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VALUATION OF PROPERTY, LABOR OR SERVICES TAKEN IN PAYMENT FOR STOCK

At law the relation of creditors to the corporation is the ordinary relation of debtor and creditor and in the absence of statute there is no relation between the creditors and stockholders. The corporation is a legal entity, distinct and separate from the stockholders who compose it, and consequently when a person extends credit to a corporation he looks to the corporation and not to the stockholders for payment. In equity, however, we find a different rule and in many cases judgment creditors are allowed to maintain bills against the stockholders of a private corporation.

The jurisdiction of equity to enforce the liability of stockholders to the extent of the par value of their stock, has given rise to the so-called "trust fund" theory. Justice Story attempted to explain the jurisdiction of equity in this regard in the case of *Wood vs. Dummer,* 3 Mason 308, Fed. Case No. 17944.

This case established the doctrine that the capital stock of a corporation is "a pledge or trust fund for the payment of the debts created" by the corporation. This doctrine is founded on the proposition, that as the state undertakes to relieve the stockholder in a corporation of general liability for the debts of the concern, to the amount that he has invested in the enterprise, he ought, in good faith, to pay in money or its equivalent, the face value of the stock so received. If he fails to do this, he should be treated as holding the remainder in trust for the benefit of the creditors of the corporation. The "trust fund" theory has been reaffirmed in the following cases:

> *Sawyer vs. Hoag,* 17 Wall. 610.
> *Upton vs. Tribilock,* 91 U. S. 45.
> *Sanger vs. Upton,* 96 U. S. 56.
> *Pullman vs. Upton,* 96 U. S. 328.
> *Graham vs. Railroad Co.,* 102 U. S. 148, 161.
> *Handley vs. Stutz,* 139 U. S. 417.

It is unfortunate that this theory crept into the law. It has caused considerable confusion and was not necessary for the decision in the case of *Wood vs. Dummer, supra.* The stockholders could have been held liable on the ground of fraud. Technically speaking, no trust either express or implied is created.

"A trust implies two estates or interests, one legal and one equitable, the trustee holding the legal title, while the cestui que trust has the beneficial interest. The capital of a corporation is its property and the corporation has the whole beneficial interest in it as well as the legal title. The corporation may sell or dispose of its property the same as any natural person. It is a trustee for its creditors in the same sense and of the same extent as a natural person, but no further."

Hospes vs. Northwestern Mfg. and Car. Co., 48 Minn. 174.

If we follow this theory to its logical conclusion, any creditor of a corporation could maintain a bill to recover the assets constituting portions of the capital stock which have been divided among the stockholders or have been otherwise diverted. The United States Supreme Court has, however, refused to carry this doctrine to such an extent and in the case of *Hollins vs. Brierfield Coal & Iron Co.,* 150 U. S. 371, refused to entertain a bill brought to recover dividends paid out of capital of the corporation. The "trust fund" doctrine was later criticized and limited to cases where the corporation is insolvent, and in the case of *McDonald vs. Williams,* 174 U. S. 397, the court said: "We think the theory of a trust fund has no application to a case of this kind, i. e., where a stockholder in good faith received a dividend, believing the same to be paid out of the profits, the bank at the time such dividend was declared and paid being insolvent. When a corporation is solvent, the theory that its capital is a trust fund, upon which there is any lien for the payment of its debts, has in fact very little foundation. No general creditor has any lien upon the fund under such circumstances, and the right of the corporation to deal with its property is absolute so long as it does not violate its charter or the law applicable to such corporation."

Thus we see that the later authorities have been reluctant to follow the "trust fund" theory and in many jurisdictions the doctrine has been repudiated entirely.

The remaining cases can be conveniently divided into two groups: (1) those which have established the "good faith" rule, and (2) those which have adopted the "true value" rule. These rules are most commonly applied in cases where stockholders have paid for their stock either in property, labor or services. Some states have constitutional or statutory provisions expressly requiring that the property, labor or services shall be taken at a fair value. Therefore if a corporation fraudulently issues its stock for property, labor or services at an overvaluation, the transaction is illegal and void as to dissenting stockholders, or creditors who relied upon the fact that the entire capital stock of the corporation was paid in full.

The courts which have adopted the "good faith" rule are not in harmony as to what must be shown to constitute good faith. Some courts hold that mere overvaluation of the property given in exchange for stock will not of itself render the stockholder liable for the difference. These courts require an affirmative showing of fraud, and in the case of *Smith vs. Prior et al,* 58 Minn. 247; 59 N. W. 1016, they refused to allow evidence to show that the corporation accepted in payment of the stock property which was greatly overvalued and grossly inadequate in value to the par value of the shares of stock issued. The court held that inasmuch as there was no allegation of fraud in the complaint, this evidence was inadmissible under the pleadings.

Reynolds, J., speaking for the court in *Schneke et al vs. Andrews,* 57 N. Y. 147, says: "If promoters of a corporation * * * with a view to defraud, fill up the capital stock by putting in property at grossly exorbitant values, they are not to be exempted from personal liability * * *. But if in the furtherance of an honest purpose they fall into error in judgment in placing a pecuniary value upon property supposed to be needful for the success of the enterprise, I think a different rule should prevail. I think it need only be suggested in support of this position, that upon the question of the value of property, and more especially that adapted to mining, mechanical and manufacturing purposes, a very wide difference of opinion may honestly exist among the most intelligent of men familiar with such operations. There is no exact mathematical value which can be applied to mines or minerals in the bowels of the earth or to mechanical contrivances or manufacturing establishments, when their development is sought for by associated wealth. It is a matter of commonest observation, that the most intelligent and conscientious of men, upon such questions entertain widely different opinions; and it would be a fatal blow aimed at every such enterprise, if those who honestly risk their capital in such adventures shall be held as guarantors to all creditors for its eventual success."

In the case of *Coit vs. North Carolina Gold Amalgamating Co.*, 119 U. S. 343, it was held that a gross and obvious overvaluation of property would be strong, although not conclusive, evidence of fraud. In other jurisdictions the courts require a showing of intentional fraud or such reckless conduct in fixing the value of the property conveyed, without regard to its value that an intent to defraud may be inferred.

Graves vs. Brooks, 117 Mich. 424; 75. N. W. 932.
Kelley vs. Fletcher, 94 Tenn. 1; 28 S. W. 1099.
Rickerson Roller Mills Co. vs. Farrel Foundry & Machine Co., 43 U. S. App. 452; 23 C. C. A. 302; 75 Fed. 554.
New Haven Horse Nail Co. vs. Lenden Springs Co., 142 Mass. 349; 7 N. E. 773.

The other class of cases which have adopted the "good faith" rule hold that overvaluation itself, especially if it is gross, constitutes, or at least raises, a very strong presumption of fraud. This presumption is conclusive unless it is rebutted by strong and convincing evidence which fully explains the apparent bad faith. All that need be proved is (1) that the stock exceeded in amount the value of the property in exchange for which it was issued and, (2) that the stock was issued deliberately and with knowledge of the real value of the property; no further fraudulent intent need be alleged or proved.

Douglas vs. Ireland, 73 N. Y. 104.
Boynton vs. Andrews, 63 N. Y. 96.
Elyton Land Co. vs. Birmingham Warehouse & Elevator Co., 92 Ala. 407; 25 Am. St. Rep. 65.
Wallace vs. Carpenter Electric Heating & Mfg. Co., 70 Minn. 321; 68 Am. St. Rep. 530.
Coleman vs. Howe, 154 Ill. 458; 45 Am. St. Rep. 133.
National Tube Works Co. vs. Gilfillan, 124 N. Y. 302.
Van Cleve vs. Berkey, 143 Mo. 109.
Wetherbee vs. Baker, 35 N. J. Eq. 501.
Manhattan Trust Co. vs. Seattle Coal & Iron Co., 16 Wash. 449.

It is not sufficient for the stockholder to show that as a mental operation, he did not intend to defraud anyone. He is required to show further, that in the exercise of ordinary business sense and prudence, he was justified in believing and did believe that the property was being turned in at a fair valuation. Where the facts are undisputed and the overvaluation so great as to show that the stockholder ought to have known if he had exercised ordinary business prudence and foresight, his actual belief or intention will be of no avail to him; the presumption is that he intended the reasonable and natural consequences of his act, which was to defraud creditors in the event of the insolvency of the corporation. The underlying doctrine of these cases is that where property is taken into a corporation in excess of its value, the creditors of the corporation and the public in general are deprived of the security contemplated by the statute and if a stockholder sells his property to the corporation, receiving in exchange stock the par value of which greatly exceeds the value of the property, he knows or ought to know that his act amounts to a fraud upon the public and the creditors of the corporation. The courts, however, make allowances for honest differences of opinion or mere mistakes in judgment.

> *Hastings Malting Co. vs. Iron Range Brewing Co.,* 65 Minn. 28.

THE "TRUE VALUE" RULE.

The "true value" rule in substance provides that, where stock is issued in exchange for property, it will be considered paid up to the extent of the true or actual value of the property so taken into the corporation. The stockholder is held personally liable for any deficiency which may exist. In the jurisdictions which have adopted the true value rule it is unnecessary to allege or prove any fraudulent intent on the part of the stockholder. The mere fact that the property has been overvalued is of itself sufficient to render the stockholder liable, regardless of his intention. The overvaluation may have been made in the utmost good faith and without any evil intention toward subsequent creditors, but the fact nevertheless remains that these corporators held out to the world that the corporation had a fully paid up capital, when in fact this was not true. They may honestly believe that the corporation will prosper and soon be running on a sound business basis, but they are not allowed to cast a part of this risk upon the others.

> *Gates vs. Tippecanoe Stone Co. et al,* 57 Ohio St. 60; 48 N. E. 285.

In the case of *Libby vs. Tobey,* 82 Me. 397; 19 Atl. 904, the court held that the payment of stock in anything but money will not be regarded as a payment except to the extent of the true value of the property or thing received in lieu of money.

"An honest mistake in judgment will not necessarily destroy the value agreed upon, but it must be such a valuation as prudent and sensible business men would approve. Values based upon visionary or speculative hopes, unwarranted by existing conditions or facts, and without reasonable evidence from present appearances are not such as the law will tolerate, as against creditors."

State Trust Co. vs. Turner, 111 Ia. 664; 82 N. W. 1029.

In Wisconsin the liability of a subscriber for shares of stock is governed by Sections 1753, 1757 and 1758, R. S., 1917, which are practically a reiteration of the common law as enunciated by the courts which have adopted the "true value" rule.

Section 1753 provides that no corporation shall issue any stock except in consideration of money, property or labor estimated at its true money value, actually received by it, equal to the par value thereof, nor any bonds or other evidence of indebtedness except for money, labor or property estimated at its true money value actually received by it, equal to seventy-five per cent of the par value thereof. All stocks and bonds issued contrary to the provisions of this section shall be void.

If bonds are issued in defiance of the statute, the fact that they are pledged, not sold, cannot avail to give them validity. The term "issue" is here used in the sense of "deliver" or "put forth." Such bonds are of no binding force for any purpose, and equity will prevent their passing into the hands of persons who might be bona fide purchasers for value.

National Foundry & P. Works vs. Oconto Water Co., 52 Fed. 29.

Inventions for which patents have been applied for and the prospective patents are "property" within the meaning of this section. *Whitchill vs. Jacobs,* 75 Wis. 474, but the issuance of the corporate bonds for antecedent debts is not issuance for "money, labor or property" within the meaning of this section. *Nichols vs. Waukesha Canning Co.,* 195 Fed. 807.

A person holding stock issued to him as collateral security for a debt of the corporation is not liable to it for the same as if he had subscribed for it; nor is he liable to the creditors of the corporation unless he allowed himself to be represented as a stockholder to them, and they (the creditors) acted in reliance thereon. *Andrews vs. National Foundry & Pipe Works,* 77 Fed. 774.

The statutes, however, do not prohibit the selling of shares of stock upon credit. *Whitewater Mfg. Co. vs. Baker*, 142 Wis. 420.

The purchaser of corporate stock for less than par value, and the corporation making the sale are both parties to an illegal transaction, and the former will not be aided in a court of equity in an action against the corporation to obtain a rescission of the transaction or a recovery of the consideration paid. *Thronson vs. Universal Mfg. Co.*, 164 Wis. 44.

This section, however, was not impaired or repealed by the Negotiable Instruments Act, and the provision that corporate bonds which are issued for price or value less than seventy-five per cent of their face value, shall be void, will be enforced between the corporation issuing and the party directly receiving such bonds. *In re Valecia Condensed Milk Co.*, 233 Fed. 173.

Section 1757 provides that the books of a corporation shall at all reasonable times be open to the inspection of stockholders; and that every creditor of a corporation shall be informed at any time of the amount of capital stock of such corporation subscribed, the amount paid in, the names of the stockholders, the amount of shares owned by each and the amount unpaid by each of the stockholders, upon the shares owned by him, and if any of the shares of stock, which were not fully paid for, have been transferred, the same and the amount due thereon at the date of such transfer. This duty is imposed upon the officers of the corporation, and if they refuse to do so, they are liable for any damage which may result because of such refusal.

The corporation and its officers may be compelled to permit such inspection of the corporate books by a writ of mandamus. *State vs. Bergenthal*, 72 Wis. 314.

Where the books and main offices of a foreign corporation are in this state, a resident stockholder, acting in good faith, is entitled to a writ of mandamus to compel said officers to permit him to examine the corporate records and ascertain who the stockholders are and what they paid for their stock. *State ex rel Quinn vs. Thompson's Malted Food Co. et al*, 160 Wis. 671. This decision shows that Section 1757 applies not only to domestic corporations, but also to foreign corporations doing business in this state.

Section 1758 provides that in actions by creditors against the stockholders to recover what may be due and unpaid on any stock, such stockholders shall only be credited with such sums as have actually been paid in money or its equivalent in value and not with any dividend which may have been declared and applied on such stock.

The case of *Gogebic Investment Co. vs. The Iron Chief Mining Co.,* 78 Wis. 427, was an action by a judgment creditor of the defendant corporation to compel certain stockholders to pay up their stock to the extent of its full and fair value. The defendants received stock in exchange for property, which was in fact only worth about one-tenth of the par value of such stock. The plaintiffs' judgment had been returned unsatisfied, the corporation being insolvent and unable to pay its debts. The question on a demurrer to the complaint was whether the complaint was sufficient because of the failure to allege that the stock was issued fraudulently. The court held that the allegation of fraud was unnecessary and that the complaint stated a good cause of action against the defendant stockholders. The presumption is that a transaction of this kind is a fraud upon the creditors, and the parties by whom the stock was issued will be held liable to such creditors, to a further payment upon their stock to the par value thereof, if it be necessary to make such further payment to satisfy the corporate debts. The holder of such stock is considered a debtor of the corporation to the extent of the difference between the par value of the stock and the true value of the property given in exchange of such stock. This is a liability imposed upon the stockholder by law, and the corporation can in no way relieve him of this liability.

In conclusion it may be said that the creditor must work out his cause of action through the corporation. It is a legal fiction and the creditor possesses rights which the corporation did not have. The creditor is not precluded from his suit by the statutes of limitation, nor by other omissions of the corporation to proceed against the stockholder; all that need be shown is that his execution against the corporation was returned unsatisfied and the corporation has become insolvent. His cause of action is then complete.

EDGAR BARK, '19.