"WATERED STOCK"-SHAREHOLDER'S LIABILITY TO CREDITORS IN ARIZONA

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INTRODUCTION

Shares of stock in a corporation are usually issued as fully paid and non-assessable,[1] and generally a corporate shareholder's investment risk is limited to the consideration given for the shares acquired.[2] When a corporation has agreed to accept less than par value[3] as full payment, the courts (in the absence of contrary statutory or constitutional provisions) have usually held the corporation bound by its agreement and estopped to assess the subscriber for the deficiency.[4] However, when the corporation has issued "watered stock,"[5] the holder of such shares may be held liable directly to corporate creditors to the extent of the "water" therein.[6]

Stock watering[7] occurs where corporate shares are issued as fully

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[1] See HENN, CORPORATIONS § 169 (1961) [hereinafter cited as HENN].

[2] See BALLANTINE, CORPORATIONS § 355 (rev. ed. 1946); see also ARIZ. REV. STAT. ANN. § 10-122 (1956), which provides that shareholders of an Arizona corporation will be personally liable for corporate debts unless the articles of incorporation provide that the shareholders will be exempt. *Cf.* Employer's Liab. Assur. Corp. v. Lunt, 82 Ariz. 320, 313 P.2d 393 (1957).

[3] Shareholder liability for watered stock ordinarily relates to par value stock, hence the discussion herein will pertain primarily to stock of that type. However, the same rules of shareholder liability may be applied to holders of stock without par value (no-par stock) when it is issued and/or capitalized on the corporate books for a fixed dollar amount ("stated value") per share. See discussion in text *infra.*

[4] Hospes v. Northwestern Mfg. & Car Co., 48 Minn. 174, 195, 50 N.W. 1117, 1120 (1892); see 1 COOK, CORPORATIONS § 38 (8th ed. 1923); 11 FLETCHER, PRIVATE CORPORATIONS §§ 5226, 5227 (perm. ed. rev. vol. 1958) [hereinafter cited as FLETCHER]; Bonbright, *Shareholders' Defenses Against Liability to Creditors on Watered Stock,* 25 COLUM. L. REV. 408 (1925).

[5] The term "watered stock" is said to be derived from the practice of salting and watering livestock before selling it by weight. HENN § 169 at 252 n. 9. The "water" in the stock, of course, is the dollar amount by which the par or stated value of shares issued exceeds the sum of money plus the fair value of other (qualitatively permissible) property received by the corporation in exchange therefor, on original issuance.

[6] See Bonbright, *supra,* note 4, at 411.

[7] Liability for watered stock (issued by a corporation which has agreed to accept cash and/or property of total value less than the full par or stated value in full payment for the stock issued) is to be distinguished from liability on a stock subscription contract on which payments have not been completed. The respective theories of liability differ. See Comment, 16 WASH. L. REV. 238, 239 (1941). For cases involving subscription contracts, see People's Nat'l Bank v. Taylor, 17 Ariz. 215, 149 Pac. 763 (1915); Stiles v. Samaniego, 3 Ariz. 48, 20 Pac. 607 (1889). Discussion herein will be limited to liability for watered stock.

paid up when in fact the full par value (or stated value in the case of no-par shares) has not been paid in.[8] Watering may occur in various ways. Shares may be issued gratuitously ("bonus shares") under an agreement that nothing shall be paid into the corporation therefor; they may be issued for cash at a discount below par value ("discount shares"); or they may be issued in payment for property, labor, or services having a fair value less than their aggregate par or stated value.[9] No shareholder liability results where no-par shares are issued in exchange for qualitatively permissible property or services contributed to the corporation if no dollar value is placed upon the shares and if the issuance occurs at a time when no other no-par shares are outstanding.[10] If, however, a fixed dollar amount ("stated value") is attributed to the no-par shares on original issuance, the same principles of liability for stock watering resulting from over-valuation of contributed property and services (or from a deficiency in cash paid) will apply to no-par as to par value shares.[11]

The problem of watered stock in publicly-held corporations has become markedly less significant in the last thirty to forty years due to the enactment and enforcement of the various state Blue Sky laws[12] and the Federal Securities Act of 1933,[13] as well as the use of no-par and low-par shares. However, the possibility of stock watering, with the resultant risk of shareholder liability, still exists in cases of small issues of securities which are exempt from federal and state securities regulation, or where property at a greatly inflated value is exchanged

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[8] Loud v. Solomon, 188 Mich. 7, 13, 154 N.W. 73, 75 (1915); Lee v. Cameron, 67 Okla. 80, 82, 169 Pac. 17, 20 (1917); see generally 18 AM. JUR. 2d *Corporations* § 266 (1965).

[9] "Watered stock," strictly speaking, refers to shares issued for overvalued property or services, but the term has been applied broadly so as to comprehend "bonus" and "discount" shares as well. See 11 FLETCHER § 5199.

[10] See BALLANTINE, CORPORATIONS § 203, 205 (rev. ed. 1946) [hereinafter cited as BALLANTINE]. Of course, if additional, authorized, no-par shares should be issued at a time when previously issued no-par shares of the same class are outstanding, holders of such outstanding shares would enjoy equitable rights to prevent dilution of the value of their holdings by issuance of such additional shares for a consideration (on a per-share basis) less than the existing fair value of the outstanding no-par shares.

[11] Livingston v. Adams, 226 Mo. App. 824, 43 S.W.2d 836 (1931); *cf.* G. Loewus & Co. v. Highland Queen Packing Co., 125 N.J. Eq. 534, 6 A.2d 545 (Ch. 1939); see BALLANTINE §§ 204, 354; see generally Bonbright, *The Dangers of Shares Without Par Value*, 24 COLUM. L. REV. 449 (1924).

[12] See *e.g.*, Securities Act of Ariz., ARIZ. REV. STAT. ANN. §§ 44-1801-2037 (1956). (1956).

[13] 48 Stat. 74, 15 U.S.C. § 77a-aa (1965).

for stock.[14] The practicing attorney should be aware of this in order to help prevent, by proper counseling and draftsmanship, the pitfalls of possible shareholder liability for watered stock.

SHAREHOLDER LIABILITY AT COMMON LAW

At early English common law, the creditors of an insolvent corporation could not compel the holders of its stock, issued as fully paid for a contribution to the corporation of less than par value, to pay up the difference between the par value and the amount paid in.[15] Most courts in the United States, however, have required the shareholder to make full payment for his stock although contrary to his actual agreement with the corporation, when such payment is necessary to prevent a fraud upon the corporate creditors.[16] Although the courts generally concur in holding the shareholder liable[17] under these circumstances, they have not been in complete agreement as to the common-law justification. Two main theories of liability have emerged.[18]

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[14] See BAKER & CARY, CASES ON CORPORATIONS 740 (3rd ed. 1959). There are two common-law rules governing the valuation of property against which stock of a corporation may be issued as fully paid.

(1) *Trule Value Rule.* This rule requires that the consideration at the time of the issue of the stock have a value no less than the par value. Motive, good faith, and intent are disregarded. This rule has been largely rejected in recent years.

(2) *Good Faith Rule.* This rule requires only that such consideration be deemed by the board of directors in good faith to have a value no less than the par value. The rule is followed by the majority of courts and has been codified by some states.

For a general discussion on valuation of property see 2 BONBRIGHT, VALUATION OF PROPERTY (1937); 11 FLETCHER §§ 5214-21.

[15] *In re* Ince Hall Rolling Mills Co., 23 Ch. D. 45 (1882). This theory prevailed in New York prior to statutory modification. Christensen v. Eno, 106 N.Y. 97, 12 N.E. 648, (1887).

[16] See 11 FLETCHER § 5232. There are two generally recognized exceptions to the rule that a corporation cannot issue par value shares for less than par.

(1) *Treasury shares.* Treasury shares need not be issued at par but may be sold at the best price that can be obtained. See 11 FLETCHER § 5204.

(2) *Handley v. Stutz Doctrine.* Where an active corporation finds its original capital stock impaired by loss or other misfortune, it may be able to rehabilitate itself by putting a new issue of stock on the market and selling it for the best price that can be obtained. Handley v. Stutz, 139 U.S. 417 (1901). See HENN § 167.

[17] The record owners of the corporate stock are usually subject to liability as shareholders. The shareholder cannot evade liability by transfer. The transferee of watered stock who believes in good faith that the full consideration had been paid will not be liable for any unpaid balance. See HENN § 171, for a discussion and case citations.

[18] These two theories are the "trust fund theory" and the "holding out theory" which are discussed in the text *infra.* Another theory, known as the "statutory obligation theory," has developed, but it cannot be classified as a common-law doctrine because it must have as its basis a statute concerning liability. In Comment, 24 TENN. L. REV. 584, 590 (1956), the author explains the statutory obligation theory as follows:

Under this view the requirement of full payment is based on an inference

Trust fund theory. Early cases justified shareholder liability on the theory, first announced by Justice Story in *Wood v. Dummer*,[19] that the corporate assets, including unpaid consideration for shares, constitute a "trust fund" for the benefit of creditors.[20] In the event of insolvency, corporate creditors have an equitable interest which they can pursue against the holders of watered stock. Under this theory, the obligation owed by such shareholders runs to the corporation, not to the creditors, hence it may be enforced by the corporation's receiver or trustee in bankruptcy.[21] Since corporate assets are not held in trust by the corporation, the trust fund theory, as an explanation of the basis of liability, has been completely discredited, and though some courts purport to follow it, they are actually applying the holding out theory.[22]

Holding out theory. The majority of American courts today have adopted the so-called "holding out" or "fraud" theory as the basis for imposing common-law liability upon the shareholder for watered shares. According to this doctrine, shareholders who accept "fully-paid" stock from the corporate issuer in exchange for a contribution of less than par value are deemed guilty of participating in a fraud (real or constructive) against those corporate creditors who thereafter presumably rely upon the corporate capital account as accurately representing the the actual paid in capital.[23] Fraud by the shareholder is conclusively presumed since the burden of proving actual fraud, which seldom exists, would defeat most creditors.[24] Legal writers have criticized the holding out theory on the ground that it is not a true application

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from the statutory and limited liability privilege; hence, the subscriber cannot defeat the creditor by proof of non-reliance, and creditors both prior and subsequent to the subscriber's purchase can avail themselves of the statutory remedy. The basis of the shareholder's liability is not misrepresentation of fact as to the amount paid in, but an obligation imposed by law on the shareholder to contribute capital as an incident of membership in a limited liability corporation. The law assures to those dealing with the corporation that the whole of the subscribed capital shall remain available for the discharge of its liabilities except as diminished by business losses.

Compare Easton Nat'l Bank v. American Brick and Title Co., 70 N.J. Eq. 732, 64 Atl. 917 (Ct. Err. & App. 1906) (leading case on statutory obligation theory), *with* Bing Crosby Minute Maid Corp. v. Eaton, 46 Cal. 2d 484, 297 P.2d 5 (1956) (rejecting statutory obligation theory).

[19] 30 Fed. Cas. 435, 436 (No. 17944) (C.C.D. Me. 1824).

[20] *Accord*, Sawyer v. Hoag, 84 U.S. (17 Wall.) 610 (1873); *In re* Phoenix Hardware Co., 249 Fed. 410 (9th Cir. 1918); see generally 2 STORY, EQUITY JUR. § 1252 (12th ed. 1877); STEVENS, CORPORATIONS § 183 (2d ed. 1949).

[21] Cases cited note 20 *supra;* see BALLANTINE § 349.

[22] STEVENS, CORPORATIONS § 183 (2d ed. 1949); BALLENTINE § 349; Wickersham, *The Capital of a Corporation*, 22 HARV. L. REV. 319, 332 (1909); see also Judge Mitchell's criticism of the trust fund theory as a basis of shareholder liability in Hospes v. Northwestern Mfg. & Car. Co., 48 Minn. 174, 192, 50 N.W. 1117, 1119 (1892).

[23] Hospes v. Northwestern Mfg. & Car Co., 48 Minn. 174, 50 N.W. 1117 (1892) (leading case); 11 FLETCHER § 5233.

[24] See Comment, 33 MARQ. L. REV. 176, 178 (1950).

of the common-law tort action of deceit. Bonbright meets their contention by stating:

> [T]his view [that the holding out theory has no common-law basis] is based on the assumption that common law is no longer a developing institution. A more realistic view may be, that our American courts have been creating common law, and that, faced with the new problem of shareholder liability, they have established a new legal principle.[25]

Under the holding out theory, only *subsequent* creditors who have *relied* on the holding-out of a substantial stated capitalization may recover.[26] Courts adhering to the holding out theory as a basis of liability usually follow the leading case of *Hospes v. Northwestern Mfg. & Car Co.*[27] in holding that proof of knowledge of stock watering by a subsequent creditor is an affirmative defense which the defendant shareholder must allege and prove.

Procedurally, creditors must proceed by a creditor's bill in equity, not a law, to enforce the shareholder's liability, unless there is a statute providing for direct liability.[28] Under the holding out theory, the shareholder's liability on watered stock is a *direct* liability to the creditors. The cause of action is not an asset of the corporation, hence most courts hold that it does not pass to and is not enforceable by the corporation's receiver or trustee in bankruptcy.[29]

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[25] Bonbright, *supra* note 4, at 413.

[26] Bing Crosby Minute Maid Corp. v. Eaton, 46 Cal.2d 484, 297 P.2d 5 (1956); Calif. Nat'l Supply Co. v. O'Brien, 51 Cal. App. 606, 197 Pac. 414 (Dist. Ct. App. 1921); Hospes v. Northwestern Mfg. & Car Co., 48 Minn. 174, 50 N.W. 1117 (1892); see annot., 7 A.L.R. 972 (1920), suppelmented in annot., 69 A.L.R. 881 (1930).

[27] 48 Minn. 174, 50 N.W. 1117 (1892).

See BAKER & CARY, CASES ON CORPORATIONS 759 (1959). In regard to reliance, GUTHMAN & DOUGALL, CORPORATE FINANCIAL POLICY 437 (1954), points out that trade creditors place less emphasis on the financial statements obtained from the buyer, and more emphasis on the credit applicant's debt-paying habits in the initial credit granting and upon his record of payment thereafter. This should weigh heavily in sustaining the burden of proof by the defendant-shareholder of non-reliance.

In determining whether to hold a holder of watered shares liable for debts of an insolvent corporation, courts should give consideration to whether the corporation after incorporation was a "going concern" for a while, or immediately embarked on a down-hill road to insolvency. If the corporation became insolvent soon after incorporation, the shareholders should be held liable. But, if the corporation had a profitable period prior to insolvency, this would tend to squeeze the water out of the stock and should limit the recovery of creditors who extended credit *during this period.* It is possible that corporate earnings may have been such as to have, in effect, squeezed all the original water out of the stock, after which subsequent creditors would seem to have no proper basis for holding the shareholders. This approach was suggested in the case of Jeffs v. Utah Power & Light Co., 136 Me. 454, 12 A.2d 592, 599 (1940), dealing with a promoter's liability for secret profits.

See Bonbright, *supra* note 4, for an excellent discussion of various shareholder defenses.

[28] See 11 FLETCHER §§ 5244, 5248; BALLANTINE § 353.

[29] See 13A FLETCHER §§ 6495 (Receiver), 6496 (Trustee in Bankruptcy); 4 COLLIER, BANKRUPTCY ¶¶ 70.29, 70.47 (14th ed. 1964). There is some question whether, in

EFFECT OF ARIZONA'S CONSTITUTIONAL PROVISION ON SHAREHOLDER'S COMMON-LAW LIABILITY

History

During the mid-eighteen hundreds, stock watering became so prevalent that many states adopted constitutional and statutory provisions designed to curb this practice. Illinois, in 1870, was the first to adopt the constitutional provision that:

> Corporations shall not issue stock or bonds except for money paid, labor done or property actually received, and all fictitious increase of stock shall be void.[30]

Some 26 other states, including Arizona, followed with substantially

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view of the "strong arm" provision of the Federal Bankruptcy Act. § 70(c), a trustee in bankruptcy can enforce a personal right of a creditor against the shareholder of the bankrupt corporation. Federal Bankruptcy Act § 70(c), 66 Stat. 430 (1952), 11 U.S.C. § 110(c) (1965) provides:

> The trustee, as to all property, whether or not coming into the possession or control of the court, upon which a creditor of the bankrupt could have obtained a lien by legal or equitable proceedings at the date of bankruptcy, shall be deemed vested as of such date with all rights, remedies, and powers of a creditor then holding a lien thereon by such proceedings, whether or not such creditor actually exists.

When state law gives a right of action to the creditor rather than to the corporation, courts generally have not allowed the trustee to pursue the right of action by virtue of his status as a creditor under this "strong arm" clause. Morris v. Sampsel, 224 Wis. 560, 272 N.W. 53 (1937), *cert. denied* 305 U.S. 608 (1938); 4 COLLIER, BANKRUPTCY ¶ 70.29, at 1281 n. 41 (14th ed. 1946); 4 COLLIER, *op. cit. supra*, ¶ 70.47, at 1938, states:

> The new § 70(c) appears to provide literal support for allowing the trustee to vindicate such rights [personal rights of the creditor against the shareholder] on behalf of the estate by giving him as of the date of bankruptcy the appurtenances of a lien as to all property upon which the judgment creditor of the bankrupt could have obtained a lien by judicial proceedings .... [But] the avowed purpose "to give the trustee the right of a lien creditor upon which the bankrupt has an interest as to which the bankrupt may be ostensible owner" may be relied on as a basis for denying to the trustee the right to pursue the "personal" rights of creditors.

[30] See 11 FLETCHER § 5209.
The ILL. CONST. art. 11 § 13 provides:
> No railroad corporation shall issue any stock or bonds except for money, labor or property actually received and applied to the purposes for which such corporation was created; and all stock, dividends and other fictitious increase of capital stock or indebtedness of any such corporation, shall be void. The capital stock of no railroad corporation shall be increased for any purpose, except upon giving sixty days' public notice in such manner as may be provided by law.

similar provisions.[31] Arizona, Washington, and Utah substituted the words "to bona fide subscribers therefor or their assignees" for the phrase "for money paid, labor done or property received."[32] The provision in those states thus reads:

> No corporation shall issue stock except to bona fide subscribers therefor or their assignees . . . . All fictitious increase of stock or indebtedness shall be void.[33]

Due to the ambiguous phrase "All fictitious increase of stock or indebtedness shall be void,"[34] a maze of confusion and litigation has arisen over its legal effect. The phrase has generally been construed to refer to the quantity or quality of the consideration given, but the effect of the phrase has been much limited. The word "fictitious" has been narrowly construed, and the word "void" read for the most part as "voidable."[35]

Effect as Between Shareholders and the Corporation

As between the shareholder and the corporation, wholly bonus shares, *i.e.*, those issued for little or no consideration, are usually held

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[31] See Ettlinger v. Collins, 25 Ariz. 115, 120, 213 Pac. 1002, 1004 (1923), where the court lists the states. California and Wisconsin have since repealed their provisions. A representative group of states having the provisions are: Illinois, Missouri, Nebraska, Oklahoma, Pennsylvania, Texas, Utah, and Washington.

[32] ARIZ. CONST. art. 14, § 6, UTAH CONST. art. 12, § 5, WASH. CONST. art. 12, § 6. At the Arizona Constitutional Convention, there was a movement to delete the phrase "to bona fide subscribers therefor or their assignees" and insert in its place "for money, labor done or property actually received" thus restoring the provision to the form of the original Illinois provision. The motion for such amendment was defeated 16 to 15. MINUTES OF CONSTITUTIONAL CONVENTION OF THE TERRITORY OF ARIZONA 271 (1910). This was unfortunate since the provision was ambiguous enough without adding another ambiguous phrase, "bona fide subscriber."

[33] ARIZ. CONST. art. 14, § 6, UTAH CONST. art. 12, § 5, WASH. CONST. art. 12, § 6, Stocks, bonds:

> No corporation shall issue stock, except to bona fide subscribers therefor or their assignees; nor shall any corporation issue any bond, or other obligation, for payment of money, except for money or property received or for labor done. The stock of corporations shall not be increased, except in pursuance of a general law, nor shall any law authorize the increase of stock of any corporation without the consent of the person or persons holding the larger amount in value of the stock of such corporation, nor without due notice of the proposed increase having been given as may be prescribed by law. All fictitious increase of stock or indebtedness shall be void.

[34] At the Arizona Constitutional Convention an attempt was made to replace the "fictitious increase" phrase with "any increase of stock or indebtedness not in conformity with the provisions of this section shall be void" or, in the alternative, to strike out the "fictitious increase" phrase. Both proposed amendments were defeated. MINUTES OF CONSTITUTIONAL CONVENTION OF THE TERRITORY OF ARIZONA 360 (1910).

[35] See 1 DODD & BAKER, CASES ON BUSINESS ASSOCIATIONS, CORPORATIONS 923 (1940); 11 FLETCHER §§ 5209, 5240.

to be void and thus not to create any rights or standing as shareholders.[36] But where the shares, although being entirely without consideration, have passed into the hands of an innocent transferee for value, some courts have construed "void" in the constitutional provision to mean merely "voidable" and have not allowed the stock to be impeached.[37]

If the shares are issued as fully paid, but for a cash consideration less than par or for overvalued property or services, a majority of the courts have not treated them as void but instead as creating the rights of a shareholder and binding the corporation to accord such rights.[38] In the leading case of *Memphis & Little Rock R.R. v. Dow*,[39] the United States Supreme Court, in construing Arkansas' constitutional provision (which is similar to that of Illinois'), held that bonds were not fictitious and void if they were issued for anything whatever of substantial value, and this reasoning would seem equally applicable to stock. That is, in order to be considered fictitious, the stock or bonds must have been issued for little or no consideration.

The Arizona court has not definitively interpreted the "fictitious increase" phrase. In *Frame v. Mahoney*,[40] the court, in an action by a minority shareholder, canceled stock that had been issued for *worthless* mining claims, holding that the defendant shareholder was not a "bona fide subscriber" as required by the constitution. The court construed "bona fide subscriber" to mean someone who has turned over something of value to the corporation for the stock issued.[41] Since the mining claims were worthless, the defendant was not a "bona fide subscriber." The court did not find it necessary to construe the "fictitious increase"

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[36] Frame v. Mahoney, 21 Ariz. 282, 187 Pac. 584 (1920); Arkansas River Land, Town & Canal Co. v. Farmers Loan & Trust Co., 13 Colo. 587, 22 Pac. 954, (1889); Mueller Furnace Co. v. Holmes, 175 Wis. 518, 185 N.W. 641 (1921). See generally 1 DODD & BAKER, CASES ON BUSINESS ASSOCIATIONS, CORPORATIONS 923 (1940).

[37] See 11 FLETCHER § 5240, citing cases holding both ways. In Overlock v. Jerome-Portland Copper Mining Co., 29 Ariz. 560, 243 Pac. 400 (1926), the court denied a bona fide purchaser of some watered shares the status and rights of a shareholder, but the stock involved had been canceled in prior litigation (see note 42 *infra*). Therefore, the case does not stand for the proposition that watered stock in the hands of an innocent transferee for value is necessarily void.

[38] Mudd v. Lanier, 247 Ala. 363, 24 So. 2d 550 (1946); Shaw v. Straight, 107 Minn. 152, 119 N.W. 951 (1909); Grants Pass Hardware Co. v. Calvert, 71 Ore. 103, 142 Pac. 569 (1914); *Contra*, Lee v. Cameron, 67 Okla. 80, 169 Pac. 17 (1917). OKLA. CONST. art. 9, § 39, provides that shares shall not be issued "except for money, labor done, or property actually received *to the amount of the par value thereof.*" (Emphasis added.) The court, in construing this phrase which is more specific than in most other states having "fictitious increase" phrase, held that stock issued for *less than par* was void in the hands of the subscriber as well as a bona fide purchaser.

[39] 120 U.S. 287 (1887); *accord* Peoria S. R.R. v. Thompson 103 Ill. 187 (1882).

[40] 21 Ariz. 282, 187 Pac. 584 (1920).

[41] *Id.* at 289, 187 Pac. at 586.

phrase.[42] The Arizona court has thus construed the "bona fide subscriber" requirement in the Arizona constitutional provision as having the same legal effect as the "fictitious increase" phrase has been construed to have by the courts of many other states, *i.e.*, shares issued for little or no consideration are void or at least subject to cancellation on suit of a dissenting shareholder.[43]

The Arizona court has not yet ruled on the status of shares issued for some substantial consideration but which is less than the par value

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[42] In Ettinger v. Collins, 25 Ariz. 115, 213 Pac. 1002 (1923), the court held that a purchaser of the *Frame* stock might recover damages from his vendor if he could show bad faith. In Overlock v. Jerome-Portland Copper Mining Co., 29 Ariz. 560, 243 Pac. 400 (1926), the court denied a bona fide purchaser of the *Frame* shares the status and rights of a shareholder. The results in both cases can be justified solely on the basis that the shares involved (or a reissue of the same) were canceled by the court in the *Frame* litigation. The court in both the *Ettlinger* and *Overlock* cases discussed the meaning and legal effect of the fictitious increase phrase, but all of this was dictum. See note 43 *infra*.

[43] See note 38 *supra*.

In light of the Arizona court's construction of the "bona fide subscriber" phrase, the question arises: What does the "fictitious increase" phrase mean in the Arizona constitution? If it has the same meaning that it was designed to have in the Illinois constitution, then the "bona fide subscriber" and "fictitious increase" phrases are essentially synonymous.

The minutes of the constitutional convention reveal that the framers were in doubt as to the meaning of the phrase. See, *e.g.*, Hunt, Verbatim Report of the Arizona Constitutional Convention 3, Friday afternoon, Dec. 2, 1910:

> Mr. Jones of Yavapai: I would like to know in section 7 what the last sentence means, "All fictitious increase of stock or indebtedness shall be void."
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> Mr. Cunniff: I beg to say that *the revisions committee in discussing this matter unanimously decided that they did not know what the word fictitious meant.* I would like some information so it can be properly amended.
> Mr. Cunningham: It is usually stated "watered."
> Mr. Roberts: I might throw a little light on the meaning by calling attention to a case in Colorado where at a meeting of stockholders of a corporation 300,000 more shares than they were permitted to issue showed up.
> Mr. Cunniff: I beg to say our presumption was to say that "fictitious stock" was stock issued without money received or labor done and was really invalid or illegal issuance of stock.
> Mr. Ellinwood: The legal definition of the word "fictitious stock" is "stock issued without consideration", just exactly what Mr. Cunniff said. (Emphasis added.)

The Arizona legislature evidently construes "fictitious increase" to mean overissue. ARIZ. REV. STAT. ANN. § 10-323 (1956) (amendments and changes in capital stock), provides: "A fictitious increase or decrease of stock or indebtedness shall be void."

The Arizona court has not yet clearly defined the meaning of the term. In Overlock v. Jerome-Portland Copper Mining Co., 29 Ariz. 560, 564, 243 Pac. 400, 401 (1926), the court stated in dictum that "The Frame stock [Frame v. Mahoney, 21 Ariz. 282, 187 Pac. 584 (1920)] was not an *overissue [i.e.*, an issue in excess of an amount authorized by law], and therefore not a 'fictitious increase of stock' and void on that ground." (Emphasis added.) But, the court at page 565, 243 Pac. at 401, of the opinion contradicts this by quoting a statement that stock issued *without consideration* is fictitious and therefore void. The concurring opinion by Lockwood, J., at page 567, 243 Pac. at 402, expressed the view that the phrase fictitious issue referred only to overissue.

Washington has construed its provision which is identical to Arizona's to refer to consideration, not overissue. Fox v. Seattle Contract Copper Co., 98 Wash. 557, 563, 168 Pac. 185, 187 (1917); Jorguson v. Apex Gold Mines Co., 74 Wash. 243, 247,

of the shares. There is a suggestion in a dictum in *Overlock v. Jerome-Portland Mining Co.*[44] that one would not be a "bona fide subscriber" unless he "paid for the stock at its face value." It is doubtful that the Arizona court, when squarely faced with the problem, would cancel the shares where the subscriber had paid substantial consideration for them, unless to hold otherwise would work a fraud on the other shareholders.[45] In such a case, the best solution (if feasible in the particular case) would seem to be that of canceling only so many of the shares as represent the water involved.

Effect as Between Shareholders and Corporate Creditors

The purpose of the constitutional provision, as well summarized by the Arizona court, "is to protect creditors, to prevent the distribution of worthless stock, and to protect stockholders against spoilation."[46] Although a major objective was, it seems, the protection of corporate creditors, the provision does not in terms impose shareholder liability for an unpaid balance of par or stated value. Recission in favor of the corporation (a fruitless gesture in the event of insolvency) would

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133 Pac. 465, 467 (1913).

Utah apparently has not construed its provision; but a three-judge dissent (for reasons other than construction of Utah's constitutional provision) in East River Bottom Water Co. v. Boyce, 102 Utah 149, 128 P.2d 277, 280 (1942), stated that:

> It is our opinion that the word "fictitious" as used in article 12 § 5 of the constitution pertained [sic] only to stock which in fact does not exist . . . we think as above stated, that as to stock the constitution meant only an *overissue* to be fictitious and therefore void. (Emphasis added.)

As can be seen from above, there is no clear answer as to what "fictitious increase" means in the Arizona constitution. A determination that "All fictitious increase of stock . . . shall be void" refers only to *overissue* might have a significant legal effect on the liability of a shareholder holding watered stock which he had promised to pay for. His stock would probably not be held void if creditors of an insolvent corporation are involved. (See the discussion of Hirschfeld v. McKinley, 78 F.2d 124 (9th Cir. 1935), in the text accompanying note 51 *infra* for the unjust results of holding stock void under these circumstances.) A determination that the phrase refers to overissues of stock would probably be the most reasonable and logical construction based on the wording of the whole provision. The "fictitious increase" phrase is not a part of the sentence referring specifically to watered stock but instead has been placed as a separate sentence at the very end of the provision. The second sentence of ARIZ. CONST. art. 14, § 6, states that "The stock of corporations shall not be increased, except in pursuance of a general law . . . ." This phrase uses *increase* to refer to the amount of capital authorized. Since the "fictitious increase" phrase follows this sentence and *increase* is used in both sentences, it is reasonable to conclude that "fictitious increase" refers to the amount of stock issued which was not authorized, *i.e.*, overissue. Also, this construction would prevent "fictitious increase" from being a redundant phrase.

[44] 29 Ariz. 560, 564, 243 Pac. 400 (1926).

[45] In Frame v. Mahoney, 21 Ariz. 282, 187 Pac. 584 (1920), the court stated that one is a bona fide subscriber if he turns over to the corporation *something of value* for the stock issued. The court did not state that the value had to be at least equal to the par value of the stock.

[46] Prina v. Union Canal & Irr. Co., 63 Ariz. 473, 478, 163 P.2d 683, 685 (1945). In Overlock v. Jerome-Portland Copper Mining Co., 29 Ariz. 560, 564, 243 Pac. 400, 401 (1926), the court stated that the provision "was intended more for the protection of creditors of the corporation than otherwise."

seem to be the only remedy directly indicated by the constitutional language, and even this remedy would seem unavailable unless the stock was entirely fictitious, as discussed above.

However, most courts have held that the only possible effect of the constitutional provision is to declare the *contract* (for the issuance of watered stock) void as between corporation and shareholder, and that such provision has no bearing on the creditor's common-law rights against the shareholder.[47] Logically this is sound since, under the modern "holding out" theory, the action is in tort and the status of the agreement between shareholder and corporation is immaterial. There is just as much holding-out by a shareholder, and just as much reliance by the creditor, where the stock is void as where it is valid. This theory is also supportable on the ground that the purpose of the provision is to benefit, not defeat, the creditors.

There have been only two reported cases arising in Arizona concerning the possible liability of holders of watered shares to corporate creditors, both having been decided by a federal court.

In *In re Phoenix Hardware,*[48] a trustee in bankruptcy, by petition in the bankruptcy proceedings, sought to assess the outstanding capital stock of the bankrupt corporation in the hands of its shareholders. The company had been incorporated in 1907, under Territorial law with an authorized capital of $50,000 consisting of 500 shares of $100 par value. All of such shares were issued for merchandise found to be worth only $10,000. The court, applying the even then out-dated "trust fund" doctrine,[49] allowed the trustee to recover. As noted above, the trust fund doctrine has been completely discredited and would not likely be followed today by the Arizona courts.[50]

In *Hirschfeld v. McKinley,*[51] a trustee in bankruptcy sued one of the original subscribers to assess his 249 shares of common stock. This stock of $100 par value ($24,900 total) was issued to defendant as "fully paid" for a consideration amounting to less than $350. A decree assessing the shares was reversed on appeal, the court basing its decision on two grounds: (1) that the shares were wholly void under Arizona's constitutional provision (making all fictitious increase in stock void) and thus could not be made the basis of liability to the corporation or its trustee, and (2) that the action could not be sustained on the common-law holding out (fraud) theory since it was necessary to show,

[47] DuPont v. Ball, 11 Del. Ch. 430, 106 Atl. 39 (Sup. Ct. 1918); Collier v. Edwards, 109 Okla. 153, 234 Pac. 720 (1925); Gray Construction Co. v. Hyde, 49 S.D. 543, 207 N.W. 536 (1926); see generally 11 FLETCHER § 5209; Bonbright, *supra* note 4.

[48] 249 Fed. 410 (9th Cir. 1918).

[49] *Id.* at 413.

[50] See note 22 *supra.*

[51] 78 F.2d 124 (9th Cir. 1955); *cert. denied,* 297 U.S. 703 (1936).

under that theory, that the particular creditors suing had been defrauded by a misrepresentation of the actual capital of the corporation.

The court correctly applied the modern "holding out" theory in the case. The cause of action belongs to the creditor who relied on the misrepresentation and is assertible by him against the shareholder. It does not belong to the corporation; hence, its trustee in bankruptcy may not properly assert it in the stead of the corporation. The court also noted that no fraud or deceit had been practiced on at least some of the corporate creditors since they either knew the true facts or did not rely upon the corporate character of the enterprise in extending credit. Non-reliance is a valid defense to a tort action based on the holding out theory.

Based on the facts of the *Hirschfeld* case, the court's holding that the shares themselves could not be the basis of liability appears correct, but its reasoning seems unsound. The court went to some length to demonstrate why it thought the shares were void and thus could not be the basis of liability on a contract theory, but the status of the shares (void or valid) was immaterial because even without Arizona's constitutional provision voiding fictitious increase of stock, the corporation (or its trustee in bankruptcy in its stead) could not impose any further assessment on the shareholders. Since the corporation issued the stock as "fully paid," it was bound by its agreement.[52]

If it is assumed, as the court evidently did, that the creditors' rights against the shareholder hinged *solely* on the status of the shares, the conclusion of the court that the shares were void even against creditors seems unreasonable.[53] To hold that watered stock is absolutely void has the effect of putting unpaid corporate creditors in a worse position than they would have occupied without the provision. It is doubtful that the Arizona court would allow the constitutional provision to be used to defeat corporate creditors — the very ones it was designed to protect.

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[52] See note 4 *supra* and accompanying text.

[53] BALLENTINE § 351, at 810, makes the following statement concerning the *Hirschfeld* case:

> In a few questionable decisions, however, these legislative prohibitions have been given literal effect and it has been held that the shares of stock issued for an inadequate consideration are void even against creditors. It seems clearly against the policy and aim of such provisions to make shares void as against claims of creditors and innocent purchasers. Such provisions might be the basis for a suit by other shareholders for cancellation of the underpaid shares in the case of a solvent corporation, but should not be construed to decrease the rights and remedies of creditors to enforce needed contributions of capital.

The court, in Stone v. Hudgens, 129 F. Supp. 273 (D. Okla. 1955), reached the same conclusion as in *Hirschfield*, permitting the shareholder to use the Oklahoma constitutional provision to defeat corporate creditors. The court in *Stone* did, however, stand on somewhat firmer ground, in view of the wording of Oklahoma's constitutional provision. See note 38 *supra*.

If the Arizona court is ever faced with this problem, it can best effectuate the manifest purpose of the constitutional provision by construing "void" to mean "voidable" (upon objection of other shareholders) as some other courts have done,[54] or by working out some basis of estoppel against the denial of liability (by the holders of watered shares) to corporate creditors.[55]

Conclusion

Arizona's constitutional provision concerning watered stock has very little effect upon the shareholder's liability as it existed at common law. The shareholder should only be held liable where a subsequent creditor has relied upon the misrepresentation of capitalization. Since a primary objective of incorporation is to shield the shareholder from personal liability, full effect should be given to this shield except where it is grossly unjust to do so. A creditor who extends credit knowing the true facts concerning the capitalization or relying only on credit reports should have no rights against the holders of watered stock.

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[54] See note 37 *supra*.

[55] For an application of estoppel in shareholder cases, see Shugart v. Maytag, 188 Iowa 916, 924, 176 N.W. 886, 890 (1920); Schiller Piano Co. v. Hyde, 39 S.D. 74, 162 N.W. 937 (1937).

If the Arizona court subsequently construes the phrase "All fictitious increase of stock . . . shall be void" to apply only to overissues of stock (see note 43 *supra* for discussion), there should be even less compulsion to hold the stock void if the result would be to defeat corporate creditors.