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# The Liability of Stockholders of a Corporation to Corporate Creditors

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T H E S I S

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THE LIABILITY OF STOCKHOLDERS  
OF A CORPORATION TO CORPORATE CREDITORS

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1891.



The subject of this thesis includes so much that it is impossible to treat, in a thorough manner many of its important branches. A superficial examination of the general law and a special reference to the statutory provisions is all that can be attempted. Any further inquiry would take us beyond the limits of this article.

In order that we may know what we are discussing it may be well to formulate some definition of a Corporation. An examination of the text-books and cases shows that the judges have been very generous in the way of definitions. One of the most famous is the one given by Chief Justice Marshall in the Dartmouth College Case. A Corporation as thus defined, is "An artificial being, invisible, intangible and existing only in contemplation

of law." This definition is too broad for our purpose as this investigation is limited to the ordinary business corporations. It has been tersely entitled by various authorities as a legal entity, a creature of the law, a legal institution and a fictitious or political person. Justice Field says in 108 W. S. 328 that, "Private corporations are but associations of individuals united for some common purpose and permitted by the law to use a common name, and to change its members without a dissolution of the association." While we can not accurately define a corporation we can give its principal characteristics and in some degree limit and distinguish its application. They are (1) the limited liability of stock-holders, (2) the capacity of perpetual succession, (3) the power to hold real and personal estate, (4) the

power to make by-laws, (5) the right to use a common seal, (6) the power to sue and be sued and to grant and receive in its corporate name.

Of all the questions arising in the domain of corporation law none are of more importance than those relating to the liabilities of stockholders and particularly when the rights of corporate creditors are concerned. This question may be divided into two divisions.

I. The common law liability. The term common law liability in this sense does not refer to the ancient common law, as the class of corporations we are discussing did not then exist, but to those principles of law which have been so often enunciated and generally accepted that they are regarded as good law in the several states whether a particular statute exists or not. Under this head are also treated those liabilities which flow from the very fact of incorporation.

II. The Statutory Liability. Under this head reference is made to the statutes of the several states which impose a greater liability than that existing at common law. ¶ It may be well at this point to discuss in what manner this liability is incurred. Generally there can be no question about it. The stock is subscribed, the company organized, the articles of incorporation filed, the corporation begins business and the stockholder becomes liable at once. But oftentimes some irregularity occurs in incorporating which changes the liability of the stockholder. The failure to comply with the statute should be on some material point. The company may still be a corporation de facto, still able and willing to carry out the original intention of the incorporators but the neglect in complying ~~exactly~~ with provision of the statute deprives the stockholder of the protection he otherwise was entitled to. It

must be a corporation de jure in order to give a shareholder the benefit of his limited liability. When this is the case a corporate creditor may proceed against the stockholders as partners on proof of the company's violation of the incorporating law. They are bound by the consequences of their own acts. It is immaterial that they styled themselves a corporation if they were not in fact one.

#### I. The Common Law Liability.

The capital stock of a corporation is regarded in the eyes of the world as the total amount of stock subscribed whether paid in or not. The unpaid shares are considered by those dealing with the corporation as part of the fund out of which creditors are to be paid. It would be entirely contrary to all accepted ideas of law and justice to allow a stockholder to escape from the



liquidation of his unpaid subscription to the detriment of corporate creditors. Any attempt to evade this liability is regarded as fraud and is generally checked by the courts. The justice of this is obvious. Oftentimes this is the only resource as the paid up capital has been sunk in the business and the creditor will be without any relief if this right is not recognized.

The limited liability of the shareholder cuts off every other remedy than that offered by the capital stock.

The general American doctrine is laid down by Justice Miller in *Sawyer v. Hoag*, 17 Wall, 610, as follows,

"We think it now well established that the capital stock of a corporation, especially its unpaid subscriptions, is a trust fund for the benefit of the general creditors of the corporation. And when we consider the rapid development of corporations as instrumentalities of the commercial and business world in the last few years,

with the corresponding necessity of adapting legal principles to the new and varying exigencies of this business, it is no solid objection to such a principle that it is modern, for the occasion for it could not sooner have arisen." Stockholders are continually endeavoring to escape from this responsibility but their efforts come to naught where there are any grounds which justify the interference of the courts. "In one case it is said that it is not within the ingenuity of man to devise a scheme to prevent courts of equity from enforcing the payment of unpaid subscriptions to capital stock for the benefit of corporate creditors." Upton v. Hansbrough 3 Biss. 417. This is rather strong doctrine perhaps but it shows the tendency of the courts and their willingness to grant relief. So strongly is this proposition established in this country that many states have incorporated it in their statute books. There seems to

be no real need for these statutes, except where this is declared to be the only liability, since no court would hold anything else in the present state of the law.

They are merely declaratory of the common law. It may be regarded however as an evidence of the wide extent and fixed character of the doctrine that the capital stock of a corporation is a trust fund for the benefit of corporate creditors. A constitutional provision to this effect may be found in the constitution of Alabama, Missouri (?), Nebraska, Oregon, Washington, West Virginia and Arizona. A similar law exists in Colorado, Delaware, Georgia, Kentucky, Louisiana, Maine, Maryland, Michigan, Minnesota, Mississippi, Montana, Ohio, North Dakota, South Dakota and Texas. This is the sole liability in the following states, Alabama, Missouri, Oregon, Arizona, Louisiana, Mississippi, North Dakota and Texas.

Any attempt of a stockholder who is also a creditor to take advantage of his superior knowledge of the affairs of the corporation and receive the payment of his own claims first will not be allowed. He must first pay in any amount which he may owe for his stock and then share equally with other creditors. If a stockholder who was also a creditor owed the company on his subscription an amount equal to his claim he might be paid in full while the other creditors only received a small percentage of their claims.

The directors of a corporation or the stockholders themselves cannot release an individual stockholder from the obligation to pay his subscription if the rights of a creditor will thereby be in any way prejudiced.

Any arrangement of the officers to issue certificates of capital stock as paid up, when in fact only a part of the subscription has been paid is a gross fraud and

will be set aside. This may be allowed however by a unanimous vote of the stockholders if the rights of creditors are not thereby injured.

This rule is modified in the case of an innocent purchaser of stock which is issued as paid up when it is not really so. The question here arises on whom shall the loss fall as between the purchaser and a creditor. Certainly not on the purchaser for he has a right to rely on the representations of the officers of the corporations. The certificate of the officers, solemnized by the corporate seal, that the stock has been fully paid up is surely evidence enough. The loss must then fall on the creditor.

When a business man contracts with a corporation he takes into consideration the amount of capital stock which the charter calls for at that time. His rights will not be changed by any subsequent increase or de-

crease of the stock by an amendment to the charter.

If the stock is decreased while he has a claim against the corporation, his right to relief will not be lessened thereby, since the constitutional provision against impairing the obligations of a contract would be violated. On the other hand an increase in the amount of stock will not add to his security.

A condition in the subscription that the subscriber may be excused from the payment of part of his debt to the corporation on the happening or not happening of some contingency is void as far as creditors are concerned.

Mere technical grounds are never sufficient to excuse a shareholder from his obligation. As where the subscription was paid by a note instead of in cash, it was held in *Little v. Owen* 9 Mass. 423, that, "It is however a sufficient answer to the objection that it

does not lie in the mouth of a stockholder for this cause to avoid his contract, which as between him and the company was made on a sufficient consideration."

In *Gaff v. Flesher* 33 Ohio State 107 the fact that the corporation had been ousted from its franchises was held to be no defense in a suit by a creditor to collect a debt of the corporation from a stockholder. The Court said, "It seems to us therefore, that this must be held to have been a corporation de facto, up to the time of ouster, previous to which the liability arose, satisfaction of which is not sought. Of course the judgment of ouster did not retroact, so as to affect or destroy a contract prior to its rendition."

Parties often pay for their stock in property of some sort presumably such as will be of use to the corporation in its particular business. The valuation of such property gives rise to much discussion. If the

valuation is a fair and just one and the property does not subsequently depreciate in value to a suspicious extent no questions can be raised. Nor if the property was equal in value to the stock at the time it was issued will the stockholder be liable if the property afterwards became worthless in the ordinary and legitimate fluctuations of values. But if there is a gross inequality between the value of the property and the par value of the stock and known to both corporation and stockholder, the stockholder will be liable to corporate creditors for the difference. This applies either to the original stockholder or to a transferee with notice.

If a corporation in its legitimate business should lose its entire capital stock by accident, honest mismanagement, or failure of those in business relations with it to meet their obligations, there is no remedy for the creditor from the stockholder. The limit of



his liability is reached when he pays up his subscription and what ever assessments may be made either by authority of the charter or legislature.

The question of what a shareholder's liability attaches to is one upon which widely divergent views have been expressed. Some courts hold that only those are liable who were members of the corporation at the time the suit for the collection of the debt was brought. This seems to be the more general rule and the one best supported by reason and justice. If this were not the rule it would be next to impossible many times to enforce the right in those companies which have a rapidly changing membership as many of the original stockholders might have transferred their stock and moved into another jurisdiction or have been lost sight of altogether. This principle is upheld by the courts of Massachusetts, Connecticut, Maine and Missouri. The contrary doctrine,

that those are liable who were members of the company at the time the debt was contracted has received some support. The argument of those holding this view is not without weight. A person dealing with a corporation takes into consideration the financial standing of the persons who are stockholders at that time, especially if any individual liability exists. The shares may be afterwards transferred while still not entirely paid up to persons who at the particular time may be unable to respond to the call of the creditors. A person purchasing stock after the company has been in business for some time may come in to the concern totally unaware of the amount of corporate debts. He had no voice in the management of the business when the debt was contracted but once inside he has some means of influencing the directors.

The dissolution of a corporation in no way impairs

the rights of creditors or decreases the liabilities of a stockholder. No law of the legislature or act of the corporation can impair the obligation of the delinquent shareholder to pay his just debt. Where it is necessary, a court of equity will intervene to secure the rightful dues of the creditor. At common law, however, an entirely different doctrine prevailed. Then dissolution served to extinguish all debts whether due to it or from it. This principle was overthrown by Chancellor Kent in these emphatic words : "To permit the odious and obsolete doctrine of ancient date, before moneyed institutions were introduced, to be applied on the dissolution of a bank, perhaps by its own management and abuse, so that all its assets were to be considered as dispersed to the winds, without any power anywhere to collect and justly apply, would be a disgrace to any civilized state. But this cannot be supposed to have

taken place ; the improved and enlightened administration of equity jurisprudence in every part of our country has taught and established sounder and juster doctrines."

Merritt v. Bank of Port Gibson, 3 Smed. & M. 520.

A brief discussion of the ways in which a stockholder may be divested of this liability will not be inappropriate. The most common way in which this is done is by transfer of the stock. There are no restrictions upon the equitable use of this privilege. The transferee takes the stock subject to liabilities then existing and succeeds to all the rights of the transferor. He takes his position. He must, however, follow all the requirements of the statute in regard to the transfer such as registry. Any attempt to defraud the company by transferring the stock to an irresponsible person will be void as regards creditors. The prevailing doctrine on this subject is well stated by Wagner J. in

McClaren v. Franciscus, 43 Md. 467, "The law is well settled, the point is very clear that no member can exonerate himself from liability or defeat the claims of creditors by transferring his interest to an insolvent person or bankrupt. The members of a corporation, therefore, who would be liable, if they continued members, to the creditors of the corporation may still be treated as members, if they have disposed of their interest to an insolvent, or with the view of exonerating themselves from their personal liability."

Bankruptcy may also serve to relieve a stockholder from responsibility. This is the case when the company is wound up previous to his bankruptcy. Then he is relieved from all liability by his certificate of discharge. But the opposite rule prevails when the bankruptcy and discharge precede the winding up of the company's affairs. In this case the debt due the corpora-

tion on the stock is treated the same as any other debt of the bankrupt and the company shares alike with the other creditors of the bankrupt.

The death of a stockholder will of course operate as a transfer of ownership. This, however, does not divest the representatives of the deceased stockholder of liability upon the stock. They are liable for his share of the losses the same as for any of his debts.

The contract which was formed by the signing of the subscription is some times broken by the directors after sufficient stock has been subscribed to carry out their object. They then change the avowed purpose of the organization and proceed to carry out their real intentions. If this works any substantial injury to the interests of any stockholder he may avoid his contract providing always he has not assented to the change.

A familiar example is the case of a Rail Road Company

locating the road in an entirely different route than that prescribed in the contract of subscription. This has been held to avoid the subscription. R. R. Co. v. Marsh 17 Wis. 13.

If a stockholder refuses to pay the assessments due on his stock, the corporation may declare his stock forfeited to the company. This is not often resorted to, however, since so many other parties are apt to be damaged thereby. If the company does not declare the shares forfeited they still have a right of action for the amount yet due on the subscription. If any creditor's rights intervene this will not be allowed. Any circumstances tending to show collusion between the stockholder and directors will tend to invalidate the forfeiture. But if the affairs of the concern are in a prosperous condition, the stock paying large dividends, and selling readily when placed on the market, no com-

plications will arise as the stock can soon be resold and the assets will be increased by the amount forfeited. Justice Hunt in Upton v. Tribilcock 91 U. S. 47, gives a forcible presentation of this doctrine. "The capital stock of a moneyed corporation is a fund for the payment of its debts. It is a trust fund for which the directors are trustees. It is a trust fund to be managed for the benefit of its shareholders during its life and for the benefit of its creditors in the event of its dissolution. This duty is a sacred one and cannot be disregarded. Its violation will not be undertaken by any just minded man and will not be permitted by the courts. Equally unsound is the opinion that the obligation of a subscriber to pay his subscription may be released or surrendered to him by the trustees of the company. This has often been attempted but never successfully. The capital paid in and promised to be paid, is a fund



which the trustees cannot squander or give away.

They are bound to call in what is unpaid and carefully to husband it when received." It is a well settled doctrine that a stockholder cannot be released from his liability if creditors are in any way injured. But a stockholder may be released by the unanimous consent of the shareholders and they are afterward precluded from attempting to enforce his subscription. *Garrett v. Dillsburg* 78 Pa. St. 465.

#### The Statutory Liability.

In addition to the liability which exists by the general law of corporations for unpaid subscriptions, the people of many of the states have seen fit either by legislature enactment or constitutional provisions to place an additional obligation upon the stockholder. These responsibilities whether constitutional or legis-

lative are known by the general name of statutory liabilities and include all additional burdens beyond the liabilities for unpaid subscription. These regulations are for the sole benefit of a corporate creditor and the remedies they provide can only be invoked by him. They can never be used by the corporation to keep its capital unimpaired.

Any attempt to lessen or increase this liability otherwise than by statute will not be allowed. An individual responsibility cannot be imposed by a by-law, nor can a stockholder be exempted from this liability by the articles of association.

At common law it is clear that no other liability existed than that for unpaid subscriptions. Any other obligation must of necessity arise from some statute. This fact taken in connection with the wide departure which these statutes make in creating an individual lia-

bility have led the courts to construe them very strictly.

A creditor can obtain the relief provided by these laws only after the ordinary proceedings against the proceedings have failed. Hence it is a common provision that the party seeking relief must first obtain judgment against the corporation and execution have been issued on the same and returned unsatisfied in whole or part before he can proceed under these laws. In some states, however, no precedent judgment is necessary. The reason for this provision is easily seen. It is to retain as much as possible the limited liability of the stockholder. The courts must be sure that the corporation is insolvent and unable to pay its debts before they will allow an action to be commenced.

The liability is several and based upon the amount of shares which the individual holds. The interests

of the stockholders are unequal and consequently a joint judgment cannot be taken. Bank v. Ibbotson 24 Wendell 473, Pettibone v. McGraw 6 Mich. 441.

No legislation shall operate to increase retrospectively the liabilities of the stockholders of a corporation. Their obligations are entirely dependent upon previous statutes. This principle does not apply, however, when the legislature has reserved the power to alter the charter. This is the case in New York under the general Banking Act, under which the legislature may impose a personal liability for corporate debts upon stockholders in banks already existing.

The nature of this personal liability of stockholders has given rise to much discussion. Two positions have been taken on the subject ; one that they are liable as partners and the other as guarantors. A principle feature of the law of suretyship is that the sure-

ty confers a favor and incurs a liability but receives nothing in return. This can hardly be said to be the fact in the case of stockholders. Many of the leading points in the law of partnership are so entirely different from status of a member of a corporation that it is difficult to see how they can be said to resemble each other. The easy transfer of membership, the power to make by-laws, the secondary liability of stockholders, when any exists, are entirely foreign to an ordinary business partnership. "Corporators are not partners, even though rendered liable by statute for certain debts of the corporation." Baker v. Backus, 32 Ill. 79.

The nature of this liability depends of course entirely upon the different statutes. In some it resembles that of a partner and in others that of a guarantor but nowhere is the likeness so marked that the law of either partnership or suretyship are exclusively applicable.

A satisfactory classification of these statutes is not easily made. The one given below will perhaps serve our purpose as well as any.

Those relating,

To Laborers,

" Banks,

" Railroads,

" Miscellaneous subjects.

1. Laborers.

The evident intention of the legislatures in framing this law was to protect that class of men who from their education and position in life are not qualified to care for their own interests. The ordinary day laborer is not generally informed as to the financial condition of the corporation for whom he works and especially needs the protection of the law. They are men who receive but a small pittance for their services

and may be said to be in a certain way in the power of the corporation. They would never think of asking security for their services, and it would be refused if they asked for it. *Ericsson v. Brown.* 38 Barb. 390.

Michigan is the only state which has a constitutional provision upon the subject. There are statutes on this question in nine states, viz ; Indiana, Massachusetts, New York, North Carolina, Pennsylvania, North Dakota, South Dakota, Tennessee and Wisconsin. A very common condition in these statutes is that the suit by the laborer must be brought within a given time varying from four months in the two Dakotas, to one year in New York, or the right to recover is lost. In six of the states there is no restriction upon this liability. In Wisconsin and Pennsylvania the individual liability of each stockholder is limited to the "amount of stock held by each of them." Considerable litigation has arisen over

the interpretation of the words laborer and servant.

The term servant is held to have a wider meaning than laborer and is construed by the courts to include some besides those performing actual manual labor.

The courts generally construe the word laborers to mean those who are performing some menial labor, who labor with their hands in preference to their heads. Professional men are never included. *R. R. v. Leuffer*, 84 Penn. St. 168. One who performs some manual labor as a mere incident to a more important position which he holds is not thereby constituted a laborer within the statute. *Kramer v. Ruckel* 17 Hun. 463. Laborers are those whose services rest on their physical rather than on their intellectual or scientific ability. The ordinary meaning of the word is the one that should be taken. A few illustrative cases will perhaps show in the best way how these words are construed. *Danforth J.* in



Wakefield v. Fargo. 90 N. Y. 213, gives a very clear and decisive meaning to these words, in deciding that a book-keeper and general manager is not included within the statute. "It is plain we think, that the services referred to are manual or menial services, that he who performed them must be of a class whose members usually look to the reward of a days labor or services for immediate or present support, from whom the company does not expect credit, and to whom its future ability to pay is of no consequence ; one who is responsible for no independent action, but who does a days work, or a stated job under the direction of a superior." Of great value also is Selden Ch. J. opinion in Aikin v. Wasson 24 N. Y. 482, where a contractor is held not to be a servant. "It is obvious from the nature and terms of this and other provisions of the act, as well as from a general policy, indicated by analagous statutes, that the

legislature intended to throw a special protection around that class of persons who should actually perform the manual labor of the company . To accomplish this design it is not necessary that the words "laborers and servants" should receive their broadest interpretation."

Another good case upon this subject may be found in *Boutwell v. Townsend* 37 Barbour 205 where Hogeboom J. uses the following language. "The obvious intent and policy of this and similar acts is to make provision for those who are the workmen and operatives on the road and who are usually persons of small pecuniary means, not able to lose their daily earnings and not to compel them to rely solely either upon the pecuniary responsibility of contractors, or the corporation itself."

## II. Banks.

The nature of these corporations shows the reason for the existence of these statutes. Many peo-

ple of limited means place all they possess in the hands of a Bank, and it is only just that more than the ordinary limited responsibility should be cast upon the recipients of the trust. The liability of each stockholder is an amount equal to the amount of his stock in addition to the purchase price of the shares.

Illinois, Indiana, Iowa, Maryland, Minnesota, Nebraska, New York, Ohio, South Carolina, South Dakota, Kansas and Washington have constitutional provision to this effect.

There are statutes on the subject in nine states ;

Colorado, Florida, Michigan, Montana, Rhode Island, Pennsylvania, West Virginia, Utah and Maine. In Montana, however, the total liability of any person or firm to a bank shall not exceed fifteen per cent of the paid up capital and surplus.

There are some additions to, and variations from the ordinary double liability, which it may be well to

note. In Illinois, Nebraska and Washington the liability must accrue while they are stockholders or they cannot be held for the value of the stock a second time. This liability continues six months after transfer in Iowa and Montana, and for one year in South Dakota, Colorado and Minnesota. The stockholders can be held by the corporate creditors for any loss caused by the mismanagement of directors in Maine and Massachusetts. In Vermont there is no statutory liability unless the articles of association so provide. In South Carolina an additional assessment of five per cent on par value of stock is added to the double liability. The general liability exists in the case of National Banks.

The provision creating the second liability is often loosely expressed. The courts, however, have generally looked to the intent of the legislature in construing its inaccurate work. Where the law has

stated the liability to be "The amount of his stock" the courts have held that it should be construed to mean "A sum equal to the amount of his stock. In Re Empire City Bank 18 N. Y. 199. If the law were construed exactly as it stood on the statute book it would be a foolish and unnecessary law as it added nothing to the liability already existing. The fluctuations of the market is not regarded in estimating the amount due under this statute, but the par value of the stock is taken as a guide.

### III. Railroads.

There seem to be no general laws which are peculiarly applicable to the responsibility of stockholders in Railroad Corporations. Only a few of any sort exist. In Minnesota any irregularity in the incorporation of a Railroad Company will make the stockholders responsible to the corporate creditors. In South Carolina five

per cent on the par value of a persons stock is the only additional burden. In New York and North Carolina, stockholders in Railroad Corporations are liable for thirty days services of ordinary laborers.

#### IV. Miscellaneous Subjects.

There are some miscellaneous statutes which it is impossible to classify in any satisfactory way, and they will be given without any attempt at classification.

In Nebraska and Minnesota any irregularity in the incorporation, makes the stockholders liable as partners. The Constitution of California contains the following peculiar provision. "Stockholders in all corporations are liable for such proportion of all its debts and liabilities contracted or incurred during the time he was a stockholder, as the amount of stock or shares owned by him bears to the whole of the subscribed capital

stock or shares of the corporation or association."

Under the laws of Colorado a stockholder may be garnisheed for unpaid subscriptions. In New Hampshire, New Jersey, Rhode Island and Vermont there are provisions of more or less severity concerning the liability of stockholders when the entire capital stock is not paid in, and a certificate to that effect filed in the proper office. In South Carolina this liability other than in Banks and Railroads is an amount besides the value of his shares therein, not exceeding five per cent of the par value of such share held at the time the demand of the creditor was created. In Wisconsin forfeiture and sale of stock, the delinquent stockholder is liable for any deficiency. The ordinary double liability of banking corporation has been extended to all corporation in Florida, Indiana, Ohio, Kansas, excepting railroads, and Minnesota, excepting those for

mechanical and manufacturing purposes.



