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HOW FAR A CORPORATION CAN, UNDER STATE STATUTES OR CONSTITUTIONAL PROVISIONS (TO EFFECT THAT A CORPORATION CAN ISSUE BONDS ONLY FOR MONEY OR ACTUAL PROPERTY RECEIVED), AUTHORIZE THE ISSUE OF BONDS AS COLLATERAL SECURITY FOR AN ANTECEDENT INDEBTEDNESS

The powers of a corporation are granted and restricted by its charter, together with the laws and constitution of the state of its creation. The ascertaining of the manner in which corporations are to be governed by laws extraneous to their charter, is a matter of interpretation. A power which is given a corporation by the common law and also by state statute and by that same statute restricted should be scrutinized more closely than statutes which are merely directory. For the interpretation of statutes we may look to the decisions of the courts of a state, but when we find that, concerning a certain portion of a statute, no direct decision has ever been rendered and that the only decisions ever made in the state on the question in point was in a case before the Federal Court of Appeals within that state, the problem becomes more difficult.

The question of issuing bonds by a corporation is regulated in most states by statutes and in the absence of statutes there is generally a constitutional provision covering the matter. Very few states rely upon the common law.

The Missouri Constitution provides,¹ "That no corporation shall issue stock or bonds, except for money paid, labor done or property actually received and all fictitious increase of stock or indebtedness shall be void."

The words of the statute² are "The stock or bonds of a corporation shall be issued only for money paid, labor done or property actually received."

In the recent case of *Mudge v. Black, Sheridan, Wilson et al.*, the Federal Court of Appeals, sitting in and for the Eighth District, held, that bonds which were issued by a corporation and given to

¹Constitution of Missouri, Article 12, Sec. 8.

²Revised Statutes of Missouri, 1909, Sec. 2891.

a creditor of that corporation as security for an antecedent indebtedness owing to that creditor must be regarded, in the light of the foregoing provisions, as invalid. It is to be understood that this decision was made without the support of any decisions on the point involved by the Supreme Court of Missouri. The practice of the Federal Court sitting within a state to recognize the decisions of that state could not be followed; their only resort then was to the decisions of the Federal Courts and to the courts of other states.

Before proceeding to the point involved in the principal case, mention should be made of the fact that bonds issued in settlement or in absolute payment of an antecedent debt, which is *bona fide*, are valid, and, that bonds duly issued to raise a present loan with which to pay an antecedent *bona fide* indebtedness are also valid. The question of a pledge or security is a different matter.

In order to be more brief and less monotonous, facts will be stated analagous to the facts in the case of *Kemmerer v. St. Louis Blast Furnace Co.*³ In that case there was a bill for foreclosure and sale. The property, which was covered by mortgage or trust deed, was sold and the proceeds were paid to the receiver appointed. The defendant had executed and delivered promissory notes for a pre-existing and past due indebtedness for goods, wares and merchandise sold and delivered by payee in the note to the maker thereof. There were collateral agreements in usual form reciting that bonds of the defendant had been deposited with the complainant as security for the payment of the notes. These bonds composed a part of an issue of which all were equally secured by a certain mortgage. The complainant sold these bonds at private sale and they were purchased by a third party for the use and benefit of the pledgees. Complainant obtained judgment against defendant on the notes less amount received from sale of bonds. After private transactions there was due certain amounts on the judgment and the bonds. Both claims were presented for allowance as a secured claim under mortgage. The Master disallowed these claims and on appeal the Federal Court sustained the Master's report.

The statute provides that "*all fictitious increase of stock or indebtedness shall be void.*"

Here the present indebtedness was not enlarged but a liability arose which would be recoverable out of the assets of the corporation; the difference between the amounts that would be ultimately realized from the enforcement of the pledges and the par value of

³*Kemmerer v. Blast Furnace Co.*, 212 Fed. 63.

the bonds pledged would increase the indebtedness of the company. For example, suppose notes are given by a corporation for twenty thousand dollars for a just antecedent debt and mortgage bonds are pledged for one hundred thousand dollars to secure it, and the pledge is foreclosed by decree of court, the bonds being sold for ten thousand dollars to a third party. There then remains a debt of the corporation of ten thousand dollars to the original creditor and a debt of one hundred thousand dollars to the purchaser of the bonds. The cause of the increase of the indebtedness from twenty thousand dollars to one hundred and ten thousand dollars, of which ninety thousand dollars would be without any valuable consideration and fictitious, would be the original pledge of the bonds. Upon such reasoning the Federal Court sustained the Master's report concerning the fictitiousness of the indebtedness.

Besides declaring all fictitious increase of indebtedness invalid the law requires that the bonds be issued for money paid. This indebtedness did represent, at the time at which it was incurred, so much property received, but the court interpreted the provisions to mean the receipt of a present consideration for the issue of the bonds and that the corporation receive for them an amount of value equal to the par value of the bonds, in order that the amount of stock and bonds should not misrepresent and deceive those who dealt with the corporation. Here the corporation had the same amount of assets the moment before it made the pledge that it had thereafter, but thereafter, that portion of its assets covered by the mortgages securing the bonds was incumbered by an additional liability.

As to the interpretation of the provisions the court say, in reference to the contentions that the pre-existing debts represent so much property received: "These interpretations of the terms of the constitution and statutes for which counsel argue seem strained, unnatural, and inconsistent with these familiar canons of construction; the plain, obvious, natural meaning should be preferred to any curious hidden sense suggested by the meditation and ingenuity of able and acute minds and the exigencies of the case. The object which the enacting body sought to attain and the evil which that body sought to remedy, may always be considered for the purpose of ascertaining its intention, and that intention should be given effect if the terms of the enactment do not render that result impossible. A rational, sensible construction, one that will advance the remedy and repress the wrong, must be given if consonant with the

terms of the constitution and statute. The obvious, natural, reasonable meaning of the inhibition of the provisions is that no corporation shall issue stock or bonds except in exchange for value equal in amount to the par value of the stock or bonds, either in money paid, labor done, or property actually received."⁴

To enlarge on the interrogation whether the court rightly decided the principal case in reference to the law of Missouri, we must, of necessity, resort to, first, the earlier decisions of the courts of Missouri concerning points extraneous to the present subject but indirectly affecting it; second, to the Federal courts and then to the decisions of other states.

In the case of *Garrett v. Kansas City Milling Co.*,⁵ the court say: "When the constitution permits a subscriber to pay for stock by labor done or property received, it means that the corporation must receive, in labor or property, what it was reasonably worth in money. The property or labor must be a fair, just, lawful and needed equivalent for the money subscribed."

In *Berry v. Rood*⁶ the court say: "This clause in the constitution puts a limit on the power of the legislature, so that if that body should attempt, it could not authorize the organization of a corporation with power to issue stock without receiving its equivalent in money, labor or property. It may be paid for in property, but in such case the property must be the fair equivalent in value to the par value of the stock issued therefor."

No question arises in this instance as to whether the decisions relating to the issuance of stock and of bonds are to be treated alike. Here we wish to ascertain the attitude of the court as regards the provisions of the constitution and statutes. These few cases are sufficient to bring to light the opinion of the Supreme Court. From this vague collection of ideas concerning the question in point the Federal court was called upon to decide the principal case. Its decision may seem inharmonious with previous decisions of that court, on first blush, but after close study the cases are distinguishable from the principal case.

We must remember throughout this discussion that it is seemingly essential to an issuance of bonds that there be a present con-

⁴*Mudge v. Black, Sheridan Wilson*, 224 Fed. 919.

⁵*Garrett v. Milling Co.*, 113 Mo. 330.

Van Cleve v. Berkey, 143 Mo. 109.

Shickle v. Watts, 94 Mo. 410.

Hunter v. Land Cooperage Co., 246 Mo. 135.

⁶*Berry v. Rood*, 168 Mo. 328.

sideration received in exchange for the bonds and the consideration must be of a value reasonably equal to the par value of the bonds. The principal case so held.

The trend of the Federal courts in respect to such provisions as are law in Missouri will now be considered.

The first case to be given consideration is that of *The Farmer's Loan and Trust Co. v. San Diego Street Car Co.*⁷ The court is very plain in the interpretation which it gives to provisions similar to those under consideration above. "This constitutional and statutory inhibition is plain, and has but one meaning—the money paid, labor done or property actually received must be paid, performed or received, as the case may be, on account of the issuance of the bonds; and any bonds issued contrary to this provision are of course illegally issued. The provision does not mean and cannot be held to mean, that such bonds may be issued as collateral security for any sort of pre-existing indebtedness. Now none of the bonds in question are, or ever were, issued or held for money paid, labor performed or property received on account of their issuance. On the contrary, all of them were delivered and are held as collateral security in part for a pre-existing indebtedness of the defendant corporation." That statement is very precise in exemplifying the fact that there must be a present consideration for an issuance of bonds and that the giving of time for the payment of the debt is not such a present consideration.

While the opinion in *William Fricke v. South Carolina Loan and Trust Co.*,⁸ often cited *contra*, shows much incongruity in its citations, the law in that case is not inconsistent with the principal case. The court say: "The constitution of the State of Arkansas has a provision in every respect the same as that in the constitution of the State of South Carolina which is now under consideration." There is then cited *Memphis R. R. Co. v. Dow*,^{8a} in which the court explains the protective purpose of the provisions and the value of that which may be received for the bonds issued and then concludes: "Provided, always, the transaction is a real one, *based upon a present consideration*, and having reference to legitimate corporate purposes, and is not a mere device to evade the law and accomplish that which is forbidden." In that case the company did not execute notes and pledge their bonds for an antecedent debt; the bonds were

⁷*Farmers Trust Co. v. San Diego Co.*, 45 Fed. 518.

⁸*Fricke v. S. C. Trust Co.*, 122 Fed. 569.

^{8a}*Memphis R. R. Co. v. Dow*, 120 U. S. 293.

pledged for a present consideration; the pledges were made to obtain funds with which to complete the purchase of machinery; and the money obtained was actually used for that purpose. The court refers to *Nelson v. Hubbard*, *contra*,⁹ and inclines to the view of that court in regard to the pledging of bonds for an antecedent indebtedness. That expression can only be regarded as *dicta*.

The case of *Nichols v. Waukesha Canning Co.*¹⁰ covers the issuance of bonds for a pre-existing debt, not surrendered. The court say: "Pre-existing debts are neither money nor property capable of being valued unless actually given up."¹¹ The court repudiates the doctrine that corporations may issue bonds as security for an antecedent debt. To be compared with the preceding case is the case of *First Savings and Trust Co. v. Waukesha Canning Co.*,¹² which is decided upon a clause in the statute of Wisconsin which is not included in the Missouri provision. In the Wisconsin case the transactions may be considered as a purchase of property at not less than three-fourths of its true value; a compliance with the spirit of the statute by express contract and obligation.

The last of the Federal cases to be mentioned is that of *Kemmerer v. St. Louis Furnace Co.*,¹³ in which the facts were identical with those of the principal case. To determine the application of the Missouri provisions to the facts, the court say: "A reading of the plain language of the constitution and statute ought to be sufficient to uphold the ruling of the court below. We approach the consideration of the question involved with the belief that it is our duty to give effect to such legislation in all cases where the law applies, and not by any strained construction to thwart its purpose out of any consideration of mere business convenience. This case presents a good illustration of the evil which the lawmaking power sought to prevent. No consideration whatever passed from *Whitney Kemmerer Co.* to the *Furnace Co.* at the time the bonds were issued and pledged, and none ever has passed on account of the issue; still an indebtedness is sought to be proved against the *Furnace Co.* If this does not make the amount of the claim fictitious within the

⁹*Nelson v. Hubbard*, 96 Ala. 238.

¹⁰*Nichols v. Waukesha Can. Co.*, 195 Fed. 807.

¹¹It is true that refunding bonds, substituted for existing valid bonds, are not within the statute. This is because they add nothing to the prior bonded debt. They merely take the place of valid bonds already out.

¹²*First Savings Co. v. Waukesha Co.*, 211 Fed. 927.

¹³*Kemmerer v. Blast Co.*, 212 Fed. 63.

meaning of the law, then we are unable to comprehend the meaning of the word fictitious."

Concerning the decisions of the courts of the several states it may be said that the controlling element in most every case holding *contra* to the principal case is the difference in the provisions of the constitutions or statutes of the respective states and the Missouri provisions involved in the Mudge case. Some clause is included in each provision which takes away the stain of evasion, in the face of which no court could hold an issuance of bonds invalid. The Missouri provisions are plain and simple, they are not encumbered with any clause to defeat their purpose; the interpretation is, we think, correct. And it is our belief that whenever the question which was involved in the principal case comes before the Supreme Court of Missouri, the holding of that court will be in accordance with the decision in the principal case.

We think the conclusion used in the Kemmerer case may well be used here; the court say, "We have examined all the cases cited and have examined all others which we have been able to find, and, with the exception of *Nelson v. Hubbard*,¹⁴ we find the whole trend of authority supporting the proposition that there must be a present consideration (and we would add, the debt not being fictitious), in order to satisfy the demand of such constitutional and statutory provisions as are here involved. Any other construction simply wastes away the safeguards which the legislature sought to throw around the creation of corporate indebtedness."

W. A. R.

¹⁴*Nelson v. Hubbard*, 96 Ala. 238.