Protective Coloring in Corporation Law

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MOST of us have heard the story about the old-time financier and his lawyer. The banker, so the story goes, asked for advice about a proposed business deal. The lawyer thought it over, and then informed his distinguished client that nothing could be done; the proposal would violate the law. Back came the financier’s indignant reply: “I don’t want a lawyer to tell me what I cannot do. I hire him to tell me how to do what I want to do.”

This attitude on the part of clients is only too familiar to the attorney. Then, too, in the bright lexicon of many a lawyer there is no such word as “can’t.” The field of corporation law, in particular, provides a rich choice of ways and means. To what extent is the lawyer justified in taking a client with him through some newly discovered path? How firm is the ground beneath his feet?

One device—that of forming a subsidiary or affiliated corporation as a step toward a desired result—is fairly familiar: we have long been told that it cannot be used “to defeat public convenience, justify wrong, protect fraud, or defend crime.” This, however, is not the only weapon in the corporate armory. There are others, not as frequently discussed, which possess equal interest, and often present even greater difficulties of analysis. Not all of them are reprehensible. “One cannot do indirectly what he is forbidden to do directly” is far from an accurate statement of the law; it is not even the expression of a desirable goal. Indirect action may sometimes serve a very useful purpose. It may, on occasion, serve a vicious one. Let us look at a few typical situations.

Case A. A statute forbids the declaration of dividends from capital. A large corporation has an impaired capital, but much ready cash. Its directors, who are majority stockholders, wish

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This article expresses only the personal views of the authors.
1See Corey, The House of Morgan (1930) 153.
2Sanborn, J., in United States v. Milwaukee Refrigerator Transit Co., (C.C. Wis. 1905) 142 Fed. 247, 255; Wormser, Piercing the Veil of Corporate Entity, (1912) 12 Col. L. Rev. 496, 517; Latty, Subsidiaries and Affiliated Corporations (1936) 75-76. For a recent example of some of the dangers of using the corporate device to conceal one’s business identity, see Flegenheimer v. Brogan, (1940) 284 N. Y. 268, 30 N. E. (2d) 591.
to declare a dividend. They are advised by counsel that if the corporation merges with another the capital structure may be rearranged. The corporation thereupon merges with a small company, complying with every legal form. It now has a smaller (but unimpaired) capital, and the directors declare a dividend from surplus. The bondholders complain that their security has been reduced. Can they obtain any relief?

Case B. The local statutes provide that foreign corporations, in order to do business in the state, must comply with local licensing acts, and that if they do not, they may not bring suit in the local courts. Suppose a foreign corporation, which has not complied with the local law, though it has been doing business locally, has a claim against someone in the state, and decides to assign this claim to an individual. The latter brings suit on the claim. Should this suit be maintainable?

Case C. A corporation owns a majority of the stock of another, and has guaranteed a dividend on the latter's shares to the minority stockholders. It causes the subsidiary to be merged, in full compliance with legal forms, with another domestic corporation, under terms which call for the dissolution of the subsidiary and the termination of the guaranty of dividends. Can the subsidiary's minority stockholders have the merger set aside?

One could continue to list devices of this sort almost indefinitely. It is the old problem of form and substance, of evasion and avoidance. When will the observance of legal forms be held to be unimpeachable? When merely a subterfuge? This difficulty is one which exists in almost every branch of law. In no branch, however, is it of greater significance than in corporation law. We cannot hope to discover and analyze every device which the ingenuity of counsel has produced—using “device” in the sense of a plan to achieve a given result by indirect means. Nor will space permit full discussion of the tax cases and the parent-subsidiary cases. Our discussion here will be limited to a few devices familiar to the corporation lawyer, and will seek to reach some tentative conclusions about their use.

3Compare, for instance, Newman v. Dore, (1937) 275 N. Y. 371, 377, 9 N. E. (2d) 966, 112 A. L. R. 643, involving an attempt to “evade” and “circumvent” the rights of the surviving spouse under N. Y. Decedent Estate Law, sec. 18. (“A wrong does not cease to be a wrong because it is cloaked in form of law.”)

4In the law of taxation, we are all familiar with the problem of “evasion” and “avoidance,” the first being an unsuccessful subterfuge, and the second being a successful escape from the tax. See Paul, Studies in Federal Taxation (1937) 110 et seq.

4See infra, notes 53, 55, 78-82.
Elusive as our problem is, there are a good many ways of starting to attack it. We might look at each device in turn, and make a catalogue of acceptable and unacceptable uses of the merger device, the parent-subsidiary device, and so on. Or we could study ultimate aims, and try to discover whether the entrance into new forms of business activity, the benefiting of stockholders, or any other given object, will justify the adoption of a particular expedient. Or, perhaps, we could treat the matter as one of statutory construction and the scope of judicial power, focusing our attention on the factors influencing judicial attitudes. Each of these approaches is inviting, and none of them can be ignored in dealing with our problem.

First of all, it seems desirable to ask ourselves this question: What is there in common about the three situations we have described? In each instance, there is a bar to desired action. Interested persons seek to escape from this restriction by the use of some substitute device, complying with the forms of law.

After this point, we begin to notice differences. In all these cases, a profit or benefit will be gained by stockholders, but in Case C this benefit is to go only to majority stockholders. A loss or detriment is suffered by the bondholders in Case A and by the minority stockholders in Case C; in Case B, no individual loss or detriment is suffered, except that if the device succeeds, the debtor will have to pay his bills, and the state will not have achieved its aim of collecting a tax or regulating the company's affairs.

We must also inquire about the nature of the restriction sought to be evaded, and of the evasion device itself:

1. In Case A, the statute evaded is for the purpose of safeguarding the corporate capital, and is primarily for the protection of creditors. The device employed—that of a merger with another company—is not in itself illegal. It is arguable, however, that it is a privilege, not intended by the legislature to be exercised for this purpose.

2. In Case B, the statute is intended to enforce the state's supervisory power over foreign corporations. The device employed—that of assigning a claim—is not illegal.

3. In Case C, we have an evasion of a contract obligation. The merger device, as in Case A, may be said to have been intended for another and more appropriate purpose. But perhaps it can be argued, in both these cases, that the merger privilege existed prior
to the contract, and that, therefore, it formed part of the contract terms.

We have now posed at least four questions which seem pertinent, though they overlap and though not all will need to be answered in every case. (1) What loss will result to individuals (or groups, such as stockholders or creditors) affected by the device? (2) What profit or benefit will result to the originator of it? (3) What policy would be served by rejecting the device? (4) What policy would be served by sustaining it?

II

In the decided cases, these questions are not always explicitly discussed or completely answered. Take, first of all, the problem of loss. Damage to one group may produce a benefit to another—and in many cases that is the very reason a particular scheme has been arranged. Certain patterns become discernible when we mark out the areas of conflict—creditors against stockholders, stockholder faction against stockholder faction, and creditor group against creditor group—and look for the Queensbury rules prevailing in each. In the discussion which follows, some of the more interesting cases in each category will be briefly mentioned, after which an attempt will be made to discover what elements these profit and loss cases have in common. In the concluding sections, cases will be considered in which there is no claim of loss, but an evasive scheme is attacked on other grounds.

Creditors v. Stockholders (or Directors). In Case A, we had an example of a complaint by creditors against a device designed to benefit stockholders. That case was derived from Small v. Sullivan, a decision of the New York court of appeals. The Interborough-Metropolitan Company, the corporation there involved, was a holding company owning subsidiaries with net assets of about $52,000,000. Its capital had become impaired, and no dividends could be declared, though the company had substantial current assets. At that time, the New York statute prohibited reduction of capital if the debts and liabilities (here $153,000,000) would exceed the amount of the proposed reduced capital (here $50,000,000), and a capital stock reduction was, therefore, not feasible. The directors, who were also majority stockholders, thereupon caused the company to merge with a small trading corporation, with assets of $550. The merged companies came out

\[5(1927) 245 N. Y. 343, 157 N. E. 261, noted (1928) 13 Corn. L. Q. 276.\]
with a capital of $50,000,000 and a surplus of $2,000,000. The directors then declared a dividend. Bondholders of the Interborough brought suit against the directors for an illegal misappropriation of corporate assets. The plaintiffs asserted that the consolidation was a colorable subterfuge "for the very purpose of wrongfully and fraudulently taking the assets . . . and distributing it among themselves. . . ." The majority of the court of appeals held that the complaint stated a cause of action. Said Judge Crane, speaking for the majority:  

"I know of no forms of law, statutory or otherwise, which may not be used for the accomplishment of a fraud or for the illegal purposes of wrongfully obtaining money, if people so desire to use them, and I know of no form of law or statute which will prevent a court of equity from seeking out the fraud, looking beyond the forms to the actual facts and compelling restitution. Compliance with forms of law does not amount to absolution for fraud."

Judge Lehman dissented, pointing out that the company had assets of $52,000,000 over and above its debts, and that the statutes had subsequently been amended to permit a stock reduction and dividend declaration in such cases. He added:  

"... it is said that in this case the consolidation was only a form or subterfuge intended to accomplish an unlawful result, viz., the distribution of income received by a corporation while its capital was impaired. Undoubtedly the inference is clear that the consolidation of a corporation having net assets of $52,000,000 with a corporation with assets of $550 was only a form used to accomplish the distribution of corporate assets otherwise forbidden. It does not follow that the subsequent distribution was unlawful. It is true that the time has passed when the courts will permit an unlawful result to be achieved, even by means which are not themselves illegal. The law may not be circumvented by subterfuges and the courts will look behind the form to determine whether an act is inherently unlawful. Distinction must nevertheless be drawn between cases where a result is itself wrongful and unlawful regardless of the means by which it is accomplished, and cases where the wrong or illegality is inherent only in the means by which the result is attained. In the latter cases there is no evasion of the law where legal means are substituted for those which are prohibited.

"Here there was no fraud on creditors or other inherent wrong in distribution of income by a corporation having net assets of $52,000,000 above its debts and obligations. . . . True, the consolidation was made only because the machinery provided at that
time for reduction of capital of a corporation which maintained its separate identity could not be used. It was not, however, unlawful at that time to achieve by the use of a more cumbersome method the result which today might lawfully be accomplished more directly." (Italics added.)

The difference in point of view in these two opinions evidently hinges on the attitude to be adopted toward the dividend statute, and toward the declaration of dividends. "Fraud" is the stigma we cast on the stockholders' purpose if we think of their desire for dividends in this situation as being completely unjustified and unprivileged. Query, however, whether this type of "fraud" bears much resemblance to the type of transaction usually described as fraudulent by the business community. At least the creditors still had a cushion of $50,000,000 after payment of the dividend.

Closely related to the scheme presented in the Small Case is that which was used in Harvey Watts Co. v. Worcester Umbrella Co. There the corporation had been organized to take over the assets of two competing firms, paying $8,000 for one property and $1,700 for the other. The owners of these businesses borrowed these amounts from a bank and indorsed to the corporation the checks representing the proceeds of the loan. The treasurer of the corporation then drew checks for these amounts on another bank and handed them to the owners in payment for the assets. The proceeds of these checks were then used by them to pay up the loans. Furthermore, one subscriber of stock had borrowed $1,000 from a bank and given the check of the bank to one of the directors of the corporation; the next day he received from the corporation $1,000 in cash against his note for the same amount, payable to the corporation. He then used the $1,000 to pay back the loan made to him by the bank. A statute at that time provided that corporate stock must be paid in cash and that no note given by a stockholder should be considered as payment of stock. The statute also imposed liability for the corporate debts

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See also Taylor v. Standard Gas & Elec. Co., (1939) 306 U. S. 307, 59 Sup. Ct. 543, 83 L. Ed. 669 (bankruptcy of subsidiary and postponement of parent's claims); In re Norcor Mfg. Co., (C.C.A. 7th Cir. 1940) 109 F. (2d) 407, cert. denied (1940) 310 U. S. 625, 60 Sup. Ct. 898, 84 L. Ed. 1396 (principal stockholder of debtor corporation in reorganization may not form new corporation for the sole purpose of buying up claims against debtor at reduced price and then present them at full value in debtor's reorganization).

9Massachusetts, Rev. Laws (1902) ch. 110, sec. 44. The present statute (General Laws 1932, ch. 156, sec. 15) omits the provision relating to notes and authorizes the issuance of stock for cash, property, services and ex-
on any director falsely swearing to a certificate that the corporate capital had been fully paid in cash. In a suit brought by a creditor under the statute the supreme judicial court of Massachusetts, reversing a judgment for the defendant directors, gave judgment for the plaintiff on the ground that there was no real payment in cash by the stockholder into the corporate treasury. There was only a *simulated* payment since, as the court pointed out:

"There is no more a payment in cash where the corporation receives cash one day and lends the cash received to the stockholder the next day than where it receives a note originally in payment of a stock subscription."

What do these cases have in common? In each, there is a transfer of assets to stockholders (or a failure by stockholders to contribute assets). While there is no very pointed desire to harm creditors, there is certainly no effort to do creditors a good turn. There is not even any attempt to do the corporate enterprise a good turn—as might be the case if the scheme had been designed to bring in new capital, rather than the reverse. The forms of law have been respected, but the atmosphere can only be described as "phony."

Other controversies between creditors and management (or stockholders) are not lacking in which creditors have complained of the use of "devices," the decisions based on wrongful manipulation of the corporation's books and accounting records being

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11In the Small Case the union of a $52,000,000 corporation with a $550 concern seems particularly striking.  
especially interesting. But we must pass on to a neighboring area of controversy.

Creditors v. Corporation. In the Small and Harvey Watts Cases, there was no attempt to deprive the creditor of his claim; the defendants' acts simply reduced the corporate assets from which that claim was to be satisfied. A further attack is possible—to aim directly at the source of the creditor's claim, and attempt to cut it off by corporate action.

In Ducasse v. American Yellow Taxi Operators, the maker of Popp taxi meters contracted with the defendant Taxi Operators to rent to the latter two hundred fifty meters, plus any additional meters it might require during a five-year term; the defendant agreed to use these meters on all of its cabs, including any cabs later acquired. About two months later, in July, 1922, the lessee merged into the Yellow Taxi Corporation; the latter continued to use the meters, and in fact added to the number in service. In July, 1923, the Yellow Taxi Corporation started, without explanation, to return the meters to the manufacturer, and in November, 1923, that company was merged into the Yellow Taxi Corporation, New York. The latter company used a number of the meters, but continued the process of returning them until by February, 1924, all the meters had been returned. At this point, the original term of five years still had more than three years to run, and the ultimate merged company was not using the Popp meters at all. It was using another type of meter, and had greatly increased its fleet of cabs. Suit was then brought against the three taxi corporations.

The court held that the successor corporations were bound by

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the contract, and that they must pay damages based on the maximum number of meters actually used. As to the "requirement" clause of the contract, the plaintiff must fail. To quote: 15

"The possessor [successor] company has never promised to install the meters on other taxicabs which it might place on the streets. In so far as it exercises the rights under the contract it assumes the correlative obligations. But in so far as the extension of the contract depended on the will of the lessee [the original company], the possessor corporation is not bound, for the fleet was increased by it and not by the merged corporation. . . . If I am right, it follows that the possessor corporation is not under obligation to install the Popp meters in taxicabs which it and not the lessee company has placed on the streets. This result is due to the character of the contract made with a corporation which is subject to the statute of merger; and I doubt if a contract could be so drawn as to accomplish any other result." (Italics added.)

A somewhat similar situation was involved in Berry v. Old South Engraving Co. 16 In 1930, the Old South Engraving Company entered into a five-year contract with a union, regulating conditions of employment and establishing a closed shop. In 1932, the company's officers became dissatisfied with this arrangement. On advice of counsel, a new company, the Old South Photoengraving Corporation, was formed. The employees of the old company (all union members) were discharged on June 4, and its assets were transferred to the Photoengraving Company in return for the latter's stock. The stockholders of the old company became stockholders in the new. On June 6 (a Monday), the Photoengraving Company hired new employees—all non-union men—and did business at the old address. The only change of substance which had occurred was the complete turnover among the employees. The union brought suit against the old and new companies, seeking an injunction and damages. The master found that the directors and officers had acted in "good faith," with the "primary purpose" of escaping from the obligations of the union contract. He recommended that the bill be dismissed. The supreme judicial court affirmed the decree of dismissal. Said the court, ". . . it is plain [that the old company] cannot be held responsible for any acts of its officers or for any acts of the new corporation." The new company also goes free, since "it never contracted with


16(1933) 283 Mass. 441, 186 N. E. 601.
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the union or assumed the contract of the old company." The court adds:17

"The motive of the officers, directors and stockholders of the old corporation, as individuals, that is, the desire of these incorporators of the new corporation to secure through the instrumentality of a corporation authority to do business exactly like the business done by the old corporation without the burden of the commercial agreement as to the employment of union labor, cannot be regarded as fraudulent in fact or in law."18

With this case, we may compare the recent decision of the House of Lords in Southern Foundries (1926), Ltd., and Federated Foundries, Ltd. v. Shirlaw.19 The Southern company employed Shirlaw as managing director, under a written contract, for a ten-year term. The company’s articles provided certain enumerated causes for the removal of directors. Later, the company entered into a so-called "merger," under which it and several other companies became wholly owned subsidiaries of Federated Foundries, Ltd. The shareholders of Southern, who were to receive shares of Federated, adopted as part of the plan a new set of articles, similar to those adopted by the other companies in the combination. These new articles provided that any director of Southern could be removed at any time by Federated. A few months later, Federated entered into negotiations with the managers of the several companies, with a view to making new compensation arrangements, on a reduced level. Shirlaw declined to accept lower compensation, and Federated then effected his discharge as managing director of Southern. Shirlaw sued Southern and Federated for breach of contract, though the complaint against Federated was finally abandoned. The lower court gave judgment for the plaintiff. This was affirmed by the Court of Appeal, one justice dissenting. The judgment of the Court of Appeal was in turn affirmed by the House of Lords by three votes to two. The majority took the view that Southern’s liability was not affected by the fact that the actual discharge was the act of Federated, or that the steps taken were all in conformity with legal forms, the amendment of the articles having been effected under statutory authority.

Of these three cases, only the Engraving Case raised the charge that the combination of enterprises had been made with the purpose of injuring the plaintiff or rendering valueless his contract

17(1933) 283 Mass. 441, 451, 186 N. E. 601.
claims. In the Ducasse Case, there was apparently a real merger—the court seems to have been satisfied that the old enterprise was no longer in existence, and hence could have no “requirements” to be satisfied under the supply contract. In the Shirlaw Case, the contracting company was still in existence, and the mere fact that power to control its action rested in another company could not relieve it from liability. From another standpoint, it may be remarked that neither decision denies the plaintiff’s substantive right: the question is one of enforcement. In the Ducasse Case, the court is saying in effect that the plaintiff’s damages are impossible to measure in respect of the “requirements” clause; in the Shirlaw Case, there is no such difficulty. In the Ducasse Case there is the further ground that the “new corporation” has not, according to the court, made any promise at all!

The issues here being discussed are not, it will be noted, substantially different from those raised in the cases where creditors complain that the formation of a corporation has been used as a “device” to escape from a contract. Where a company forms a subsidiary to acquire new property to prevent the after-acquired property clause of an old mortgage from attaching, or where individuals who have promised not to do a given thing form a corporation which thereupon starts to do that very thing, we have a situation closely akin to the Ducasse and Small Cases. The incorporation statute and the merger statute both lend themselves to attempts to create a new “legal person.” or rather to take advantage of the fiction of corporate personality with the hope that the new “entity” will not be subject to the same limitations and obligations as its creators. The use of the merger device adds the further complication that the other party to the merger may be an actual enterprise, with independent stockholders and creditor interests which may be harmed by a drastic decree. Similar considerations apply to the use of the sale-of-assets statute: the purchasing company may or may not represent the same interests as the selling company. In Small v. Sullivan and the Berry Case, the other company participating in the combination represented exactly the same interests as the original enterprise: there were no outside interests which required protection.

See Latty, Subsidiaries and Affiliated Corporations, (1936) 75-76, and cases cited.

See cases cited supra note 12.

See Note, Efficacy of the corporate entity in evasions of statutes, (1941) 26 Iowa L. Rev. 350.
Minority Stockholders v. Majority Stockholders. Cases in which minorities attack corporate acts intended to benefit the majority stockholders constitute the largest single body of authority on the use of "protective coloring." The defendants are often the directors and officers; the majority stockholders may not be named at all. Yet the real contest is between minority and majority. Examples of the devices considered in these cases include the following:

(a) A statute permits the dissolution of the corporation on majority vote of the stockholders; the majority seek to effect a dissolution in order to "freeze out" the minority, intending to carry on the business without them. Held (by most courts) unlawful.22

(b) The majority (as in Case C) has guaranteed to the minority a dividend on the company's shares; in order to relieve themselves from this guaranty, the majority vote for a dissolution, intending to continue the company's business through a new corporation. Held (by most courts) unlawful.23

(c) The majority use the statute permitting sale of all the corporation's assets as a means of dissolution, availing themselves of the sales statute because they were already stockholders in the purchasing company, and because the continuance of the selling corporation's business in its present form is forbidden by another statute, though the latter statute would not prevent the


purchasing company from continuing in the same line of business. Held (by the New Jersey court) unlawful.24

(d) The majority stockholder causes the corporation to merge with another, as a means of complying (at minimum loss to the majority) with a statute requiring the majority stockholder to relinquish its holdings in the corporation. Held (by the New York court) lawful.25

(e) The majority of G Co. stockholders use the sale-of-assets statute as a means of effecting a reorganization, the plan providing that the assets of G are to be sold to W Co., but that the purchase price is not to be paid to G; instead, the stockholders of G are to receive shares of stock of W directly from W, apparently for tax reasons. Held (by the Delaware court) unlawful, though the complainants were barred by laches from injunctive relief.26

(f) The majority use the dissolution statute as a first step toward effecting a consolidation with a foreign corporation. Held (by the New Jersey court) unlawful, as such a combination could not have been effected directly under the consolidation statute.27

(g) The majority seek to have the corporation merged with another company, the plan providing for the abrogation of contracts between the majority and the corporation under which (in effect) the majority have guaranteed the dividends receivable by the minority. Held (by the New Jersey court) unlawful.28

(h) The majority cause the corporation to reduce its authorized capital stock, with the intention of benefiting those stockholders who had not paid their stock subscriptions in full. Held (by the Wisconsin court) unlawful.29

26Finch v. Warrior Cement Corp., (1928) 16 Del. Ch. 44, 141 Atl. 54. The opinion states, at p. 54: “If the majority insisted on a sale as the method of reorganizing this company’s affairs, the complainants as stockholders were entitled to insist that the sale which was being forced on them, and not something else, should constitute the entire extent of their submission.”
28Outwater v. Public Service Corp., (1928) 103 N. J. Eq. 461, 143 Atl. 729, decree affirmed. (1929) 104 N. J. Eq. 490, 146 Atl. 916. The burden was held to be on the majority to show the fairness of the plan under the facts, this burden could not be sustained.
29Theis v. Durr. (1905) 125 Wis. 651, 660, 104 N. W. 985, 1 L. R. A.
(i) The directors increase the corporate capital, complying with the applicable statute, but using the increased stock in the purchase of worthless property for the purpose and with the result of depriving a minority stockholder of his relative share in the corporate property. Held (by the New York court) unlawful.\(^3\)

(j) The directors transfer certain corporate assets to a newly formed subsidiary, and then offer the subsidiary's stock to the company's stockholders at a cash price; a stockholder objects, on the ground that this amounts to a forced assessment. Held (by the New York court) unlawful, as an attempt "to increase the capital stock of the old company without complying with the provisions of the statute governing the subject."\(^3\)

It is evident that plans of this sort have not, in general, fared very well in the courts. Typical is the reasoning of the New York court of appeals in *Kavanaugh v. Kavanaugh Knitting Mills Co.*,\(^3\) where the majority had attempted to use the dissolution statute in order to "freeze out" the minority. The statute provided that if the directors should resolve "that it is in their opinion advisable to dissolve," the stockholders might upon a two-thirds vote dissolve the corporation. The court of appeals, analyzing this statute, concluded that it was the intention of the legislature that the action of the directors

"be based upon the belief that the interests and welfare of the corporation and the stockholders generally will be promoted by the dissolution. The belief may be erroneous or ill-founded, but it must be formed in good faith. . . . The plaintiff took his stock subject to the provisions of the statute. Judicial authority does not extend to enjoining the exercise of a right conferred by legislative authority. The courts cannot pass upon the question of the ex-


\(^3\)Schwab v. Potter, (1909) 194 N. Y. 409, 87 N. E. 670. This case is still occasionally cited for the strange proposition that a corporation cannot have subsidiaries. It seems limited today to situations in which there is oppression or bad faith, and to those in which an attempt is made to do something without statutory authority. See (1934) N. Y. Attorney General's Report 237; Moore v. Los Luges Gold Mines, (1933) 172 Wash. 570, 21 P. (2d) 253.

\(^3\)226 N. Y. 185, 123 N. E. 148. See Hornstein: Voluntary Dissolution—A New Development in Intracorporate Abuse, (1941) 51 Yale L. J. 64.
pedia of the dissolution. . . . They can, however, and will, whenever the facts presented to them in the appropriate action demand, inflexibly uphold and enforce, in accordance with established equitable principles, the obligations of the fiduciary relation. The good faith of the individual defendants is a proper and fundamental subject to be adjudged.\textsuperscript{33}

\textit{Preferred Stockholders v. Common Stockholders (or Directors).} This area of conflict bears a close resemblance to that existing between majority and minority stockholders—there is the same relationship of power and dependence. The \textit{control} of the corporation is being used in a way which gives rise to real or alleged abuse. It also bears strong likeness to the \textit{Creditors v. Stockholders} situation, where there is a similar attempt to take away or minimize certain privileges and advantages arising by virtue of contract and status.\textsuperscript{34}

In these cases, the courts apparently feel that the “best interests of the corporation” will in many instances demand a strengthened financial structure, accompanied by certain sacrifices on the part of the preferred stockholders. In such a case, the benefit to the common stockholders appears to be regarded as incidental—or at least not deserving of condemnation.

\section*{III}

Let us try to formulate some of the lessons these cases teach. It is all too easy to say that we must not use the forms of law as


a "device" to commit a "fraud" or a "breach of fiduciary duty" or a "breach of contract." Such a statement is not particularly satisfying—though vagueness in these matters may sometimes serve a useful purpose. Reckless drivers may stay farther away from the precipice if they know there is no fence along the brink.

In some of these cases our problem can be phrased as one of statutory construction; in others, as one of contract interpretation; in some, as both. Where, for example, a parent company has guaranteed the payment of dividends on the stock of a subsidiary, and then seeks to remove this obligation through the use of the merger device, one approach is to ask whether the contract was entered into subject to the statutory privilege; another is to ask whether the privilege was ever intended to be used for such a "fraudulent" purpose. The first approach finds some echo in the cases, but it is the second which is favored in the more recent decisions. This trend is doubtless in keeping with the new attitude of caveat venditor. The corporate enterprise is based on fairness and continuity: these ideals must inevitably shape the interpretation both of statutes and of contracts governing the relationship of the parties interested in the enterprise.

When we leave the realm of generality, we run into difficulties. Yet a certain amount of definition seems possible. The following aims seem generally to have been condemned by the courts:

(a) The distribution of assets to stockholders, to the prejudice of creditors.

(b) The exclusion of minority stockholders from continuing to share in the corporate enterprise.


36See, generally, cases cited supra, notes 22-31.

37Novel ways of giving benefits to stockholders are quick to receive judicial condemnation if they are not fully sustainable under the dividend statute. See 791 Corporation v. Engel, (1934) 152 Misc. Rep. 107, 273 N. Y. S. 322, where a stockholder in a company owning an apartment house was given a rent-free apartment in lieu of dividend, and was dispossessed at the suit of creditors; In re Bay Ridge Inn, Inc., (C.C.A. 2d Cir. 1938) 98 F. (2d) 85, where the stockholders attempted to impose a lien on the corporate assets for their own benefit. See also People ex rel. Wedgewood Realty Co. v. Lynch, (1933) 262 N. Y. 202, 186 N. E. 673, where distribution of bonds in reorganization was held taxable dividend. With the Small Case, compare Greene v. Boardman, (1932) 143 Misc. Rep. 201, 256 N. Y. S. 340, where a dividend was declared from capital, but was held cured by a subsequent stock reduction to create a surplus; the creditors had consented, and the court found that they were not injured.

38Statutes authorizing the appraisal of the shares of dissenting stockholders raise the argument that this remedy should be exclusive and that the majority should be allowed uncontrolled freedom subject only to the
(c) The granting of benefits and privileges to the majority without granting them to the minority.\textsuperscript{39}

That is about as far as one can go with any degree of assurance. The following questions, among others, still remain:

(1) Will special facts ever create justification for any of these condemned aims?

(2) Is it of any significance that indirect rather than direct action is used to achieve a forbidden aim?

(3) Just how important is a selfish motive?

(4) Is a given device sustainable if its proponents show that it will not produce a loss to any individual or group?

These are hard questions. On the point of "justification," we recall that many cases discussed in the preceding section involved an attempt to benefit one group at the expense of another—an attempt generally frowned upon by the courts. Clearly, under these decisions, the harm our device does to others is not excused simply and solely because we expect it to produce some benefit to ourselves: it cannot be justified merely by the self-interest motive. The groups interested in the corporation are too closely related to permit the free play of the acquisitive instinct. In Mr. Berle's words, "Corporate powers are powers in trust."\textsuperscript{40}

Management, stockholders and creditors are subject to responsibilities of the same type, their weight depending upon the amount of power which the group possesses. Creditors, of course, are seldom entrusted with power to control corporate acts; if they are given such power, we cannot doubt but that they must exercise it fairly.\textsuperscript{41} The same is certainly true of preferred stockholders, once they come into a position of control.\textsuperscript{42}

\textsuperscript{39}See supra, note 38.

\textsuperscript{40}See Berle, Corporate Powers as Powers in Trust, (1931) 44 Harv. L. Rev. 1049. The old problem of motive in the torts field, as presented, for example, in Beardsley v. Kilmer, (1923) 236 N. Y. 80, 140 N. E. 203, 27 A. L. R. 1411, seems irrelevant here. The relationships in the corporation field are too close to permit of doubt as to the importance of motive and intent.


\textsuperscript{42}Krell v. Krell Piano Co., (1921) 14 Ohio App. 74.
The simplest case we have to deal with, then, is that in which a controlling group attempts to defend a device which has produced a profit to itself and a loss to some other interest (such as stockholders or creditors), without any accompanying benefit to the company's treasury or to any other interested group. Here the courts seldom hesitate. The privileges given by the charter or by the legislature in permissive corporation laws can hardly, it is said, have been intended for such a use. Any one of several concepts can be invoked: the Fraud idea (Small v. Sullivan), the Fiduciary idea (Kavanaugh Case), or perhaps simply the Contract idea (Shirlaw Case). The controversy may be Stockholders v. Directors, Minority Stockholders v. Majority Stockholders, or Creditors v. Stockholders, but the same results will be reached. This is even true, apparently, of action taken by creditors in respect of each other's claims: it has recently been held in a reorganization case that certain creditors who would be benefited by the release of corporate claims against stockholders cannot be permitted to vote in the same class with other creditors.43

Suppose, on the other hand, that our device will benefit the enterprise as a whole. It happens also that we ourselves will be benefited, though another interested group will be harmed. Under these facts, will our device be sanctioned?

In the contract-creditor cases, the answer is reasonably clear. Certain duties are imposed regardless of motive, good or bad, and regardless of benefit or loss to the enterprise. In the Ducasse Case, it will be recalled, there was no allegation that the defendants had brought about the mergers with the intention of defeating the plaintiff's claim. For all that appeared, the mergers were carried out for other reasons, and the injury to the plaintiff was merely incidental. Similarly, in the Shirlaw Case, it was admitted by the plaintiff that the amalgamation and the amendment of the by-laws were not motivated by any desire to get rid of the managing director. There were other reasons for the steps taken. In the Berry Case, the plaintiff's motive was clear. Getting out of the union contract was the sole reason for the sale of assets—and it is that which shocks us about the court's disposition of the case. We can only conclude that the court had no great love for the closed shop system, and that it did not regard the union contract as being entitled to protection. It is impossible to believe

that a businessman with a contract claim against the company
would have been treated by the court in the same fashion.\footnote{See cases cited supra, note 12.}

We must recognize, then, that in the contract cases, such as
Ducasse and Shirlaw, some liability will be imposed regardless of
motive. Creditors should be protected against some, at least, of the
consequences of a merger, no matter why it was arranged. Statutes
generally provide as much. But the relief so given is limited; it
is a claim for damages. Shall we say that if the merger was
motivated entirely by a desire to escape from a contract, greater
relief should be given, i.e., the setting aside of the merger, or the
specific enforcement of the contract against the merged enterprise?
Such authority as has been found supports this conclusion.\footnote{See Dairy Co-op. Ass'n v. Brandes Creamery, (1934) 147 Or. 488, 30 P. (2d) 338.} If
the device is to be deemed a "nullity," by reason of the fact
that its sole motive is to escape from a contract, the creditor should
be given such relief as will preserve his contracted position, sub-
ject to the established rules of equity.

Small v. Sullivan does not fall into quite the same category as
the cases just mentioned; the threatened damage to creditors is
less close and direct. Here we can conclude that the motive of
the proponents of the plan, and the benefit or loss to the enter-
prise, will play a larger part. In that case, there was no business
reason for the merger—no benefit to the enterprise as a whole.
The only possible reason for the merger was to carry out the
plan of dividend distribution which the directors had in mind.
The decision of the case might well have been different if the
other company taking part in the merger had been a large enter-
prise, with assets which might contribute substantially to the
future prosperity of the Interborough. Such a merger would have
had independent justification, and a dividend made after the
amalgamation in an attempt to adjust the contributions made by
interested groups might well have gone unquestioned.

What about the Stockholders v. Stockholders conflict? Are
we to conclude that advantage for the company will justify a de-
vice which is accompanied by gain to the proponents? Let us
look at a few more decisions. In Allau n v. Consolidated Oil Co.,\footnote{(1929) 16 Del. Ch. 318, 147 Atl. 257.} decided by the Delaware chancery court, the plaintiff was a minority stockholder, who sought to prevent a sale of all of the
company's assets. He alleged inadequate consideration and selfish
motives on the part of the controlling directors, who were also majority stockholders. The assets consisted of the stock of a wholly owned subsidiary operating company; the purchase price consisted of $50,000 cash and the assumption by the purchaser of the defendant corporation's debts, in the amount of $700,000. The plaintiff alleged that certain members of the majority had loaned money to the corporation to be secured by first mortgage sinking fund bonds, and that as a result of the sale the purchaser would pay these claims. He contended that this personal interest of the controlling stockholders in the sale tainted the transaction with fraud. The court denied his petition for an injunction, concluding that stockholders who happen also to be overdue creditors may not be "inhibited from using their voting power in favor of a fair sale where the only claim of tainting fraud is that their debts as well as others will result in being paid." The Delaware court further stated that

"If the ensuing of that sort of result can properly be called a personal advantage, it is not such a personal advantage as could in reason be regarded as indicating a fraud."

A similar result was reached in the Allied Chemical & Dye Case, another Delaware decision, likewise involving an injunction suit brought by minority stockholders to enjoin the sale of corporate assets. It was there held that the defendant majority stockholders could not be denied a voice upon the question of sale merely because in the event of liquidation they would receive more for their stock than they had paid for it. Since the terms of the sale were found to be fair and adequate, and since the decision to sell was justified by the financial situation of the corporation, which although not amounting to insolvency nevertheless caused "serious apprehension concerning the future," the fact that some majority stockholders would make a profit on their investment was considered as "purely incidental and collateral."

An even more difficult problem was presented in Liebman v.
Auto Strop Co. There the minority stockholders (49.9 per cent) of a holding company had made an agreement with the majority holder (Gaisman), designed to give them a veto power over certain of the company’s activities, as well as continuing representation on the directorate. This agreement was reflected by appropriate provisions in the certificate of incorporation. It was accompanied by an understanding that the company's stock in a subsidiary (a manufacturing company which was the active unit in the enterprise) was to be voted in such a way as to give the subsidiary company the same board as the parent. In this and other ways the minority exercised a powerful influence in the operations of the parent and subsidiary. Nine years after this arrangement was made, the directors of the parent voted to distribute the stock of the subsidiary as a dividend, thus giving Gaisman a majority of the subsidiary’s shares. The minority now seek an injunction against the distribution. The plaintiffs point out that the whole system of checks and balances agreed upon in the past will fall down when Gaisman becomes a direct stockholder of the manufacturing subsidiary. The defendant directors argue that their purpose is to benefit the enterprise: that the growth of the business has rendered the old arrangement a brake upon progress, that the minority directors no longer even speak to the majority directors, and that efficient operation demands a cooperative board. Gaisman—the majority stockholder, and a director—tells the court that the directors must be permitted to run the company as their best judgment dictates. It is not disputed that they are taking this important step upon the motion of Gaisman.

A referee was appointed to hear and determine. He found that the dividend was declared in good faith and for the best interests of the parent company; that the plaintiffs were not harmed; and that there was no merit in the complaint. The appellate division affirmed. The court of appeals, also affirming, said:

"The declaration of a dividend must be for the benefit of all. If it is done solely for the purpose of benefiting the majority..."

52(1926) 241 N. Y. 427, 434, 435, 150 N. E. 505. It is arguable that a distinction should be drawn between directors' acts and stockholders' acts, allowing the stockholders to hide behind the screen of "directors' discretion." Where, however, directors and a controlling group of stockholders are completely in accord, this argument seems untenable, and the "control" should be viewed as a unit.
to the detriment of the minority, then a court of equity will never hesitate to exercise its equitable powers to prevent the perpetration of the wrong by which the majority are seeking to impose upon the minority. But before a court of equity will interfere with the action of a majority of the directors, facts must be presented from which the court can find that such action has underlying it a fraudulent purpose and corrupt intent. Obviously, if such action is for the benefit of the corporation, which includes all of the stockholders, bad faith or a fraudulent or corrupt intent cannot arise or be inferred.

"These findings [of good faith and honest business purpose], having been unanimously affirmed, conclusively establish that the purpose of the declaration of the dividend was not 'to accomplish an ulterior object in the interest of a particular stockholder,' but, on the contrary, that the same was in the interest of the corporation and, if so, necessarily in the interest of all the stockholders." (Italics added.)

This last statement is no doubt too broad. The court's generalization may hold good in many cases, but it is certainly not a universal solvent.

IV.

We have been speaking of the problem of justifying a scheme or device in cases where some interested party complains of being injured. What if there is no claim of injury? Can we then conclude that the device is sound? Let us go back to Case B, the foreign corporation case at the start of our discussion. We saw that the scheme there involved was calculated to produce a benefit to its originator without corresponding loss to anyone else in the community—at least, not to any particular individual.

Let us look at two more situations:

Case D. A statute prohibits foreign corporations from operating public utilities within the state, but permits domestic corporations to do so after fulfilling stated requirements. A foreign corporation causes a domestic corporation to be organized, and the latter, a wholly owned subsidiary, seeks to operate a public utility within the state. Should this conduct be considered a meticulous and praiseworthy observance of the statute? Or is it a mere subterfuge—an invasion which cannot be permitted to stand?

Case E. In New York, insurance agents and brokers are prohibited by statute from allowing to the insured, as an inducement to the making of an insurance contract, any rebate from the premium. Suppose that certain individuals who wish to take out large policies decide to form a corporation and have it licensed
as an insurance broker. The license is obtained, and the corporation thereafter procures the issuance of policies to the various stockholders. Later, of course, the corporation declares dividends from the profits made in its brokerage business, and the individual stockholders find that they have obtained their insurance at smaller cost than otherwise. Has there been a violation of the statute?

The pattern of Cases D and E is a familiar one. They both present the problem of whether a stockholder (a parent company in Case D) may perform an act through a corporation (a subsidiary in Case D) when the performance of the act by the stockholder would be forbidden. In all three cases—B, D, and E—the evasive device employed will produce no individual loss.

Other examples of the same type may be cited. Statutes often require that a director of a corporation also be a stockholder. Suppose that we assign one or two shares of stock to a friend, and then manage to elect him as a director. He turns over to us any dividends received on the shares. Is this a violation of the statute, and, if so, what can be done about it?

Under the "fraud" test, the devices we have been discussing would seem to be good. There is no intention on our part to cheat anyone, no vicious motive. The case of the assigned claim is perhaps the most doubtful. The debtor cannot complain, since he is merely being forced to pay his just debts. The state would be better pleased if we had complied with the law, but we have hardly "defrauded" it of anything. And our action in assigning the debt is in itself not vicious or even extraordinary. In the stock case, we are making the assignment for reasons best known to ourselves—presumably because we think the assignee will be a good director and will, therefore, agree with us on all disputed points. We are not intending to cheat the other stockholders—in fact, we would be perfectly willing to have them make similar assign-

50 Cases in which a corporation has been organized to evade a statute are quite plentiful. For a discussion of cases under the Elkins Act, see Wormser, Disregard of the Corporate Fiction (1927) 65; Latty, Subsidiaries and Affiliated Corporations (1936) 68; under the Hepburn Act, Wormser, at 31; Latty, at 16, 19-21, 38. A somewhat similar problem has come up under the Robinson-Patman Act: Quality Bakers of America v. Federal Trade Comm., (C.C.A. 1st Cir. 1940) 114 F. (2d) 393. See also Cregg v. Electri-Craft Corporation, (1941) 175 Misc. Rep. 964, 25 N. Y. S. (2d) 920; Flegenheimer v. Brogan, (1940) 284 N. Y. 268, 30 N. E. (2d) 591; note, Efficacy of corporate entity in evasion of statutes, (1941) 26 Iowa L. Rev. 350.

512 Fletcher, Cyclopedia of Private Corporations (1931) sec. 299, 300.
ments of their shares if they wish to qualify their friends for directorships.

In spite of these arguments, we have to admit that our conduct in some of these situations does not quite accord with the "spirit" of the law, or, in different words, the "intention of the legislature." In the public utility case, we are entitled to argue that we have done all that the legislature could expect. We have not really "escaped" from anything. The insurance statute, on the other hand, was doubtless intended to put all purchasers of insurance policies on the same plane. Does our formation of a brokerage company substantially interfere with this ideal? Is it a plan which contains the seeds of destruction, threatening the overthrow of the entire insurance edifice? Perhaps so. In the claim case, our plan might, if universally adopted, nullify the regulatory act. In the stock case, again, the general adoption of our little idea might mean that in time all the corporations in the state would be governed by directors who had had no actual investment in the company, even though the legislature may have thought that an added measure of protection would be extended to stockholders by the requirement that all directors be holders of shares.

Let us look at what the courts have actually done. In the public utility case, the statute\(^{25}\) will be held simply to establish a rule of procedure, requiring incorporation under local law but not forbidding a foreign corporation to control a domestic utility.\(^{26}\) As to our insurance problem, the matter has been settled for New York by *Arcim Corporation v. Pink*,\(^{27}\) in which on facts

\[\text{\footnotesize\text{\textsuperscript{25}}}\text{See Ill. Smith-Hurd Ann. Stats., ch. 111\%4, sec. 28; Ind. Ann. Stats. (1933) sec. 54-603; Ohio, Page's Gen. Code, sec. 614-73; Wis. Stats. (1939) sec. 196.53. These statutes prohibit the granting of any license to a foreign corporation to "own, operate, manage or control" any utility plant. (Italics added.) See Ohio Power Co. v. Craig, (1935) 50 Ohio App. 239, 197 N. E. 820 (city ordinance authorizing mortgage upon improvements of municipal utility held invalid, where a stipulation in the mortgage would give to a purchaser, in the event of a foreclosure sale, the right to the franchise, since the purchaser may be a foreign corporation).}\]


similar to those we have stated the superintendent of insurance brought suit to cancel the license of the offending brokerage company. The court held that the statute had been violated and that the license should be cancelled. In the claim situation, opinions vary. In the majority of jurisdictions the suit by the assignee will fail, in only a few states will it be allowed to proceed. Opinions vary also as to the stock assignment device. In Matter of Ringler & Co., the transferees of the stock, who had immediately re-assigned the shares in blank to the beneficial owners, were elected directors, and their election was then challenged by their fellow directors. The New York court of appeals held that the transfer was "fictitious" and that such compliance with the "naked letter of the law" could not be tolerated. In other jurisdictions, similar practices have been upheld against the same challenge of subterfuge.

What, then, is the effect of a "motive to evade the statute?" If the court approves or condones our act, it will announce that motive is immaterial; if it dislikes our act, it will speak of a "fraud on the statute." As an example of the first attitude, we have Black & White Taxi & Transfer Co. v. Brown & Yellow Taxi & Transfer Co. where a corporation organized another and transferred all its assets to it in order to qualify as plaintiff in the federal courts. This was held not to violate sec. 37 of the Judicial Code, the court stating that inasmuch as there was

58 N. Y. Insurance Law, sec. 188.
59 See Note, Right of an Assignee of a Foreign Corporation Which Has Not Complied with State Laws to Sue, (1940) 28 Cal. L. Rev. 648; 17 Fletcher, Cyclopedia of Private Corporations (1932) sec. 8523. Cf. Association Collectors, Inc. v. Hardman, (1940) 2 Wash. (2d) 414, 98 P. (2d) 318. The dogma that the assignee cannot sue where the assignor could not has had an important effect here.
62 (1912) 204 N. Y. 30, 37, 97 N. E. 593, Ann. Cas. 1913C 1036. The holding of the lower court, which had emphasized that the complainants had not alleged any fraud or any damage, was reversed. Matter of Ringler & Co., (1911) 145 App. Div. 361, 370, 130 N. Y. S. 62.
65 Section 37 provides: "If in any suit commenced in a district court, or removed from a state court to a district court of the United States, it
an "actual" transfer, it would not inquire into motives. On the other hand, in Shapiro v. Wilgus, the court held that a conveyance of an individual's assets to a corporation, with the purpose of subsequently causing the company to go into receivership, would be disregarded because under local law a receiver could not be appointed to take over the assets of an individual. The scheme was spoken of as a "protective cover for a fraudulent design," even though the proponents "acted in the genuine belief that what they planned was fair and lawful."

We must admit that in this field much depends on the court's confidence in the wisdom of the legislature, or, to put it a little differently, on the court's view as to whether the legislature's medicine should be given to the whole population or to only a few desperate cases. In the cases involving directors' qualifying shares, we can conclude that the legislature felt that directors should have a personal pecuniary interest in the affairs of the corporation. The position taken by any court confronted with the facts of the Ringler Case will be decisively influenced by the attitude which it takes toward that policy. If it is convinced that that policy is eminently sound and wise, it will, as the New York court of appeals did in the Ringler Case, condemn the ostensible transfer of legal title as fictitious; it will not be influenced by the fact that no damage was inflicted on any interested person by that fictitious transfer. On the other hand, a court which takes

shall appear . . . that the parties to said suit have been improperly or collusively made or joined, either as plaintiffs or defendants, for the purpose of creating a case cognizable or removable under this chapter, the said district court shall proceed no further therein. . . .


69(1932) 287 U. S. 348, 357. Compare In re Loeb Apartments, Inc., (C.C.A. 7th Cir. 1937) 89 F. (2d) 461, noted (1937) 50 Harv. L. Rev. 1311, where formation of a corporation solely for the purpose of starting reorganization proceedings for mortgaged property was held lawful (one judge dissenting) where plan was approved by and would be beneficial to creditors.

70It is, of course, quite possible for the court to take the view that the legislature's medicine is absolute poison. Thus, a statute authorizing the issuance of preferred stock convertible into mortgage bonds cannot be used to defeat the claims of creditors arising before the date of the conversion; as to such claims, the new bonds are subordinated. In re Phoenix Hotel Co., (C.C.A. 6th Cir. 1936) 83 F. (2d) 724, cert. denied (1936) 299 U. S. 568, 57 Sup. Ct. 31, 81 L. Ed. 418, noted (1937) 37 Col. L. Rev. 128. The statute has thus been emasculated so as to conform to settled judicial policy, expressed in such cases as In re Fechheimer Fishel Co., (C.C.A. 2d Cir. 1914) 212 Fed. 357.

71Stevens, Corporations (1936) 612.
the statute less seriously—feeling perhaps that it has outlived its usefulness, or that ability rather than stock ownership should determine a director’s eligibility—will reach the opposite result. It will argue that a provision requiring a director to “hold” stock does not need to be interpreted too meticulously,\(^7\) that anyone is a “holder” of stock in whose name shares are registered on the books of the corporation, and that an inquiry into the ownership of the beneficial title would go too far.\(^7\) Such a court, therefore, will condemn the transfer only where a director who was enabled in this manner to assume managerial functions actually commits some tort against the corporation or its stockholders, or where the transfer was used as a shield for wrongdoing or some actively dishonest purpose.\(^7\)

What is the relation of these “public interest” cases to the “private loss” cases previously discussed? It would seem to be this. Schemes and devices in corporation law must meet a double test. They must not outrage either public or private interests. But these two tests are branches of the same tree: they merge into the same ultimate issue of the desirability of encouraging a certain type of conduct. The closeness of the relationship of these public and private tests can be seen by referring back to the cases in the preceding sections. In the Harvey Watts Case, for example, the court had to consider the public interest in maintaining corporate capital for creditors generally, as well as the desirability of protecting the particular creditor who brought suit. In American

\(^7\)Compare the decision of the lower court in Matter of Ringler & Co., (1911) 145 App. Div. 361, 130 N. Y. S. 62; the court distinguished between the provision requiring a director to be merely a stockholder and present sec. 116, subdiv. 4, of the New York Banking Law which states that “every director of a bank or trust company shall be a stockholder of the bank or trust company owning in his own right free from pledge, lien or charge shares of its capital stock at least ten in number and having an aggregate par value of at least one thousand dollars.”

\(^7\)See cases cited supra note 63.

\(^7\)Holcomb v. Forsyth, (1927) 216 Ala. 486, 113 So. 516: Matter of St. Lawrence Steamboat Co., (1882) 44 N. J. L. 529, 541; In re Leslie, (1896) 58 N. J. L. 609, 33 Atl. 954; Dueber Watch Case Mfg. Co. v. Daugherty, (1900) 62 Ohio St. 589, 597, 57 N. E. 455. See generally, Stevens, Corporations, (1936) sec. 153, pp. 611, 612. Cf. Kardo Co. v. Adams, (C.C.A. 6th Cir. 1916) 231 Fed. 950, 965. See also Jenkins v. Moyse, (1930) 254 N. Y. 319, 172 N. E. 521, 74 A. L. R. 205; the statute made usury a defense to individuals but not to corporations. Moyse was refused a loan unless he would form a corporation, transfer property to it, and cause the corporation to borrow on mortgage, at a high rate. Later, Moyse sought to set aside the mortgage, but failed. Said Judge Lehman, speaking for a unanimous court (p. 324): “The law has not been evaded, but has been followed meticulously in order to accomplish a result which all parties desired and which the law does not forbid.”
Life & Accident Insurance Co. v. Ferguson,\textsuperscript{75} where a somewhat similar scheme was involved, the court permitted the commissioner of insurance to maintain action to cancel the company's license to do business, thus preventing loss to the creditors, even though at the time of the suit no loss had yet occurred. In such cases, the "public" and "private" tests both point to the same result.

V.

Much of what has been said in the preceding pages can be summed up in a single inquiry: is the challenged plan based on a legitimate business purpose? Our difficulties turn on what is to be regarded as "legitimate." Whether a particular corporate act is direct or indirect is a secondary inquiry.\textsuperscript{77} In seeking to find out what the courts will regard as "legitimate," much guidance can be obtained from the tax cases.\textsuperscript{78} In the leading case of Gregory v. Helvering,\textsuperscript{79} the facts of which are familiar to most business attorneys, the petitioner was the sole owner of the stock of a corporation, which held among its assets 1,000 shares of stock of another corporation. She desired to transfer these shares to herself in order to sell them for her individual profit, but wished to avoid the income tax which would result from direct transfer by way of dividend. With this intent, she brought about a "reorganization" of the corporation owned by her: a new corporation was formed to which she transferred the 1,000 shares in exchange for all the stock of the new corporation. The new corporation,

\textsuperscript{75}See supra note 13.

\textsuperscript{77}The reader will have noted that some of the cases we have just been discussing do not fall into the "scheme" or "device" category at all. In the Allaun and Allied cases, e.g., there is no attempt to do something by indirect direction which could not be done directly. In these two cases, a sale was the desired transaction, and it was a sale which was sought to be carried out. In the Havender Case, supra note 34, it was a wiping out of dividend arrearages which was desired, and a merger which was adopted as the means. In Colgate v. U. S. Leather Co., (1907) 73 N. J. Eq. 72, 67 Atl. 657, reversed 75 N. J. Eq. 229, 72 Atl. 126, a merger was restrained for the reason, among others, that the companies were not engaged in the "same or similar line of business," within the meaning of the merger statute. This question then arises: Suppose that two businesses, seeking to merge, are dissimilar; can they amend their charters so as to make them identical, and then merge? Or would that be an "evasion?" In Clarke v. Gold Dust Corporation, (C.C.A. 3d Cir. 1939) 106 F. (2d) 598, cert. denied, (1940) 309 U. S. 671, 60 Sup. Ct. 614, 84 L. Ed. 1017, it was held that such a course of action was not improper, the merger plan being fair to all parties. Thus all these cases involve the same central question.


\textsuperscript{79}See Paul, Studies in Federal Taxation (1937) 144 et seq.

after an existence of three days, and without having engaged in any business, was then liquidated and all its assets (i.e., the 1,000 shares), distributed to petitioner. The United States Supreme Court, denying that this was a transaction "in pursuance of a plan of reorganization," held that this was "a transfer of assets by one corporation to another in pursuance of a plan having no relation to the business of either" and "an operation having no business or corporate purpose." On the other hand, a reorganization intended to carry out a substantial alteration of the financial structure of the corporation and the diminishing of the relative voting power of certain preferred stockholders was recognized as having a legitimate "business purpose" and therefore entitled to the tax exemption provided by statute.

A similar yardstick should be applied to corporate transactions other than tax evasions, and in fact most of the cases we have been discussed can be explained on that basis. Wherever benefit to the enterprise, through a legitimate business transaction, is present, incidental benefits to one group and losses to another are likely to be overlooked as immaterial—as in the Allaun and Auto Strop Cases.—while the lack of any such benefit, as in Small v. Sullivan and Harvey Watts Co. v. Worcester Umbrella Co., will be the decisive reason for invalidation of the plan by the

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80 Under sec. 112 (i) of the Revenue Act of 1928 "reorganization" is defined as a total or partial transfer of assets by one corporation to another if the transferor or its stockholders remain in control of the transferee corporation.

81 Schoenberg v. Commissioner of Internal Revenue, (C.C.A. 8th Cir. 1935) 77 F. (2d) 446, cert. denied (1935) 296 U. S. 586, 56 Sup. Ct. 101, 80 L. Ed. 414 (sale of property at price below cost made as part of plan whereby substantially identical property was to be reacquired at sale price); Griffiths v. Commissioner of Internal Revenue, (1939) 308 U. S. 355, 60 Sup. Ct. 277, 84 L. Ed. 319 (investment corporation organized not for business purposes, but for sole benefit of taxpayer who owned all its stock and transferred to it amount due him by third person). See also Minnesota Tea Co. v. Helvering, (1938) 302 U. S. 609, 58 Sup. Ct. 393, 82 L. Ed. 474.


83 In addition to the cases discussed above, see City Bank F. T. Co. v. Hewitt Realty Co., (1931) 257 N. Y. 62, 177 N. E. 309, where the directors did not declare a dividend for a period of years, though the corporation had a large surplus. The president showed animosity toward one of the stockholders. However, it was shown that the non-dividend policy was justifiable under prevailing business conditions, and that all stockholders were treated alike. The court refused to compel the declaration of a dividend. For another case of mixed motive, see Colby v. Equitable Trust Co., (1908) 124 App. Div. 262, 108 N. Y. S. 978, discussed in Lattin, Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders, (1932) 30 Mich. L. Rev. 645, 656. Cf. Starrett Corp. v. Fifth Ave. & Twenty-ninth St. Corp., (S.D. N.Y. 1932) 1 F. Supp. 868.
courts. Moreover, in the latter group of cases the transactions involved cannot be explained in terms of the "business purpose" test. The *Small Case* is particularly in point, because the consolidation of a $52,000,000 concern with a small corporation having only $550 in cash was not carried out for the purpose of consolidation, but as a smoke-screen for the otherwise illegal distribution of dividends. A further qualification must be added: creditors receive a higher degree of protection than do minority stockholders, as the *Shirlaw Case* may serve to show.

It must also be noted that directors and majority stockholders have not been subjected to as high standards as certain other fiduciaries, such as express trustees under a will or a deed. The courts, in the interest of allowing business to be carried on without constant judicial interference, have permitted a certain degree of selfishness to be coupled with the advancement of the enterprise.\(^\text{84}\)

The whole problem of the "colorable" transaction is thus identical with the age-old question of judicial enforcement of moral values in business. This has gone far in recent years, and may go further.\(^\text{85}\) Predictions for the future in so fluid and flexible a field are not easy to make. Yet it would seem that the "legitimate business purpose" test, when limited by the other tests we have discussed, is a workable tool for the lawyer and for the courts.

\(^\text{84}\)By contrast, in non-profit organizations, the courts have gone far in forbidding any action which, even though in strict compliance with statute or charter, and not productive of monetary loss to any interested person, will nevertheless change the purpose and character of the organization against the wishes of a substantial minority. Group No. 23 of the *Ass'n of the Sons of Poland v. Ass'n of the Sons of Poland*, (1936) 121 N. J. Eq. 102, 187 Atl. 356, where merger was enjoined in spite of legislative authority; *Detroit Osteopathic Hospital v. Johnson*, (1939) 290 Mich. 283, 287 N. W. 466, where the charter gave the trustees power to amend by-laws as to election of trustees, and the trustees now amend the by-laws to permit election of trustees by all the members rather than by the trustees themselves, thus making possible a change in the aims of the organization; injunction granted.