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The Legal Relations Among Shareholders of a Corporation

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THESIS.

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The Legal Relations Among

Shareholders of a Corporation

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In an age, such as the present, when new corporations, and so-called trusts, are springing into existence every day in all branches of business, the legal relations which shareholders in such corporations assume, and which exist by reason of the incorporation, become a matter of some moment, and often, if considered seriously, might be assumed among the principal relations are those which exist among the shareholders, or stockholders, themselves.

Let us consider first what a shareholder or stockholder is. In the United States the terms share and stockholder are synonymous, and, for the sake of uniformity, we will use the former.

"In the strict sense of the term, a shareholder is 'a person who has agreed to become a member of a company, and with respect to whom all the required formalities have been gone through, e.g. signing deed of settlement, or the like.' Such is Lindley's definition.[1]

[1] Lindley on Partnership, p. 130

"A stockholder is one who holds membership in a "corporation or joint stock company, by virtue of owning "one or more shares of its stock."[1]

A shareholder is " x x x one who owns stock in a "corporation, and has been accepted as a stockholder, by "the corporation."[2]

For our own convenience, we will call a shareholder one who owns or holds shares of stock in a corporation, or one who has subscribed for shares of stock in a corporation. The next question which thus presents itself is, when does a person become a shareholder? Does the subscription for stock of once constitute an individual a shareholder. I hold that a person becomes a shareholder the moment he agrees, as a subscriber to subscribe, and has signed the subscription book, and the stock is issued to him at once, even though he may never see a certificate of stock. As authority for such a statement I would quote from some opinions in leading cases. In the case of Hibbard v. Bagby,[3] affirmed in the Court of

[1] Amer. & Eng. Ency. of Law, Vol. 26, p. 779
[2] Cook on Stock and Stockholders, Vol. 1, p. 15.
[3] 95 U. S. 188

dispute [illegible] the evidence and facts, including that certificate was not obtained from the records of the company and was not entitled to [illegible]. [illegible] the nature of the transaction and [illegible] to be a [illegible].

The court, in the case of [illegible],[1] [illegible] Company, [illegible] said: "The court found, as a matter of fact, that the [illegible] necessary for the issuance of the stock ... that [illegible] constituted a 'holder' within the meaning of the Statute . . . . The necessary contractual agreement between [illegible] and the company and [illegible] against which the parties respectively might [illegible], and it was [illegible] that certificates of stock were not [illegible] issued."

The court, in the case of [illegible],[2] said: "A certificate of stock is not necessary to constitute a stockholder, [illegible] the existence of stock."

We will consider, therefore, that issuance or delivery of a certificate of stock is not essential to consti-

[1] [illegible]

[2] [illegible]

[3] [illegible]

tute an individual a stockholder; that the agreement to subscribe for shares constitutes him such, and that the certificate of stock is merely evidence of the contract of subscription between the subscriber and the corporation. The subscription to the stock of a corporation by the different subscribers, corresponds to the partnership agreement that the members will contribute money or services to the partnership. It is not a sale of personal property. There is an implied agreement on the part of the corporation that it will allow the subscriber a certain number of votes for directors; it agrees that the directors will manage the business faithfully; that if they make money the corporation will give the subscribers such an amount as the subscribers' shares bear to the entire number of shares.

Having, therefore, ascertained what a shareholder is, and when an individual becomes such, let us now look into the relations one assumes by becoming a shareholder with his co-shareholders in the corporation.

Taylor, in his excellent work on Private Corporations, divides these relations into two classes: "First, those which subsist between shareholders, as it were indirectly, by reason of the relationship sustained by them towards the body corporate. x x x Secondly, those legal relations, which subsist directly between the successive holders of the same shares of stock, or between persons possessing rights in the same shares, legal relations which have no reference to the rest of the shareholders, and do not depend primarily on a relationship sustained towards the corporation." Accepting this division of the subject as the most logical, let us now proceed to a detailed examination of these relations. The classes are, therefore, first, the relations existing between present shareholders, and second, those existing between present and succeeding shareholders.[1] These relations and rights, as Morawetz says are "in the corporate concern rather than against the corporation, and can be enforced only through the corporate organization."

[1] Morawetz on Private Corporations, Sec. 225.

In the first class, which is, perhaps, the main class, the relations are so numerous and varied, under different sets of circumstances, that the subject will have to be further divided in order to treat it properly. We will consider, I, the relations which arise as to stock in the corporation; as to (a) common stock, (b) preferred stock, (c) assessable and non-assessable stock and (d) watered stock; II. the relations which exist where a shareholder is also a creditor of the corporation; and III. those which exist by reason of the charter or articles of incorporation, the business carried on by the corporation and its operation, and upon a dissolution of the corporation.

I.

(a) Common Stock. Stock is described by Lowell as "the sum of all the rights and duties of the shareholders."[1] We will use the term stock in the sense of shares of stock. Shareholders of common stock stand on an equal footing. Each is entitled to share pro rata in the profits

[1] Lowell, Transfer of Stock, Sec. 4

of the corporation, if there are any, neither has an advantage over the other, except such as he may have by reason of being the owner of a greater number of shares; each stands in the position to the whole body of shareholders, and each has the same privilege of voting at meeting of the shareholders, and thus a voice in the management of the business of the corporation. Then, too, each has the same rights against the corporation. This, of course, when there are no preferred shareholders.

(b) Preferred Stock. When we enter the realm of preferred stock, the relations among the shareholders become more complicated. A corporation may, if given power so to do by its charter, articles of incorporation or the statute under which it is organized, or by the subsequent action and agreement of the shareholders, issue both common and preferred stock. This is most often resorted to in order to enable the corporation to obtain a larger capital or basis on which to begin business. Holders of preferred shares are given preference over holders of common shares in a dividend of the net profits of the corporation. Thus, if the actual profits are small, the preferred shareholders will receive their pro rata share of such profits, even to the total exclusion of common shareholders.

Difficult and knotty questions have arisen when corporations have issued preferred stock when power to make such issue was not expressly granted by the charter, the articles of incorporation or the statute under which it was incorporated. The general rule seems to be that such authority to issue preferred stock must be expressly granted to the corporation.[1] In the cases cited it is held that such an unauthorized issue does not affect the interests of holders of common stock. Courts, however, have held that an authority to increase the capital stock will allow the enactment of by-laws providing for the issuance of preferred shares.[2] Then, too, an issue of preferred shares

[1] Kent v. Quicksilver Min. Co., 78 N. Y. 159
Campbell v. American Zylonite Co. 122 N. Y. 455
[2] Harrison v. Mexican R.R. Co. L. R. 19 Eq. 358
Rutland R.R. Co. v. Thrall, 35 Vt. 545.
Gordon v. Richmond R.R. Co., 78 Va. 501.

[illegible]

(b) [illegible]

(c) [illegible]

[illegible]

to creditors and other stockholders of regular paid up stock, that the corporation has a certain amount of capital stock paid up, - that it has a certain amount of assets on which to begin business. Such an issue is unfair to the stockholders who have subscribed and paid up in full. They may, therefore, unless guilty of laches, sue the corporation and compel, in a suit in equity, the holders of shares of such watered stock to pay the full subscription price. Creditors may also compel the full payment of stock if the corporation becomes insolvent.[1] A state of affairs might exist, however, when an issue of watered stock might be fair to the other stockholders. If the capital stock had only been half subscribed and paid in, and half of that capital sunk in the business, so that the market value of the stock is only fifty per cent. of its face, then the corporation might issue stock to new subscribers as fully paid up, when they had only paid half its face. This will be fair to existing stockholders because the net assets, on dissolution, remaining

[1] Camden v. Stuart, 144 U. S. 104
Potts v. Wallace, 146 U. S. 689.

from the time of such fictitious issue, will be distributable pro rata to the contributions to the capital. As between stockholders also, neither obtains a benefit over others, unless the stock is unevenly watered. New subscribers to unissued stock, in case other stock is watered, cannot be injured, because they will only pay for the stock what is the then market value of the already issued watered stock. New subscribers to stock already issued, will not be injured either, because they will take such stock only at the market value. An issue of watered stock might be fair to all concerned if it was issued openly for a larger amount than was thought necessary to carry on the business, giving a statement, of course, to the public of fictitious assets, and then the corporation to assess the stockholders for further payments, if necessary.[1] As a matter of fact, however, business men, in dealing with a corporation, never take a statement of the capital stock paid up or subscribed as a basis for giving credit, or subscribing to new issues

[1] Professor Collin's Syllabus Sec. 11.

of stock. They inquire what are the assets and liabilities of the corporation, and what is the present market value of the stock, and then base their dealings with the corporation on such a statement.

We might properly consider here pretended and colorable subscriptions for stock. It is often the case that promoters, in order to induce people to subscribe for stock in the corporation they are launching, will procure fictitious signatures to the subscription books, or agree with certain subscribers that shares need not be paid for or need not be paid for in full. Such agreements amount to naught. The corporation can enforce the subscriptions against the pretended subscribers, and against subsequent subscribers, who seek to repudiate their subscriptions when they learn of such agreements. It is no defense for subsequent subscribers that the corporation has agreed that certain subscriptions need not be paid in full. An agreement to subscribe is an agreement to subscribe the entire amount.

Other and subsequent shareholders may compel the corporation to enforce the unpaid subscriptions and compel payment of subscriptions in full. And where a person subscribes under a fictitious name he is held liable for the subscription under that name.

Generally, as to all classes of stock, each shareholder, such as subscribers for shares, assumes that each of his co-shareholders is subject to the same obligations he has undertaken, and he may, by appropriate action, compel the enforcement of such obligations by the corporation, as e.g. he may compel delinquent shareholders to pay their subscriptions or any calls or assessments on their shares, which they have not met.

11.

A shareholder in a corporation may also be a creditor of the corporation. Such a dual relationship might

1 Mann v. Mechanics' Bank, 1 Peters 46

Armstrong v. Danahy, 75 Hun 405

Quick v. Lemon, 105 Ill. 578

Ramsey v. Thompson Mfg. Co., 116 Mo. 313

2 [illegible] 566

exist in a number of different ways. Many questions might therefore arise between him, in his double relationship to the corporation, and other shareholders. Has he, as a shareholder alone, a right to any preference over other shareholders? No, clearly not. He being also a creditor, would not give him, as such, any preference over the other shareholders, and he would be responsible for the obligations he had assumed as a shareholder, the same as the rest; and conversely, as a creditor, he, being also a shareholder, would not obtain any preference over other creditors of the corporation, and should it for any reason become insolvent, he would have to come in, prove his claim, and take his share of the net assets along with the other creditors. He being a shareholder in the corporation, courts would look with a good deal of care into the dealings between him and the corporation through which he became a creditor, to see that no fraud had entered into them. If, as a shareholder, he pays debts of the corporation, he can only sue his co-shareholders for contribution, and must stand his share of them himself. This must be by a bill in Equity.[1] He must first, however, exhaust the property of the corporation.[2]

III.

The principal relations which exist by reason of the charter or articles of incorporation are that each shareholder assumes a partnership liability for the debts of the corporation, each becomes entitled to share pro rata in any distribution of assets, upon a winding up or dissolution of the corporation, or in any dividends which may be declared during the life of the corporation. At all times, all the shareholders, except when some may be preferred, are equally interested in the property and also the business of the corporation.[3] The court, at page 359 in the case last cited, says:

"They assume the same liabilities, are entitled to the same rights, and are equal owners of the property."

[1] Thayer v. Union Tool Co., 4 Gray 75.
Bailey v. Bancker, 3 Hill 188.
[2] Gray v. Coffin, 9 Cush. 192.
[3] Jones v. Terre Haute etc. R. R. Co. 29 Barb 353, aff. 57 N. Y. 196.

In case of an unfair distribution of assets or dividends, a shareholder may sue in equity.[1] And it was held on the winding up of a corporation that one party of shareholders might buy up a piece of property belonging to the corporation for the benefit of adjoining property owned by them, and that it would be no fraud on the other shareholders.[2] In a case of dissolution, after the payment of the debts, the surplus belongs to the shareholders, and they share in it pro rata to the number of shares they own.[3]

In case of mismanagement or fraud, shareholders may apply for the appointment of a receiver. Upon accepting the stock and electing directors, they agree to be governed by them, and trust the management of the business of the corporation to them. The only way shareholders can properly control the action of the directors is by the power of removal and the election of others in their stead. A shareholder may, however, at any time enjoin the majority of stockholders

[1] Harrison v. Mo. R.R. Co. L.R. 15 Eq. 358

Jones v. R.R. Co. 28 Barb 553.

Jackson's Adm. v. The Newark etc. Co. 31 N.J.L. 277

[2] Taylor, Note 1 page 789 Citing 145 U.S. 349.

[3] Hamen v. Bottom 83 Mo. 549

and directors in the performance of an ultra vires contract, even though he is not injured.[1]

We come now to a consideration of the second branch of our subject, namely the relations which exist between present and succeeding shareholders.

A corporation has "perpetual succession". Upon the death of a shareholder, therefore, his shares of stock go to his personal representatives. In the case of a partnership, the death of a partner dissolves the partnership, but the death of a shareholder has no such effect upon the life of the corporation itself. It lives on and on until it is dissolved by insolvency or an act of the legislature or of the corporation itself. The personal representatives of a deceased shareholder therefore stand in the same relation to the stock and the corporation as he did, and they are liable for the performance of the same obligations as the original shareholder. They are merely substituted in his place and stand

[1] Byrne v. Schuyler Elec. Co. 31 At. Rep. 833

as shareholders. The legal representatives are, therefore, in their legal capacity, liable for all calls, as long as the deceased's name appears on the books of the corporation without notice of his death.[1] Likewise, a shareholder may sell his shares of stock to whom he pleases and substitute any person in his place and stead as a member of the corporation, and no other shareholder can object. There may also be a specific legacy or gift of shares of stock, and thus other than the original shareholders be substituted. When another person is so substituted, various questions as to his liability might arise. Certificates of stock are regarded as negotiable instruments. One of the main questions likely to arise therefore is, who may buy shares of stock in a corporation? In England the rule, as to the competency of a corporation to buy is that it cannot buy shares of its own stock.[2] In this country the courts differ somewhat, some holding that a corporation may purchase shares of its own stock.[3] In most

[1] New Zealand Gold Co. v. Peacock, 1 Q. B. 622

[2] Trevor v. Whitworth, 57 L. T. Rep. 457

[3] Buhl Nat'l. Bk. v. Salem Co. 39 Fed. Rep. 89
Ohio, &c. R.R. Co. v. President &c. 84 Ill. 145
Contra Holladay v. Elliot, 8 Oregon84

States, such as e.g. New York, banks and railroad corpora-
tions are forbidden by Statute from purchasing their own
stock. Nor can one corporation, on the other hand, subscribe for
shares of stock in another corporation. If it is within the
object and business of a corporation, as for instance a broker-
age corporation, then that corporation may subscribe for stock
in other corporations. Otherwise the subscriptions are void.[1]
As to infants' subscriptions - these are governed by laws
which apply to infants' contracts in general. The subscrip-
tion generally is not void but voidable.[2] As to the rights of
married women to subscribe, now that they have their separate
property rights in this country and in England, such sub-
scriptions are undoubtedly good.[3] Otherwise anyone who can
enter into a contract, who is under no legal restraint, may
subscribe for stock in a corporation.

The question arises, on the sale of stock, does the
original shareholder warrant his title? Taylor, in his work,
at page 783 says:

[1] Nassau Bank v. Jones, 95 N. Y. 115
Franklin Co. v. Lincoln Bank, 68 Me. 43
[2] Cumberland's Case, L. R. 4 Chan. 51
Hibbard's Case, L. R. 5 Chan. 302
[3] Wilson v. Squire, 32 Ind. 157
Butler v. Gumbley, L. R. 7 Eq. 16

"A party selling as his own personal property, of "which he is in possession, impliedly warrants his title "to the thing sold. This doctrine applies to such "choses in action as shares of stock." This was so held in the case of People's Bank v. Kurtz.[1] The Court, at page, 344 says;

"The certificate is the evidence of such ownership, "and there can be no doubt that if the certificate is "forged, or the holder is not such bona fide, so that he "has no claim on the corporation, the vendor would be "liable to his vendee, on the implied warranty of title." This is also held in Harter v. Eltzroth, 111 Ind. 159, and many other cases. The vendor, however, only warrants that the corporation is a corporation _de facto_, and not a corporation _de jure_.[2]

We might consider briefly what is a _de facto_ corporation. One class of _de facto_ corporations is that in which the promoters have made an attempt to incorporate and comply with the Statute, but some necessary step was omitted, and

[1] 99 Pa. St. 344

[2] Harter v. Eltzroth, 111 Ind. 159

both the incorporators and third persons dealing with the corporation believe it to be properly incorporated.[1] There is however, only one person who can take advantage of the defect, and that is the State. The members of the corporation themselves are, on the theory of estoppel, prevented from taking advantage of the fact that they are not properly incorporated.

Upon a sale or transfer of stock, some question might arise as to who is entitled to dividends on the stock. It is clear, as Taylor says at sec. 709:

"Shareholders have no right to profits made by a corporation until a dividend is declared."

We might have question chiefly whether shareholders can compel directors to declare dividends. In the case of preferred shareholders, even though the corporation, on issuing the shares, guaranteed dividends, such shareholders cannot compel dividends to be declared by the directors, except where there are net profits properly applicable to such dividends.[2] Of course there can be no question that where there

1 Professor Collin's Syllabus, Sec. 21.
2 Field v. Lamson Mfg. Co. 162 Mass 388.

is sufficient surplus, which is properly applicable to dividends, the stockholders may, by appropriate action, compel the directors to declare one, should they refuse so to do.[1] When a dividend is declared, therefore, all persons who are stockholders at the time it was declared, are entitled to share therein.[2] The dividends belong to the holders of shares at the time they were declared.[3]

In conclusion, we will summarize as follows: Every subscriber to shares of stock in a corporation agrees to take a certain number of shares. As a stockholder he agrees to pay for such shares, and be governed by the directors and officers, for whom he can vote. On the otherhand, the corporation agrees that the stockholders shall have power to vote, that it will manage the business in a proper manner, and that should it prove profitable, dividends will be declared. The stockholder agrees also to assume a partnership liability for

[1] Hiscock v. Lacy, 50 N. Y. 860

[2] Jones v. Terre Haute &c. R.R. Co. 29 Barb. 353

Hill v. Newichawanick Co., 48 How. pr. 427

[3] Brundage v. Brundage, 65 Barb. 397, aff. 60 N. Y. 544

the debts of the corporation, and to respond to calls and assessments. If the corporation, through its directors fails to make necessary calls for subscriptions, or in any manner, fails to properly carry on the business, the shareholder has his relief in his ballot, and in appropriate suits in equity to compel proper management, and if the corporation fails to make a proper division of profits, or to declare a dividend at all when there are profits properly applicable, the share-holder also has his relief in equity.

Table of Cases and Texts Cited.