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# Creditors' Remedies Against Holders of Watered Stock

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dealing with legislation on this subject, continue to restrict its application by means of strict construction and a reading in of older provisions. As the statute which has been so restricted seems to be drafted with a view toward broader application than it is presently being given, it is not unlikely that it will undergo a revision in the near future, such change providing a tool which should prove useful in the solution of a vexing social and economic problem in our state.

*Jerry Simon*

# Creditors' Remedies Against Holders of Watered Stock

Watered stock has been traditionally defined as "stock which is issued by a corporation as fully paid-up stock, when in fact the whole amount of the par value thereof has not been paid in." [1] The term includes "bonus shares," "discount shares," shares issued for over-valued services or property, and other forms of shares issued for a fictitious consideration. It should be kept in mind that in the watered stock situation there is no outstanding promise to pay as in the case of an unpaid subscription.[2] Hence, any action against the stockholder must be ex delicto or based on statutory liability.

Since the passage of the corporation act in 1928[3] there have been no reported Louisiana cases on the liability of holders of watered stock to creditors. Necessarily, our subject will be limited to a discussion of the different theories of liability in other jurisdictions, the basis for liability in Louisiana before 1928, and the writer's views on which theory should be used by our courts today.

## I. Theories of Liability in Other Jurisdictions

### A. *The Trust Fund Theory*

The leading case of *Scovill v. Thayer*[4] involved an agreement between a shareholder and a corporation whereby the latter issued fully paid stock at a discount with a provision that

1. Black, Law Dictionary (3 ed. 1933).
2. Gray Construction Co. v. Fantle, 62 S.D. 345, 253 N.W. 464 (1934); 13 Am. Jur., Corporations § 563 (1934). See La. R.S. (1950) 12:15.
3. La. Act 250 of 1928, now La. R.S. (1950) 12:1-71.
4. 105 U.S. 143 (1881).

the stockholder would not be held for any additional assessment. The Supreme Court of the United States held "that such a contract, though binding on the company, is a fraud in law on its creditors, which they can set aside; that when their rights intervene and their claims are to be satisfied, the stockholders can be required to pay their stock in full. . . . The reason is, that the stock subscribed is considered in equity as a trust fund for the payment of creditors. . . . It is so held out to the public, who have no means of knowing the private contracts made between the corporation and its stockholders. The creditor has, therefore, the right to presume that the stock subscribed has been or will be paid up, and if it is not, a court of equity will at his instance require it to be paid."[5] The above quotation shows that the trust fund theory makes no distinction between prior or subsequent creditors, or creditors with or without knowledge of the watered nature of the stock. This doctrine simply states that the issuance of watered stock is a fraud on *all* creditors, and stockholders will be required to make up the difference between the purchase price and the par value.

The trust fund doctrine found much criticism among legal scholars,[6] and gradually it fell into disrepute, with only a few states still adhering to it.[7] Many states modified the doctrine into either the fraud theory[8] or the statutory obligation theory.

*B. The Fraud or Holding Out Theory*

A notable example of the evolution of the trust fund theory into the fraud theory appeared in the famous case of *Handley v.*

5. 105 U.S. 143, 154.

6. Bonbright, Shareholders' Defenses Against Liability to Creditors on Watered Stock, 25 Col. L. Rev. 408 (1925); Hunt, The Trust Fund Theory and some Substitutes for It, 12 Yale L.J. 63 (1902). Briefly, the basis of this criticism is that where there is no unpaid subscription obligation to the corporation there is actually nothing for the corporation to hold in trust. The natural consequence of such an illogical situation was a resort to the much censured use of fictions.

7. For late applications of the trust fund theory see cases in 11 Fletcher, Cyclopedia on Corporations 577, n. 81 (1924).

8. Hospes v. Northwestern Mfg. and Car. Co., 48 Minn. 174, 197, 50 N.W. 1117, 1121, 15 L.R.A. 470, 474, 31 Am. St. Rep. 637, 646 (1892): "It is difficult if not impossible, to explain or reconcile these cases upon the 'trust fund' doctrine, or, in the light of them, to predicate the liability of the stockholder upon that doctrine. But by putting it upon the ground of fraud . . . we have at once a rational and logical ground on which to stand. The capital of a corporation is the basis of its credit. It is a substitute for the individual liability of those who own its stock. People deal with it and give it credit on the faith of it. They have a right to assume that it has paid in capital to the amount which it represents itself as having; and if they give it credit on the faith of that representation, and if the representation is false, it is fraud upon them. . . ."

*Stutz.*[9] Here the court talked in terms of the trust fund theory, but in its final disposition of the case held that the shareholders were liable for the full par value to all those creditors who become such subsequent to the issuance of the stock. By limiting recovery to subsequent creditors, the court departed from the trust fund theory and seemed to be approaching the fraud theory of liability which requires a holding out of stock as fully paid and reliance thereon by the creditor. Under this theory only those creditors who are deceived are allowed to recover;[10] thus the courts have held that anyone becoming a creditor before the watered stock is issued cannot complain[11] nor can a subsequent creditor with notice of the watered stock situation.[12] Unless there is actual knowledge, the subsequent creditor will be presumed to have relied on the holding out.[13] Professor Ballantine criticizes[14] the soundness of this doctrine by advancing the argument that public subscribers very seldom participate in any misrepresentation to creditors and "are usually themselves victims of these frauds." Be that as it may, the fraud theory is still followed by a majority of the states.

Although at first glance the fraud theory and the trust fund theory seem to be somewhat similar, basically they are quite different. The fraud doctrine approaches the problem from the point of view that the stockholder has committed a fraud against relying creditors by holding out the stock as fully paid. The trust fund approach is that the agreement between the corporation and the shareholder limiting the latter's liability is void because it is a constructive fraud on all creditors. The law therefore implies a promise on the part of the stockholder to make up the unpaid portion.

*C. The Statutory Obligation Theory*

Because the legislation on this subject varies considerably, it would not be practical to attempt to analyze the problem by examining the statutes of all states which have adopted this approach. However, a good example of an application of such

9. 139 U.S. 417 (1891).
10. Collier v. Edwards, 144 Okla. 69, 289 Pac. 260, 69 A.L.R. 874 (1930); Hospes v. Northwestern Mfg. & Car. Co., 48 Minn. 174, 50 N.W. 1117, 15 L.R.A. 470, 31 Am. St. Rep. 637 (1892).
11. Fletcher, Cyclopedia on Corporations § 5238 (1924).
12. 139 U.S. 417 (1891).
13. R. H. Herron Co. v. Shaw, 165 Cal. 668, 133 Pac. 488 (1913).
14. Ballantine, Corporations 806 (rev. ed. 1927).

a statute is shown in the case of *DuPont v. Ball*,[15] where the court said, "Our statute is very general in its language, and broad enough to comprehend all claims that are legally and equitably collectible. Under it the stockholder's liability is express and unqualified; it makes no exception and recognizes no distinction between creditors. . . . We are clearly of the opinion that mere knowledge that stock issued as fully paid and nonassessable was not in fact paid for, should not preclude the creditor from enforcing the liability of the holder because the creditor may also know or have good reason to believe that the holders of such stock would be legally liable for the debts of the company to the extent of the par value of their stock." [16]

The result under this theory is that a shareholder is liable for the full par value of his stock, and there is no distinction between prior or subsequent creditors. The exponents of this theory argue, "the capital stock of a corporation is the basis of its credit, not because of actual reliance by creditors on the precise amount of stock issued, but because the contributions of the stockholders are the substitute for their personal liability. It is not any misrepresentation of fact as to the amount of paid-in capital which is the basis of liability, but the obligation imposed by law on the stockholder to contribute capital as an incident of membership in a limited liability corporation. This obligation is in the nature of an asset of the corporation and should be available to prior creditors and to subsequent creditors with notice as well as to those whose debts were contracted after the subscription without notice. . . ." [17]

## II. The Basis for Liability in Louisiana Prior to 1928

Before the corporation act, Louisiana had only two written laws dealing with watered stock, and for all practical purposes these were identical. Article 266 of the Constitution of 1898[18] provided:

> "Corporations shall not issue stock or bonds except for labor done, or money or property actually received; and all fictitious issues of stock shall be void; and any corporation issuing such fictitious stock shall forfeit its charter."

15. 11 Del. Ch. 430, 106 Atl. 39, 7 A.L.R. 955 (1918).
16. 11 Del. Ch. 430, 443, 106 Atl. 39, 45, 7 A.L.R. 955, 966 (1918).
17. Ballantine, Stockholders' Liability in Minnesota, 7 Minn. L. Rev. 79, 90 (1923).
18. Now La. Const. of 1921, Art. XIII, § 2.

The similar statutory provision is found in Act 267 of 1914, Section 20.

The early case of *Belknap v. Adams*[19] dealt with the situation of the defendants' issuing to themselves $15,000 worth of stock with no actual consideration being given therefor. In the course of the decision the court stated:[20] "The liability of shareholders to the corporation for their stock is treated as a trust fund for creditors. . . . Nor is it of the least consequence that there were no corporate creditors when that issue was made. The shareholders' liability for unpaid stock received for [from] the corporation is to future as well as existing creditors." From this excerpt it can be seen that our court went along with a majority of states at this time in predicating liability upon the trust fund theory.

In the case of *Dilzell Engineering and Construction Company v. Lehmann*[21] it was held that under Article 266 the value of property or labor received in payment of stock must be equal to the face value of the stock, and the stockholders were found liable to the creditors of the insolvent corporation for the difference between the value of the property given in payment and the par value of the shares of stock. The case of *S. M. Jones Company v. Home Oil and Development Company*[22] fell in line with the reasoning of the foregoing cases. Here the receiver in filing his provisional account did not include certain stockholder creditors as entitled to participate in the sums he had recovered from the same stockholder creditors, being the difference between the amount paid for their stock and the par value. The stockholder creditors had been condemned by judgment to pay the difference, and in this suit they were claiming as creditors the return of part of this sum. The receiver contended that they were properly excluded on the ground that they were estopped because the stock was issued, to their knowledge, for less than its par value. The receiver's contentions should have been sustained had the court based liability on the fraud theory, but the court held:[23] "It being settled that directors and stockholders

19. 49 La. Ann. 1350, 22 So. 382 (1897).
20. 49 La. Ann. 1350, 1353, 22 So. 382, 383.
21. 120 La. 273, 45 So. 138 (1907).
22. 124 La. 148, 49 So. 1009 (1909).
23. 124 La. 148, 151, 49 So. 1009, 1010. See also Webre v. Christ, 130 La. 450, 58 So. 145 (1912), which affirmed the *Dilzell* case and held that a receiver representing the creditors had the right to show that shares given by the defendant shareholders in payment of his stock subscription were of little money value and that the defendant had not paid for the stock.

may become creditors and rank as to their claim the same as any other creditors, we come next to the proposition that stockholder creditors, with full knowledge when they become creditors that the stock of the corporation had been sold for less than its par value, are not entitled to share in the proceeds. We do not find it possible to agree with that view. They are creditors despite the fact that they knew that the stock was issued for less than par. We see no necessity for two classes of creditors, one whose rights should be made to depend upon the fact that they knew that stock had been issued for less than its par value, and the other class without that knowledge. . . . And then, again, it would be singular if a creditor owning only one share of little value were excluded from participating in the disposition of the trust fund although he might be a creditor for thousands of dollars."

The trust fund theory seemed to be firmly established in our jurisprudence by the decisions in the preceding cases. However, in 1922 the supreme court decided the case of *Walmsley v. Brothers*,[24] which contains dictum that appears to be out of line with this doctrine. In this case the defendant shareholder was being sued by the corporate receiver who was attempting to collect for the *corporation* the difference between the par value of the stock and the value of the services rendered by the defendant. (There were no creditor's rights involved.) The court held that the corporation did not have a valid claim against the defendant, as there was no subscription contract between the parties nor had the defendant committed an offense or quasi-offense in accepting the shares. But the court went further than necessary by discussing the meaning of *Handley v. Stutz*[25] in relation to the *Dilzell* case[26] and seemed to look with favor upon the distinction between prior and subsequent creditors as made in *Handley v. Stutz*. Although dictum, the court did show a tendency to swing over to the fraud or holding out theory.

The last expression by our court on this problem may be found in *Rapides Grocery Company v. Grant*.[27] The supreme court cited with approval the language of *Webre v. Christ*,[28] where it was said that under Article 266 the value of the property

24. 152 La. 148, 92 So. 766 (1922).
25. 139 U.S. 417 (1891). See note 8, supra.
26. 120 La. 273, 45 So. 138 (1907).
27. 165 La. 593, 115 So. 791 (1928).
28. 130 La. 450, 58 So. 145 (1912). See note 23, supra.

or labor received in payment of a stock subscription must be equal to the face value of the shares, and the stockholder is liable to creditors for the difference between the value of the property given in payment and the par value of the shares. In the *Grant* case stock was issued in return for consideration consisting of merchandise which was grossly inflated in value. The court did not distinguish between prior or subsequent creditors; but since the stock was issued shortly after the signing of the charter, in all probability the creditors were subsequent. However, the court made no mention of this point or of the *Walmsley* case and its possible effect on the prior jurisprudence.

## III. The Louisiana Law Today

### A. *Which Theory Should Be Used by Our Courts Today?*

The Louisiana law on the problem at hand is contained in Article 13, Section 2,[29] of the Constitution and in Sections 17 and 19 of the Business Corporation Act.[30] As stated in the introduction, there have been no decisions on the question since the passage of the corporation act in 1928; therefore, we will have to interpret these provisions without the benefit of recent jurisprudence by the courts of this state.

In regard to Article XIII, Section 2, of the Constitution, it has been stated[31] that there are some twenty-seven states having constitutional or statutory provisions similar to this article. What exactly is the effect of such a provision declaring "all fictitious issues of stock shall be void"? The Louisiana courts seem to hold that the only effect of this section is to declare the contract void as between the corporation and the shareholder,[32] but not to affect any cause of action a creditor of the corporation might have against the shareholder.[33] This is the result reached by most of the other states,[34] although a variety of approaches is used. Thus

29. La. Const. of 1921, Art. XIII, § 2, is set out under the preceding topic as La. Const. (1898) Art. 266.

30. La. R.S. (1950) 12:17, 19.

31. Ettlinger v. Collins, 25 Ariz. 115, 213 Pac. 1002 (1923).

32. It has been held that a corporation cannot sue for the difference between the value of services given and the par value (Walmsley v. Brothers, 152 La. 148, 92 So. 766 [1922]), although it might sue for a cancellation of the shares, and the corporation cannot be estopped from asking for such a cancellation (Mackie Pine Products v. Fredericks, 148 La. 687, 87 So. 712 [1921]).

33. Rapides Grocery v. Grant, 165 La. 593, 115 So. 791 (1928); Dilzell Engineering & Const. Co. v. Lehmann, 120 La. 273, 45 So. 1009 (1907).

34. See discussion in 35 Mich. L. Rev. 108 (1936). The Louisiana position is set forth in Dilzell Engineering and Const. Co. v. Lehmann, 120 La. 273, 45

it can be seen that Article XIII, Section 2, offers little help in determining which of the three theories the courts will follow. It certainly does not set forth any mandatory law on the subject, and the courts would have a wide area in which to operate were this the only law on the matter.

The solution as to which theory our courts will adopt when allowing relief to creditors is rather definitely indicated by the provision of Section 19C, that "Nothing in this Chapter shall be construed as in derogation of any rights which any person may by law have against an incorporator, subscriber, shareholder, director, officer, or the corporation, because of any *fraud* practiced upon him by any of such persons or the corporation. . . ." (Italics supplied.) Since this statute expressly mentions fraud, and since Article XIII, Section 2, of the Constitution has never been interpreted by the courts as a basis for the statutory obligation theory, it is unlikely that relief will be granted under that doctrine.[35] Therefore the problem narrows itself down to one of whether the courts will retain the trust fund theory which was used before the corporation act, or whether they will follow the course of the majority of states by switching from the trust fund theory to the fraud theory.

A basic argument in support of the trust fund theory has been that the public has "no means of knowing the private contracts made between the corporation and its stockholders."[36] This argument may be largely refuted today by pointing out that Section 18 of the corporation act requires the filing of a report and affidavit as to the consideration given for shares. Also, the fact that most courts and scholars believe the trust fund theory to be unsound would likely have persuasive effect on the Louisiana courts.

### B. *Test of Shareholder's Liability in Overvaluation Cases*

Turning to the related problem of the valuation of services

So. 138 (1907), where it was stated that as between the stockholder and the creditors, the former are estopped from setting up the nullity. For another approach see Scully v. Automobile Finance Co., 12 Del. Ch. 174, 109 Atl. 49 (1930).

35. 9 U.L.A. 96 (1951), the Commissioner's note sustains this observation: "There is no statutory liability imposed upon the shareholders either toward the corporation or toward the creditors of the corporaton. Why should there be liability to a corporate creditor who knows of the fact of overvaluation? Undoubtedly, a creditor might work a right in deceit based on the intentional false representations made by a shareholder. Such a liability is not negatived by anything in this act."

36. Scovill v. Thayer, 105 U.S. 143, 154 (1881).

or property for determining liability to creditors,[37] there are two standards in general use—the "true value" rule and the "good faith" rule. By the true value rule a stockholder must give property or services actually equal to the par value of the stock, and good faith or an honest mistake will not be a defense. Under the good faith rule a valuation will be conclusive if the parties deal at arm's length and there is no *intentional* overvaluation. A few of the jurisdictions following the good faith rule hold that a shareholder will be liable if he does not exercise reasonable care. Before the passage of the corporation act in 1928, the Supreme Court of Louisiana made use of the true value rule at least once.[38] As to which standard the Louisiana courts will use today, an answer can best be formulated by analogizing from Section 20, which holds responsible for overvaluation only those "incorporators, shareholders, or directors . . . who knowingly, or *without the exercise of due and reasonable care and inquiry*, consented to or voted in favor thereof." (Italics supplied.) It should be noted that "shareholders" as used in the section refers to shareholders as a group, which in some instances may be charged with the duty of valuation, and does not refer to the purchaser of the stock.[39] Since Section 20 requires only due care on the part of incorporators, shareholders, or directors, it would hardly seem equitable to hold the person purchasing the stock to a greater degree of care than the corporate representatives with whom he deals. Hence, the true value rule, which imposes strict liability, would not seem appropriate. Turning then to the good faith rule, a question arises as to whether the courts will hold the stockholder to the same degree of care as the corporate

37. The valuation problem in regard to the stockholder's obligation to the *corporation* should be distinguished from the valuation problem in determining liability to *creditors*. The answer to the former is found in La. R.S. (1950) 12:17.

38. Rapides Grocery Co. v. Grant, 165 La. 593, 115 So. 791 (1928). In this case the court quoted as follows from 14 C.J. 961, which is in the section entitled "The True Value Rule": "By this rule, with slight qualifications in some states, one who subscribes for or receives stock of a corporation must pay therefor the par value thereof, either in money or money's worth, so that the real assets of the corporation, at the outset, at least, shall square with its books; and therefore, whenever, whether by fraud, accident or mistake, the true value of the property, labor or services received in payment does not equal the par value of the stock, it is deemed unpaid to the full extent of the difference, and the holders are liable to or for the benefits of creditors of the corporation for this difference." See also Dilzell Engineering and Const. Co. v. Lehmann, 120 La. 273, 284, 45 So. 138, 142 (1907): "While it is not here said expressly that the value of the labor or property received in payment of the stock must be equal to the face value of the stock, that is the idea meant to be conveyed."

39. This observation is borne out by La. R.S. (1950) 12:20(c).

representative, that is, to require due care as to the valuation (which is the minority good faith rule); or whether the stockholder will be liable only if there is an *intentional* overvaluation (the majority rule). We have very little on which to make a prediction, and since it is not within the scope of this comment to go into the relative merits of allowing the action of deceit to include negligence, a definite conclusion on this controversial issue[40] will not be attempted.[41] However, it is submitted that under the present laws of this state, either of the good faith rules of valuation coupled with the fraud or holding out doctrine (although itself not flawless in theory) presents a more logical approach to the determination of creditors' remedies against holders of watered stock than the previously used true value and trust fund theories.

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40. Prosser, A Handbook of the Law of Torts § 87 (1941).

41. The Commissioner's Note at 9 U.L.A. 97 (1951) takes the position that "a creditor might work out a right in deceit based on the *intentional* false representations made by a shareholder." (Italics supplied.) From this it would seem that the majority good faith rule of valuation would combine better with the fraud theory than the minority rule.