

Washington Law Review

Volume 2 | Number 1

11-1-1926

No-Par Stock and Its Effect on Washington Law

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Recommended Citation

Jeffrey Heiman, Notes and Comments, *No-Par Stock and Its Effect on Washington Law*, 2 Wash. L. Rev. 33 (1926).

Available at: <https://digitalcommons.law.uw.edu/wlr/vol2/iss1/4>

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WASHINGTON LAW REVIEW

Published Four Times Yearly by the Law School of the University of
Washington

Founded by John T. Condon, First Dean of the Law School

SUBSCRIPTION PRICE \$2.50 PER ANNUM, SINGLE COPIES 65 CENTS

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To fill a vacancy occurring several years ago, and heretofore unfilled, the school faculty has received an addition this fall in the person of Crawford Morrison Bishop, B. A., Dartmouth, 1906, LL.B., Maryland, 1909; M.A., Columbia, 1917. Before coming to the University of Washington, Mr. Bishop served in the diplomatic and consular service in China, engaged in the private practice of law in New York City, specializing in international law, served at different times in various governmental departments at Washington, D. C., and recently was attorney with the United States Agency of the Mixed Claims Commission, United States and Mexico, Washington, D. C.

NO-PAR STOCK AND ITS EFFECT ON WASHINGTON LAW—In 1912 the New York Legislature passed the first statute authorizing the organization of corporations in New York with stock of no-par value.¹ Such stock is defined by Cook as "stock which does not state how much money it represents."² Immediately upon the passage of the law in New York a furor arose in the law reviews of the country, either

¹ N. Y. Laws 1912, ch. 351.

² COOK ON CORPORATIONS, 8 ed.

in criticism of, or in defense of, the innovation in the field of corporation finance.³

That this subject is becoming a popular field of corporate legislation is beyond denial for at the present time thirty-nine states, including Washington⁴ allow corporations to issue such stock;⁵ and the common stock issues are becoming increasingly popular.⁶

The fact that the statutory provisions of the various states differ widely produces a wide variety of problems. Any attempt to summarize them is too great a task to be accomplished now, although a scholarly attempt has been made.⁷ Under such circumstances one cannot draw conclusions that one may safely apply to all states. The field of no-par stock is one sorely in need of uniform legislation, so that the enactment of restrictive provisions in one state will not result in a flight of its corporations to another state.

At the present writing (October, 1926), in only two states has the question of constitutionality been raised, if cases involving the taxation of no-par stock be excepted.⁸ In Alabama, in the case of *Randle v. Winona Coal Co.*⁹ the Court held that "permitting shares of stock to be changed from a stated to a no-par value does not violate a constitutional provision", and that stock shall be issued only for money, labor done, or property actually received. Washington has provisions similar to those of Alabama in its constitution.¹⁰

There are two cases in California dealing with the constitutionality of the no-par stock statute there.¹¹ In the case of *Del Monte Light and Power Co. v. Jordan*¹² the power company organized a corporation with an authorized capital of \$25,000, consisting of 125 shares of

³ The articles of Mr. Cook appearing in the AMERICAN BAR ASSOCIATION JOURNAL for October (1921) denounce the system "as a dangerous method of defrauding both the public and creditors," saying, "The whole theory of no-par stock is let the buyer beware and let the creditor beware." Subsequent contributors to the JOURNAL remark that Mr. Cook's views are not well taken but that a no-par stock corporation does not tend to defraud anyone. A share of no-par stock is mere evidence of an aliquot or divisional interest in the assets or earnings of the corporation issuing the same. No representation is made by the stock as to its value. Creditors are put on notice as to the true value of the shares of stock issued, purchasers are not misled by a gold engraved certificate stamped in large letters, "Par Value One Hundred Dollars." J. C. Bonright, in the COLUMBIA LAW REVIEW, and William Cook in his recent book lead the opposition, while Thompson, Elihu Root, Dewing, Wickersham and the courts generally have favored the idea as a step forward in corporation finance.

⁴ Rem. Comp. Stat. § 3805 as amended by Session Laws of 1925, ch. 87, page 112; P. C. § 4505.

⁵ A complete list of the statutes of each state is given in 25 COL. L. REV. 44.

⁶ In a recent issue of the FINANCIAL CHRONICLE, 85% of the common stock issues advertised in the field of industrial and public utility corporations were issues of no-par stock.

⁷ 25 COL. L. REV. 43.

⁸ For discussion of the question of taxation under the No-Par Stock statutes, see 39 HARV. L. REV. 289.

⁹ 206 Ala. 254, 89 So. 790 (1921).

¹⁰ See Constitution of Washington, Art. XII, § 6.

¹¹ Cal. Civil Code, beginning with § 2906.

¹² 70 Cal. Dec. 115, 238 Pac. 710 (1925).

preferred stock and 125 shares of common stock, both of which were to have a par value of \$100, and 250 shares of common stock of no-par value. The Supreme Court sustained the refusal of the Secretary of State to grant the corporation a charter on the ground that it violated the constitution of California. The Court affirmed the principles laid down in *Film Producers v. Jordan*,¹³ which held that every share of stock in a California corporation must be of a single par value. The constitution of the state was interpreted to mean that there should be a proportionality of voting power to liability, and therefore a corporation composed of no-par stock of one value, and par stock of another (both of which have the same voting power), is a violation of the constitutional provision.¹⁴ In *Land Development Co. v. Jordan*,¹⁵ it is held that the constitutional provision is complied with "when each share of the corporation represents the same interest as every other share and there is a unity of liability as between all the shares." Hence, a corporation with mixed stock is not constitutionally organized. However, in the case of *Commonwealth Acceptance Corporation v. Jordan*,¹⁶ the Court held that a foreign corporation, even though it had a stock structure consisting of par and no-par stock may do business in California.

The authority for local corporations to issue mixed par and no-par stock is denied in Nevada,¹⁷ as it is in California,¹⁸ but is allowed in Illinois.¹⁹

To change from par to no-par stock is allowed in Alabama²⁰, Delaware,²¹ Massachusetts,²² and New Jersey,²³ the decisions in each case depending on the wording of statutory and constitutional provisions.

¹³ 171 Cal. 664, 154 Pac. 605 (1916).

¹⁴ Legal writers have questioned the wisdom of this decision, one author stating, "It seems to be reading an artificial and most gratuitous limitation into a constitution which is already a legal anachronism on the subject of corporations" (13 CAL. L. REV. 483). This decision, which disrupted many corporations in California organized under an unconstitutional act, was limited to corporations capitalized with both par and no-par stock. To determine the effect of this decision, the Secretary of State, Jordan, took a test case to the Supreme Court of California.

¹⁵ 71 Cal. Dec. 342, 245 Pac. 187 (March, 1926).

¹⁶ 246 Pac. (Cal.) 796 (May, 1926). The Court held that Art. XII, § 15 of the State Constitution had no application. The Section reads: "No corporation organized outside the limits of this state shall be allowed to transact business within this state on more favorable conditions than are prescribed by law to similar corporations organized under the laws of this State."

Accord—*North American Petroleum Co. v. Hopkins*, 105 Kan. 161, 181 Pac. 625 (1919), *Standard etc. Co. v. Sullivan*, 282 Mo. 261, 221 S. W. 728 (1920).

¹⁷ *State ex rel. Goodman v. Greathouse*, 47 Nev. 197, 217 Pac. 957 (1923).

¹⁸ See note 13, *supra*.

¹⁹ *Roberts and Schaefer Co. v. Emmerson*, 313 Ill. 137, 144 N. E. 818 (1924).

²⁰ *Winona Coal Co. v. Randle*, note 9, *supra*.

²¹ *Peters v. United States Mortgage Co.*, 13 Del. Ch. 11, 114 Atl. 598 (1921).

²² *Hood Rubber Co. v. Commonwealth*, 238 Mass. 369, 131 N. E. 201 (1921), *Olympic Theatres v. Commonwealth*, 238 Mass. 374, 131 N. E. 204 (1921).

²³ *Grausman v. Porto Rican Tobacco Co.*, 95 N. J. Eq. 155, 121 Atl. 895 (1923).

There is little or no difference between the rules governing subscription agreements to par and no-par stock. The fundamental principles are the same.²⁴ Hence, where one makes payments under a contract to buy shares of certain par value, he may recover back money already paid upon such a contract where it appears that the corporation has changed its financial organization and now tenders shares of no-par value.²⁵ The subscriber has lost the protection afforded by the par value statute,²⁶ and when no-par stock was sold to one group of stockholders at a higher price than to others, the former could recover the difference between the market value of the shares, and the price paid for them.²⁷

Every member of a par stock corporation has a right to demand that all subsequent sales of stock resulting in increased capitalization be at par. A sale below par would, of course, reduce his interest proportionately. The question arises, may a shareholder set aside or object to the sale of no-par stock below its market value? To answer this question, it must be first remembered that in general, two types of no par stock statutes exist: first, the "Stated No Par Stock" statutes, modeled after New York's, and secondly the "True No-Par Stock" statutes, modeled after Delaware's. The former requires a statement of the value of the no-par stock to be placed on the stock certificate,²⁸ and the latter merely requires a statement of the number of shares issued.²⁹ (The Washington statute requires the incorporators to certify that a certain amount of capital has been paid in.)³⁰

In cases involving Stated No-Par Stock statutes, the holders of stock already issued have a right to demand that the new issue be sold for at least the capital payment set forth in the certificate of incorporation.³¹ In fact New York requires that not only shall the stated value be paid in for shares already issued, but that the same stated value will be paid in against all the shares hereafter issued.³² It would seem, therefore, that under this type of statute that a shareholder may set aside the sale of stock sold for less than the value stated in the articles of incorporation or under the fair valuation placed on the stock by those empowered to evaluate it. It would seem however, that the financial exigencies of the concern and the good faith of the purchasers are elements to be considered by the court in upholding the validity of the sale.

²⁴ *Smith v. The General Motors Co.*, 289 Fed. 205 (1923). The Court said, p. 207, "A subscription to original stock at a definite par value and a subscription to an issue of increased no-par value stock at a fixed and definite price seem to depend upon the same principles."

²⁵ *Paul v. Pacific Development Co.*, 197 N. Y. S. 811 (1922).

²⁶ 37 HARV. L. REV. 467.

²⁷ *Hodgman v. Atl. Refining Co.*, 300 Fed. 590 (1924).

²⁸ N. Y. Corporation Laws, § 12b.

²⁹ Laws of Del., 1925, Ch. 112, 1918a, § 4a.

³⁰ Rem. Comp. Stat. § 3805, amended Sess. L., 1925, Ch. 87, p. 112; P. C. § 4505.

³¹ 25 Col. L. Rev. 56.

³² N. Y. Corporation Laws, § 12a.

A more difficult question is raised by the True No-Par Stock statutes. One of the main reasons for the adoption of the no-par stock as a system of corporate finance was to make legal a means of selling stock below par without entering into the old fiction of first issuing the stock to some person who immediately proceeded to turn the same back to the corporation, whereupon it would be sold at any price. The theory was that the stock had been fully paid for by someone.³³ Most statutes of this class provide, with Washington³⁴ "the liability of a subscriber to no-par stock shall be such as shall be, or shall have been, mutually agreed upon between the corporation and the subscribers." It is at least doubtful whether the corporation can contract to give its stock away. Some consideration must pass.³⁵ And it would seem that the shareholder has an absolute right to go into equity and demand that the courts intervene on behalf of those whose assets are being endangered. The precise point has not yet been raised however.³⁶

In the Johnson case, *supra*, the Court says, on page 862 of its opinion, "the general, if not universally accepted theory of the purpose of such (no-par stock) statutes is that they are intended to do away with both the 'trust fund' and the 'holding out' doctrines." This *dicta* is of particular interest to Washington because the "trust fund" theory is recognized here.³⁷ So far as the stated value of no-par stock statutes are concerned the "trust fund" or "holding out" doctrines must still apply. If a corporation, organized under one of these statutes, represents that each share of stock has a value of five dollars, and creditors rely upon that representation, there would seem to be a "holding out" as much as there would have been under the old system.

In Washington, the "trust fund" theory is that all the assets of an insolvent corporation are a trust fund for the benefit of all the creditors and no creditor can secure a preference over others. The unpaid subscription to true no-par stock of a corporation would seem to be an asset within the meaning of the theory.³⁸ And since it has been held an asset with reference to stock of par value,³⁹ the mere fact that the stock has no par value would seem to be an inadequate reason for holding otherwise. It is submitted that Washington will hold the subscriber liable to the creditors for the balance of the subscription price of his

³³ See *Connor v. Robinson*, 137 Wash. 672, 243 Pac. 849, 246 Pac. 758 (1926).

³⁴ Rem. Comp. Stat. § 3805, Amended 1925 Sess. L., Ch. 87, p. 112; P. C. § 4505.

³⁵ *Stone v. Young*, 210 App. Div. 303, 206 N. Y. S. 95 (1924).

³⁶ See 25 COL. L. REV. 43; *Hodgman v. Atlantic Refining Co.*, note 27, *supra*; *Johnson v. Louisville Trust Co.*, 293 Fed. 857 (1923).

³⁷ See 1 WASH. L. REV. 81, "The Trust Fund Theory."

³⁸ *Melville v. Rhodes*, 136 Wash. 220, 239 Pac. 560 (1925) (stock had par value), see also 39 HARV. L. REV. 757, "Liability of Stockholders Taking Stock at a Discount to Pay Par Value Thereof."

³⁹ See note 38, *supra*.

stock, especially in view of Rem. Comp. Stat., § 3805, as amended 1925 Sess. L. Ch. 87, P. C., §4505.⁴⁰

Washington, contrary to the weight of authority, has adopted the rule that when the board of directors of a corporation pay for property bought with shares of stock, the legality of such act can be attacked by the creditors if the true value of the property was less than the value of the stock.⁴¹ The majority rule upholds the legality of the act, if the directors acted in good faith and the subscriber was *bona fide*. Under the Washington no-par stock statute, since it makes no difference to the creditor whether the property paid for in stock is represented by 100 or 1,000 shares, the creditor could not attack the legality of the act although the existing shareholders might. The recent case of *Connor v. Robinson*⁴² lends color to the view that the "true value" theory is doomed, and that the "good faith" theory will be adopted.

Although there are no decisions on this question, the writer ventures the opinion as to the effect of this innovation upon the corporation law of this state, that: 1. The "trust fund" theory will stand in cases where there is a definite subscription for a definite sum—there remaining a balance unpaid on the subscription. 2. The "true value" rule will give way to the "good faith" rule, and where property is transferred for no-par value shares, relief will be granted creditors only in cases of actual fraud on the part of the directors in evaluating the property

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JURISDICTION OF A JUSTICE OF PEACE—The judgment of a court of record and of general jurisdiction, acting within the scope of its jurisdiction, is presumed to be valid in all particulars unless the contrary affirmatively appears on the face of the record.¹ But even such a judgment is subject to attack on the ground of lack of jurisdiction.² The judgment of a court of limited jurisdiction and not of record enjoys no such presumption, and the jurisdiction of such a court must be affirmatively shown.³ In this state, a justice court is not, and cannot be made, a court of record,⁴ and its jurisdiction is limited both as to subject matter⁵ and as to territory.⁶ Yet in a recent case the Supreme Court upheld, against a direct attack, the validity of a default

⁴⁰ "After the 'initial no-par capital' shall have been paid up, the liability of a subscriber to no-par value stock shall be such as shall be, or shall have been mutually agreed upon between the corporation and the subscriber of the stock."

⁴¹ *Lantz v. Moeller* 76 Wash. 429, 136 Pac. 687 (1913).

⁴² *Connor v. Robinson*, note 33, *supra*.

¹ *Ritche v. Carpenter* 2 Wash. 512, 28 Pac. 380 (1891).

² *Kline Bros. & Co. v. North Coast Fire Ins. Co.*, 80 Wash 609, 142 Pac. 7 (1914).

³ *Grignon v. Astor* 2 How. (U. S.) 319, 11 L. ed. 283 (1844).

⁴ Const. Art. IV, § 11.

⁵ Const., Art. IV, § 10; Rem. Comp. Stat., §§44-45; P. C., §§ 9564-65.

⁶ Rem. Comp. Stat., § 47 P. C., § 9458; further restricted as to civil cases by Rem. Comp. Stat., §§ 1756-7, P. C. §§ 9559-60.

⁷ *Nichols v. National Association of Creditors, Inc.*, 137 Wash. 74, 241 Pac. 960 (1925).