

NOTES

THE ESTABLISHMENT OF LIABILITY ON WATERED STOCK IN MISSOURI

INTRODUCTION

It has been a long-established policy in Missouri that the holders of "watered" stock in a corporation or their transferees with notice will be liable under certain circumstances to the creditors of the company in the event that the company becomes insolvent and there are no corporate assets upon which to levy.¹ Connected with that policy, however, are at least two problems. One involves deciding whether or not a particular stockholder should be classed as a watered stockholder. Stated another way, the court must decide whether the service rendered or the property given by the stockholder in exchange for a certain number of purportedly full paid and non-assessable par value shares² was sufficient to justify the corporation's having paid for it with that amount of stock. The solution to this issue involves chiefly the weighing of experts' opinions on the value of the consider-

1. *Babbitt v. Read*, 215 Fed. 395 (S.D.N.Y. 1914), *aff'd*, 236 Fed. 42 (2d Cir. 1916); *Hodde v. Hahn*, 283 Mo. 320, 222 S.W. 799 (1920); *L. M. Rumsey Manufacturing Co. v. Kaime*, 173 Mo. 551, 73 S.W. 470 (1903); *Shields v. Hobart*, 172 Mo. 491, 72 S.W. 669 (1903); *Berry v. Rood*, 168 Mo. 316, 67 S.W. 644 (1902); *Van Cleve v. Berkey*, 143 Mo. 109, 44 S.W. 743 (1897); *Shickle v. Watts*, 94 Mo. 410, 7 S.W. 274 (1888); *Wagner v. Eisenmenger*, 65 S.W.2d 108 (Mo. App. 1933); *Hastings v. Scott*, 248 S.W. 973 (Mo. App. 1923); *Raleigh Investment Co. v. Cureton*, 232 S.W. 766 (Mo. App. 1921); *Rogers v. Stag Mining Co.*, 185 Mo. App. 659, 171 S.W. 676 (1915); *Schneider v. Johnson*, 143 S.W. 78 (Mo. App. 1912); *Anheuser-Busch Brewing Association v. Park Novelty Co.*, 120 Mo. App. 513, 97 S.W. 209 (1906); *Shepard v. Drake*, 61 Mo. App. 134 (1895); *Leucke v. Tredway*, 45 Mo. App. 507 (1891); *Farmers' Bank of Frankfort v. Gallaher*, 43 Mo. App. 482 (1890); *cf. Meyer v. Ruby Trust Mining & Milling Co.*, 192 Mo. 162, 90 S.W. 821 (1905); *Woolfolk v. January*, 131 Mo. 620, 33 S.W. 432 (1895); *Bobb v. Walmar Theater Co.*, 206 Mo. App. 236, 277 S. W. 841 (1921); *McClure v. Paducah Iron Co.*, 90 Mo. App. 567 (1901); *Carp v. Chipley*, 73 Mo. App. 22 (1898).

With regard to the liability of transferees with notice, see

Van Cleve v. Berkey, 143 Mo. 109, 44 S.W. 743 (1897); *Schneider v. Johnson*, 143 S.W. 78 (Mo. App. 1912); *Anheuser-Busch Brewing Association v. Park Novelty Co.*, 120 Mo. App. 513, 97 S.W. 209 (1906).

2. In *Livingston, Trustee v. Adams*, 226 Mo. App. 824, 43 S.W.2d 836 (1931), a holder of no par stock was held liable as an unpaid stockholder on the ground that the articles of incorporation stated that a certain amount of property had been paid in when in fact it had not been so paid.

ation at the time of the transaction,³ and it is, of course, of the utmost importance to the final outcome of the issue of the imposition of liability. However, the discussion in this note will center around the other question inherent in the policy set out above; that is, assuming that the value given for the shares was inadequate, under what conditions will the holder of those shares be held liable to the corporate creditors? It will be pointed out below that the Missouri courts, prior to the passage of the General and Business Corporation Act of 1943, had outlined rather clearly the fact elements which would result in liability of the watered stockholder. However, the last sentence of section nineteen of that Act promises to work a change in Missouri legal theory on this particular subject. It provides: "In the absence of actual fraud in the transaction, the judgment of the board of directors or the shareholders, as the case may be, as to the value of the consideration received for shares shall be conclusive."⁴ As a starting point, the content of the theory of liability developed in Missouri prior to 1943 and a summary of the established rules in other jurisdictions will be set forth. Then the possible impact of the new section will be discussed.

I. THE ESTABLISHED THEORIES

A. THE MISSOURI RATIONALE

The courts of Missouri, in attempting to give a short explanation of the theory on the basis of which they have held watered stockholders liable to corporate creditors, have employed two labels, the trust fund doctrine and the legal fraud theory.⁵ On the surface at least, that practice might be a ground for arguing that there have been two separate concepts of liability in this jurisdiction with regard to watered stockholders. On the one hand, the first-mentioned term refers to the rationale which dictates that the watered stockholder should be held accountable to

3. See 11 FLETCHER, CORPORATIONS § 5215 (Revised ed. 1932).

4. The provision was first contained in Mo. Laws 1943, p. 410, § 19. It now appears in Mo. REV. STAT. § 351.185 (1949).

5. Exemplary cases where the phrase "trust fund" or its equivalents have been used are: Meyer v. Ruby Trust Mining and Milling Co., 192 Mo. 162, 90 S.W. 821 (1905); Van Cleve v. Berkey, 143 Mo. 109, 44 S.W. 743 (1897); Shickle v. Watts, 94 Mo. 410, 7 S.W. 274 (1888). Cases where the phrase "legal fraud" or its equivalents have been used are: L. M. Rumsey Manufacturing Co. v. Kaime, 173 Mo. 551, 73 S.W. 470 (1903); Berry v. Rood, 168 Mo. 316, 67 S.W. 644 (1902); Bobb v. Walmar Theater Co., 206 Mo. App. 236, 227 S.W. 841 (1921).

creditors because the capital stock of a company, especially its unpaid subscriptions, is a trust fund for the benefit of creditors.⁶ A corollary of that reasoning is that the legal obligation to pay the full par value cannot be released even though the directors have consented to treat the stock as full paid.⁷ The term "legal fraud," on the other hand, has been applied to the theory which holds the owners of diluted stock liable because the issuance of such stock involves a misrepresentation to those persons who do business with the corporation in reliance on the outward showing that the stock is fully paid. Inherent in that approach is the rule that all prior and those subsequent creditors with notice of the fact that the stock has been watered are excluded from the right to sue because it cannot be logically said that they relied on the ostensible amount of the capital stock.⁸ So defined, the concepts seem different. However, a study of the Missouri cases has revealed that the courts of this jurisdiction have merged the two theories outlined above,⁹ and thus it would be hardly accurate to say that in using the terms "trust fund" and "legal fraud," the same courts have intended to designate two distinct concepts. On the contrary, they have employed the two labels to designate the one theory which has resulted from that merger.

The question then arises: what is the actual content of this resultant rationale? The decisions show that, although both of the original theories have influenced the content of this resultant concept, they have not done so to the same degree. In fact, it is clear that, regardless of the wording of the opinions, the notion of strict accountability associated with the trust fund theory has

6. BALLANTINE, CORPORATIONS § 349 (Revised ed. 1946).

7. *Ibid.*

8. *Id.* § 350.

9. The following quotation from the case of Colonial Trust Co. v. MacMillan, 188 Mo. 547, 87 S.W. 933 (1905) is indicative of this fact:

... it is good law that underlying the trust fund theory and the true value theory is the proposition that the creditors have the right to assume that stock has been fully paid in money or money's worth as set forth solemnly in the articles of association of a corporation and to extend credit on the faith of such assumption; but because of this underlying proposition it follows that, if a creditor of an insolvent corporation did not extend credit on the faith of shareholders' having paid their stock subscriptions in money or money's worth, but, to the contrary, knew at the time of the creation of the corporate debt that such stock was paid for in simulated values, he is not entitled to the remedy here sought. *Id.* at 567-568, 87 S.W. at 939.

A statement of similar import may be found in *Bobb v. Walmar Theater Company*, 206 Mo. App. 236, 245, 227 S.W. 841, 843 (1921). See BALLANTINE, *op. cit. supra* note 6, § 349.

been the predominant consideration. The truth of that assertion, despite the fact that the fraud ingredient has been the source of the one important limitation to an otherwise strict approach, will be discussed below. The chief reason, however, that the notion of strict accountability has been predominant is found in the interpretation that the Supreme Court of Missouri has given to the constitutional and statutory provisions which bear on this subject. The constitution of Missouri has long contained a section to the effect that corporate stocks and bonds are not to be issued except for money paid, labor done, or property actually received and that all fictitious increases of stock or indebtedness are to be considered void.¹⁰ A statutory provision to the effect that a creditor unsatisfied by an execution issued against corporate property may have that execution levied against any stockholder to the extent of the unpaid balance on his stock has also been the law in this state for many years.¹¹ Those provisions have been construed by that court to mean that this jurisdiction has a conservative approach toward watered stock schemes.¹² Exemplary of that construction is the following quotation from the oft-cited case of *Van Cleve v. Berkey*:¹³

Upon a review of all the cases decided by the appellate courts of this state since the adoption of the constitution of 1875, . . . it is impossible to escape the conviction that in this state, whatever may be the case in some of the other states, the "American trust doctrine," . . . has indeed been reenforced by its constitution and statutes; and that the proposition that the stock of a corporation must be paid for "in meal or in malt," in money or in money's value, is not a mere figure of speech, but really has the significance of its terms; it may be paid for in property, but in such case the property must be the fair equivalent in value to the par value of the stock issued therefor; that it is the duty of the stockholders to see that it possesses such value; that when a corporation is sent forth into the commercial world, accredited by them as possessed of a capital in money, or its equivalent, in property, equal to the par value of its capital stock, every person dealing with it, unless otherwise advised, has a right to extend credit to it on the faith of the fact

10. Mo. CONST. Art. XI, § 7; Mo. CONST. Art. XII, § 8 (1875); Mo. REV. STAT. § 351.160 (1949).

11. Mo. REV. STAT. § 351.280 (1949); Mo. REV. STAT. § 736 (1879).

12. *Berry v. Rood*, 168 Mo. 316, 67 S.W. 644 (1902); *Van Cleve v. Berkey*, 143 Mo. 109, 44 S.W. 743 (1897).

13. 143 Mo. 109, 44 S.W. 743 (1897).

that its capital stock has been so paid for, and that the money or its equivalent in property will be forthcoming to respond to his legitimate demands; in short, that it is the duty of the stockholder, and not of the creditor, to see that it is paid. Hence, the inquiry in a case between a creditor and a stockholder when property has been paid in for the capital stock of the corporation, is not whether the stockholder believed, or had reason to believe that the property was equal in value to the par value of the capital stock, but whether, in point of fact, it was such equivalent.¹⁴

As it was indicated above, the courts of this state have not been inconsistent in using the label "trust fund theory" to describe the conservative position that they have taken as regards the watered stockholder since one is part and parcel of the other. However, misgivings could arise to the assertion that by and large the name "legal fraud" has been expressive of the same position. Dispelling those doubts can be perhaps best accomplished by showing that, with one qualification, the term "legal fraud" has not had in Missouri any relation to the theory associated with the tort action of deceit and that thus it has actually referred to something that could not be accurately classed as fraud.

If it is assumed that the court has already decided that the consideration was not in fact equal to the aggregate par value of the shares issued to the stockholder, it could be argued that he participated in the making of a misrepresentation. That argument is questionable,¹⁵ but even postulating that it is warranted, still it is clear that at that point the similarity between the two types of fraud ceases. In the first place, the Missouri courts have not required the creditors to establish as conditions to the imposition of liability that either the defendant stockholder or those in charge of valuing the consideration¹⁶ knew that they were making a false representation and that they were actuated by an intent to deceive.¹⁷ That fact was pointed up in the case

14. *Id.* at 135-136, 44 S.W. at 750.

15. Ballantine, *Stockholders' Liability in Minnesota*, 7 MINN. L. REV. 79, 89 (1923).

16. See note 29 *infra*.

17. *Shields v. Hobart*, 172 Mo. 491, 72 S.W. 669 (1903); *Berry v. Rood*, 168 Mo. 316, 67 S.W. 644 (1902); *Van Cleve v. Berkey*, 143 Mo. 109, 44 S.W. 743 (1897). In the case of *Woolfolk v. January*, 131 Mo. 620, 335 S.W. 432 (1895) there was dictum to the effect that "fraud" must be shown in addition to proof of an over-valuation, but that dictum was disapproved in *Van Cleve v. Berkey*, *supra*. Proof of an intent to deceive is, of course, a necessary element in the tort action of deceit. PROSSER, TORTS 705 (1941).

of *Berry v. Rood*.¹⁸ There certain of the defendants, who had been organizers of the defunct corporation, had turned in as full payment for their stock property worth less than five per cent of the face value of the stock. After the insolvency of the company, the receiver sued them to recover their unpaid stock subscriptions. The lower court, on the basis of its finding that the defendants were blameless of any intentional deception as regards the public or creditors, ruled for the defendants, and the receiver appealed. The supreme court described and ruled upon the defendants' arguments for sustaining the lower court as follows:

The main proposition . . . is that a stockholder who has turned into the corporation property in payment of his stock, which has been accepted by the corporation as the equivalent of the face value of the stock, and who has been guilty of no actual fraud, cannot be called to account by creditors of the concern, or made to pay, in satisfaction of debts, the difference between the value of the property turned in and the face value of the stock. This proposition, as contended for, under the facts of this case, also draws a distinction, in favor of the stockholder, between actual fraud and legal fraud, and leaves him on the safe side of the line, although the property he turned in was in fact worth less than 5 per cent. of the face value of the stock, provided we find that his mind had been so excited by indications of prospective mineral wealth that he really believed that, when the unexplored caverns should be opened, mines of fabulous value would be disclosed. If that is the correct interpretation of the law of Missouri on this subject, then the manifest efforts of the framers of our constitution and the makers of our statutes to authorize the establishment of only conservative and reasonably safe business corporations have been in vain.¹⁹

In fact, the courts of Missouri have gone further: they have ruled out the element of wrongful conduct entirely, which fact is evidenced by the following statement:

. . . the inquiry in a case between a creditor and a stockholder, when property has been paid in for capital stock . . ., is not whether the stockholder believed, or had reason to believe, that the property was equal in value to the par value of the capital stock but whether, in point of fact, it was such equivalent.²⁰

18. 168 Mo. 316, 67 S.W. 644 (1902).

19. *Id.* at 328, 67 S.W. 647-648.

20. *Van Cleve v. Berkey*, 143 Mo. 109, 135-136, 44 S.W. 743, 750 (1897).

Because of that opinion, the concept of liability in this jurisdiction has become known as the "true value" approach. It will be pointed out later that other states, the so-called "good faith" states, have required, in addition to evidence that the property was not actually worth the face value of the stock, proof of some sort of wrongful conduct on the part of the directors or stockholders or of facts from which bad faith on their part could be inferred. But the Missouri rule has been that that factor is immaterial.

With respect to the element of reliance, the concept of fraud in relation to stockwatering again differs from the fraud associated with the action of deceit. Proof of justifiable reliance is, of course, an indispensable factor in the tort action,²¹ but the attitude of the Missouri courts on this issue in the watered stock cases is shown in the frequent statements to the effect that every person has a right to extend credit on the faith of the fact that capital stock has been paid up in money or in money's worth.²² On the basis of the proposition that the creditor has a right to rely, it would seem to follow that his actually depending on the capital stock records of the corporation would not be necessary to his possible cause of action against the watered stockholders, and the opinions have shown acceptance by the courts of this idea. As against those who gave credit to the corporation after the issuance of the diluted stock,²³ the courts have uniformly held the holders of that stock liable without referring any more to the problem of whether the creditors did in fact rely than merely asserting that they did. Thus the satisfaction of this requirement

21. PROSSER, *op. cit. supra* note 17, at 706.

22. See, e.g., *Colonial Trust Co. v. MacMillan*, 188 Mo. 547, 567-568, 87 S.W. 933, 939 (1905); *Van Cleve v. Berkey*, 143 Mo. 135-136, 44 S.W. 745, 750 (1897).

23. None of the Missouri cases have involved creditors who extended credit before the issuance of the diluted stock. In *Chrisman-Sawyer Banking Co. v. Independence Manufacturing Co.*, 168 Mo. 634, 645, 68 S.W. 1026, 1029 (1902), there is a statement that "all creditors without regard to when their debts were contracted" have a right to sue the holders of unpaid stock, which would seem to indicate that even those whose debts were contracted prior to the issue of the unpaid stock could sue. However, since the plaintiff in that case was the purchaser of the claim of a subsequent creditor, that statement is dictum and thus should not be relied on too heavily. Also, in *Shickle v. Watts*, 94 Mo. 410, 418, 7 S.W. 274, 277 (1888), there is a statement that the amount due on unpaid stock is deemed in equity as a ". . . part of the capital stock for all of the creditors. . . ." However, that case involved subsequent creditors too, and thus it is also dictum.

has been more presumed than actual.²⁴ Only in cases where it would be illogical to say that the creditor was misled, *i.e.*, where he had actual²⁵ notice that the consideration had been inadequate, has the liability of the stockholder been restricted on the ground of failure to comply with this requisite.²⁶ That limitation is an important one, but it is the only aspect of the Missouri theory that, as far as the actual decisions are concerned, can be lined up with the fraud that is the basis of the tort action of deceit.²⁷

24. In *Hastings v. Scott*, 248 S.W. 973 (Mo. App. 1923), the court said: . . . creditors of the corporation have the right, in the absence of information to the contrary, to assume that the value of the assets of the corporation is equal to its paid-up capital stock, and are presumed to deal with the corporation on the faith of that value. . . . *Id.* at 975.

25. In *Rogers v. Stag Mining Co.*, 185 Mo. App. 659, 171 S.W. 676 (1915), it was ruled that the fact that pursuant to a statutory requirement a copy of the articles of incorporation of the company had been filed with the Secretary of State and had been recorded in the county where the corporation was located was not notice that the stock of the company was watered.

26. *Colonial Trust Co. v. MacMillan*, 188 Mo. 547, 87 S.W. 933 (1903); *Berry v. Rood*, 168 Mo. 316, 67 S.W. 644 (1902); *Bobb v. Walmar Theater Co.*, 206 Mo. App. 236, 227 S.W. 841 (1921). Two cases have said that the creditor who extended credit to the corporation with actual knowledge that the stock is watered is estopped from suing the watered stockholder. *Meyer v. Ruby Trust Mining & Milling Co.*, 192 Mo. 162, 90 S.W. 821 (1905); *Rogers v. Stag Mining Co.*, 185 Mo. App. 659, 171 S.W. 676 (1915).

27. The case of *Ingraham v. Commercial Lead Co.*, 177 Fed. 341 (8th Cir. 1910), is a case where liability of a bonus stockholder in a Missouri corporation was limited. There a corporation was organized under the laws of Missouri to engage in the business of lead mining. Its original capital was \$60,000. The venture went poorly, and the corporation had incurred debts of \$60,000 or \$65,000. In an attempt to get more capital, the original stockholders increased their capital stock under the prescribed legal procedure from \$60,000 to \$100,000, but they were unsuccessful in getting the new stock sold. Still having confidence in the ultimate success of their project, they devised a plan whereby they would lend the corporation \$75,000 and, as an inducement and part consideration for the loan, they would receive in increased stock fifty per cent of the amount loaned. The evidence showed that the directors were in absolute good faith in adopting this plan. The arrangement was carried out, the investors receiving promissory notes to the amount of the loan plus the agreed amount of stock. However, in spite of their attempts, the company failed. Subsequently a judgment creditor brought suit to collect this judgment against the holders of the stock issued under the above plan on the ground that they had not paid for their stock. The Circuit Court of Appeals applied the rule set down in the famous United States Supreme Court case, *Handley v. Stutz*, 139 U. S. 417 (1891), because the fact situations in both cases were similar, and ruled for the defendant stockholders. In brief, the doctrine of *Handley v. Stutz*, *supra*, is that a "going concern" may, on finding its original capital impaired, issue new stock and sell it for the best price obtainable, and, provided that the transaction was in good faith and not just a cover-up for watering the stock, the holders of the stock so issued will not be liable to creditors.

The courts of Missouri have not dealt with such a factual situation. However, whether that ruling could become law in this state, should a similar case arise, would seem to depend, so far as liability on bonus or watered

At this point it is clear that the term "legal fraud," as it has been used in the stock watering cases, really has referred to a concept that is not fraud at all. The name has been expressive of only one aspect of the Missouri theory of stockholder liability, *i.e.*, that a creditor who has had actual notice cannot recover. Otherwise, it is fair to say that the fraud verbiage has actually been employed as a vehicle for following a policy of almost strict liability, which policy has been commanded, according to the interpretation of the Supreme Court of Missouri, by the constitution and statutes of this state.

B. THE RULES IN OTHER JURISDICTIONS

On the question of the general theory of liability on watered stock, a majority of the states ostensibly have had an approach similar to the Missouri theory, *i.e.*, a combination of the original trust fund and legal fraud concepts.²⁸ However, there has been a divergence, at least in the wording of opinions, between Missouri and a majority of the other jurisdictions on the issue of what proof has been expected of the creditor before he could legally hold the watered stockholder accountable. It was pointed out above that this state has followed the "true value" rule, which in substance has dictated that the factor of wrongful conduct on the part of the stockholders or the directors is at the most im-

stock is concerned, on whether the Supreme Court of Missouri would be willing to distinguish between shares issued as a part of the original capital and additional shares issued under a later-devised capital set-up. Although the court in the Ingraham case felt that there were no statutory provisions affirmatively compelling an opposite result, it should be noted that the Missouri constitutional and statutory provisions which bear on this subject do not, with one qualification, make such a distinction. MO. CONST. ART. XI, § 7; MO. REV. STAT. § 351.160 (1949).

The origin of the qualification mentioned may be traced to the later case of *Brockett v. Winkle Terra Cotta Co.*, 81 F.2d 949 (8th Cir. 1936). There the court rejected a reorganization plan for an insolvent corporation under the terms of which preferred stock in the reorganized company was to be issued in exchange for the bonds issued under the old capital set-up. The court reasoned that this arrangement added no new money or its equivalent to the corporation and that thus the holders of the preferred stock could well be liable to creditors as watered stock holders. This ruling, however, probably no longer has any force in Missouri because of the present constitutional and statutory provisions to the effect that no issue or increase of stock for valid bona fide antecedent debts shall be deemed fictitious or void. See MO. CONST. ART. XI, § 7; MO. REV. STAT. § 351.160 (1949). Thus in this one particular situation, *i.e.*, where the additional stock is earmarked to satisfy a valid bona fide antecedent debt, as distinguished from a case where the stock is given as an inducement for the extension of credit (the Ingraham case), that stock will probably not be held to be watered.

28. BALLANTINE, *op. cit. supra* note 6, §§ 349-350.

material. The majority of states, on the other hand, has subscribed to the "good faith" rule, which in short has meant that before the creditor of a corporation could hold a particular stockholder liable on the ground that his stock was watered, he had to prove not only that the property exchanged or the labor done had been in fact worth less than the aggregate par value of the stock issued for it but also that those in charge of valuing the property, the directors,²⁹ had overvalued it in "bad faith."³⁰ The theory has been that if the directors had acted in "good faith," even though the property was not actually worth the amount in cash that the directors assigned to it, the creditors could not recover. What type of conduct by the directors has constituted "fraudulent" action has varied from jurisdiction to jurisdiction, but the majority of the "good faith" courts have held that if the creditors could prove that the property was overvalued and that the overvaluation was deliberate, they could recover.³¹ In addition, a considerable number of courts have adhered to the rule that a gross or obvious overvaluation is strong evidence of fraud, which, if not rebutted by the defendant stockholder, is conclusive against him.³² The decisions of the Court of Chancery of New Jersey have represented another interpretation of the rule. That tribunal has exacted much higher standards of con-

29. It will be noted in the "good faith" states, the "bad faith" of the directors, in addition to evidence of an overvaluation of the consideration, could theoretically result in liability even though the particular stockholder held was innocent. A similar result could conceivably occur under section nineteen since it provides that so long as actual fraud in the transaction is not shown, "the judgment of the board of directors or the shareholders, as the case may be" shall be conclusive on the issue of valuation. [Italics ours].

At first glance, it may seem unfair to hold the stockholder liable because the directors have acted wrongfully, but that apparent injustice is dispelled by two considerations. One is that in the great majority of stockwatering cases the interests of the directors and the stockholders have been almost identical. The directors usually have valued property which they themselves owned, or they have been mere dummies acting in behalf of the property owners. The Missouri cases illustrate this fact, and it seems improbable that the situation will be different very often in the future. See DODD, STOCK WATERING 58 n. 1 (1930).

If, however, such a case should arise, it is almost certain that under the Missouri theory of almost strict liability, the innocent stockholder would still be held liable. *Berry v. Rood*, 168 Mo. 316, 67 S.W. 644 (1902). Thus the Missouri Supreme Court has settled in the negative the question of whether such a result is an unfair one.

30. DODD, STOCK WATERING 58-61 (1930).

31. *Ibid.*

32. *Id.* at 70.

duct by the directors before the creditors will be prevented from recovering. This may be seen in the following quotation:

When such differences are brought before judicial tribunals, the judgment of those who are by law intrusted with the power of issuing stock "to the amount of the value of the property" and on whom, therefore, is placed the first duty of valuing the property, must be accorded considerable weight. But it cannot be deemed conclusive when duly subjected to judicial scrutiny. Nor is it necessary that concious overvaluation or any other fraudulent conduct on the part of these primary valuers should be shown to justify judicial interposition. Their honest judgment, if reached without due examination into the elements of value, or if based in part upon an estimate of matters which really are not property, or if plainly warped by self-interest may lead to a violation of this statutory rule as surely as would corrupt motive.³³

Thus "good faith" in New Jersey has meant that there must be evidence that the directors exercised ordinary business prudence in their valuation of the property and that they did so without any hope of furthering their own personal interests. Anything less would render the stockholder liable.

As compared with the "good faith" rule, the "true value" rule has been criticized on the ground that although it is good policy to shield creditors against the fraudulent sales of corporate stock, it is going too far "to hold liable an honest subscriber, who has paid for his shares in good faith, in property, at what he and the officers of the company thought it was worth, because in the subsequent judgment of a judge or jury it was not worth that much."³⁴ It seems clear that theoretically, at least, such a criticism is valid not only on grounds of fairness but also because a strict application of the rule would result in discouraging prospective investors in stock.³⁵ However, arguing the merits of that criticism would not be productive for two reasons: (1) In the majority of cases decided in Missouri under the "true value" rule, the overvaluation of the property was so gross that even if

33. *Donald v. American Smelting & Refining Co.*, 62 N. J. Eq. 729; 731-752, 48 Atl. 771, 772-773 (1901). This case was a stockholders' suit to enjoin the company from issuing stock, but it was quoted with approval in subsequent New Jersey cases where creditors' rights were being asserted. *Holcombe v. Trenton White City Co.*, 80 N.J. Eq. 122, 82 Atl. 613 (1812), *aff'd*, 82 N.J. Eq. 364, 91 Atl. 1069 (1913); See *v. Heppenheimer*, 69 N.J. Eq. 36, 61 Atl. 843 (1905).

34. *McClure v. Paducah Iron Co.*, 90 Mo. App. 567, 580 (1901).

35. *Schenck v. Andrews*, 57 N.Y. 133, 142, 143 (1874).

the "good faith" rules of other jurisdictions had been applied, the defendant stockholders would in all probability have been held liable.³⁶ Thus the actual decisions, as distinguished from the theory, cannot be criticized as having been unduly strict. (2) The adoption of section nineteen seems clearly to have changed Missouri from a "true value" to a "good faith" state since, by the very terms of the section, "actual fraud" will be required before the directors' valuation of the property will be upset.³⁷ The element of fraud has been made, by statute, material where it was not so before.

II. THE MEANING OF THE NEW PROVISION

At this point, it would be well to restate the provision henceforth to be discussed. Section nineteen of the Missouri General and Business Corporation Act of 1943 provides, *inter alia*:

In the absence of actual fraud in the transaction, the judgment of the directors or the shareholders, as the case may be, as to the value of the consideration received for shares shall be conclusive.³⁸

36. *Hodde v. Hahn*, 283 Mo. 320, 222 S.W. 799 (1920) (in consolidation of two companies into one with capital of \$50,000, the two old companies were transferred to the new corporation at an aggregate valuation of \$50,000, \$30,000 of which was goodwill); *Shields v. Hobart*, 172 Mo. 491, 725 S.W. 669 (1903) (land purchased for \$26,000 capitalized two days later at \$100,000); *Berry v. Rood*, 168 Mo. 316, 67 S.W. 644 (1902) (land actually worth around \$3,000 exchanged for \$200,000 worth of stock); *Van Cleve v. Berkey*, 143 Mo. 109, 44 S.W. 743 (1897) (\$100,000 worth of stock exchanged for a worthless patent); *Hastings v. Scott*, 248 S.W. 973 (Mo. App. 1923) (property worth \$18,000 exchanged for \$30,000 worth of stock); *Raleigh Investment Co. v. Cureton*, 232 S.W. 766 (Mo. App. 1923) (property exchanged for the stock was actually worth only one-fifth of the par value of the stock); *Rogers v. Stag Mining Co.*, 185 Mo. App. 659, 171 S.W. 676 (1915) (property worth \$1,000 exchanged for \$43,000 worth of stock); *Schneider v. Johnson*, 143 S.W. 78 (Mo. App. 1912) (lease worth \$15,000 exchanged for \$79,400 worth of stock); *Farmers' Bank of Frankfort v. Gallaher*, 43 Mo. App. 482 (1890) (real property worth \$2,000 capitalized at \$24,800). The facts of the case of *L. M. Rumsey Manufacturing Co. v. Kaime*, 173 Mo. 551, 73 S.W. 470 (1903) might provide a basis for arguing that defendant stockholders would not have been held liable under the "good faith" rule whereas they were held liable under the "true value" rule. There goods of an actual value of \$77,000 were transferred to the corporation for \$95,000 in stock, but only after the defendant stockholders' appraisers had valued the goods at \$102,000. Perhaps the defendants in that case were in good faith because of that appraisal.

37. In *Whitlock v. Alexander*, 160 N.C. 465, 76 N.E. 538 (1912), it was ruled that the North Carolina actual fraud provision established the "good faith" rule in that state.

38. See note 4 *supra*. The Missouri provision differs from all its counterparts except that of Illinois in that it contains the words ". . . or the shareholders, as the case may be. . . ." This language apparently is with

The problem now is: what construction will the Supreme Court of Missouri put on this section? In an attempt to find guides to possible interpretations, the decisions in other jurisdictions which have or have had in substance the same provision will be discussed.³⁹

One possible choice would be to say that the statute requires the creditor, or other party seeking to upset the directors' valuation, to establish that the directors have been guilty of common law fraud. This, of course, would involve his proving that those who made the appraisal had been guilty of a misrepresentation to the creditor, that they had been actuated by an intent to deceive, that the creditor had justifiably relied on the verity of that representation to his damage.⁴⁰ The West Virginia case of *Fayette Wholesale Grocery Co. v. Brown Bros.*⁴¹ seems to indicate that that state, in which a provision similar to the Missouri provision is in effect,⁴² has taken the above view with regard to the meaning of the section. There the partners in a lumber business formed a corporation and transferred the assets of the partnership, subject to its liabilities, to the new company in exchange for \$10,000 of its par value capital stock. At the time of the transfer the liabilities of the partnership were \$10,960; hence the directors, who were the three former partners and the wives of two of them, must have valued the property at \$20,960. After the insolvency of the company, the corporate creditors sought to hold the stockholders personally liable. The Supreme Court of West Virginia found that the market value of the assets of the partnership was around \$11,034 but ruled that the stock was still full-paid and non-assessable because there was no evidence of deceit on the part of the appraisers and because there

reference to a provision in the same section which allows the shareholders to fix the consideration for the issuance of no par shares if that right has been reserved to them in the articles of incorporation. See MO. REV. STAT. § 351.185 (1949).

39. The following statutory provisions contain the words "actual fraud": DEL. REV. CODE c. 65, § 14 (1935); ILL. REV. STAT. c. 32, § 157.18 (1951); IND. ANN. STAT. § 25-205 (Burns 1933); KANS. GEN. STAT. ANN. § 17-3206 (Corrick 1949); ME. REV. STAT. c. 49, § 18 (1944); MO. REV. STAT. § 351.185 (1949); NEB. REV. STAT. § 21-128 (1943); NEV. COMP. LAWS ANN. § 1611 (1929); N.M. STAT. ANN. § 54-319 (1941); N.C. GEN. STAT. ANN. § 55-63 (1943); ORE. COMP. LAWS ANN. 77-238 (1940); W.VA. CODE ANN. § 3040 (1949). Only cases from states which have construed their actual fraud provisions have been included in the text discussion.

40. PROSSER, *op. cit. supra* note 17, at 705.

41. 102 W.Va. 181, 135 S.E. 235 (1926).

42. W.VA. CODE ANN. § 3040 (1949).

was no proof that the creditors of the corporation had been misled because of that valuation.

However, the other states which have or have had sections substantially identical with section nineteen and which have construed them have not taken the West Virginia approach.⁴³ In fact, the Court of Chancery of New Jersey took an almost diametrically opposite view. It has been mentioned above that a good statement of the New Jersey policy with regard to the problem of watered stock is found in the following quotation:

When such differences are brought before judicial tribunals, the judgment of those who are by law entrusted with the power of issuing stock "to the amount of the value of the property" and on whom, therefore, is placed the first duty of valuing the property, must be accorded considerable weight. But it cannot be deemed conclusive when duly subjected to judicial scrutiny. Nor is it necessary that conscious overvaluation or any other fraudulent conduct on the part of the primary valuers should be shown to justify judicial interposition. Their honest judgment, if reached without due examination into the elements of value, or if based in part upon an estimate of matters which really are not property, or if plainly warped by self-interest may lead to a violation of the statutory rule as surely as would corrupt motive.⁴⁴

The existence of the provision that the directors' judgment should be conclusive in the absence of actual fraud was not deemed to have any effect on that rule; indeed, it was considered to be merely declaratory of it.⁴⁵ Thus that court did not deem that that provision even connoted a requirement that the party seeking to upset the directors' valuation prove intentionally

43. The New Jersey actual fraud provision, contained in Section 49 of the New Jersey Corporations Act of 1896, was repealed in 1913. N.J. Laws 1913, c. 15, p. 28. For a discussion of the effect of its repeal on the State of the New Jersey law, see *Bryson v. Conlen*, 104 N.J. Eq. 180, 144 Atl. 723 (1929). On the basis of what was said in that case, it appears that the quotation set out in the text is still the law in New Jersey. Interestingly enough, however, it appears that for pleading purposes at least, the New Jersey courts still require that the party seeking to upset the directors' valuation allege in his petition that there was actual fraud in the transaction. *Sokoloff v. Wildwood Pier and Realty Co.*, 108 N.J. Eq. 362, 155 Atl. 125 (1931).

44. *Donald v. American Smelting and Refining Co.*, 62 N.J. Eq. 729, 731, 48 Atl. 771, 772 (1901).

45. *Holcombe v. Trenton White City Co.*, 80 N.J. Eq. 122, 82 Atl. 618 (1912), *aff'd*, 82 N.J. Eq. 364, 91 Atl. 1069 (1913); see *Easton National Bank v. American Brick and Tile Co.*, 69 N.J. Eq. 326, 329, 60 Atl. 54, 55 (1905).

wrongful actions by the valuers. In addition, the factor of reliance was not even mentioned in the opinions. Such an interpretation meant that although New Jersey under its actual fraud provision had on the surface a "good faith" rule, there was not much difference, so far as the practical effect on watered stockholders was concerned, between it and the Missouri "true value" rule.

The decisions by the Supreme Court of North Carolina on the question of liability on watered stock have been more consistent with the apparent mandate of the actual fraud provision than the New Jersey opinions. Although both states have, by failing to mention the reliance factor, impliedly agreed that it is unimportant, North Carolina has at least required proof of a gross and intentional overvaluation. However, it is arguable that in so ruling the court was not consciously following the actual fraud section. A discussion of two North Carolina cases will serve to point up this incongruity.

The early decision of *Hobgood v. Ehlen*,⁴⁶ although it did not involve the North Carolina actual fraud provision, has become the basic North Carolina watered stock case. There the trustee of a bankrupt Delaware corporation sued the stockholders and promoters of the company, who had gotten their stock in exchange for the assets of a lumber business formerly owned by them. The evidence showed that the directors of the company had been under the control of the defendants and that the consideration for the stock had been grossly and intentionally overvalued. In addition, there had been a secret parol agreement between the defendants and the corporation by which the corporation was to reimburse the defendants for the property conveyed to it; hence, all that the corporation had actually received had been the goodwill of the lumber business. The trial court applied the pertinent Delaware statutory section, which provided at that time that the directors' judgment should be conclusive in the absence of fraud, not "actual fraud." The trial court charged the jury that the word "fraud" meant actual, not constructive, fraud and that thus it required proof of an intent to deceive. The defendants were held liable, the jury having found that they had been so motivated, and one of them appealed on the ground that the above evidence was inadequate to establish such an intent.

46. 141 N.C. 344, 53 S.E. 857 (1906).

The Supreme Court of North Carolina ruled that the "circumstances were amply sufficient to be submitted to the jury on the issue of actual fraud, and warranted their finding."⁴⁷ At the end of its opinion, the court further stated:

Although a margin may be allowed for an honest difference of opinion as to value, a valuation grossly excessive, knowingly made, . . . is a fraud on creditors and they may proceed against the stockholder individually, who sells the property, as for an unpaid subscription.⁴⁸

That assertion has become the North Carolina rule even in cases where the actual fraud provision of that state has been applicable.⁴⁹

Assuming that the North Carolina Supreme Court still feels, as it implied in the *Hobgood* opinion, that the phrase "actual fraud" requires proof of an intent to mislead, the rule that the directors' valuation should be upset on proof of a gross and intentional overvaluation does not seem to be, in spite of statements to the contrary,⁵⁰ inconsistent with such a requirement. It is clear that, excepting the possibility of an admission, the fact of a deceitful intent is going to have to be established by circumstantial evidence, and it has been ruled that such an intent can be raised from evidence that the party making the representation knew that he had insufficient information by which he could justify it.⁵¹ On that rationale, it could be argued that the directors, by having grossly and wilfully overvalued the property, had been motivated by such an intent. The mere fact of the grossness would indicate that the information, if any, that the directors had was insufficient, and the words "knowingly made" or their equivalents would seem to be just another way of saying that the directors knew that they had inadequate information on which to base their valuation.

However, on the basis of *Goodman v. White*,⁵² it could be contended that the Supreme Court of North Carolina would not accept such an argument. There the trustees of a bankrupt corporation had sued a stockholder of the company on an alleged

47. *Id.* at 348, 53 S.E. at 859.

48. *Id.* at 354-355, 53 S.E. at 861.

49. *Goodman v. White*, 174 N.C. 399, 93 S.E. 906 (1917); see *Whitlock v. Alexander*, 160 N.C. 465, 469, 76 S.E. 538, 540 (1912).

50. *DODD, op. cit. supra* note 30, at 60.

51. *PROSSER, op. cit. supra* note 17, at 729.

52. 174 N.C. 399, 93 S.E. 906 (1917).

unpaid stock subscription. The evidence showed a lack of exercise of independent judgment on the part of the valuers of the property and a gross and intentional overvaluation. The trial court gave a directed verdict for the plaintiff, and on appeal the North Carolina Supreme Court, following the *Hobgood* rule, affirmed the action of the trial court. However, when it quoted the applicable statutory provision, the word "actual" was omitted. Does that omission indicate that that court thought that the proof offered was insufficient to establish actual fraud?⁵³ Since that question is not answered, it could conceivably be argued that that was the court's opinion. And yet, on the basis of the above considerations with respect to the probative value of the fact of a gross and intentional overvaluation, it seems that there was really no reason to leave out the word "actual." The result of all this is that there is no definitive ruling by the North Carolina Supreme Court on the issue of how much proof will be exacted *under the actual fraud section*. However, the court has been very clear on how much proof it will require before upsetting the directors' valuation and holding the stockholder liable.

The Court of Chancery of Delaware indicated at a rather early date that it did not equate the phrase "actual fraud" with common law fraud. In *Ellis v. Penn Beef Co.*⁵⁴ a stockholder of a corporation brought a bill in equity to have cancelled the shares of two other stockholders and to have a receiver *pendente lite* appointed. The Chancellor heard the case on the issue of why a receiver should not be appointed. The facts before the court showed that the other two stockholders, who had been incorporators of the company, had gotten their shares by virtue of an agreement under which they were to convey a lease and some personal property to the company in payment for their stock, the par value of which was \$20,000. The directors, who were controlled by these two stockholders, had valued the aggregate consideration at \$20,000, but the fact was that the defendants had

53. It should be noted that the present North Carolina statutes contain two provisions concerning the conclusiveness of the directors' judgment on the issue of valuation. One says that their judgment shall be conclusive in the absence of fraud. N.C. GEN. STAT. ANN. § 55-62 (1943). The following section says that their judgment shall be conclusive in the absence of actual fraud. N.C. GEN. STAT. ANN. § 55-63 (1943). The provision referred to in *Goodman v. White*, 174 N.C. 399, 93 S.E. 906 (1917) was the predecessor of the present actual fraud provision.

54. 9 Del. Ch. 213, 80 Atl. 666 (1911).

failed to give the real consideration for which the shares had been issued to them. However, it was also established that the complainant had had notice of the way in which defendants had gotten their stock. The court ruled that that fact was not conclusive against him and then went on to discuss the application of the Delaware actual fraud provision⁵⁵ as follows:

If all the then stockholders join in an action by the company by its officers and directors, in issuing part of the capital stock for something which does not exist and which they never furnish to the company, it is an "actual fraud" though no one be then deceived or injured. There is fraud towards the state, which in effect has prohibited such transactions. No pretended exercise of judgment can say that something which has no existence has value. There is possibly an actual fraud against the stockholders who subsequently acquired shares then unissued.⁵⁶

The decision on the effect of the fact that complainant had had notice is completely contrary to any idea of reliance.⁵⁷ In addition, it seems difficult to say that the language of the quotation imports that the court felt that an intent to deceive was part of the meaning of actual fraud.

However, a somewhat different view was taken in the comparatively recent case of *Diamond State Brewery, Inc. v. de la Rigaudiere*.⁵⁸ There the corporation was suing to cancel the defendants' stock, the aggregate par value of which was \$81,250. Although the directors had valued at that amount the formula which had been given for the stock, the fact was that the formula had no substantial value. In addition, there was evidence of a partial failure of the consideration. The court ruled that although a showing of an excessive valuation was not sufficient to overcome the conclusiveness of the directors' judgment, that factor could be considered in connection with other circumstances from which fraud could be inferred. Thus, since there was coupled with the fact of gross overvaluation the fact of the partial failure of the consideration, the court upset the directors' appraisal and allowed the cancellation. It based its decision on the Kentucky case of *McCoombs Producing and*

55. DEL. REV. CODE c. 65, § 14 (1935).

56. *Ellis v. Penn Beef Co.*, 9 Del. Ch. 213, 219-220, 80 Atl. 666, 668 (1911).

57. BALLANTINE, *op. cit. supra* note 6, § 350.

58. 25 Del. Ch. 257, 17 A.2d 313 (1941).

Refining Co. v. Ogle,⁵⁹ which also involved the Delaware actual fraud section. In that case the following statement was made:

That actual fraud or intentional wrongdoing may be and often is proved by or inferred from circumstances is an established principle, and that inadequacy of consideration may be considered in connection with other facts from which fraud may be inferred is also well settled.⁶⁰

In the *de la Rigaudiere* case, the Delaware court also said:

The issuance of stock as full paid for a consideration never delivered to, nor acquired by the corporation constitutes "actual fraud" within the meaning of Section 14 of the Delaware Corporation Law. *Ellis v. Penn Beef Co.* . . . Indeed, the circumstances of this case [the *de la Rigaudiere* case] point to the conclusion that the resolutions and dealings with respect to the formula and equipment were nothing more than a veil to hide the issuance of shares without consideration.⁶¹

The statement to the effect that the issuance of stock as full paid for a consideration never acquired by the corporation constitutes actual fraud does not seem to refer to proof of an intent to deceive. The fact, however, that the court based its decision on the *McCoombs* case in addition to the general emphasis of the opinion indicates that it now considers the phrase "actual fraud" to refer to proof of such an element.

Guides to possible interpretations of the Missouri actual fraud provision may also be found in the pronouncements of the Supreme Court of Missouri in past watered stock cases in which the phrase or its equivalents were used. It will be recalled that that court rejected the contention that an intent to deceive must be established before the watered stockholder could be held liable. However, the wording of the discussions of that contention indicates strongly that the court felt that an intent to mislead was an essential element in the meaning of the words "actual fraud." Thus in *Van Cleve v. Berkey*⁶² the following extract from the opinion of the lower court was adopted as a fair statement of the case:

The evidence shows that all of the defendants acted in good faith, so far as their actual intentions were concerned, and

59. 200 Ky. 208, 254 S.W. 425 (1923).

60. *Id.* at 214, 254 S.W. at 428.

61. *Diamond State Brewery, Inc. v. de la Rigaudiere*, 25 Del. Ch. 257, 264, 17 A.2d 313, 317 (1941).

62. 143 Mo. 109, 44 S.W. 743 (1897).

that none of them was moved by any actual fraudulent intent in the transaction.⁶³

Later on in the same opinion the court noted that the counsel for the defendant-appellants (the watered stockholders) contended that judgment should have been for them:

. . . for the reason that it is not alleged in the petition, nor shown by the evidence, that the stockholders, in capitalizing the Braun invention . . . and issuing therefor full paid and non-assessable stock . . . actually intended to defraud creditors of the corporation or purchasers of its stock. . . . In other words, the contention is that as the corporation could receive property in payment for its capital stock, and did in fact accept the valueless Braun invention in full payment thereof, in the absence of actual fraud upon the part of the incorporators, charged and affirmatively proven aliunde the transaction, the appellants' stock, as to the creditors of the corporation, was fully paid for, and they should have had judgment.⁶⁴

Although the court then went on to reject the contention that, because the defendant-stockholders had been in good faith, they were not liable, such statements are helpful, for present purposes, to show what that tribunal felt that the phrase "actual fraud" connoted.

It will be noted that the element of justifiable reliance was not mentioned in the statements just quoted. However, it could be argued that that fact should not be given too much weight since the requirement of reliance, if there had been such a requirement in Missouri at the time that those assertions were made, was presumed to be satisfied and thus the court would not have felt the need to say expressly that that factor was also inherent in the meaning of the phrase. Consequently, it seems possible that the Missouri Supreme Court could require proof of both an intent to deceive and justifiable reliance and still be consistent with its prior statements.

Finally, there are the Oregon decisions on that state's counterpart to section nineteen. The construction represented by those cases differs from the above interpretations in that in it the meaning of the other words in the section have been stressed. A

63. *Id.* at 117, 44 S.W. at 744.

64. *Id.* at 119-120, 44 S.W. at 744-745. To the same effect, see the quotation in the preceding section from *Berry v. Rood*, 168 Mo. 316, 67 S.W. 644 (1902).

case in point is *Atwell v. Schmitt*.⁶⁵ Plaintiff there was a corporate creditor seeking to enforce defendant's liability on allegedly unpaid stock. The facts showed a gross overvaluation; two hundred thousand dollars' worth of stock had been issued to the promoters as fully paid in exchange for options on which they had expended four hundred dollars. The facts also indicated a personal interest of the directors in the overvaluation and lack of an exercise of independent judgment by the directors in their appraisal. In ruling for the plaintiff, the court pointed out:

The judgment of the directors of a corporation upon the value of property or stock to be taken and accepted by the corporation in exchange for its own stock . . . , the exercise of which, when acted upon, is made conclusive by statute, refers to an honest attempt to determine the value of the property or stock by a board of directors representing the corporation alone and . . . anxious to secure for the corporation all that it is justly entitled to. Anything less than that is dishonest and fraudulent. The directors may be honestly mistaken. They may exercise poor judgment and make a very poor bargain, but this is wholly immaterial so long as they have no personal interests of their own to further and act fairly and honestly by the corporation they profess to represent.⁶⁶

The court then went on to rule that since the directors had been personally interested in the transaction and since there had been a gross overvaluation of the consideration, there had been no such exercise of judgment by the directors as was intended by the statute and that thus their appraisal was not conclusive.⁶⁷ It

65. 111 Ore. 96, 225 Pac. 325 (1924).

66. *Id.* at 106, 225 Pac. at 328. Dictum from the Maine case of *Mason v. Carrothers*, 105 Me. 392, 404, 74 Atl. 1030, 1035 (1909) indicates that Maine has taken an approach similar to that of Oregon on this issue. For an argument in favor of adopting an interpretation similar to that of Oregon, see Wallstein, *The Issue of Corporate Stock for Property Purchase—A New Phase*, 15 YALE L.J. 111 (1906).

67. A parallel approach was taken in the Delaware case of *Cahall v. Lofland*, 12 Del. Ch. 299, 114 Atl. 224 (1921), *aff'd*, 13 Del. Ch. 384, 118 Atl. 1 (1922). There the receiver of a dissolved corporation brought suit to recover from the officers and directors of the company and others property of the corporation improperly disposed of by the officers and directors. Part of this property improperly disposed of was ninety shares of the corporation's stock which the directors had issued to themselves for services rendered in organizing the company and selling its stock. The court ruled that as regards these ninety shares, the directors' action was constructively fraudulent on the other stockholders because there was no express or implied contract on the part of the company to pay for the "services." There was no such contract because the defendants had not been the proper officers to make it for the corporation. To the defendants' contention that the valuation of the issuance cannot be avoided on the grounds of constructive

should be mentioned that there were indications in the opinion that the court felt that the two factors referred to above conclusively established fraud, but the emphasis in that opinion as well as in later Oregon decisions was on the idea that a legal judgment had not been exercised.⁶⁸

What are the relative merits of these various constructions? The West Virginia interpretation is most consistent with the common law conception of fraud. However, it is wondered whether its adoption would work justice in the watered stock situation. Even disregarding the problem of establishing deceit, the creditor would have considerable difficulty in establishing that he had actually relied on the professed capital of the company before extending credit to it. Present day businessmen require much more assurance that the debtor corporation will be able to repay than merely the amount of its ostensible capital.⁶⁹ The possible result of following that construction would be a shift from a situation where in nearly all the cases the watered stockholder is held liable to one where in only a very few cases would he be held accountable. In view of the established Missouri theory of almost strict liability on watered stock, it is doubtful whether the Supreme Court of this state would be willing to accept the possibility of such a great change.

In addition, there are two reasons which militate against the adoption of the New Jersey definition of the phrase even though that interpretation in effect comes very close to the "true value" rule. One is that such a construction is, to say the least, far removed from the elements generally associated with the fraud concept.⁷⁰ Furthermore, the Missouri Supreme Court has in past used the label "actual fraud" in a way that clearly evidences

fraud because of the "actual fraud" provision in the statute, the court answered that these defendants, being personally interested in the transaction, were wholly incompetent to represent the corporation in the transaction and were not "directors" within the meaning of that term as used in the provision. Thus, instead of making the meaning of the phrase "actual fraud" determinative of the outcome, the Delaware court in the above case made the decision on that issue turn on the legal significance of the term "directors."

68. *Compton v. Perkins*, 144 Ore. 346, 24 P.2d 670 (1933); *Rugger v. Mt. Hood Electric Co.*, 143 Ore. 193, 20 P.2d 412 (1933).

69. Ballantine, *supra* note 15, at 90. See *Merchants' and Mechanics' Savings Bank v. Belington Coal & Coke Co.*, 51 W.Va. 60, 79-80, 41 S.E. 390, 398 (1902).

70. See Wickersham, *The Capital of a Corporation*, 22 HARV. L. REV. 319 (1909).

that that court deemed an intent to deceive an inherent feature of the concept that that label represents. The use of the New Jersey construction would involve the disregard of those pronouncements.

Since the North Carolina Supreme Court has not indicated clearly what it considers the phrase "actual fraud" to signify, it would be misleading to say that the decisions of that court constitute another possible interpretation of the provision. However, the uncertainty connected with the North Carolina approach does not much matter because the issues discussed in the North Carolina opinions, as distinguished from the actual decisions, suggest a construction like that of Delaware, *i. e.*, that the words "actual fraud" do not require proof of reliance on the valuation by the party seeking to upset it but that they do require proof of an intent to deceive on the part of the valuers. The adoption of such an interpretation would force the Missouri courts to determine how much and what type of evidence will be required before an intent to deceive may be legally inferred. Should evidence of a gross and intentional overvaluation be sufficient to take the case to the jury on the issue of actual fraud, or should other circumstances be required? Such decisions will not be easy ones to make since they will involve the weighing of the probative value of circumstantial evidence. On the other hand, such a construction would have merit in that it would be consistent with prior statements of the Supreme Court of Missouri on the issue of the meaning of actual fraud.

Finally, the Missouri Supreme Court could construe section nineteen in the manner that the Oregon Supreme Court has interpreted the Oregon counterpart. That construction may be recommended because under it the same evidentiary factors could be used to upset the directors' valuation and still their use would not raise any question with regard to whether the court was leaning over backwards to reach a desired result. No matter how one may view the probative value of a gross and intentional overvaluation on the issue of actual fraud, that circumstance is strong evidence that the directors have not exercised a business-like judgment. However, such a construction does not seem to be in line with the spirit of the provision. If all that the legislature had desired when it passed this section was that the directors should exercise a legal judgment in the valuation of the

property, it seems difficult to perceive why the phrase containing the words "actual fraud" was included. That factor is the one great drawback of the Oregon interpretation.

In summary, it is submitted that, taking all aspects of the problem into consideration, the adoption by Missouri of an interpretation to the effect that the words "actual fraud" require proof of an intent to deceive in the valuation but not of justifiable reliance on that valuation would be the most advisable course to take. Admittedly, it will be hard to determine the quantum and type of evidence that will be expected in order to prove an intent to deceive. However, such a course does not carry with it such a propensity for radical change on the important issue of the frequency of liability on watered stock as does the West Virginia approach. Furthermore, the recommended interpretation not only is more in line with the clear meaning of the provision than either the New Jersey or Oregon constructions, but it also is more consistent with the past statements of the Supreme Court of Missouri on this subject.

CONCLUSION

With the enactment of section nineteen, it is clear that the law of Missouri has been altered on the issue of how much proof will be required of the party who seeks to hold a stockholder liable on the ground that his stock is watered. Whereas the fraud element under the "true value" rule was deemed immaterial, the complainant in the future will have to establish actual fraud in the transaction before the directors' valuation of the consideration will be upset. On the question of possible interpretations, the best alternative appears to be that the phrase "actual fraud" requires proof of an intent to deceive in the appraisal but not proof of justifiable reliance on that appraisal. On the issue of how to prove such an intent, it has been pointed out above that it could be argued that evidence of a gross and intentional overvaluation is alone sufficient to establish actual fraud. However, the Missouri courts may require more evidence than that. In any event, it will be interesting to see what course they do take with regard to this problem.

A. E. S. SCHMID