CHAPTER TWELVE

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Section 12.01 Sale of Assets

At common law, a corporation could not sell all of its assets over the objection of even a single shareholder. *Pomierski v. W. R. Grace & Co.*, 282 F Supp 385, 394 (ND Ill 1967); *Geddes v. Anaconda Copper Mining Co.*, 254 US 590 (1921).

This rule was subject to much criticism and courts found reasons

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to avoid it. *See:* 6A FLETCHER CYC CORP § 2949.10 (Perm Ed 1997). For instance, courts held that a majority of shareholders could authorize the sale of all assets if the corporation proved unprofitable, even though not insolvent. *Geddes v. Anaconda Copper Mining Co.*, 254 US 590 (1921). In Washington, the board of directors could sell all corporate assets if necessary to pay corporate debts. *Turpin v. Dunis*, 66 Wash 2d 749, 405 P2d 239 (1965).

The common law rule has been changed by statute. "In general, under Washington law, a corporation has broad power to encumber or distribute its assets, so long as creditors of the corporation are not prejudiced thereby." *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 279, 892 P2d 98, 104 (1995).

RCW 23B.12.010 governs the sale of all corporate assets in the regular course of business. RCW 23B.12.020 governs sales outside the ordinary course of business.

If the sale occurs in the regular course of business, a board of directors may authorize the sale of all corporate assets without shareholder approval. RCW 23B.12.010(1). For instance, if a corporation's stated purpose is to buy and sell or to lease real estate, the corporation's sale or lease of a property which constitutes the corporation's only asset may be "in the usual course of business." If so, the sale or lease does not require shareholder approval. RCW 23B.12.010(1)(a); *Van Buren v. Highway Ranch, Inc.*, 46 Wash 2d 582, 283 P2d 132 (1955); *Western Land Corp. v. Lichtenstein*, 47 Ill App 233, 361 NE2d 730 (1977); *Sailer v. Land-Livestock-Recreation, Inc.*, 268 Or 531, 522 P2d 214 (1974); *Eisen v. Post*, 3 NY2d 518, 146 NE2d 779, 169 NYS2d 15 (1957).

Even if a mortgage is not in the usual course of its business, the board of directors may authorize the corporation to mortgage all of its property without shareholder approval. RCW 23B.12.010(1)(b).

Otherwise if the sale is not in the ordinary course of business, a sale of all, or substantially all, corporate assets requires shareholder approval. RCW 23B.12.020. To obtain such approval, the board of directors must act first and then refer the matter to the shareholders for their approval. RCW 23B.12.020(2)(a). Next, the corporation must notify all shareholders of the meeting at which the vote on the sale is to occur, even shareholders not entitled to vote, and the meeting notice must inform the shareholders of the proposed transaction and the vote on that

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transaction. RCW 23B.12.020(4). Generally, two-thirds of the shareholders must approve such a sale. RCW 23B.12.020. The articles of incorporation may provide for a higher approval vote or may provide for a lower approval vote (but not less than majority approval). RCW 23B.12.020(5).

Unless a corporation complies with these rules, any such sale of corporate assets is voidable by the corporation. *Carson v. Isabel Apartments, Inc.*, 20 Wash App 293, 579 P2d 1027 (1978); *Naas v. Lucas*, 86 Or App 406, 739 P2d 1051, *opinion adhered to as modified*, 88 Or App 141, 744 P2d 586, *review denied*, 304 Or 680, 748 P2d 142 (1987).

If an asset sale requires shareholder approval, the shareholders have the right to dissent. RCW 23B.13.020(1)(c). *See:* Section 8.04 of this book.

Section 12.02 Merger & Share Exchange

A. Procedures.

One or more corporations may merge into another, surviving corporation. RCW 23B.11.010(1). Generally in a merger, the board of directors of each surviving and nonsurviving corporation adopts a plan of merger.

In a similar manner, a corporation may acquire all of the outstanding shares of another corporation through a share exchange. RCW 23B.11.020.

With two exceptions, both a merger and a share exchange require shareholder approval of the plan of merger or plan of share exchange. RCW 23B.11.030. Usually, the board of directors must recommend approval by the shareholders and then two-thirds of the shareholders must so approve the plan. RCW 23B.11.030. The articles of incorporation may provide for a higher approval vote or may provide for a lower approval vote (but not less than a majority approval). RCW 23B.11.030(5) & (6). Voting by voting group may be required. RCW 23B.11.030(5) & (6).

If a merger or share exchange requires shareholder approval, the shareholders have the right to dissent. RCW 23B.13.020(1)(a) and (b). *See:* Section 8.04 of this book. Normally, the right to dissent is the exclusive remedy available to a shareholder who objects to the merger. *Matteson v. Ziebarth*, 40 Wash 2d 286, 242 P2d 1025 (1952). However, this right to dissent may not apply to certain technical mergers, such as

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mergers done merely to change the domicile of the corporation, if the merger "does not constitute a `merger' in the business sense of the term, nor within the meaning of the statute." *China Products North America, Inc. v. Manewal*, 69 Wash App 767, 776, 850 P2d 565, 569 (1993). The right to dissent may not apply to the sale of all a corporation's assets if the sale is in the ordinary course of business. *Van Buren v. Highway Ranch, Inc.*, 46 Wash 2d 582, 283 P2d 132 (1955).

Corporations may merge with limited liability companies, partnerships and limited partnerships. RCW 23B.11.080.

***B. Exceptions - merger of subsidiary into parent; merger of greatly unequal corporations*.**

There are two exceptions to the requirement that the shareholders of both corporations must approve the merger.

First, if a corporation owns at least 90% of another corporation, the merger of the subsidiary corporation into the parent may be approved by the board of directors of the parent without the approval of the shareholders of either the parent or the subsidiary corporation. RCW 23B.11.040(1). The shareholders of the subsidiary corporation, but not the shareholders of the parent corporation, have the right to dissent. RCW 23B.13.020(1)(a)(ii).

Second, the shareholders of a surviving corporation sometimes are not required to approve the merger of the surviving corporation with a much small, nonsurviving corporation. If the articles of incorporation and outstanding shares of the surviving corporation are to remain unchanged and the total number of shares (including options and convertible securities) to be outstanding after the merger do not exceed the total number of voting shares of the surviving corporation immediately before the merger, then the shareholders of the surviving corporation do not need to approve the merger. RCW 23.11.030(7). The shareholders of the nonsurviving corporation, but not the shareholders of the surviving corporation, have the right to dissent. RCW 23B.13.020(1)(a)(i).

***C. Effect of merger*.**

After a merger, the surviving corporation is responsible for all liabilities of each corporation involved in the merger, surviving and nonsurviving corporations alike. RCW 23B.11.060; *Nike, Inc. v. Spencer*, 75 Or App 362, 707 P2d 589 (1985); *Gaswint v. Case*, 265 Or 248, 509 P2d 19 (1973); *Lamb v. Leroy Corp.*, 85 Nev 276, 454 P2d 24 (1969).

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A surviving corporation possesses all rights and privileges possessed by each of the merged corporations. *Diamond Parking, Inc. v. Seattle*, 78 Wash 2d 778, 479 P2d 47 (1971); *All Brand Importers, Inc. v. Department of Liquor Control*, 213 Conn 184, 567 A2d 1156 (1989); *Knightstown Lake Property Owners Association, Inc. v. Big Blue River Conservancy District*, 178 Ind App 463, 383 NE2d 361 (1978). An exception may exist, however, where a competing state statute requires state approval of the holder of a license. *State ex rel Don Williams Export, Inc. v. Timm*, 78 Wash 2d 520, 477 P2d 15 (1970) (transfer of common carrier permit to surviving corporation required state approval). But the same is not true where a city ordinance requires approval. *Diamond Parking, Inc. v. Seattle*, 78 Wash 2d 778, 479 P2d 47 (1971).

If a lawsuit is pending against a corporation which is merged into another corporation, upon motion by a party, the court may substitute the surviving corporation in place of the nonsurviving corporation. Alternatively, the court, in its discretion, may continue the action against the nonsurviving corporation. RCW 25.10.830; *Lloyd Enterprises, Inc. v. Longview Plumbing & Heating Co.*, 91 Wash App 697, 958 P2d 1035 (1999).

***D. Consolidations*.**

Consolidations are not authorized by the current Washington Act.

In a consolidation, a new corporation comes into being and none of the original corporations survive. Today, this same result may be achieved by forming a new corporation and then by merging all of the old corporations into the new corporation.

***E. Antitakeover Act*.**

Washington has adopted legislation to hinder a hostile takeover of a corporation whose shares are publicly traded. RCW 23B.19.010 *et seq.*

A discussion of this statute appears in Callahan & Burman, *The Validity of Washington's Antitakeover Act Under the Commerce and Supremacy Clauses*, 13 U PUGET SOUND L REV 41 (1989); Fay, *State Takeover Laws: Shareholder Protection, the Constitution, and the Delaware Approach*, 24 GONZAGA L REV 249 (1989).

Section 12.03 Dissolution, Generally

At common law, there were several ways in which a corporation could be dissolved. 16A FLETCHER CYC CORP § 7976 (Perm Ed 1995). But today, all states have enacted statutes for the dissolution of corporations.

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Today, a corporation may only be dissolved in the manner prescribed by statute. *Reese Sales Company, Inc. v. Gier*, 16 Wash App 664, 557 P2d 1326 (1977); *Spokane Merchants' Association v. Lobe*, 13 Wash App 68, 533 P2d 133 (1975). "Failure to follow the prescribed statutory method renders ineffectual any attempt to dissolve a corporation." *Moore v. Los Lugos Gold Mines*, 172 Wash 570, 589, 21 P2d 253, 260 (1933). Not even a court acting in equity may dissolve a corporation absent a statute giving it such authority. *Richter v. Richter*, 202 Ga 554, 43 SE2d 635 (1947); *Enterprise Printing & Publishing Co. v. Craig*, 195 Ind 302, 144 NE 542, 145 NE 309 (1924).

The Washington Business Corporation Act provides for only three methods of dissolving a corporation: voluntary dissolution, administrative dissolution, and judicial dissolution. Each of these methods is discussed below.

While the great majority of dissolutions are intended to be voluntary dissolutions, they are technically administrative dissolutions; that is, the directors and shareholders make a conscious decision to dissolve, but then fail to go through the formalities of a voluntary dissolution. Instead, they walk away from the business, fail to file the next required annual report with the Secretary of State, and are administratively dissolved. As such, their shareholders are not able to take advantage of the protections afforded by the voluntary dissolution procedures described in Section 12.04 below.

Section 12.04 Voluntary Dissolution

A. Procedures.

A voluntary dissolution may be initiated by one of two means:

(i) Prior to issuing shares and starting business, a majority of initial directors or incorporators may vote to dissolve the corporation. RCW 23B.14.010.

(ii) At any time, the directors may propose, and the shareholders may approve, dissolution of the corporation. RCW 23B.14.020. Unless the articles of incorporation provide for a greater vote, such shareholder approval requires a two-thirds majority vote. RCW 23B.14.020(5).

At any time after dissolution is authorized by one of these two procedures, the corporation may dissolve by delivering articles of dissolution and a revenue clearance certificate to the Secretary of State. The articles of dissolution must contain:

(i) The name of the corporation;

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(ii) The date dissolution was authorized; and

(iii) If shareholder approval was required for dissolution, a statement that dissolution was duly approved by the shareholders in accordance with RCW 23B.14.020. RCW 23B.14.030(1)(b).

If there are shareholders, the dissolution process must be initiated by the board of directors; the shareholders may vote on dissolution only after the question has been referred to them by the board. RCW 23B.14.020; *Kelly v. Galloway*, 156 Or 301, 66 P2d 272, 68 P2d 474 (1937).

Under the prior statute, the board of directors did not need to authorize the dissolution and distribution of assets if the shareholders unanimously consented. *Zimmerman v. Kyte*, 53 Wash App 11, 765 P2d 905 (1988). The Comment to RCW 23B.14.020 by the Washington State Bar Association's Corporate Act Revision Committee indicates that the Committee considered, but rejected, a provision which would have permitted the shareholders to consent to dissolution without the dissolution proposal being referred to them by the directors. It is clear that the board of directors must first refer the matter of dissolution to the shareholders; the shareholder may not independently vote to dissolve.

The corporation is dissolved upon the effective date of its articles of dissolution. RCW 23B.14.030(2). The articles of dissolution are effective upon filing with the Secretary of State, unless a delayed effective date is specified in the articles, not to be later than the 90th day after filing. RCW 23B.01.230.

***B. Effect of dissolution on conducting business*.**

At common law, the dissolution of a corporation was the equivalent of "its civil death; dissolution immediately abated all actions by and against the corporation." *University of Alaska v. Thomas Architectural Products, Inc.*, 907 P2d 448, 450 (Alaska 1995)(interpreting Washington law). *See also: Tillett Brothers Construction Company, Inc. v. Department of Transportation*, 210 Ga App 84, 435 SE2d 241 (1993); *Indiana National Bank v. Churchman*, 564 NE2d 340 (Ind App 1990); *United States v. Maryland State Licensed Beverage Ass'n*, 138 F Supp 685, 708 (D Md 1956).

Later statutes generally created a fixed period after dissolution in which a corporation could continue to sue or be sued. *Pacesetter Real Estate, Inc. v. Fasules*, 53 Wash App 463, 767 P2d 961 (1989); *Clatsop County v. Taylor*, 167 Or 563, 119 P2d 285 (1941).

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> Under the common law a corporation's capacity to sue or be sued terminated when the corporation was legally dissolved. Today, however, the harshness of the common law on creditors and shareholders has been replaced in every state by statutes which extend the corporate life for a definite time for the purpose of prosecuting and defending suits. However, where a statute continues the existence of a corporation for a certain period, it is generally held that the corporation becomes defunct upon the expiration of such period, at least in the absence of a provision to the contrary, so that no action can afterwards be brought by or against it and must be dismissed. (citations omitted) *Canadian Ace Brewing v. Joseph Schlitz Brewing Co.*, 629 F2d 1183, 1185 (7th Cir 1980).

Although the "corporation continues its corporate existence," upon dissolution, the corporation "may not carry on any business except that appropriate to wind up and liquidate its business and affairs." RCW 23B.14.050. Under prior law, the right of a corporation to pursue or defend claims in the courts ceased after a fixed period. *Pacesetter Real Estate, Inc. v. Fasules*, 53 Wash App 463, 767 P2d 961 (1989). Under present law, this right appears to continue throughout the winding up and liquidation period. RCW 23B.14.050(e) and (f). There are no fixed time limits. Lawsuits against the corporation, however, must generally be filed within two years of dissolution. RCW 23B.14.340. But, this two-year limitation may not apply to a known claimant who does not receive any notice as required by RCW 23B.14.060. *University of Alaska v. Thomas Architectural Products, Inc.*, 907 P2d 448 (Alaska 1995)(interpreting Washington law).

The purpose of the provision permitting lawsuits after dissolution is "to provide that dissolution will not abate legal claims by and against a corporation, just as death will not abate personal claims by and against an individual." *Savannah Laundry & Machinery Company, Inc. v. Oweenby*, 186 Ga App 130, 366 SE2d 787, 789 (1988).

***C. Creditors have first claim to assets upon dissolution*.**

It is a well-established doctrine that upon dissolution, the assets of a corporation are to be applied first to the payment of corporate debts and then, if there are assets remaining, to the shareholders. *Georgia, Florida & Alabama R. Co. v. Bankers Trust Co.*, 170 F2d 733 (5th Cir 1948); *United States v. Butterworth Corp.*, 269 US 504 (1926); *Smyth v. Kenwood Land Co.*, 97 Or 19, 190 P 962 (1920).

Under some circumstances, a creditor who is not paid prior to the distribution of assets to the shareholders may recover from the shareholders. *Lonsdale v. Chesterfield*, 99 Wash 2d 353, 662 P2d 385 (1983); *Spokane Merchants' Association v. Lobe*, 13 Wash App 68, 533 P2d 133 (1975); *Fountain v. Burke*, 160 Ga App 262, 287 SE2d 39

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(1982); *Wakeman v. Paulson*, 257 Or 542, 480 P2d 434 (1971). *But see: Walter A. Wood Reaping and Mowing Manufacturing Co. v. Angemeier*, 51 Ind App 258, 99 NE 500 (1912).

> The law which sends a corporation into the world with the capacity to act imposes upon its assets liability for its acts. The corporation cannot disable itself from responding by distributing its property among its stockholders and leaving remediless those having valid claims. In such a case the claims after being reduced to judgments may be satisfied out of the assets in the hands of the stockholders. *Pierce v. United States*, 255 US 398, 402 (1921).

But as describe in Sections 10.11 and 10.12 of this book, most cases hold that a creditor of an insolvent corporation may recover debts owed to the corporation by shareholders only through an equitable proceeding naming all creditors and all shareholders located within the jurisdiction. *Royer v. Maib*, 6 Wash 2d 286, 107 P2d 593 (1940); *Wakeman v. Paulson*, 264 Or 524, 506 P2d 683 (1973). This also seems to be the rule in actions to collect improper distributions after dissolution.

> From the principle thus established in this state the proper remedy of a creditor of an insolvent corporation to reach the fund alleged to have been paid to a stockholder as a dividend in liquidation is by a suit in equity and not by an action at law as commenced in the case at bar. *Garetson Lumber Co. v. Hinson*, 69 Or 605, 610, 140 P 633, 635 (1914).

A recent decision by the Washington Court of Appeals held that a creditor could proceed directly against the shareholders without mentioning any obligation to include other creditors as parties to the lawsuit.

> Recovery of corporate assets distributed to former shareholders upon dissolution is permissible in certain circumstances. Such recovery may be proper here, and we hold that Smith may proceed against [the shareholder defendants] individually. (footnotes omitted) *Smith v. Sea Ventures, Inc.*, 93 Wash App 613, 619, 969 P2d 1090, 1093, *review denied*, 138 Wash 2d 1003 (1999).

The doctrine of laches may apply to lawsuits by creditors against shareholder for improper distributions. *Parker v. Richards*, 43 Or App 455, 602 P2d 1154 (1980).

A discussion of creditor lawsuits against directors for improper distributions appears in Section 9.07 of this book. A discussion of creditor lawsuits against shareholders for improper distributions appears in Section 10.12 of this book.

D. Cutting off claims against corporation.

Creditors have first priority to corporate assets. But at some point, the board of directors needs to know how much is available for distribution

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to the shareholders.

Generally, a corporation will pay all known, undisputed claims and establish a reserve for the payment of disputed and unknown claims. It will then distribute the remaining assets to the shareholders.

RCW 23B.14.060 (based upon RMBCA § 14.06) sets forth the procedure for cutting off corporate liability for known claims. It provides:

> (1) A dissolved corporation may dispose of the known claims against it by following the procedure described in this section.
>
> (2) The dissolved corporation shall notify its known claimants in writing of the dissolution at any time after its effective date. The written notice must:
>
> > (a) Describe information that must be included in a claim;
> >
> > (b) Provide a mailing address where a claim may be sent;
> >
> > (c) State the deadline, which may not be fewer than one hundred and twenty days from the effective date of the written notice, by which the dissolved corporation must receive the claim; and
> >
> > (d) State that the claim will be barred if not received by the deadline.
>
> (3) A claim against the dissolved corporation is barred:
>
> > (a) If a claimant who was given written notice under subsection (2) of this section does not deliver the claim to the dissolved corporation by the deadline; or
> >
> > (b) If a claimant whose claim was rejected by the dissolved corporation does not commence a proceeding to enforce the claim within ninety days from the effective date of the rejection notice.
>
> (4) For purposes of this section, "claim" does not include a contingent liability or a claim based on an event occurring after the effective date of dissolution.

Washington did not adopt a procedure for cutting off corporate liability for unknown claims. *Smith v. Sea Ventures, Inc.*, 93 Wash App 613, 969 P2d 1090, *review denied*, 138 Wash 2d 1003 (1999).

NOTE: In *Smith v. Sea Ventures, Inc.*, 93 Wash App 613, 617-18, 969 P2d 1090, 1093, *review denied*, 138 Wash 2d 1003 (1999), the court states: "RCW 23B.14.340 is based upon section 14.06 of the Model Business Corporation Act." Actually, RCW 23B.14.060 is based upon Section 14.06 of the Model Act. RCW 23B.14.340 has no corresponding section in the Model Act.

RCW 23B.14.340 provides that a creditor must file suit within two

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years of dissolution. But this two-year limitation may not apply to a known claimant who does not receive notice as required by RCW 23B.14.060. *University of Alaska v. Thomas Architectural Products, Inc.*, 907 P2d 448 (Alaska 1995) (interpreting Washington law).

***E. Distributions to shareholders*.**

After the board of directors has provided for payment of all third party obligations, the remaining assets of the corporation may be distributed to the shareholders. Unless the shareholders unanimously agree to the contrary, any such distributions are allocated in proportion to the number of shares held by each shareholder. *In re Monks Club, Inc.*, 64 Wash 2d 845, 394 P2d 804 (1964); *Squires v. Balbach Co.*, 177 Neb 465, 129 NW2d 462 (1964); *Kleinschmidt v. Central Trust Co.*, 103 Or 124, 203 P 598 (1922). As a contract among the shareholders, the articles of incorporation may provide for a different allocation of assets upon dissolution. *Hay v. Hay*, 38 Wash 2d 513, 230 P2d 791 (1951).

Shareholders are entitled to distributions of cash, but not of specific corporate property. *Thimsen v. Reigard*, 95 Or 45, 186 P 559 (1920).

If there are two or more classes of stock, the articles of incorporation may include the relative rights of the classes to distributions upon dissolution. RCW 23B.06.010(3)(c) & (d). The articles of incorporation must provide for the distribution of all of the corporation's net assets among the various classes upon liquidation. RCW 23B.06.010(2).

If there is a class of preferred shares, that class is entitled to payment of the preference amount, plus unpaid distributions, before any payments may be made to the common shareholders. *Hay v. Hay*, 38 Wash 2d 513, 230 P2d 791 (1951); *Haworth v. Hubbard*, 220 Ind 611, 44 NE2d 967 (1942). But if the articles of incorporation are silent as to any further participation in the corporation's assets, the rights of such preferred shareholders are exhausted once the preference has been satisfied. *In re Olympic National Agencies, Inc.*, 74 Wash 2d 1, 442 P2d 246 (1968).

Assets which belong to a creditor, claimant, or shareholder who cannot be found may be deposited with the state treasurer. RCW 23B.14.400. Unclaimed property is subject to the Uniform Unclaimed Property Act. RCW 63.29 *et seq*.

In the event the board of directors does not act to liquidate the remaining corporate assets and distribute the proceeds, the shareholders become tenants in common in those assets. *Ban-Mac, Inc. v. King*

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County, 69 Wash 2d 49, 416 P2d 694 (1966); *Ring v. Williams*, 192 Ga App 329, 384 SE2d 914 (1989); *Service Lumber Co. v. Sumpter Valley Ry. Co.*, 81 Or 32, 149 P 531, 152 P 262, 158 P 175 (1916). In such an event, the shareholders also become co-tenants in contractual rights and chooses in action. *Follett v. Clark*, 19 Wash 2d 518, 143 P2d 536 (1944).

> Regardless of whatever the rule may have formerly been, it is now a well-established doctrine that the property of a corporation, including rights of contracts and chooses in action, upon dissolution of the corporation, become vested in the stockholders, subject to the rights of creditors; and ordinarily, and in the absence of debts, the stockholders, upon dissolution of the corporation, become the owners of its assets. (citations omitted) *Smyth v. Kenwood Land Co.*, 97 Or 19, 34-5, 190 P 962, 967 (1920).

Under some circumstances, a creditor who is not paid prior to the time that assets are distributed to shareholders may recover those distributions from shareholders. *Smith v. Sea Ventures, Inc.*, 93 Wash App 613, 969 P2d 1090, *review denied*, 138 Wash 2d 1003 (1999); *Lonsdale v. Chesterfield*, 99 Wash 2d 353, 662 P2d 385 (1983). A discussion of creditor suits against directors for improper distributions appears in Section 9.07 of this book. A discussion of creditor suits against shareholders for improper distributions appears in Section 10.12 of this book.

Section 12.05 Administrative Dissolution

A. Grounds - administrative dissolution.

The Secretary of State may dissolve a corporation which is delinquent in filing its annual report or fees or which is without a registered agent or office. RCW 23B.14.200; *Equipto Division Aurora Equipment Co. v. Yarmouth*, 134 Wash 2d 356, 950 P2d 451 (1997).

The constitutionality of prior versions of this statute were upheld. *Peck v. Linney*, 97 Wash 103, 165 P 1080 (1917); *Hawley v. Bonanza Queen Mining Co.*, 61 Wash 90, 111 P 1073 (1910).

The Secretary of State may dissolve a Washington corporation on any of the six grounds set out in RCW 23B.14.200:

> (1) The corporation does not pay when due any license fees or penalties imposed by this title, when they become due;
>
> (2) The corporation does not deliver its completed initial report or annual report to the secretary of state when due;
>
> (3) The corporation is without a registered agent or registered office in this state;
>
> (4) The corporation does not notify the Secretary of State that its registered agent or registered office has been changed, that its

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> registered agent has resigned or that its registered office has been discontinued;
>
> (5) The corporation's period of duration stated in its articles of incorporation expired after July 1, 1990; or
>
> (6) The corporation's period of duration stated in its articles of incorporation expired prior to July 1, 1990, but the corporation has timely paid all license fees imposed by this title and set by rule by the secretary, has timely filed annual reports with the secretary of state, has never been without a registered agent or registered office in this state for sixty days or more, and has never failed to notify the secretary of state of changes in a registered agent or registered office within sixty days of such change.

In addition, RCW 23B.14.300 permits the Secretary of State to administratively dissolve a corporation upon the application of a governmental entity if the corporation is using a name which is not distinguishable from the name of that governmental entity.

RCW 23B.14.210 describes the procedure for administrative dissolution.

Under earlier law, corporations which were delinquent in payment of their annual fee or tax were held not to be able to maintain a lawsuit in the Washington courts. *Pacesetter Real Estate, Inc. v. Fasules*, 53 Wash App 463, 767 P2d 961 (1989); *Follett v. Clark*, 19 Wash 2d 518, 143 P2d 536 (1944); *State ex rel Bowen v. Superior Court*, 135 Wash 315, 237 P 722 (1925). After adoption of a modified version of the Model Act, Washington permitted corporations delinquent in paying these fees to simply cure their disablement by paying the owed fees and penalties and then commencing suit. *Jet Boats, Inc. v. Puget Sound National Bank*, 44 Wash App 32, 721 P2d 18 (1986). A corporation which is administratively dissolved after commencing a lawsuit can cure the disablement by obtaining reinstatement before trial, or even after trial but before the trial court renders a decision on a motion to dismiss. *Roger Lee Construction Co. v. Toikka*, 62 Wash App 87, 813 P2d 161 (1991). But if the corporation does not cure the disablement by paying its license fees, the case will be dismissed. *Inducon Corp. v. Crowley Maritime Corp.*, 53 Wash App 872, 771 P2d 356 (1989).

Under present law, an administratively dissolved corporation "continues its corporate existence but may not carry on any business except that necessary to wind up and liquidate its business and affairs." RCW 23B.14.210(3). "Dissolution terminates a corporations [sic] power to enter into contracts unrelated to winding up and liquidation." *White v. Dvorak*, 78 Wash App 105, 109, 896 P2d 85, 88 (1995). A party who

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enters into a contract on behalf of a dissolved corporation becomes a party to that contract and is both liable on the contract and able to enforce the contract. *Id.* After dissolution, an administratively dissolved corporation can sell corporate property, but cannot acquire new property. *High v. Davis*, 283 Or 315, 584 P2d 725 (1978). But after reinstatement, the corporation may ratify an acquisition. *Id.*

Once a corporation has been an administratively dissolved, its shareholders become owners of the corporation's assets. *Zimmerman v. Kyte*, 53 Wash App 11, 765 P2d 905 (1988). The owners may then file suit on a cause of action previously owned by the corporation, even though the corporation itself is disabled from filing suit by the dissolution. *Id.* Alternatively, the directors, as trustees for the creditors and the shareholders, may bring suit in their capacity as trustees and seek to recover corporate property. *Pacesetter Real Estate, Inc. v. Fasules*, 53 Wash App 463, 767 P2d 961 (1989).

***B. Reinstatement*.**

An administratively dissolved corporation may be reinstated within five years after dissolution. RCW 23B.14.220. But once the five year period has elapsed, the dissolution is irrevocable. *Pacesetter Real Estate, Inc. v. Fasules*, 53 Wash App 463, 767 P2d 961 (1989); *Hawley v. Bonanza Queen Mining Co.*, 61 Wash 90, 111 P 1073 (1910).

Under prior law, during the period of dissolution, the corporation's rights to function in a corporate capacity were suspended. *Follett v. Clark*, 19 Wash 2d 518, 143 P2d 536 (1944). Any contracts entered into during the period of dissolution were void. *Klorfine v. Cole*, 121 Or 76, 252 P 708, 254 P 200 (1927). Under prior law, it was necessary for a reinstated corporation to ratify any action taken by it during the period of dissolution. *High v. Davis*, 283 Or 315, 584 P2d 725 (1978).

Under the current Washington Act, an administratively dissolved corporation continues "its corporate existence but may not carry on any business except that necessary to wind up and liquidate its business and affairs." RCW 23B.14.210(3). If the corporation is reinstated, however, the reinstatement relates "back to and takes effect as of the effective date of the administrative dissolution and the corporation resumes carrying on its business as if the administrative dissolution had never occurred." RCW 23B.14.220(3). In such a case, corporate officers should not be personally liable for contracts signed during the period of dissolution. *Creditors Protection Association, Inc. v. Baksay*, 32 Or App 223, 573 P2d

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766, 768 (1978).

If after administrative dissolution the corporation continues to conduct "ongoing" business, the persons conducting that business will be liable if they have "actual knowledge" of the dissolution. *Equipto Division Aurora Equipment Co. v. Yarmouth*, 134 Wash 2d 356, 950 P2d 451 (1997). *See also: Micciche v. Billings*, 727 P2d 367 (Colo 1986); *Spector v. Hart*, 139 So2d 923 (Fla 2d DCA 1962). If however, a person conducting business in the name of corporation lacks actual knowledge, such a person will not be liable.

> All persons purporting to act as or on behalf of a corporation, knowing there was no incorporation under this title, are jointly and severally liable for liabilities created while so acting except for any liability to any person who also knew that there was no incorporation. RCW 23B.02.040.

If an officer or corporate agent is liable on a contract entered into after dissolution, that person becomes a party to the contract and may enforce the contract in such person's individual capacity. *White v. Dvorak*, 78 Wash App 105, 896 P2d 85 (1995).

See also: Thomas G. Fischer, Annotation, *Liability of Shareholders, Directors, and Officers Where Corporate Business Is Continued After Its Dissolution*, 72 ALR 4th 419 (1989).

If officers and directors dissipated corporate assets during the period of dissolution, they may be liable to creditors under the trust theory. *Lents, Inc. v. Borstad*, 251 Or 296, 445 P2d 597 (1968). The trust fund theory is discussed in more detail in Section 12.07 of this Chapter.

Section 12.06 Judicial Dissolution

The Washington superior courts have the power to dissolve a corporation in certain proceedings initiated by the Attorney General, a shareholder, a creditor, or the corporation. RCW 23B.14.300.

The Attorney General may initiate a proceeding to dissolve a corporation if the corporation obtained its articles of incorporation through fraud or if the corporation exceeds or abuses the authority conferred upon it by law. RCW 23B.14.300(1).

A creditor may initiate a proceeding to dissolve a corporation if the creditor obtains a judgment against the corporation and unsuccessfully tries to execute on that judgment and if the corporation is insolvent. RCW 23B.14.300(3). Alternatively, creditor may initiate such a proceeding if the corporation admits in writing that it owes the creditor money but is insolvent. *Id.*

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RCW 23B.14.300(2) provides that a shareholder may seek dissolution of the corporation if:

> (a) The directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock;
>
> (b) The directors or those in control of the corporation have acted, are acting or will act in a manner that is illegal, oppressive or fraudulent;
>
> (c) The shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of he corporation can no longer be conducted to the advantage of the shareholders generally, because of deadlock;
>
> (d) The corporate assets are being misapplied or wasted; or
>
> (e) The corporation has ceased all business activity and has failed, within a reasonable time, to dissolve, to liquidate its assets, or to distribute its remaining assets among its shareholders.

A corporation may initiate a proceeding to have its voluntary dissolution continued under court supervision. RCW 23B.14.300(4).

Courts also have the power to appoint a receiver to wind up a corporation's business and affairs. RCW 23B.14.320. *See also: Boothe v. Summit Coal Mining Co.*, 55 Wash 167, 104 P 207 (1909).

***A. Shareholder initiated dissolutions*.**

RCW 23B.14.300(2)(b) permits a minority shareholder to seek judicial dissolution of a corporation if:

> The directors or those in control of the corporation have acted, are acting, or will act in a manner that is illegal, oppressive, or fraudulent.

One Washington case discusses two tests which have been applied to determine whether conduct is "oppressive."

> Washington cases have not addressed the question of what constitutes "oppressive" action against a shareholder. A number of courts in other states have found oppression in minority shareholder settings. The court in *Gimpel v. Bolstein*, 125 Misc 2d 45, 477 NYS 2d 1014 (1984) attempted to set a standard for determining the existence of oppression, stating that "[t]he most prominent definition of oppression stems from the writings of F. Hodge O'Neal, which define "oppression" as a violation by the majority of the "reasonable expectations" of he minority." "Reasonable Expectations" are those spoken and unspoken understanding on which the founders of a venture rely when commencing the venture.
>
> The Court in *Gimpel* did not use the reasonable expectations test because the corporation was 53 years old, the current shareholders were

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> not the original shareholders, and the plaintiff had stolen from the corporation, thereby breaking all bargains. The court thus applied a secondary definition, describing oppression as
>
> > burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visible departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely.
>
> Under either of these test, the factual findings support the legal conclusion that [defendant] did not oppress [plaintiff] as a minority shareholder. (citations omitted) *Robblee v. Robblee*, 68 Wash App 69, 76, 841 P2d 1289, 1293 (1992).

The statute refers to "illegal, oppressive, or fraudulent" conduct. In interpreting a similarly-worded statute, one court held that the terms "illegal," "oppressive," and "fraudulent," are to be read in the disjunctive:

> In considering the meaning and application of the term "oppressive" conduct it is first to be noted that by the very terms of [the statute] conduct need not be fraudulent or illegal to be "oppressive" within the meaning of that statute.
>
> While general definitions of "oppressive" conduct are of little value for application in a specific case, perhaps the most widely quoted definitions are that "oppressive conduct" for the purposes of such a statute is:
>
> > "burdensome, harsh and wrongful conduct; a lack of probity and fair dealing in the affairs of a company to the prejudice of some of its members; or a visual departure from the standards of fair dealing, and a violation of fair play on which every shareholder who entrusts his money to a company is entitled to rely."
>
> We agree, however, that the question of what is "oppressive" conduct by those in control of a "close" corporation as its majority stockholders is closely related to what we agree to be the fiduciary duty of a good faith and fair dealing owed by them to its minority stockholders.
>
> Thus, an abuse of corporate position for private gain at the expense of the stockholders is "oppressive" conduct. Or the plundering of a "close" corporation by the siphoning off of profits by excessive salaries or bonus payments and the operation of the business for the sole benefit of the majority of the stockholders, to the detriment of the minority stockholders, would constitute such "oppressive" conduct as to authorize a dissolution of the corporation under the terms of ORS 57.595. (footnotes omitted) *Baker v. Commercial Body Builders, Inc.*, 264 Or 614, 628-9, 507 P2d 387, 393-4 (1973).

See also: Iwasaki v. Iwasaki Bros., Inc., 58 Or App 543, 649 P2d 598 (1982).

RCW 23B.14.300(2)(a) permits a minority shareholder to seek judicial dissolution of a corporation if:

> The directors are deadlocked in the management of the corporate affairs, the shareholders are unable to break the deadlock, and

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> irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of deadlock.

"Deadlock is the inaction which results when two equally powerful factions stake out opposing positions and refuse to budge." (footnote omitted) *Wilcox v.Stiles*, 127 Or App 671, 678, 873 P2d 1102, 1105 (1994). If one shareholder owns a majority of the shares, a corporation is not necessarily deadlocked simply because its board of directors is deadlocked since the statute also requires that "the shareholders are unable to break the deadlock." *Gregory v. J. T. Gregory & Son, Inc.*, 176 Ga App 788, 338 SE2d 7 (1985).

RCW 23B.14.300(2)(c) permits judicial dissolution on the basis of shareholder deadlock alone, but only if:

> The shareholders are deadlocked in voting power and have failed, for a period that includes at least two consecutive annual meeting dates, to elect successors to directors whose terms have expired, and irreparable injury to the corporation is threatened or being suffered, or the business and affairs of the corporation can no longer be conducted to the advantage of the shareholders generally, because of the deadlock.

Thus, a temporary shareholder deadlock over an issue is not enough to justify judicial intervention. A more serious, long-standing deadlock is required.

***B. Court's power to dissolve is discretionary*.**

The court's power to dissolve a corporation is a discretionary one and the courts appear most hesitant to exercise this power. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *Boothe v. Summit Coal Mining Co.*, 55 Wash 167, 104 P 207 (1909).

Historically, courts have been disinclined to intervene and dissolve a corporation, even in cases involving deadlock or oppressive conduct.

> The shareholder deadlock provisions of the Illinois Business Corporation Act, of the Model Business Corporation Act, and of the Oregon Business Corporation Law are clearly couched in language of permission. It is incredible that the many able lawyers who worked from time to time on these three identical acts would have used such phraseology to express a mandate. The statute contemplates that the court of equity shall take jurisdiction once a requisite showing of fact is made and contemplates further that having taken jurisdiction it will bring its discretion to bear in granting or refusing to grant equitable relief. The very fact that the legislature has made the remedy of liquidation a matter of discretion for the courts is a mandate to us to use discretion, and we would not be carrying out the legislative will by simply decreeing liquidations as a matter of course once the jurisdictional facts and nothing more are proven. The common law rule was thought to be an insufficient safeguard of the rights of the half-owner of a corporation who happened

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> to be out of power. As we read the statute its intent is to obligate the courts to thread their way from case to case without the assistance of sweeping generalizations. *Jackson V. Nicolai-Neppach Co.*, 219 Or 560, 574-5, 348 P2d 9, 16 (1959).

See also: Henry George & Sons, Inc. v. Cooper-George, Inc., 95 Wash 2d 944, 632 P2d 512, 514 (1981); *Boothe v. Summit Coal Mining Co.*, 55 Wash 167, 104 P 207 (1909); *McMunn v. ML&H Lumber, Inc.*, 247 Or 319, 429 P2d 798 (1967).

Courts have been reluctant to substitute the court's judgment, or the minority shareholders' judgment, for the business judgment of the majority. *Nursing Home Building Corp. v. De Hart*, 13 Wash App 489, 535 P2d 137 (1975).

> At common law, many courts refused to intervene in shareholder disputes since the State licensed the corporation, and as such the State and not the courts had the authority to dissolve the corporation. In a few jurisdictions, courts of equity began to carve out areas in which they would use the powers of the chancellors to liquidate the assets and business of the corporation. A few courts asserted the power to liquidate on a showing of irreparable injury to the shareholders and the corporation due to gross or fraudulent mismanagement. *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 95 Wash 2d 944, 948, 632 P2d 512, 514 (1981).

The courts will usually not intervene even in the case of alleged director incompetence and mismanagement. *Beeler v. Standard Investment Co.*, 107 Wash 442, 181 P 896 (1919). One Washington decision recognized the right of the board of directors to shift the balance of voting power, stating that "directors . . . may in the exercise of their honest business judgment adopt a valid method of eliminating what appears to them a clear threat to the future of their business by any lawful means." *Hendricks v. Mill Engineering & Supply Co.*, 68 Wash 2d 490, 495, 413 P2d 811, 813-4 (1966).

Another court said:

> In the absence of a fraudulent or coercive design or purpose on the part of the management neither the judgment of the court nor that of a minority stockholder can properly be substituted for the judgment of the majority of the directors and stockholders of a corporation. *Horner v. Pleasant Creek Mining Corp.*, 165 Or 683, 699, 107 P2d 989, 995, 109 P2d 1044 (1941).

Another court put it more bluntly:

> No principle of law is more firmly fixed in our jurisprudence than the one which declares that the courts will not interfere in matters involving merely the judgment of the majority in exercising control over corporate affairs. *Regenstein v. J. Regenstein Co.*, 213 Ga 157, 159 97 SE2d 693, 695 (1957).

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Usually, either bad faith or fraud is required to be present in order for a court to intervene in internal corporate affairs.

A court may find inequitable conduct, but order relief short of dissolution. *Agronic Corporation of America v. deBough*, 21 Wash App 459, 585 P2d 821 (1978); *Browning v. C & C Plywood Corp.*, 248 Or 574, 434 P2d 339 (1968); *Delaney v. Georgia-Pacific Corp.*, 278 Or 305, 564 P2d 277, *supplemented*, 279 Or 653, 569 P2d 604 (1977), *appeal after remand*, 42 Or App 439, 601 P2d 475 (1979).

***C. Court's equitable power to regulate corporate affairs*.**

In addition to the rights granted by RCW 23B.14.300, courts retain the equitable power to dissolve or regulate the affairs of a corporation. *Henry George & Sons, Inc. v. Cooper-George, Inc.*, 95 Wash 2d 944, 948, 632 P2d 512, 514 (1981); *Baker v. Commercial Body Builders, Inc.*, 264 Or 614, 507 P2d 387 (1973); *Nelkin v. H.J.R. Realty Corp.*, 25 NY2d 543, 307 NYS2d 454, 255 NE2d 713 (1969). Some courts are more inclined to exercise their equitable powers to fashion a remedy other than dissolution. *See, for example: Delaney v. Georgia-Pacific Corp.*, 278 Or 305, 564 P2d 277, *supplemented*, 279 Or 653, 569 P2d 604 (1977), *appeal after remand*, 42 Or App 439, 601 P2d 475 (1979); *Baker v. Commercial Body Builders, Inc.*, 264 Or 614, 507 P2d 387 (1973); *Browning v. C & C Plywood Corp*, 248 Or 574, 434 P2d 339 (1968).

Section 12.07 Insolvent Corporations; Rights of Creditors; Trust Fund Theory

***A. Duty of directors*.**

Once a corporation becomes insolvent, directors have an obligation to protect corporate assets for the corporation's creditors. As discussed below, courts have sometimes said that upon insolvency, directors become trustees holding corporate assets for the benefit of creditors.

Certainly, officers and directors cannot use their positions to obtain an unfair advantage for themselves over other corporate creditors. In particular, officers and directors may be held liable to corporate creditors if they diverted corporate funds to themselves when the corporation is insolvent.

> By the great weight of authority, where a corporation is insolvent or has reached such condition that its directors or officers see that they must deal with its assets in the view of its probable suspension, they cannot use those assets to prefer themselves as creditors or sureties in respect to past advances to the prejudice of general creditors. *Gantenbein v. Bowles*, 103 Or 277, 289-90, 203 P 614, 619 (1922).

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See also: Randall & Neder Lumber Company, Inc. v. Randall, 202 Ga App 497, 414 SE2d 718 (1992); *Wortham v. Lachman-Rose Co.*, 440 SW2d 351 (Tex Civ App 1969).

RCW 23B.08.310(1) provides that a director who votes for an unlawful distribution may be liable to the corporation for that unlawful distribution, unless the director complies with the standards of conduct set out in RCW 23B.08.300. This topic is discussed in more detail in Section 9.07 of this book.

A director held liable for an unlawful distribution is entitled to contribution from "each shareholder for the amount the shareholder accepted knowing the distribution was made in violation of RCW 23B.06.400 or the articles of incorporation." RCW 23B.08.310(2)(b). This topic is discussed in more detail in Section 10.12 of this book.

There is a two-year period for bringing such lawsuits. RCW 23B.08.310(3).

***B. Rights of creditors*.**

Directors may be held personally liable to creditors if they dissipate assets of their dissolved corporation. *Lents, Inc. v. Borstad*, 251 Or 296, 445 P2d 597 (1968).

A judgment creditor may seek the appointment of a receiver if the corporation is insolvent. RCW 23B.14.320. A receiver may initiate a proceeding to set aside a preference made within four months before the date of application for appointment of a receiver. RCW 23.72.010 *et seq.*

Under some circumstances, a creditor may initiate an involuntary bankruptcy proceeding.

A transfer of corporate assets for inadequate consideration may be set aside as fraudulent, particularly if the transfer is to an officer, director, or shareholder. *Eagle Pacific Insurance Co. v. Christensen Motor Yacht Corp.*, 135 Wash 2d 894, 959 P2d 1052 (1998); *Hall v. Armstrong Cork, Inc.*, 103 Wash 2d 258, 692 P2d 787 (1984); *Randall & Neder Lumber Company, Inc. v. Randall*, 202 Ga App 497, 414 SE2d 718 (1992); *Allen v. Meinig*, 109 Or App 341, 819 P2d 744 (1991), *review denied*, 313 Or 209, 830 P2d 595 (1992); *Peterson v. Harville*, 445 F Supp 16, 24 (D Or 1977); *US Marketing Concepts, Inc. v. Don Jacobs Buick-Subaru, Inc.*, 547 NE2d 892 (Ind App 1989).

Under some circumstances, a creditor who is not paid prior to the distribution of assets to the shareholders may recover from the shareholders. *Lonsdale v. Chesterfield*, 99 Wash 2d 353, 662 P2d 385

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(1983); *Spokane Merchants' Association v. Lobe*, 13 Wash App 68, 533 P2d 133 (1975); *Fountain v. Burke*, 160 Ga App 262, 287 SE2d 39 (1982); *Wakeman v. Paulson*, 257 Or 542, 480 P2d 434 (1971). *But, see: Walter A. Wood Reaping and Mowing Manufacturing Co. v. Angemeier*, 51 Ind App 258, 99 NE 500 (1912).

> The law which sends a corporation into the world with the capacity to act imposes upon its assets liability for its acts. The corporation cannot disable itself from responding by distributing its property among its stockholders and leaving remediless those having valid claims. In such a case the claims after being reduced to judgments may be satisfied out of the assets in the hands of the stockholders. *Pierce v. United States*, 255 US 398, 402 (1921).

But as describe in Sections 10.11 and 10.12 of this book, most cases hold that a creditor of an insolvent corporation may recover debts owed to the corporation by shareholders only through an equitable proceeding naming all creditors and all shareholders located within the jurisdiction. *Davis v. Olson*, 4 Wash App 390, 482 P2d 795 (1971); *Royer v. Maib*, 6 Wash 2d 286, 107 P2d 593 (1940); *Wakeman v. Paulson*, 264 Or 524, 506 P2d 683 (1973). This also seems to be the rule in actions to collect improper distributions after dissolution.

> From the principle thus established in this state the proper remedy of a creditor of an insolvent corporation to reach the fund alleged to have been paid to a stockholder as a dividend in liquidation is by a suit in equity and not by an action at law as commenced in the case at bar. *Garetson Lumber Co. v. Hinson*, 69 Or 605, 610, 140 P 633, 635 (1914).

A recent decision by the Washington Court of Appeals held that a creditor could proceed directly against the shareholders without mentioning any requirement that the plaintiff-creditor include other creditors as parties to the lawsuit.

> Recovery of corporate assets distributed to former shareholders upon dissolution is permissible in certain circumstances. Such recovery may be proper here, and we hold that Smith may proceed against [the shareholder defendants] individually. (footnotes omitted) *Smith v. Sea Ventures, Inc.*, 93 Wash App 613, 619, 969 P2d 1090, 1093, *review denied*, 138 Wash 2d 1003 (1999).

If a corporation sells its assets and, in exchange, receives insufficient consideration, the fraudulent transfer statutes may apply. RCW 19.40 *et seq.*; *Eagle Pacific Insurance Co. v. Christensen Motor Yacht Corp.*, 135 Wash 2d 894, 959 P2d 1052 (1998); *Hall v. Armstrong Cork, Inc.*, 103 Wash 2d 258, 692 P2d 787 (1984); *Allen v. Meinig*, 109 Or App 341, 819 P2d 744 (1991), *review denied*, 313 Or 209, 830 P2d 595 (1992).

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If just prior to, or after, insolvency, corporate assets are transferred to officers, directors, or shareholders for inadequate consideration, a court may disregard the corporate form and impose liability for corporate debts on the person or persons receiving the assets. The theory of corporate disregard is discussed in more detail in Chapter Ten of this book.

Disappointed creditors may seek relief by initiating an involuntary bankruptcy proceeding against the corporation under the United States Bankruptcy Code.

***C. Trust fund theory*.**

The "trust fund theory" was first set down by Mr. Justice Story in *Wood v. Dummer*, 3 Mason 308 (1824). Essentially, the trust fund theory provides that a corporation's capital stock, or if insolvent its assets equivalent to its capital stock, constitutes a trust fund for the benefit of its creditors. 15A FLETCHER CYC CORP § 7369 (Perm Ed 1990). A corporation's board of directors constitute the trustees of this trust fund.

> The doctrine that the stock of a corporation is a trust fund for the benefit of creditors is one which is founded in equity and fair dealing, and in any event has become so well established in this country that it can no longer be gainsaid. This doctrine was announced by Chancellor Kent, as early as 1824, in *Wood v. Dummer*, 3 Mason, 309, and since that time has become the established law of this country and is termed the "American doctrine," although, as shown in the case above referred to, the same doctrine had long been established in England; and so universally has this doctrine been accepted, in America especially, that the citation of authorities seems a work of supererogation. We will, however quote from 2 Morawetz on Private Corporations, § 820, the rule which is announced as follows:
>
>> Debts due a corporation are equitable assets, and may be reached by creditors through the aid of a court of chancery, if the legal assets which can be reached by execution prove insufficient. The liability of the shareholders to contribute the amount of their shares as capital is treated in equity as assets, like other legal claims belonging to the corporation. This liability, together with the capital actually contributed, constitutes the trust fund which in equity is deemed pledged for the payment of corporate debts.
>
> *Adamant Manufacturing Co. of America v. Wallace*, 16 Wash 614, 617-8, 48 P 415, 416 (1897).

By the turn of the century, cases began to limit application of the trust fund theory to situations "involving the liquidation of a corporation by sale of all its assets to another company." *Meikle v. Export Lumber Co.*, 67 F2d 301, 304 (9th Cir 1933). By as early as 1913, the Washington Supreme Court noted "that the expressions of this court, from time to time, have not been harmonious upon this question." *Lantz v. Moeller*, 76

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Wash 429, 434, 136 P 687, 688 (1913).

Under the trust fund theory, the assets of an insolvent corporation were deemed to be a trust fund for all creditors and the corporation was prohibited from preferring creditors. Corporate assets were to be distributed equally and
ratably among all creditors. One court has said that the trust fund theory means that:

> an insolvent corporation may not prefer its creditors; that, although an individual creditor may do so, even to the exhaustion of his property, the right does not exist in a corporation; that its property on insolvency becomes a trust fund for the benefit of all of its creditors to be equally and ratably distributed among them. *Woods v. Metropolitan Nat. Bank*, 126 Wash 346, 218 P 266, 267 (1923).

The trust fund theory applied to all corporate assets at the time of insolvency.

> The assets of an insolvent corporation constitute a trust fund for the payment of its creditors. Those assets may consist of property in the possession of the corporation, accounts receivable, choses in action, claims of various kinds, as well as unpaid stock subscriptions, payments made to creditors in preference of the rights of other creditors, statutory claims against officers and trustees, and rights against stockholders for dividends paid out of capital. *Gaunce v. Schoder*, 145 Wash 604, 261 P 393, 393 (1927).

Under the trust fund theory, a creditor could seek to have a court set aside preferential transfers. The proceeding was in equity. *Gaunce v. Schoder*, 145 Wash 604, 261 P 393, 393 (1927). In such an action, the creditor was required to prove: (i) that the disputed transfer occurred while the corporation was insolvent; (ii) that the asset depleted corporate assets; and (iii) resulting damage to the creditor. *Cargill, Inc. v. American Pork Producers, Inc.*, 426 F Supp 499, 507 (D S Dak 1977).

***D. Washington's statute on preferences*.**

The trust fund theory, in its broadest construction, is not widely followed today. At one time it could be said "no jurisdiction followed [the trust fund theory] more consistently or extended it further than Washington." Ellis & Sayre, *Trust Fund Doctrine Revisited, Part I*, 24 WASH L REV 44, 44 (1949). But Washington stopped applying a strict trust fund theory in 1931 when:

> the legislature confirmed the doctrine but limited its application to two types of transfers; first, all those made during insolvency to a creditor having reasonable cause to believe he was receiving a preference, and second, all preferential transfers occurring within 4 months of the date of application for appointment of a receiver. *Block v. Olympic Health Spa, Inc.*, 24 Wash App 938, 947, 604 P2d 1317, 1323 (1979).

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See also: Whiting v. Rubinstein, 7 Wash 2d 204, 109 P2d 312 (1941).

The Legislature further limited the application of this doctrine in 1941 when it enacted a statutory scheme for dealing with transfers at about the time of insolvency. *Engstrom v. De Vos*, 81 F Supp 845, 857 (ED Wa 1949). As amended, these procedures are in effect today.

Under these statutory procedures, a creditor is permitted to seek the appointment of a receiver by the court and to have that receiver cause to be set aside preferences made by the corporation to other creditors. RCW 23.72.020. Any such proceeding is governed by equitable principles. *Glendale Realty, Inc. v. Tennis World of Seattle*, Inc., 52 Wash App 892, 765 P2d 325 (1988).

The 1941 legislation, together with a 1959 amendment, today permits the court to appoint a receiver for the corporation and to set aside preferences made within the four months before the date that application is made for the appointment of the receiver.

> Any preference made or suffered within four months before the date of application for the appointment of a receiver may be avoided and the property or its value recovered by such receiver, if the person receiving the preference or to be benefited thereby or his agent acting therein shall then have reasonable cause to believe that the debtor corporation is insolvent. No preference made or suffered prior to such four months' period may be recovered, and all provisions of law or of the trust fund doctrine permitting recovery of
>
> any preference made beyond such four months' period are hereby specifically superseded. RCW 23.72.030.

If the court finds that a creditor received a preference, it will order the preferential amount turned over to the receiver for pro rata distribution to all creditors adversely affected by the preference.

> Should [the corporation's] creditors -- acting through a receiver -- be successful in invalidating the preference, recovery would be measured by the amount of transfer, not by the corporation's liability on the lease. This is best illustrated by assuming the following hypothetical example:
>
> > Corporation X owes A $30,000 and corporate officer B $3,000.
> >
> > X becomes insolvent.
> >
> > B prefers himself with a $3,000 payment.
> >
> > No receiver is appointed
> >
> > A sues B.

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> Under [the theory of the creditor who initiated the lawsuit], B becomes personally liable to A for $30,000 merely to avoid the alleged circuity involved in having a receiver appointed. But, we perceive no particular circuity in requiring an insolvent corporation's creditors to proceed through their representative so they may share ratably in any recovery, instead of proceeding individually for their own accounts. In the illustration X is always liable to A for $30,000, but the damage to X -- and ultimately its creditors -- from B's act does not exceed $3,000. Clearly there is no basis in law demanding that B pay X's debt to A. *Block v. Olympic Health Spa, Inc.*, 24 Wash App 938, 950-1, 604 P2d 1317, 1325 (1979).

Even if a preferential transfer does not fall within the four month period before the filing of the action to appoint a receiver, the transfer may still be set aside by the more general fraudulent conveyance statutes. RCW 19.40 *et seq.* Thus in one case, a preference to an officer, made more than four months before the litigation commenced, was set aside by the court on the grounds that it was not supported by fair consideration. *Tacoma Association of Credit Men v. Lester*, 72 Wash 2d 453, 433 P2d 901 (1967).

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