Michigan Law Review

Volume 48 | Issue 2

1949

CORPORATIONS-GENERAL EFFECT OF STATUTES PROHIBITING CORPORATE LOANS TO DIRECTORS, OFFICERS AND STOCKHOLDERS

Paul W. Eaton, Jr.
University of Michigan Law School

CORPORATIONS—GENERAL EFFECT OF STATUTES PROHIBITING CORPORATE LOANS TO DIRECTORS, OFFICERS AND STOCKHOLDERS— Over the years a number of states have felt that loans by private corporations to their directors and stockholders should be regulated to protect the interests of creditors and, in many cases, stockholders. At present, twenty-two states[1] have statutes which either alsolutely prevent such loans or else limit their scope, and this number will probably increase. A typical statute may be found in New Jersey: "No corporation shall loan money to a stockholder or officer thereof. If any such loan be made the officers who make it, or assent thereto,

1 California, Connecticut, Delaware, Georgia, Illinois, Indiana, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Hampshire, New Jersey, New Mexico, New York, North Carolina, Ohio, Oklahoma, Rhode Island and South Dakota.

shall be jointly and severally liable, to the extent of such loan and interest, for all the debts of the corporation until the repayment of the sum so loaned."[2] Not only are there numerous variations among the statutes, but there are differences among their judicial interpretations. The purpose of this comment is to consider the necessity for the statutes and to indicate the variations which may be encountered.

A. The Purpose of the Statutes

The reason generally given for enactment of the statute is "to prevent an improper withdrawal of capital,"[3] or as it is put by the Supreme Court of California,[4] to prevent directors from taking advantage of their position to grant themselves or their colleagues (and stockholders, in a number of other states) unwarranted loans and thus dissipate corporate funds in violation of their trust. The sufficiency of these reasons may be questioned. The fact that a director assents to a corporate loan to a co-director or a stockholder does not indicate that he has breached his trust,[5] contrary to the idea expressed by the California court. An early Maryland court succumbed to this idea when it relied on a violation of the statute as evidence of a breach of duty on the part of the directors.[6]

If an "improper withdrawal of capital" means a withdrawal which creates insolvency or which occurs after insolvency, the loan statute adds nothing to the remedies already available. The corporation, receiver or trustee in bankruptcy may hold the directors liable for breach of their fiduciary duty; and the creditors, in most cases, will be able to petition successfully for the appointment of a receiver who may sue the directors for their breach of trust. However, in those cases where a creditor is unable to initiate a receivership, there is no way, in the absence of a statute, for him to hold the directors liable, unless the corporation goes into voluntary receivership. If the corporation is solvent, directors still may be liable to it if the loan is considered improper; and creditors, of course, have no cause to com-

[2] 14 N.J. Rev. Stat. (1937) c. 8, §10.

[3] SPELLMAN, CORPORATE DIRECTORS 557 (1931).

[4] Wulfjen v. Dolton, 24 Cal. (2d) 878, 151 P. (2d) 840 (1944).

[5] Blum v. Fleishhacker, (D. C. Cal. 1937) 21 F. Supp. 527.

[6] Fisher v. Parr, 92 Md. 245, 48 A. 621 (1901). A later Maryland court decided that a loan of money in violation of the statute was a misapplication of the corporation's assets, which along with other acts of mismanagement furnished ground for appointment of a receiver. Hagerstown Furniture Co. v. Baker, 155 Md. 549, 142 A. 885 (1928).

plain, for their security remains sufficient. In addition, it is difficult to comprehend why a state should absolutely forbid the making of loans, since there is no corollary between a loan and a dissipation of capital (which the statute is intended to prevent).[7] The fact that some statutes do allow loans under certain conditions may indicate that a few legislatures have realized that a loan is not necessarily a dissipation of capital, and that common law and other statutory remedies may be adequate to preserve the rights of the corporation and its creditors where the loan is made under those conditions.[8]

There is, nevertheless, something to be said in favor of the statute from the standpoint of the corporation and creditors. There is no question about the liability of the directors; it is made absolute.[9] It is unnecessary to prove a breach of the directors' fiduciary duty; the breach of trust is conclusively presumed from the violation of the statute.[10] Moreover, the situation mentioned previously, in which a creditor who is unable to institute receivership proceedings has no remedy against the directors, is eliminated if the statute allows a suit by a creditor. If the courts would get away from the idea that the statute is intended to prevent dissipation of assets and interpret it instead as assuring to creditors another means by which they can collect their claims in whole or in part, the policy criticism might not be justified. If loans, proper or improper under common law principles, have been made, creditors will receive payment on their claims, to the extent of the loans, from the directors. Of course, this solution may place a great burden on the latter, but they probably will have the right to secure reimbursement from the corporation if the loans have been proper. The practical objection, however, is that this right is an empty one, for there are no assets or, in the usual situation, insufficient assets from which full reimbursement may be made. Nevertheless, directors

[7] 3 FLETCHER, CYC. CORP., rev. ed., §955 (1947). But it would seem that a company which has no power to lend money cannot ratify loans made by a director or officer to himself. People's Bank v. Mobile Towing & Wrecking Co., 210 Ala. 678, 99 S. 87 (1924).

[8] See notes 17, 18, 19 and 20, infra.

[9] GRANGE, CORPORATION LAW FOR OFFICERS AND DIRECTORS 427 (1935): "But if a loan violates a statutory provision, the liability is absolute, and neither good faith in making the loan, nor ignorance of the statute will be accepted by the courts as a defense. In other words, the officers and directors authorizing the forbidden loan are practically guarantors of its repayment." The New Hampshire statute even makes the stockholders who received the loan liable, to the extent of the loan, for the corporation's debts then existing or afterwards contracted. N.H. Rev. Laws (1942) c. 274, §103. The state, however, is alone in this respect.

[10] Fisher v. Parr, 92 Md. 245, 48 A. 621 (1901).

could authorize proper loans thereunder without any imputation of breach of trust.

It may be that this view is the theory lying behind *Swan v. Burnham*,[11] in which the New Hampshire court held that a creditor of a corporation has a right to action against the directors to enforce their statutory liability independent of his right of action against the corporation. Certainly the creditor is given more freedom under this decision than he is given in Massachusetts, where he can invoke the aid of the statute only if he has first made demand upon the corporation for satisfaction of its debt.[12] The only justification for the Massachusetts view is its recognition that the primary obligation to a creditor rests in the corporation itself, not in the directors or officers. Actually, the decision in the *Swan* case is not so radical, for, since it is reasonable to believe that a creditor will have less scruples than the corporation against suing the directors under the statute, the latter may be less willing to authorize improper loans. Consequently, the purpose of the statute as commonly set forth would be attained.

B. Statutory Provisions and Interpretations

The statute, of course, cannot be relied upon if it is shown that the transaction complained of is not a loan. Whether the transaction is a loan is a problem with which the courts are continually faced, for there seems to be no test which may be used. In a recent California case[13] a corporation repaid to its directors an amount which the directors had advanced to the company, although the contingency establishing the company's legal obligation to repay the directors according to their agreement had not materialized. The court held that since the contingency had not occurred, the corporation's act was not a repayment but rather a loan, and, since it violated the statute, the directors were liable to the judgment creditor prosecuting the

[11] 70 N.H. 580, 49 A. 93 (1901).

[12] Old Colony Boot & Shoe Co. v. Parker-Sampson-Adams Co., 183 Mass. 557, 67 N.E. 870 (1903). The problem facing the court in the case was whether the liability of a director under the loan statute was provable in bankruptcy against the director's estate under the Federal Bankruptcy Act of 1898. The court decided that the director's liability was not a debt, but was only contingent upon the failure of the corporation to satisfy the creditor. Consequently, his discharge in bankruptcy after the creditor had obtained judgment against the corporation was not a bar to a bill in equity to enforce the statutory liability of the director.

[13] Wulfjen v. Dolton, 24 Cal. (2d) 878, 151 P. (2d) 840 (1944).

suit. Similarly, the execution by a corporation of a note to a bank to which a director was indebted has been held to be a loan or guaranty of the director's obligation for which he is liable under the statute.[14] On the other hand, the Supreme Court of Maryland has held not to be a loan a transaction in which the directors of a corporation took from an officer who had misappropriated its assets his notes with collateral security for the amount of the embezzlement.[15] In none of these cases can it be said that there has been a loan within the traditional meaning of the word.

Where a loan is made contrary to the statute, however, the security (e.g., a note) given therefor will not be declared void and unenforceable by the corporation, for otherwise the corporation will be without a remedy to recover that to which it is entitled.[16]

Of the twenty-two states which prohibit loans in one form or another, four restrict the limitation to directors and officers only.[17] Moreover, of the eighteen states which do apply the prohibition to stockholders, five restrict it to loans made upon the security of the stock of the corporation.[18] Consequently, no protection is secured by the statute if loans are made upon other types of security or upon no security at all. The effectiveness of the statute is further curtailed in one of the above five states, California,[19] and in Michigan,[20] by allowing a loan to remain valid if it is approved by a certain fraction of the board of directors. Thus, of the twenty-two states which do have loan statutes, ten allow loans to be made to stockholders. It would seem, therefore, that regardless of the statute, creditors and corporations in certain instances in those ten states must resort to their

[14] In re Globe Drug Co., (C.C.A. 9th, 1939) 104 F. (2d) 114.

[15] Murphy v. Penniman, 105 Md. 452, 66 A. 282 (1907). A payment by a corporation to an officer, with the consent of the directors and stockholders, so that the officer might purchase property to transfer to the corporation (without which the corporation could not carry on its business) was held not to be a loan within the meaning of the statute in New York Credit Men's Assn. v. Dingfelder, 287 N.Y. 531, 41 N.E. (2d) 86 (1942).

[16] In re Wood's Estate, 299 Mich. 635, 1 N.W. (2d) 19 (1941).

[17] 22 Ga. Code Ann. (1933) §723; Ill. Ann. Stat. (Smith-Hurd, 1948 Cum. Supp.) c. 32, §157.42 (d); 25 Ind. Stat. Ann. (Burns, 1948) §212; Conn. Gen. Stat. (Rev. 1949) c. 250, §5168. In Connecticut, the limitation is not absolute. If interest is paid to the corporation, if a majority of the directors approve, and if adequate security is given, loans may be made to officers and directors.

[18] Cal. Corp. C. A. (Deering, 1947) §823(a); Del. Rev. Code (1935) c. 65, §36; 20 Minn. Stat. Ann. (1945) §301.32; Neb. Rev. Stat. (1943) c. 21, §180; 18 Okla. Stat. (1947 Cum. Supp.) §1.175(a). It is even doubtful whether the Oklahoma statute prohibits loans to stockholders.

[19] Cal. Corp. C. A. (Deering, 1947) §823(a).

[20] 15 Mich. Stat. Ann. (1937) §21.46.

common law and other statutory remedies. Considering the statute's purpose as it is commonly set forth, there seems to be no reason why the loan prohibition should not include loans to stockholders also. Dissipation of assets may be as large when a loan is made to a stockholder as when made to a director or officer; a creditor may need as much protection in the one case as he does in the other.

Most of the statutes provide that "the directors of a corporation who vote for or assent to the making of a loan . . . shall be jointly and severally liable . . . for the amount of such loan until the repayment thereof."[21] The Illinois statute also provides for a conclusive presumption of assent by the director if he attends the meeting of the board at which the action in question is considered, and if he has not dissented thereto.[22] This conclusive presumption is approved in Indiana, although its statute imposes liability on a director only "for knowingly and wilfully making or assenting to a loan."[23] If a director must "knowingly and wilfully" assent in order to be held liable, it is difficult to apprehend how there can be a presumption of assent. It may be that the Massachusetts statute is stricter in that it requires a showing that the director voted in opposition to the transaction.[24] In New York a director will be exempted from liability if he can show that he had no knowledge of the loan.[25] However, it would seem that if he attends the meeting at which the loan is made, the reasonable presumption is that he will know of the loan, even though his assent or dissent has not been recorded.

An important and often difficult problem which the courts have had to face involves the question of whom the statute is intended to benefit. Did the legislature intend to protect the creditors of the corporation, the stockholders or both? Only in Mississippi does the statute expressly provide for an action by creditors;[26] no mention is made of an action by stockholders also.[27] On the other hand, five states[28]

[21] Ill. Ann. Stat. (Smith-Hurd, 1948 Cum. Supp.) c. 32, §157.42(d).
[22] Id., §157.42(h).
[23] 25 Ind. Stat. Ann. (Burns, 1948) §251.
[24] 5 Mass. Ann. Laws (1948) c. 156, §37.
[25] Murray v. Smith, 224 N.Y. 40, 120 N.E. 60 (1918).
[26] 4 Miss. Code Ann. (1942) §5330.
[27] This fact, however, does not mean that the statute takes away or limits the right of the corporation to bring suit against its officers. The corporation still has a common law right to hold its officers liable for breach of their fiduciary duty. Manning v. Campbell, 264 Mass. 386, 162 N.E. 770 (1928).
[28] Ill. Ann. Stat. (Smith-Hurd, 1948 Cum. Supp.) c. 32, §157.42(d); 15 Mich. Stat. Ann. (1937) §21.46; 14 Mo. Rev. Stat. Ann. (1948 Cum. Supp.) §4997.18; 6 Ohio Gen. Code Ann. (Page, 1938) §8623-123(a); R.I. Gen. Laws Ann. (1938) c. 116, §42.

have statutes which seem to limit the right of action to the corporation. However, the Michigan statute, which provides that the officer or director ". . . who shall knowingly violate the provisions of this section shall be liable to the corporation . . . ,"[29] has only recently been interpreted as benefitting creditors as well as stockholders.[30] Only in Oklahoma are all doubts eliminated by express language in the statute making the directors liable to both the corporation and its creditors.[31] New York, for a long time, has held that its statute was intended to protect only creditors, even though any view is possible under the language of its statute; and the protection is given to those who extended credit prior to repayment of the loan.[32] Probably all but the Indiana and Massachusetts courts will agree with this latter point. A reading of the statutes in those two states would seem to indicate that directors can be liable only for debts contracted between the time of making or assenting to the loan and the time of its repayment.[33] Why creditors of the corporation prior to the making of the loan should be barred from using this remedy is a question which cannot be sensibly answered. Such a creditor should receive the same protection as that given by the statute to one who becomes a creditor after the loan is made.

The New York courts, which have held that the statute is intended for the protection of the creditors only, have denied a trustee in bankruptcy the right to maintain an action under the statute.[34] On the other hand, a federal court has allowed a trustee in bankruptcy to sue the directors under a Mississippi statute which limits liability thereunder to creditors.[35] The problem involved is whether a trustee may sue third parties on behalf of the creditors, and the

29 Ibid.

30 In re Wood's Estate, 299 Mich. 635, 1 N.W. (2d) 19 (1941). The court's decision may be questioned in regard to its reliance on Lester v. The Howard Bank, 33 Md. 558 (1871). In that case, the Maryland statute provided only for the punishment of its violators. There was no express language in the statute to the effect that violators would be liable to the corporation, as there is in the Michigan statute.

31 18 Okla. Stat. (1947 Cum. Supp.) §1.175(b).

32 Billings v. Trask, 30 Hun. 314 (1883); Waters v. Spalt, 80 N.Y.S. (2d) 681 (1948). The fact that a stockholder is a creditor does not prevent him from employing the remedy given to creditors by the statute. Dustin v. Randall Faichney Corp., 263 Mass. 99, 160 N.E. 528 (1928).

33 25 Ind. Stat. Ann. (Burns, 1948) §251; 5 Mass. Ann. Laws (1948) c. 156, §37.

34 Stolz v. Ginsburg, 217 A.D. 701, 215 N.Y.S. 927 (1926), affd. 245 N.Y. 519, 157 N.E. 841 (1927).

35 In re Dalton Electric Co., (D. C. Miss. 1934) 7 F. Supp. 465.

decision of the federal court may be questioned today in the light of the Federal Bankruptcy Act of 1938.[36] However, if the Mississippi statute can be interpreted as giving a right of action to the corporation also, the decision seems satisfactory.

Conclusions

In summary, it may be said again that the purpose of the loan statute is to prevent a dissipation of capital through loans. On this point, and this point alone, will agreement be found among the courts. If this is the only rationale which can be offered, the statute seems unnecessary for two reasons: (1) dissipation of capital is not necessarily concomitant with a loan of corporate funds; and (2) common law and other statutory remedies provide sufficient protection to the corporation and its creditors. In view of the first reason, it appears reprehensible to term the statute penal in nature, as some states do,[37] and subject its violators to criminal prosecution for making loans which do not dissipate assets. A desirable solution may involve either a repeal of the statute, or a revision or judicial reinterpretation of it which will provide for the directors, who are made liable for loans which are not improper as measured by common law standards, a means of reimbursement from the corporation. Such a solution would provide some relief to directors without taking away from creditors the advantage of the present loan statutes.

Paul W. Eaton, Jr.

---

[36] 52 Stat. L. 842, §2 (1938), 11 U.S.C. §11 (1948 Cum. Supp.); 52 Stat. L. 860, §47 (1938), 11 U.S.C. §75 (1943).

[37] In Illinois, directors who violate the statute are guilty of conspiracy and subject to criminal prosecution. Ill. Ann. Stat. (Smith-Hurd, 1948 Cum. Supp.) c. 32, §157.42(h). In Minnesota, the violation is a felony punished by fine or imprisonment. 20 Minn. Stat. Ann. (1945) §300.60. Also, see Billings v. Trask, 30 Hun. 314 (1883). Contra, Cole v. Brandle, 127 N.J.Eq. 31, 11 A. (2d) 255 (1940), holding that the statute is remedial.