

PHILIPPINE LAW JOURNAL

Vol. XVII

SEPTEMBER, 1937

No. 3

THE LEGAL ASPECTS OF THE BONUS STOCK IN A CORPORATION

By AMBROSIO D. Go *

CHAPTER I

NATURE OF BONUS STOCK

a. DEFINITION

"The term 'bonus stock' is used to describe stock issued gratuitously to those who purchase or subscribe for stock of bonds of a corporation as additional inducement to them to make their purchase or subscription." (Elliot, *Law of Private Corporation*. 5th ed. sec. 306.)

"Bonus stock is that issued gratuitously, but as an inducement, rather than as a gift. The term is sometimes applied to shares of stock that are actually donated, but strictly speaking, it designates stock offered as an inducement to the purchasers either of bonds or loan money or other stock of a corporation." (4 *Thompson, Corporations*. 2nd ed. sec. 3444.)

Strictly, as may be deduced from the above exposition of the nature of a "bonus stock", it is gratuitously given as an inducement for an investor to purchase either a bond or stock of the corporation or to loan money to the same. Indeed, the bonus stock is a strong inducement to one who want to invest his money in a corporation; for a share of stock does not only represent the investment participation of the holder thereof, but it also carries with it certain participation and rights in the management of the affairs of the corporation, as, the voting power, the right to inspect the books of the corporation, the right to receive dividends, etc. Thus if one buys bonds from a corporation he shall—if "bonus stock" is issued with the bonds so purchased—have ample protection to safeguard his interest, for he shall be able to express his voice in the management of the corporation due to the fact that his "bonus stock" carries with it the right to so express his ideas in the management of the business of the corporation. Thus, the method of issuing bonus stock attract investors in a corporation is a very effective

* LL.B., University of the Philippines.

one for a dwindling corporation to easily secure fund with which to carry out its financial enterprise, as: the expansion of its business, the meeting of debts that are becoming due, the construction of buildings, the purchase of necessary machinery and equipments, etc.

b. ADVANTAGE OF THIS METHOD OF FINANCING

There are of course various methods with which a corporation may raise money to meet its financial difficulties, such as: the mortgaging of its property, the issuance of promissory notes, the issuance of different kinds of bonds, the selling of its unissued or treasury stocks, the solicitation of donation from its stockholders, etc. But from the point of view of a continuing corporation, the issuance of "bonus stock" as an inducement to the investor to invest his money in the said issuing corporation has more advantages than other methods of financing. It accomplishes its main objective easily i.e. the raising of funds, and secondarily secures the continued stability of the concern. As may be illustrated, one who buys the bonds of a corporation or who loans money to the corporation and receiving "bonus stock" together with the evidence of indebtedness of the corporation shall have more interest in the continued existence of the corporation, for he has a further interest in the said corporation aside from his money loaned, that is he expects to receive dividends on his "bonus stock." But one who did not have "bonus stock" for his money loaned to the corporation has but one primary objective, that is, to collect his money loaned when it becomes due. Thus the latter may always press for the payment of his money loaned irrespective of business circumstances, even to the extent of causing the insolvency of the concern and ultimately in the death of the legal person. While the former may not always press hard for the payment of his money loaned, for he is just as well interested in the continued existence of the corporation as the founders of the same, due to his stock in the form of a bonus which make him a part owner in the corporation. He has that feeling that the failure of the concern will reflect to his business capabilities; he may, therefore, instead of harrassing the corporation, extend the collection of the debt, and may even co-operate in the solution of the business difficulty of the concern to assure its continued existence. It

is but apparent when one becomes a member of an association, he would do his best to uplift the interest of the same, than hope for its downfall.

On the other hand, the corporation may finance its needs by mortgaging its properties. But this method of financing is more hazardous, for in the event of the failure of the corporation to meet the due obligation, the death of the legal corporation is assured by the foreclosure of the mortgage. It is therefore readily seen that this is not a very desirable method of financing a business enterprise to meet its financial difficulties.

The selling of the unissued or treasury stock of a corporation is however the best, but common sense will tell us that nobody would be interested in investing his lifetime savings in a dwindling concern, unless there is some inducement to counterbalance the hazard he would encounter in his investment. Then the "bonus stock" may serve as the counterbalancing factor, which may be analogous to any handicap given to an opponent in a game to encourage him to try the venture.

Thus after exposing the above probabilities, one may be convinced that the issuance of "bonus stock" as an inducement for an investor is quite justified.

c. DISTINCTION BETWEEN BONUS STOCK, WATERED STOCK AND FOUNDERS' STOCK

"If shares have been issued by the corporation as full paid, when in fact it has intentionally or knowingly received or agreed to receive nothing at all for them or less than their par value, either in money or in property or services, the shares are said to be "watered" or "fictitiously paid up" to the extent to which they have not been or are not to be paid for." (5 Fletcher on Stock Corporation, sec. 3518.)

"Watered stock or fictitiously paid up stock is stock which is issued as fully paid up stock, when in fact the whole amount of the par value thereof has not been paid in. All stock which has been issued as paid up stock, but the full par value of which has not been paid into the corporation in money or money's worth is watered to the extent that the par value exceed the value actually paid in. Watered stock is, accordingly, stock which purports to represent, but does not represent in good faith, money paid into the treasury of the corporation, or money's worth actually contributed to the capital of the concern to the extent of the par value of the stock." (1 Cook, Treatise on the Law of Corporation, sec. 28.)

The historical origin of this term arose when a cattle rancher who was very far from the town wanted to sell his herd of cattle. But while on his way to town, due to the distance and the scanty food for the herd, the cattle lost in weight.

So upon passing a stream before reaching town, he made the cattle drink plenty of water in order that they may gain in weight, thus the term "Watered Stock" or "Watering the Stock" is used whenever a corporation fictitiously represent that the stock it has issued has been fully paid up when in fact it has not or been partially paid only.

From the nature of the "watered stock" it is entirely different from a "bonus stock." This difference as we shall see hereafter is also manifested in the holdings of judicial decisions. The issuance of a watered stock carries with it the *element of fraud*, either upon subsequent investors or creditors of the corporation, while the bonus stock does not have such fraudulent misrepresentations, but rather serves as a mere *inducement* for investors to buy the bonds or stocks of the corporation or loan money to the corporation. This distinction is of primary importance, for many students of law often confuse one for the other.

To have a clearer idea of a "watered stock" let us then see in what ways it is issued.

"It may be issued gratuitously (1) under an agreement that nothing at all shall be paid into the corporation therefore; or it may be issued (2) upon payment of less than its par value in money or for cash at a discount; or it may be issued in (3) payment of property, labor or services, the value of the property, labor or services being known to be less than the par value of the shares; or (4) it may be issued in the guise of a stock dividend, that is, issued to stockholders as a dividend representing surplus profits or an increase in the value of the property when there are not sufficient profit or sufficient increase in the value to justify it." (5 Fletcher's on Stock Corporation, sec. 3518.)

With this clear distinction in mind between a "watered stock" and a "bonus stock" we shall then proceed to distinguish the latter with the so called "Founder's Stock." This kind of stock is commonly issued in England.

It is "such stock as is issued to promoters or founders of a corporation, commonly used as compensation to the promoters, or to others who have given their names and influence in putting the corporation on its feet." (4 Thompson on Corporations, 2d ed., sec. 3440.) This kind of stock is analogous to the so called "promotion stock" in American law. "A promoter is a person who brings about the incorporation and organization of a corporation. He brings together the persons who become interested in the enterprise, aid in procuring subscriptions, and sets in motion the machinery which leads to the formation of the corporation itself." (Cook on Corporation, sec. 651.)

Thus a "promoter's stock" as its name implies is not issued as *fictitiously paid* in full or in part, nor is it issued as an *inducement* to investors. It is rather issued as a *compensation* for services rendered, and for this reason most states of the United States recognize and uphold the validity of its issuance, in the absence of fraud; it was held in one case; "Promoters are allowed reasonable compensation for their services", *Chaffe v. Bakley*, 141 Iowa 344; so it was also held: "Stock can be issued for services rendered in promotion and organization to a reasonable sum agreed on all holders having knowledge of it." *Fritzpatrick v. O'Neill*, 118 Pac. 273.

The distinctions as exposed must be always kept in mind, for others take bonus stock as synonymous and the same as watered stock, thus when watered stock is held by courts as fraudulent and unlawful they think that the holding also apply to bonus stock which is not so by the very difference in their nature and purposes.

CHAPTER II

LEGAL ASPECTS OF THE BONUS STOCK

a. LEGAL PROVISIONS REGULATING BONUS AND WATERED STOCK

1. Sec. 28 of the Jones Law provides:

"That all franchises or rights granted under this act shall forbid the issue of stock or bonds except in exchange for actual cash or for property at a fair valuation equal to the par value of the stock or bond so issued."

This provision of the Jones Law is not repealed by the Act of Congress, No. 127 or the Tydings-McDuffie Law as provided, by necessary implication in its Sec. 15.

It must be noted, however, that the above provision of the Jones Law only covers *Public Utility* companies as evidenced in the first paragraph of said Sec. 28 which provides, "That the Government of the Philippine Islands may grant *franchise* and *rights*, * * * for the construction and operation of works of *public utility and service*." Thus it governs only those companies which are engaged in public service, so we must then inspect other statutory provisions which cover ordinary business concern on their issuance of stocks.

2. Under Sec. 16 of our Corporation Law, Act 1459, it is provided that:

“* * * no corporation shall issue stock or bonds except in exchange for actual cash paid to the corporation or for property actually received by it at a fair valuation equal to the par or issued value of the stock or bonds so issued; * * *, or for profit earned by it, but not distributed among its stockholders or members.

To have a clear interpretation of our statutory provision we must first inspect similar provision of American States constitution.

The Constitution of California in its Art. 12, Sec. 11 it provides:

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

The Supreme Court of California said in discussing the case of California Trona Co. v. Wilkinson, 130 Pac. 190, that

“Said provision means to prevent the disposal of the stock by the corporation without sufficient consideration in money, property or labor, but where there is a consideration of *some sort*, and the transaction is intended for the benefit of the corporation in the prosecution of the purposes, the consideration is sufficient, though not equal in the value of the stock.”

Provisions in the Constitutions of other states similar to those involved in the above case have been considered by the Supreme Court of the United States, and thus been uniformly held not to mean that the consideration should always be equal to the par value of the stock or bonds so issued”; the word equal is a *real one*, based upon a *present consideration*, and having reference to *legitimate corporation purposes*, it is valid. Memphis Railroad v. Dow, 120 U. S. 287; Grant v. East & West Railroad Co., 54 Fed. 569; Nelson v. Hubbard, 96 Ala. 238; Speer v. Borduleau, 79 Pac. 332; Fogg v. Blair, 139 U. S. 118; Ecuadorian Ass. v. Ecuador Co., 65 Atl. 1051.

While the Oklahoma constitution in its Sec. 39, Art. 9, it provides:

“No corporation shall issue stock except for money, labor done, or property actually received *equal to the amount of the par value thereof*, and all fictitious increase of stock or indebtedness shall be void.”

The Court in interpreting the above provision in the case of Lee v. Cameron, 169 Pac. 17, said:

“It prohibits the issuance by the corporation of watered stock or fictitiously paid up stock, and a sale of the shares of stock by the corporation for

money labor done, or property actually received *less than the par value of said stock* is in violation of said constitution and the stock so issued is void."

The court even went to the extent of declaring said stock void even in the hands of subsequent holders in good faith. The reason given by the court is that it is like a stock issued in excess of the amount provided in its articles of incorporation. I think this latter view of the court with respect to the nullity of the stock in the hands of a subsequent purchaser is so drastic and so sweeping in that it did not take into account the protection that the investing public ought to have when they invested their money in good faith. Of course, according to the trends of opinion, notwithstanding the presence of the same provisions in their constitution as the one involved herein, most courts put more regard to the protection of a subsequent purchaser for value and in good faith, by declaring that the stock is valid in the hands of said subsequent holders. This latter view is more in accord to the very purpose of all these laws, that is, for the protection of an innocent purchaser from fraud.

(a) *Autopsies of Sec. 16 of our Corporation Law, Act No. 1459.*

After inspecting the two extreme holdings of American courts in accordance to the spirit of their laws, we shall now, so to say, have a legal autopsy of our own law. The said section 16 of Act 1459, for the sake of clarity, is again to be quoted, it provides:

"* * * and no corporation shall issue stock or bonds except:

"(1) In exchange for actual cash paid to the corporation or for property actually received by it at a fair valuation equal to the par value of the stock or bonds so issued, * * *.

"(2) Or for profit *earned* by it, but not distributed among its stockholders or members."

The first part of statutory provision is clear and for that reason, we must adhere to the holding of the court in interpreting the Oklahoma constitutional provision in the case of *Lee v. Cameron*, (supra), that is stocks must only be issued after the actual payment in money or delivery of property at a fair valuation to the corporation in amount equal to the par value of the stock so issued. That is, a newly organized corporation upon issuing for the first time its subscribed stocks (not treasury stocks) it must not issue them less than their par value in cash or property. Because our law as that of the Oklahoma provision says "equal

to the par value of the stock or bonds so issued"; the word equal is so definite and explicit that it admits of no other interpretation.

As to the second part of the statutory provision it regulates the issuance of stocks by the corporation among its stockholders as "Stock Dividend". The provision says, "for profits earned", what does "profits earned" means. Does it mean the amount appearing in the "Surplus" account of the corporation. Certainly not, it rather means profits that has been actually realized or received by the corporation in the form of money. To elucidate the point to the reader, I shall give two cases where by the mere manipulation of the accounts, the books will show an increase profit or surplus which has not been actually realized by the corporation. These cases are the ones often resorted to by business concerns to show that they have a big surplus account.

(1) By the increase of their fixed assets. This is effected when the value of land or other assets increase in assessment value or its selling value has risen up. Some companies will debit their corresponding fixed asset account as land, and credit the Surplus account. Under the law, we are now discussing, this increased amount cannot be declared as stock-dividends for it is not earned profit; and to do so would be watering the stocks.

(2) The partial or total failure to provide for the necessary depreciation reserves or obsolescence of the corporate assets in the corporation books. We know that almost all things, due to the lapse of time and by their constant use, they lost in value. The failure to deduct the corresponding depreciation reserved for the assets so affected will naturally show an increased amount of Surplus than would have been if the said reserve has been created on the books, and this increased amount of the Surplus cannot be legally declared as Stock dividend, for it is not earned profit.

We must now lay ourselves content of these two examples, due to the lack of necessary space for discussion, tho there are more other ways by which a corporation can easily show thru its books that it has big surplus ready for distribution as dividends than it really ought to have by the mere manipulation of its accounts.

With the above discussion, we have seen as to what kind of stock dividend is prohibited by the second part of Sec. 16 of Act No. 1459. Because a stock dividend declared by the corporation out of surplus not actually earned by the corporation

is a mere watered stock. This is also given by Fletcher as one of the ways of issuing a watered stock in which he says:

"It (watered stock) may be issued in the guise of a stock dividend representing surplus profits or an increase in value of the property where there are not sufficient profit or sufficient increase in the values to justify it, (supra)."

The reason, as already pointed in our previous discussions, why this is prohibited, because by the misrepresentation of showing that it is making a big profit than it actually does, investors and lenders of money as banks will be led to extend the loan or make investments therein, which they might not do if they knew the actual facts, thus it is fraudulent. And this is the very spirit of the law, "to prevent fraud".

At first blast it may seem, under the above provision of law, that whatever is held by our judicial tribunals about the legality or illegality of the issue of a "watered stock" holds true also to "bonus stock." But this is not the case, for at the very outset of this work it was purposely shown the difference of a "watered" and "bonus" stock, and it is for this difference that a declaration of nullity of a watered stock does not mean that said declaration holds true to bonus stock also. This fine distinction is so illuminatingly discussed in *Handley v. Stutz* (infra).

b. VALIDITY OF "BONUS STOCK" TO ORIGINAL HOLDERS

1. *With the Issuing Corporation*

As to the validity of the "watered stock" between the original holder and the corporation, some American courts have upheld its validity, giving as reason that the corporation itself is the judge to determine the sufficiency of the consideration for the stock so issued. This principle has been upheld in *First National Bank of Deadwood v. Austin Minerva Con. Min. Co. et al.*, 44 N. W. 198; *California Trona Co. v. Wilkinson*, 130 Pac. 190; *Shaw v. Straight*, 107 Mich. 152; *Christensen v. Eno*, 106 N. Y. 97; *Scovill v. Thayer*, 105 U. S. 143; *Southworth v. Morgan*, 205 N. Y. 293. But the fallacy of this holding is so manifest, that it tends to defeat the very purpose of the law to protect the investors from fraud.

Notwithstanding the further provision of Sec. 16, which provides:

"Any officer of any corporation consenting to the issuance of stock or bonds in exchange for property valued in excess of its real fair value

* * * shall be severally and jointly liable to the corporation and its creditors for the difference of the real present cash value of the property at the time of the issuance of the stock and the issued or par value of the same”.

The watered stock so issued as between the corporation and the original holder must be declared void. The above quoted provision provides only the remedy in case the watered stock issued has already passed in the hands of an innocent purchaser; and in that event the officers who have consented to or knowing it to have been issued have failed to object in writing, are held liable. The above provision does not by implication consider that the watered stock is valid as between the corporation and the original holder. Our law is clearly prohibitory in saying:

“No corporation shall issue stock or bonds except in actual cash paid to the corporation or for property * * * equal to the par value or issued value of the stock or bond.”

Now, may a “Bonus Stock”, under the spirit and purpose of our law, be also declared void *ab initio* as between the corporation and the original holder? Bearing in mind that the purpose of the law is to prevent fraud, then if the corporation had agreed to certain persons, who in order to loan money to the same, to issue stock gratuitously as bonus. Is this bonus stock as between the original holders and the corporation void? In the case of *Dickerman v. Northern Trust Co.*, 176 U. S. 181, it is said:

“A declaration that shows of stock issued as bonus to purchaser of bonds are fully paid up and unassessable is conclusive in favor of the holders as against the corporation and its stockholders, when the right of creditors are not involved.”

This holding was also intimated in *Handley v. Stutz* (*infra*); *Dummer v. Smedley*, 68 N. W. 260; *Allenhurst Park Estates, Inc. v. Smith*, 138 Atl. 709. The court in holding such a principle, reasoned, in substance, that under the circumstances, the issue of the bonus stock was even for the benefit of the corporation and the stockholders, for the purchasers of the bonds were materially induced to purchase the bonds of the corporation due to the gratuitous issue of the bonus stock; thus upon realizing the benefit of the loan, the corporation must be bound to the terms of its contract.

This holding is clearly very equitable for the stocks are not issued due to any material or monetary consideration, but that they are issued of a consideration that is intangible, i.e. the con-

fidence reposed by the investors on the corporation which is on the verge of financial ruin; the bonus stock are issued not only as a sort of inducement but also, at the same time, as gratification for the salvation given to it by the lenders from its impending bankruptcy. Can we ever condemn one who willingly acknowledged and gratified the favor given to him by donating in good faith a part of his property to said saver, or one who on ground of the offer he is induced to save another from ruin, which the latter absolutely needs? Certainly we cannot blame nor condemn the one or the other; for the one who needs the help must rather be encouraged to legitimately stand on its feet again rather than be forcefully held down to sink deeper and deeper to its ruin; while the other who extended the help must naturally be rewarded in his valiant effort to help, even to the extent of ruining himself, his comrade to stand stably again on its feet.

2. *With the Other Stockholders*

As to the validity of a "watered Stock" between the original holders and the other stockholders, we must take into account the participation or non-participation of the complaining stockholder. Under our law if the stockholder or officer of the corporation had consented or not having consented or simply had knowledge of it, yet he did not thereby express his disapproval in writing shall be jointly and severally liable to the corporation and its creditors. Thus under this provision he is estopped to complain, but instead he is also jointly and severally held liable with the others who also consented to the issuance of the watered stock for the deficiency of the value of the property exchanged and the par value of the stock. This doctrine has been upheld in the case of Ricard Hanlon Co. v. Miss. Valley Co., 158 S. W. 359.

But suppose he did not have any knowledge of its issue, can he complain as against the original holder of the watered stock? The law is explicit and clear, he has every right to file his complaint in due time to have the stock so issued cancelled for the issuance of the watered stock is fraudulent to his rights in the corporation.

The said stockholder who did not participate in the issue of the watered stock can have the said stock cancelled, so long as the rights of creditors subsequent to the issue of the watered stock are not affected neither has it passed in the hands of

subsequent holders in good faith; and for this reason he has to bring his action within a reasonable time before the rights of the aforesaid persons have accrued. The reason for this is, as we have discussed before, Sec. 16 says that no corporation shall issue stock * * * except for property actually received by it at a fair valuation equal to the par of the issued stock; and we have said that the watered stock so issued is, under our law void ab initio.

But if the watered stock has already passed in the hands of subsequent purchaser in good faith, the stockholder who did not participate can bring on action in behalf of the corporation against the officers who consented to the issue of the watered stock, and also against the original holders to pay the deficiency of the property exchange for the watered stock. The reason why he can no longer have the stock cancelled, because equity protects the subsequent holder in good faith and it is for this very purpose that provisions like the one we are now discussing are enacted. So, since he can no longer have the watered stock cancelled in the hands of a subsequent holder in good faith and for value, Sec. 16 provides the remedy in declaring that the officers who agreed to the issue of the watered stock in exchange of property shall be liable for the deficiency to the corporation * * *. By this provision the corporation could not itself bring the action, for the officers of said corporation would not certainly bring the action against themselves. So the stockholders who did not participate in the issue of the watered stock could bring the action in behalf of the corporation. For it is a well established principle that stockholders can bring an action in behalf of the corporation when the action is against those persons who are the ones empowered to bring the action.

Now what is the validity of an issued bonus stock as between the original holder and the other stockholders. This point has been decided in the case of *Dickerman v. Northern Trust Co.*, 176 U. S. 181, that:

"A bonus stock given to purchaser of bonds as an inducement to such purchaser, and if done in good faith, will not entitle *dissenting* stockholders to have a deduction upon the par value of the stock made from such bonds."

It was also held in *Dummer v. Smedley*, 68 S. W. 760 that:

"Where the corporation was embarrassed and it was found difficult to raise money on a second mortgage, and a large portion of this stock was given to certain persons in consideration of the advance of a large sum of

money on the said mortgage, the other stockholders and creditors are not in a position to question either the right of the corporation to increase its capital stock or to sell or pledge such bonus stocks to raise money for the legitimate purpose of the corporation."

By these common law principle, one for whose benefit the financial help is extended is precluded and cannot be allowed to disavow the help and be allowed to retake the consideration for such monetary help after he has taken full advantage of the help so extended. To allow him so would be clearly inequitable and against justice. Therefore, for the aforesaid reason, a stockholder who either agreed or not to the issuance of a bonus stock which was so created for the good of the corporation is by the common law rule precluded to complain against the original holders of said bonus stock. It must be noted that the stockholder is the one primarily benefited for the loan, because by such loan the corporation shall have a chance to financially improve again.

3. *With the Creditors of the Corporation*

Notwithstanding the fact that under our law the issue of a watered stock is void as between the original holder and the corporation, yet by the strict rule of the common law such an issued watered stock is considered valid in favor of the creditors of the corporation even the said watered stock is in the hands of the original holder. So that in the event of insolvency of the corporation the original holder of the said watered stock is held accountable for the deficiency of his payment to the par of the stock so issued. This principle is clearly and purely based on the strict rule of equity, for there was misrepresentation by the corporation and the original holder on the real amount of the capital of the corporation, and the creditor is deemed in the eyes of the law to have depended on the capital stock as shown by the books of the corporation. It was said in *William E. Dee Co. v. Proviso Coal Co.*, 290 Ill. 252, that, "The property and assets of an insolvent corporation constitute a trust fund for the benefit of all its creditors." This was also held in *Peninsular Bank v. Howe*, 39 N. E. 725; *Webster v. Upton*, 91 U. S. 65; *Melville v. Rhodes*, 136 Wash. 220; *Sawyer v. Hoag*, 17 Wall. 610; *Fogg v. Blair*, 139 U. S. 118; *Howe v. Agricultural Works*, 46 Ill. 85; *MacDaniel v. Harvey*, 51 No. 198; *Thayer v. Mining Co.*, 40 Ill. 344. By this principle does the deficiency of the amount of the property over the par value of the stock

constitute an asset of the corporation? Undoubtedly, it can, under the law, be considered as an asset of the insolvent corporation in favor of the creditors, because as from the point of view of the creditors of the corporation such deficiency is a part of the capital of the insolvent corporation and considered as if it were a mere "account receivable" in favor of the corporation.

As to the legal aspect of the "*Bonus Stock*" with respect to creditors of the corporation it is said in *Handley v. Stutz* (infra) that, only the creditors of the corporation subsequent to the vote to increase the stock of the corporation can enforce their claims against the holders of the increased stock (bonus stock). From this it can be deduced that creditors previous to the vote creating the bonus stock cannot enforce their claims against the holders of the said bonus stock. The reason is obvious, for at the time when the amount due to the said creditors previous to the vote creating the bonus stock was made there was no defect in the capital of the corporation, thus the subsequent vote of creating the bonus stock did not nor will it thereafter prejudice the interest of said creditors previous to the vote creating the bonus stock; yet on the contrary, by the subsequent loan extended to the corporation by the bondholders through the inducement of a promise to issue bonus stock together with the bonds, will even redound to the benefit of said creditors previous to the vote creating the bonus stock, for by the extension of the loan, the corporation may have the chance to become solvent again, thus the full claim of said creditors will be paid in full; while this will not be the case if the corporation were not extended the loan; the creditors might only realize a small amount of their credit out of the proceeds of the property of the insolvent corporation, or they may not receive anything at all.

c. VALIDITY OF THE ISSUE TO SUBSEQUENT HOLDERS

The "bonus stock" or the "watered stock" which has passed into the hands of a purchaser in good faith and for value is valid, and the said subsequent purchaser is not held liable for the deficiency of the property or money so exchanged, to the par value of the stock issued. The aforesaid principle has been upheld in *Taylor v. Citizens Oil Co.*, 204 U. S. 644; *Dickerman v. Northern Trust Co.*, 176 U. S. 181; *First National Bank v. Gustin et al.*, 44 N. W. 198; *Wallace v. Carpenter Elec. Heating Co.*, 73 N. W. 189.

The writer believes that the aforesaid principle also applies in this jurisdiction under our law, for Sec. 16, par. 2 of our Corporation Law provides:

"Any officer of any corporation consenting to the issuance of stock or bonds in exchange for property valued in excess of its real fair cash value, or who, having knowledge thereof, does not forthwith express his disapproval in writing, shall be severally and jointly liable to the corporation and its creditors for the difference between the real present cash value of the property at the time of the issuance of the stock and the issued or par value of the same, as the case may be."

This means that if per ignorance of the law or by collusion of the parties the watered stock is so issued, and it passed in the hands of an innocent purchaser for value, the officers of the issuing corporation who consented thereto or having knowledge of its issue have failed to express their objection thereto in writing are held liable. However, suppose the corporation and the officers are insolvent that the claims of the creditors cannot be satisfied, who shall then be held liable. By clear reason of equity, then the original holders must be held liable, for under the law the provision is prohibitory, so the parties who have both transgressed the law must both be held liable; and the express provision of the law as to liability is just a mere order of succession as to who shall be held liable first.

This principle is clear in accord to the purposes and spirit of the law, for the law has its precise purpose to protect innocent investors from the scrupulously-cunning business maniacs. Besides to hold an innocent purchaser liable in these cases would rather discourage and serve as a set back to the financial progress of the country in general, for there shall be much hesitancy on the part of an investor and thus there would be delay in the possible progress of the business concern.

d. LIABILITY OF DIRECTORS OF THE ISSUING CORPORATION

The last paragraph of Sec. 16 provides:

"No corporation shall make or declare any dividend except from the surplus profits arising from its business."

Sec. 16 in the last part of its first paragraph it provides:

"Provided, however, that no stock or bond dividend shall issue without the approval of the stockholders representing not less than two-thirds of all stocks then outstanding and entitled to vote at a general meeting of the corporation or at special meeting duly called for the purpose."

Sec. 17 provides:

"A certificate in duplicate must be signed by a majority of the directors of the corporation * * * setting forth:

"(c) If an increase of the capital stock * * *, the amount paid by each on his subscription in cash or property * * *, if such increase is for the purpose of making effective a stock dividend therefore authorized."

Sec. 16, par. 1, provides:

"Any officer of any corporation consenting to the issuance of stock or bond in exchange of property valued in excess of its real fair cost value * * * shall be severally and jointly liable to the corporation and its creditors for the difference between the real present cash value of the property at the time of issuance of the stock and the par value of the same."

By the above provisions of our law, in a watered stock issued in exchange of property or money less than the actual par value of the stock so issued, the directors, who consented or who having knowledge of the same failed to object in writing are held *primarily* liable to the corporation and its creditors for the deficiency. The reason why the directors are *primarily* liable in the above case of issuance of watered stock is because a subscription is a contract, and the parties thereto must therefore be held bound by the terms of said contract. However, as discussed in the foregoing pages, the original holder of the watered stock is also liable. But his liability is only secondary to that of the directors of the corporation. It must be noted that the watered stock was issued in exchange of money of property at a valuation less than the actual par value of the stock issued.

If, however, the watered stock has been issued in the form of a stock dividend out of surplus not actually realized by the corporation, I think, the liability of the directors in this case is only *secondary*, and the stockholders are *primarily* liable to the creditors of the corporation. Because the last part of the first paragraph of Sec. 16 provides that no stock or bond dividend shall be issued without the approval of the stockholders representing not less than two-thirds of all stocks outstanding at a general or special meeting. This provision of the law clearly support our contention, for the stockholders themselves are the one who agreed to the issuance of the stock dividend out of surplus not actually realized or watered stock, and they are themselves the one who indirectly declared the said stock dividend,

for the directors who declared the stock dividends after the meeting of the requisite member of stockholders are voted as directors by the latter.

Thus it would rather be absurd and inequitable to allow, by the nature of the transaction, the stockholder to hold the benefits of his indirect declaration and hold the actual representative (directors) primarily liable. By the rule of Agency the principal is liable for the acts of his agents provided the latter has acted within the scope of his authority and powers. It is also a recognized principle of law that, "no one shall enrich himself at the expense of another." Thus the director in this case should be held but secondarily liable for the watered stock issued in the form of stock dividend.

As to the "bonus stock", it is generally held that, the directors of the corporation cannot be held liable for the amount of the bonus stock. The reason is manifest, for when a debt is contracted by the corporation as the issue of bonds, the stockholders shall have a meeting to discuss the creation of the debts, thus the act is the act of the corporation itself through its stockholders and not by the directors. So it would be inequitable to hold the directors liable at all; it would be a gross miscarriage of justice to hold them so liable for acts which cannot be properly imputed to them.

CHAPTER III

CIRCUMSTANCES VALIDATING THE ISSUE OF BONUS STOCK

a. APPLICATION OF THE DISTINCTION BETWEEN BONUS STOCK AND WATERED STOCK

Fortunately the case of *Handley v. Stutz*, 139 U. S. 417, illustrates to us the two classes of stocks (bonus and watered stock) which are specially differentiated in this work. We must, therefore, study minutely the facts of the case; it must also be noted that this is the leading case on the subject:

Facts:

The Clifton Coal Corporation was in financial difficulties to pay its debts and to finance its business operations. It, therefore, issued bonds to the amount of \$50,000.00. But nobody wanted to buy the bonds. So the corporation which was in dire financial straits, offered, after the stockholders' meeting and as agreed, to issue bonus stock equal in amount to each bond so issued. After issuing the bonus stock, there remained \$30,000.00 worth of stock, which was distributed among the old stockholders.

So the present action is brought by Sebastian Stutz and others against the Clifton Coal Corporation and other stockholders to compel an assessment upon certain shares of stock held by the individual defendants, and the payment of the same as a trust fund for the satisfaction of the debts of the company.

The holders of the \$30,000 worth of stocks which was distributed to the said old stockholders after the bonus stock was issued to the purchaser of bonds made the defense that they never agreed to contribute or pay for the same, that the stock was expressly declared to be fully paid and free from all claims or demands upon the part of the company, that there is no evidence that the creditors of the company knew of or relied upon, this increase, in their deal with the company; and that they had a right to return and surrender the same, which they offered to do.

The court held as to this kinds of stocks so issued that; The fact that they did not subscribe for it or agreed to take it until the receipt of the certificates is immaterial, as the acceptance of the certificates is sufficient evidence of an agreement to pay their par value. The holders of this kind of stocks (watered stock) are liable to the creditors of the corporation and an agreement that the stock is fully paid and nonassessable does not hold good as against the creditors of the corporation.

The position of holders of the "bonus stock" who subscribed to the purchase of bonds is discussed by the court in a different attitude, reasoning; "somewhat different consideration apply to those who subscribed for the bonds of the company, with the understanding that they were to receive an amount of stock equal to the bonds as an inducement to their subscription on the bonds. The evidence is contradicted that the bonds could not be sold without the stocks (bonus); that the transaction was in good faith, and considering the risk taken by the subscribers, the price paid for the stock and bonds was fair and reasonable. To say that a corporation may not, under the circumstances 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 * * * 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."

We have seen that the above case is so typical that it serves our very study of the legal aspect of a bonus stock and a watered stock. It must be noted that the \$30,000 worth of stock distributed to the shareholders after the bonus stock was given to the purchasers of bonds is watered stock and the court held that they are liable to pay the par value of the stock so taken by them.

But as to the holders of the bonus stock the court ably discussed and appreciated the value of a "bonus stock" in the financial world. It clearly recognizes the stimulus that a bonus stock gives to an investor.

The circumstances, as shown by the court's decision, which validate the issue of a bonus stock are; it is necessary that the issuing corporation is in financial stress; that the money raised is to meet the due debts of the corporation or to be used in the legitimate purposes of the corporation; that the issue must have been done in good faith, that there is no other way to secure financial aid without the inducement of a bonus stock. To this we may add that the amount of the bonus stock must be in direct reasonable proportion to the amount of the bond purchased or money loaned to the corporation.

The reader is further directed to the other cases which also deal on the bonus stock;—*Dummer v. Smedley*, 68 N. W. 260; *Dickerson v. Northern Trust Co.*, 176 U. S. 181; *Coit v. North Carolina Gold Co.*, 44 N. W. 198.

The above circumstances must always be taken into account in order to determine whether the bonus stock so issued is justified, for without these circumstances the stock issued will be watered stock and not bonus stock.

CONCLUSION AND COMMENTS

In as much as our Corporation Law, Act 1459, is of American origin, we must therefore adopt and be justified thereby to follow the American precedents. For to adopt the statutory provisions of their law and reject their precedents would be tantamount to stripping the law of its fine and equitable qualities in carrying its purpose.

The attention of the reader is also called to the fact that this holding of the court on bonus stock is clearly based on equity.

I would like to further justify its validity by an analogy. Suppose a man has, thru exhaustion and hunger; fell down on his knees, would it be equitable for us to hasten his downfall by stepping on him and prevent him forever to rise up again on his feet stably? I think, on the contrary, we ought to extend to him our helping hand or, at least, our moral support, to encourage him again to stand bravely on his feet to face the fit-falls of life. In like manner, the state should encourage rather than discourage the bona fide intention of financially embarrassed business concerns to recuperate and overcome their financial difficulties by recognizing the validity of the "bonus stock" as a financial measure in curing the malady of the, so to say, sick corporation.

To deny the validity of a bonus stock, the investing public would not gain anything thereby; but to recognize its validity and usefulness as an appropriate method of financing, would give relief and aid to the shareholders, creditors, and to the public in general; the State itself would be benefited for if the corporation would be denied to resort to the use of bonus stock and no other less burdensome method of obtaining fund is available by the same, then it shall be forced into bankruptcy and the government would lose the annual taxes paid by said corporation. The more prosperous enterprises are there in a State, the more advantageous it is to the State, for the State shall have increased yearly income in the form of taxes paid by said corporations.

Therefore, with this end in view, let us then also recognize the validity and advantage of a "Bonus Stock" as a panacea to business concerns in a financial sense.