PREFERENCES BY INSOLVENT CORPORATIONS TO OFFICERS, DIRECTORS OR STOCKHOLDERS

I a*. A "preference" is the paying or securing, by an insolvent debtor, to one or more of his creditors, of the whole or a part of their claim to the detriment of his other creditors. The insolvent debtor may be either a natural person or a corporation, but it is preferences granted by an insolvent corporation to its directors, officers or stockholders that we wish particularly to examine. In the case of a corporation the preference is generally granted by the directors, they being the managing agents of the concern and therefore bound to authorize most of its business transactions. The preference frequently takes the form either of a transfer directly to the creditor of a part of the assets of the insolvent corporation or of a mortgage or lien on the property, or of confessing judgment in his favor to the exclusion of other creditors. "Preference" then is the expression of a motive or desire on the part of the directors of an insolvent corporation to favor some creditors over others, to put them, as the word implies, ahead in the race for assets.

I b. A distinction should be made, however, between the cases where one or more creditors are preferred to others, and cases where a creditor, at the same time that the debt is contracted, is given security for it. Thus where a corporation becomes financially embarrassed and needs funds at once to meet its running expenses, even though its liabilities exceed its assets, if a loan is taken from a director, in the form of a mortgage or lien on its property, it is clearly not a preference.[1] The director has put so much money into the concern and has taken out a proportionate amount of the assets as security for his debt. But a different situation arises where a corporation is failing and has either ceased

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* For explanation of these headings, see Analysis by the author, at end of article.

[1] Cowan v. Pennsylvania, etc., Co., 184 Pa. St. 1; Hopson v. Aetna, etc., Co., 50 Conn. 597; Mullanphy v. Schott, 135 Ill. 655; Millsaps v. Chapman, 70 Miss. 952; Gordon v. Plattsmouth, etc., Co.; 36 Neb. 548; First Nat. Bnk v. Commercial, etc., Association, 185 N. Y. 575.

to carry on its business entirely or intends shortly so to do and being in hopeless financial straits, gives a director security for some pre-existing debt or claim, or secures some note or claim on which a director is liable personally. This is clearly a preference and gives the director an advantage not possessed by other creditors.[2] The transaction is not contemporaneous with the contracting of the debt, but is separate and distinct and is not connected at all with the borrowing of the money, but comes at a time when the corporation sees financial failure at hand and desires to save its own directors from loss at the expense of other creditors. It is in that class of cases that the courts disagree as to whether the director should be allowed to receive such a preference because of his relation to the company. In the former case, provided the transaction is a *bona fide* effort to enable the company to continue its business and is not merely an effort to give a director a preference for a pre-existing debt, there is no question that a director should be allowed to retain his security, and the vexing question of preferences does not come in because it is a well established rule in law that a director may contract and deal in business with his corporation.

I c. As a preference is an act done when insolvent, it becomes important to determine when a corporation can be said to be insolvent and examine under which of the various states of insolvency the question of preferences would be most likely to arise.

When a corporation has been declared bankrupt under the National Bankruptcy Act, it is said to be insolvent. This statute enacted by Congress provides a method by which the assets of an insolvent may be distributed among his creditors, under the supervision of the court.[3] His assets, therefore, being out of his own control and in the hands of the court, the question of preferences can not arise, as it is provided that there can be no payment to a creditor by the bankrupt.

A corporation is said to be insolvent also when it has made

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[2] Sutton Mfg. Co. v. Hutchinson, 63 Fed. 496; Lippincott v. Shaw Carriage Co., 25 Fed. 577; Rokker v. Paper Co., 88 Ill. App. 278; Beach v. Miller, 130 Ill. 162; Rouse v. Merchant's Nat. Bank, 460 Mo. 493; Taylor v. Gray, 59 N. J. E. 621.

[3] Bankruptcy Act, 1898, 324 U. S. Stat. at large, 797.

an assignment for the benefit of its creditors and its assets are insufficient to meet its liabilities.[4] And here, unless some statute permits preferences to be granted in connection with the assignment, such preference will be declared void, whether it be in the form of security for a debt or the transfer of property. Here also the assets of the corporation are taken by the assignment out of its own hands and consequently the question of preferences will not arise.

When a corporation has ceased to carry on the business for which it was organized, and its liabilities exceed its assets it is clearly insolvent, and also in the case where, although it may be continuing its business, there is no prospect that its assets will be increased sufficiently to meet its liabilities, or where it is at present a going concern, but is about to take a step that will incapacitate it from continuing its business further. It is in these cases that the courts differ as to the right of the corporation to prefer certain creditors to the detriment of others, and in speaking of an insolvent corporation it will be understood to mean one that is in this condition.

"To render a corporation insolvent within the rule prohibiting preferences," said the Alabama court, "it is not enough that the assets are insufficient to meet all its liabilities, if it be still prosecuting its line of business with the prospect and expectation of continuing to do so; in other words, if it be in good faith what is sometimes called a going business or establishment. Many successful corporate enterprises, it is believed, have passed through crises when their property and effects, if brought to present sale would not have discharged all their liabilities in full. On the other hand when a corporation's assets are insufficient for the payment of its debts and it has ceased to do business and has taken or is about to take a step which will practically incapacitate it for conducting the corporate business with reasonable prospect of success, or its embarrassments are such that early suspension and failure must ensue, then such corporation must be pronounced insolvent."[5] We see then that something more than the liabilities exceeding the

[4] Chamberlain v. Bromberg, 83 Ala. 576; Fietsam v. Hay, 122 Ill. 293; Vanderpoel v. Gorman, 140 N. Y. 563.

[5] Carey v. Wadsworth, 99 Ala. 68.

assets is necessary before a corporation can be called insolvent in the sense that we here use it.

IIa. The courts have not always agreed as to whether an insolvent corporation might prefer certain general creditors who are not directors, officers or stockholders. Some have taken the attitude that as an insolvent debtor is allowed this right of preferring certain creditors, there is no reason, in the absence of statute, why an insolvent corporation should be denied the right. A corporation, they say, is but an artificial person endowed, in respect to the business which it is transacting, with the attributes of a natural person, and, like a natural person, should be allowed to select a particular creditor and prefer his claim to others.[6] In a leading case upholding this right to grant preferences, where the directors of an insolvent bank preferred a certain creditor by paying money and assigning notes, it was said: "The cases of an individual and a corporation, in the matter under discussion, it appears to me, are not merely analogous, but identical; and I discern no reason for the slightest difference between them. There exists no doubt that there have been many instances of actually insolvent corporations, where certain creditors have been preferred to others, and the perfect silence until now on the subject of this fancied diversity is powerful to show what has been the universal opinion."[7] In another case it is said: "An individual may turn out part or the whole of his property in payment of his debts and in so doing may prefer creditors. We do not see why this corporation may not do the same, and that through its board of directors. Kent lays it down: 'Independent of positive law, all corporations have the absolute *jus disponendi* of lands and chattels, neither limited as to object nor circumscribed as to quantity.' In addition here the law of the state where the corporation was created conferred upon it the right to make contracts, acquire and transfer property with the same powers in such respects as private individuals."[8]

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[6] Catlin v. Eagle Bank, 6 Conn. 233; Reichwald v. Commercial Hotel Co., 106 Ill. 439; Buell v. Buckingham, 16 Iowa, 284; Garrett v. Burlington Plow Co., 70 Iowa, 697; Planters Bank v. Whittle, 78 Va. 737; Hollins v. Brierfield, etc., Iron Co., 150 U. S. 171; Sanford Fork, etc., Co. v. Howe, 157 U. S. 312.

[7] Catlin v. Eagle Bank, 6 Conn. 233.

[8] Reichwald v. Commercial Hotel Co., 106 Ill. 439.

In fact except in the jurisdictions where the trust fund doctrine has obtained a footing and is applied strictly, we rarely find the analogy between the natural debtor and the artificial person, as a debtor, questioned in regard to the granting of preferences in insolvency.

IIb. In the jurisdictions where such preferences are denied an insolvent corporation it is often found that the courts have adopted the trust fund doctrine referred to above. This doctrine because of its wide influence and the courts of high authority which have announced and followed it, will be more particularly noticed. The so-called "trust fund doctrine" was definitely announced for the first time by Mr. Justice Story in *Wood* v. *Dummer*, 3 Mason 308, in 1824. A banking corporation had distributed a greater part of its capital among its stockholders, as dividends, and left nothing for the payment of its creditors. In deciding the case the learned judge took the position, "that the capital stock of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank. . . . If the capital stock is a trust fund, then it may be followed by the creditors into the hands of any person having notice of the trust attaching to it." It is seen from the case stated that the decision could have been based on fraud without going further because it is a clear case of fraud on the creditors, but the court chose to base the decision on the ground of the assets of a corporation being a trust fund for the creditors. The doctrine once being announced was taken up at once by many courts and applied to cases of preferences by insolvent corporations, and the courts argued that as the assets, on insolvency, became a trust fund, the directors, being the trustees of the fund, could not prefer certain creditors and exclude others. It was often said that the creditors, under the trust fund doctrine, could follow and subject to the payment of their claims assets wrongfully distributed among or withdrawn by the stockholders, and that when the corporation became insolvent particular creditors could not be given or obtain any preference by way of payment or security over other creditors. If based on fraud on the creditors, the resulting conclusions are undoubtedly correct, but the doctrine has led many courts into rather extreme positions, as for example that the directors of an insolvent corporation are absolute and technical trustees.

The Supreme Court of the United States at first accepted the doctrine in its fullest sense, but has long since limited it to mean only that the corporation's property must be applied to the payment of the debts of the corporation before any part of it could be distributed to the stockholders; and as between itself and its creditors the corporation is simply a debtor and does not hold its property in trust in any other sense than does an individual debtor.[9] The result has been that although many courts still speak of the trust fund doctrine in some connections and speak of the directors being trustees to the extent of not being allowed to prefer or reap any benefit for themselves, it is not often found that a court denies a preference to a general creditor because of the trust fund doctrine. One line of cases holds that the trust fund theory, that prevents preferences, does not attach until a court of equity has taken charge of the corporate property, in some proper proceeding, with a view to administering it. But it will be seen at once that this is not the trust fund doctrine in any proper sense, because it is a well known fact that, after a court of equity has taken charge of the corporate assets, no preference will be allowed.

Another reason might be assigned for denying preferences by insolvent corporations, namely, that the fact that the corporation is allowed to carry on business in the corporate capacity and that the liability of its members is limited to a certain fund, would require the corporation to give up the additional privilege of preferring certain creditors. This view has not been taken by the courts, but it seems to be an argument against the complete analogy which many of the courts draw between the natural person as debtor and the corporate debtor.

The individual when he trades alone or associated with others is unlimitedly liable for his debts. When therefore a group of individuals receives a corporate franchise, one of the privileges of which is that their liability shall be limited to the common fund, it might well be argued that in return for this privilege they shall be required to abandon the right to grant preferences, and further that it rendered void any attempt to exercise the right of granting preferences. The states that have enacted statutes denying pre-

[9] Hollins v. Brierfield, etc., Iron Co., 150 U. S. 371.

ferences by insolvent corporations doubtless had this idea in view and believed that a business concern acting in a corporate capacity and having received certain material benefits and privileges from the state, such as the power to contract as an individual, limited liability, and rights under a corporate franchise, should not have the additional common law right of preferring certain creditors. It is true that in the absence of statute it may seem hard to deny the analogy between the individual and corporate debtor in the right of granting preferences, but in view of the unusual rights and privileges that are incident to corporate existence it seems a proper place for legislation to step in and bar a corporation from doing an act which is undoubtedly a hardship on certain of its creditors although it may be an act which is allowed it by law.

II c. As mentioned above, several states, recognizing the right of an insolvent corporation to grant preferences have enacted statutes prohibiting such preferences,[10] having come to the conclusion that it is inequitable for a corporation when insolvent or in failing circumstances, to turn over to certain creditors all or a greater part of its assets, leaving other creditors with equally meritorious claims, without redress. For the provisions of the various statutes the laws of the various states should be consulted, but some of the more important may be mentioned.

The National Banking Act prohibits and renders void any transfer or conveyance by a national bank, to prefer a creditor, after an act of insolvency or in contemplation thereof. In Massachusetts, the general insolvency law provides that if a person being insolvent or in contemplation thereof, within six months before the filing of a petition in insolvency proceedings by or against him, shall give a preference to any creditor, such preference shall be void; and this provision is made expressly applicable to corporations. Michigan, New Jersey and New York have similar statutes differing in only minor details. The Virginia statute provides in substance that if a corporation create any lien

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[10] New York, 3 N. Y. Rev. Stat. 591, ss. 9, 10; 3 N. Y. Rev. Stat. (8th ed.) p. 1729, s. 4; 2 N. Y. Rev. Stat. (8th ed.) p. 1554, ss. 186, 187; N. Y. Laws (1896), c 688, s. 48.

New Jersey, Pub. Laws, 1896, p. 298, s. 64; North Carolina, Code s. 685; Illinois, General Assignment Act; Minnesota, Laws of 1881, chap. 148.

or incumbrance upon its works or property for the purpose of giving a preference to one or more creditors except it secures a debt contracted at the time of the creation of the lien, the same shall inure ratably to the benefit of the creditors.

The National Bankruptcy Act[11] as enacted by Congress does not apply to all corporations, but to corporations "engaged principally in manufacturing, trading, printing, publishing, mining or mercantile pursuits." The act also provides in §60b, "If a bankrupt shall have given a preference and the person receiving it or to be benefited thereby, or his agent acting therein, shall have had reasonable cause to believe that it was intended thereby to give a preference it shall be voidable by the trustee, and he may recover the property or its value from such person." It is thus seen that it is a violation of the Bankruptcy Act for a corporation to transfer any of its property to one or more creditors with intent to prefer such creditors. It does not follow however, that a payment or transfer of assets by an insolvent corporation to a creditor is necessarily an act of bankruptcy. Two things must concur in order to constitute such payment or transfer of assets an act of bankruptcy; (1) such payment or transfer must be made with the intent to prefer the creditor over other creditors; (2) and it must be done at a time when the corporation is insolvent. The burden of proving both intent and insolvency is upon the person alleging the same. It is thus seen that knowledge of an intent to prefer on the part of the creditor is made material under this Act, whereas in other cases such knowledge is not brought into question.

It must be remembered that where, either by the common law or by statute, all preferences by insolvent corporations are denied, the question of preferences to officers, directors or stockholders can not arise, so in the following discussion it will be presumed that reference is had to states where such preferences to general creditors are allowed.

III. We now come to consider the question of the right of an insolvent corporation to prefer its own stockholders, who are also creditors, and to find out whether any rule applies to them which does not apply to general creditors. The courts are far

[11] Bankruptcy Act, 1898, 32 U. S. Stat. at large.

from unanimous on this point, but it seems that their opinions are generally based upon the real position of the stockholders in relation to the company and not on the mere fact of whether the person preferred own stock in the company or not. Some courts have taken the position that the fact of being a stockholder carries with it the relation of proprietor and have denied preferences on that ground, much as they would deny a preference to a member of a partnership.[12] The greater number of courts however, have, with apparently better judgment inquired into the real relation of the stockholder to the company.[13] Thus in a small corporation where the stock is held by a few persons and each of these by necessity is intimately connected with the management of the company, the preference would probably be denied them, while in a large corporation where the stockholder, except in his right to participate in the selection of officers, has no control over the management, the corporation would doubtless be allowed to grant him a preference to the same extent that it could prefer a general creditor who was entirely disconnected with the company. When a stockholder is in fact also one of the officers or managers of the corporation, then another question is brought up which will be treated later under preferences to directors, but which has no place in a discussion of a stockholder's rights as such. It is a well-settled principle of law that a stockholder may deal with the corporation as if he were an entirely disinterested outsider and that his relation of stockholder as such would in no way bar him from becoming a creditor of the company. "The circumstance of being a stockholder in the corporation," says an Illinois case, "did not debar him from obtaining security for debts due to himself to the exclusion of other creditors."[14] This view is held by probably the majority of the courts, or as was said in Kentucky, "a stockholder in a corporation may deal with the company as an individual, and become a creditor as any other individual, and may be secured as a preferred creditor in an assignment by the cor-

[12] Reagen v. Chicago First Nat. Bank, 157 Ind. 623; Washington Mill Co. v. Sprague Lumber Co., 10 Wash. 165.

[13] Reichwald v. Commercial Hotel Co., 106 Ill. 439; Parsons v. Hattonz-snowden Co., 58 Ill. App. 272; Lexington, etc., Ins. Co. v. Page, 17 B. Mon. (Ky.) 412; Whitewell v. Warner, 20 Vt. 425.

[14] Reichwald v. Commercial Hotel Co., 106 Ill. 439.

poration, without on that account incurring the imputation of fraud."[15]

IVa. The cases in regard to preferences by insolvent corporations over which there has been the greatest conflict among the courts have arisen where the corporation has .attempted to prefer one of its own directors or officers by either paying or securing his debt and allowing other creditors, in whose welfare it is not interested, to go unpaid and without relief. The question, of course, does not arise in jurisdictions where, either because of the common law or statute, *all* preferences are denied, for there the directors or officers are barred from being preferred just as any general creditor would be. But aside from these cases, we find many in which the views of the courts are in conflict and they base their holdings on various grounds. Before going into the examination of this class of preferences it will be well to clear up some collateral matters that frequently arise when this subject of preferences to directors is discussed.

IV b. The distinction before referred to should always be kept in mind in considering this subject, namely the difference between securing and preferring a director. Even where the debts of a company exceed its assets, but it is still a going concern the director is generally allowed to advance money or credit to the corporation in a *bona fide* effort to keep it alive, and in return to take security for the debt. Where such a transaction is made in good faith, there in no reason to deny the director his advantage over unsecured creditors. This is a very different case from the one where, on insolvency, the director obtains payment or security for a prior indebtedness and one not contracted at the same time that the security was given. The Georgia court and a Federal court have gone further however, and not allowed a director any advantage even in a *bona fide* transaction when the security was given at the same time the debt was contracted.[16]

IV c. Another question that frequently comes up, in jurisdictions where preferences to general creditors are allowed, is whether the right of a general creditor to accept a preference of his claim

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[15] Lexington, etc., Ins. Co. v. Page, 17 B. Mon. (Ky.) 412.

[16] Monroe, etc., Co. v. Arnold, 108 Ga. 449; Wyman v. Bowman, 127 Fed. 257.

is affected by the fact that one or more directors are indorsers or guarantors of his debt. Several courts have used ingenious arguments to uphold such preferences. The Illinois court has said: "His relation as a creditor is created by his contract with the corporation and not with the guarantors. He is just as clearly, by law, a creditor with such guaranty as without it. His rights as such creditor remain, to the end, unimpaired, during solvency and through insolvency . . . . The creditor loaned this money to the corporation in good faith, while solvent and a going concern, and the money so obtained was used for its benefit. On no principle of law or reason can such creditor be deprived of his right to a preference merely because the directors guaranteed the debt. The act of obtaining such guaranty on the part of the creditor or giving it on the part of the directors was neither illegal nor improper. It is not uncommon for the directors to be compelled to lend their personal credit by way of surety or guaranty, in order to secure means to carry on the business. If this is done during solvency, for the benefit of the corporation, neither the right of such creditor so loaning on such guaranty, nor the power of the directors, is in any way affected or abridged as to a preference of such a debt."[17]

On the other hand, where preferences to directors are not allowed, such an argument certainly is not consistent because the directors, by voting the preference to the creditor, would surely prefer themselves by relieving themselves from personal liability on the debt. The question will be treated along with the question of preferences to directors, but it may be said that in jurisdictions where preferences to directors are not allowed by the decided weight of authority, a creditor may not be preferred on insolvency who has his debt guaranteed or indorsed by one or more directors.[18] However, while the corporation is a going concern, continuing and intending to carry on its business, a director may secure or indemnify himself against possible loss by reason of his indorsement

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[17] Rackford, etc., Grocery Co. v. Standard Groc. Co., 175 Ill. 89.

[18] Lowry Banking Co. v. Empire Lumber Co., 90 Ga. 624; Rosebloom v. Whittaker, 132 Ill. 81; Love Mfg. Co. v. Queen City Mfg. Co., 74 Miss. 290; Merchants Nat. Bank v. McDonald, 63 Neb. 363; Taylor v. Gray, 59 N. J. E. 621; Consolidated Tank Line Co. v. Kausar, etc., Co., 45 Fed. 7; Lippincott v Shaw Carriage Co., 34 Fed. 570.

of corporate debts, and the subsequent insolvency of the company can not prevent the directors from enforcing the security given him. But this is clearly a different case from where, after insolvency, the directors prefer a debt on which some of their number are liable.

IV d. Some courts seem to have drawn a distinction between the cases where the vote of the individual director preferred was necessary to carry the motion granting the preference and the cases where there was the necessary majority of unpreferred directors present and voting.[19] The Wisconsin Supreme Court has said, with better reasoning: "It is unnecessary to decide the question whether there was a quorum of disinterested directors that directed the mortgage to be given. The mortgage is an entirety and it makes no difference how many persons are severally interested in it as mortgagees. If such mortgagees, as directors, authorized it, they authorized an act in which they were all jointly interested. They may not have been joint creditors, but they are joint mortgagees, because the mortgage as a security is an entirety. Whether in this view, the mortgage was never authorized to be given by the president and secretary of the company, by the company through its directors, it may not be necessary to decide, but it seems to me rather illogical to say that, because there is a quorum of directors who are creditors severally, a majority of them may authorize their claims to be secured by one mortgage, and do not act on their own claims, but each one acts in respect of the claims of the others."[20] This, it is submitted is the better view, and the one that has with it the weight of authority. The Supreme Court of Indiana, however, in holding that a preference made in favor of two directors was valid where the execution of the mortgage making such preference was authorized by the unanimous vote of five directors, these constituting the entire directorate, said: "Consequently, a majority of the directors, constituting a quorum, by their votes authorized the preference, independent of the two"[21] in whose favor such preference was made.

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[19] Taylor v. Mitchell, 80 Minn. 492; Klein v. Funk, 82 Minn. 3; European, etc., R. Co. v. Poor, 59 Me. 277; Buell v. Buckingham, 16 Iowa, 284; Levering v. Bimel, 146 Ind. 545; Nappanee Canning Co. v. Reid. etc., Co., 159 Ind. 614.

[20] Haywood v. Lumber Co., 64 Wis. 639.

[21] Levering v. Bimel, 146 Ind. 545.

In the jurisdictions where directors are not allowed to prefer themselves the right to prefer their relatives and friends has also been denied them. Thus a director of an insolvent corporation could not provide for the payment of a debt due his wife from the corporation and exclude other creditors.[22] This is the natural effect of the rule denying preferences to directors because the preferring of those in whom the director is personally interested is merely another way of preferring the director himself. And a preference made in favor of an estate of a deceased director by the remaining board, two of whom were brothers of the deceased director, was held void, and the unsecured judgment creditors were allowed to recover of the directors such percentage of their debts as they would have received if the sum wrongfully paid by way of such preference had been divided *pro rata* among all unsecured creditors.[23] It follows from this that directors are not allowed to prefer another corporation of which they, or a majority of them, are the managing officers and directors. Thus a bank whose officers were also the *de facto* managers of another bank, known by them to be insolvent and about to go into the hands of a receiver, could not, as against a receiver subsequently appointed, retain assets of the insolvent bank as collateral security for the payment of its indebtedness.[24]

IV e. It has been held, in jursidictions where officers are not allowed to prefer themselves, that the rule does not apply where an officer has paid himself for back salaries.[25] When a corporation has accepted the services of an officer and he has allowed his salary to remain unpaid for some time, in order to relieve the strain on the finances of the corporation, such salary is a preferred claim on the corporate assets and an officer has been allowed to pay to himself this back salary even when he knew that the corporation was in an insolvent condition. This is not the unanimous rule, but has been frequently applied and is apparently based on principles of justice and right.

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[22] West v. West, etc., Mfg. Co., 44 Hun. (N. Y.) 623.

[23] Adams v. Kehlor Milling Co., 35 Fed. 432.

[24] Slack v. Northwestern Nat. Bank, 103 Wis. 57.

[25] Asheville Lumber Co. v. Hyde, 172 Fed. 730; Richmond Standard Steel, etc., Co. v. Allen, 148 Fed. 657; Potts v. Rose Valley Mills, 167 Pa. St. 310.

V. A large number of states that allow preferences to be granted to ordinary creditors and to stockholders have denied the right of a director or officer of an insolvent corporation to receive such a preference.[26] Thus where a corporation has become insolvent and is unable to carry on its business or when it appears that its insolvency is inevitable within a short time, the directors would not be allowed to meet and execute a mortgage on the property of the company to secure some debt which the corporation may owe them and which they see will not be paid in full unless such security is taken, because the assets of the company would have to be distributed *pro rata* among all the general creditors, themselves included.[27] Neither, as has been already stated, in such a situation, [28]would they be allowed to secure or pay some creditor of the company holding corporate notes on which they are sureties or indorsers, and thus relieve themselves from personal liability; for in this case the transaction would be as much a preference as if they had paid themselves directly. The same principle is applied where the corporation confesses judgment in favor of a director who is a creditor, or in favor of a creditor for the payment of whose debt the directors are personally liable as indorsers. Any preference so granted to a director or officer will be declared void and he will be required to relinquish the amount in excess of

[26] Lippincott v. Shaw Carriage Co., 25 Fed. (Ind.) 577; Adams v. Kehlar Milling Co., 35 Fed. (Mo.) 433; Consol. Tank Line Co. v. Kansas, etc., Co., 45 Fed. (Mo.) 7; Bouney v. Tilley, 109 Cal. 346; Fishel v. Goddard, 30 Colo. 147; Lowry Banking Co. v. Lumber Co., 91 Ga. 624; Milledgeville Banking Co. v. McIntyre, etc., Store, 98 Ga. 503; Atlas Tank Co. v. Hardware Co., 101 Ga. 393; Rokker v. J. W. Butler, etc., Co., 88 Ill. App. 278; Cahill v. Peoples, etc., Co., 47 La. Ann. 1483; Janney v. Minneapolis Industrial Expo., 79 Minn. 488; Love Mfg. Co. v. Queen City, etc., Co., 74 Miss. 290; Ingeversen v. Edgecombe, 42 Neb. 471; Reynolds v. Smith, 60 Neb. 197; Montgomery v. Phillips, 53 N. J. Eq. 203; Taylor v. Gray, 59 N. J. Eq. 621; Hill v. Lumber Co., 113 N. C. 173; Kerstetcr's Appeal, 149 Pa. 148; Pangburn v. American Valut Co., 205 Pa. 83; Sweeny v. Grape Sugar, etc., Co., 30 W. Va. 443; Hulings v. Hulings, etc., Co., 38 W. Va. 351; Rowe v. Leuthold, 101 Wis. 242; Koehler v. Black River, etc., Co., 2 Black (U. S.) 715; Richardson v. Green, 133 U. S. 30; Kittel v. Augusta Ry., 78 Fed. (N. J.) 855.

[27] Lippincott v. Shaw, etc., Co., 25 Fed. (Ind.) 577; Atlas Tank Co. v. Hardware Co., 101 Ga. 393; Rokker v. Paper Co., 88 Ill. App. 278; Ingeversen v. Edgecombe, 42 Neb. 741; Montgomery v. Phillips, 53 N. J. Eq. 203; Kersteter's Appeal, 149 Pa. 148; Rowe v. Leuthold, 101 Wis. 242.

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what would have been a *pro rata* share among all the general creditors had he not received such preference.

In denying the right of a director to receive a preference, the courts have assigned various reasons to justify their position. Of course, in the states where statutes exist denying the right to grant preferences in all cases the directors are barred from receiving preferences just as any other creditor would be. Also where the trust fund doctrine is still adhered to in its strictest sense, and all creditors are denied the right of receiving preferences, the same principle applies to directors, and they are prevented from receiving an advantage, on the ground that all the creditors should receive an equal share in the assets of the insolvent company. But a large number of courts that are not governed in their decision by either of the above reasons have denied the preferences to directors on other grounds. Some courts, while not holding that the assets of all insolvent corporations are a trust fund for equal distribution among the creditors, state that the powers of the directors are held in trust by them for all creditors and can not be used by them for their own benefit. Thus the directors, while not considered as technical trustees of a trust fund, are treated as fiduciaries and held to the rule that a fiduciary can not reap a benefit to himself which arises out of his position as such. Another court puts it that directors are fiduciaries as to their powers and the law prohibits a trustee from speculating in the subject matter of his trust. Much the same position has been taken by the courts that say that as the director's position as manager of the company puts him in a position of special knowledge as to corporate affairs, he shall not be allowed to use this special knowledge to gain advantages for himself that are not open to other creditors. Other courts have carried out the analogy between the individual debtor and the corporate debtor and say that as an individual debtor can not secure an advantage to himself when insolvent, neither can directors or managers of an insolvent corporation secure preferences to themselves. Another court has said that the directors ought not to be competitors in a contest of which they must be the judges.

In *Koehler* v. *Iron Co.*[29] it was said, in speaking of a preference

[29] 2 Black (U. S.) 715.

obtained by the directors: "Directors can not thus deal with the important interests entrusted to their management. They hold a place of trust and by accepting the trust are obliged to execute it with fidelity, not for their own benefit, but for the common benefit of the stock-holders of the corporation." And in *Barney* v. *Tilley*[30] the court said, in speaking of directors' powers: "These powers are held by them in trust for all the creditors and can not be used for their own benefit. It is to be observed however, that a person who is creditor of an insolvent corporation is not deprived of any of his rights as creditor by the fact that he also occupies the position of director of the company. He is merely incapacitated as director from using any of the powers of his position for his own benefit or the benefit of his co-directors."

In *Fisher* v. *Goddard*[31] the court said: "The relationship of a director of a corporation to the legal entity which he represents is fiduciary and the law treats him as a trustee in this respect. A purchase by him of corporate assets may not be void *ab initio* as to creditors, but he will not be permitted to reap a benefit to their detriment, by dealing in them as a third party, because the law inhibits a trustee from speculating in the subject matter of his trust."

In the case of *Lippincott* v. *Shaw Carriage Co.*[32] the court carried out the analogy between the individual debtor who is insolvent and the insolvent corporation, and stated that the trust fund doctrine is not necessary in order to deny preferences to directors: "While it is generally conceded that a corporation, notwithstanding insolvency, continues possessed of a general power of management of its affairs and, like natural persons, may give preferences by way of payment or security to one creditor or class of creditors over others, yet in close analogy to the rule which prohibits the giving of preferences by individual debtors for the purpose of securing, or in such a manner as to secure advantage or benefit to themselves, and in manifest accord with the tendency of judicial opinion as expressed upon consideration of kindred questions, it has been decided in a number of cases that preferences

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[30] 109 Cal. 346.
[31] 30 Colo. 147.
[32] 25 Fed. (Mo.) 577.

given by insolvent corporations in such a manner as to be of a special benefit to the directors or managing agents or any of them, will be set aside."

In *Howe* v. *Tool Co.*[33] the court said: "A sound public policy and a sense of common fairness forbid that the directors or managing agents of a business corporation, where disaster has befallen or threatened the enterprise, shall be permitted to convert their powers of management, and their intimate, it may be exclusive knowledge of corporate affairs into means of self-protection to the harm of other creditors. They ought not to be competitors in a contest of which they must be the judges."

It is thus seen that these preferences are denied on a number of grounds, and probably a majority of the courts today would take one of these positions and not allow a director to receive a preference. Other courts, as it will be seen, have justified such preferences and these will now be considered.

VI. Although the weight of authority is probably in accord with the rule just stated, some courts have carried the right of an insolvent corporation to prefer creditors to the extent of allowing preferences to be granted to directors and officers of the company.[34] Several grounds have been given as a basis of decision, but most of the courts seem to feel that if they do not follow the trust fund doctrine and deny all preferences, there is no place to stop, short of allowing preferences to directors.

An early Iowa case adopted the rule and the court said that, although it might be a good case for the legislature to change the law, giving *pro rata* to all creditors, they had no power to deny a preference to directors in the present state of the law.[35]

In *Corey* v. *Wadsworth*[36] the court overruled an earlier case

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[33] 44 Fed. (Ind.) 231.

[34] Wilson v. Stevens, 129 Ala. 630; Carey v. Wadsworth, 118 Ala. 488; West v. Hanson Bod. Co., 6 Colo. App. 467; Smith v. Skeary, 47 Conn. 47; Warfield v. Marshall, etc., Co., 72 Iowa, 666; Buell v. Buckingham, 16 Iowa, 284; Planter's Bank v. Whittle, 78 Va. 737; Brown v. Furniture Co., 58 Fed. 286; Sanford Fork & Tool Co. v. Howe, 157 U. S. 312; Foster v. Planing Mills, 93 Mo. 79; Railway Co. v. Claghorn, 1 Speers Eq. (S. C.) 545; Campan v. Detroit Driving Club, 135 Mich. 575.

[35] 16 Iowa 284.

[36] 118 Ala. 488.

in this respect and said: "One just and honest debt, it seems necessary to remark, is as just and honest as any other just and honest debt, and may be paid in the same way under the same conditions. . . . . To the exercise of this undoubted right to make preferences it is essential that the corporation must act. It can only act through the directors. If the directors can not act to the end of preferring their own just debts—having the undoubted right to such preferences—the preference can not be made and the entitled right of the corporation to make it and of the directors to accept it is denied and defeated." This court had repudiated the trust fund doctrine which it had adhered to before and through the above argument justified the granting of preferences to directors by themselves.

The Missouri court, after stating that the assets of an insolvent corporation were not a trust fund, said: "Then if the assets of an insolvent corporation in the hands of its board of directors are not a trust fund to be used for the benefit of all of its creditors ratably, can not they dispose of the property to themselves as creditors, to the exclusion of others if desired, bound only by the limit of good faith?"[37]

In an Indiana case, a mortgage executed by an insolvent corporation, in compliance with an agreement to secure an advance of money to discharge an indebtedness of the corporation, was held valid as against its creditors although the president and secretary were individually liable on the indebtedness so discharged, of which fact the mortgagee had knowledge.[38]

In *Buell* v. *Buckingham*[39] referred to above, the court announced that "being an officer in the corporation did not deprive Buell of the right to enter into competition with the other creditors and run the race of diligence with them, availing himself in the contest of his superior knowledge and of the advantages of his position to obtain security for the payment of his debt."

It is thus seen that the courts are not unanimous in their denial of the right to grant preferences to directors or officers. The trust fund doctrine seems to have caused as great confusion

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[37] Butler v. Harrison Co., 139 Mo. 467.

[38] Bank v. Dovetail Gear Co., 143 Ind. 550.

[39] 16 Iowa 284.

and done as much evil to the courts that have abandoned it as to those that have retained it. Having repudiated the doctrine, the courts go to the other extreme and refuse to recognize any fiduciary relation whatsoever existing between the directors and the creditors of an insolvent corporation.

Some courts, like the Missouri court,[40] have allowed these preferences to directors to stand, in the absence of bad faith or an intent to delay or defraud the other creditors. This rule however does not seem to mean anything because it is not the question whether they intended to prefer themselves in good faith, but whether the preference itself should be allowed. Besides, actual bad faith can rarely be proved in preference cases, because of the abundance of opportunity open to the directors to conceal their fraudulent purposes, and unless, as a matter of law, a director is deemed to act in bad faith when he accepts payment or security from the insolvent corporation to the exclusion of other creditors.

VII. From the above discussion, we may deduce a few general principles in regard to preferences. In the first place, if we admit the common law right of an insolvent debtor to prefer certain of his creditors and leave others without remedy, it cannot be seen why an insolvent corporation should not be allowed a like privilege. Although an absolute analogy in all cases might not be drawn between the two debtors, the analogy in regard to granting preferences certainly seems to hold good. The doctrine is based on the idea that a person has the absolute power and control over his property in regard to distribution and that this power is not in any way changed or abridged by the fact that he has become insolvent and unable to pay all his debts. For the purposes of transacting business and managing its affairs the corporation is as much a person as an individual, and owns and controls its property as absolutely, and the fact that this artificial person is created by the state and is controlled and managed by a board of directors instead of by its own will and volition as in the case of the individual, in no way changes its property rights, nor denies it the right to grant preferences to the same extent as the individual debtor.

In regard to preferences to stockholders of the insolvent cor-

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[40] State v. Manhattan Rubber, etc., Co., 149 Mo. 181.

poration it will be seen from the decisions that the courts consider the actual relation to the corporation occupied by the stockholder, and base their holdings on that rather than on the mere fact that he is a stockholder. The whole question of preferences to members of a corporation rests on equitable grounds of fairness and equality and equity should not allow, between creditors whose claims are equally meritorious, that one creditor should obtain an advantage over another, not through any diligence or virtue in himself, but merely because he holds an office or occupies a position in respect to the corporation, that enables him at an earlier stage to see the approaching calamity and secure himself against it. Thus we see that the real question to be determined is, not whether the creditor preferred held stock in the company, but whether he was in fact so intimately associated with its management that it would be inequitable for him to receive special benefits derived from his position It may be that the stockholder is also a director or officer or that the concern is very small and all stockholders keep in close touch with its affairs, but, in the ordinary case that will arise, the stockholder is no more aware of what is actually going on in the company, than a stranger is.

There can be little doubt that by all the rules of justice and fair dealing, a director should be barred from preferring himself or any one with whom he is closely associated. Leaving to those who wish to discuss it, the subject of whether a director on insolvency becomes a technical trustee, it need only be said that his position is undoubtedly one of trust and one which demands the highest degree of integrity. His accepting of preferences may possibly be justified from a legal point of view, but public policy demands that no such advantage should be allowed the managing agents of a company. In some cases it may seem hard on a director who has previously, in good faith and in a *bona fide* effort to help the company, advanced it money when possibly no one else could be found to do so, to deny him security for his money when the concern fails, but even that case would not justify the breaking of the sound rule denying preferences to directors. He is not bound to accept the position as a manager of the corporation, but having once accepted it, he should not be allowed in any way to take advantage of his position to obtain for himself any advantage not open to all creditors. Any other rule would undoubtedly place the temptation on directors who had advanced money, to secure to themselves a part of the assets of a failing corporation and so hasten its end, where it would have survived the crisis had it been in possession of all its assets and could count on the faithful and devoted efforts of the directors to the very end.

John L. Campbell, Jr.

Lexington, Va., December, 1912.

ANALYSIS

I. Preliminary.
  (a) What is a preference.
  (b) How distinguished from security.
  (c) When a corporation is insolvent.

II. Preferences by corporation to creditors who are not officers, directors or stockholders.
  (a) Cases allowing such preferences.
  (b) Cases denying such preferences.
  (c) Statutes prohibiting or limiting the right of the corporation to make such preferences.

III. Preferences to stockholders.

IV. Preferences to directors.
  (a) Introductory.
  (b) Preferring and securing a director.
  (c) Directors as indorsers or guarantors.
  (d) Votes by directors preferring themselves.
  (e) Preferring relations or friends.
  (f) Payment of back salaries.

V. Preferences denied directors.

VI. Preferences allowed directors.

VII. Conclusion.