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Comments

THE RECOVERY OF ILLEGAL DIVIDENDS IN LOUISIANA

The recovery of illegally paid dividends and other unlawfully distributed assets from shareholders has become a paramount consideration in the majority of modern corporation statutes.¹ The right of recovery of these illegal dividends is conveniently

1. For the purpose of this comment, all unlawful distributions to shareholders will be referred to as "illegal dividends." On some occasions unlawful distribution will take the form of corporate repurchase of shares. In either event the ultimate effect of such a transaction is to deplete the capital structure of the corporation upon which the creditors and other shareholders must rely.

divided into two categories: rights against the *directors* of the corporation and rights against the *shareholders*.

Illegal dividends are defined by express provision of the Louisiana Corporation Act.² In essence such dividends are those paid by the corporation when no surplus exists on the corporate balance sheet. When such dividends are declared and paid, it is of great interest to the creditors and the ultimate corporate body to see that these assets are reacquired by the corporation, either by a suit against the directors or by an action against the shareholders to recover the funds received by them.

LIABILITY OF DIRECTORS

It is elementary that the directors of a corporation occupy a fiduciary relationship toward the corporation.³ Thus, liability attaches if the directors pay illegal dividends when there is no corporate surplus available for such payment. The early common law gave the corporation a cause of action against the directors.⁴ An early New York case⁵ clearly enunciated the rule that directors who declared and paid illegal dividends would be liable in equity to the *creditors*.⁶ The latter rule has been corroborated by numerous other decisions.⁷

Statutory provisions now exist in practically all states imposing liability on directors for breach of their fiduciary duties, and in the vast majority of these states the problem of imposing liability for illegally paid dividends is specially treated.⁸ However, these statutes are far from uniform.⁹ The degree of negligence which is necessary to impose liability on the directors also

2. La. Act 250 of 1928, § 26(I) [Dart's Stats. (1939) § 1106(I)]. The procedure of surplus accounting is a distinct problem in itself. The derivation of surplus and its categorization into appropriate surplus accounts are beyond the scope of this comment. For a complete discussion of these accounting problems, see Grahm, *Accounting in Law Practice* (1932) 140, c. 14.

3. *Spiegel v. Beacon Participations, Inc.*, 297 Mass. 398, 8 N.E. (2d) 895,904(1937).

4. *McGinnis v. Corporation Funding & Finance Co.*, 8 F.(2d) 532, 541, (M. D. Pa. 1925).

5. *The Excelsior Petroleum Company v. Lacey*, 63 N.Y. 422(1875).

6. The pith of the action against the directors for declaring and paying illegal dividends is tort. Consequently, in absence of statute, the statute of limitations applicable to such action is that generally applicable to tort action. *Fell v. Pitts*, 263 Pa. 314, 106 Atl. 574(1919).

7. *Walker v. Man*, 253 N.Y. Supp. 458(1931); *Cochran v. Shetler*, 286 Pa. 226, 133 Atl. 232(1926). These cases contain excellent collections of early authorities on this point.

8. 12 *Fletcher*, *Cyclopedia of the Law of Private Corporations* (1932) 143, § 5432.

9. For an excellent discussion of the early statutes and their obscurity, see *Comment* (1926) 35 *Yale L. J.* 870.

differs among the various state statutes.¹⁰ It is well settled, however, that mere errors of judgment will not impose liability on the directors.¹¹

The Louisiana Corporation Act of 1928 provides that corporate directors who declare illegal dividends will be liable if they did so "knowingly, or without exercising that diligence, care and skill which ordinarily prudent men in like positions would exercise under similar conditions."¹² Although no Louisiana cases have directly applied this provision of the act, related decisions make it apparent that Louisiana courts would not hesitate to apply the clear meaning of the statute when the factual situation is presented.¹³

The Louisiana Corporation Act gives the cause of action against the directors to the *creditors* alone, and not the corporation. In this respect the Louisiana Corporation Act differs from the Uniform Business Corporation Act of 1928, in that the latter provides that the *corporation* shall have a cause of action against the directors in case of illegal dividends.¹⁴ The variation made by the Louisiana act in this regard is indeed a simplification of the process necessary for a creditor's recovery under the Uniform Act. The directors of a corporation, particularly a small corporation, would not be likely to institute an action against themselves on behalf of the corporation, and thus the creditors to obtain relief under the Uniform Act might be forced to resort to the duplicitous action of suing the corporation and then levying on the corporate cause of action against the directors. The Louisiana act abrogates the necessity of these extra legal steps by directly providing a cause of action for the creditors.¹⁵

The placing of the cause of action *only* in the creditors, however, involves a significant limitation. The amount of the illegal dividend that may be recovered from the directors must be measured by the amount of the creditors' claims. This sum may be

10. See Comment (1926) 35 Yale L. J. 870, 875.

11. *Speigel v. Beacon Participations, Inc.*, 297 Mass. 398, 8 N.E. (2d) 895, 904 (1937).

12. La. Act 250 of 1928, § 27(I) [Dart's Stats. (1939) § 1107(I)].

13. *Fudickar v. Inabnet*, 176 La. 777, 146 So. 745 (1933); *Stock v. E. A. Fabacher, Inc.*, 185 So. 48 (La. App. 1938); *Chelsea Sales Corporation v. A. Jacobs Co., Inc.*, 193 So. 402 (La. App. 1940). In the *Chelsea Sales Corporation* case the plaintiff-creditor was seeking to invoke Section 27(I) of the Louisiana Corporation Act. The court found that the defendant-directors had properly distributed certain assets to pay debts including past-due salaries. Thus the court could not find that the directors were "negligent" and thereby make them liable to the creditors.

14. 9 U.L.A., Model Business Corporation Act (1928) § 25(I).

15. Cook, Principles of Corporation Law (1925) 314.

only a small fraction of the improper dividend. As the statute does not provide for a corporate cause of action, the entire wrong perpetrated against the corporation by the directors is not rectified.¹⁶

The main provisions of statutes of some other states are noteworthy at this point. The Minnesota statute, almost identical with the Uniform Business Corporation Act, places the cause of action against the directors in the corporation alone.¹⁷ The recently revised California Civil Code provides that the creditors may bring a direct action against the directors for illegal dividends, if they were creditors prior to the declaration of the dividend.¹⁸ It should be noted that this statute is similar to the provisions of the Louisiana act in granting direct action to the creditors, but differs in that the Louisiana act does not mention that the creditor must have extended credit before the declaration of the dividend.¹⁹ The Delaware and New York statutes combine the benefits of the Uniform Business Corporation Act and the Louisiana Corporation Act by providing for a cause of action in either the corporation or the creditors.²⁰ This type of statute has been highly commended by some writers as the better form to facilitate recovery of illegal dividends from guilty directors.²¹

In brief summary, the Louisiana Corporation Act is explicit in providing for a direct action by creditors against directors in the event of illegal dividends. The salient limitation of the Louisiana act, however, is that recovery by the creditors alone might be for a far less sum than the loss caused by the directors' breach of their fiduciary duty in declaring those dividends. An amendment to Subdivisions 1 of Section 27 of the Corporation Act, placing the cause of action against the directors in *either* the corporation or the creditors would eliminate this limitation, and provide for a full recovery from those who by their improper conduct have depleted the corporate structure to the detriment of both the corporation and its creditors.²²

16. Ballantine, *Corporations* (1946) 595, § 254.

17. Minn. Stats. Ann. (1945) § 301.23.

18. Calif. Corp. Code Ann. (Deering, 1947) §§ 824, 825, 826.

19. Where the statute merely makes the directors liable to the "creditors," the general rules seem to be that prior and subsequent may recover alike. The statutory scheme is set up apparently for the benefit of creditors, present and future. *Stoltz v. Scott*, 23 Idaho 104, 129 Pac. 340(1912); *Brennan v. Whitehouse* 85 Wash. 355, 148 Pac. 24(1915); *Hodde v. Nobbe*, 204 Mo. App. 109, 221 S. W. 130(1920).

20. Del. Rev. Code(1935) c. 65, § 2067, as amended by Del. Laws(1937) c. 130; New York Stock Corporation Law of 1923, § 58.

21. Bennett, *The Louisiana Business Corporation Act of 1928(1940)* 2 LOUISIANA LAW REVIEW 597, 624.

22. Del. Rev. Code (1935) c. 65, § 2067, as amended by Del. Laws (1937) c. 130; New York Stock Corporation Law of 1923, § 58.

LIABILITY OF SHAREHOLDERS

The liability of shareholders who have received illegal dividends presents an even more complicated problem. The earliest form of recovery from shareholders was instituted by creditors in what was called a "creditor's bill." When a corporate creditor had a judgment against the corporation returned unsatisfied, he could institute an action in equity against the stockholders on behalf of himself and all other creditors who chose to join him.²³ Emphasis was placed, however, on the fact that the creditor was "merely enforcing the right which the corporation had, and the relief granted must be measured by that right."²⁴ Even with the appearance of statutes making the directors liable for these illegal dividends, courts still recognized a creditor's right of action against the stockholders.²⁵

At an early date the courts, in imposing liability on the shareholders, embarked on one of two main avenues of judicial doctrine. The first of these was the "trust fund" doctrine. In the earlier decisions this doctrine appeared to be the panacea of all corporate problems and was frequently used in obtaining equitable relief for creditors who sought to recover illegal dividends from the shareholders.²⁶ The essence of the "trust fund" doctrine was that the assets of the corporation were held in trust for the creditors, and second for the shareholders. When any dividend was declared which reduced this capital or "trust fund," the creditors found immediate basis for their action. Under this doctrine the good faith of the stockholder who received the dividend and the solvency of the corporation had nothing to do with the creditor's right of recovery.²⁷ The clarity and rigidity of this rule was short lived. The Supreme Court of the United States dealt the earliest and heaviest blow to the creditor's right to recover under the "trust fund" theory in the celebrated case of *McDonald v. Williams*.²⁸ In that case the receiver of a national bank was seeking to recover illegal dividends, and the court refused recovery on the ground that the corporation was solvent at the time

23. Cook, *Principles of Corporation Law* (1925) 312.

24. *Gager v. Paul*, 111 Wis. 638, 87 N.W. 875(1901); *Detroit Trust Co. v. Goodrich*, 175 Mich. 168, 141 N.W. 882(1913). In both these cases the corporation had a cause of action provided by statute. It would seem that this is of the essence before creditor action can be contemplated through a *creditor's bill*.

25. *Powers v. Heggie*, 268 Mass. 233, 167 N. E. 314 (1929).

26. See Barrows, *The Equitable Liability of Stockholders: The Grounds Upon Which It Rests* (1903) 13 Yale L. J. 66.

27. *American Steel & Wire Co. v. Eddy*, 138 Mich. 403, 409, 101 N.W. 578, 581(1904).

28. 174 U.S. 397, 19 S.Ct. 743, 43 L. Ed. 1022 (1899).

of the declaration of the dividend, and that the stockholder received the dividend in good faith and without notice of its illegality. This decision was supported later by *Bartlett v. Smith*²⁹ where the court went to great lengths to point out that if the corporation remained solvent upon paying the dividend, and the shareholder was in good faith in receiving that dividend, it would be totally impracticable to seek to hold this shareholder liable long after the dividend had been paid.³⁰ A recent Iowa case refused recovery by the creditor on the theory that since the corporation was not insolvent at the time of payment of the dividend it was of no moment that later insolvency resulted.³¹ These and similar decisions have virtually erased the true theory of the "trust fund" doctrine.

The other approach to the creditor's recovery in proceedings against shareholders has been the so-called "fraud" theory.³² Under this theory the creditor can recover only if his claim has arisen prior to the payment of the dividend.³³ Although the majority of cases support this view, there are strong decisions to the contrary. One case has held that the very payment of illegal dividends defrauded existing and subsequent creditors alike;³⁴ another that the payment constituted a "constructive fraud" as persons who extended credit after the payment of an illegal dividend had just reason to assume that the capital structure had not previously been impaired.³⁵ General rules are difficult to glean from this array of conflicting jurisprudence. A review and rationaliza-

29. 162 Md. 478, 160 Atl. 440 (1932).

30. 162 Md. 478, 482, 160 Atl. 440, 441 (1932). The court's reasoning is noteworthy at this point, in that this language has become the thesis of later decisions. It has also been adopted by some students of corporation law as the only just picture of the shareholders' position in the case of illegal dividends. The court said: "In this situation we are disposed to follow the Federal decisions as being more in accord with modern conditions and with the realities of life. In these days stocks of corporations are so widely held that it would be practically impossible for stockholders generally to know whether or not each semi-annual dividend paid in regular course was earned. Whatever their position may be theoretically, practically they are in no better position than creditors to know the condition of the company, and it would be an unfair and unreasonable burden to require them to pay back, years after they have been spent, dividends received in good faith from a solvent corporation in regular course of business."

31. *Bates v. Brooks*, 222 Iowa 1128, 270 N.W. 867, 109 A.L. R. 1371 (1937).

32. *Johnson v. Canfield-Swigart Co.*, 292 Ill. 101, 126 N.E. 608 (1920).

33. *Wood v. National City Bank*, 24 F.(2d) 661 (C.C.A. 2d, 1928); *Ratcliff v. Clendenin*, 232 Fed. 61 (C.C.A. 8th, 1916).

34. *Fricke v. Angemeier*, 101 N.E. 329 (Ind. App. 1913).

35. *Mackall v. Pockock*, 136 Minn. 8, 161 N.W. 228 (1917). Held that subsequent creditors could recover as they had trusted the corporation in ignorance that its capital had been impaired. The basis of the action was not actual fraud, but "constructive fraud" and the good faith of the stockholder did not prevent recovery.

tion of the "trust fund" and "fraud" doctrines would in itself be a herculean task. Suffice it to say that in the absence of definite legislative guidance in such cases, the limitation of these judicially developed theories is the ingenuity of the bench itself.³⁶

It is now pertinent to consider in detail certain provisions of the Louisiana Corporation Act. Subdivision II of Section 27 provides:

- "II. Every shareholder who received any such dividend or such distribution or return of assets shall in the following instances be individually liable to the *corporation* in an amount equal to the amount so received by him:
- (a) when no director is liable to a creditor as provided in subdivision I of this section; or
 - (b) to the extent that a creditor is unable to obtain satisfaction after judgments recovered against directors upon the liability imposed by subdivision I of this section."

The good faith of the shareholder in receiving the dividend and the solvency of the corporation are immaterial. The only qualifications to shareholder's liability are those set out in the statute itself—the non-liability or the insolvency of the directors. This provision of the act, however, gives the cause of action solely to the *corporation*, and then states that the liability attaches only in case of non-liability or the insolvency of the directors. An anomalous situation is at once presented by the very text of the statute. It is indeed peculiar that the corporate cause of action against the shareholders *must* be predicated upon the failure of the creditors' cause of action against the directors, yet the cause of action asserted exists *only* in favor of the corporation. The only practical solution for the corporation is to promote a friendly creditors' action against the directors, thus giving the corporation statutory basis for proceeding against the shareholders.

Since the statute does not mention creditors' rights against the shareholders, the next question that arises is: In Louisiana, what recourse, if any, does a creditor have against the shareholders? Reference to the jurisprudence is helpful at this point. In the case of *Fudickar v. Inabnet*³⁷ the Supreme Court of Louisiana allowed the creditors to recover directly against the share-

36. In 1843 a Kentucky court sought to justify a creditor's recovery against the shareholders by utilizing the law of mistake. For an excellent discussion of the folly of this approach to the problem, see Note(1933) 33 Col. L. Rev. 481, 486.

37. 176 La. 777, 146 So. 745 (1933).

holders who had received distribution of assets in anticipation of liquidation. The court first noted that under Section 27 of the Louisiana Corporation Act the shareholders' liability runs in favor of the corporation itself. This fact was of no importance, because *the corporation had ceased to exist*, and no receiver was available to act on behalf of the corporation. In allowing recovery by the creditors, the court cited Section 27 of the Louisiana Corporation Act, but practiced a bit of judicial hedging by further stating: "We think the several provisions of Act No. 250 of 1928 [Louisiana Corporation Act] are broad enough to cover a case of this kind. *But*, if we are wrong in this, we think plaintiff is entitled to a remedy under the *equity* powers conferred upon the courts by the state by Article 21 of the Civil Code, particularly in view of Article 3183 which declares 'The property of the debtor is the common pledge of his creditors.'" In conclusion the court referred to an earlier case, *Derbes v. Till*,³⁸ where under similar circumstances the court allowed the creditors direct recovery against the shareholders. In the *Derbes* case the corporation was no longer in existence, and the counsel for the creditors was quite frank in stating in his brief that he knew of no statutory provision in Louisiana which provided for a direct creditors' action against the shareholders. His entire prayer for relief was based on Articles 21 and 3183 of the Civil Code. Judge Janvier agreed that it would be most inequitable to allow a shareholder to benefit at the expense of a creditor, but in allowing the creditors to recover directly against the shareholders he made it very clear that *only* when the corporation has ceased to exist and is not represented by a receiver or liquidator will such direct action lie. Two other Louisiana cases substantiate these views.³⁹

The propriety of placing the cause of action against the shareholders in the corporation is not here questioned. It is certainly true that the corporation may recover the entire illegal dividend, whereas a creditor might recover only what is owed to him. However, where lies the creditors' remedy in case the corporation is in existence and is controlled by the shareholders who have received the improper dividends? It is very unlikely that these shareholders would institute corporate action against themselves in order to protect the capital structure for the benefit of the creditors. If the creditors are unable to recover from the directors, as provided by Subdivision I of Section 27 of the Louisiana Cor-

38. 128 So. 196(La. App. 1930).

39. *Stock v. Fabacher, Inc.*, 185 So. 48(La. App. 1938); *New Orleans Gas Light Co. v. Bennett*, 6 La. Ann. 456 (1851).

poration Act, what is their next step in protecting their investment? After a diligent search no case has been found which presents this problem. It has been suggested by one writer that the Louisiana courts would allow a suit in the nature of a *creditor's bill* against the shareholders, thus allowing the creditor to levy on the corporate cause of action against the shareholders.⁴⁰ In the *Derbes* case, Judge Janvier stated that if there still exists a receiver or liquidator who can bring the necessary suit, the creditor should "either by appropriate action, force the receiver or liquidator to act, or *in the alternative*, should bring the suit *himself*, not for his sole individual benefit, but *on behalf* of the whole estate."⁴¹ It must be remembered that he is speaking of a corporation which is in the hands of a receiver or a liquidator. A creditor could argue by analogy to the above opinion that he should be allowed to sue on behalf of an existing corporation when that corporation refused to bring the proper action against the shareholders. This is at best an argument and its acceptance in future litigation is conjectural. There exists the further possibility that Louisiana courts might adopt either the "trust fund" or "fraud" doctrine plus or minus the many modifications attached to both. There is no way of ascertaining what other equitable doctrines might be borrowed from the mass of litigation that has flooded other jurisdictions on the same questions.

It is very unfortunate that the basic relationships of creditor and shareholder, as contemplated by the corporate form of business, should be left to flounder in this myriad of conflicting doctrine.⁴² In reality both the shareholder and the creditor are investors in the corporation. The creditor expects the return on his investment ahead of the shareholder. The capital structure of the corporation is the security for his investment. The shareholder, on the other hand, is led to expect return on his investment only after primary obligations of the corporation have been met and net profits are available for dividend payments. The various classes of participating shares exemplify the choice given to the shareholder to participate at different levels of net profit. No share of stock on its face purports to prime the claims of creditors. The Louisiana Corporation Act establishes with no un-

40. Bennett, *The Louisiana Business Corporation Act of 1928* (1940) 2 *LOUISIANA LAW REVIEW* 597, 625.

41. 128 So. 196, 198 (La. App. 1930).

42. For a discussion of the various applications of equitable doctrines in suits against shareholders, and the failure of most courts to recognize the basic relationship of a stockholder and creditors to the corporation, see Note (1933) 33 *Col. L. Rev.* 481.

certainty that dividends shall not be paid except from surplus.⁴³ It cannot be denied that such statutory policy of dividend restriction is intended primarily for protection of creditors.

There is no need for future Louisiana litigation to shoot judicial rapids experienced in other states, replete with confusing and conflicting theories of shareholders' liability. Preventive legislation is desirable. An amendment to Subdivision II of Section 27 of the Louisiana Corporation Act, allowing the creditors, in addition to the corporation, a direct action against shareholders to recover illegal dividends, regardless of the good faith of the shareholder, solvency of the corporation, or position of the creditor's claim in relation to the declaration of the dividend, would insure the basic relationships of both creditors and shareholders and uphold the clear statutory policy of dividend restrictions.⁴⁴ A very brief prescriptive period for this action would relieve the shareholder of a long period of uncertainty, which has been the touchstone of so many decisions allowing the good faith stockholder to retain a clearly illegal dividend.⁴⁵

Subdivision III of Section 27 of the Louisiana Corporation Act provides that directors who are held liable "for the sole reason of having acted negligently" shall have a right of action over against each shareholder for the proportionate amount of the illegal dividend, distribution, payment or return of assets received by the shareholder. This excellent provision in our corporation law has been highly commended as an appropriate statutory method of reimbursing merely negligent directors who should not be made to stand this burden for such a minor misfeasance.⁴⁶

WILLIAM F. WILSON, JR.

CORPORATIONS: SHAREHOLDER RATIFICATION OF DIRECTORS' ACTION

It often happens that the board of directors of a corporation authorizes an unenforceable transaction. Such transactions are unenforceable because they are either ultra vires, voidable, or

43. La. Act 250 of 1928, § 26(I) [Dart's Stats. (1939) § 1106(I)].

44. Ballantine, *Corporations* (1946) 601, § 255. "The true basis of liability (of the shareholder) is neither the trust fund theory nor a fraudulent conveyance theory, but the enforcement of the statutory policy of dividend restrictions and the questions of what remedies are practical and just for the purpose of protecting all parties concerned."

45. See note 30, *supra*.

46. Briggs, *Stockholders' Liability for Unlawful Dividends* (1934) 8 Temple L. Q. 145, 184.