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CORPORATIONS — RIGHTS OF CREDITORS OF INSOLVENT CORPORATION — GREATER THAN RIGHTS OF CORPORATION — The dissenting and majority opinions of Justices Roberts and Cardozo in the recent case of *McCandless v. Furlaud*[1] are illustrative of basically divergent conceptions of the status and function of the corporate receiver. In the following examination and evaluation of these conflicting positions, attention will be directed chiefly to those situations involving the problem of promoter's profits. The language and attitude of the courts, however, is typical of that adopted in all cases in which the questions considered arise and the conclusions suggested are of general application.

According to Mr. Justice Roberts, the receiver's rights are strictly derivative; he is quite literally successor to his predecessor corporation and his rights are no different from, nor can they rise any higher than, the insolvent's.[2] Mr. Justice Cardozo, on the other hand, would admit instances in which a receiver for the benefit of the corporate creditors could bring actions which the corporation could not and thus recognize his rights as not being essentially derivative but different from and even superior to those of the insolvent.[3] The answers to several interrelated but important questions concerning the receiver's capacities are dependent upon which of these views is adopted.

Assets are overvalued and overcapitalized and excessive amounts of stock are given promoters. What sort of action do creditors have against promoters upon insolvency brought about because of such practices? Does corporate approval of promoters' machinations insulate them from everything save an action for deceit? Is the receiver merely the successor of the insolvent corporation subject to all of the disabilities attaching to it at the time of insolvency or do his rights in the interests of creditors transcend those of the insolvent so that he may

[1] 296 U.S. 140, 56 S. Ct. 41 (1935). The case is noted on another matter at p. 1192 of this issue of the Review, where a complete exposition of its facts will be found.

[2] "It has never been doubted that his [receiver's] right of action for a fraud committed upon the corporation by a third person is no greater than and no different from that available to the corporation. . . . a suit by the receiver must be in the right of the corporation, and the most he can claim is what the corporation could claim, namely a derivative right of suit based upon fraud perpetrated upon innocent stockholders who were such at the time of the consummation of the scheme. . . . the receiver's rights can in no way differ from those of the corporation." 296 U. S. 140 at 173-175, 56 S. Ct. 41 (1935).

[3] "No consent of shareholders could make such conduct lawful when challenged by the receiver as the representative of creditors. . . . It was not within the power of the shareholders to legalize this waste to the detriment of others. . . . Included in those assets are moneys fraudulently diverted to the prejudice of creditors. . . . There is power at the instance of the receiver to bring them back into the trust." 296 U. S. 140 at 159-161, 56 S. Ct. 41 (1935).

bring into the receivership fund assets which the corporation by its own action had precluded itself from recovering? In other words, if the corporation acting through its promoters permits itself to be despoiled by such promoters can the creditors be made whole in an action by the receiver or must they resort to some other form of remedy?

Support for both points of view is found in the cases; an array of actual decisions as well as dictum can be adduced on either side. The attitude of the earliest American cases would seem to incline them to the more limited view of the receiver's functions, that is, the receiver is the successor of the corporation and although he "represents the creditors," it is only for the purpose of liquidating the corporation as he finds it, subject to all attaching disabilities.[4]

The legal genealogy of this view is obscure. An early Georgia case[5] attributes it to Lord Hardwicke[6] as interpreted by Story.[7] Upon examination, however, the only basis for ascribing this position to his lordship is his enigmatic remark that the appointment of a receiver "does not at all affect the right."[8] The case adverted to involved a very different matter.[9]

Although it is not often articulately expressed in the cases, perhaps the real basis of this restricted capacity view is the conception of the receiver as being essentially a custodian who does little more than hold the property entrusted to him pending its disposition by the court.

[4] Moise v. Chapman, 24 Ga. 249 (1858); Republic Iife Insurance Co. v. Swigert, 135 Ill. 150 at 167, 173, 175-177, 25 N. E. 680 (1890); Kuser v. Wright, 52 N. J. Eq. 825 at 828, 31 A. 397 (1894); Bostwick v. Young, 118 App. Div. 490 at 496, 103 N. Y. S. 607 (1907); Mayer v. Metropolitan Traction Co., 165 App. Div. 497, 150 N. Y. S. 1026 at 1032 (1914); Folsom v. Smith, 113 Me. 83 at 86-89, 92 A. 1003 (1915); W. D. Cashin & Co. v. Alamac Hotel Co., 98 N. J. Eq. 432 at 443, 131 A. 117 (1925); Allen v. Marshall, 294 Pa. 185 at 189, 144 A. 77 (1928); Bank of California v. Clear Lake Lumber Co., 146 Wash. 543 at 561, 264 P. 705 (1928); Clark Car Co. v. Clark, (C.C.A. 3rd, 1931) 48 F. (2d) 169 at 117; Rockwood v. Foshay, (C. C. A. 8th, 1933) 66 F. (2d) 625 at 630; First Nat. Bank of Seminole v. Henshaw, 169 Okla. 49 at 53, 35 P. (2d) 898 (1934).

[5] Moise v. Chapman, 24 Ga. 249 at 251 (1858):

> "But Lord Hardwick, in Skip v. Howard, says, that the appointment of a receiver, 'does not at all affect the right' . . . .
>
> "And so great an authority as Lord Hardwick, may safely be followed in a statement so reasonable.
>
> "It follows, then, that any defense which might have been made by the defendant, against the bank, may be made by him, against the receiver."

The case mentioned is incorrectly cited; the true caption is Skip v. Harwood, 3 Atk. 565, 26 Eng Rep. 1125 (1747).

[6] Skip v. Harwood, 3 Atk. 564, 26 Eng. Rep. 1125 (1747).

[7] 2 STORY, EQUITY JURISPRUDENCE, 2d ed., p. 133, § 831 (1839).

[8] Skip v. Harwood, 3 Atk. 564 at 565, 26 Eng. Rep. 1125 (1747).

[9] The court actually held that a commission of bankruptcy did not supersede a decree for a receiver since the latter was discretionary with the court.

This doctrine is most clearly set forth in the often cited case, *Republic Life Insurance Co. v. Swigert.*[10]

Other courts, however, early began to find exceptional instances in which the receiver might maintain actions on behalf of creditors which the corporation would have been unable to prosecute for its own benefit.[11] This created an exception to the general rule which has often

[10] 135 Ill. 150, 25 N.E. 680 (1890). An insurance company was in difficulties. Much of its stock was only one-fifth paid up. A stockholders' meeting by resolution permitted any shareholders who desired to turn in their old certificates, have them cancelled, and receive new certificates representing one-fifth the number of shares of fully paid up stock. The receiver by petition sought to enforce a subscriber's liability based upon the original number of shares held. The applicable statutory provision permitted the appointment of receivers "to take charge of the estate and effects of the company . . . and do all other acts necessary for the collection, marshalling and distributing of the assets of the company and the closing of its concerns." The court held that only creditors were entitled to impeach the operations delineated. Could the receiver do it in their behalf?

The court pointed out (135 Ill. 150 at 167):

"We understand the rule to be, that where a receiver is appointed for the purpose of taking charge of the property and assets of a corporation, he is, for the purpose of determining the nature and extent of his title, regarded as representing only the corporate body itself, and not its creditors or shareholders, being vested by law with the estate of the corporation, and deriving his own title under and through it, and that, for the purposes of litigation, he takes only the rights of the corporation, such as could be asserted in its own name, and that upon that basis, only, can he litigate for the benefit of either shareholders or creditors."

Further on (135 Ill. 150 at 176-177) the court suggests:

"A receiver, *virtute offici* . . . is only a custodian of property. He is ordinarily, in respect to his title and in respect to the litigation in which he may engage, merely the representative of the owners of the property submitted to his control."

The Republic Life Insurance case must be read in conjunction with a subsequent and almost equally well-known Illinois case, Peabody v. New England Water Co., 184 Ill. 625 at 627, 56 N. E. 957 (1900), in which it was held that a receiver represented creditors as well as the corporation and might do some things the corporation could not when he was appointed under a statute reading: "and courts of equity shall have full power, on good cause shown, to dissolve or close up the business of any corporation, to appoint a receiver therefor, who shall have authority, by the name of the receiver of such corporation [giving the name], to sue in all courts and do all things necessary to closing up its affairs, as commanded by the decree of such court." Cf. Sangamon Loan & Trust Co. v. Peoples Savings Bank & Trust Co., 204 Ill. App. 7 (1917).

[11] Gillet v. Moody, 3 N. Y. 479 at 488 (1850); Casey v. Cavaroc, 96 U. S. 467 at 488, 489, 24 L. Ed. 779 (1877); Pittsburgh Carbon Coal Co. v. McMillan, 119 N. Y.. 46 at 53, 23 N. E. 530 (1890) and cases cited therein; Voorhees v. Indianapolis Car & Mfg. Co., 140 Ind. 220 at 239, 39 N. E. 738 (1894); Hamor v. Taylor-Rice Engineering Co., (C. C. Del. 1897) 84 F. 392 at 399; Franklin National Bank v. Whitehead, 149 Ind. 560 at 583-584, 49 N. E. 592 (1898); In re The Wilcox & Howe Co., 70 Conn. 220 at 231, 39 A. 163 (1898), and the cases cited therein; Hayes v. Pierson, Jr., 65 N. J. Eq. 353 at 354, 58 A. 728 (1899); Harrigan v. Gilchrist, 121 Wis. 127 at 237, 240, 99 N. W. 909 (1904); Atlantic Trust Co. v. Chapman, 208 U. S. 360 at 371, 28 S. Ct. 406 (1908); Marion Trust Co. v. Blish, 170

been interpreted as comprehending all those cases in which a "fraud" had been practiced upon the creditors which the corporation by assenting thereto had rendered itself unable to assail.[12] The courts seem to have been greatly influenced toward the recognition of receiver's superior rights in situations entailing "fraud" by *High* on *Receivers*[13] which is cited in case after case.[14] A similar attitude was adopted for insolvent partnerships.[15]

Mr. Justice Roberts would seem to reject this "fraud" qualification in the *McCandless* case. The assets were grossly overvalued and bonds issued against them upon the basis of such extravagant appraisals. Most of the difference between the amount realized from the sale of the bonds and the actual cost of the properties was pocketed by the promoters. It would not be difficult to find a "fraud" even though the bonds

Ind. 686 at 690, 691, 696, 699, 84 N. E. 814 (1908); E. I. Du Pont Co. v. John Shields Construction Co., (C. C. Pa. 1908) 162 F. 198, affd. H. K. Porter Co. v. Boyd, (C. C. A. 3rd, 1909) 171 F. 305; American Can Co. v. Erie Preserving Co., (C. C. N. Y. 1909) 171 F. 540 at 542; Marcouvich v. O'Brien, 63 Ind. App. 101, 114 N. E. 100 (1916); Welliver v. Coate, 65 Ind. App. 195, 114 N. E. 775 (1917); Sangamon Loan & Trust Co. v. Peoples Savings Bank & Trust Co., 204 Ill. App. 7 (1917); Graselli Chemical Co. v. Aetna Explosive Co., (C. C. A. 2nd, 1918) 252 F. 456; Fletcher American National Bank v. McDermid, 76 Ind. App. 150, 128 N. E. 685 (1920); Keedy v. Sterling Electric Appliances Co., 13 Del. Ch. 66 at 75, 115 A. 359 (1921), and cases cited therein; Westinghouse Electric & Mfg. Co. v. Brooklyn Rapid Transit Co., (D. C. N. Y. 1922) 291 F. 836 at 858; Sweet v. Lang, (D. C. Minn. 1924) 14 F. (2d) 758 at 760; Stone v. Young, 210 App. Div. 303, 206 N. Y. S. 95 at 100 (1924); Duke v. L. Y. Stayton Co., 132 Wash. 69, 231 P. 171 (1924); Woodward, Jr. v. Sonnesyn, 162 Minn. 397 at 404, 203 N. W. 221 (1925); Peterson v. Darelius, 168 Minn. 365, 210 N. W. 38 (1926); Hoyt v. Hampe, (Iowa 1927) 214 N. W. 718; In re Bryce Cash Store, 12 La. App. 365, 124 So. 544 (1929); Weber Showcase & Fixture Co. v. Waugh, (D. C. Wash. 1930) 42 F. (2d) 575; Iglehart v. Todd, 203 Ind. 427, 178 N. E. 685 (1931); Shaw v. Borchers, (Tex. Comm. App. 1932) 46 S. W. (2d) 967; Cecil B. De Mille Productions, Inc. v. Woolery, (C. C. A. 9th, 1932) 61 F. (2d) 45; Smith v. Commercial Credit Corp., 113 N. J. Eq. 12 at 17, 165 A. 637 (1933), affd. (*sub nom.* Morrow v. Smith), 115 N. J. Eq. 310, 170 A. 607 (1934); Beach v. Beach Hotel Corp., 117 Conn. 445, 168 A. 785 (1933); Verder v. American Loan Society, 1 Cal. (2d) 17, 32 P. (2d) 1081 (1934). The trend of the decisions is indicated by a recent decision in which the emphasis was shifted and the usual statement of the rule was amended to read that the receiver represents stockholders as well as creditors. Greenbaum v. Lehrenkrauss Corp., (D. C. N. Y. 1935) 9 F. Supp. 425.

[12] Franklin National Bank v. Whitehead, 149 Ind. 560, 49 N. E. 592 (1898); In re The Wilcox & Howe Co., 70 Conn. 220, 39 A. 163 (1898); Marion Trust Co. v. Blish, 170 Ind. 686, 84 N. E. 814 (1908); Stone v. Young, 210 App. Div. 303, 206 N. Y. S. 95 (1924); Shaw v. Borchers, (Tex. Comm. App. 1932) 46 S. W. (2d) 967.

[13] HIGH, RECEIVERS, 4th ed., pp. 386-387, § 315 (1910).

[14] For example, Voorhees v. Indianapolis Car Mfg. Co., 140 Ind. 220, 39 N. E. 738 (1894); Harrigan v. Gilchrist, 121 Wis. 127, 99 N. W. 909 (1904).

[15] Lees v. Dobson, 26 App. Div. 624, 49 N. Y. S. 902 (1898).

were held for a brief period by the promoters themselves. Because the minority judges accept the premise that a receiver's rights can rise no higher than those of his corporate principal, they assert that the result reached by the majority is equivalent to investing the receiver with the personal actions of the various creditors for deceit and misrepresentation.

Mr. Justice Cardozo expressly repudiates this interpretation in the concluding paragraph of his opinion: "As we have striven to make clear, the receiver does not claim to have succeeded to the rights of bondholders or noteholders to recover damages for deceit. The wrong that is here redressed is the unlawful depletion of the assets whereby the company was made insolvent and the creditors were defrauded of their lawful rights and remedies."[16] The "fraud" involved was launching a corporation which was grossly insolvent from the outset because the promoters had appropriated for themselves a large part of what should have been its assets; that is, the money realized from the sale of securities based upon knowingly inflated values of properties acquired.

It is submitted that the latter view and the cases giving to the receiver actions for the benefit of creditors for "fraud" make possible the more desirable result. Such a view would prevent a multiplicity of actions among creditors, promoters, and the insolvent and make receivership better serve what modern courts are coming to recognize as its fundamental purpose: salvaging for the creditors all rights which accrue to them in consequence of their relations with the insolvent corporation.

Desirable as the result may be, the analysis by which it has been obtained in most prior decisions represented at best a transitory position in legal evolution and leaves much to be desired. The explanation of most courts involves a compromise: The receiver represents the corporation and succeeds only to its rights, subject however to certain exceptions where fraud has been practiced upon the creditor. Under such a view, the definitive part of the rule lies in its nebulous group of exceptions.

Such a solution has been productive of much confusion, since courts have felt that they have placed themselves in a somewhat paradoxical position. Much of this confusion would seem to have arisen from the concept of "representation." The receiver represents the corporation. By the unconscious force of analogy the courts assimilated this to the similar situation in the law of wills and estates, wherein a successor who took by representation might not improperly be viewed as standing in the shoes of his predecessor. Equitable and practical considerations, however, made application of such a doctrine in its most rigorous form

[16] 296 U. S. 140 at 167, 56 S. Ct. 41 (1935).

undesirable. To protect creditors and enable them to act in concert when a collective "fraud" had been practiced upon them, it came to be said that the receiver also represented the creditors.[17] But analysis of this sort has proved awkward and confusing; how can the receiver as representative occupy the conflicting positions of the insolvent and the creditor?

Such confusion would seem to be largely epithetical. The receiver represents the creditors in the sense that he is their instrument for collective action to enforce whatever rights inhere in them as a group and represents the insolvent corporation in that he preserves for its stockholders the residue that remains after all legitimate claims against it have been satisfied.

F.K.B.

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[17] The analysis in Sweet v. Lang, (D. C. Minn. 1924) 14 F. (2d) 758 at 760 is typical:

"Under the foregoing facts, no action could be maintained by the corporation itself to recover the amount so paid. Having fully acquiesced in such payments, the corporation would be estopped from claiming a right of recovery. So, too, the receiver, if he proceeded alone as a representative of the corporation, and for the enforcement of its rights, could not recover. His rights, under such conditions, would be the same as those of the corporation. . . .

"The receiver, however, in actions like these, represents and may enforce the rights of creditors as well as those of the corporation.

"Under certain [circumstances] an action on behalf of creditors for the recovery of moneys expended by the corporation may succeed, while an action on behalf of the corporation itself for the same purpose may not."