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Banks and Banking -- Insolvency as Bar to Defense of Fraud in Action on Statutory Liability

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The following students have been elected to the Order of the Coif: William J. Adams, Jr., J. M. Little, Jr., and Frank Parker Spruill, Jr.

The Winston-Salem Foundation Award, an honorary loan fund established in 1932, was awarded for next year to Hugh L. Lobdell.

The Henry Strong Educational Foundation Award, an honorary loan fund just established, has been awarded to Emmett C. Willis, Jr. as the first recipient.

NOTES AND COMMENTS

Banks and Banking—Insolvency as Bar to Defense of Fraud in Action on Statutory Liability.

In an action by the Commissioner of Banks to recover a statutory assessment, defendant stockholder set up, as defense and ground for rescission of his subscription, the fraud of the bank's president inducing the purchase. Two and a half years elapsed between defendant's subscription and the insolvency of the bank, during which time dividends amounting to twelve per cent a year were received and retained by defendant and his name appeared as stockholder on the books of the bank. *Held*: Defense and counterclaim allowed, for otherwise the defrauding bank president would benefit, as depositor, creditor, and subscriber, by his own fraud.¹

Authorities differ as to whether insolvency of a bank will prevent one of its stockholders from showing, as against the receiver, that fraudulent misrepresentations by the bank's agents² induced his purchase. What are probably the better reasoned decisions, viewing the double liability as imposed solely for the benefit of creditors³ and hence not subject to be prejudiced by acts of the bank of which creditors had no knowledge, deny⁴ to a shareholder the right of pleading such fraud, after failure of the bank, either as defense⁵ to the

¹ *Hood v. Martin*, 203 N. C. 620, 166 S. E. 793 (1932).

² Promoters come within this classification. *Stone v. Walker*, 201 Ala. 130, 77 So. 554 (1917); *Green v. Stone*, 205 Ala. 381, 87 So. 862 (1921). But see note (1910) 24 HARV. L. REV. 147.

³ Equities of other stockholders may influence the result. *Meholin v. Carlson*, 17 Idaho 742, 107 Pac. 755 (1910).

⁴ Some courts consider the stockholder "estopped" as against creditors. *Blackert v. Lankford*, 740 Okla. 61, 176 Pac. 532 (1918); *Farmers' State Bank v. Empey*, 35 S. D. 107, 150 N. W. 936 (1915); see *Baird v. Anderson*, 60 N. D. 444, 235 N. W. 150, 152 (1931). But see *Wehby v. Spurway*, 30 Ariz. 274, 246 Pac. 759, 762 (1926) (holding estoppel unnecessary).

⁵ Although the stockholder may seek redress against the defrauding party in a separate suit, in the receiver's action he cannot set-off or counterclaim

receiver's action to recover a statutory assessment⁶ or as a ground for rescission of the subscription⁷ or stock purchase.⁸ It makes no difference that the fraud was not discovered⁹ or could not, by the exercise of reasonable diligence, have been uncovered¹⁰ prior to the

for the fraud against his double liability. *Lantry v. Wallace*, 182 U. S. 536, 21 Sup. Ct. 878, 45 L. ed. 1218 (1901); *Taylor v. American Nat. Bank*, 2 F. (2d) 479 (1924); *Dyar v. Mobley*, 170 Ga. 65, 152 S. E. 74 (1930); *Smith v. Groesbeck*, 54 S. D. 350, 223 N. W. 308 (1929); Note (1932) 41 *YALE L. J.* 583.

⁶ *Anderson v. Cronkleton*, 32 F. (2d) 170 (C. C. A. 8th, 1929); *Litchfield Bank v. Church*, 29 Conn. 137 (1860) ("Stockholders, who hold themselves out as constituting the bank, should bear the loss"); *Meholin v. Carlson*, *supra* note 3; *Com. of Banks v. Cosmopolitan Trust Co.*, 253 Mass. 205, 148 N. E. 609 (1925); *State Bank v. Gotschall*, 121 Ore. 92, 254 Pac. 800 (1927); *Smith v. Bradshaw*, 54 S. D. 158, 222 N. W. 683 (1928) ("Deceit by officers of the bank or the government is no defense, but defendant must look to them for redress"); *Duke v. Johnson*, 123 Wash. 43, 211 Pac. 710 (1923); 7 C. J. §101; see *Lantry v. Wallace*, 182 U. S. at 549, 21 Sup. Ct. at 883, 45 L. ed. at 1225; *Rathbun v. Goldman*, 164 Minn. 507, 205 N. W. 436, 437 (1925).

"A stockholder's liability upon a stock assessment is a matter between him and creditors of the banks, . . . and his responsibility therefor must be determined by the fact of his ownership and what he permitted or caused the bank's records to show concerning it, and not by what was said and done by the bank's officers to induce him to become such." *Wehby v. Spurway*, *supra* note 4, 246 Pac. at 761. See also *Winsett v. Spurway*, 30 Ariz. 287, 246 Pac. 763 (1926).

⁷ *Ryan v. Mt. Vernon Nat. Bank*, 224 Fed. 429 (C. C. A. 2d, 1915); *Salter v. Williams*, 219 Fed. 1017 (D. N. J. 1914); Note (1932) 41 *YALE L. J.* 583; *CLARK, CORPORATIONS* (8th ed. 1923) §164.

"It is contrary to legislative policy for protection of depositors . . . that stockholders, who appear to be such on the books of the trust company at the time it goes into . . . liquidation, may repudiate liability to creditors because they have been defrauded. . . . [A stockholder] is in a better position to protect himself than the depositors and other creditors who could only rely on . . . the stockholders' liability". *Bittenbender v. Cosmopolitan Trust Co.*, 253 Mass. 230, 148 N. E. 619, 620 (1925).

A counterclaim seeking rescission after insolvency of the bank is usually set up primarily to avoid the statutory liability. It differs from a mere defense on the same ground in that return of the purchase price is sought.

It is well settled in England that after insolvency fraud cannot be pleaded to avoid liability. *Oakes v. Turquand*, L. R. 2 H. L. 325 (1867); *CLARK, CORPORATIONS* (8th ed. 1923) §163.

⁸ The rule denying the right to rescind after the bank's insolvency applies only to subscriptions, not to purchases of stock. *Merrill v. Florida Land Co.*, 60 Fed. 17 (C. C. A. 5th, 1893); *Litchfield Bank v. Peck*, 29 Conn. 384 (1860); Note (1931) 65 U. S. L. REV. 291. *Contra*: *Brooks v. Austin*, 206 S. W. 723 (Tex. Civ. App. 1918) ("The argument that other stockholders should not profit by the fraud of their officers does not apply when the fraud is by an outsider"). No distinction is recognized in *Farmers' State Bank v. Empey*, *supra* note 4. Since the capital of the bank is in no way impaired by rescission of a stock transfer between two individuals, the majority rule appears to be preferable.

⁹ *Meholin v. Carlson*, *supra* note 3; Note (1932) 41 *YALE L. J.* 583.

¹⁰ *Scott v. Latimer*, 89 Fed. 843 (C. C. A. 8th, 1898). *Contra*: *Smith v. Jones*, 173 Ky. 776, 191 S. W. 500 (1917).

insolvency. Nor will the case be altered by the fact that rescission has been obtained, either informally¹¹ or by judgment.¹²

A second line of cases, however, adhering to what is termed the American rule, and acting on the theory that the bank's fraud vitiates the contract at the purchaser's option,¹³ holds that insolvency alone will not prevent rescission.¹⁴ This result is frequently reached when the court considers that insolvency followed the purchase so closely as not to allow time for investigating the affairs of the bank.¹⁵ In the leading case announcing this doctrine there was the additional significant finding that the creditors had waived their claims against the subscribers.¹⁶

A close analysis of the seemingly opposite views leads to the conclusion that, in practical effect, there exists little or no difference between the two. Both agree in general that the fraudulent contract is voidable only,¹⁷ and that it cannot be revoked where the defrauded party is chargeable with lack of diligence in discovering the fraud, with laches in asserting his claim,¹⁸ or with acts giving rise to

¹¹ *Farmers' State Bank v. Empey*, *supra* note 4.

¹² *Blackert v. Lankford*, *supra* note 4 (shareholder's name remained on the books); see *Bundy v. Wilson*, 66 Colo. 253, 180 Pac. 740, 741 (1919).

Even a rescission prior to the insolvency may be avoided as being an illegal transfer within the time limit before bankruptcy. *Wehby v. Spurway*, *supra* note 4; Note (1932) 41 YALE L. J. 583.

¹³ The general rule—that a repudiated contract is void *ab initio*—is not applied so as to prejudice rights of creditors. *Wehby v. Spurway*, *supra* note 4. But see *Chapman v. Penix*, 274 S. W. 187, 189 (Tex. Civ. App. 1925).

¹⁴ *Newton Bank v. Newbegin*, 74 Fed. 135 (C. C. A. 8th, 1896); *People v. Cal. Safe Deposit Co.*, 19 Cal. App. 414, 126 Pac. 516 (1912); *Gress v. Knight*, 135 Ga. 60, 68 S. E. 834 (1910); Note (1926) 41 A. L. R. 674; (1919) 5 IOWA L. BULL. 59; (1910) 24 HARV. L. REV. 147; BALLANTINE, CORPORATIONS (1927) 149.

After rescission, the stockholder becomes a creditor of the bank, subject to paramount claims of depositors and other creditors who dealt with the bank in good faith relying upon his subscription. *Green v. Stone*, *supra* note 2.

¹⁵ *Stone v. Walker*, *supra* note 2 (stock held six months, between the purchase and the insolvency); *Rathbun v. Goldman*, *supra* note 6 (stock held nine months); *Morrisey v. Williams*, 74 W. Va. 636, 82 S. E. 509 (1914) (stock held one month).

¹⁶ *Newton Nat. Bank v. Newbegin*, *supra* note 14. In that case a stockholder of six months standing brought suit for rescission while the bank was operating as a solvent, going concern, under a reorganization plan; creditors had agreed to compromise their claims, accepting in satisfaction obligations of the reorganized bank. The court found that creditors had thereby waived their claims against stockholders.

¹⁷ *Stufflebeam v. De Lashmutt*, 101 Fed. 367 (C. C. D. Ore. 1900); *Com. of Banks v. Cosmopolitan Trust Co.*, *supra* note 6.

¹⁸ *Williams v. Stone*, 25 F. (2d) 831 (C. C. A. 4th, 1928); *Meholin v. Carlson*, *supra* note 3; *Reid v. Owensboro Savings Bank*, 141 Ky. 444, 132 S. W. 1026 (1911); *Foster v. Broas*, 120 Mich. 1, 79 N. W. 969 (1899). See *Smith v. Groesbeck*, *supra* note 5.

an estoppel,¹⁹ or where rights of innocent third parties have intervened.²⁰ It is in regard to the pleading and proof essential to this last factor that the dispute arises. Unless the statute clearly provides, as does the one in North Carolina,²¹ that stockholders are liable for all debts,²² the outcome of a particular case is likely to depend upon the presence or absence of intervening, good faith creditors.²³ Only in one or two instances have rights of subsequent claimants been affirmatively denied.²⁴

The burden of showing absence of such creditors should fall upon the stockholder, since the ordinary presumption is that debts are constantly being created by a solvent bank;²⁵ but some courts, considering the information peculiarly within the knowledge of the bank,

¹⁹ *Scott v. Deweese*, 181 U. S. 202, 21 Sup. Ct. 585, 45 L. ed. 822 (1901); *Ryan v. Mt. Vernon Nat. Bank*, *supra* note 7; *Alsop v. Conway*, 188 Fed. 568 (C. C. A. 6th, 1911); *Scott v. Latimer*, *supra* note 10; *Little v. Owensboro Savings Bank*, 150 Ky. 331, 150 S. W. 334 (1912); *Reid v. Owensboro Savings Bank*, *supra* note 18; *Com. of Banks v. Carrier*, 202 N. C. 850, 165 S. E. 678 (1932).

²⁰ MORSE, BANKS AND BANKING (6th ed. 1928) §671 A; note (1919) 5 IOWA L. BULL. 59.

²¹ "Stockholders of every bank . . . shall be individually responsible . . . for all contracts, debts, and engagements of such corporation. . . ." N. C. CODE ANN. (Michie, 1931) §219 (a).

²² *Anderson v. Cronkleton*, *supra* note 6; *Lantry v. Wallace*, 97 Fed. 865 (C. C. A. 8th, 1899); *Foster v. Broas*, *supra* note 18; see *Bundy v. Wilson*, *supra* note 12, 180 Pac. at 742.

²³ *Com. of Banks v. Cosmopolitan Trust Co.*, *supra* note 6; *Farmers' State Bank v. Empey*, *supra* note 4; *Chapman v. Harris*, 275 S. W. 75 (Tex. Civ. App. 1925); *Davis v. Burns*, 173 S. W. 476 (Tex. Civ. App. 1914); *Burleson v. Davis*, 141 S. W. 559 (Tex. Civ. App. 1911); *Morrisey v. Williams*, *supra* note 15 (stating that transferor of stock remains liable for debts that accrued while he held the stock); (1919) 5 IOWA L. BULL. 59; (1910) 24 HARV. L. REV. 147; see *Taylor v. Am. Nat. Bank*, *supra* note 5, at 482; *Gress v. Knight*, *supra* note 14 (stating that prior creditors might defeat rescission by showing laches, estoppel, or that the shareholder allowed increase of indebtedness and lessening of assets); FLETCHER, CORPORATIONS (1917) §636. But see (1908) 22 HARV. L. REV. 58.

²⁴ *Litchfield Bank v. Peck*, *supra* note 8; *Marion Trust Co. v. Blish*, 170 Ind. 686, 84 N. E. 814 (1908) (holding that receiver can assert only rights common to all creditors).

"If creditors' rights in the capital were no greater than defendant's before appointment of a receiver, they surely are no greater after. Rights of both are fixed by law, not by change from solvency to insolvency of the bank". *Salter v. Williams*, 244 Fed. 126 (C. C. A. 3rd, 1917), reaching the curious and somewhat illogical result of allowing rescission after the shareholder had paid his assessment and disclaimed intention to sue for its recovery.

²⁵ *Smith v. Bradshaw*, *supra* note 6; *Farmers' State Bank v. Empey*, *supra* note 4; *Chapman v. Harris*, *supra* note 23. See *Anderson v. Cronkleton*, *supra* note 6, at 172; *Lantry v. Wallace*, *supra* note 22, at 867; *Stufflebeam v. De Lashmutt*, *supra* note 17, at 371; *Newton Nat. Bank v. Newbegin*, *supra* note 14, at 140 (stating that lapse of a considerable time between subscription and insolvency will obviate the necessity of showing debts incurred).

require proof by the receiver of intervening liabilities.²⁶ Most courts do not, however, require a showing that such were incurred in reliance upon the subscription in issue.²⁷ Probably the best practical result is reached by the few courts which neatly avoid the whole difficulty by considering rights of creditors as intervening at the time of the bank's insolvency.²⁸ Indeed, the courts might well cease to talk of intervening equities; the proneness to presume either absence or presence of creditors and reliance on the subscription makes such requirement largely superfluous.

The conclusion seems to be that, while insolvency alone may not bar a plea of fraud,²⁹ yet when taken in connection with other factors which are inevitably present, it will serve to exclude such evidence. In other words, although it is material only on the question of intervention of creditors' rights, the practical certainty of a finding of such claims renders academic the possibility of superior equity on the part of the shareholder.

²⁶ *Smith v. Jones*, 173 Ky. 776, 191 S. W. 500 (1917) (stock held seven months); see *Stone v. Walker*, *supra* note 2, at 561; *Gress v. Knight*, *supra* note 14.

"It is not to be inferred that creditors parted with anything on the faith of plaintiff's money fraudulently held by the bank; to allow the receiver to retain the proceeds of the fraudulent sale would be to give creditors the fruits of a gross fraud, which would make them *particeps criminis*". *Merrill v. Fla. Land Co.*, *supra* note 8, stock held six months).

The amount of new indebtedness that must be shown varies. Excess over the value of stock subscribed, though not necessarily a "large proportion", was held sufficient in *Wilkes v. Knight*, 142 Ga. 458, 83 S. E. 89 (1914); any creditors becoming such in reliance upon the shareholder's apparent ownership sufficed in *Farmers' State Bank v. Empey*, *supra* note 4; "considerable" subsequent liability was required in *Newton Nat. Bank v. Newbegin*, *supra* note 14, and *Morrissey v. Williams*, *supra* note 15; see BALLANTINE, CORPORATIONS (1927) 149; and "substantial" intervening debts were enough in *Gress v. Knight*, *supra* note 14.

²⁷ *Reid v. Owensboro Savings Bank*, *supra* note 18; *Bittenbender v. Cosmopolitan Trust Co.*, *supra* note 7 ("Creditors have presumably relied in part upon the stability of stockholders' liability"); *Davis v. Burns*, *supra* note 23; *Burleson v. Davis*, *supra* note 23 ("By subscribing, defendants induced depositors and creditors to become such, relying on the subscriptions"); see *Lantry v. Wallace*, *supra* note 22, at 867 ("One reason defendant was solicited to become a stockholder was that his influence would attract patronage to the bank. And it is probably true that some persons became creditors because of defendant's connection with the bank"); BALLANTINE, CORPORATIONS (1927) 149. *Contra*: *Stufflebeam v. De Lashmutt*, *supra* note 17 (stock held one month) ("Where there is no room for inference that credit was given on the faith of defendant's ownership of stock, he should be allowed to rescind whether there are intervening creditors or not"); see *People v. Cal. Safe Deposit Co.*, *supra* note 14, at 519.

²⁸ *Scott v. Deweese*, *supra* note 19; *Salter v. Williams*, *supra* note 24; *Com. of Banks v. Cosmopolitan Trust Co.*, *supra* note 6.

²⁹ As pointed out in Note (1927) 51 A. L. R. 1203, it is difficult to determine how far insolvency controls a decision that fraud is barred as a defense, since such actions are only brought after insolvency.

It is readily apparent that the instant case is considerably out of line with the authority as outlined above. The fact set-up seems to furnish adequate basis, in connection with the bank's insolvency, for protecting the equities of depositors, creditors, and other stockholders. The distinction pointed out by the court between the instant case and *Corporation Commissioner v. McLean*³⁰ would, in accordance with authority,³¹ further impeach the result of the instant case. The court's reliance on the fact that the defrauding bank president would profit by his own fraud—described by the court as “the egg that spoils the omelet”—is, from the standpoint of innocent creditors, as unsatisfactory as it is unique. The court seems to have disregarded entirely the plain wording, as well as the evident intent of the North Carolina “double liability” statute.³²

JAMES M. LITTLE, JR.

Banks and Banking—Power of Banks to Pledge Assets to Secure Depositors.

Plaintiff railroad had deposited its funds in defendant national bank on condition that the bank should furnish corporate surety bonds, which it did. While the bank was still solvent, it induced the railroad to accept a substitution of Liberty bonds owned by the bank for the surety bonds which secured the deposit. The bank failed, and this action is against the receiver who has failed to surrender the Liberty bonds. *Held*: The action cannot be maintained; the agreement by which the bank pledged some of its assets to secure private funds was beyond the power of the bank, and unenforceable.¹

³⁰ 202 N. C. 77, 161 S. E. 854 (1932). The tenor of this case is distinctly in accord with the stricter view: “It is only when it is shown that a person whose name appears on the books of the corporation as a stockholder, is not in fact an owner of stock, that such person is not subject to the statutory liability. . . . The only issues of fact which may be raised by such appeal and determined in the Superior Court, ordinarily, are: (1) Was the appellant a stockholder of the insolvent banking corporation at the date of his assessment? (2) If so, how many shares of the capital stock of said corporation did appellant own at said date? . . . Having received all the benefits arising from the ownership from stock . . . it is not unjust that they should now bear their share of the burden imposed by law upon them by reason of their ownership of said stock.”

³¹ See note 8 *supra*.

³² *Supra* note 21. The case is perhaps supportable by North Carolina authority dealing with corporations other than banks. *Chamberlain v. Trogden*, 148 N. C. 140, 61 S. E. 628 (1908).

A recent enactment, P. L. 1933, ch. 159, provides for a surplus fund in lieu of the additional liability imposed upon bank stockholders. The statute is mandatory as to banks organized after its ratification, and those then in operation are given the option of coming within its provisions.

¹ *Texas & P. R. Co. v. Pottorff*, 63 F. (2d) 1 (C. C. A. 5th, 1933).