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Assignments and Preferences by Corporations

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T H E S I S

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Assignments and Preferences by Corporations.

for

The Degree of Bachelor of Laws.

by

Alexander R. Graham.

C o r n e l l U n i v e r s i t y .

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1893.

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A corporation is regarded as a mere creature of the law, created for the accomplishment of the objects specified in its charter, and having no powers, except such as are expressly granted, or are incidental to its very existence. When the law creates a corporation it does so with the contemplation that it will remain solvent; but experience has shown to us that this most desirable condition can not always be maintained. The result is that the corporation becomes insolvent, and then a new state of things commences, unforeseen and unprovided for, by the charter of its creation; and a new rule for the government of its agents, necessarily comes into existence, by operation of law.

The corporation is rendered, by its insolvency, incapable of pursuing the object for which it was created without perpetrating a fraud upon the public generally and also upon its existing creditors.

After insolvency the corporation is restrained from exercising its corporate franchise because it would be an abuse of its powers and privileges conferred by its charter. The question that at once confronts us is, what

are the duties of the corporation and its agents in regard to the property remaining under their control; and in what manner it is to be applied? In the absence of any positive law upon the question the rule would be to dispose of it according to the principles of natural justice and equity.

Since a corporation can be brought into existence only by virtue of some special act or general law, its dissolution is in like manner governed by certain legal principles.

At an early day it becomes customary for a corporation which was unable to meet its obligations, and when it saw that failure was imminent to assign all its assets to some particular individual to hold in trust for its corporate creditors.

In this connection we will first consider the right of a corporation to make an assignment.

At com. law and in the absence of that, there is but little question that the latitude given to corporations in this respect is as broad as that allowed to private individuals. "A corporate body, as well as a private individual", observes Chancellor Kent in his commentaries,

(2 Kent's com. p.398 (10 th sec.)) "when in failing circumstances and unable to redeem its paper, may without any statute provision, and upon general principles of equity, assign its property to a trustee, in trust to collect its debts and pay debts and distribute as directed. It has unlimited power over its property to pay its debts." And it may be said to be settled by the weight of authority, that a corporation has a right to make an assignment in trust for its creditors; and may exercise that right to the same extent and in the same manner as a natural person, unless restricted by its charter or some statutory provision.

The reports throughout the different jurisdictions are filled with cases in support of this general rule.

In Hoxton v. Bishop 3 Wend. 13, which came before the supreme court of this state, in 1829, an insolvent bank made a general assignment of all its property, in trust to sell the same, and apply the proceeds to the payment of all the creditors of the bank ratably. And chief justice Savage held that the assignment was valid.

A leading case in this country is that of DeRuyter v St. Peter's Church (3 Barb. Ch. 119) decided by Chan-

cellor Walworth in 1848, and affirmed by the Court of Appeals (3 N.Y. 238). By an act of the legislature of New York the trustees of St. Peter's Church were authorized to dispose of the real and personal estate of the corporation for the benefit and advantage of the church and congregation, with the concurrence of the chancellor's first obtained, in the manner specified by the act for the incorporation of religious societies. The trustees of the corporation executed an assignment of all its property, real and personal, to assignees for the payment of all debts ratably-- a petition being presented to the vice-chancellor, and an order obtained authorizing such assignment. The case turned upon the validity of this assignment and it will thus be observed that the direct question involved was dependent somewhat upon the statutory authority to which reference has been made. Chancellor Walworth, however, discusses the question upon general principles, as well as affected by the statute in question.

"It appears," he says, "to be settled by weight of authority which is irresistible that a corporation has a right to make an assignment, for its creditors, and may

exercise that right to the same extent, and in the same manner, as a natural person, unless restricted by its charter or by some statutory provision."

This doctrine is so firmly implanted in American Jurisprudence, that it needs no further citations of authorities for its support.

In like manner a corporation has, in the absence of a statutory prohibition, the same power of making preferences among its creditors, in the distribution of its assets, as an individual.

This point has repeatedly been decided by the courts throughout the different jurisdictions; and an assignment made by a corporation of all its assets to a trustee, to pay certain creditors in full, leaving the others unpaid, will be sustained both at law and in equity. An interesting case upon this point is that of *Ringo v Biscoe* 13 Ark. 563 in which it was said by Chief Justice Watkins in the course of his opinion, that; "It is now well settled that a corporation, unless restricted by its charter, or prevented by the operation of ~~some~~ bankrupt or insolvent law, by virtue of its general power to contract, may well make an assignment of its effects, entire or partial, is made bona fide for the payment of its debts, the same as any natural person may be, and the corporation has the same right to make preferences among its creditors of particular creditor or classes of creditors; and such preferences, when they are meritorious

so far from furnishing an argument against the deed, conduce rather to uphold it."

In this state in the recent case of Coats v Donnell 94 N.Y. 168 it was held by J. Andrews that a corporation, in the absence of statutory restrictions, has the right to prefer one creditor to another on the distribution of its property.

Although the above doctrine is recognized both in courts of law and of equity. still it can not be defended upon the ground of principle. From the very nature of the rule itself, it is seen that an injustice is worked against those creditors who are unpreferred. Now if a corporation is allowed to make a preference in favor of a few of its creditots, how are the claims of the remainder going to be satisfied? There is only a myth or shadow left to which resort can be had for payment of their claims; a soulless, fictitious, unsubstantial entity that can be neither seen nor found. The capital and assets of the corporation, the creditors trust fund, may, under this rule, be carved out and apportioned among a chosen few, usually the family connections or some particular friends of the officers making the preference.

We will show that the allowance of preferences is contrary to the first principles of corporation law.

It is a principle of corporation law which is fundamental, that the assets of an incorporated company are regarded as a trust fund for the benefit of creditors. This doctrine is of modern date and, it is believed, was invented or brought conspicuously to the notice of the profession by Judge Story in the case of *Wood v Dummer* 3 Mason 308; it is, however, considered the most important principle applicable to the law of corporations. By a careful examination of the cases it will be seen that this rule is constantly struggling for recognition. This rule regards the funds of a corporation as pledged exclusively for the payments of its debts. Since the private property of the stockholders is not liable, and since in the absence of statute there is no individual responsibility on the part directors for corporate obligations; the corporate property is therefore the only source to which the creditors can resort.

The assets, as we have seen, might properly be considered as a special fund or property, set apart in law, in lieu of the private property of the incorporators,

to which resort may be had for the payment of the debts of the corporation. It was said by Hunt J. in *Upton v Tribilcock* 91 U.S. 45 that "The capital stock of a monied corporation is a fund for the payment of its debts. It is a trust fund, of which the directors are trustees. It is a trust to be managed for the benefit of its shareholders during its life, and for the benefit of its creditors in the event of its dissolution. This duty is a sacred one, and can not be dieregarded. Its violation will not be undertaken by any just minded man, and will not be permitted by the courts." This rule was denied in the case of *Cotlin v Eagle Bank* 6 Conn. 233, but that case is at variance with the whole theory of the law concerning the rights of creditors of insolvent corporations, and is contrary to the plainest principles of justice.

Now regarding this rule as well settled we will consider it in connection with another which is equally just and equitable.

The rule that the creditors are entitled to a pro rata distribution of the assets of an insolvent corporation. This rule is based upon the equitable maxim, "Equality is Equity."

A careful study of these principles will clearly show the pernicious character and the evil results which flow from the practical application of this doctrine.

There has been a constant struggle both in the cases and in the statutes to suppress preferences. the results accomplished by the statutes of this state will be considered in a later chapter of this article.

The Common law rule in regard to assignments was modified somewhat by statutes passed during the reign of Elizabeth, restraining alienations of church property by religious corporations; these statutes, forming a part of the law of Eng. at the time of the settlement of this state by colonists from Eng. under the charter of the Duke of York, were probably brought here by those emigrants, and became a part of the laws of the colony; although it seems that they were not afterwards re-enacted here. For it is only natural to presume, that on the settlement of a new territory by a colony from another country, they carry with them the general laws of that country, so far as those laws are applicable to the colonists in their new situation.

That there was an unwritten law in this state, restraining religious corporations from alienating church property is evident from the fact that in March, 1806, the legislature thought it necessary to pass a special statute, authorizing the chancellor, upon the petition of the corporation, to make an order for such sale, and for the application of the proceeds thereof to such uses as the

corporation, with his assent, should conceive to be most for the interests of the society to which the property so sold did previously belong.

4 W. & S. Laws, 360.

This provision was embodied in the general act of 1813 for the incorporation of religious societies.

3 R.S. 298 sec. 11.

A construction of this statute was soon called forth by the case of *De Ruyter v the Trustees of St. Peter's Church* and it was then held that under the sanction of an order of the court of Chancery, the corporation had power to make an assignment of all its real estate, to trustees, in trust for the payment of all the creditors of the corp. ratably.

There are however cases in which it is contended and also some instances successfully, that a general assignment of corporate property, since it practically works a dissolution of the corporation, is an act outside of the corporate powers of the officers of the company.

Some of the lower courts in the state of New York lay down this rule. In the famous rubber case of *Abbott v Am. Hard Rubber Co.* 33 Barb. 578. Sutherland J. in the course of his opinion said, "That directors of a corporation are agents of the corporation to manage its affairs and carry out the purpose and object of its formation, and not to inflict upon it political death. They are only authorized to do such things as are directly or impliedly directed or authorized or authorized by the charter. When the acts are inconsistent with the object and purpose for which the body corporate was organized, they are void. In this case it seems that the Def's. who are a majority of the corp. made a general assignment of all the property of the corporation without the consent and against the wishes of Plf.. Plaintiff now brings an action to have this sale set aside as fraudulent and void; for an injunc-

tion to restrain the defendants from intermeddling with the property so transferred; and for a receiver to take possession thereof, under the direction of the ct. It was held that the sale could not be permitted to stand; that the transfer was made without power in the directors or trustees and was a violation of the trust and confidence reposed in them, and that Plf. was entitled to an injunction restraining the Def't. from interfering with the property so transferred, and to a receiver to take possession thereof."

In *Beastom v The Farmers' Bank of Delaware*, 12 Vet. 102, grave doubts as to the correctness of this principle "that a corporation has a right to make an assignment, in trust, for its creditors", were expressed by no less an authority than Mr. Justice Story. the case arose upon the construction of an act of congress providing that, when any person indebted to the United States should become insolvent, the debt due to the U.S. should be first satisfied; and that the priority thus established should be deemed to extend as well to cases in which a debtor, not having sufficient property to pay all his debts, should make a voluntary assignment thereof, as in other

cases enumerated, And one of the questions presented to the court was whether a corporation was a person within the meaning of the act, and hence capable of assigning for the benefit of its creditors. Story dissented from the decision of the court, in one of his luminous opinions which sometimes shed as much of the light of clear judicial reasoning upon the subject under discussion as the opinion of the majority of the court. He says: "I must say that, independent of some special and positive law or provision in its charter to such an effect, I do exceedingly doubt if any corporation, at least without the express assent of all the corporators, can rightfully dispose of all its property by such a general assignment, so as to render itself incapable in future of performing any of its functions. That would be to say that the majority of a corporation had a right to extinguish the corporation by its own will and at its own pleasure. I doubt that right, at least unless under very special circumstances."

The arguments very properly advanced to support that case were, that any transfer of the corporate assets made by the directors, which would necessitate a discon-

tinuance or complete change of the business of the corporation, would not be tolerated without the assent of the stockholders. And it must be conceded that upon the facts as they appear in that case these arguments are both sound and logical; but it is to be noticed that the case involved the question of the right of a corporation acting by its directors to make a sale of practically its entire plant and property, and was not the case of an assignment by an involved corporation for the benefit of creditors. So that the case can scarcely be regarded as an authority against the rights of an involved corporation to make an assignment in trust for the benefit of creditors, when all the assets are required for the payments of debts.

From the very nature of a corporation it is seen that it must necessarily act by agents who are the directors or trustees. As the general management of all affairs relating to the corporation, and the disposition and use of corporate assets, is necessarily intrusted to the directors or trustees, there is no reason why they should not also be considered as vested with the discretion to determine the necessity for making a general

assignment, and clothed with the power to carry out their conclusion. Since the directors of a corporation are in such a position as to command a broader knowledge of the details of the business, their knowledge of the exigency in the corporate affairs inducing the act is manifestly more complete than that of stockholders or creditors. It seems clear that creditors have no such interest in corporate affairs as confers upon them the right to interfere with corporate assignments for the benefit of creditors when no fraud is practiced upon them. And as to stockholders, they have given the management of the affairs of the association to the managing agents, who ought to be empowered to act according to their best judgment in any crisis that demands the prompt appropriation of corporate assets to the payment of debts. It is evident that if the corporation owes a debt, it must be paid. It is certainly the duty of the trustees to pay the corporate debts and to apply the corporate property to this end, although it should exhaust it; and if that is to destroy the corporation, such result can not be avoided. A corporation can no more avoid the payment of its debts than an individual can evade his honest obligations: The individual must

apply his property to satisfy the just demands of his creditors until they are exhausted, although the result be the destruction of his business and his impoverishment. There is no more reason in favoring a corporation more than an individual in this respect and it may be said generally that the better opinion and the one sustained by the weight of authority, is that an assignment of all the corporate property does not effect the corporate franchise and does not dissolve the corporation.

In *Hulbert v Carter* 21 Barb. 221, it was held that it did not follow because a corporation can make a voluntary assignment, that it can transfer the power of its officers to the assignee or surrender its franchise.

This doctrine was followed in *State v Bk. of Md.* 6 Gill & J. 205 and in *Ringo v Real estate Bank* 13 Ark. 563, and in many other states.

Now admitting the above to be the true rule there is, it seems to me an aparent, if not real, absurdity growing out of this doctrine.

While asserting the right of a corporation to thus divest itself of everything pertaining to the nature of property, and to denude itself of every element necessary

to its continued operation, the courts have jealously insisted upon the retention of the franchise, holding that to be capable of surrender only by the action of the courts, or by consent of the legislature which granted it.

Thus in state v Bank of Md. the courts insisted that, although a corporation should, by a transfer of all its property, render itself powerless to discharge the ordinary purposes for which it was created, it still remains an entity-- a living corporation.

So in Town v Bank of River Raisin, 2 Dougl.(Mich.) 530 it is held that the transfer or assignment of its property does not necessarily, dissolve the corporation, and is not a surrender of its franchise, but affords, at the most, only ground for forfeiture by reason of misuser or non-user.

And the same distinction runs through most of the decisions which assert the right of a corporation to divest itself of all its property by means of a general assignment for the benefit of creditors.

Perhaps this distinction is based upon that fundamental American idea that the charter, when accepted, becomes a contract between the state and the corporation. At any rate while the distinction is well taken in point

of law, it is a distinction without difference. The substance is taken, the shell is left. The naked franchise alone remains--- The right to do corporate business under a corporate name. Denuded of every agency through which a corporation can operate, the phantom corporation still lives, a sort of ignis fatuus.

The absurdity of such a distinction can be seen in the fact that the act of the corporation in thus assigning all its property is upheld by the courts as a valid assignment, while the non-user of the franchise, which necessarily follows when it is deprived of all the agencies through which alone it can be exercised, results in a judgement of forfeiture in proceedings in quo warranto. The same act is held to be legal and illegal at one and the same time.

This is a good illustration of judicial hair splitting frequently met with in corporation law.

Although it is almost universally held that a corporation, in the absence of statute, has the right to make both an assignment and a preference, still there are few jurisdictions in which this right is not limited and modified by statutory enactments. Since we could not pretend to discuss, in a treatise of this nature, the statutory changes of this law throughout the different states, special reference will therefore be had to the statutes and decisions of New York.

An act was passed in this state April 21, 1825 2 R.S. (7th. ed.) p. 1534 sec: 4. which was to the effect that (whenever any incorporated company shall have refused the payment of any of its notes, or other evidences of debt, in specie, or lawful momey of the United States, it shall not be lawful for such company, or any of its officers, to assign or transfer any of the property or shares in action of such company, to any officer or stock holder of such company, directly or indirectly for the payment of any debt; and it shall not be lawful to make any transfer or assignment in contemplation of the insolvency of such company, to any person or persons what-

ever; and every such transfer and assignment to such officer, stockholder or other person, or in trust for them or their benefit, shall be utterly void." All preferences were prohibited.

In 1829 a construction of the statute was called forth by the case of Hoxton v Bishop 3 Wend. 13. In this case an assignment was assailed as being void under this statute. But the Supreme Court held that, as it was not an assignment "to any officer or stockholder for the payment of any debt" of theirs, nor an assignment to any one "in contemplation of insolvency," within the meaning of the act, it was valid. And it was remarked by Savage, C.J., who delivered the opinion of the court, that the legislature did not, by the act, intend to prohibit assignment by corporations in all cases, but only in the two instances designated: one, before insolvency and in anticipation or contemplation of that event; the other, after insolvency, to officers or stockholders for the payment of any debt.

In the case of Harris v Thompson 15 Barb. 62, which came before the Supreme Court of this State, in 1853, the court in construing the language of the fourth section of the

fourth title of the Revised Statutes, reenacting the provision of the act of 1825, held that the second clause of that section, which declares it to be unlawful "to make any transfer or assignment in contemplation of the insolvency of such company, to any person or persons whatever," was not, like the first clause, confined in its application to assignments by incorporated companies who had "refused the payment of any of their notes or other evidences of debt in specie or lawful money of the United States," but applied to all assignments and transfers by corporations, in contemplation of insolvency, to any person or persons whatever, and they accordingly held that an assignment by a manufacturing company, of all its property to a trustee, in trust for the payment of its creditors ratably, made in contemplation of insolvency, was absolutely void by statute. And the position taken by the court in this case has been approved by the court of appeals in several cases.

In *Robinson v Bank of Attica* 21 New York 406 it was held that an act in contemplation of existing insolvency was as much within the statute as one done in anticipation of future insolvency. This may be taken, therefore

as the true construction of the statute; but an act in either case must be in anticipation or in view of that condition. In other words, the act must have been done because of existing or anticipated insolvency, or else it is not prohibited. It is not enough that insolvency and the act co-exist.

It was held in *Dutcher v Importers and Traders Bank* 59 New York 5, that the payment in the usual course of business, although by an insolvent corporation, was not prohibited nor a sale so made, and as the evidence tended to show that the payment objected to would have been made in the same way had the paying bank been entirely solvent the judgement directed by the trial judge, on the ground that actual insolvency was conclusive evidence of the intent or purpose of payment, was reversed.

This case was followed and approved by *Paulding v Chrome Steel Co.* 94 New York 334. Holding that the act must be done because of existing or anticipated insolvency, or else it is not prohibited.

This act, however was made inapplicable to literary or religious corporations. In 1830 the above was made a part of the revised statutes, part 1, chap. 18, title 4, sec., 4, by which the provision was also made inapplicable to moneyed corporations; so that, down to 1882 a corporation other than a religious or moneyed corporation could not make a general assignment in this state: 3 R.S., 8th Ed., J. 1731, Sec. 11. In 1882, by a curious tapse in legislation, the provision was done away with: Laws of 1882, Chap. 402, Sec. 1, part 39; but in the same year the provision prohibiting preferences by moneyed corporations and transfers without resolution of the directors was re-enacted in the Banking Law of 1882, Chap. 409, Sec. 187. In 1884 the original provision prohibiting assignments by insolvent corporations or in contemplation of insolvency was restored: Laws of 1884, Chap. 434.

The result is that down to 1890, with the exception of the years 1882 to 1884, a corporation could not make a general assignment for the benefit of creditors when insolvent or in contemplation of insolvency unless it was a moneyed or religious corporation; a moneyed corporation might make a general assignment to a person

not connected with it provided no preferences were given and if the property was worth over \$1,000 and the assignment was authorized by resolution of director's.

In the important case of Curtis v Leavitt 15 New York 9, the construction of this section of the statute was made the subject of much discussion. It was held by three of the judges who delivered opinions, that the language of the statute must be strictly pursued, and that there must actually be a formal resolution of the board of directors, adopted previous to the transfer and expressly authorizing it,. It was maintained on the other hand , by two of the judges, that it was sufficient if the requisition of the statute be substantially complied with, that the transfer might be approved at the time or ratified afterwards, and that the ratification need not be declared in express terms. The conclusion finally arrived at by the court seems to have been that the transfers in the case before the court were void, as not being authorized by a previous resolution; but that the purchasers and pledgers of the companys bonds secured by such transfers, were "purchasers for a valuable consideration and without notice," and therefore within the saving

clause of the eighth section already cited.

It was further held in the case just cited, in accordance with previous decisions in this state, that banking associations, organized under the general banking law of 1838, are corporations, and therefor within the provisions of the Revised Statutes relating to moneyed corporations.

Chap. 18 of the general laws and the provisions of the laws of 1882 above mentioned are now repealed and in their place has been enacted Sec. 48 of Chap. 36, Stock Corporation Law, as finally passed in the laws of 1892, Chap. 688: 5th R.S. (Supp. 8th Ed.), p. 4102, Sec 48. This provision does not include a prohibition against general assignment by corporations to disinterested parties but prohibits preferences. The doing away of this prohibition is an act of justice to corporations, which prior to this were obliged to accept some person to hold their property who although he might be favored by the court might be very undesirable to the members of the corporation. But the restrictions above mentioned never applied to foreign corporations.

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- 2 Kents Com. p. 398 (10th Ed.)
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3 Rev. Stat. 298 sec. 11.
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3 R.S. 8th Ed. p. 1731, Sec. 11

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5th. R.S. (Suff. 8th Ed.), p. 4102, sec. 48.