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Corporations—Liability of Directors—Illegal Stock Issue.—Bay State York Co. v. Cobb

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not called for it, with the implication that henceforth in Illinois derivative actions would follow the rule of *Chicago Macaroni* rather than that of *Brown*.[27] Despite the official frown on pro rata recovery in Illinois, a recent decision indicates that that state might in the future be forced to look more tolerantly upon it as a solution in some instances. In *Duncan v. National Tea Co.*,[28] the court, on the one hand, stressed the traditional concept that the individual has no standing in a derivative action except as a representative of the corporation. It went on to note, however, that shareholders who had participated in the activities causing injury to the corporation should be precluded from sharing in any way in benefits accruing from corporate recovery. It is conceivable that pro rata individual recovery could be, at times, the only satisfactory solution to an originally derivative action, especially in small close corporations where perhaps only one or two shareholders are innocent of involvement in the wrongdoing.

As far as can be seen from the tangled skein of facts in the instant case, allowance of pro rata recovery, in the form of the compromise settlement, would adequately conclude this action. The only objection to the compromise comes from an intervenor who has a foot in both camps. He claims standing on the basis of his ownership of forty-five shares in his own name. In addition to this, however, he controlled a forty percent interest in a partnership owning ninety-two percent of the majority holdings. His now deceased partner was one of the delinquent directors, and, as the dissent, on rehearing, points out, his status as a surviving partner obliges him to discharge partnership liabilities, including this one.[29]

While the intervenor can validly claim the technical status of a minority holder representing the corporation, his long silence during the course of this decade of litigation, coupled with his allegation of the continuance of the partnership responsibilities in another recently decided case,[30] tips the equities against him. Since derivative actions are equity proceedings controlled by the court's discretion, denial of the intervenor's petition deprives him not of a right, but of an equitable forum which his ambiguous position does not appear to warrant. To permit an intervenor possessing such doubtful credentials to obstruct pro rata recovery in a situation which seems clearly to call for it appears to be a needlessly formalistic foreshortening of that "lengthening reach of equity" into complex business activities which the Illinois court once found so desirable.[31]

ROBERT J. MULDOON, JR.

Corporations—Liability of Directors—Illegal Stock Issue.—*Bay State York Co. v. Cobb*.[1]—This is an action brought by a creditor to establish the indebtedness of the defendant-directors of a Massachusetts corporation

27 The briefs in the instant case discuss *Brown* as if the *Voorhees* decision had no importance for the *Brown* rule.

28 14 Ill. App. 2d 280, 144 N.E.2d 771 (1957).

29 Shlensky v. South Parkway Building Corp., supra note 1, at 43.

30 Englestein v. Mackie, 35 Ill. App. 2d 276, 182 N.E.2d 351 (1962).

31 Brown v. DeYoung, supra note 23, at 558, 47 N.E. at 866.

1 —— Mass. ——, 195 N.E.2d 328 (1964).

pursuant to a statutory remedy which imposes joint and several liability for the debts of the corporation upon the directors if the par value stock of the corporation be issued at less than par.[2] The defendants introduced evidence that the total par value of the stock had been paid in, part in cash and the remainder in the form of an alcoholic beverage license. The case was referred to a master, who found that full value had not been paid for the shares issued, since an alcoholic beverage license could not have been found to constitute a partial cash payment; the stock was authorized by the articles of incorporation to be issued only for cash; and that the cash actually paid in did not equal the aggregate par value of the shares issued. On appeal to the Supreme Judicial Court it was HELD: Liability of defendants affirmed, as cash payments for stock did not equal the total par value of the stock issued.

In authorizing the stock to be issued only for cash, the corporation has, by its articles of incorporation, imposed restrictions more stringent than those required by the incorporating statute in Massachusetts.[3] This self-restriction is the only basis utilized by the court in affirming the liability of the directors. It is unnecessary to consider the license in this case since even if valuable, it is, under no possible construction, a cash item. Note that, even assuming no such exclusive restriction to cash payments, the argument that the license could represent a stock payment of any kind is, in Massachusetts, weak at best.[4]

It should be noted that there are various methods of avoiding liability available to the incorporating business under these circumstances. It will be sufficient for present purposes to note that combining the omission of any restriction authorizing the issue only for cash with a low par or no par value issue would have avoided liability in this case.[5] Either of these methods of stock issuance would be available to the corporation, and in light of the fact that this is a close corporation, both these methods would be particularly attractive since the small close corporation is not faced with the problem of marketing securities which must be attractive to the public.

Having affirmed that the corporation did not receive the total par value

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[2] Mass. Gen. Laws ch. 156, § 36 (1932) as amended St. 1941, ch. 514, § 1.

> The . . . directors of every corporation shall be jointly and severally liable for *all* the debts . . . of the corporation . . . if *any* stock is issued in violation of section fifteen . . . . (Emphasis supplied.)

Mass. Gen. Laws ch. 156, § 15 (1932).

> Capital stock may be issued for cash, at not less than par, if the shares have par value, and may be issued for property . . . or for services or expenses. . . .

[3] Ibid.

[4] Mass. Gen. Laws ch. 138, § 23 (1933) as amended St. 1955, ch. 652, states in part that:

> No holder of such a license . . . shall have any property right in any document or paper evidencing the granting of the license . . . .

See Jubinville v. Jubinville, 313 Mass. 103, 46 N.E.2d 533 (1943) holding that a liquor license once granted does not run with the business. It is a non-transferable personal privilege, revocable at pleasure and conveying no vested interest to the licensee.

[5] See generally Smith & Cavitch, Massachusetts Corporation Law With Federal Tax Analysis, Ch. 2 (1963); Isreals, Problems of Par and No-Par Shares: A Reappraisal, 47 Colum. L. Rev. 1279, 1292 (1947).

for the stock issued, the court leaves unresolved the hypothetical question, whether the failure of *one* subscriber to pay par value for his share would be fatal as to the joint and several liability of all directors, in a situation where the total amount paid in exceeded the par value of the total number of shares issued.

The area of interest presented by this decision lies not in the question which the court determined, but rather in the hypothetical situation posed and left open. In examining the problem area, it will be necessary to remain cognizant of the statutory basis on which the hypothetical action would be commenced.[6] Obviously, under this approach, the pivotal issue becomes whether the factual situation constitutes a violation of section fifteen.

Due to the lack of any local authority on the precise point, it is valuable to consider foreign statutory approaches and to note the one case which has ruled on the point in question.[7]

In all jurisdictions the statutory emphasis is the protection of creditors.[8] Many states prescribe a stated minimum capital before a corporation can commence business in the state,[9] and for breach of this requirement impose joint and several liability on the directors.[10] In addition, most states also provide that par value stock be issued at no less than par.[11] In these jurisdictions, however, liability is usually predicated on the basis of either a fraud perpetrated on creditors or on the basis of a holding out by the directors if the stock is issued at less than par value.[12] Valuation of the consideration received is normally a matter for the directors, the judiciary refusing to intervene in the absence of fraud.[13] Under this "minimal control" approach, creditor recovery is limited to the difference between the amount actually paid in, and the value of either the capital stock at par value or the statutory minimum capital. Director liability terminates when this deficiency is satisfied.[14] The rationale of this theory of recovery is that the total amount of stated capital was all that the creditor had relied on in extending credit

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6 Supra note 2.

7 Winston v. Saugerties Farms, Inc., 287 N.Y. 718, 39 N.E.2d 934 (1942).

8 For an historical treatment of the source and development of the legal safeguards for the protection of creditors, see Warren, Safeguarding the Creditors of Corporations, Massachusetts Business Corporation Statutes, 36 Harv. L. Rev. 509, 523 (1923).

9 Many states require that minimum amounts of capital be paid in as a prerequisite to doing business. E.g., Ark. Stat. §§ 64-101, 107 (1947); Conn. Gen. Stat. Rev. § 33-290 (1958); Ill. Rev. Stat. ch. 32, § 157.47 (1959); Okla. Stat. tit. 18, § 1.15 (1951).

10 E.g., Ark. Stat. § 64-607 (1947); Conn. Gen. Stat. Rev. § 33-295 (1958); Ill. Rev. Stat. ch. 32, § 157.42 (1959); Okla. Stat. tit. 18, § 1.83 (1951).

11 E.g., Fla. Stat. Ann. § 608.15 (1953). Exceptions to this general rule are, e.g., Cal. Corp. Code § 1110(a) (1947); Ind. Ann. Stat. § 25-205(c) (1960).

12 Provident Land Corp. v. Bartlett, 72 Cal. App.2d 672, 165 P.2d 469 (1946). See generally 2 Bonbright, The Valuation of Property 790 (1937); Dodd, Stock Watering (1930).

13 It is held in thirty eight jurisdictions, that in the absence of fraud, the director's valuation of the consideration received is conclusive. See 1 CCH Corp. Law Guide ¶ 622.

14 Supra note 10.

to the corporation.[15] This is essentially the position of the Model Business Corporation Act which states:

> If a corporation shall commence business before it has received at least one thousand dollars as consideration for the issuance of shares, the directors who assent thereto shall be jointly and severally liable to the corporation for such part of the one thousand dollars as shall not have been received before commencing business, but such liability shall be terminated when the corporation has actually received one thousand dollars as consideration for the issuance of shares.[16]

It should be noted that, under this view, which is held by the majority of the states, the emphasis is on the aggregate of par value rather than upon the individual's payment for each and every share.

Some jurisdictions, however, have no statutory provision requiring a certain minimum capital to be paid in prior to commencing business, so protection of the creditor must be provided by other methods. Since both New York and Massachusetts fall within this latter category, it is valuable to contrast the approaches taken by these two states when faced with the problem.

In New York, the current statute provides:

> Directors of a corporation who vote for or concur in any of the following actions shall be jointly and severally liable to the corporation for the benefit of its creditors . . .
>
> (1) The declaration of any dividend or other distribution to the extent that it is contrary to . . . section 510. [Section 510 deals with insolvency.]
>
> (2) The purchase of the shares of the corporation to the extent that it is contrary to . . . section 513. [Section 513 covers purchase and redemption by a corporation of its own shares.]
>
> (3) The distribution of assets to shareholders after dissolution of the corporation without paying or adequately providing for all known liabilities of the corporation . . . .
>
> (4) The making of any loans to directors contrary to section 714.[17]

This statute, like the Model Act,[18] is not regarded as being penal in nature, but merely requires directors to compensate creditors for damages sustained by reason of their wrongful acts.[19] The New York courts have required the showing of some evidence of bad faith or negligence on the part of the

[15] Supra note 12.

[16] ABA-ALI Model Bus. Corp. Act § 43(e) (1958).

[17] N.Y. Bus. Corp. Law § 719. See also, N.Y. Bus. Corp. Law § 504(a), (c), infra note 22. Though not specifically provided for by the statute, it seems reasonable to conclude that the court would interpret it to provide a remedy against the directors on a basis of fraud if the stock were issued at less than par value.

[18] Supra note 16.

[19] Waters v. Spalt, 22 Misc.2d 937, 80 N.Y.S.2d 681 (1948).

directors as a prerequisite to recovery[20] and in all cases limit the liability of directors to the loss suffered by reason of the capital impairment.[21] New York statutes also provide for the issuance of par value stock at no less than par, but state that in the absence of fraud, the valuation of the consideration received by the board of directors will be conclusive.[22] It is significant that in light of the emphasis on limiting recovery to that caused by the fraudulent or bad faith conduct of the directors, in essence, New York follows the majority approach.[23]

Paralleling New York, Massachusetts imposes joint and several liability on directors for declaring a dividend if the corporation is thereby rendered insolvent, to the extent of such dividend, or for making or assenting to a loan to a stockholder or director, to the extent of such loan.[24] As with the majority of states, the purpose of this type of provision is to protect corporate creditors.[25] Strikingly distinguishable, however, from the New York and majority views is Massachusetts' statutory provision[26] which embodies a strict liability approach. This statute has now been construed to grant relief without the showing of any evidence of bad faith or fraud,[27] without limiting the recovery to the unpaid amount of par value stock issued,[28] or without any showing of reliance by the creditor on the aggregate par value of the stock issued.[29] It would appear that any further construction of this section, as would be necessitated by a resolution of the hypothetical problem, would be influenced by this strict liability tendency which has prevailed in past constructions.

The Massachusetts Supreme Judicial Court, in posing the hypothetical

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20 Diamond v. Davis, 292 N.Y. 552, 54 N.E.2d 683 (1944).

21 Friedman v. Video Television, Inc., 281 App. Div. 815, 118 N.Y.S.2d 844 (1953).

22 N.Y. Bus. Corp. Law § 504(c).

> Shares with par value may be issued for such consideration, not less than the par value thereof, as is fixed from time to time by the board.

N.Y. Bus. Corp. Law § 504(a) states in part:

> In the absence of fraud in the transaction, the judgment of the board . . . as to the value of the consideration received for shares shall be conclusive.

23 For a discussion of the organization of a close corporation under the New York Business Corporation Law see Kessler, A Close Corporation Checklist for Drafting the Certificate of Incorporation under the New York Business Corporation Law, 31 Fordham L. Rev. 323 (1962-63).

24 Mass. Gen. Laws ch. 156, § 37 (1932).

> The directors of every corporation shall be jointly and severally liable for the debts . . . of the corporation in the following cases:
>
> First. For declaring or assenting to a dividend if the corporation is, or thereby is rendered, bankrupt or insolvent, to the extent of such dividend. Second. For debts contracted between the time of making or assenting to a loan to a stockholder or director and the time of its repayment, to the extent of such loan.

25 National Refractories Co. v. Bay State Builders Supply Co., 334 Mass. 541, 137 N.E.2d 221 (1956).

26 Mass. Gen. Laws ch. 156, § 36 (1932) as amended, St. 1941, ch. 514, § 1.

27 Bay State York Co. v. Cobb, supra note 1.

28 Ibid. Note that Massachusetts has no provision making the valuation of consideration received by the directors conclusive in the absence of fraud. Compare this situation with notes 13 and 22, supra.

29 Enterprise Wall Paper Mfg. Co. v. Gordon, 312 Mass. 1, 42 N.E.2d 809 (1942).

issue, noted the decision of the New York court in *Winston v. Saugerties Farms, Inc.*,[30] holding that a statute prohibiting a corporation from issuing stock except for "value," does not strictly require payment from the person to whom the stock is issued, but merely requires that the corporation receive full value for all stock issued. However, in the light of the history of uncompromising interpretation of the Massachusetts statute,[31] whether the cited decision will be decisive of the question is far from a certainty. This doubt is further buttressed by decisions in Massachusetts which have construed jointly[32] section fifteen[33] with section seventeen,[34] which provides that "no corporation shall issue *a share* for a less amount to be paid in thereon than the par value of the shares at the date of issue." (Emphasis supplied.)

It would appear that adoption by the court of the "New York" view would have much to recommend it, since a contrary view amounts more to a windfall than to a legitimate protection of the creditor. Since protection of corporate creditors and not the punishment of directors is the end to be sought,[35] the manifest injustice to the directors under a strict interpretation of the statute in the hypothetical situation, should be enough to convince the court of the impropriety of a further extension of this theory.[36]

PETER J. NORTON

Creditors' Rights—Federal Income Tax Lien—Cash Surrender Value of Life Insurance Policy—Equitable Doctrine of Marshaling Inapplicable.—***Meyer v. United States.***[1]—The petitioner's husband was the owner of four life insurance policies, of which she was the revocable beneficiary, having a total face value of $50,000. In 1943, the husband pledged the policies to a bank as collateral security for a loan. The bank was given the right to satisfy its claim from the net proceeds of the policies, *i.e.*, the amount which would be paid by the insurers upon the husband's death. Subsequently, the Commissioner of Internal Revenue assessed deficiencies against the hus-

[30] Supra note 7.

[31] Supra note 2.

[32] Boucher v. Hamilton Mfg. Co., 259 Mass. 259, 156 N.E. 424 (1927); Mitchell v. Mitchell Woodbury Co., 263 Mass. 160, 160 N.E. 539 (1928).

[33] Supra note 2.

[34] Mass. Gen. Laws ch. 155, § 17 (1932).

[35] Frank Kumin Co. v. Marean, 283 Mass. 332, 186 N.E. 780 (1933).

[36] Analogously, even under the provisions of the Uniform Fraudulent Conveyance Act, Mass. Gen. Law ch. 109A, §§ 1-13 (1932), which allow a creditor to set aside a fraudulent conveyance which is detrimental to his rights, recovery is limited to that property, the conveyance of which tended to result in a fraud on the creditor. If recovery is limited to such a "cause-effect" relation under a statute dealing with a person guilty of "fraudulent" conduct, a fortiori, should not such a limit be imposed in the hypothetical situation? This is not to construe the Uniform Fraudulent Conveyance Act and the applicable sections of Mass. Gen. Law ch. 156 *in pari materia*, but merely to compare the theories of recovery in so far as the underlying policy of both is the protection of creditors. See also, N.Y. Bus. Corp. Law § 720.

[1] 375 U.S. 233 (1963).