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BANK STOCK LIABILITY AND THE HOLDING COMPANY DEVICE

WILLIAM S. McCLANAHAN*

IN THE period from 1929 to 1933 the United States witnessed the closing of thousands of banks, both state and national, and millions of depositors saw their savings swept away in the maelstrom that we chose to call "the depression." Then began that long, drawn out, cumbersome process of "liquidation" of these banks, which is nothing more than an attempt to transform all of the bank's assets into cash to be applied in payment of its debts. One of the methods of securing cash for the closed bank was the attempted enforcement of the so-called "double liability" or "superadded liability" provisions against the shareholders of the bank. Because these provisions were contained in the statutes of the United States¹ and in the constitutions or statutes of most of the states,² it is safe to say that there were literally thousands of legal actions filed to enforce this liability. It is not surprising, therefore, that scores of novel factual situations and legal relations were presented to the trial courts and subsequently reached the reviewing courts.

One of the most complex problems that arose from this litigation was the problem of enforcing the liability on bank shares which were issued to and registered in the names of holding companies, and it is this problem that we propose to discuss here. Before entering on a discussion of this specific problem, however, it may be well to examine briefly the purpose and origin of the superadded liability statutes in general.

THE PURPOSE AND ORIGIN OF THE SUPERADDED LIABILITY STATUTES

The purpose of such statutory and constitutional provisions was simply to give additional protection to the bank's

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¹ 12 U.S.C.A. §§ 63, 64.

² Although no detailed examination of state constitutions and statutes was made, all but ten states have, at one time or another, had such provisions in their con-

creditors, which means, with few exceptions, its depositors. In the early days of our development a large part of the banking was done by private bankers and they were generally men of considerable wealth and reputation in their local communities. As the wealth of the country grew, however, it was necessary that we have more banks of deposit in which the public could deposit their savings and working capital, in order to make these funds available for reinvestment in our expanding economy. As the custom grew of chartering corporations to do a general banking business, it was natural that the legislatures should seek to give all possible protection to the depositors, so that their funds would be safely invested and available for them on demand. One of the methods of protection was to require a certain minimum of capital to be subscribed and paid in before the charter was issued, and another was to regulate the type and amount of loans which banks should make. But something more was felt necessary, and legislative genius devised the "superadded liability" provisions to fill this gap.

The very theory of general corporations is to limit the liability of incorporators and stockholders to the amount of capital stock which they have invested in the corporation. Why not make banking corporations different? Most of the incorporators and stockholders of banks in our early history were the most wealthy and influential citizens in their communities, men of real substance. If their personal liability could be placed behind the banks, would not this give the public full confidence in the banks and, in cases of insolvency, would not this liability more than compensate for the impairment of capital?

Answering these questions in the affirmative the legislatures began to adopt the added liability provisions. The provisions relating to national banks were first enacted in 1864³ and continued in force to 1933.⁴ Many of the states placed such provisions in their constitutions⁵ and others in

stitutions or statutes. Note 80 U. of Pa. L. Rev. 1133 (1932); 9 C.J.S. 120, Banks and Banking, § 74; Michie, Banks and Banking (Michie Co., 1931), II, 108-9, § 22; 7 Am. Jur. 64, Banks, § 72.

³ 12 U.S.C.A. § 63.

⁴ 12 U.S.C.A. § 64a, repealing 12 U.S.C.A. § 63.

⁵ Ill. Const., 1870, Art. XI, § 6; S. Car. Const., Art. IX, § 18; Ind. Const., Art. XI, § 6; N.Y. Const., Art. VIII, § 7; Neb. Const., Art. XII, § 7.

their statutes,⁶ some retaining the laws to this date⁷ and others having repealed them in the last decade.⁸ The added liability provisions relating to bank stock first appear in the law of Illinois in the constitution of 1848,⁹ affirmed in the laws of 1851,¹⁰ but these provisions related only to banks issuing bank notes or other credits intended to circulate as money. In the Illinois Constitution of 1870 the liability clause was retained, but the provisions were broadened to include all banks, and the now famous clause which keeps a stockholder liable for years after he has sold his stock was inserted.¹¹ Section 6 of the Banking Act¹² is a mere affirmation of the constitutional provisions. These provisions remain in the law of Illinois today, in spite of recent attempts to remove them.¹³

THE NATURE OF THE ADDED LIABILITY ON BANK STOCK

It has been said that the added liability imposed by statute on shares in a banking corporation is contractual and

⁶ Ill. Rev. Stat., 1939, Ch. 16½, § 6; Ohio, Gen. Code, §§ 710-75, 710-95; Mont. Revised Codes, § 4012; Texas Rev. Stat. 1925, § 535; Colo. C. L. § 218; 1 Hills Ann. St. and Codes Wash. § 1511.

⁷ Of the thirty-eight states once having these provisions, about half have repealed or amended their laws or constitutions, leaving about twenty states with such provisions still in their laws.

⁸ Some of the constitutional provisions were amended as follows: Ohio, July 1, 1937; Nebraska, Nov. 8, 1938; Texas, Sept. 8, 1937.

⁹ Ill. Const. 1848, Art. X, § 4.

¹⁰ Public Laws of 1851, § 10.

¹¹ "Every stockholder in a banking corporation or institution shall be individually responsible and liable to its creditors, over and above the amount of stock by him or her held, to an amount equal to his or her respective shares so held, for all its liabilities accruing while he or she remains such stockholder." (Italics supplied.) Ill. Const. 1870, Art. XI, § 6. It is this last phrase, and its interpretation by the courts of Illinois, that has placed liability on stockholders who have sold their shares years before, if any of the debts (i.e. deposits) which accrued while such person was a stockholder are still outstanding and unpaid at the time the bank closed. The Illinois courts have held that it would be possible, under this clause, to collect the full amount of liability on one share from each of many successive owners of the share. See *Sanders v. Merchants' State Bank of Centralia*, 349 Ill. 547, 182 N.E. 897 (1932); F. H. Gane, "The Liability of State Bank Shareholders in Illinois," 30 Ill. L. Rev. 743 (1936).

¹² Ill. Rev. Stat. 1939, Ch. 16½, § 6.

¹³ An amendment to the constitution, 60th Gen. Assembly, H.J. Res. 14, was submitted to a vote of the electors in the election of November 1938, but failed to be adopted. With the strict provisions for amendment of the constitution, (Art. XIV, § 2), and even limiting specifically legislation regarding banks, (Art. XI, § 5), it appears that the banking laws of Illinois will remain unchanged for many years to come. See Kenneth C. Sears, "The Illinois Constitution and the Banking Amendment," 6 U. of Chi. L. Rev. 234 (1939).

not penal in nature,¹⁴ and this is true in the sense that the liability is not imposed as a penalty for wrong doing. That is, the liability is one imposed because of a legal status into which one has entered voluntarily. Thus it has been held that the liability is sufficiently contractual that no subsequent state statute can impair its obligation.¹⁵ But in *Christopher v. Norvell*,¹⁶ where the defense was that the stockholder was a married woman and hence unable to enter into a valid contract, it was said,

The vice in this argument is in the assumption that the liability of Mrs. Christopher as a shareholder arises wholly out of contract between herself and the bank or its creditors; whereas, upon becoming a shareholder, she made, strictly, no direct contract with anyone, and became, . . . by force of the statute individually responsible to the amount of her stock. . . .

The liability of the shareholder runs directly to the creditors and is not a liability to the bank.¹⁷ In most jurisdictions the liability cannot be enforced by the bank or its general receiver, but must be at the suit of the creditors, with a special receiver or officer appointed to enforce the assessments and distribute the funds to the creditors.¹⁸ It has been stated that in theory there is a separate and direct liability of each shareholder to each creditor.¹⁹ Thus the liability, although often called contractual, is really quasi-contractual, arises by force of the statute,²⁰ and runs directly to the cred-

¹⁴ *Austin v. Strong*, 117 Tex. 263, 1 S. W. (2d) 872 (1928); *Allen v. McFerson*, 77 Colo. 186, 235 P. 346 (1925); *Barth v. Pock*, 51 Mont. 418, 155 P. 282 (1916); *Burnett v. West Madison State Bank*, 305 Ill. App. 113, 26 N.E. (2d) 881 (1940); *Squire v. Cramer*, 64 Ohio App. 169, 28 N.E. (2d) 516 (1940); 9 C.J.S. 151, Banks and Banking, § 78.

¹⁵ *Howarth v. Lombard*, 175 Mass. 570, 56 N.E. 888 (1900); *Squire v. Cramer*, 64 Ohio App. 169, 28 N.E. (2d) 516 (1940); 7 Am. Jur. 81, Banks, § 98.

¹⁶ 201 U. S. 216, 225, 26 S. Ct. 502, 50 L. Ed. 732 (1906).

¹⁷ *American National Bank of Mt. Carmel v. Holsen*, 331 Ill. 622, 163 N.E. 448 (1928); *Cohen v. North Ave. State Bank*, 304 Ill. App. 413, 26 N.E. (2d) 691 (1940); *State v. Citizens State Bank of Royal*, 118 Neb. 337, 224 N.W. 868 (1929); *Michie, Banks and Banking* (1931), II, 109, § 22.

¹⁸ 9 C. J. S. 151-3, Banks and Banking, § 78; 7 Am. Jur. 81-2, Banks, § 99; F. H. Gane, "The Liability of State Bank Shareholders in Illinois," 30 Ill. L. Rev. 743, 745 (1936).

¹⁹ *Cohen v. North Avenue State Bank*, 304 Ill. App. 413, 26 N.E. (2d) 691 (1940); *Bell v. Farwell*, 176 Ill. 489, 52 N.E. 346 (1898); 7 Am. Jur. 81-2, Banks, § 99.

²⁰ *Hillmer v. Chicago Bank of Commerce*, 304 Ill. App. 430, 26 N.E. (2d) 726 (1940); *Brown v. O'Keefe*, 300 U. S. 598, 57 S. Ct. 543, 81 L. Ed. 827 (1937), at p. 606 of 300 U. S. it is said, "True indeed it is that the liability is created by a statute, and not solely by agreement . . . No disclaimer by a stockholder would be

itors. Let us now examine the cases to determine against whom this liability is enforceable.

PERSONS LIABLE — IN GENERAL

In the enforcement of this liability the question frequently arises as to who is a shareholder within the meaning of the statute creating the liability. If the statute defines the persons included within the meaning of the terms, of course the statutory definition will control. But most of the statutes are silent on this point, generally using the term "stockholder" or "shareholder" without qualifying words. In such case the terms must be given their ordinary meaning.

As a general rule all persons registered on the books of the bank as owners of stock (and without qualification of their ownership) are held liable.²¹ It has been said that this fact (of registration) raises a presumption of ownership,²² but, if this is true, it is a very strong presumption. However, a person may deny ownership of stock, if, in fact, such person is not a shareholder.²³ But if the person shown on the records as a shareholder has done any act which would imply a ratification of his becoming a shareholder, he will be held liable on the stock.²⁴

In *Rosenfeld v. Horwich*²⁵ shares were issued in the name of one person for the accommodation of the real owner. Upon being informed of this fact the registered holder receipted for the shares, assigned the certificate in blank and left it with the bank for transfer to the real owner, but the transfer was not completed for some time. The court held the registered holder liable on the stock for the period from the date of issue until the actual transfer on the records of the bank although he had no beneficial ownership of the shares.²⁶ The same result was reached in *Golden v.*

effective to avoid it. Even so, the liability, created through it is by statute, is quasi-contractual in its origin and basis."

²¹ *Golden v. Cervenka*, 278 Ill. 409, 116 N.E. 273 (1917); *Sherwood v. Illinois Trust and Savings Bank*, 195 Ill. 112, 62 N.E. (1902); 7 Am. Jur. 69-71, Banks, §§ 81-82.

²² *Sherwood* case, note 20, supra; *Andrew v. Citizens State Bank of Mt. Vernon, Iowa*, 220 Iowa 219, 261 N.W. 810 (1935).

²³ 7 Am. Jur. 70-1, Banks, § 82.

²⁴ *Rosenfeld v. Horwich*, 221 Ill. App. 304 (1921).

²⁵ Supra, note 24.

²⁶ See also *Wheelock v. Kost*, 77 Ill. 296 (1875); *Heine v. Degen*, 362 Ill. 357, 199 N.E. 832 (1935).

Cervenka,²⁷ where brokers who held shares as agents for their customers or as collateral for loans, but who appeared on the records of the bank as sole owners, were held liable.²⁸ The controlling motive in holding the registered owners liable in almost every case seems to be that the creditors have a right to rely on the ownership as disclosed on the bank's records, and, to allow one's name to appear on these records when one is not a beneficial owner is a form of fraud upon the creditors of the bank. It has been stated that to allow the record holder to escape liability would be to invite shareholders generally to register their shares in the names of irresponsible persons and thus make the real ownership difficult or impossible to trace.²⁹

But the courts have not felt constrained to stop with the records of the bank as the sole criterion of ownership and, hence, of liability. There are many situations where the record holder is not the beneficial owner and, quite often, the latter is better able to respond to the assessment. It was natural, therefore, that creditors should attempt to enforce the liability on the "real, true and beneficial" owners. Perhaps the leading case on this point, in relation to national bank stock, is *Ohio Valley National Bank v. Hulitt*,³⁰ where the Ohio Valley Bank held shares in another national bank as collateral to a loan. On the death of the pledgor, the pledgee bank credited the note with the supposed value of the pledged shares, accepted payment of the balance of the note and then caused the shares to be transferred into the name of an employee of the pledgee bank. In holding the pledgee bank liable as the real owner of the shares it was said, "As to such owner the law looks through subterfuges and apparent ownerships and fastens the liability upon the owner to whom the shares really belong."³¹

²⁷ 278 Ill. 409, 116 N.E. 273 (1917).

²⁸ See also *Hurlburt v. Arthur*, 140 Cal. 103, 73 P. 734 (1903).

²⁹ *Wheelock v. Kost*, 77 Ill. 296, 298 (1875), "The legal title to the stock was in appellant by his own procurement, although the equitable title may have been in other parties; but it would be a singular doctrine to hold that the creditor should seek out the equitable owner against whom to enforce his claim. Primarily, he may proceed against the party in whom is the legal title to the stock." See also 7 Am. Jur. 77, Banks, § 94.

³⁰ 204 U. S. 162, 27 S. Ct. 179, 51 L. Ed. 423 (1907).

³¹ *Ibid.* at 168 of 204 U. S. In *Pauly v. State Loan & Trust Co.*, 165 U. S. 606, 17 S. Ct. 465, 41 L. Ed. 844 (1897), where the pledgee had caused the certificate to

Another class of cases where it is often attempted to enforce the liability on one who is not the registered holder of the shares involves stock owned by decedants and passing to their heirs by descent or to their legatees by will. In *Austin v. Strong*³² a husband had died owning shares and the receiver attempted to assess the liability on the widow, claiming that title had passed to her by the statute of descent. In denying liability the court held that the statute of descent only vested such right as to enable her to become a shareholder, and, since she had done nothing to indicate assent to or acceptance of ownership, the relationship did not exist.³³ A different result was reached in the recent leading case of *Gahagan v. Whitney*,³⁴ where a widow inventoried the shares as part of her husband's estate, accepted dividend checks payable to her personally and used the funds as her own. In holding the widow liable, although the shares were not registered in her name, the court stated,³⁵ "It may be conceded that a bank stock liability cannot be imposed upon one against his will, but the character of the obligation is such that slight evidence of its acceptance is, in the absence of countervailing proof, sufficient."

There are many cases in accord with these, where pledgees, transferees and legatees who are not the record holders have been held liable on the theory that the statutes contemplate that the real shareholders, those who receive the benefits and exercise the privileges of being a shareholder, shall assume the liability on the stock.³⁶ The rules and principles laid down in these cases involving natural persons indicate the general attitude of the courts toward the

be issued to himself *as pledgee* and the records showed this relationship, the pledgee was held not liable. See also *Mobley v. Macon National Bank*, 174 Ga. 256, 162 S. E. 708 (1932); note, 82 A.L.R. 565.

³² 117 Tex. 263, 1 S.W. (2d) 872 (1928); note, 79 A.L.R. 1537.

³³ See also *Andrew v. Citizens State Bank of Mount Vernon, Iowa*, 220 Iowa 219, 261 N.W. 810 (1935); *Gillett v. Chicago Title & Trust Co.*, 230 Ill. 373, 82 N.E. 891 (1907).

³⁴ 359 Ill. 419, 194 N.E. 581 (1935).

³⁵ *Ibid.* at p. 421 in 359 Ill.

³⁶ In *Pauly v. State Loan & Trust Co.*, note 31, *supra*, 165 U. S. at p. 623, it was said, "The object of the statute is not to be defeated by the mere forms of transactions between shareholders and their creditors. The courts will look at the relations of parties as they actually are, or as, by reason of their conduct, they must be assumed to be for the protection of creditors." See also 7 Am. Jur., 77-9, Banks, §§ 92-4; note, 82 A.L.R. 565.

statutory added liability on bank stock in general, and hence will serve as a guide in examining the holding company cases.

DISREGARDING CORPORATE ENTITY — IN GENERAL

When the first holding company cases were presented to the courts, and it was sought to enforce the liability on the stockholders of the holding company, there were no direct precedents to be followed. Here was a problem that was novel and yet involved well known legal principles. The general rules of bank stock liability were well settled and would be of some service. But should bank stock holding companies be treated differently? What is this holding company device, its purpose, and its effect? When is the corporate entity disregarded as to ordinary business corporations?

In general, a corporation has an existence and entity quite separate and apart from its incorporators, stockholders and owners; its acts are not their acts and its deeds are not their deeds.³⁷ The very theory and purpose of corporations is to create an entity or being that is endowed with attributes peculiar to itself. Corporations are often referred to as fictitious persons and corporate existence as a convenient legal fiction, yet the general rule is that the separate existence and entity of a corporation will be recognized by the courts.³⁸ In *Elenkrieg v. Siebrecht*,³⁹ the court refused to disregard the corporate existence and hold the sole owner liable for damages sustained in the property owned by the corporation. In this case the court discussed the situation where a person incorporates his business or property for the express purpose of avoiding future personal liability in the operation of the business, and stated that, if in fact the corporation has a real existence, that existence will not be disregarded.

It is only in unusual situations that the courts feel justified in thrusting aside the corporate veil and dealing with the

³⁷ *Sellers v. Greer*, 172 Ill. 549, 50 N.E. 246 (1898); *People v. Dennett*, 276 Ill. 43, 114 N.E. 493 (1916); 18 C.J.S., Corporation, §§ 1-4; 13 Am. Jur. 157-60, Corporations, § 6.

³⁸ *Peterson v. Chicago, Rock Island, & Pacific Railroad Co.*, 205 U. S. 364, 27 S. Ct. 513, 51 L. Ed. 841 (1907); *Cannon Mfg. Co. v. Cudahy Packing Co.*, 267 U. S. 333, 45 S. Ct. 250, 69 L. Ed. 634 (1925); *Commerce Trust Co. v. Woodbury*, 77 F. (2d) 478 (1935).

³⁹ 238 N.Y. 254, 144 N. E. 519 (1924).

stockholders as the real persons involved. Most of the cases where this result is obtained have involved fraud, illegality, or strong considerations of public policy.⁴⁰ In a leading Illinois case, *Felsenthal Company v. Northern Assurance Company*,⁴¹ the court did disregard the corporate existence and refused to allow the corporation to recover on an insurance policy where the sole owner and creditor of the corporation was the incendiary who caused the fire. Here the fraudulent and illegal acts were so apparent that any other result would have been absurd.⁴² In *Kellogg v. Douglas County Bank*,⁴³ corporate property was attached on judgments against an insolvent individual where the corporation had been formed for the sole purpose of carrying on his business in fraud of his creditors. The same result has been reached where a bankrupt has conveyed his property to a corporation for the sole purpose of placing it out of reach of his creditors.⁴⁴ Where a person had sold his business and had agreed by contract not to engage in this business in a particular locality, it was held that he could not avoid his contract by forming a corporation for the purpose of engaging in this business.⁴⁵ It has also been held that the promoters and stockholders of a corporation formed for an illegal purpose will be liable for money received by the corporation in furtherance of such purpose.⁴⁶ In most of these cases the courts have acted only when there was actual fraud or illegality involved or where the facts were such that public policy would not countenance a contrary result.⁴⁷

⁴⁰ Notes, 1 A.L.R. 610, 34 A.L.R. 597; Wormser, "Piercing the Veil of Corporate Entity," 12 Col. L. Rev. 496 (1912); Charles Horowitz, "Disregarding the Entity of Private Corporations," 14 Wash. L. Rev. 285 (1939); 15 Wash. L. Rev. 1 (1940); note, 37 Mich. L. Rev. 314 (1938); Elwin R. Latty, "The Corporate Entity as a Solvent of Legal Problems," 34 Mich. L. Rev. 597 (1936).

⁴¹ 284 Ill. 343, 120 N.E. 268 (1918).

⁴² "It is therefore certainly good law to hold that an incendiary cannot by a circuitry of action recover from an insurance company a loss occasioned by his own willful conduct, which loss he could not recover by a direct suit against the company on a policy made direct to him." *Felsenthal Co. v. Northern Assurance Co.*, 284 Ill. 343 at 353, 120 N.E. 268 (1918).

⁴³ 58 Kan. 43, 48 P. 587 (1897).

⁴⁴ *In re Berkowitz*, 173 F. 1012 (1908).

⁴⁵ *Beal v. Chase*, 31 Mich. 490 (1875).

⁴⁶ *Brundred v. Rice*, 49 Ohio St. 640, 32 N.E. 169 (1892).

⁴⁷ 18 C.J.S. 376-7, Corporations, § 6; 13 Am. Jur. 160-3, Corporations, §§ 7-8. The rule is well stated in *United States v. Milwaukee Refrigerator Transit Co.*, 142 F. 247, 255 (1905): "If any general rule can be laid down, in the present state of authority, it is that a corporation will be looked upon as a legal entity as a gen-

THE BANK STOCK HOLDING-COMPANY CASES

It was, perhaps, fortunate that one of the earliest holding-company cases involved the simplest factual situation. *Corker v. Soper*⁴⁸ involved a typical "family holding company," organized for the sole purpose of holding bank stock, with the avowed intent of avoiding the statutory liability, with no paid in capital, with no assets other than the bank stock and with but a small portion of the total stock of the bank held by the holding company. When the creditors sought to enforce the statutory liability against the holding company it was found to be a mere shell and, naturally, the creditors conceived the idea of reaching the real, beneficial owners of the bank shares, *i.e.*, the stockholders of the holding company. The court had no difficulty in finding the defendant liable for the assessment; not on the theory of disregarding the corporate entity, however, but merely on the theory that the defendant was the beneficial owner of the shares. In fact the court specifically recognized that title to the shares was vested in the holding company, but that it held the shares not as owner but as a mere creature of, or agent for, the defendant. It is easy to see why the court had no difficulty with this factual situation, for here we had an actual, express, and admitted intent or purpose to evade the effect of a statute, and this has been generally held to be sufficient ground to disregard the existence or entity of any ordinary corporation.⁴⁹ Here it seems that the court could have based the decision squarely on the ground of disregarding corporate entity, and the effect of the decision was to

eral rule, and until sufficient reason to the contrary appears; but when the notion of legal entity is used to defeat public convenience, justify wrong, protect fraud, or defend crime, the law will regard the corporation as an association of persons. This much may be expressed without approving the theory that the legal entity is a fiction, or a mere mental creation; or that the idea of invisibility or intangibility is a sophism. A corporation, as expressive of legal rights and powers, is no more fictitious or intangible than a man's right to his own home or his own liberty."

⁴⁸ 53 F. (2d) 190 (1931), cert. den., *Corker v. Howard*, 285 U. S. 540, 52 S. Ct. 313, 76 L. Ed. 933 (1931).

⁴⁹ In accord, on substantially similar factual situations, *Brusselback v. Cago Corp.*, 85 F. (2d) 20 (1936); *Durrance v. Collier*, 81 F. (2d) 4 (1936); *Harris Investment Co. v. Hood*, 123 Fla. 598, 167 So. 25 (1936); *Nettles v. Sottile*, 184 S.C. 1, 191 S.E. 796 (1937); *Hansen v. Agnew*, 195 Wash. 354, 80 P. (2d) 845 (1938); *Dixon v. Dial*, 24 F. Supp. 264 (1938).

accomplish this very act, even though the court sidestepped the issue by following the "beneficial owner theory."

One of the next cases to reach the reviewing courts was *Barbour v. Thomas*,⁵⁰ and here the factual situation was not as simple as in the *Corker* case. Here the court found a typical modern business holding company which is so often used to control subsidiary companies. The holding company (Detroit Bankers Company) had been organized to acquire the control and centralize the management of five large metropolitan banks, including the First National Bank — Detroit, which is involved in this case. It should be noted that this purpose of unifying control of a group or chain of banks was entirely legitimate in the state of incorporation (Michigan). A further aura of legitimacy was acquired when, at the insistence of the State Banking Commissioner and other officials, the famous article IX was placed in the articles of incorporation of the holding company, whereby the shareholders of the holding company expressly agreed to assume any liability assessed on the holding company by reason of its ownership of bank stocks. The stock of the holding company was then exchanged for the shares of the various banks on an appraised basis and the holding company exercised absolute control of the various banks.⁵¹ When the bank here involved closed, the holding company owned all except the directors' qualifying shares and the holding company had no assets except the shares in this and the other banks and was, therefore, hopelessly insolvent.⁵² This was the factual situation when the stockholders of the holding company sought to enjoin the receiver from enforcing the liability against them.

In holding the stockholders liable for the assessment the

⁵⁰ 7 F. Supp. 271 (1933), aff'd 86 F. (2d) 510 (1936), cert. den. 300 U. S. 670, 57 S. Ct. 513, 81 L. Ed. 877 (1937), noted in 33 Mich. L. Rev. 273 (1934), 2 U. of Chi. L. Rev. 484 (1935), 46 Yale L. J. 718 (1937).

⁵¹ The holding company was authorized to issue 120 shares of no par value stock at \$10 per share and \$50,000,000 of stock of a par value of \$20 per share. All voting power was vested in the no par value stock for five years. The 120 shares of no par value stock were issued to twelve officers of the five banks and the banks paid in the \$1,200 of capital.

⁵² The holding company had issued 1,775,000 shares of the par value stock, 335,000 shares being allocated to the First National Bank—Detroit. The holding company held 97 per cent of the stock of the five banks, the total capital stock of First National Bank—Detroit, then being \$25,000,000.

court relied on both the "disregard of corporate entity" and the "beneficial owner" theory. It would seem that the contract contained in Art. IX would have great weight in this case, and would eliminate the necessity of relying on other theories, but the court indicated that the result would have been the same without this express agreement.⁵³ In a well-considered opinion which has become one of the leading authorities in this field, the court indicates that we are here dealing with a special situation and hence the general principles of corporate entity will not apply. It is said,

Generally, the primary purpose of incorporating is to limit the liability of the investors for corporate debts to the stock subscribed. The general principle is against further liability in the absence of statute. But this is not a general corporation operating under general rules. The situation is singular, and the principle must be considered in the light of such a situation.⁵⁴

The court recognized that here there was no fraudulent intent, no purpose to evade a statute, in the organization of the holding company. Although the court does not so state, it seems that one of the controlling factors is the apparent public policy as expressed in the statute. All through the history of bank-stock cases the courts have been zealous in not allowing any device to succeed in shielding the true owner from liability on his shares. This idea seems to be clearly in mind in the Barbour case, where it is said, "It is contrary to a sound public policy to permit such a beneficial statute affecting such a large portion of our people to be so completely nullified."⁵⁵

⁵³ The district court states that, if the company had been formed for the purpose of defeating liability (as in the Corker case), the stockholders would certainly be held liable; therefore they should not escape liability merely because they preserved the security of the creditors by the express agreement contained in Article IX.

⁵⁴ Barbour v. Thomas, 7 F. Supp. 271, 277 (1933).

⁵⁵ *Ibid.* at 278. The Banco Kentucky Company cases are based on a factual situation very similar to that of the Barbour case. In these cases about 95 per cent of the stock of National Bank of Kentucky and Louisville Trust Company was held by six trustees, who had issued trustees participating certificates to the former holders of the bank stocks. The trust agreement (and the certificates) expressly provided that the holders of certificates would remain liable on the bank stock. The holding company, Banco Kentucky Co., was then organized and issued its stocks in exchange for the trustees participating certificates, acquiring practically all of the latter. The articles of the holding company did *not* provide that the stockholders would remain liable. When the National Bank of Kentucky failed the receiver recovered a judgment of \$3,772,000 against the receiver of the

Shortly after the decision in the Barbour case, the state courts of Michigan were presented with two cases in which the factual situations were very similar to that of the Barbour case and involving the same group of holding companies. In *Simons v. Groesbeck*⁵⁶ the stockholders of two holding companies sought to enjoin the receivers from enforcing the liability which had been assumed by the stockholders in the articles of incorporation, but the court held the defendant stockholders liable, almost solely on the basis of the contract or agreement contained in this article. Here the court treated the statutory liability as essentially contractual, regarding the shareholders of the bank as having the primary liability, but the holding company stockholders as having assumed that liability. The court indicates that this contract (to assume the liability) is not illegal or contrary to public policy and hence there is no reason why it should not be enforced. Although the decision seems sound on the facts of this case, one wonders whether the court would go further and hold that this liability (statutory in origin) could be assumed by another by contract (including natural persons) whenever it seemed expedient to do so. In the other Michigan case, *Fors v. Farrell*,⁵⁷ the factual situation involved several holding companies and trustees, each holding the stocks for the benefit of the next link in the chain, yet the court reached through all of these intermediate entities to place the liability on the ultimate or top holding company.⁵⁸ Here again we

holding company on the statutory liability, and about \$90,000 was paid (the holding company being now insolvent). See *Laurent v. Anderson*, 70 F. (2d) 819 (1934). The bank receiver then sued the stockholders of the holding company to enforce the liability, and, on a motion to dismiss, it was held that the complaint stated a cause of action. *Anderson v. Abbott*, 23 F. Supp. 265 (1938). In the same year a complaint in the District Court of Illinois (Northern District) against other stockholders of the same company was held to state a cause of action. *Anderson v. Atkinson*, 22 F. Supp. 853 (1938). On a later hearing on the merits, the District Court of Kentucky held the stockholders not liable on the stock, *Anderson v. Abbott*, 32 F. Supp. 328 (1940), largely on the ground that the holding company was not organized for the avowed purpose of evading liability. This decision seems open to criticism for reasons discussed later in connection with the Michigan and South Carolina cases.

⁵⁶ 268 Mich. 495, 256 N.W. 496 (1934); notes, 33 Mich. L. Rev. 273 (1935), 36 Mich. L. Rev. 1336 (1936).

⁵⁷ 271 Mich. 358, 260 N.W. 886 (1935); notes, 49 Harv. L. Rev. 149 (1935), 20 Minn. L. Rev. 217 (1936).

⁵⁸ "In a proceeding to enforce stockholder's liability it is of little or no importance as to how many paper ownerships or holdings in trust may intervene be-

find the court disregarding corporate entity (or rather several corporate entities) without difficulty, but at the same time stating simply that it is merely seeking the real beneficial owner and fastening the liability on such owner. The decision is sound, however, and contains one of the best statements of the attitude of the courts toward this problem.⁵⁹

One other set of cases is worthy of notice in connection with the cases discussed above. In *Nettles v. Rhett*,⁶⁰ the holding company was formed to effect the consolidation and merger of banks in South Carolina. At the time that the Peoples State Bank of South Carolina closed it had outstanding \$2,000,000 in shares of which the holding company owned \$740,000, the only assets of the holding company. It should be noted that an additional element present in this case was the fact that the statutes of South Carolina expressly forbid a general corporation to have any of its funds invested or used in banking operations.⁶¹ When the receiver sought to enforce the liability against the stockholders of the holding company, the defendants denied any attempt to evade the statute and any fraudulent intent. The district court refused to hold defendants liable, relying on dicta in a previous South Carolina case⁶² and the fact that no actual intent to evade the statute had been proved. The district court also stressed the changed public policy of the state in denying liability, since South Carolina had removed the liability provisions

tween the bank that issued the stock and the ultimate or actual owner thereof. The beneficial owner is liable for the stock assessment." *Fors v. Farrell*, 271 Mich. 358, 260 N.W. 886 at 889 (1935).

⁵⁹ "It all comes to this: That neither an individual nor a corporation can, through a trust arrangement or by other indirect means or circumlocution possess as an owner and enjoy the beneficial interest in bank stock without assuming the contingent liability of a stockholder's assessment imposed by law. To hold otherwise would be to nullify the protection given the bank creditors by the statute imposing double liability." *Fors v. Farrell*, 271 Mich. 358, 260 N.W. 886 at 891 (1935).

⁶⁰ 20 F. Supp. 48 (1937); note, 36 Mich. L. Rev. 492 (1938).

⁶¹ Civil Code S. Car., 1932, § 7677 (5). For cases holding that, since South Carolina law forbids the corporation to hold bank stocks, the transferor to the corporation remains liable on the shares, see *Kohn v. Dixon*, 100 F. (2d) 306 (1938); *Nettles v. Lightsey*, 190 S. C. 116, 2 S.E. (2d) 481 (1939).

⁶² *Nettles v. Sottile*, 184 S. C. 1, 191 S.E. 796 (1937). In holding the defendants liable in this case, where intent to evade the statute was clear, the Supreme Court of South Carolina disapproved a statement of the lower court that the corporate entity of a holding company should be disregarded "regardless of the particular plan or scheme" (to evade a statute). It was this narrowing down of language that impressed the district court in the *Rhett* case.

from its constitution by amendment prior to the decision in this case.⁶³ On appeal, the Circuit Court of Appeals reversed the lower court, holding the defendants liable.⁶⁴ There is no specific theory of liability advanced by the court, but it does advance the argument that since the corporation was forbidden to own stock it did not have a valid title, therefore it is not liable, and, unless the stockholders are held liable, the constitution and statute will be completely nullified. Several previous cases are also cited in support of the theory that good faith or lack of fraudulent intent is no defense to the action.⁶⁵

In *Nettles v. Childs*⁶⁶ this same holding company is involved in a suit by the same receiver against four different stockholders, and the principal defense raised is that the stockholders not only did not know that the holding company owned and held bank stock but were the victims of a fraud, since they purchased stock solely on the representation by the incorporators that no bank stocks would be owned or held by the company. The defense was certainly novel and the facts as stated in the opinion indicate that these wealthy, retired, northern businessmen had been sorely misled by the promoters of the holding company. Here for the first time we find a court refusing to assess the liability on the defendant stockholders, relying solely on the basis of the ignorance of these stockholders as to the corporation's assets. It is submitted that this is a very tenuous ground on which to base the decision. The court admits that the general principle is that the law imputes knowledge when opportunity and interest and reasonable care would cause a prudent man

⁶³ The question of whether the changed public policy indicated by an amendment of the constitution or statutes of a state should affect cases arising before the amendment is dealt with later in this article.

⁶⁴ *Nettles v. Rhett*, 94 F. (2d) 42 (1938); notes, 36 Mich. L. Rev. 1336 (1938), 33 Ill. L. Rev. 104 (1938).

⁶⁵ The Fors case, note 57, supra; the Barbour case, note 50, supra; Metropolitan Holding Co. v. Snyder, 79 F. (2d) 263 (1935).

Perhaps the best answer to the defense of good faith is found in *Nettles v. Sottile*, 184 S. C. 1, 191 S.E. 796, 805 (1937), where the court said: "The individual defendants may feel that they acted in good faith, but, unfortunately for them, their personal sentiments form no test of law. 'Good faith in law, however, is not to be measured always by a man's own standard of right . . . The good faith of a party under such circumstances must be determined by the legal effect of what he deliberately does.' "

⁶⁶ 100 F. (2d) 952 (1939).

to inquire, but states that the stockholders relied on the statements of the incorporators and hence should not be charged with knowledge.⁶⁷ The sounder rule would seem to be that where one invests money in an enterprise, voluntarily assuming the position of stockholder, exercising the privileges and securing the benefits of that position, with opportunity to make whatever inquiries he deems necessary as to the company's business, he should be charged with knowledge of the company's acts and doings.

Still another factual situation, involving a different type of holding company (when considered from the viewpoint of motive and purpose of organization) was presented in *Metropolitan Holding Company v. Snyder*.⁶⁸ The corporation had been organized by the directors of the bank in order to purchase a large block of the bank's shares from an insolvent investment company, so that the shares could be resold to the public for a larger amount and the profit paid into the bank to restore impaired capital. The directors invested \$57,000 of their own funds in the holding company, the company borrowed \$75,000, part of the stock was sold and the profit of \$35,000 was transferred to the bank. The bank failed, however, and the receiver sued the stockholders for the liability on the bank shares still owned by the holding company. Here the whole plan was conceived and executed in good faith, and, as the court indicated, the motives of the incorporators were highly commendable. Yet the court held the defendants liable for the assessments, largely on the principle that the purpose of the statute involved cannot be defeated by mere corporate forms and the like.⁶⁹

⁶⁷ This question has been raised in several of the cases, including the Illinois cases discussed later. Linked with this defense of ignorance of the stockholders is the contention that the stockholders who originally held bank stock and exchanged it for holding company stock should be treated differently from the stockholders who became such by purchasing holding company stock on the market, never having held bank stock. This contention was expressly rejected in *Nettles v. Rhett*, 94 F. (2d) 42, 49 (1938).

⁶⁸ 79 F. (2d) 263 (1935), 103 A.L.R. 912.

⁶⁹ "To deprive the creditors of a national bank of their statutory protection by such a method is wrong and the courts will not countenance the interposition of a mere corporate shadow to conceal who are the actual and beneficial owners of bank shares. To permit individuals to circumvent the contingent liability under this statute by simply organizing a corporation for the purpose of holding shares would set up a device against which the statute would ever afterwards be ineffective." *Metropolitan Holding Co. v. Snyder*, 79 F. (2d) 263 at 268 (1935).

In *Burrows v. Emery*,⁷⁰ the Michigan court had a factual situation presented which differs in important aspects from cases previously discussed, and this is one of the few cases where stockholders of a holding company were held not liable. In this case the holding company (Lumbermans' Securities Corporation) was an outgrowth of the bond department of the National Lumbermans Bank, organized in 1931 to trade in all kinds of securities. In a period of about a year and a half the Securities Company traded about \$1,500,000 in securities and seemed to be a successful enterprise. In June, 1931, the First State Savings Bank (of the same city) needed additional capital and several banks and business firms subscribed to the stock, including the Securities Company. When the First State Savings Bank closed, the Securities Company held 264 shares of its stock and the receiver attempted to assess the liability for these shares on the stockholders of the Securities Company. In holding the defendant stockholders not liable, the court distinguished this case from its previous decision in the Fors case and the Simons case on the grounds that here the holding company was not the same type in any sense as in the previous cases; it was in a legitimate business, had other assets, carried on a large and profitable securities business, its purchase of stock in the bank was only incidental to its main business and it held only a small portion of the total stock of the bank. This decision seems sound and, for reasons stated in the opinion,⁷¹ should be followed where factual situations similar to this case are presented.

THE RECENT ILLINOIS CASES

The bank stock holding company problem has been recently presented to the reviewing courts of Illinois in three cases, and the discussion of these has been reserved, since these cases can be better understood in the light of cases previously discussed. In *Flanagan v. Madison Square State*

⁷⁰ 285 Mich. 86, 280 N.W. 120 (1938).

⁷¹ "Here the stockholders did not assume liability for an assessment and the history of the corporation persuades one to believe that it enjoyed a bona fide existence free from fraudulent intent to evade liability." *Burrows v. Emery*, 285 Mich. 86, 280 N.W. 120 at 124 (1938).

Bank,⁷² *Galinski v. Adler*,⁷³ and *Trupp v. First Englewood State Bank of Chicago*,⁷⁴ the creditors of three state banks sought to enforce the liability on various bank stocks registered in the name of the holding company (National Republic Bancorporation) against the stockholders of the holding company. All of the cases were decided in the trial courts on motions to dismiss, the amended complaints being dismissed for various reasons set out in the pleadings.⁷⁵ On appeal, the Illinois Appellate Court reversed two of the trial court decisions and remanded the cases for further proceedings,⁷⁶ but in the third case the trial courts order of dismissal was sustained.⁷⁷

The factual situations in these cases were similar to those in the Michigan cases and South Carolina cases discussed above, and, had the cases been tried on the merits, the decisions might have followed these cases. Since the cases were decided on motions to dismiss under Section 45 of the Civil Practice Act,⁷⁸ the court was forced to take the allegations of the complaints as admitted, at least for the purpose of ruling on the motions, and this may have weakened the decisions as authority on the questions of substantive law involved. The National Republic Bancorporation was organized in 1930 with an authorized capital stock of 1,000,000 shares of par value of \$20 each, most of which were issued

⁷² 302 Ill. App. 468, 24 N.E. (2d) 202 (1939).

⁷³ 302 Ill. App. 474, 24 N.E. (2d) 205 (1939), involving the stock of United American Trust & Savings Bank.

⁷⁴ 307 Ill. App. 258, 30 N.E. (2d) 198 (1940).

⁷⁵ The pleadings were rather complicated, some of the amended and supplemental bills of complaint having seven or eight amendments as new parties were added or others dismissed. Several questions of pleading were argued and decided, but will not be discussed here.

⁷⁶ The Flanagan case and the Galinski case, notes 72, 73, *supra*.

⁷⁷ The Trupp case was sustained largely on the theory that the decree of Dec. 28, 1934, against Bancorporation, adjudicating it to be the owner of 1890 shares, was a final decree and that plaintiffs could not now set aside that decree (more than two years later) and proceed on a different theory, adding 1,250 parties as defendants.

A fourth case involving this holding company, as relating to stock in Peoples National Bank & Trust Co., was heard in the United States District Court. In *Pearson v. Allborg*, 23 F. Supp. 837 (1938), the court held that the complaint did not state a cause of action and dismissed the case. Leave was later granted to file an amended complaint and, on the hearing on motion to dismiss, it was held that the amended complaint did state a cause of action. *Garvy v. Allborg*, 1 F.R.D. 131 (1939).

⁷⁸ Ill. Rev. Stat. 1939, Ch. 110, § 169.

to an investment trust. The stated purpose of the company was to buy, sell, and deal in securities of all kinds, including bank stocks. In fact the company proceeded to exchange its stock for the stocks in seven state banks and one national bank until it had control of the eight banks. There are many conflicting statements in the briefs of counsel but it seems that Bancorporation owned and held stock ranging from 51 per cent of the Madison Square State Bank to almost all of the stocks in other banks, that it owned 81 per cent of the aggregate stock issued by all of the eight banks, that for the first few months of its existence its only assets were bank stocks, that from then until the corporation was petitioned into bankruptcy 95 per cent of its assets were bank stocks, that it held itself out as a group of banks with uniform operation and management, that in fact it did control the policies of the various banks, that it was hopelessly insolvent when these cases were filed and that no part of the assessment against Bancorporation on the various bank stocks has been paid.

In the argument of these cases the plaintiffs and defendants made use of all of the authority of the cases previously decided in other jurisdictions and the court had ample precedent to follow. On the facts as stated in the cases, the decisions of the Appellate Court in reversing and remanding the Flanagan case and the Galinski case seem correct. Here the holding company had practically no assets other than bank stock and held such large blocks of stock in the various banks that, to deny liability of the stockholders, would practically nullify the added liability statute in relation to these banks. If any of these cases, after being heard in the trial court on complaint and answer, with full hearing on the facts, and with the allegations in the complaints found to be true, should again reach our reviewing courts, the decisions should be in favor of the creditors, holding the stockholders of Bancorporation liable for the assessments.

CONCLUSION

Much has been written on added liability on bank stock from the legal, social, economic, and political viewpoint. That the attitude and public policy of the Federal Govern-

ment and many of the states has been modified and changed cannot be denied.⁷⁹ Deposit insurance has been substituted for added liability in the national banking structure and in many states.⁸⁰ Whether the F.D.I.C. could withstand a major economic crisis is a question on which even the best of economists disagree. What effect this will have on the future of banking only time will tell. Perhaps deposit insurance will remain, or perhaps we will design some wholly different means of protection for the bank depositor of the future.

But, from the legal viewpoint, these changes of public policy should not be considered in deciding cases which arose under the previous statutes. As to the cases now in the courts, it should be remembered that the statutory provisions creating this liability were in full force and effect when the acts, for which the various defendants are called to account, were done and when the relations of the defendants to the corporations were voluntarily assumed. As to the cases which may arise in the future in those states which still retain these provisions in their statutes (and Illinois will probably be among them), it seems that the statutes should be enforced, relying on the cases discussed here as precedents, regardless of the public policy of other states in changing their laws.

In cases where the holding company is organized for a purpose other than holding bank stock, in fact does engage in some other business, the major part of its assets are other than bank stock, the acquisition of the bank stock is only incidental to its main business, and the stock held is only a small portion of the total stock of the bank, then the stockholders of the holding company should be held not liable.⁸¹ One writer has suggested that whenever more than one-half of the company's assets are in bank stock, by reason of this very fact the company could not respond to a "double liability" assessment from the other half of its assets, and the

⁷⁹ Note, 48 Harv. L. Rev. 659-72 (1935) on legislation regarding branch, chain, and group banking.

⁸⁰ Harold James Kress, "The Banking Act of 1935," 34 Mich. L. Rev. 155 (1935).

⁸¹ *Burrows v. Emery*, 285 Mich. 86, 280 N.W. 120 (1938), comes the nearest to fitting into this factual situation and it is felt that the nonliability decision in this case was justified.

stockholders should then be held liable.⁸² There is merit in this argument, but it seems best to leave the question of the specific facts which will place the case in the non-liability class to the courts. In cases where the company is similar to those in the Michigan, South Carolina, and Illinois cases, that is, where it does not satisfy the factual situation outlined above, liability should attach to the stockholders of the holding company.⁸³

⁸² 2 U. of Chi. L. Rev. 484 (1935).

⁸³ The general policy behind the rule is well stated in *Barbour v. Thomas*, 7 F. Supp. 271, 278 (1933), "If this device is permitted by the courts to defeat the assessment, individual stockholders in corporations whose stock is subject to a statutory liability will resort to this corporate plan and evade the statute. It is contrary to a sound public policy to permit such a beneficent statute affecting such a large portion of our people to be so completely nullified. Whenever the principal business of a corporation is to hold stock of this statutory liability class and is without capital or other substantial assets to respond to the statutory liability, the corporation should be disregarded and its stockholders held individually liable in proportion to the stock owned by them as the true and beneficial owners of the stock."