it in the light of the rights of creditors. In this case the trustee in bankruptcy of a corporation was seeking to recover full par value from stockholders who held stock as a gratuity. Three of the judges denied liability on the ground that

[31] For cases on this, see the lengthy annotation in 1 COOK, CORPORATIONS, 8th ed., § 45b (1923), and especially Shugart v. Maytag, 188 Iowa 916, 176 N. W. 886 (1920), and Dupont v. Ball, 11 Del. Ch. 430, 106 A. 39 (1918), in which it is expressly stated that illegality of issue is no defense in an action by a creditor.

[32] Overlock v. Jerome Portland Copper Mining Co., 29 Ariz. 560 at 564, 243 P. 400 (1926).

[33] Art. 12, § 6. "Corporations shall not issue stock except to bona fide subscribers or their assignees."

[34] Gordon v. Cummings, 78 Wash. 515, 139 P. 489 (1914).

[35] And in the earlier case, Re Phoenix Hardware Co., (C. C. A. 9th, 1918) 249 F. 410, the same federal court, applying the same Arizona law, held that where a stock of merchandise was turned over to a corporation for stock, the par value of which was five times the value of the merchandise, the corporate creditors might hold the parties receiving the stock liable for the difference.

[36] N. D. Constitution, § 138.

[37] 43 N. D. 135, 174 N. W. 764 (1919).

there was no showing the creditors had ever dealt with the bankrupt as a corporation or had been deceived in any way. Three more judges, however, placed their decision on the ground that the stock was issued as a bonus in conflict with the constitutional and statutory prohibition. Hence they said the stock was void and carried no liability. The defense of illegality of issue, they maintained, is as available against creditors as against the corporation itself.

The California court seems to have taken the position that if the stock is issued without consideration and is entirely fictitious no liability attaches even as against creditors. At least that appears to be the holding of two California cases. In *Kellerman v. Maier* [38] there had been a bonus issue of stock to *A* and *B* to equalize their holdings with those of other parties to whom stock had been issued at a lower price. The court denied a recovery to a creditor on the ground of the statutory voidness of the stock, with the following statement: "The parties receiving them [the shares] did not thereby become shareholders nor make themselves liable to creditors as for an unpaid subscription."

This result may seem strange in view of the fact that California is a state that follows the tort theory of liability.[39] The court in the above case did not mention this, however, but proceeded on the assumption that the statute making fictitious stock void controlled the situation. Although it does not appear clearly on the record, it is arguable that the plaintiff was proceeding entirely on a contract theory. It is noticeable that the court says that there is no liability "as for an unpaid subscription." Liability for an unpaid subscription is clearly based upon contract.

The *Kellerman* case was relied upon in *Lucey v. McMullen*,[40] decided by the same court twenty years later. In that case the complaint of the plaintiff, a judgment creditor, alleged that the defendant had been issued stock for which no consideration had been paid. For answer the defendant denied that the stock was issued without consideration, but claimed that it was issued to him as part consideration for a loan he made to the corporation. The court held that the complaint was itself defective, and that a demurrer to it should have been sustained, because if no consideration had been paid for the stock, it was void and defendant was not liable for its value. But the court said that the defect of the complaint had been remedied by the answer, for if *any* consideration had been received for the stock, it was not void. If not void, defendant would be liable for the balance of the par value thereof on general principles of stockholder liability. Certainly this is a very

[38] 116 Cal. 416 at 424, 48 P. 377 (1897).

[39] Supra, notes 27, 28.

[40] 178 Cal. 425, 173 P. 1000 (1918).

strange result and an illogical one to be reached by a court that ordinarily proceeds on a tort theory of stockholder liability. Aside from these two states there appear to be no others that give any such effect to their constitutional and statutory provisions concerning watered stock. It will be noticed that the result is by no means clear even in these states.

Before concluding our discussion, for the purpose of completing our picture let us consider the case wherein the watered stock issued is also subject to attack as over-issued stock. In such case the stock is invariably held void even as against a creditor, and the defendant stockholder is not estopped to assert the illegality of the issue as a defense to an action to enforce his liability for par value.[41] These cases, however, do not constitute an exception to our general statement that the constitutional or statutory voidness of an issue of stock is of no effect upon the liability of holders of such stock as it existed at common law. Even at common law a stockholder could not be held liable on his watered stock, if it were also an over-issue.[42] The act of the corporation in making the issue is ultra vires and the contract is void; but it is difficult to see how this rules out liability to creditors on a fraud theory. Yet this is the result that follows logically from an illogical premise. Both the fraud and the trust fund theories depend upon *reliance* by the creditor, but it is reliance upon the *authorized* capital of the corporation as shown in the state files. Over-issued stock would not be shown in the records of the state ordinarily—or, if it were shown, it would necessarily appear on its face to be over-issued stock, and creditors would be chargeable with knowledge of this. The really difficult case to explain is the one in which there is actual reliance upon an actual representation by the corporation that it has a new and valid issue of stock, completely paid in. Bonbright, in an article in the *Columbia Law Review*, states the problem and his answer thereto in this manner:

> "If fraud is the basis of liability at common law as the courts say it is, why then is not the fictitious issue of unauthorized stock just as fraudulent as the authorized issue for an invalid consideration? One possible answer is that creditors are presumed to have

[41] Pruitt v. Oklahoma Steam Baking Co., 39 Okla. 509, 135 P. 730 (1913); State ex rel. Walcott v. Hardister, 108 Okla. 64, 237 P. 75 (1924); Heide v. Capital Securities Co., 200 Ala. 397, 76 So. 313 (1917); Marion Trust Co. v. Bennett, 169 Ind. 346, 82 N. E. 782 (1907); Kampman v. Tarver, 87 Tex. 491, 29 S. W. 768 (1895).

[42] The leading case on this point is Scoville v. Thayer, 105 U. S. 143, 26 L. Ed. 968 (1881). In that case the assignee in bankruptcy was denied a recovery against stockholders who held watered, but over-issued stock. The distinction was taken between shares which the company had no power to issue and shares which the company had the power to issue although not in the manner in which or upon the terms upon which they have been issued.

> a knowledge of the law . . . and therefore their personal knowledge that the issue is illegal disqualifies them from asserting a fraud liability. On the other hand creditors are not supposed to have knowledge of the facts . . . and therefore their knowledge of the inadequate consideration will not be pre-supposed but will be a matter of defense on the part of the stockholder." [43]

Expressed more simply, creditors may rely only upon the authorized stock of the corporation and over-issued stock is not authorized stock.

In conclusion it must be said that these statutory and constitutional provisions declaring watered stock to be void have had very little effect upon the rights of creditors as they existed at common law, or under other statutes. They have no doubt served somewhat as a deterrent to the issuance of fictitious stock—especially where the statute is penal in nature, but their deterrent effect has been diminished by the interpretation that an issue of stock below par is not necessarily fictitious, if some consideration is advanced.[44] Such provisions clearly do not add much to the creditor's rights against the holders of watered stock personally, though they might be the basis for an action by the creditor to force cancellation of such stock. If the basis of stockholder liability on watered stock is ex contractu, the provision may decrease the rights of the creditor. Logically it could absolutely prevent the enforcement of any liability because no contract should be implied from receipt of a void stock certificate. Logically it would also prevent any action upon the contract for any unpaid balance due upon the watered stock by the express terms of the subscription contract. Courts have generally followed the logic of the situation here in the first situation, but the result in the second is doubtful. However, whether or not we can agree with the logic of the courts, the very great majority of them place the stockholder's liability upon an ex delicto basis. With this as one starting point it is difficult to see that a provision declaring stock void can have any effect upon the liability of the stockholder as it existed at common law. Considering the purpose of these provisions, such a result was to be expected. The cases of over-issued watered stock form no real exception because the holders of such stock seem not to have been liable to creditors at common law.

J. S. W.

[43] Bonbright, "Shareholders' Defenses Against Liability to Creditors in Watered Stock," 25 COL. L. REV. 408 at 426 (1925).

[44] For summary criticism of this type of provision see 11 FLETCHER, CYCLOPEDIA CORPORATIONS, perm. ed., § 5209, p. 495 (1932); 1 COOK, CORPORATIONS, § 45b (1923).