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Corporations - Stockholders - Cancellation of Stock Issues Without Consideration

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CORPORATIONS—STOCKHOLDERS—CANCELLATION OF STOCK ISSUED WITHOUT CONSIDERATION—Defendant, a veterinarian, and six others formed plaintiff corporation to produce vaccines for livestock. Defendant, pursuant to a resolution of the board of directors composed of all stockholders, received forty-five shares of stock in exchange for a vaccine formula developed by him. Plaintiff sued for cancellation of the shares held by defendant, alleging no consideration in that the shares were not issued for money or property actually received or labor done, as required by law.[1] The lower court cancelled defendant's shares. On appeal, *held*, reversed. Where the corporation benefited from use of alleged consideration, and no innocent third party, change in stock ownership, or fraud was involved, the corporation was estopped from asserting that defendant's shares were issued without consideration.[2] *Murray v. Murray Laboratories*, (Ark. 1954) 270 S.W. (2d) 927.

[1] "No private corporation shall issue stocks or bonds, except for money or property actually received or labor done, and all fictitious increase of stock or indebtedness shall be void." ARK. CONST., art. 12, §8.

[2] Generally unpatented formulas are not considered property so as to constitute valid considerations for fully paid stock. DODD, STOCK WATERING 51-52 (1930).

Where stock is issued without the consideration required by state statutes and constitutions,[3] it is well settled that such stock is subject to cancellation at the suit of the corporation[4] or at the suit of a stockholder suing on behalf of the corporation.[5] If, however, the stock is issued for what is merely an inadequate consideration, the right to cancellation is not so universally recognized. On the theory that the decision of the directors is conclusive when valuing property,[6] insufficient consideration does not provide grounds for cancelling stock in some states.[7] Others allow cancellation to the extent of the inadequacy, allowing the stockholder to retain an amount of stock equal in value to the consideration provided.[8] Where the prescribed consideration is the performance of services over a period of time, and the stockholder ceases performance before completion, thus rendering his retention of the stock inequitable, cancellation is permitted.[9] Even though consideration is wholly lacking, there are several possible defenses to a suit for cancellation. Lack of jurisdiction over the stockholder may bar the action,[10] but according to one recent case, jurisdiction over the corporation is sufficient even where stock is transferable by delivery alone under the Uniform Stock Transfer Act.[11] The availability of other defenses often depends on whether stock issued without consideration is void or only voidable.[12] Where the stock is voidable and has passed into the hands of a

[3] See note 1 supra. See also 58 N.Y. Consol. Laws (McKinney, 1944) §69, and Ind. Stat. Ann. (Burns, 1948 Repl.), tit. 25, c. 2, §25-205, as illustrations of statutes requiring payment for stock in money, property, or services.

[4] Bell Isle Corp. v. McBean, 30 Del. Ch. 373, 61 A. (2d) 699 (1948); Meir v. First Citizens Bankers Corp., 301 Mass. 410, 17 N.E. (2d) 106 (1938); Riverside Oil & Refining Co. v. Lynch, 114 Okla. 198, 243 P. 967 (1925); James v. P. B. Steifer Mining Co., 35 Cal. App. 778, 171 P. 117 (1918); Hillsdale Cemetery Assn. v. Holmes, 97 Minn. 261, 105 N.W. 905 (1906). To the contrary see 11 FLETCHER, CYC. CORP. §5251 (1932), citing Vasey v. New Export Coal Co., 89 W.Va. 491, 109 S.E. 619 (1921).

[5] The suit ". . . is derivative because cancellation . . . is sought to remedy a direct injury to the corporation. . . ." Bennett v. Breuil Petroleum Corp., (Del. Ch. 1953) 99 A. (2d) 236 at 241. See also Blair v. F. H. Smith Co., 18 Del. Ch. 150, 156 A. 207 (1931); Scully v. Automobile Finance Co., 12 Del. Ch. 174, 109 A. 49 (1920).

[6] 18 C.J.S., Corporations §246 (1939). Colonial Biscuit Co. v. Orcutt, 264 Pa. 40, 107 A. 315 (1919). Statutes often provide that the valuation reached by the directors is conclusive. See statutes cited in note 3 supra. Cf. Bennett v. Breuil Petroleum Corp., note 5 supra, where inadequate consideration was money, not property.

[7] Kunkle v. Soule, 71 Colo. 221, 205 P. 529 (1922); Colonial Biscuit Co. v. Orcutt, note 6 supra.

[8] Lewis v. Elk Hills 36 Oil Co., 103 Cal. App. 14, 283 P. 879 (1929); Taylor v. Citizens Oil Co., 182 Ky. 350, 206 S.W. 644 (1918) (stockholding reduced one-half). Cf. Ackerman Tool and Construction Co. v. McArthur, (La. 1954) 73 S. (2d) 507.

[9] Therm-O-Proof Insulation Mfg. Co. v. Hoffman, 329 Ill. App. 645, 69 N.E. (2d) 725 (1946).

[10] Fiedelman v. Paragon Paint and Varnish Corp., 64 N.Y.S. (2d) 385 (1946).

[11] Even though the certificate and owner are not in the state, and the state has adopted a transfer act that protects bona fide holders, there is jurisdiction to cancel the stock in the state of incorporation. Hodson v. Hodson Corp., 32 Del. Ch. 76, 80 A. (2d) 180 (1951).

[12] The Arkansas Constitution, note 1 supra, specifically provides that stock without consideration shall be "void." Statutes such as the New York and Indiana statutes, note 3 supra, fail to indicate the effect of issuance of stock without the required consideration. Illustratively, the defense of laches is not effective where stock is void. Tooker v. Nat. Sugar Refining Co., 80 N.J. Eq. 305, 84 A. 10 (1912).

bona fide holder, the corporate right to cancellation is cut off,[13] but not so if the stock is considered void.[14] The same distinction is drawn where an estoppel is asserted to prevent cancellation. If the stock issued without consideration is voidable only, the corporation cannot repudiate a declaration that the stock is fully paid because such a declaration is binding as between the corporation and its stockholders.[15] There are other grounds of estoppel. Should the corporation and stockholders receive benefits of an unauthorized consideration, as in the principal case, they would be estopped in a suit for cancellation.[16] A more common ground upon which equity refuses to cancel stock issued without consideration in violation of a statutory or constitutional provision is that the stockholders have acquiesced in or consented to the unauthorized issue.[17] Protection of these laws cannot be waived where the rights of third parties such as creditors or subsequent stockholders are involved, but ". . . no principle of public policy prevents a stockholder from waiving the benefit of a statute enacted for his own protection."[18] In those jurisdictions where such an issue is declared void, however, neither the corporation nor the stockholders can be estopped.[19]

In a technical sense the decision of the principal case is objectionable. The specific mandate of the Arkansas Constitution is that stock issued without consideration is "void."[20] Logically, stock that is void has no existence and the holder thereof has no rights. But by refusing cancellation the court rejected these conclusions. Its decision is justifiable, however, for to allow the corporation and the objecting stockholders to receive the benefit of an agreement to which all interested parties assented directly or indirectly and then deny the validity of the agreement would be unconscionable. The fact that there were

[13] Southern Mut. Aid Assn. v. Blount, 112 Va. 214, 70 S.E. 487 (1911); Cuba Colony Co. v. Kirby, 149 Mich. 453, 112 N.W. 1133 (1907) (stock held as security).

[14] Walton v. Standard Drilling Co., 43 S.D. 576, 181 N.W. 96 (1921); First Avenue Land Co. v. Parker, 111 Wis. 1, 86 N.W. 604 (1901).

[15] Granite Brick Co. v. Titus, (4th Cir. 1915) 226 F. 557; Bruner v. Brown, 139 Ind. 600, 38 N.E. 318 (1894). Cf. Mudd v. Lanier, 247 Ala. 363, 24 S. (2d) 550 (1945).

[16] ". . . persons who participate in an unauthorized or illegal issue of . . . stock . . . and receive the benefits thereof . . . will be estopped to deny the validity of the issue. . . ." Geiman-Herthel Furniture Co. v. Geiman, 160 Kan. 346, 161 P. (2d) 504 (1945), quoting 18 C.J.S., Corporations §257(c). Cf. Pierce v. Guaranty Laundry Co., 200 Okla. 395, 194 P. (2d) 875 (1948) (corporation not estopped by acceptance of benefits where holder aware of illegality in issuance of stock).

[17] Geiman-Herthel Furniture Co. v. Geiman, note 16 supra. Where stockholders assent only through proxies there is no estoppel. Blair v. F. H. Smith Co., note 5 supra. *Contra*, Gray v. Aspironal Laboratories, (5th Cir. 1928) 24 F. (2d) 97.

[18] Kimmel Sales Corp. v. Lauster, 167 Misc. 514 at 520, 4 N.Y.S. (2d) 88 (1938); Gray v. Aspironal Laboratories, note 17 supra. Cf. American Macaroni Corp. v. Saumer, 174 N.Y.S. 183 (1919), where there was no showing that there were third parties to protect, but cancellation was allowed.

[19] 11 FLETCHER, CYC. CORP. §5251 (1932). Failure of consideration renders stock absolutely void and nullity cannot be cured by consent or estoppel. Mackie Pine Products Co. v. Frederick, 148 La. 687, 87 S. 712 (1921). See also Mudd v. Lanier, note 15 supra; First Avenue Land Co. v. Parker, note 14 supra.

[20] See note 12 supra.

no third-party rights injured by the illegal issue of stock adds to the soundness of the result. The court merely read the word "void" as "voidable," a liberty often taken when necessary to the desired result.[21]

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[21] It is interesting to note that in another situation the Arkansas court has held that stock issued without consideration is absolutely void. Lepanto Gin Co. v. Barnes, 182 Ark. 422, 31 S.W. (2d) 746 (1930) (stock issued for negotiable note).