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Corporations - Stockholders - Effect of State Constitutional Provisions on Liabilty to Creditors for Unpaid Subscriptions

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CORPORATIONS—STOCKHOLDERS—EFFECT OF STATE CONSTITUTIONAL PROVISIONS ON LIABILITY TO CREDITORS FOR UNPAID SUBSCRIPTIONS—Basset and Company, an Oklahoma corporation, issued stock to defendant for which defendant never paid. The sum due was carried on the corporate books as "subscriptions receivable." The corporation became bankrupt and the trustee brought suit in the federal district court to recover the amount due on the subscriptions. *Held,* judgment for the defendant. Under the Oklahoma Constitution, where stock is issued for consideration which is less than par value, the issue is void.[1] The stock certificate cannot serve as a consideration to support the would-be stockholder's promise to pay for the stock, and no liability attaches to the stockholder except where his unfulfilled promise works a fraud upon innocent third persons. *Stone v. Hudgens,* (D. C. Okla. 1955) 129 F. Supp. 273.

Absent any statute or constitutional provision, the stockholders of an insolvent corporation are liable to creditors of the corporation for the amount unpaid on their subscriptions for stock, to the extent payment is necessary to satisfy the claims of those creditors.[2] This liability is based upon either of two grounds, not always clearly distinguished by the courts.[3] First, where the action is to enforce an unpaid subscription price agreed to by the stockholder, the action is *ex contractu* in nature and the creditor steps into the shoes of the corporation in order to enforce an obligation

[1] OKLA. CONST., art. 9, §39.

[2] In re Caledonia Coal Co., (D.C. Mich. 1918) 254 F. 742; 13 FLETCHER, CYC. CORP. §6051 (1943).

[3] For a discussion of these alternative theories of liability, see Spencer v. Anderson, 193 Cal. 1 at 5, 222 P. 355 (1924); 35 MICH. L. REV. 108 (1936).

owed to it by the subscriber.[4] But where the corporation has agreed to transfer shares to the subscriber for less than par value and to recognize those shares as being fully paid, the creditors, upon insolvency, could not recover on a contract theory since the corporation would be bound by its contract with the subscriber. However, under these circumstances the creditor can still recover from the subscriber the difference between the consideration paid to the corporation and the par value of the shares received in exchange.[5] This second basis for recovery is justified either on the ground that the unpaid balance represents a "trust fund" for the benefit of creditors,[6] or, more recently, that the failure to pay par value is a fraud on creditors.[7]

It is in this context that a constitutional provision such as that involved in the principal case must be considered.[8] It is clear that the provision was intended to give added protection to investors and creditors by prohibiting the practice of "stock-watering."[9] The cases indicate, however, that the provision has not had the desired effect. It has not added to the rights of creditors because, in general, the courts have not construed the provision as, in and of itself, requiring payment of par value, or as giving rise, assuming that voidness is established, to any liability of the subscriber for the unpaid balance.[10] Thus, in those states where a shareholder would not be liable under common law for having paid less than par value for "fully paid" shares,[11] this provision would not, without more, change the result. On the other hand, the provision has not decreased the right of creditors to recover on watered stock when the action is founded on the "trust fund" or fraud theory. Since the claim is based on tort and not on contract, a provision that the contract under which the shares were issued

4 The court in Spencer v. Anderson, note 3 supra, describes this as ". . . in the nature of an equitable garnishment in aid of execution."

5 See notes 6 and 7 infra. Southworth v. Morgan, 205 N.Y. 293, 98 N.E. 490 (1912) is representative of a minority of decisions holding that, even where there was sale at a discount or stock-watering involved, the creditors' rights are not greater than those of the corporation.

6 The leading case is Scovill v. Thayer, 105 U.S. 143 (1882). In Chilson v. Cavanagh, 61 Okla. 98, 160 P. 601 (1916), this doctrine is cited with apparent approval. See also Guinness v. Remick, 228 Mich. 461, 200 N.W. 120 (1924).

7 Hospes v. Northwestern Mfg. and Car Co., 48 Minn. 174, 50 N.W. 1117 (1892); Collier v. Edwards, 109 Okla. 153, 234 P. 720 (1924). For discussions of these common law doctrines and the effect of statutes upon them, see DODD, STOCK WATERING, c. I (1930), and Bonbright, "Shareholders' Defenses Against Liability to Creditors on Watered Stock," 25 COL. L. REV. 408 (1925).

8 OKLA. CONST., art. 9, §39, provides in part: "No corporation shall issue stock except for money, labor done, or property actually received to the amount of the par value thereof, and all fictitious increase of stock or indebtedness shall be void. . . ."

9 Lee v. Cameron, 67 Okla. 80 at 82, 169 P. 17 (1917); 11 FLETCHER, CYC. CORP., §5209 (1932).

10 See the discussion in 11 FLETCHER, CYC. CORP. 495 (1932), and in Bonbright, "Shareholders' Defenses Against Liability to Creditors on Watered Stock," 25 COL. L. REV. 408 at 414 (1925).

11 Southworth v. Morgan, note 5 supra.

shall be null and void does not affect the creditors' rights of recovery.[12] This is so since there is still a misrepresentation—to the effect that the shares have been fully paid for—and reliance on that misrepresentation.[13] Thus, in Oklahoma, the creditor can still recover against the shareholder who has not paid in full for his shares, where he can establish a representation that they were fully paid.[14] In the absence of such a representation, however, and where the creditor is suing on the contract for unpaid subscriptions, the principal case holds that, under the constitutional provision referred to, the creditor cannot recover.[15] Logically, this is sound, since it is difficult to perceive how a creditor can recover on a contract which is null and void. But it produces the anomalous result that a constitutional provision which was designed to give added protection to creditors has resulted in a decrease in the protection which they would have had at common law.[16] The better approach, therefore, would be to construe the language in the light of what it was intended to do, and to hold that, whatever the liability as between corporation and shareholder,[17] the shareholder cannot use the constitutional provision to escape liability to corporate creditors upon his promise.[18]

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[12] See 35 MICH. L. REV. 108 at 113 (1936), citing duPont v. Ball, 11 Del. Ch. 430, 106 A. 39 (1918). But see Lavell v. Bullock, 43 N.D. 135, 174 N.W. 764 (1919), where three of the justices indicated that, even in a fraud action, voidness of the stock issue is a defense.

[13] "Reliance" in these cases is generally presumed. Hospes v. Northwestern Mfg. and Car Co., note 7 supra.

[14] This is codified in 18 Okla. Stat. (1951) §1.83. See Paxton v. Hyer, 184 Okla. 407, 87 P. (2d) 938 (1939), interpreting the statutory predecessor of this provision. This right of recovery extends only to creditors without knowledge. Collier v. Edwards, 144 Okla. 69, 289 P. 260 (1930).

[15] Principal case at 275.

[16] See notes 2 and 3 supra and adjacent text.

[17] See 35 MICH. L. REV. 108 (1936).

[18] Bell v. Aubel, 151 Pa. Super. 569, 30 A. (2d) 617 (1943); Tooker v. National Sugar Refining Co., 80 N.J. Eq. 305, 84 A. 10 (1912). In Bottlers Seal Co. v. Rainey, 243 N.Y. 333, 153 N.E. 437 (1926), this result is reached on the basis of a statute providing for shareholder liability. But see Collier v. Edwards, note 14 supra, involving a similar statute.