THE POWER OF MISSOURI TELEPHONE CORPORATIONS TO INCREASE THEIR CAPITAL STOCK AND TO SELL SUCH INCREASE AT LESS THAN THE PAR VALUE,

There is no objection to increasing the capital stock of a going telephone corporation in need of funds and selling such stock in an honest transaction for its market value. Such a sale is not a fictitious issue of increased stock within the meaning of Section 8, Article XII of the Missouri Constitution and Section 9740 of the 1919 Revised Statutes of Missouri. The sale of such increased stock is for money paid within the meaning of the constitution, and while *original* stock under the decisions of Missouri and the great weight of authority must be *fully paid at par value,* in money, labor done, or property actually received, it has been equally established that *increased stock* can be issued by a going solvent concern in need of additional capital for money paid, labor done, or property actually received at the *market value* or in the absence of a market value, at the actual value of such stock although the market or actual value may be less than par. Where an increase of capital stock has been made, and sold under such circumstances, the so-called but severely criticized "trust fund doctrine" does not apply, and no liability is created in favor of creditors for the difference between the market or selling price of the stock and the par value. The law as stated in this brief does not apply to manufacturing and business corporations, as Sec. 10144, Mo. Rev. Statutes, 1919, expressly provides they shall issue no stock except as is actually paid for at its par value in cash or in property of a cash value equal to the par value of the stock.

CONSTITUTIONAL AND STATUTORY PROVISIONS.

§8 of Art. XII of the Constitution provides:

"No corporation shall issue stock or bonds, except for money paid, labor done or property actually received, and all fictitious increase of stock or indebtedness shall be void."

Section 9740 Missouri Revised Statutes 1919 provides:

"The stock or bonds of a corporation shall be issued only for money paid, labor done or money or property actually received. * * * All fictitious issues or increases of stock shall be void."

II.

A CAPITAL STOCK INCREASE SOLD AT LESS THAN PAR IS NOT A FICTITIOUS INCREASE WITHIN THE MEANING OF THE CONSTITUTION WHEN MADE IN GOOD FAITH.

In the case of Stein v. Howard, (1884, Sup. Ct. of Cal.) 4 Pac. 663, the Constitution of California contained a provision which is the exact duplicate of the provision in the Missouri Constitution. The question arose as to whether an increase in stock sold at less than the par value was a fictitious issue within the meaning of the constitution. The Supreme Court said:

"The circumstances under which the stock is proposed to be issued and sold, as above stated, are: that the corporation has actual need of money for the purposes of its business; that the stock is proposed to be sold at the actual market value of the stock of the corporation; and to be sold only in such quantities as may produce the requisite funds. * * * Each share is offered at a price equal to the price of any one of the old shares. So far from the new shares being fictitious as to the old shares, it may be that burdens which would otherwise rest on the old shares, to-wit, the payment of the corporation debts, will be entirely removed by the application of the funds realized or shared in pro rata by the new shares. We cannot say but that this removal of such burdens, or the sharing therein, will be of the value of the discount in the price at which the new shares are proposed to be sold, or increase the actual value of the old shares to their par value. *It may very properly be said that the use of the word 'fictitious' in the constitution, as above quoted, was as in contrast with the*

preceding sentence; as if to say that stock issued for money paid, labor done, or property actually received (price not named) is not fictitious. We do not think the issue or sale of the stock in question is within the prohibition of the constitution."

In the case of Lee et al v. Cameron, (Sup. Ct. of Okla., November 27, 1917), 169 Pac. 20, the Court said:

"We find constitutional provisions in Pennsylvania, Illinois, California, Nebraska, Kentucky, Alabama, Arkansas, *Missouri,* Texas, Louisiana, Colorado, South Dakota, and some other states, and statutory provisions in Ohio, New York, Wisconsin, Maine, Utah, Indiana, Minnesota, New Jersay, Tennessee, Washington, Oregon, Massachusetts, and Iowa. The provisions are not always the same, and there is an important difference in the provision in our Constitution. In most of the above-named states, the constitutional or statutory provision is substantially as follows:

"No corporation shall issue stock or bonds, except for labor done, or money or property actually received, and *all fictitious increase of stock shall be void."*

* * * * * *

"Where the provision itself does not require payment for the stock at its par value, as is required by our Constitution, a transaction wherein stock is disposed of by the *corporation for less than par value is not prohibited, but in such cases the transaction must be a real and honest one, made in good faith and not merely an attempt to evade the law.* Stein v. Howard, 65 Cal. 616, 4 Pac. 662; Mathis v. Pridham, 1 Tex. Civ. App. 58, 20 S. W. 1015; Brown v. Duluth, etc., Ry Co. (C.C.) 53 Fed. 889; Continental Trust Co. v. Toledo, etc., Ry. Co. (C.C.) 82 Fed. 642; Memphis, etc., Ry Co. v. Dow, 120 U. S. 287, 7 Sup. Ct. 482, 30 L. Ed. 595. But where the stock is issued without consideration in either money paid, labor done, or property actually received, or where the transaction is plainly a mere attempt to evade the law, the issue of stock is

void. New Castle, etc., Ry Co. v. Simpson (C.C.) 21 Fed. 533."

In the case Memphis and Little Rock Railroad Co. v. Dow, 30 L. Ed. 595, l. c. 600, it was contended that an issue of $2,600,000, in bonds was a fictitious issue of indebtedness, where $1,300,000 in stock, and $2,600,000 in convertible bonds was given for property said to be worth $1,300,000. The provision in the Arkansas Constitution was identical with the provision now in force in the Missouri Constitution. The United States Supreme Court said:

"The prohibition against the issuing of stock or bonds, except for money or property actually received or labor done, and against the fictitious increase of stock or indebtedness, *was pretended to protect stockholders against spoliation, and to guard the public against securities that were absolutely worthless.*"

* * * * *

"In reference to a provision in the Constitution of Illinois, adopted in 1870, containing a prohibition, as to railroad corporations, similar to that imposed by the Arkansas Constitution upon all private corporations, the Supreme Court of the former State, in Peoria & S. R. R. Co. v. Thompson, 103 Ill. 201, said:

* * * * *

" 'The object was, doubtless, to prevent reckless and unscrupulous speculators, under the guise or pretense of building a railroad or of accomplishing some other legitimate corporate purpose, from *fraudulently issuing* and putting upon the market bonds or stocks that do not and are not intended to represent money or property of any kind, either in possession or expectancy, the stock or bonds in such case being entirely fictitious.' * * * * *

"Recurring to the language employed in the Arkansas Constitution, we are of opinion that it does not necessarily indicate a purpose to make the validity of every issue of stock

or bonds by a private corporation depend upon the inquiry whether the money, property or labor actually received therefor was of equal value in the market with the stock or bonds so issued. It is not clear from the words used that the framers of that instrument intended to restrict private corporations —at least when acting with the approval of their stockholders —in the exchange of their stock or bonds for money, property or labor, *upon such terms as they deem proper; provided, always, the transaction is a real one based upon a present consideration,* and having reference to legitimate corporate purposes, and is not a mere device to evade the law and accomplish that which is forbidden. *We cannot suppose that the scheme whereby the appellant acquired the property, rights and privileges in question, for a given amount of its stock and bonds, falls within the prohibition of the State Constitution.*"

In the case Toledo St. L. & K. C. R. R. Co. v. Continental Trust Co., 95 Fed. 497, l. c. 517 & 518, it was alleged that a payment of bonds to a contractor was a fictitious issue of indebtedness on the ground that the consideration was less than the par value of bonds. The Court said:

"A provision in the constitution of Arkansas (article 12, §8) provided that 'no private corporation shall issue stock or bonds, except for money or property actually received, or labor done; and all fictitious increase of stock or indebtedness shall be void.' The court held that this provision 'did not necessarily indicate a purpose to make the validity of every issue of stock or bonds by a private corporation depend upon the inquiry whether the money, property, or labor actually received therefor was of equal value in the market with the stock or bonds so issued.'"

* * * * *

"*The Ohio statute did not forbid the sale or exchange of stock at its market value.* Neither does it any more forbid the exchange of its bonds for a railroad, or their use in exchange for construction work, than did the Arkansas consti-

tution. The most that can be said is that, if used in exchange for a railroad, or in payment for property or construction work, the railroad, or the property, or labor or materials, shall be the equivalent of the money price for which the bonds might be lawfully sold."

In the case Speer et al v. Bordeleau, Court of Appeals, Colorado (1905) 79 Pac. 332, l. c. 335 it was maintained that an issue of increased capital stock, sold at market value was fictitious. The Court said:

"It frequently happens that corporations, as well as individuals, find it necessary to increase their capital in order to raise money to prosecute their business successfully, and one of the most frequent methods resorted to is that of issuing new shares of stock, and putting them on the market for the best price that can be obtained; *and, so long as the transaction is bona fide, and not a mere cover for watering the stock, and the consideration obtained represents the actual value of such stock, the courts have shown no disposition to disturb it.'* Handley v. Stutz, 139 U. S. 417, 430, 435, 11 Sup. Ct. 530, 535, 37 L. Ed. 227; Dummer v. Smedley, 110 Mich. 466, 68 N. W. 260, 38 L. R. A. 490; Stein v. Howard, 65 Cal. 616, 4 Pac. 662; Kellerman v. Maier, 116 Cal. 416, 48 Pac. 377."

In the case Granite Brick Co. v. Titus, Circuit Court of Appeals (1915) 226 Fed. 557, l. c. 569 and 570, the same question arose under the constitution of South Carolina, which contained the identical provision drafted in the Missouri Constitution. The Court after calling attention and quoting from Memphis v. Dow supra and Handley v. Stutz supra, said:

"If, under the provisions of the Constitution, bonds may be hypothecated, or issued, as collateral for notes, in excess of the amount of the notes, it is not easy to see why unissued stock, within the power of the corporation to issue, may not be used in the same way. The reason, or policy, which moved the makers of the Constitution and statutes, apply with equal

force to both. If therefore the Constitution did not invalidate the stock issued as collateral because a larger amount at par was issued than the amount of the debt, *it is manifest that the real value of the stock did not exceed the amount for which it was issued, and was not so regarded by the stockholders.*"

* * * * *

"Without pursuing this branch of the case further, or citing the numerous decisions of courts more or less in point, we are of the opinion that, in issuing the stock to Titus, as collateral security, for the amount advanced by him on it, there was *no violation of the provisions of the Constitution; it was issued 'for money paid,' and was therefore not fictitious and not void.*"

In the case Grant et al v. East & West R. R. Co. of Alabama (1893) 54 Fed. 569, an increase of stock and bonds was involved, and it was asserted that they were transferred for property, the value of which was for less than the par value of the bonds and stock. The identical provisions is found in Alabama Constitution, and with reference to whether the increase of capital stock and indebtedness was fictitious the Court said:

"This well-settled doctrine of the general law relating to subscriptions to the stock of corporations as announced by the United States Supreme Court in the cases above cited has been embodied in the constitutions and codes of many of the states; and issues of stocks and bonds, under constitutional and statutory provisions substantially similar to those of Alabama, *have been sustained when they have been disposed of by a corporation after its organization for the best price that could be obtained, though for less than their face value.*"

In the case, Mathis v. Pridham, Court of Civil Appeals of Texas (1892) 20 S. W. 1015, l. c. 1021 & 1022, the Court said:

"The point made by exceptions to the petition that the stock alleged to have been issued to defendants in excess of the price to be paid was void under article 12, §6, of the constitution, which provides: 'No corporation shall issue stock or

bonds except for money paid, labor done, or property actually received, and all fictitious increases of stock or indebtedness shall be void,'—and that, therefore, no liability on their part could grow out of it. The first clause of this provision prohibits the issuance of stock unless it has been paid for; the second renders void 'all fictitious increases of stock or indebtedness.' *The petition does not allege any fictitious increase of stock, but that the original stock was sold at less than par to the defendants, in violation of the rights of creditors.* Stock issued and disposed of for a valid consideration is not fictitious, within the provision quoted. The language is not that all stock sold for less than its face value shall be void, *but that 'all fictitious increase of stock shall be void.'* In the case of Stein v. Howard, 65 Cal. 617, 4 Pac. Rep. 662, an increase and sale by a corporation of its stock below par was held not to be fictitious under a constitution having the same provision. Railway Co. v. Thompson, 103 Ill. 187, is another case which construes a constitutional provision very similar to our own "

In the case, Handley v. Stutz, 139 U. S. 417, 35 L. Ed. 227, l. c. 235, the United States Supreme Court, in a case appealed from the Circuit Court of the United States, Middle District of Tennessee, involving a Kentucky corporation, said:

"It frequently happens that corporations, as well as individuals, find it necessary to increase their capital in order to raise money to prosecute their business successfully, and one of the most frequent methods resorted to is that of *issuing new shares of stock* and putting them upon the market for the best price that can be obtained; *and so long as the transaction is bona fide, and not a mere cover for 'watering' the stock, and the consideration obtained represents the actual value of such stock, the courts have shown no disposition to disturb it.*"

In the case, Fogg v. Blair, (1891) 139 U. S. 118, 35. L. Ed 104, l. c. 107, a railroad corporation organized under the laws of Missouri issued to a contractor $480,000 in bonds and $425,-

000 in stock as a bonus for the building of a certain part of its road. It seemed that $480,000 in bonds would have been a fair price for the work. Suit was brought to recover the difference between the subscription price and the par value of the stock. The possibility of increased stock, being a fictitious issue and void, was not directly involved, but such a possibility could not be remotely entertained from the following language taken from the decision:

"While it was competent for the St. Louis, Hannibal and Keokuk Railroad Company, exercising good faith, to use its bonds and stock in payment for the construction of its road, *it could not rightfully, at least as against creditors or stock. holders, issue its stock to Blair and Taylor as full paid, without getting some fair or reasonable equivalent for it. What was such an equivalent depends primarily upon the actual value of the stock at the time it was contracted to be issued, and upon the compensation which, under all the circumstances, the contractors were equitably entitled to receive for the particular work undertaken or done by them.*"

No case can be found holding an increase of capital stock or indebtedness sold at less than par value or face value, void, under the provision of the Missouri Constitution or the constitution of any of the other states, containing a similar provision, where it was a bona fide transaction free from fraud, and the money paid, labor done or property received was equivalent to the actual value of the stock regardless of whether such actual value was ten per centum, twenty per centum or any other per centum of its par value.

III.

THE OBLIGATION THAT STOCK MUST BE FULLY PAID AT PAR VALUE APPLIES TO ORIGINALLY SUBSCRIBED STOCK AND NOT TO INCREASED STOCK

That all issues of stock resolve themselves into two classes bearing distinct and separate liabilities has been recognized

by a large number of courts, and text book writers on the subject. The so called "trust fund doctrine" applies to the originally suscribed stock. Public policy demanded that stock holders be made liable for the par value of the original stock, not only to protect creditors, but the stockholders themselves. That stockholders of an insolvent corporation are liable to creditors for the difference between the subscription price and the par value of original stock is firmly established, but it is equally established that increased stock issued subsequent to the commencement of business, by a going concern, to pay debts and prevent financial embarrassment, or to pay for extentions demanded to the corporate property at the market value or at such price as the corporation is able to obtain. creates no liability against the purchaser in favor of creditors and such stock is treated as fully paid.

In the case Thomas & Brenneman v. Goodman, (1918) Cir. Ct. of Appeals (Ohio) 254 Fed. 39, l. c. 42 and 43, the court points out the difference betwen original stock and increased stock, stating the ground upon which the distinction is based in the following language:

"All classes of stock issue resolve themselves into two classes: *First,* those which are incidental to the organization of the corporation on the launching of its business. All persons who take this stock are the original and voluntary associates. As to this class, it may well be, as has often been held, that the form adopted for their association is not controlling and that they may be treated as subscribers solely through the effect of their acceptance of stock, issued as if on a subscription—provided that the acceptance of stock in good faith exchange for property at an agreed valuation or as incidental to a bond purchase does not by the local law bar further liability. The *second class* comprises those incidental to the raising of *additional capital* for a going concern. In many of these cases, the issue of stock is characteristically a compulsory sale of a corporate interest rather than a mere subscription or voluntary joinder in a new enterprise; and while the

underlying principles in the two classes applicable to the issue—subscription or sale?—do not furnish entirely satisfactory distinctions, the practical difference is often convincing and controlling. *The undoubted fact, known to all, is that the capital stock of a corporation which needs additional working capital is often, if not typically, impaired in value, and that when the capital stock is thus impaired in value it is wholly impossible to sell new stock at par, and the corporation, as a matter of practical necessity, must sell it for what it is worth, or else not sell it at all.* The Supreme Court seems to have considered that such possible theoretical injury as might come to creditors through permitting sales of stock at less than par and without liability for the balance, in those cases where the stock could not be sold for par, was a lesser evil than compelling every corporation to wind up its business or reorganize, if it had sustained some losses and needed more invested capital. The decision in Handley v. Stutz rests essentially upon the classification above stated between *original associates and those who buy at its real value treasury stock in a going concern.*"

In the case, Speer v. Bordeleau, Colorado (1905) 79 Pac. 332 l. c. 335, the Court quotes the following paragraph from Cook on Corporations, with approval:

"Where stock is issued for cash at less than par, the parties taking it are liable to corporate creditors for the unpaid par value thereof, *unless the issue was subsequent to the commencement of business, and the real value of the stock was paid into* the corporation in order to enable it to go on with its business instead of becoming insolvent."

In the case, Clark v. Bever, 139 U. S. 96, 35 L. Ed. 88, l. c. 95, the Supreme Court said:

"To say that a public corporation, charged with public duties, may not relieve itself from embarrassment by paying its debt in stock at its real value— there being no statute

forbidding such a transaction—*without subjecting the creditor, surrendering his debt, to the liability attaching to stockholders who have agreed, expressly or impliedly, to pay the face value of stock subscribed by them, is, in effect, to compel them either to suspend operations the moment they become unable to pay their current debts, or to borrow money secured by mortgage upon the corporate property. We do not think the Statute of Iowa can be properly construed to cause such a result in respect to corporations organized under its laws.*"

In the case, Handley v. Stutz, 139 U. S. 417, 35 L. Ed. 227, l. c. 235 and 237, the Supreme Court said:

"To say that a corporation may not, under the circumstances above indicated, put its stock upon the market and sell it to the highest bidder, *is practically to declare that a corporation can never increase its capital by a sale of shares, if the original stock has fallen below par.*" * * * "*The liability* of a subscriber for the par value of increased stock taken by him may depend somewhat upon the circumstances under which, and the purposes for which, such increase was made. If it be merely for the purpose of adding to the original capital stock of the corporation, and enabling it to do a larger and more profitable business, such subscriber would stand practically upon the same basis as a subscriber to the original capital. *But we think that an active corporation may, for the purpose of paying its debts, and obtaining money for the successful prosecution of its business, issue its stock and dispose of it for the best price that can be obtained.*"

In the case, Grant v. East & West R. R. Co. (1893) 54 Fed. 569, l. c. 575 the railroad company had increased its capital stock from $50,000 to $1,000,000 and issued $375,000 in stock, and $375,000 in bonds to the Cherokee R. R. Co. in payment for its property. It was contended that the stock at par value fully paid for the property and there was no consideration for the bond issue. The provision in the Alabama Constitution is identical with tthe provision of the Missouri Constitution. The Court said:

"It has long been the settled doctrine in the United States courts that the capital stock of an insolvent corporation is a trust fund for the payment of its debts; that the law implies a promise by *the original subscribers* of stock who do not pay for it in money or other property to pay for the same when called upon by creditors; and that a contract between themselves and the corporation that the stock shall be treated as fully paid and nonassessable, or otherwise limiting their liability therefor, is void as against creditors. * * * This well-settled doctrine of the general law relating to subscriptions to the stock of corporations as announced by the United States Supreme Court in the cases above cited has been embodied in the constitutions and codes of many of the states; and issues of stocks and bonds, under constitutional and statutory provisions substantially similar to those of Alabama, have been sustained when they have been disposed of by a corporation *after its organization* for the best price that could be obtained, though for less than their face value."

In the case, Ingraham v. Commercial Lead Company, (1910) 177 Fed. 341, l. c. 344, a Missouri corporation increased its capital stock from $60,000 to $100,000. It needed money but could not find purchasers for the increased stock. They borrowed the money from their original stockholders and as an inducement gave them fifty per cent of the loan in stock, as a bonus:

"This contemporaneous utterance of the Supreme Court in a case involving the laws now under consideration, compels us to hold that the doctrine of Handley v. Stutz was intended, in the absence of statutes affirmatively compelling different conclusions, to be of general application, and that it controls us in the disposition of the present case. Our conclusion is that the corporation received the fair and reasonable value in money for the *increased stock* issued to some of the defendants as bonuses for their loans, and that the learned thail court committed no error in deciding in their favor."

The distinction between organization stock and increased stock was clearly brought out in the case, Morrow v. Nashville Iron & Steel Co. et al, Sup. Court of Tenn.(1889) 10 S. W. 495, l. c. 500 in which the Court said:

"The necessities of the business of an organized company *might demand an increase of capital stock,* and, if such stock is lawfully issued, it may very well be offered upon special terms. In such case, if the market price was less than par, it is clear that a purchaser or subscriber for such stock at its market value would, in the absence of fraud, be liable only for his contract price. So a case might arise where the stock of a going concern was much depreciated, and where its bonds were likewise below par, and there was lawful authority to issue additional stock and bonds. Now, in such case, the real market value of an equal amount of stock and bonds might not exceed, or even equal, the par value of either. In such cases, all questions of fraud aside, a purchaser would only be held for his contract price. The case we have been considering is that of the issue of the *initiatory or organization stock,—that class of stock which is to constitute the capital stock upon which the grant of the franchise depends.*"

Further than indicating the difference in liability of holders of organization stock and increased stock to creditors which is now a very widely recognized distinction, this case should not be taken as controlling in Missouri, since the United States Supreme Court in Fogg v. Blair supra, refused to enforce the liability of holders of organization stock to creditors. where the creditors failed to show that the stock was received *without consideration,* or *fraudulently* to the prejudice of creditors. It would seem under the ruling in this case that it would not even be necessary to make the well known distinction between *organization stock* and *increased stock,* but the Missouri courts have held steadfastly to the "trust fund doctrine" as applied to *original stock,* the older cases going so far as to hold there is a liability even where the actual value,

or a fair honest consideration was given less than par, for the original stock.

The leading case in Missouri is Van Cleve v. Berkley, (1898) 143 Mo. 109, which reaffirmed the American *"trust fund doctrine."* These cases, Fogg v. Blair, Handly v. Stutz and Clark v. Bever, were discussed but not considered to have the effect of qualifying or overruling the law as established by the decisions in Missouri. The following quotation is taken from page 122:

"and in the latter case of Camden v. Stuart, 144 U. S. 104, it was held that 'the trust arising in favor of creditors by subscriptions to the stock of a corporation can not be defeated by a simulated payment of such subscription, *nor by any device short of an actual payment in good faith;' and it was not intend in Clark v. Bever, Fogg v. Blair or Handley v.* Stutz *to overrule 'or qualify this* wholesome principle adopted by this court in the earlier cases, * * * *but only to draw a line beyond which the court was unwilling to go in affixing a liability upon those who had purchased stock of the corporation, or had taken it in good faith, in satisfaction of their demands,'* and in the case of Handley v. Stutz, Justice Brown, speaking for the court, was careful to re-assert the doctrine that the trust arising in favor of creditors by subscriptions to the stock of a corporation can not be defeated by a simulated payment of such subscription, nor by any device short of *an actual payment in good faith;"*

Using the court's own language to the effect that the decisions of the United States Supreme Court do not *qualify* or *overrule* the law as established in Missouri; then the law must be, considering all of the cases, that there is a distinction between *organization stock* and *increased stock,* and a difference between the liability of the respective holders. The latter proposition, however, will be more fully discussed.

There are numerous other authorities holding that the obligation that stock must be fully paid applies to originally subscribed stock and not to increased stock.

In Re; Remington Automobile & Motor Co. (1905) 139 Fed. 766; Hospes v. Northwestern Manufacturing & Car Co. Minnesota Supreme Court 1892. 15 L. R. A. 470; Dummer v. Smedley 110 Mich. 466, 38 L. R. A. 390; Seaboard National Bank v. Slater 117 Fed. 1002; McDowell v. Lindsay 213 Pa. 63 Atl. 130; Mathis v. Pridham Cicil Court of Appeals Texas (1892) 20 S. W. 1015; Toledo, St. L. & K. C. R. R. Co. v. Continental Trust Co. (1899) 95 Fed. 497; Granite Brick Co. v. Titus (1915) 226 Fed. 557; Kellerman v. Maier (1897) Sup. Ct. of California, 48 Pac. 377; Atlanta Trust Co. v. Wood Bridge Canal & Irr. Co. Cir. Ct. Northern Dist. Cal. (1897) 79 Fed. 842; Lee v. Cameron Sup. Ct. Oklahoma (1917) 169 Pac. 17 Enright v. Hecksher (Ct. of Appeals, Second Cir. 1917) 240 Fed. 863; Stein v. Howard (1884) Sup. Ct. California, 4 Pac. 662.

IV.

WHERE MARKET OR ACTUAL VALUE IS PAID FOR INCREASED STOCK IN A BONA FIDE TRANSACTION THE STOCKHOLDERS ARE NOT LIABLE TO CREDITORS FOR THE DIFFERENCE BETWEEN THE AMOUNT SO PAID AND THE PAR VALUE

The "trust fund doctrine" that has had such a wide application throughout the United States has never been applied to stock other than organization stock. Unfortunately the expression was used by Chief Justice Story in an early case, before he took a place on the Supreme Bench. The phrase that unpaid stock subscriptions were a trust fund for the benefit of creditors became very widely used because it was catchy and impressive, although it never had any sound basis in law. No one can strictly conceive of a relation of trustee and *cestui que trust* between a stockholder and creditor of a corporation. The stockholder has none of the duties of a trustee and the creditor has none of the rights of beneficial ownership ordinarily belonging to a *cestui que trust.* The phrase "trust fund" has been much criticized in some of the later decisions by the State courts, and the doctrine very much

qualified in the later decisions of the United States Supreme and Federal Courts. They have been unwilling to apply the doctrine in many cases where the stock in question was part of the organization issue, on the ground that if it was sold for market or actual value, and the corporation was in need of funds, no injury was done to the creditor. This was the decision in *Fogg v. Blair,* 35 L. Ed. 104 (1891) involving a Missouri corporation and Missouri laws. The decisions of the State courts are not so liberal but whatever conflict may be found between the decisions of the Supreme Court of Missouri and the United States Supreme Court on the liability of stockholders to creditors, involved original stock, *and had no application to the liability of stockholders to creditors for increased stock.*

As neither the statutes nor the constitution of Missouri contain a provision exempting stockholders from liability or making them liable for increased stock the question is to be determined by the principles of law developed by decisions of the State and Federal courts.

Section 9764 of the Revised Statutes of Missouri has no application to the matter here discussed. The Section has been construed by the decisions in Missouri to apply only to amounts unpaid for subscribed stock, growing out of a contract between the stockholder and the corporation. Under this Section, if the stockholder owes nothing to the corporation upon the subscription for stock, no action would lie for recovery by creditor. The Section was primarily intended to give the creditor a direct action in a suit of law against the stockholder. Under the common law, a creditor could only proceed against a stockholder to recover the unpaid portion upon his subscription for stock, by the proceeding in equity.

Section 9764 provides:

"If any execution shall have been issued against any corporation, and there cannot be found any property or effects whereon to levy the same, then such execution may be issued against any of the stockholders *to the extent of the amount*

of the unpaid balance of such stock by him or her owned: Provided, always, that no execution shall issue against any stockholder except upon an order of the court in which the action, suit or other proceedings shall have been brought or instituted, made upon motion in open court, after sufficient notice, in writing, to the person sought to be charged; and, upon such motion, such court may order execution to issue accordingly; and provided further, that no stockholder shall be individually liable in any amount over and above the amount of stock owned."

In the case, Steam Stone Cutter Co. v. Scott, 157 Mo. 520, a suit was brought against organization stockholders for unpaid portions upon their stock subscriptions and the effect of Section 9764 quoted above was construed, l. c. 525:

"Section 9766 is in *pari materia* with section 9764 and both are designed merely to afford remedies, not to render stockholders liable where they were not before liable. Section 9364 provides that after an ineffectual execution against a corporation, the court which rendered the judgment may, on motion and due proceeding thereunder, issue execution against the stockholder to the extent of his unpaid stock holdings, and section 9766 affords a remedy by suit against the stockholder on the same account when the corporation is dissolved leaving debts unpaid. The stockholder as such is liable to the extent of his unpaid subscription independent of the provisions of those sections, but the remedies there given to the crditor are much more speedy and efficacious than before existed. *The statute does not attempt to make the stockholder liable beyond the amount he owes the corporation for the stock.* Perry v. Turner, 55 Mo. 418; Van Cleve v. Berkley 143 Mo. 109."

In the case, Rogers v. Yoder, Springfield Court of Appeals (1917) 198 Mo. App. 27, a suit was brought by creditors to recover unpaid portion of a stock subscription and the Court said:

"The basis for recovery in this character of case is on the implied contract of the stockholders in a corporation to pay for their stock; it is the contract of subscription which constitutes the foundation of an action to recover a call on stockholders to make their subscription good. * * * It is held that the obligation of each shareholder is several and each must respond to his contract of subscription to calls without reference to others."

In the case, Rogers v. Mining Co., 185 Mo. App. 659 l. c. 663, the effect of Section 9764 was construed in a prior case and the Court said:

"*We may grant that such obligations are contractual and grow out of the stockholders' voluntary subscription of stock.* Yet, the laws of the State authorizing the corporation to be formed and to exist enter into and become a part of that contract and the liability imposed must be determined by the laws of such State."

The effect of these decisions is to limit the statutory remedy to a recovery by creditors from stockholders to the contractual obligations between the corporation and the stockholders, and further, where organization stock was issued as fully paid for a valuable consideration less than par and no contract remained between the stockholder and the corporation, upon which the corporation could collect, the stockholder, if held liable at all to a creditor, is to be held liable upon the so called "trust fund doctrine."

It is therefore, under the "trust fund doctrine" to be determined whether a purchaser of the increased stock of a going, active, solvent corporation is to be held liable to a creditor for the difference between the purchase price and the par or face value of the stock or bonds, when the purchase price is the actual value or the market price of the stock or bonds.

In the case of Handley v. Stutz, 35 L. Ed. 227, the United States Supreme Court, after citing the general rule as to the liability of stockholders to creditors, and the difference be-

tween the purchase price and the par value, said, on pp. 235, 237:

"To say that a corporation may not, under the circumstances above indicated, put its stock upon the market and sell it to the highest bidder, is practically to declare that a corporation can never increase its capital by a sale of shares, if the original stock has fallen below par. The wholesome doctrine, so many times enforced by this court, that the capital stock of an insolvent corporation is a trust fund for the payment of its debts, rests upon the idea that the creditors have a right to rely upon the fact that the subscribers to such stock have put into the treasury of the corporation, in some form, the amount represented by it; but it does not follow that every creditor has a right to trace each share of stock issued by such corporation, and inquire whether its holder, or the person of whom he purchased, has paid its par value for it. It frequently happens that corporations, as well as individuals, find it necessary to increase their capital in order to raise money to prosecute their business successfully, and one of the most frequent methods resorted to is that of issuing new shares of stock and putting them upon the market for the best price that can be obtained; and so long as the transaction is bona fide, and not a mere cover for 'watering' the stock, and the consideration obtained represents the actual value of such stock, the courts have shown no disposition to disturb it. * * * As the company in this case found it impossible to negotiate its bonds at par without the stock, and as the stock was issued for the purpose of enhancing the value of the bonds, and was taken by the subscribers to the bonds at a price fairly representing the value of both stock and bonds, we think the transaction should be sustained, *and that the defendants cannot be called upon to respond for the par value of such stock, as if they had subscribed to the original stock of the company.*"

In the case, Clark v. Bever (1891), 35 L. Ed. 88, l. c. 95, the Court held that the "trust fund doctrine" could not be applied to increased stock in the following terms:

"To say that a public corporation, charged with public duties, may not relieve itself from embarrassment by paying its debt in stock at its real value—there being no statute forbidding such a transaction—*without subjecting the creditor, surrendering his debt, to the liability attaching to stockholders who have agreed, expressly or impliedly, to pay the face value of stock subscribed by them, is, in effect, to compel them either to suspend operations the moment they become unable to pay their current debts, or to borrow money secured by mortgage upon the corporate property. We do not think the Statute of Iowa can be properly construed to cause such a result in respect to corporations organized under its laws.*"

In the case, *Fogg v. Blair,* 35 L. Ed. 104, l. c. 107, the Court applied the law in relation to increased stock to original stock in a controversy involving a Missouri Corpoartion, using the following words:

"But the bill contains no allegation whatever as to the real or market value of the stock. The Court cannot say, from any facts set forth in the bill as to the condition of the railroads in question, that the stock when delivered to the contractors was worth par, or that it had any substantial value. *If, when disposed of by the railroad company, it was without value, no wrong was done to creditors by the contract made with Blair and Taylor.* If the plaintiff expected to recover in this suit upon the ground that the stock was of substantial value, it was incumbent upon him to distinctly allege facts that would enable the Court—assuming such facts to be true—to say that the contract between the railroad company and the contractors was one which, in the interest of creditors, ought to be closely scrutinized. * * * As he impugned the good faith of the transaction between the company and the contractors, it was incumbent upon him to state the essential, ultimate facts upon which his cause of action rested, and not content himself with charging, generally, that what was done was 'colorable,' a 'fraud,' a 'breach of trust' and a 'scheme' by which Blair and Taylor were to get the stock without paying for it."

In re Remington Automobile & Motor Co., 139 Fed. 767, (Dist. Ct., N. D. New York, 1905), the Court quoted the following provision from Handley v. Stutz with approval:

" 'An active corporation, finding its original capital impaired by loss or misfortune, may, for the purpose of recuperating itself, and of producing new conditions for the successful prosecution of its business, *issue new stock, and put it upon the market, and sell it for the best price that can be obtained; and in such case no such trust in favor of a creditor arises against the purchaser who, in good faith, buys for less than par.*' "

"But that is not this case. *Here we have subscriptions to the original capital stock.* Those who took it knew they were giving 'currency' standing to the corporation, and as between them and creditors the equities of the latter prevail when there was no pretense of full payment in any way."

The leading case in Missouri Von Cleve v. Berkley, 143 Mo. 109, involved original stock and in considering the foregoing cases decided by the United States Supreme Court relating to increased stock, the Court stated (l. c. 122 & 123) there was no conflict between the decisions of the State Court and the United States Supreme Court, in the following language:

"and in the latter case of *Camden v. Stuart,* 144 U. S. 104, it was held that 'the trust arising in favor of creditors by subscriptions to the stock of a corporation can not be defeated by a simulated payment of such subscription, *nor by any device short of an actual payment in good faith;' and it was not intended in Clark v. Bever, Fogg v. Blair, or Handley v. Stutz, to overrule' or qualify* this wholesome principle adopted by this court in the earlier cases, * * * *but only to draw a line beyond which the Court was unwilling to go in affixing, a liability upon those who had purchased stock of the corporation, or had taken it in good faith, in satisfaction of their de-*

mands;' and in the case of Handley v. Stutz, Justice Brown. speaking for the Court, was careful to re-assert the doctrine that the trust arising in favor of creditors by subscriptions to the stock of a corporation can not be defeated by a simulated payment of such subscription, nor by any device short of *an actual payment in good faith;"*

In the case Hospes v. Northwestern Manufacturing & Car Co., Minnesota Supreme Court (1892 15 L. R. A. 470 l. c. 474, the Court speaking of the "trust fund doctrine" said:

"It does not exist in favor of a subsequent creditor who has dealt with the corporation with full knowledge of the arrangement by which the 'bonus' stock was issued, for a man cannot be defrauded by that which he knows when he acts. Deadwood First Nat. Bank v. Gustin M. C. Min. Co. supra. It has also been held not to exist where stock has been issued and turned out at its full market value to pay corporate debts. Clark v. Bever, supra. * * * It is difficult, if not impossible, to explain or reconcile these cases upon the 'trust-fund doctrine,' or, in the light of them, to predicate the liability of the stockholder upon that doctrine. *But by putting it upon the ground of fraud, and applying the old and familiar rules of law* on that subject to the peculiar nature of a corporation and the relation which its stock-holders bear to it and to the public, we have at once rational and logical ground on which to stand."

In the case, Thoms & Brenneman et al v. Goodman, (1918) Circuit Ct. of Appeals, Sixth Circuit, 254 Fed. 39 l. c. 41, 42, 44, the Court said:

"No less well settled, as a matter of general corporate law and rule of equity, is the (seeming or possible) exception to the universality of the general rule, *by which exception a corporation, the value of whose capital stock has become impaired, and which finds it necessary to sell additional capital stock, may sell the same at the real worth or market value*

thereof, in which case the purchaser does not incur the liability of a subscriber under the general rule. This was most explicitly declared in Handley v. Stutz, 139 U. S. 417, 11 Sup. Ct. 530, 35 L. Ed. 227, and the care with which the question was considered and decided is evidenced by the dissent of two judges, and by the simultaneous consideration and decision of analogous problems, with corresponding result. Clark v. Bever, 139 U. S. 96, 109, 11 Sup. Ct. 468, 35 L. Ed. 88; Fogg v. Blair, 139 U. S. 118, 126, 11 Sup. Ct. 476, 35 L. Ed. 104. * * * The Hamilton Company was a going concern; the circumstances indicate that its existing stock was worth less than par; it needed additional capital; it is at least probable that bonds could not be sold for par, in such amounts and so quickly as needed; and the case is plainly one where bonds and stock were sold together for a gross sum. It is not alleged that they were worth any more than was received. There is no room for doubt that the petition and the proofs herein fail to make a case, unless Handley v. Stutz ought not to be followed; and the claim that it ought not to be followed rests upon the proposition that the law of Ohio is otherwise and that the Ohio law must control. * * * We find nothing else to support the claim that the Ohio rule is inconsistent with Handley v. Stutz; on the contrary, there are two decisions tending to support the opposite conclusion. In Peter v. Union Co., 56 Ohio St. 181, 46 N. E. 894, there had been capital stock issued at a discount after the corporation had been in business for some time and when it needed additional capital. Upon insolvency, a suit was brought to compel a holder of this discount stock to pay the difference between this purchase price and par. After an exhaustive and fully reported argument of counsel, in which Handley v. Stutz was cited, it was held that the liability did not exist. It is true that the court relied upon, as more or less controlling, the fact that the complaint was made by another stockholder rather than by a creditor, and it is true that this distinction has later been noted by the same court (Trust Co. v. Ford, supra, 75 Ohio St. at pp. 338, 79 N. E. 474, 8 L. R. A.

(N. S.) 263); but, with all deference, we cannot see that this is a distinction in principle."

In the case, Morrow v. Nashville Iron & Steel Co., Supreme Court of Tenn. 1889, 10 S. W. 495, l. c. 500, the Court said:

"The necessities of the business of an organized company *might demand an increase of capital stock,* and, if such stock is lawfully issued, it may very well be offered upon special terms. In such case, if the market price was less than par, it is clear that a purchaser or subscriber for such stock at its market value would, in the absence of fraud, be liable only for his contract price. So a case might arise where the stock of a going concern was much depreciated,, and where its bonds were likewise below par, and there was lawful authority to issue additional stock and bonds. Now, in such case, the real market value of an equal amount of stock and bonds might not exceed, or even equal, the par value of either. In such cases, all questions of fraud aside, a purchaser would only be held for his contract price. The case we are considering is *that of the issue of the initiatory or organization stock—that class of stock which is to constitute the capital stock upon which the grant of the franchise depends.*"

In the case, Ingraham v. Commercial Lead Co., (1910) Eighth Circuit, Circuit Ct. of Appeals, 177 Fed. 341, *involving a corporation organized under the laws of Missouri,* the Court said, l. c. 343 and 344:

"The effort of learned counsel for complainant to distinguish between Handley v. Stutz and the case now under consideration, on the ground that the former did not involve the application of the laws of Missouri, is not satisfactory to us. In the case of Fogg v. Blair, 139 U. S. 118, 11 Sup. Ct. 476, 35 L. Ed. 104, which was before the Supreme Court at the same it was considering Handley v. Stutz, *a judgment creditor of an insolvent corporation, organized and doing business under the*

laws of the State of Missouri, sought to hold a stockholder liable for unpaid portions of stock held by him. It was there urged and conceded that capital stock of a corporation was a trust fund for the benefit of creditors, and the laws of Missouri and the decisions of the Supreme Court of that State on the subject were under consideration. *In view of them all, conclusions were reached to the effect that, in determining whether stock is full-paid or not, regard should be had to the actual value of the stock at the time it was issued and to the circumstances attending its disposition. It was said, among other things:* "If, when disposed of by the railroad company, it was without value, no wrong was done to creditors. * * *" This contemporaneous utterance of the Supreme Court, in a case involving the laws now under consideration, compels us to hold that the doctrine of Handley v. Stutz was intended in the absence of statutes affirmatively compelling different conclusions, to be of general application, and that it controls us in the disposition of the present case.

"Our conclusion is that the corporation received the fair and reasonable value in money for the *increased stock* issued to some of the defendants as bonuses for their loans, and that the learned trial court committed no error in deciding in their favor."

In the case, Grant v. East & West R. R. Co., (1893) 54 Fed. 569, l. c. 575, the Court said:

"This well-settled doctrine of the general law relating to subscriptions to the stock of corporations as announced by the United States Supreme Court in the cases above cited has been embodied in the constitutions and codes of many of the states; and issues of stocks and bonds, under constitutional and statutory provisions substantially similar to those of Alabama, *have been sustained when they have been disposed of by*

a corporation after its organization for the best price that could be obtained, though for less than their face value."

In the case, Speer et al. v. Bordeleau (1905) Colorado 79, Pac. 332 l. c. 335, the Court said:

"It frequently happens that corporations, as well as individuals, find it necessary to increase their capital in order to raise money to prosecute their business successfully, and one of the most frequent methods resorted to is that of *issuing new shares of stock* and putting them upon the market for the best price that can be obtained; *and so long as the transaction is bona fide, and not a mere cover for 'watering' the stock, and the consideration obtained represents the actual value of such stock, the courts have shown no disposition to disturb it."*

The following additional authorities are cited in support of this proposition:

Atlanta Trust Co. v. Wood Bridge Canal & Irrigation Co. (1897) California 79 Fed. 842; Kellerman v. Maier (1897) California 48 Pac. 377; Memphis & Little Rock R. R. Co. v. Dow (1897) Arkansas 30 L. Ed. 595; Dummer v. Smedley 110 Mich. 466, 38 L. R. A. 490; Seaboard National Bank v. Slater, 117 Fed. 1002; McDowell v. Lindsay (Pa.) 63 Atl. 130; Toledo St. L. & K. C. R. R. Co. v. Continental Trust Co. (1899) 95 Fed 497; Granite Brick Co. v. Titus (1915) 226 Fed. 557; Lee v Cameron Sup. Ct. Okla. (1917) 169 Pac. 17; Enright v. Hecksher (1917) 240 Fed. 863; Stein v. Howard (1884) Sup. Ct. California, 4 Pac. 662.

V

CONCLUSION

The unanimous decision of various courts construing constitutional provisions similar to the provision in the Missouri Constitution indicates clearly that the word *fictitious* as used in the Constitution was for the purpose of preventing the fraudulent issuing, and putting on the market, increased stock or bonds that do not, and are not intended to represent money or property of any kind, either in possession or expectancy, but it was not intended to prevent an increase in stock or bonds by an active, going, solvent corporation and the sale of such stock or bonds for less than the par value or face value, in a bona fide transaction, where the stock or bonds are sold or transferred for property of the market or actual value of the stock or bonds.

Further that the so called "trust fund doctrines" is to be applied to *organization stock* which must not be sold for less, than par under the law in Missouri, but in the absence of fraud does not apply to *increased stock* which may be sold in good faith by an active going corporation for the best price it will obtain without rendering the purchaser liable to subsequent creditors for the difference between the purchase price and the par value. The reason being that the organization stock is designed primarily to give a corporation its currency standing, upon which standing creditors rely and do business with the corporation, but where the organization stock falls to less than par, and additional capital is needed by an active going corporation it would compel it to suspend operations if only allowed to sell its increased stock at par value; that the creditors and stockholders are better protected by permitting a corporation under such circumstances to obtain the needed funds by a sale of increased stock or bonds in an honest transaction for the best price that can be obtained.

Following the same reasoning the courts have further unanimously held that stockholders are not liable to creditors for the difference between the purchase price and the par value or face value of the increased stock or bonds when they are sold under the foregoing circumstances.

JAMES J. MILLIGAN.