PHILIPPINE LAW JOURNAL

Vol. XVII MARCH, 1938 No. 9

RIGHTS OF CORPORATE CREDITORS AND THE TRUST FUND DOCTRINE

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I. THE TRUST FUND DOCTRINE

A. ORIGIN

This so-called trust fund doctrine is a principle of equity not a rule of law, given life by an American court and reared by American jurisprudence. No similar Statement of a doctrine in any English book of reports can be found, and, in fact, it has never been recognized by the English courts. This doctrine was first enunciated by Mr. Justice Story in the case of Wood v. Dummer (3 Mason 308, Fed. Cas., No. 17944) decided in 1824. This was a suit brought by the creditors of a corporation to hold the stockholders of such corporation liable, it appearing that the greater part of the capital of the corporation had been distributed to the stockholders as dividends, thereby rendering the bank insolvent and the creditors of the corporation unpaid. Mr. Justice Story in deciding the case announced the doctrine as follows:

"It appears to me very clear upon general principles, as well as the legislative intention, that the *capital stock* of banks is to be deemed a pledge or trust fund for the payment of the debts contracted by the bank. The public, as well as the legislature, have always supposed this to be a fund appropriated for such purpose. The individual stockholders are not liable for the debts of the bank in their private capacities. The charter relieves them from personal responsibility and substitutes the capital stock in its stead. Credit is universally given to this fund by the public as the only means of repayment. * * * If the capital stock is a trust fund, then it may be followed by the creditors into the hands of any persons, having notice of the trust attaching to it. "If Mr. Justice Story revolved the question in the case by the simple application of the rule of fraud, the result that he would reach would have been the same, and

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this doctrine would not have come to being. The subsequent long line of American decisions which followed and adopted this doctrine with approval, firmly imbedded it in American jurisprudence.

B. STATEMENT OF THE DOCTRINE

Briefly and broadly stated, the trust fund doctrine is: the capital stock of a corporation or the assets of an insolvent corporation representing its capital stock is trust fund for the benefit of creditors of the corporation. In many decisions, this is stated more briefly to the effect that "assets of a corporation constitute a trust fund." This doctrine does not mean, however, all that the language used in some of the decisions would seem to imply.

The original rule as stated in the case of Wood v. Dummer (supra) in the course of judicial decisions, has developed into a system of legal principles, and the decisions enunciating this doctrine include other collateral principles expanding in effect its application. Thus the assets are held a trust fund to the extent that creditors generally may follow and subject to the payment of their claims, assets wrongfully distributed among or withdrawn by the stockholders, assets paid or conveyed to third persons without or with insufficient consideration, assets due from unpaid subscription, assets transferred to another corporation as a result of a merger or consolidation or the reorganization of a corporation, and the assets that may be realized from wrongful payments of shares, so that when the corporation becomes insolvent, particular persons, whether creditors, shareholders, or corporations, cannot be given or obtain an advantage over the other creditors by way of payment, security or any other means. The extended application of the trust fund doctrine has subjected it to severe criticisms on the ground that it has given rise to a confusion of ideas as to its real meaning. In fact not all the courts who recognize this doctrine are agreed on the application of the same.

C. WHAT DOES THIS FUND CONSIST

As to what constitute the fund to which creditors of a corporation may look to for payment of their claims has not been the subject of very constant decisions. From the point of view of economics, capital must be considered or viewed as the assets of a going concern acquired and set aside for productive use.

(The Capital of a Corporation, 22 Harvard Law Review 319.) And the general idea that pervades the statutes of the various jurisdictions is, the amount specified in the Articles of Association as the result of contributions to be paid in and to be represented by shares the holders whereof have the right to participate in the net earnings distributed during the corporate life, and to divide among themselves on dissolution all assets remaining after the payment of the corporate debts. In relation, however, to the trust fund doctrine, originally, only the capital stock, strictly so-called, of a corporation acquires a trust character, and not the entire property and capital of a corporation, but some courts do not make this distinction and hence they include not only the capital stock proper of a corporation but such other property or assets which a corporation may have acquired in the course of its business.

Where a distinction is made between "capital" and "capital stock", the latter term represents the amount in money or property subscribed and paid in or secured to be paid in by the shareholders, and always remains the same unless changed by proper legal authority, (Person v. Board of State Tax Com'ers. 115 S. E. 336, 184 N. C. 499.) The phrase in its technical sense, is not used to indicate the value of the property of the corporation and takes no account of profits or losses. (State v. Morristown Fire Ass'n., 23 N. J. Law 195.) Thus the surplus of a corporation is no part of its capital stock, nor is money borrowed a part of the same. It is usually represented by shares issued to subscribers of a stock on the initiation of the corporate enterprise; the capital stock being the consideration which the corporation receives in exchange for all issued stock, whether that consideration take the form of money paid in, labor done, or property actually received, and includes all subsequent transmutation of the consideration originally paid or given for the stock. (Dominguez Land Corp. v. Daugherty, 196 Cal. 468, 238 Pac. 703.) The term "capital" is a broader term and includes all funds, securities, credits property of every kind whatever belonging to the corporation (Person v. Board of State Tax Com'ers., supra) but it does not designate shares of stock owned by shareholders or identical lands or chattels. (Central Illinois Public Service Co. v. Swartz, 119 N. E. 990, 284 Ill. 108.) It signifies the actual estate whether in money or property. In reference to a corporation, it is, strictly speaking the aggregate of the sum subscribed and paid in, or secured to

be paid in, by the shareholders, with the addition of all gains or profits realized in the use and investment of these sums, or, if losses have been incurred, then it is the residue after deducting such losses. (People v. Commissioners of Taxes, 23 N. Y. 219.) However, in revenue statutes this distinction is not often followed and the two terms are used interchangeably.

From what has been said, it appears that not all the property of a corporation constitute the fund to which equity attaches a trust character for the security of the creditors of a corporation. It is constituted only of such property and money as forms the capital stock of a corporation. This is made up of: (1) money paid in for subscribed shares of stock; (2) the unpaid balances which the subscribers have agreed to pay (Sanger v. Upton, 91 U. S. 56, 23 L. ed. 220); (3) money thus subscribed but afterward improperly divided among the members, leaving debts of the corporation unpaid (Wood v. Dummer, supra); (4) property contributed in lieu of money where such are allowed by statute; and, (5) all subsequent transmutations of the consideration originally given or agreed to be given for the stock. (Dominguez Land Corp. v. Daugherty, supra.) These items make up the capital stock of a corporation which in case of corporate insolvency becomes a trust fund for creditors.

D. THE WORD "TRUST", EXPLAINED

The word "trust" as used in the trust fund doctrine does not really have the meaning it ordinarily has in legal contemplation, for as was said by the United States Supreme Court, "While it is true language has been frequently used to the effect that the assets of a corporation are a trust fund held by a corporation for the benefit of creditors, this has not been to convey the idea that there is a direct and express trust attached to the property." (Hollins v. Brierfield Coal and Iron Co., 150 U. S. 371, 14 Sup. Ct. 127, 37 L. ed. 1113.) In other words, the insolvency of a corporation i.e., the existence of a corporation with property and debts, the property being insufficient to pay the debts—is not within the definition of any trust known to equity jurisprudence, so much so, that one of the main criticisms of this doctrine is the vagueness of this term.

To explain the meaning of the word "trust" as used in this doctrine a little analysis of the different trusts known and recognized in law and equity would be of great help. All trusts are of two kinds: expressed and implied. All implied trusts are

also of two kinds, namely, resulting and constructive. "Resulting trusts," says Mr. Pomeroy, "arise where the legal estate is disposed of or acquired, not fraudulently or in the violation of any fiduciary duty, but the intent in theory of equity appears or is inferred or assumed from the terms of the disposition, or from the accompanying facts and circumstances, that the beneficial interest is not to go with the legal title." (Pomeroy, Equity Jurisprudence, Sec. 155.) And they are said to arise under the following states of facts: (1) where the purchaser of an estate pays the purchase money, and takes title in the name of a third person; (2) where a person standing in a fiduciary relation uses funds to purchase property and takes the title in his own name; (3) where an estate is conveyed upon trusts which fail, either in whole or in part, or are not declared, or are illegal; and, (4) where a conveyance is made without consideration, and it appears from the circumstances that the grantee was not intended to take beneficially. (10 Am. & Eng. Enc. Law, pp. 4, 5.) It requires no discussion to demonstrate the impossibility of referring this doctrine of trusts for corporation creditors to the head of resulting trusts, and much less so in considering it as an express trust. In the incorporation of a corporation nothing is expressly stated as to its capital stock constituting a trust fund for creditors, nor can anything of that character be inferred from the terms of the usual and ordinary articles of incorporation i.e., that the beneficial ownership should be separate from the naked title.

Again, all constructive trusts are of three kinds, or arise from one of these three conditions of fact: (1) trusts arising from actual fraud; (2) trusts arising from constructive fraud; and (3) trusts that arise from some equitable principle, independent of the existence of fraud. (10 Am. & Eng. Enc. Law, p. 60.) As there is no fraud, actual or constructive, involved in the mere fact that a corporation is insolvent,—and this fact is the basis for all the structure of trust for its creditors,—it cannot be conceived that such trust is referable to either the first or second heads of constructive trusts. And it is the conclusion of so prominent an authority as Mr. Pomeroy that the third classification of constructive trusts has no existence dissociated from either actual or constructive fraud. It is his opinion, "that all instances of constructive trusts properly so called may be referred to what equity denominates fraud either actual or constructive, as an essential element and as their final source. Even

in that single class where equity proceeds upon the maxim that an intention to fulfil an obligation should be imputed and assumes that the purchaser intended to act in pursuance of his fiduciary duty, the notion of fraud is not involved simply because it is not necessary under the circumstances; the existence of trust might in all cases of this class be referred to constructive fraud. This notion of fraud enters into the conception in all its possible degrees. Certain species of constructive trusts arise from actual fraud. Many others spring from the violation of some positive fiduciary relation. In all the remaining instances there is, latent perhaps, but none the less real, the necessary element of that unconscientiousness conduct which equity calls constructive fraud." (Pomeroy, Eq. Juris., Sec. 1044.) If this view be adopted, the relation between an insolvent corporation and its creditors is excluded from every possible category of constructive trusts for the reason that that relation involves no fraud whatever, except in some cases where the decisions of courts had invoked the trust fund doctrine where the doctrine of fraud may perfectly apply. But even then, to adopt this view would be to deny the trust fund doctrine in those cases where fraud is absent in the relation between the corporation and its creditors.

If the view formerly stated is adopted that the constructive trusts may arise by force of some equitable principle independent of the existence of fraud, actual or constructive, which is also the view of Mr. Perry (see Perry, Trusts, Sec. 168), the same conclusion will be reached. In all cases of constructive trusts where it is said equity proceeds without regard to fraud, relief is granted upon some acknowledged ground of equitable jurisdiction and administered by holding the wrongdoer to account as a trustee. There must be a confidential relation and unconscientious conduct on the part of one party to and in abuse of that relation or there must be some ignorance, accident, mistake, of the like, against the consequences of which equity, on general principles, will grant relief. But the relation of debtor, whether a person or a corporation, and creditor is not one of a confidential character, for it is absurd to think that a debtor has property of his creditor which in equity belongs to the creditor because the debt and obligation contracted has not been paid. Hence, this trust relation between an insolvent corporation and its creditors cannot fall under any of these real trust relations.

(O'Bear Jewelry Co. v. Volfer, 106 Ala. 205, 17 So. 525, 28 L. R. A. 707, 54 Am. St. 31).

The word "trust", therefore, as used in connection with the trust fund doctrine is a misnomer. At most, it can be said that it is used only in a figurative sense or by "way of analogy or metaphor" or as stated in the case of Sawyer v. Hoag (17 Wall. 610; 21 L. ed. 731), "the capital of a corporation is a trust only *sub modo*" i. e. under a qualification. Whatever of trust there is, arises from the peculiar and diverse equitable rights of the stockholders as against the corporation in its property, and their conditional liability to its creditors. It is rather a trust in the administration of the assets after possession by a court of equity, than a trust attaching to the property, as such, for the direct benefit of either creditor or stockholder. (Hollins Brierfield Coal and Iron Co., 150 U. S. 371, 37 L. ed. 1113.) It is this misuse of the word "trust" which has invited severe criticisms on this doctrine from courts and prominent legal minds, so much so, that time and again, intended substitutes for this doctrine have been advocated.

E. WHEN TRUST CHARACTER ATTACHES

The assets of a corporation as a trust fund for creditors is not made so by the mere fact of its being the assets of a corporation. This is so because a corporation is an entity, distinct from its stockholders. Solvent, it holds its property as any individual holds his, free from the touch of a creditor who has acquired no lien and from the claims of a stockholder who, though interested equitably in, has no legal right to, the property. This rule is too well known to require any citation of authorities. This doctrine considers the assets of a corporation as property earmarked with a trust character only when it becomes insolvent. The question which arise is, when is a corporation insolvent for the purposes of this doctrine? Is it from the time of actual insolvency i.e. when its assets are insufficient to pay its debts, although it still continues to be a going concern, or is it from the time of its assured insolvency i.e. when it becomes not only insolvent but also ceases to be a going concern?

Although the authorities are not quite agreed on this point, the weight of opinion and reason favors the last interpretation of insolvency. The Supreme Court of Tennessee, correctly expressed the majority view in the case of Hicks v. Whiting (258 S. W. 784, 149 Tenn. 411), this court holding that "A corpora-

tion is not insolvent in such a sense that its assets become a fixed trust fund in the hands of its officers for pro rata distribution among its creditors so long as it continues to be a going concern conducting its business in the ordinary way, although its debts may greatly exceed its assets." The wisdom of this ruling may be seen if one takes into account that an insolvent but a going concern may if it continue to do business still recuperate its losses and again become solvent, hence, to consider its assets as trust fund from that moment would be to prohibit it from making transactions which may aid its business which in the end would be to the benefit of the creditors. On the other hand, when a corporation is not only actually insolvent but also ceases to do business or else commits an act of insolvency, the only logical inference is that it has given up hope of ever putting its business on a sound basis or else it intends to defraud its creditors, in which case the application of the trust fund theory will not only protect the creditors but also other persons who may deal with it later.

However, a corporation, insolvent in fact, but still doing business, may by commission of acts of insolvency be considered as in such a state of insolvency that its assets acquire a trust character even before it ceases to be a going concern. (Mickey Bros. v. Lonsdate Mfg. Co., 258 S. W. 776). Such acts may be the filing of a bill to administer assets, or making general assignment, or cessation to do business. (Bank v. Lumber & Mfg. Co. 91 Tenn. 12; Tradesman Publishing Co. v. Car Wheel Co. 95 Tenn. 634, 32 S. W. 1097). But a corporation does not commit an act of insolvency by calling a creditors' meeting for a conference looking to an adjustment of its indebtedness where it continued to be a going concern. (Hicks v. Whiting, 149 Tenn. 411; 258 S. W. 784).

In the case of Chattanooga v. Evans (66 Fed. 809) the extent to which an embarrassed corporation but still a going concern may do acts which it otherwise may not do if it ceases to be a going concern is fully discussed. It was said in that case that a going corporation, though embarrassed and its debts exceeding its assets, might bona fide assign its assets for the benefit of preferred creditors, or make a sale to purchaser in good faith and for value because whatever a natural person might do an embarrassed but going corporation could do, unless prevented by some provision of its charter or inhibition found in the law. In case of an absolute sale of all the property of an embarrassed

corporation, the purchase price, with respect to creditors will stand as a substitute for the property conveyed, and the creditors' rights may be enforced against that price. Altho the ruling in this case is not universally accepted by all the courts, yet this perfectly illustrates the difference of the extent of powers between insolvent and going corporations from those which are insolvent and also ceases to do business.

II. APPLICATION OF THE DOCTRINE

The principal office of the trust fund doctrine is to preserve the assets of a corporation as a fund for the payment of the corporate debts when such assets or some part thereof have not been paid or wrongfully diverted. It was conceived of mainly as an aid to creditors in reaching assets of corporation which otherwise would be beyond the reach of creditors for the satisfaction of their claims. An examination of the various situations in which this doctrine is applied to attain such end is, therefore, in point.

A. Conveyances of Corporate Property

In a number of cases, the trust fund doctrine has been referred to as ground for holding that a corporation cannot as against creditors, transfer its property without consideration to a natural person or another corporation, and that if it does so, its creditors may follow the property or hold the transferee liable to the extent of its value. (Sutton Mfg. vs. Hutchison, 63 Fed. 496; Wilson v. Baker Clothing Co., 25 Idaho 378, 50 L. R. A. 239; Barrie v. United Rys. Co. of St. Louis, 125 Mo. App. 96; 1025 S. W. 1078; Gole v. Millerton Iron Co. 133 N. Y. 164, 30 N. E. 847.) This may be considered simply as a case of fraudulent conveyance and the right of creditors to attack the transfer may be based on that ground, without resorting to the trust fund doctrine. The general principle of law and the statutes of different jurisdictions governing fraudulent conveyances apply to corporations to the same extent as natural persons, and if a corporation conveys or transfers its property, with intent to hinder, delay or defraud creditors, with or without consideration, existing creditors may sue to set the conveyance or transfer aside, and to subject the property to the satisfaction of their claims, or to hold the grantee or transferee liable for its value. (Fletcher, Cyclopedia of Corporations, Vol. VIII, Secs. 5045.) The application in these class of cases of the trust fund doctrine

seems to be unnecessary and an unwarranted extension of the doctrine. The application of the rule of fraud which is more universally recognized would be in consonance just as well, if not more, with the laws and statutes on the subject.

B. PREFERENCES

One of the most unsettled questions in the application of the trust fund theory is that regarding preferences of creditors. There are two lines of opposing decisions on this matter, one allowing preferences and the other denying it based on the trust fund as prohibition.

1. Rule Allowing Preferences.

In many jurisdictions, the mere insolvency of a corporation does not render its assets a trust fund for the benefit of creditors in such a sense as to prevent it from giving a preference to one or more of its creditors to the exclusion of others. (Fletcher, Cyclopedia of Corporations, Vol. VIII, Sec. 5036). In most of these cases the courts deny the doctrine that the assets of a corporation, although insolvent, are a trust fund for its creditors in any other sense than that in which the assets of a partnership or of an individual are a trust fund for creditors, necessarily holding that the creditors of the corporation have no equitable charge or lien upon it or equitable title to it in any different sense from that which an individual or partnership creditor has upon the property of an individual or partnership debtor. Most of the later cases referring to the trust fund doctrine and sustaining the right to prefer creditors, apply the limited doctrine by which the corporation has full control of its property until proceedings have been taken in a court of equity to administer the property of the corporation. (Smith Middlings Purifier Co. v. McGroarty, 136 U. S. 237, 34 L. ed. 346; Gould v. Little Rock M. R. and T. Ry. Co., 52 Fed. 680; Haight v. Smith, 178 Mich. 392, 144 N. W. 830). As a matter of fact, it may be pointed out that no other view is consistent with the right of an insolvent corporation to prefer creditors.

On the other hand, some courts which sustain the rule allowing preferences and repudiating entirely any trust fund doctrine held that a denial of the right would be to give effect to the trust fund doctrine. (Passow and Sons v. Wetherbee, 169 Pac. 350). In a large majority of the states where the doctrine has been repudiated, it is only to the extent of recognizing the right of in-

solvent corporations to prefer their common unofficial creditors in the same manner and to the same extent that an insolvent individual may, unless prevented by some provision of its charter or inhibition found in the law.

a. May a Shareholder be Preferred?

The rule that a corporation can prefer creditors to the exclusion of the others has been carried by some courts to the extent of holding that in the absence of any express prohibition it can prefer one of its own shareholders. (Reichwald v. Commercial Hotel Co. 106 Ill. 439; Parson v. Hatton Snowden Co. 58 Ill. 272). As the shareholders are in substance the proprietors, it cannot escape attention that this doctrine is tantamount to the doctrine that a man may engage in business and prefer himself over his own creditors. The modern trend of the decisions, however, points to the contrary.

The juster and more accepted doctrine is that a corporation cannot prefer its own shareholders over its outside creditors. (Reagan v. Chicago First Nat. Bank, 157 Ind. 623, 61 N. E. 575, 62 N. E. 701; Washington Mill Co. v. Sprague Lumber Co., 52 Pac. 1067). This is the rule adopted not only in those jurisdictions which recognize the trust fund doctrine but also in most of those which admit the right to prefer creditors. The reason for this rule is that shareholders are in substance and in a sense its proprietors, or at least, its beneficial owners, and hence any rule which would allow a corporation to prefer its own shareholders would be violative not only of reason and justice but also of public policy inasmuch as it facilitates the commission of frauds upon third persons and protects those who are in a better position to commit the fraud. Nor can this rule be obviated by the consideration that a corporation is one person in law and its shareholders another for the fiction of legal personality of a corporation should not be urged to an intent and purpose not within the reason and policy of the fiction.

b. May Directors be Preferred?

It is to be regretted that some of the American courts have carried the right of an insolvent corporation to prefer creditors to the extent of holding that it may not only prefer creditors who are its own shareholders but may prefer such as are its own directors. Thus in the case of Gould v. Railway Co. (52 Fed. 680) it was said that, although it may be conceded that

the trust relation justifies and requires courts of equity to subject preferences by an insolvent corporation to the closest scrutiny, and places the burden upon the preferred director of showing beyond question that he had a bona fide debt against the corporation still, there is no reason why, if a corporation may prefer a creditor over others it may not prefer a director who is a bona fide creditor—preferences not being based on any equitable principle but that they go by favor and as an individual may prefer among his creditors, his friends and relatives, so a corporation may prefer its friends.

The better doctrine, and one resting on principles of justice, is that a corporation when insolvent, or when it reaches such a condition that its creditors see that they must deal with its assets in the view of its probable suspension, they cannot use those assets to prefer themselves, as creditors or sureties, in respect of past advances, to the prejudice of its creditors. The governing principle is that the directors and managers of insolvent corporations are trustees of the funds as well for the creditors as for the corporation, and are bound to apply them pro rata, and cannot use them to exonerate themselves to the prejudice of other creditors. (Richard v. New Hampshire Ins. Co., 43 N. H. 263). That such is the rule of distribution results from the principle that equity is equality, and that in the administration of assets in equity all who stand in equal relations are entitled to share ratably.

2. Rule Denying Preferences—Trust Fund Doctrine as Prohibition

Diametrically opposed to the doctrine allowing preferences, is the rule denying the right of insolvent corporations to prefer creditors to the prejudice of others. The doctrine in short is that a corporation, being insolvent, or dealing with its funds in contemplation of insolvency, and not in the ordinary course of its business, has no power to prefer particular creditors. This doctrine is founded by many of the courts on the trust fund doctrine which holds the assets of an insolvent corporation or one in a contemplation of insolvency as necessarily pledged to the payment of all its debts, ratably and equally. The basis of this rule being that a preferred creditor during insolvency has caused a depletion of assets of a corporation to the detriment of other creditors. (Terhune v. Weise, 132 Wash. 208, 231 Pac.

954). This rule finds statutory affirmations in the bankruptcy and insolvency laws of the different states.

Admitting this rule, it is necessary to determine the point of time at which a corporation loses its power to deal with its assets so as to pay particular creditors in full. If the trust fund doctrine is made the basis of this rule, it follows that this point of time should be considered to exist as from the time that the trust character attaches to the corporate assests. As was previously stated (supra II, E) this trust character attaches, according to the weight of opinion, from the time an insolvent corporation ceases, to do business or to be a going concern or commits an act of insolvency.

C. UNPAID SUBSCRIPTIONS AS TRUST FUND

The most common application of the trust fund doctrine is with regard to unpaid subscription to capital stock of corporations. The rule as to the trust fund doctrine as applied to unpaid stock was stated by the United States Supreme Court thus: "The capital stock of an incorporated company is a fund set apart for the payment of its debts. * * * When debts are incurred, a contract arises with the creditors that it shall not be withdrawn or applied otherwise than upon their demands, until their demands are satisfied. The creditors have a lien upon it in equity. If diverted, they may follow it as far as it can be traced, and subject it to the payment of their claims except as against holders who have taken it bona fide for a valuable consideration and without notice. It is publicly pledged to those who deal with the corporation, for their security. *Unpaid stock is as much a part of this pledge and as much a part of the assets of the company, as the cash which has been paid upon it.* Creditors have the same right to look to it as to anything else and the same right to insist upon its payment as upon the payment of any other debt due to the company." (Sanger v. Upton, 91 U. S. 56, 23 L. ed. 220). To the extent of the par value of his subscription the stockholder is deemed to hold any unpaid part thereof in trust or in his pocket, which equity will compel him to surrender for the payment of corporate debts.

It should be noted, however, that in Wood v. Dummer (supra) the trust was held to attach to property in which subscriptions paid had been invested; in other words, this theory was not originally announced with respect to unpaid subscriptions as

being equally property of the corporation, and even more clearly, perhaps, part of its capital. The reason for this extension of the original application of the doctrine is: that which a corporation holds as its capital stock is that which it held out to the world as a reliance for those who deal with it, in lieu of the unlimited personal liability of the associates or members of the firm, and the unpaid subscriptions are as much a part of that fund as the money and property representing the paid up portion of the capital stock, so that it is but fair and just that the corporation can no more release the obligation of the former than give away the latter to the injury of the creditors.

It is a necessary part of this doctrine that shareholders who have not paid in all that they have subscribed are, as to so much as they still retain, constructive trustees for the creditors of the corporation. But some of the American courts have gone further and held that they are express trustees for such creditors, and that his trust is of that fiduciary character which prevents the running of the statute of limitations, until the corporation itself dissolves or ceases to do business. (See the cases of Hightower v. Thornton, 8 Ga. 486, 52 Am. Dec. 412; Payne v. Bullard, 23 Miss. 88, 66 Am. Dec. 74). Perhaps, it would be going too far to call such subscribers express trustees, unless expressly provided by law, but that at most, they are trustees in a constructive sense by virtue of their relations and limited liability to the corporation and of the latter to the public who deals with it on the reliance on what it holds out as its capital stock.

Another corollary of the application of this doctrine is that a corporation cannot transform unpaid subscription into an ordinary debt by simulated payment (Sawyer v. Hoag, 17 Wall. 610, 21 L. ed. 731). Such agreement is not only violative of the trust fund theory but has been characterized as fraud upon other subscribers. (White Mountains Co. v. Eastman, 34 N. H. 124). The same thing may be said of agreements among members that their shares shall be deemed to be fully paid up, when in fact they have not been so paid, or else issue its shares as a bonus. (Handley v. Stutz, 139 U. S. 417, 35 L. ed. 227; Skrainka v. Allen, 7 Mo App. 434). However, the Court of Appeals of New York has held—denying to this extent the doctrine that the assets of a corporation are a trust fund for its creditors—that a corporation can issue its unpaid shares as pretendedly paid up, as a bonus to its bondholders in order to market its

bonds. (Christensen v. Quintard, 8 N. Y. Sup. 400, 29 N. Y. St. 61). In America the better doctrine, notwithstanding, is that this cannot be done as against creditors of the corporation though such arrangement may be valid as between the company and the shareholders.

D. IN REORGANIZATION

Corporations, insolvent or financially embarrassed, often find it necessary to scale their debts and readjust stock issues with an agreement to conduct the same business with the same property under a reorganization. Corporate property is thereby transferred to a new company having the same shareholders. The act is in itself perfectly legal, but a question may arise as to the corporate assets, which is, whether the subordinate rights of the stockholders in the old corporation may be secured at the expense of the prior rights of creditors.

The answer to this question may be found in the case of Livingston County Agricultural Soc. v. Hunter (110 Ill. 155) where it was held that the assets of the old corporation remain liable in the hands of the new one, where the circumstances are such as to render the transaction a diversion of corporate property as a trust fund for the payment of creditors. The case of Ewing v. Composite Brake Shoe Co. (169 Mass. 72, 47 N. E. 241) supports the doctrine in the former case. In this instance, a corporation ceased to do business and its stockholders, with one other person formed a new corporation, with a different name, taking all the assets of the old corporation but it did not assume to pay all the debts of the old one. The court in this case held that, where a new corporation is formed the creditors of the old corporation have an equitable right to follow the assets of the old corporation; but they cannot maintain an action at law against the new corporation, for there is no privity of contract. Although the trust fund theory was not expressly applied in this case, the effect is, however, the same as though it were applied inasmuch as the decision is based on equitable grounds which is also the basis of this doctrine.

E. WHERE CORPORATIONS ARE CONSOLIDATED OR AMALGAMATED

Where two or more corporations are consolidated a new and distinct one is created. (10 Cyc. 288). One of the effects of consolidation of corporations is the disappearance of the absorbed corporations and the transfer of all the property of the

latter to the former, as a consequence of which the creditors of the old corporations are deprived of the property which may be made liable to their claims. This being the case, may they follow such property in the hands of the new corporation?

In the consideration of this question the trust fund doctrine likewise enters in its solution. The governing principle here is that a corporation cannot give away its assets to the prejudice of its creditors. The new corporation, following this principle, holds the assets received from the corporations which have ceased to exist on account of the consolidation, subject to the equitable lien of the creditors of the old corporation, and according to the case of Goodwin v. McGehee (15 Ala. 232) a court of equity will follow such assets as a trust fund into the hands of any new custodian, the same not being a creditor or bona fide purchaser. In such a case the consolidated corporation holds the property received from the absorbed company with notice of any trust attaching to it in favor of its creditors, and cannot claim the right of a bona fide purchaser without notice. (Montgomery etc. R. Co. v. Branch, 59 Ala. 139). As a necessary consequence of the above rule the creditors of the absorbed corporation may require the payment of their claims in equity to the extent of the assets received by the new corporation. Beyond this, the liability of the latter ceases inasmuch as no privity of contract exist between the creditors of the absorbed corporation and the consolidated one.

F. PAYMENT OF SHARES

The payment for the shares of a corporation affords another application of the trust fund doctrine. Several situations may arise under this general heading such as, the issuance of stock for unauthorized or insufficient consideration, issuance of stock in exchange of property worth less than the par value of the former, the transfer of assets of one corporation for stock of another, and the issuance of stock at a discount or as being fully paid up.

It has been held that when at the inception of its enterprise a corporation issues its stock for a consideration in money or property of admitted value less than the par value of such stock, the subscribers are liable for the unpaid portion of the subscription. (Sherman v. Harley, 178 Cal. 584, 174 Pac. 901). The measure of the liability of the subscriber being the difference between the par value and the amount actually paid in, if that

amount is needed to satisfy the creditors of a corporation. (Scovill v. Thayer, 105 U. S. 143; The Nature of the Stockholder's Liability for Stock Issued at a Discount, 29 Harvard Law Review 854). Under the trust fund theory, this difference is still a part of the fund for the benefit of creditors.

A contrary doctrine however exists in some jurisdiction. Thus in the case of Maryland Rail Co. v. Taylor (231 Fed. 119) the court held that corporate creditors cannot be made liable on the ground that their subscriptions had not been paid, where there was no fraud in the transaction in which the stock was issued for property. This is known as the "fraud or holding out theory," which rest mainly on fraud, actual or constructive. Under this theory the stockholder's liability is based upon a reliance by creditors on a representation of the stockholder that the stock has been fully paid up and as a consequence of this only those creditors who became so subsequent to the fraudulent transaction and who relied upon such representation, can recover. (The Nature of the Stockholder's Liability for Stock Issued at a Discount, Note 29 Harv. L. Rev. 854; Ballantine, Manual of Corp. Law & Practice, Sec. 212). But this contrary doctrine does not seem to find much favor with the majority of state courts. Moreover, this doctrine seems to be contrary to the provision, common to all corporation statutes, that stocks can only be issued in exchange of actual cash or property at a fair valuation equal to the value of stock, regardless of the existence of fraud in the transaction of course, strict equality in value, between the property paid (in case stock is issued in exchange of property) and the stocks issued is not necessary, but only substantial equality is required. The trust fund rule affords, therefore more protection to creditors than the fraud or holding out theory.

Other courts which refuse to accept the "trust fund theory" find another basis on which to hold holders of stock issued for property liable for the debts of the corporation, in what is known as the "true value" rule. "The true value rule," says Judge Seymour D. Thompson, (36 Cent. L. J. 92) "is strictly the rule of the English courts, as we understand their decisions. When they use the expression 'money's worth' they mean that the property which is turned over to the corporation in payment of its shares must be turned over at a fair valuation, and they mean, further, that whether or not it has been turned over at a fair valuation it may become a subject of judicial inquiry in

a proceeding to charge a shareholder in favor of creditors on the ground that his shares have not been fully paid for." In short this rule is, that payment of corporate stock in anything except money will not be regarded as payment except to the extent of the true value of the property received in lieu of money and regardless of the question of fraud. This theory is applicable only however in case of payment of shares of stock by property. Yet, in spite of the divergence in basis between this rule and the trust fund theory, the same result is reached i.e. that stock is issued only in exchange of property at fair or true valuation.

In the case of payment of shares of stock of one corporation by the transfer of assets of another corporation the rule is that, when such transfer is accompanied by an assumption of debts, the assets in the hands of the purchasing corporation constitute a trust fund for the benefit of the creditors of the selling corporation, of whose claims the purchaser had notice at the time of purchase. (Perrine Sawmill & Co. v. Powell, 93 So. 33, 207 Ala. 447). Even where there is no assumption of debts by the selling corporation, it is ventured that equity may interfere to protect the rights of creditors where the assets transferred greatly exceeds the value of the stocks issued to such a degree that the creditors are deprived of the fund to which they look for payment or that such fund is so reduced as to negative payment of their claims. Although this has not been decided yet, the adoption of this rule by courts adhering to the trust fund doctrine is not very remote.

G. WITHDRAWAL OR RETIREMENT OF CORPORATE ASSETS

Retirement of corporate property or assets which in effect reduces the capital stock of corporations is a device often resorted to further decrease stockholders' liability on their stocks. This may take the form of a release by the corporation of the subscribers to its capital stock or a reduction of the subscribers' liability, or by redemption by a corporation of its stocks, and by any other like means. To hold the subscribers liable to the extent of their original liability or to prevent such withdrawal of corporate assets, courts often resort to the trust fund doctrine to be able to do these things.

In a Connecticut case a stockholder, knowing of the corporation's insolvency, sold to it his stock, receiving fully secured notes held by the corporation. The court held that recovery can be had of him for the benefit of the corporation's creditors,

though the notes were surrendered to the payer, and he gave new notes payable to the stockholder, and secured on property other than that which the original notes were secured on the ground of the trust fund doctrine. (Buck v. Ross, 68 Conn. 29; 35 Atl. 763; 57 Am. St. 60). So also, in the case of Benner v. Billings (181 Pac. 19; 107 Wash. 1), it was decided that a purchaser of corporate stock on installments at all times cognizant of the growing insolvency of the corporation, cannot as far as creditors are concerned, be released from his liability to pay therefor by any agreement or arrangement between himself and the corporation or its agents, or by resolution of the directors, or by the stockholders, or by a transfer to another person incapable of paying for the stock, nor by reduction of the number of shares to be paid for. Creditors are given the right to enforce subscriptions under the theory of the trust fund. The only way to legally effect a valid capital stock reduction would be to follow the procedure prescribed in the corporation law of each jurisdiction. Even, the soundness of the doctrine enunciated in the case of Murphy v. Panton (165 Pac. 1074; 96 Wash. 637) that unpaid subscription can only be waived or cancelled by mutual consent of all interested, is doubtful unless such release takes the form of capital stock reduction following the procedure prescribed by law. This is so because stockholders have the full benefits of the profits made by the corporation with the corresponding danger of suffering the losses if any. They cannot be made to enjoy the benefits only, with the creditors assuming the losses. This is not only an unsound business policy but is unjust, unequitable and unfair. To attain the arrangement desired, it is, therefore, necessary that stockholders should be prohibited from taking any portion of the funds, and corporation from dispensing with any assets that may be due to it from its stockholders, until all the claims on the corporation by third persons are extinguished. The rights of the stockholders should not be to the capital stock but to the residue after all demands on it are paid.

III. RIGHTS OF CREDITORS IN RELATION TO THE TRUST FUND DOCTRINE

A. Creditors who can invoke this Doctrine

The trust fund doctrine does not arise absolutely in every case, in favor of every and any creditor. It is not true, and no

case can be found which holds, that it is in the power of a creditor, in every and all cases, as a matter of right, to inquire into the value or amount of the consideration given for stock any more than that it would be his right, in any and every case, to inquire into the distribution of the capital among the shareholders.

It is only to those creditors who relied upon or whom the law presumed to have relied upon, the amount of capital stock of a corporation, without knowledge of the transactions made to deplete the assets which constitute this trust, may invoke this doctrine. (First Nat. Bank of Deadwood v. Gustin, 42 Minn. 327). For example, to distribute the capital among the shareholders without provision for paying corporate debts would be a fraud on existing creditors, as well as on such subsequent creditors as deal with the corporation in reliance upon the assumption that its capital remains intact. So again, where corporations have organized and engaged in business with a certain amount of ostensible and professed capital, but which was not in fact paid in, there are numerous cases in which the courts have set aside the arrangement by which the stock is called "paid up" and impressed a trust upon the subscription of the shareholder in favor of subsequent creditors who have relied upon or whom the law would presume to have relied upon, the apparent and professed amount of capital. (Sawyer v. Hoag, 17 Wall. 610).

In every case where the courts have impressed a trust upon the subscription of the shareholders it has been in favor of creditors becoming such afterwards and hence fairly to be presumed as relying upon the amount of capital which the company was represented as having. No such trust has been enforced in favor of creditors who have dealt with corporations with full knowledge of such facts. (First Nat. Bank of Deadwood v. Gustin, supra). The reason is apparent for in such cases no fraud, actual or constructive, has been committed on such creditors.

If a corporation issue new shares after the claim of a creditor arose, it is clear that the latter could not have dealt with the company on the faith of any capital represented by them. Whatever was contributed as capital in respect of the new shares was a clear gain to the creditor's security. So too, if a party deals with a corporation with full knowledge of the fact that its nominal paid up capital has not in fact been paid for in

money or property to the full amount of its par value, he deals only on the faith of what has been actually paid in, and has no equitable right to insist on the contribution of a greater amount of capital by the shareholders than the corporation itself could claim as part of its assets. (Coit v. Amalgamating Co., 14 Fed. 12).

B. CREDITORS TO EXHAUST ALL LEGAL REMEDIES

One of the limitations on the power of a court of equity to administer assets of an insolvent corporation is that it cannot proceed until the remedy at law is exhausted or obstructed. (Burton v. R. G. Peters Salt and Lumber Co., 190 Fed. 262). Exhausting all legal remedy means that a creditor should first exhaust the remedy against the corporation. This is done by obtaining a judgment at law against the corporation, and an execution returned unsatisfied. (Bank of U. S. v. Dallam, 4 Dana 574; Walser v. Seligman, 13 Fed. 415; Wetherbee v. Baker, 35 N. J. Eq. 501). Nothing short of this exhaust the remedy against the corporation. A mere award in arbitration has been held not to be sufficient. (Strelow v. American etc. Co., 162 Mich. 709). Having exhausted all legal remedies a creditor can then come into court alleging his judgment, the execution, and the return of the same unsatisfied and the court will then take notice of him.

There are, however, some exceptions to the above rule. In cases of dissolution and hopeless insolvency of a corporation the creditor is exempted from exhausting his legal remedy against the corporation. (State Savings Ass. v. Kellogg, 52 Mo. 583; Dryden v. Kellogg, 2 Mo. App. 87; Terry v. Tubman, 92 U. S. 156; Sherman v. S. K. D. Oil Co. 197 Pac. 799). The reason for this exception is obvious. The dissolution of a corporation renders the recovery of such judgment impossible or nugatory because nothing can be recovered against a dead corporation and it would be a vain thing to do to try to recover from a hopelessly insolvent corporation. To avoid unnecessary expenses and useless suits a creditor is allowed to overlook the corporation and go directly either to the shareholders or to other persons having the custody of the property of the corporation.

But in jurisdictions where statutes exist providing that assets of an insolvent corporation constitute a trust fund for the benefit of creditors i. e., in those states where this doctrine has attained statutory recognition,—the creditors may at once in-

voke this remedy without exhausting all other legal remedies. This is so in Alabama. (Cassells Mills v. First National Bank of Gadsden, 187 Ala. 325, 65 So. 820). In this case the doctrine is taken away from the realm of equity and the application must necessarily rest upon the requirements prescribed by law or statute.

C. CREDITORS TO SHARE RATABLY

The mere statement that the capital stock of a corporation is trust fund carries with it the conclusion that all the beneficiaries of the trust—all the creditors—are entitled to share ratably in its distribution, according to the principles of equity upon which courts proceed in the distribution of equitable assets. (Rieperv. Rieper, 79 Mo. 352). But in jurisdictions which leaves it in the power of a corporation to prefer its creditors, even in contemplation of insolvency, the proportionate distribution of the assets of an insolvent corporation is made impossible, specially if a preference is actually made. But in so far as the trust fund doctrine is concerned the rule is absolute that the creditors of a corporation should share ratably in the assets of the corporation.

IV. CRITICISMS OF THE TRUST FUND DOCTRINE

Salutary as this doctrine may seem to many courts, yet, there are not a few courts and writers who not only denies its existence but also criticizes it severely. The English courts, for instance, never recognized this doctrine in its laws and jurisprudence on corporations. In the United States, the Supreme Court of Minnesota is its most outstanding critic. In some other states, as in Missouri, Oregon, and lately in New York, this so-called American doctrine of trust is not recognized or being departed from.

First of all, this doctrine has been criticized on the ground that it "has given rise to much confusion of ideas as to its real meaning, and much conflict of decision in its application," because it is not sufficiently precise or accurate to constitute a safe foundation upon which to build a system of legal rules (Hospes v. Northwestern Manuf'g. & Car Co., 48 Minn. 174; 50 N. W. 1117). The same critic considers the phrase "the capital of a corporation constitutes a trust fund for the benefit of creditors" as misleading, because it considers corporate property as not

held in trust in any proper sense of the term due to the existence of absolute power of disposition by the corporation of its corporate property which control is denied or absent in the trustee holding the legal title in real trust cases. It is argued that the corporation has the whole beneficial interest as well as legal title over its property and may use it in any way it pleases, while in real trust, the beneficiaries have some control of the property—they can interfere with its management and can even ask for an accounting. (See also Javier, Law on Private Corporations, pp. 78-79). It is also pointed out that the character of the actions which are frequently mistakenly instituted on the strength of this doctrine shows how confusing a device it is.

The use of the word "trust" is also very much criticized because it is admittedly a misnomer, (see supra II, D). Professor Pomeroy considers the theory as one based on analogy and metaphor, which stand of his was confirmed by the United States Supreme Court in the case of Hollins v. Brierfield Coal and Iron Co. (150 U. S. 371, 37 L. ed. 1113) when it says that there is no direct and express trust attaching to the property of the corporation but rather in its administration. (To the same effect see Chick v. Fuller, 114 Fed. 22).

Professor George W. Pepper in an article (in 34 Am. L. Reg. 448) strongly objects to the expression "trust fund" and considers that the trust theory is untenable, and that the conception is at war with notions which were derived from English law with regard to the nature of corporate bodies. The same writer is of the opinion that the expression "trust fund" is one which is applied by American courts to the judicial recognition of the demand of the commercial world, which is in substance that the liability of stockholders shall be unlimited up to the par value of his shares and he shall not be entitled to any legal principle which would entitle him to advantage against corporate creditors.

Another criticism is that there is much confusion in regard to what the "trust fund" doctrine applies. It is pointed out that unpaid subscribed capital is a trust fund, while other assets are not, that courts are not agreed as to the limits of its application, that while some courts held that once subscription is paid in, it ceases to be a trust fund, while other cases hold that paid or unpaid it is all a trust fund. However, it may be said in this connection that like all other rules, legal or moral, its

scope is often found to "terminate in a penumbra shading gradually from one extreme to the other." This is more so where there is an absence of statutory rules legally fixing the limits of its application, and leaving it to equity to define its boundaries depending upon particular circumstances in each case. Moreover, the fundamental rule is clear that, the capital stock of a corporation is a trust fund for the benefit of its creditors, so that however it may be applied, provided it can be embraced within the rule and doing no violence to it, there should be no real objection in its application, especially, if account is taken of the fact that equity lays more stress in the equitable ends desired rather than in the means used to accomplish them.

V. THE FUTURE OF THE TRUST FUND DOCTRINE

The present status of the trust fund doctrine is by no means the final and permanent one that it will assume. Like any other legal institution it may still grow and creep into the settlement of new questions regarding the rights of corporate creditors and corporation and its stockholders involving corporate capital stock and assets, or it may also outgrow its usefulness, or be supplanted by other doctrines now or hereafter to be enunciated by courts or by laws of the legislature. But if its past development is to be the guide of its future it may be predicted that it will continue to stay in corporation law and may be further expanded in its application.

Perhaps this doctrine may be extended to cover capital stock reduction, a recent device often resorted to by corporations especially during the recent economic depression. Through this device many corporations have succeeded in eliminating or reducing, at least, on their books—deficits or losses incurred during the depression, thus apparently restoring its financial standing to a dividend paying basis. This stock reduction which is a bookkeeping adjustment makes available to stockholders assets which they would not be otherwise entitled. (Capital Stock Reduction as Affecting the Rights of Creditors, 47 Harv. Law Rev., pp. 693-698). This may be a new field for the application of the trust fund doctrine inasmuch as there is a clash of interests between stockholders and creditors, for notwithstanding statutory requirements for the keeping by corporations of minimum financial reserves, still creditors are only given a minimum protection by this requirement. A capital stock reduction, in effect, is considered a pro tanto dissolution, and, where-

as in the case of dissolution it is a requirement that no distribution can be made without outstanding claims being paid first, in this newly resorted device corporate assets are paid as dividends to stockholders in preferences over creditors.

From the foregoing discussion, it appears that the trust fund doctrine really serves the purpose for which it was created, notwithstanding criticisms and objections against it. Although called a confusing device by those who deny its existence, yet if properly understood and applied within the limits of its proper application, there is really nothing confusing against it. On the contrary it is a convenient and seemingly appropriate phrase to express a certain general idea in the relation between corporation and its creditors.

The usefulness of this doctrine shall remain as long as corporations retain the prominence it now occupies in the commercial and business world. Its place in American jurisprudence, and for that matter in Philippine jurisprudence, is secure until a better substitute for it is invented either by the courts or by the legislature.