

Sawyer Vs. Hoag

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SooperKanoon Citation : sooperkanoon.com/82409

Court : US Supreme Court

Decided On : 1873

Appeal No. : 84 U.S. 610

Appellant : Sawyer

Respondent : Hoag

Judgement :

Sawyer v. Hoag - 84 U.S. 610 (1873)

U.S. Supreme Court Sawyer v. Hoag, 84 U.S. 17 Wall. 610 610 (1873)

Sawyer v. Hoag

84 U.S. (17 Wall.) 610

APPEAL FROM THE CIRCUIT COURT FOR

THE NORTHERN DISTRICT OF ILLINOIS

SYLLABUS

1. Capital stock or shares of a corporation -- especially the unpaid subscriptions to such stock or shares -- constitute a trust fund for the benefit of the general creditors of the corporation.

2. This trust cannot be defeated by a simulated payment of the stock subscription, nor by any device short of an actual payment in good faith.
3. An arrangement by which the stock is nominally paid, and the money immediately taken back as a loan to the stockholder, is a device to change the debt from a stock debt to a loan, and is not a valid payment its against creditors of the corporation, though it may be good as between the Company and the stockholder.
4. The twentieth section of the Bankrupt Act was not intended to enlarge the doctrine of setoff beyond what the principles of legal or equitable setoff previously authorized.
5. A stockholder indebted to an insolvent corporation for unpaid shares cannot set off against this trust fund for creditors a debt due him by the corporation. The fund arising from such unpaid-shares must be equally divided among all the creditors.
6. The relations of a stockholder to the corporation, and to the public who deal with the latter, are such as to require good faith and fair dealing in every transaction between him and the corporation, of which he is part owner and controller, which may injuriously affect the rights of creditors or of the general public, and a rigid scrutiny will be made into all such transactions in the interest of creditors.

About the 1st of April, 1865, and prior, therefore, to the passage of the Bankrupt Act of 1867, the directors of the Lumberman's Insurance Company of Chicago -- a company then recently incorporated and authorized to begin business on a capital of \$100,000, of which not less than one-tenth should be paid in, the residue to be secured -- invited subscriptions to the capital stock of the company; stating, in most instances, to those whom they invited to subscribe, that only 15 percent would be required to be paid down in cash, and that the remaining 85 percent would be lent back to the subscriber, and a note taken therefor, payable in five years, with 7 percent interest, payable semiannually, secured

by collateral security satisfactory to the directors of the company.

In this state of things one Sawyer about the said 1st of April, 1865, at the solicitation of one of the directors, subscribed for fifty shares of stock. When called upon to close his subscription, he was informed, as indeed all the subscribers were, that the matter would be closed on the plan above mentioned.

Sawyer accordingly complied with the requirements, and gave his check to the company for \$5,000, the full amount of his stock, and his note payable to it in five years from date, for \$4,250, that is to say, for 85 percent of the par value of the stock, with interest, payable as aforesaid, and delivered to the company as collateral security for the payment of his note satisfactory securities, and received from the company a check for \$4,250 or 85 percent of the par value of the stock, by way of, and as for a loan thereof from the company. At the same time, Sawyer gave a written authority to the company to sell the securities at public auction, for cash, in case default should be made in the payment of the note and the interest thereon.

Sawyer subsequently took up this note and gave in substitution therefor another note, and new securities as collateral, with power, as in the case of the former ones, to sell them on default of payment of the note or interest.

At the time when the said original and substituted notes were made, money was worth and could have been lent in Chicago at from 8 to 10 percent interest per annum, payable semiannually, on good security.

The original transaction was regarded and treated by the company and by Sawyer as a loan by the company to him, and his stock was treated as fully paid for. At various times after the giving of the original note, the company reported to the authorities of the state of Illinois and of other states that its capital stock was fully paid.

On the 8th and 9th day of October, A.D. 1871, a great fire devastated the city of Chicago and rendered the Lumberman's Insurance Company insolvent; and on the 25th of

January, 1872 -- it being at that time a notorious fact, one well understood by the public, and one which Sawyer had good reason to believe, that the said company was insolvent and unable to pay its liabilities -- Sawyer purchased of a certain Hayes a certificate of an adjusted loss for \$5,000 against the company for 33 percent of its par value.

In June, 1872, after Sawyer had purchased this certificate of adjusted loss, a petition in bankruptcy was filed against the company, and it having been adjudicated a bankrupt, one Hoag was appointed its assignee.

The thirteenth section of the Bankrupt Act enacts "that after the adjudication in bankruptcy the creditors shall choose one or more assignees of the debtor." And the fourteenth section, under the marginal head of, "What is to be vested in the assignee by the adjudication of bankruptcy," &c., enacts that:

"All the property conveyed by the bankrupt in fraud of his creditors, all rights in equity, choses in action . . . all debts due him or any person for his use, and all liens and securities therefor, and all his rights of action for property or estate . . . and for any cause of action which the bankrupt had against any person . . . with the like right, title, power, and authority to sell, manage, dispose of, sue for and recover the same, as the bankrupt might or could have had if no assignment had been made, shall, in virtue of the adjudication of bankruptcy and the appointment of his assignee, be at once vested in such assignee: and he may sue for and recover the said estate, debts and effects, and may prosecute and defend all suits at law and equity, . . . *in the same manner and with the like effect as they might have been prosecuted or defended by such bankrupt.* "

The fifteenth section of the act enacts:

"That the assignee shall demand and receive from any and all persons holding the same all the estate assigned or intended to be assigned under the provisions of this act."

The sixteenth section enacts:

"That the assignee shall have the like remedy to recover all said estate, debts and effects, in his own name, as the debtor

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might have had if the decree in bankruptcy had not been rendered and no assignment had been made."

Among the effects of the company, which came into Hoag's hands as assignee, was the already-mentioned note of Sawyer for \$4,250, with the securities assigned as collateral. Hoag demanding of Sawyer payment of this note, Sawyer produced his certificate of adjusted loss for \$5,000 and insisted on setting it off against the demand; asserting a right to do this under the twentieth section of the Bankrupt Act, a section in these words:

"In all cases of mutual debts or mutual credits between the parties, the account between them shall be stated, and one debt set off against the other, and the balance only shall be allowed or paid, but no setoff shall be allowed of a claim in its nature not provable against the estate:"

" *Provided*, that no setoff shall be allowed in favor of any debtor to the bankrupt of a claim purchased by or transferred to him after the filing of the petition."

Hoag refused to allow the setoff, and was about to sell the collateral securities in accordance with the power given to him. Hereupon Sawyer filed a bill in the court below to enforce the setoff, in which he alleged, among other things, that the note given by him to the insurance company was for money lent to him.

The assignee, in his answer, denied that the note was for money lent, and averred that it was in fact for a balance due by Sawyer for his stock subscription, which had never been paid, and insisted that such balances constituted a trust fund for the benefit of all creditors of the insolvent corporation, which could not be made the subject of a setoff against an ordinary debt due by the company to one of its creditors. After the general replication, the case was submitted to the court below

on an agreed statement of facts. That court decreed against the complainant, and from that decree the case was brought by the present appeal to this Court.

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MR. JUSTICE MILLER delivered the opinion of the Court.

The first and most important question to be decided in this case is whether the indebtedness of the appellant to the insurance company is to be treated, for the purposes of this suit, as really based on a loan of money by the company to him, or as representing his unpaid stock subscription.

The charter under which the company was organized authorized it to commence business upon a capital stock of \$100,000, with ten thousand paid in, and the remainder secured by notes with mortgages on real estate or otherwise. The transaction by which the appellant professes to have paid up his stock subscription is, shortly, this: he gave to

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the company his check for the full amount of his subscription, namely, \$5,000. He took the check of the company for \$4,250, being the amount of his subscription less the 15 percent required of each stockholder to be paid in cash, and he gave his note for the amount of the latter check, with good collateral security for its payment, with interest at 7 percent per annum. The appellant and the company, by its officers, agreed to call this latter transaction a loan, and the check of the appellant payment in full of his stock; and on the books of the company, and in all other respects as between themselves it was treated as payment of the subscription and a loan of money. It is agreed that at this time the current rate of interest in Chicago was greater than 7 percent, and it is not stated as a fact whether these checks were ever presented and paid at any bank, or that any money was actually paid or received by either party in the transaction. It must therefore be treated as an agreement between the corporation, by its officers, on the one part, and the appellant, as a subscriber to the stock of the company, on

the other part, to convert the debt which the latter owed to the company for his stock into a debt for the loan of money, thereby extinguishing the stock debt.

Undoubtedly this transaction, if nothing unfair was intended, was one which the parties could do effectually as far as they alone were concerned. Two private persons could thus change the nature of the indebtedness of one to the other if it was found to be mutually convenient to do so. And in any controversy which might or could grow out of the matter between the insurance company and the appellant we are not prepared to say that the company, as a corporate body, could deny that the stock was paid in full.

And on this consideration, one of the main arguments on which the appellant seeks to reverse the decree stands. He assumes that the assignee in bankruptcy is the representative alone of the corporation, and can assert no right which it could not have asserted. The weakness of the argument is in this assumption. The assignee is the representative of the creditors as well as the bankrupt. He is appointed

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by the creditors. The statute is full of authority to him to sue for and recover property, rights, and credits, where the bankrupt could not have sustained the action, and to set aside as void transactions by which the bankrupt himself would be bound. All this, of course, is in the interest of the creditors of the bankrupt.

Had the creditors of this insolvent corporation any right to look into and assail the transaction by which the appellant claims to have paid his stock subscription?

Though it be a doctrine of modern date, we think it now well established that the capital stock of a corporation, especially its unpaid subscriptions, is a trust fund for the benefit of the general creditors of the corporation. And when we consider the rapid development of corporations as instrumentalities of the commercial and business world in the last few years, with the corresponding necessity of adapting legal principles to the new and varying exigencies of this business, it is no solid objection to such a principle that it is modern, for the occasion for it could not

sooner have arisen.

The principle is fully asserted in two recent cases in this Court, namely, *Burke v. Smith*, [[Footnote 1](#)] and in *New Albany v. Burke*. [[Footnote 2](#)] Both these cases turned upon the doctrine we have stated, and upon the necessary inference from that doctrine, that the governing officers of a corporation cannot, by agreement or other transaction with the stockholder, release the latter from his obligation to pay, to the prejudice of its creditors, except by fair and honest dealing and for a valuable consideration.

In the latter case, a judgment creditor of an insolvent railroad company, having exhausted his remedy at law, sought to enforce this principle by a bill in chancery against the stockholders. The court, by affirming the right of the corporation to deal with the debt due it for stock as with any other debt, would have ended the case without further inquiry. But asserting, on the contrary, to its full extent,

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that such stock debts were trust funds in their hands for the benefit of the corporate creditors, and must in all cases be dealt with as trust funds are dealt with, it was found necessary to go into an elaborate inquiry to ascertain whether a violation of the trust had been committed. And though the court find that the transaction by which the stockholders had been released was a fair and valid one, as founded on the conditions of the original subscription, the assertion of the general rule on the subject is nonetheless authoritative and emphatic. [[Footnote 3](#)]

In the case before us, the assignee of the bankrupt, in the interest of the creditors, has a right to inquire into this conventional payment of his stock by one of the shareholders of the company; and on that inquiry we are of opinion that, as to these creditors, there was no valid payment of his stock by the appellant. We do not base this upon the ground that no money actually passed between the parties. It would have been just the same if, agreeing beforehand to turn the stock debt into a loan, the appellant had brought the money with him, paid it, taken a receipt

for it, and carried it away with him. This would be precisely the equivalent of the exchange of checks between the parties. It is the intent and purpose of the transaction which forbids it to be treated as valid payment. It is the change of the character of the debt from one of a stock subscription unpaid to that of a loan of money. The debt ceases by this operation, if effectual, to be the trust fund to which creditors can look, and becomes ordinary assets, with which the directors may deal as they choose.

And this was precisely what was designed by the parties. It divested the claim against the stockholder of its character of a trust fund, and enabled both him and the directors to deal with it freed from that charge. There are three or four of these cases now before us in which precisely the same thing was done by other insurance companies organized

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in Chicago, and we have no doubt it was done by this company in regard to all their stockholders.

It was therefore a regular system of operations to the injury of the creditor, beneficial alone to the stockholder and the corporation.

We do not believe we characterize it too strongly when we say that it was a fraud upon the public who were expected to deal with them.

The result of it was that the capital stock of the company was neither paid up in actual money, nor did it exist in the form of deferred installments properly secured.

It is said by the appellant's counsel that, conceding this, it is still a debt due by him to the corporation at the time that he became the owner of the debt due by the corporation to Hayes, and therefore the proper subject of setoff under the twentieth section of the Bankrupt Act. That section is as follows:

"In all cases of mutual debts or mutual credits between the parties, the account between them shall be stated, and one debt set off against the other, and the balance only shall be allowed or paid, but no setoff shall be allowed of a claim in

its nature not provable against the estate, *provided* that no setoff shall be allowed in favor of any debtor to the bankrupt of a claim purchased by or transferred to him after the filing of the petition."

This section was not intended to enlarge the doctrine of setoff, or to enable a party to make a setoff in cases where the principles of legal or equitable setoff did not previously authorize it.

The debts must be mutual; must be in the same right.

The case before us is not of that character. The debt which the appellant owed for his stock was a trust fund devoted to the payment of all the creditors of the company. As soon as the company became insolvent, and this fact became known to the appellant, the right of setoff for an ordinary debt to its full amount ceased. It became a fund belonging equally in equity to all the creditors, and could not be appropriated by the debtor to the exclusive payment of his own claim.

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It is unnecessary to go into the inquiry whether this claim was acquired before the commission of an act of bankruptcy by the company, or the effect of the bankruptcy proceeding. The result would be the same if the corporation was in the process of liquidation in the hands of a trustee or under other legal proceedings. It would still remain true that the unpaid stock was a trust fund for all the creditors, which could not be applied exclusively to the payment of one claim, though held by the stockholder who owed that amount on his subscription.

Nor do we think the relation of the appellant in this case to the corporation is without weight in the solution of the question before us. It is very true, that by the power of the legislature there is created in all acts of incorporation a legal entity which can contract with its shareholders in the ordinary transactions of business as with other persons. It can buy of them, sell to them, make loans to them, and in insurance companies, make contracts of insurance with them, in all of which both parties are bound by the ordinary laws of contract. The stockholder is also relieved

from personal liability for the debts of the company. But after all, this artificial body is but the representative of its stockholders, and exists mainly for their benefit, and is governed and controlled by them through the officers whom they elect. And the interest and power of legal control of each shareholder is in exact proportion to the amount of his stock. It is therefore but just that when the interest of the public, or of strangers dealing with this corporation is to be affected by any transaction between the stockholders who own the corporation and the corporation itself, such transaction should be subject to a rigid scrutiny, and if found to be infected with anything unfair towards such third person, calculated to injure him, or designed intentionally and inequitably to screen the stockholder from loss at the expense of the general creditor, it should be disregarded or annulled so far as it may inequitably affect him. [[Footnote 4](#)]

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These principles require the affirmation of the decree in the present case, and it is accordingly

Affirmed.

MR. JUSTICE HUNT dissented, holding that the transaction was a loan by the company to the appellant.

NOTE

At the same time with the preceding case were submitted and adjudged two other cases, *Meyer v. Vocke*, and *Jaeger v. Same*, both from the same court as the preceding case, which though differing, both, in some respects -- the latter case especially, which was a suit at law -- from the one just above reported, were declared by the court to fall within the same governing principles. In both cases, the decision below had been in favor of the assignee in bankruptcy, and in both it was accordingly affirmed in this Court.

[[Footnote 1](#)]

[83 U. S. 16](#) Wall. 390.

[[Footnote 2](#)]

[78 U. S. 11](#) Wall. 96.

[[Footnote 3](#)]

See also [Curran v. State of Arkansas](#), 15 How. 304; *Wood v. Dummer*, 3 Mason 305; *Slee v. Bloom*, 19 Johnson 456, and numerous other cases cited by the counsel for the appellees.

[[Footnote 4](#)]

Lawrence v. Nelson, 21 N.Y. 158.

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