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Corporations - Officers and Directors - Effect of An Equitable Lien on Directors' Liability

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CORPORATIONS—OFFICERS AND DIRECTORS—EFFECT OF AN EQUITABLE LIEN ON DIRECTORS' LIABILITY—Defendants, directors of a corporation, appealed from a judgment against them in favor of their company's creditor. The corporation had executed a note promising to repay plaintiff's loan out of the funds from a forthcoming stock issue. The board of directors passed a resolution ordering the officers to repay plaintiff in this manner. The money was then spent for other purposes, with the knowledge of the individual directors, after which the corporation became insolvent. On appeal, *held,* affirmed. The note and resolution imposed an equitable lien on the fund from the stock sale. The corporation's conversion of this interest permits a corporate creditor to hold the individual directors liable. *Emmert v. Drake,* (5th Cir. 1955) 224 F. (2d) 299.

The decision in the principal case demonstrates how a court may extend a director's liability beyond its traditional bounds. It is generally accepted that a creditor of a corporation may not hold a director personally liable for his mismanagement or negligence in handling the affairs of the corporation,[1] or for a breach of a contract signed by the corporation.[2] But courts will hold a director liable for conversion of a creditor's property in the hands of the corporation.[3] Liability is based on the fact that he knew other corporate directors were converting the property,[4] or that he should have learned of the conversion in the ordinary course of business.[5] In the principal case the court establishes an equitable lien, which supposedly gives the creditor a property interest, the conversion of which provides the basis for holding the director liable.[6] The extreme difficulty of predicting

[1] United States Fidelity and Guaranty Co. v. Corning State Bank, 154 Iowa 588, 134 N.W. 857 (1912); 45 L.R.A. (n.s.) 421 (1913); 50 A.L.R. 462 (1927); *Contra:* Delano v. Case, 121 Ill. 247, 12 N.E. 676 (1887). See 3 FLETCHER, CYC. CORP. §§1180, 1182 (1947).

[2] 3 FLETCHER, CYC. CORP. §1175 (1947).

[3] Walker v. Howell, 209 Iowa 823, 226 N.W. 85 (1929).

[4] Richards v. North Henderson Grain Co., 308 Ill. App. 386, 32 N.E. (2d) 189 (1941); Kropf v. Gilbert, 213 Wis. 196, 251 N.W. 478 (1933).

[5] Minnis v. Sharpe, 198 N.C. 364, 151 S.E. 735 (1930); Vujacich v. Southern Commercial Co., 21 Cal. App. 439, 132 P. 80 (1913); 152 A.L.R. 696 (1944); *Contra,* Sweet v. Montpelier Savings Bank and Trust Co., 73 Kan. 47, 84 P. 542 (1906). A director cannot be held liable without knowledge of the conversion, even though his own failure to attend board meetings caused the lack of knowledge. Phelps Dodge Refining Corp. v. Federal Trade Commission, (2d Cir. 1943) 139 F. (2d) 393. And exemption from liability is justified where the directors could not have learned of the conversion. Bluefields S.S. Co. v. Lala Ferraras Cangelosi S.S. Co., 133 La. 423, 63 S. 96 (1913).

[6] Directors have been held liable for conversion of funds subject to equitable liens in two other cases. Lynch v. Conger, 181 App. Div. 221, 168 N.Y.S. 855 (1917); Hirsch v. Phily, 4 N.J. 408, 73 A. (2d) 173 (1950).

what contracts will be held to create equitable liens[7] indicates that the director may have corresponding difficulties in determining what standard of conduct he must follow. The traditional American view has been that no equitable assignment or lien[8] is created by a promise to assign out of a fund to be created in the future,[9] unless there is a present transfer of the fund to the assignee.[10] But at the same time it is said that any executory agreement demonstrating an intention to make some particular property or fund a security for a debt will create an equitable lien.[11] Several federal cases have held that an executory promise to assign out of a fund not yet in existence creates an equitable lien upon the fund as soon as it is in the promisor's possession.[12] As a result of the decision in the principal case, the director who is, or who should be, aware of the corporation's failure to comply with an agreement giving rise to the nebulous equitable lien will be held personally liable. This is a radical departure from the traditional limits of a director's liability to corporate creditors for his corporation's breach of contract. The equitable lien has been created to establish, as between debtor and creditor, certain responsibilities which are quite unrelated to the question of directors' liability.[13] In view of the uncertainty which accompanies the application of the equitable lien concept, it is doubtful that its use in the context of the principal case is justified.

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[7] See notes 9, 10, 11 and 12 infra.

[8] An equitable lien is distinguished from an equitable assignment, where courts draw a distinction between the two, in that an assignment demands a present transfer of domain while a lien does not. See 4 CORBIN, CONTRACTS §877 (1951).

[9] Donovan v. Middlebrook, 95 App. Div. 365, 88 N.Y.S. 607 (1904).

[10] Christmas v. Russell, 14 Wall. (81 U.S.) 69 (1872); Dillon v. Barnard, 21 Wall. (88 U.S.) 430 (1875).

[11] Hauselt v. Harrison, 105 U.S. 401 (1881); Simpson v. Amarillo Mutual Benev. Assn., (Tex. Civ. App. 1934) 68 S.W. (2d) 597.

[12] Ingersoll v. Coram, 211 U.S. 335, 29 S.Ct. 92 (1908); Barnes v. Alexander, 232 U.S. 117, 34 S.Ct. 276 (1914); In re Interborough Consolidated Corp., (2d Cir. 1923) 288 F. 334. However this rule has not been uniformly followed, even in the federal courts. See Kuppenheimer and Co. v. Mornin, (8th Cir. 1935) 78 F. (2d) 261.

[13] See Britton, "Equitable Liens—A Tentative Analysis of the Problem," 8 N.C.L. REV. 388 (1930).