THE VANISHING DISTINCTION BETWEEN CREDITORS AND STOCKHOLDERS

E. ENNALLS BERL

Two recent cases warrant the hope that courts are becoming less disposed to encourge corporate financing schemes which permit investors to be treated as creditors for purposes of security, and as stockholders for purposes of profit.[1] These cases deal with instruments entitled "Participating Operation Certificates", which have become popular in the promotion and financing of chain gasoline and accessory stations. The language of the certificate is the same (*mutatis mutandis*) in both cases and reads as follows:

> "Consumers Service Stations, Inc., . . . for and in consideration of the receipt of Two Hundred Fifty Dollars, and other good and valuable consideration, agrees to create a fund from the operation of a so-called service station in the place designated on the reverse side hereof (Oskaloosa, Iowa) and to distribute said fund in the manner hereinafter set forth to the registered owner of this certificate and all other registered owners of such certificates in said station, and such distribution shall continue until there shall have been paid on this certificate the sum of Five Hundred Dollars, whereupon it shall become null and void.
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> "To provide the fund hereinbefore mentioned from the daily receipts of said station, there shall be set aside in a bank one cent (1¢) on each gallon of gasoline and five per cent (5%) on all other merchandise sold by said station, and the fund thus created shall be distributed every month among the registered holders of these certificates in said station, as their interests may appear."

There is no necessity for discussing the claims of the certificate holders in the cases referred to, to be equitable lien holders, for the interesting point is that in each case the certificate holders were held to be not even general creditors of the issuing corporation. The grounds upon which the courts appear to have

[1] *In re* Hawkeye Oil Co., 19 F. (2d) 151 (D. C. Del. 1927). United States & Mexican Oil Co. v. Keystone Auto Gas & Oil Co., 19 F. (2d) 624 (W. D. Pa. 1924). See Note, (1927) 76 U. OF PA. L. REV. 80.

based their judgments may not be wholly satisfactory, but it is submitted that the result reached is highly desirable and indicates a judicial tendency to consider stockholders as stockholders and creditors as creditors, and refuse to permit the two to change places as special considerations may suggest the advantage of such change.

Probably the most important factor in the development of industry and commerce within the last one hundred and fifty years was the recognition by the courts of the principle of the limited liability of shareholders. With the general acceptance of the doctrine that one could risk a specific amount of capital in a commercial venture without thereby engaging his private fortune as security for the success of the enterprise, great sums became available for commercial development.

The recognition of limited liability is, comparatively speaking, a recent thing. As late as Lord Nottingham's time, in a case where certain of the shareholders of a corporation were also creditors, it was said that "if loss must fall upon the creditors, such losses should be borne by those who were members of the company, who best knew their estates and credit, and not by strangers who were drawn in to trust the company upon the credit and countenance it had from such particular members."[2] And well into the nineteenth century we find an occasional case in which the limited liability of stockholders is not yet accepted.[3] In the main, however, a stockholders's limited liability had been fully recognized before the beginning of the nineteenth century, and with this general recognition, an investor for the first time found himself free to engage his capital in the development of new fields, knowing that his risk of loss was limited to the amount of capital to which he subscribed. But when he invested in shares, his postion was unequivocal. He was an adventurer; the risk of failure was his; the fruits of success were his; he was in no sense a creditor. In the event of failure of the enterprise he had no rights against the corporation assets, except in the rare cases

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[2] Naylor v. Brown, Temp. Finch 83 (1673), 23 Eng. Reprints 44.

[3] See Samuel Williston, *History of the Law of Business Corporations Before 1800,* (1888) 2 HARV. L. REV. at 162.

in which creditors were paid in full and a balance remained. The creditor advanced his money upon the security of the corporate assets. The stockholder advanced his upon the hope of a profitable utilization of the corporate assets. His status was fixed; there was no possibility of confusion regarding his position. He did not blow hot and cold. He was an owner of the enterprise; he was not a creditor. With his status thus defined, commercial development was carried in the nineteenth century to lengths theretofore unknown and unimagined.

But toward the end of the nineteenth century there developed a tendency to tempt creditors with the promise or hope of a share of the corporation's profits, and a corresponding tendency to encourge investment by stockholders with the promise of a security akin to a creditor's. An example of a case of this kind is found in an insurance policy which was popular a quarter of a century or more ago and which was known as Tontine Insurance. The insured was the holder of an endowment policy which ran for a period of years at a stated premium. If the insured died during the endowment period, his beneficiary or his estate was entitled to collect the face amount of the policy. If the insured survived the endowment period, he was entitled to receive from the insurance company not only the face amount of the policy but whatever profits had accrued to his policy by reason of the longevity of other policy holders in the same group, or by economy in administration, or wise investment of the premiums of that group. While the insured was always considered a creditor of the insurance company,[4] he none the less received some of the profits of the company which could ordinarily only have been distributed to stockholders, so that a dual relationship came into being, or at least a rapproachment of stockholder and creditor.

Another example is the case of income bonds. The holder of income bonds is undoubtedly a corporate creditor,[5] and it not infrequently happens that his debt is secured by the mortgage

[4] Peters v. Equitable Life Assurance Society, 196 Mass. 143, 81 N. E. 965 (1907); Pierce v. Equitable Life Assurance Society, 145 Mass. 56, 12 N. E. 863 (1887); Ulham v. New York Life Assurance Co., 109 N. Y. 421, 17 N. E. 365 (1888).

[5] Edwards v. Bay State Gas Co., 91 Fed. 946 (D. C. Del. 1898).

of the corporation, with a definite date named upon which he is entitled to demand the face amount of his bond. Nearly everything else points to his being a stockholder rather than a creditor. There is no obligation on the part of the company to pay the interest named in the bond, unless, during the period covered by the particular coupon, the company has earned the interest due. Even where the interest has been earned, the question is still to an extent one of discretion with the directors as to whether such earnings should be applied to additions and betterments, or to reserves for depreciation, or to other corporate purposes, to the partial or total exclusion of the bondholder's right to collect interest for the period in question.[6] Income bonds are often issued in lieu of preferred stock in cases in which the corporation credit is not sufficiently strong to allow of the sale of preferred stock, so that a bond is offered to the investor with a high return upon his investment and an ultimate security for the corpus of the investment by the obligation, or mortgage obligation, of the corporation. In some cases even the voting rights of stockholders have been conferred upon income bondholders, and in at least two important issues the bondholders were entitled to elect one less than the majority of the directors of the corporation in periods during which the interest remained unpaid. In fact, the stockholder character of the income bond holder seems to have been so well recognized that one author says that "the temptation to placate impatient security holders by what is a bond in name but not in substance seems to have been too great to resist." [7]

One of the best illustrations of cases in which the investor becomes a creditor, for purposes of security of investment, but a stockholder, for possibilities of speculative gains, is the convertible bond. A convertible bondholder may be indifferently either a creditor or a stockholder, as the advantage of the one position over the other may be, at a particular time, made to appear. If the corporation is prosperous and its stock increases in value, he becomes a stockholder and shares in dividends, and extra dividends, and the rise in value of his stock. If the success of

[6] 1 DEWING, FINANCIAL POLICY OF CORPORATIONS (1920) 84.
[7] 1 DEWING, FINANCIAL POLICY OF CORPORATIONS (1920) 86-87.

the company is uncertain, he remains a creditor, and in all likelihood a mortgage creditor. He is in effect at once a stockholder and a creditor. To such an extent is he recognized as a stockholder that the courts hold that where stock may not be issued below par, they will enjoin the issuance of bonds convertible into stock at prices which would, if the conversion privilege should later be exercised, amount to an issuance of the stock under par.[8] Of late years there has grown up a custom which cuts off to an extent the absolute right which the bondholder has to be either a creditor or a stockholder, as the advantage of the one or the other position may be shown. Under the new plan, the corporation offers the right of conversion into its stock at a low price in the case of the first designated percentage of the bondholders who wish to convert, and a higher price for the next designated precentage, and so on. This results in some cases in a stampede to convert, and in such cases soon after issuance, a considerable number of bondholders, by their precipitation to convert, have definitely lost their rights as creditors and have become stockholders. Such a system, while permitting of the possibility of the dual relationship, at least tends toward an earlier definition of the status of the investor.

Another instance of the combination creditor-stockholder status is a hardly believable one. This is the case of the participating bond. While the existence of this anomaly is rare, there are a few examples of it in railroad and public utility finance. One such example is the Union Pacific Railroad's Oregon Short Line Participating 4's, which were issued in 1903 in the very considerable amount of $36,500,000. These bonds were entitled to participate with the stockholders in any dividends in excess of four percent upon certain stock which had been deposited as collateral to secure the Participating 4's.[9] This represents the most extreme case. The bondholder is a stockholder without having to incur the trouble or risk of converting. He receives his dividend while still a bondholder. A convertible bondholder does, at least, lose his

[8] Carver v. Southern Iron & Steel Company, 78 N. J. Eq. 81, 78 Atl. 240 (1910).

[9] RIPLEY, RAILROADS, FINANCE & ORGANIZATION (1915) 164, 205.

status as a creditor when he converts. A participating bondholder does not convert and gets his stockholder's dividend without ever ceasing to be a creditor. An attempt to issue an obligation of this sort was made upon the reorganization of the Philadelphia and Reading Railway in 1881. There the proposed obligation was to be in the nominal value of $50 and to be issued for $15. No provision was made for any maturity or payment of the obligation, which entitled the holder to receive six percent after the payment of six percent upon the common stock, and thereafter to participate equally with the common stock. Under the charter provisions of the company, it had the right to borrow money and the question before the court was whether such an obligation was a loan. The court held, however, that in the absence of any obligation of the company ever to repay, the transaction was essentially an attempt to issue stock in violation of the provisions of the charter, and the issue was enjoined.[10]

Occasional isolated instances of the dual relationship which do not admit of generic classification are found in the reports. One such is *In re Spot Cash Hooper Company*.[11] There an instrument called a "Trade Certificate" was before the court. The language of the certificate was as follows:

> "Trade Certificate.
>
> Incorporated under the Laws of the State of Texas.
> No. 2 $100.00
>
> Spot Cash Hooper Company, Incorporated,
> of Hillsboro, Texas.
>
> Capital Stock, $10,000.
> Trade Certificates Issued, $10,000.
>
> This certifies that J. J. Mitchell has deposited with Spot Cash Hooper Company $100.00, which entitles him or the holder thereof to purchase goods from said corporation at a profit not to exceed 10 percent. This certificate shall be taken into account in declaring dividends, and the holder shall receive for the use of said sum of $100.00 an amount annually equal to the dividend declared, based on $20,000

[10] Taylor v. Philadelphia & Reading Ry., 7 Fed. 386 (E. D. Pa. 1881).
[11] 188 Fed. 861 (W. D. Tex. 1911).

> and paid on account of stock certificates; the holder being guaranteed to receive at least 8 percent per annum of said sum of $100.00. After the end of two years this certificate is payable in merchandise on demand of holder after 30 days notice."

Upon the bankruptcy of the Spot Cash Company, objection was urged to the creditor status of the certificate holders, but the court held that the certificate evidenced an indebtedness provable in bankruptcy. The language of the "Trade Certificate" in this case savors of a participating bond, so that the disposition of the case at least suggests that courts would hold participating bondholders to be creditors, should their status as such be challenged.

The Participating Operation Certificate is an attempt to provide another opportunity for persons to be at once creditors and stockholders. Logically there would seem to be no good reason why such a certificate holder is not as much entitled to be considered a creditor as the income bondholder, the convertible bondholder, the participating bondholder, or the trade certificate holder of the *Spot Cash* case. Indeed, the participating certificate holder's position as a creditor should be stronger than that of the others. He is not actually promised a one hundred percent profit on his investment. No time is mentioned in the certificate within which the $500 promised in return for the $250 investment must be paid, and it could well be that such a long repayment time was contemplated that the transaction amounted to no more than a loan with lawful interest.

In the *Hawkeye* case, *supra,* the decision of the referee in bankruptcy, which was reviewed by the court, was to the effect that a participating operation certificate holder was in the nature of a dormant partner. The court upon review affirmed the referee's order but did not attempt to define the nature of the certificate holders. It contented itself with the statement that they were co-adventurers with the stockholders and consequently not creditors. In the *United States Mexican Oil Company* case, *supra,* the court thought that the participating certificates evidenced "an attempt on the part of the defendant to create a novel type of stock ownership," and while admitting that the status of the certificate holders was "rather puzzling," it concluded that the contract was invalid as against the claims of creditors.

Whether the certificate holder is to be treated as a stockholder or as a dormant partner, it is plain that important characteristics of each status are lacking. The certificate holder, according to the terms of the instrument, is to be repaid by a charge upon the sales of the particular station, regardless of whether the station is being operated at a profit or at a loss, and entirely without regard to the existence of profits or surplus applicable to the payment of the certificates. Neither a stockholder nor a partner, dormant or general, can be paid dividends other than from profits or surplus,[12] so that this important element of both the stockholder and partner relation is absent. It is also fundamental that in the absence of some special limitation of the right, a partner, either dormant or general, as well as a stockholder, is entitled to a voice in the management of the partnership enterprise,[13] but no such right is given these certificate holders. Moreover, the participation of a dormant partner is, as a rule, a secret one,[14] and there is nothing in the participating operation certificate situation to indicate that all the world was not aware of the issuance of the certificates. Thus tested by familiar principles of the law of corporations and of partnerships, a participating certificate holder is neither a shareholder of the one nor a member of the other. Hence, resort is had in one of the cases, at least, (and this is doubtless the *ratio decidendi* of the other case) to the great popular panacea—public policy. The court concludes that "on general principles of public policy . . . this contract is void as against the claims of general creditors." [15] This simply means that in financing gasoline stations there is no public policy which demands that in the event of insolvency, one who wears such indicia of ownership as those suggested by the participating operation certificate, should be treated as a creditor. The fact that undoubtedly strikes the courts is that

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[12] 2 MACHEN, CORPORATIONS, § 1313; LINDLEY, PARTNERSHIPS, Ch. 7.

[13] 20 R. C. L. 1072.

[14] 20 R. C. L. 1072.

[15] United States & Mexican Oil Co. v. Keystone Auto Gas & Oil Co., *supra* note 1.

this person hoped to make one hundred percent profit upon his investment, and it would be against public policy to consider such a person a creditor.

Since public policy, then, appears to be the moving consideration in the decision that the participating operation certificate holder is not a creditor, it is reasonable to suppose that there was a public policy which called for the recognition by the courts of the creditor status of the holder of the various other instruments discussed. The only instance among those mentioned which would seem to present a case involving public policy is the income bond. Here a consideration of public policy may properly enter in. The income bond, as a rule, is an expedient resorted to in the reorganization of railroad or other public service companies in financial difficulties. There is in this case a necessity for reorganizing and re-financing, and the public by virtue of the service for which it depends upon the company, is interested in seeing that sufficient capital for the continuation of the business is raised. The income bond has in the past been a useful device for accomplishing this result, and through its medium junior security holders, and in some cases, even stockholders, have been enabled to save their investments, sometimes in full, and often in part, by a contribution of capital to the reorganized structure in return for income bonds issued in an amount which took into consideration the investment in the predecessor company. In such a situation there may be a public policy which accounts for the issuance of a patchwork security of this type.

But while public policy is often the explanation of illogical things, it has not as yet, so far as we are aware, demanded that acts in the nature of legal crimes need be committed in its name. There must be a reasonable limit, and such limit has certainly been passed in the convertible bond, the participating bond, and the trade certificate of the *Spot Cash* case. Stockholders and creditors are, in the scheme of the law of corporations, two distinct classes of people, whose interests in the corporation are of such different natures as to be often diametrically opposed one to the other. Should resort to devices under which rights are conferred to be either the one or the other, as expediency may later dictate, continue to grow in popularity, the effect must be the ultimate breaking down of the barrier between stockholders and creditors, a result which will necessitate the re-writing of an important part of the law of corporations. No consideration of public policy demands such violence as this to established principles of law. On the contrary, any consideration of public policy which exists calls for restriction and not multiplication of devices which clothe investors with the dual rights of stockholders and creditors. The refusal to accord to the holders of participating operation certificates the rights of creditors upon insolvency of the company issuing the certificates, is at least a move in the right direction.