10-1-1934

Unscrambling Rights in Pennsylvania Building and Loan Associations

Nochem S. Winnet

Follow this and additional works at: https://ideas.dickinsonlaw.psu.edu/dlra

Recommended Citation
Available at: https://ideas.dickinsonlaw.psu.edu/dlra/vol39/iss1/2

This Article is brought to you for free and open access by the Law Reviews at Dickinson Law IDEAS. It has been accepted for inclusion in Dickinson Law Review by an authorized editor of Dickinson Law IDEAS. For more information, please contact lja10@psu.edu.
Problems confronting building and loan associations are increasing in number and difficulty. Rights are becoming more scrambled. This comes as a distinct shock to shareholders who remember the naive simplicity with which associations were operated. They are confounded when they see arising out of the decisions, an unfamiliar entity, a legal form shaped by the forces of adversity and depression, a form which even the lawyers and courts are finding difficult to classify.

What is a building and loan association? Is it a corporation? Yes. Is it a partnership? Maybe. Is it a private business? Hardly. Why is it necessary to know just what it is? Because, unless we have some clear conception we cannot answer the complexing problems that confront building and loan associations—answers the courts have not as yet given.

We start from the principle that a building and loan association is a corporation. Unlike a shareholder of any other corporation, a shareholder may bring an action to recover the value of his stock. Unless insolvency be shown, such shareholder is entitled to judgment for the value of his stock. The courts have also held that he cannot have judgment if the effect will be to render the association insolvent. But, it would seem that the shareholder should still be entitled to judgment for the value of his stock, whatever it may be, subject to a restraint of execution, to prevent embarrassment to the association.

The present article concerns itself particularly with rights of shareholders in an embarrassed association, where there is the problem of unscrambling the various rights of shareholders of different classes, and of creditors whose claims do not arise through the ownership of shares. Unless the fundamental conception be kept clearly in mind, the form we shall find ourselves with, will indeed be an uncontrollable monster.

A building and loan association is a corporation formed for the purpose of

*AB., Harvard, 1920; LL.B., Harvard, 1923; Member of the Pennsylvania Bar.

2Christian's Appeal, 102 Pa. 184 (1883).
3Stone v. Schiller B. & L. Association, supra; O'Rourke v. West Penn Loan Association, 93 Pa. 308 (1880).
enabling its shareholders or members, by a process of gradual and compulsory savings, to accumulate a fund to purchase a homestead, or a fund for the private use of the members. It contemplates, certainly in Pennsylvania, participation by the shareholder in control and in sharing of profits. So much is this true, that the court lately has said definitely that a building and loan association has the features of a partnership. In Stone v. Schiller B. & L. Association, it is said:

"A building and loan association is much like a partnership though possessing corporate rights. . . . Where an investment in a building and loan association turns out to be doubtful and the directors by careful and prudent management, can save the venture or greatly minimize the loss, these officers should be given every opportunity to bring the matter to a successful conclusion. This is a fundamental idea of partnership . . . that the shareholder owes a duty to his fellow members of the so-called partnership not to place them, as well as himself, in a position where unnecessary loss must be suffered."

This conception is fundamental, and if it be borne in mind at all times, the recent decisions are readily understandable, and the future ones more easily predictable. If the shareholder is truly a partner, then it follows logically he cannot ask for the value of his stock before creditors whose claims do not arise through the ownership of shares. He cannot ask for the value of his shares and obtain a preference over shareholders in the same class. Both of these propositions are clearly set forth in Weinroth v. Homer B. & L. Association, and Nice Ball Bearing Co. v. Mortgage B. & L. Association. No law, however, has yet been passed or declared which sets forth how long a demanding shareholder can be held off. The courts have clearly indicated that a restraint of execution on a judgment obtained by a shareholder is proper as an exercise of the equitable power to prevent an undue preference or even an injustice. That same equitable power must impose the restraint to give an

---

6Supra, Note 1. In Sperling v. Euclid B. & L. Association, 308 Pa. 143, 148 (1932), Mr. Justice Simpson in discussing restraints on executions by shareholders having judgments, says: "all of whom are or were, in essence . . . partners in the common enterprise." In Publicker v. Potash B. & L. Association, 104 Pa. Superior Ct. 530, 533 (1931) it is said, "a shareholder owes a duty to his fellow members of the so-called partnership, to not place them, as well as himself, in a position where unnecessary loss must be suffered. He should not embarrass the association by suit or judgment." Sharps v. Homer B. & L. Association, 111 Pa. Superior Ct. 556 (1934).
7310 Pa. 265 (1933). "The fundamental principle is that a withdrawing shareholder is entitled only to his proportionate share of the profits of the association after the payment of creditors. He may not gain any preference by prosecuting his claim to judgment."
7310 Pa. 560 (1933).
8Weinroth v. Homer B. & L. Association, supra, 271: "Equity is not powerless to act when appealed to even though no previous steps have been taken to safeguard all these rights, and for this purpose may stay an execution issued to gain a preference."
embarrassed association a full opportunity to liquidate in an orderly and reasonable manner. It may be a matter of months or a matter of years, depending on circumstances. Until it be shown that the liquidating trustees are delinquent, no further embarrassment should be cast on them by allowing the shareholder to issue execution. Remember, the shareholder is like a partner, and, while he himself has no personal liability, the fund which he has committed to the association has a full liability which it cannot escape until a proper accounting and dissolution.

How far can an embarrassed association go in making payments to demanding shareholders? Here, too, if the fundamental conception of a partnership be kept in mind, the answer to the question will follow logically. A partner can be paid out if the assets remaining are sufficient to take care of debts. In a solvent association, there is no question about a shareholder's right of withdrawal; just as clear a right as that of a partner to withdraw from a solvent partnership. If it is an operating association and there are many shareholders who have given notice of withdrawal, there is no reason why a settlement can not be made where the association derives a benefit. This, it is thought, is prohibited by the new Building and Loan Code. But there is no apparent reason why the association should not be allowed to negotiate with withdrawing shareholders if it be done on a fair and open basis. Formerly shareholders were compelled to bid on the premiums to be paid for a loan; now they might be made to bid a premium for receiving payment.

Suppose, after settlement with the withdrawing shareholder, conditions turn out to be worse than had been anticipated and it now looks as if this shareholder has made an excellent bargain. Can he be made to return the excess? Again, let us look to partnership law. If a partner has been paid out, such action is final, except in a case where there was a mutual mistake of fact. Partners stand in a position of trust to each other. One should not

10Weinroth case, p. 274: "The court below should give defendant without security reasonable time to ascertain and fix the rights of all shareholders in equal right. A reasonable time should consider liabilities and assets, with a view to prevent unnecessary loss to the latter."

Nice Ball Bearing case, p. 570: "In determining what is a reasonable time, due consideration should be given to liabilities to the public authorities, accruing and to accrue, to the necessity for keeping the real estate belonging to the new association in such a condition as to preserve its value and to render it income-producing; and to the wisdom of strengthening the new association as an effective organization."

11See Uniform Partnership Act, March 26, 1915, P. L. 18, sec. 36.


13See Building and Loan Code, sec. 616.

14See Endlich on Building Associations, Ch. XIV, Premiums, p. 376: "The premium which is to be paid by any member, upon an advancement made to him by the society, must be fixed by free and open competition between all the applicants, and in no other way. It is the price to be obtained for obtaining preference before other members, who may desire the same loan, . . . "
profit at the expense of the other and if a mistake is made, there is no reason why recovery should not be allowed. Thus, it has been held by the courts that suits may be brought to recover amounts paid by mistake by an association. An illegal maturity may be upset and suits brought to recover payments made. If, however, the payment to the stockholder represents a settlement made with him, in which settlement there was a distinct benefit to the association, no possible interest can be served by allowing the association to upset the settlement, because in the end it did not turn out so favorably. The law has always favored settlements, and as long as no fraud or mistake in the negotiations be shown, it should be allowed to stand.

This does not offend the principle that all shareholders in the same class must share equally. A partner may get out at the right time and so may a shareholder. It has been held that a shareholder is not chargeable with losses after his notice of withdrawal has matured.

In Sullivan v. Ideal B. & L. Association, the Supreme Court held that an association must, when it is solvent, appropriate the value of the stock on account of a mortgage when requested by a shareholder. But, in the event of later insolvency the shareholder must share losses which occurred during the time of his membership. This view can only be defended on the theory that when the appropriation is made the shareholder does not cease to become a member, and therefore, as a member, is chargeable with losses which might have accrued during his term of membership. It should not be held to be an authority in a case of actual settlement made with a shareholder.

The problems may become more complex. An association faced with withdrawals which have matured and cannot be paid, is eventually forced either to merge, revalue its stock, or liquidate. The rights of shareholders become more scrambled. What are the rights of such a shareholder in a merged association, and what are his rights in an association that is liquidating?

A merged association usually provides that all payments on free shares

---

15Sperling v. Euclid B. & L. Association, supra, Note 6: "... upon clear proof of a mistake or fraud resulting in an untimely declaration of maturity, relief will be given against the effects thereof, though defendant was not insolvent at that time. Kurtz v. Buback, 39 Pa. Superior Ct. 370."

16Endlich on Building Associations, supra, Note 5, p. 93: "The better and more logical doctrine would seem to be that the existence of a state of insolvency at the time of the giving of the withdrawal notice, ascertained at any time before actual payment of the claim, renders the notice abortive and destroys the right to withdraw or to claim any benefit under the notice already given. This principle, does not, of course, invalidate settlements already made in good faith with withdrawing members who have been paid out."

See also Miller v. Jefferson Building Association, 50 Pa. 32 (1865).

17Stone v. Schiller B. & L. Association, supra, Note 3, p. 554: "A withdrawing shareholder is not obliged to share losses after a notice of withdrawal has been given to a solvent corporation."

18313 Pa. 407 (1934).
shall thereafter be on a preferred basis, not chargeable with accrued losses. It is sometimes provided that the dues on free shares be segregated so that the shareholder may at least withdraw 100 cents on the dollar on money paid in after the reorganization. What are the rights of such a shareholder, first, as against creditors, and, second, as against other shareholders? Again the partnership analogy is helpful. Partners cannot attract new capital and say it shall not be answerable for old debts. If it becomes a part of the capital then it is liable for the debts, whether such debts be new or old. Neither can a corporation segregate a fund from the sale of new stock and say that it shall not be answerable for the debts of the corporation. The funds of capital stock have always been considered a trust for creditors. Unless some act of the creditors can be interpreted as an inducement to the shareholders to continue payments and thereby create an estoppel, it would seem that all payments must be subject to the claims of creditors. As between the shareholders themselves, a different situation arises. As an old shareholder, he is estopped from proceeding against new funds which were brought in for the purpose of enabling the association to better its condition. A withdrawing partner has no basis of claim against a new partner who is coming in with the understanding that he is to be preferred on his investment. It cannot prejudice the old partner and certainly may help him.

While a new shareholder may be preferred as against the old, nevertheless the old shareholder who does not assent to the merger is in a preferred position to the new one. This principle was considered surprising when announced in the Nice Ball Bearing case because it penalized the shareholder who had faith in the building and loan association, and in the future. The law, however, is sound either from a partnership conception or a corporate one. The Nice Ball Bearing case bases it on corporate law. It states that it is a shareholder's constitutional right to refuse to become a member of the new association. This case, as well as the Weinroth case, for the first time defines the relative rights of claimants in a merged building and loan association. The order of preference set out is: (1) The claims of preferred or general creditors; (2) Withdrawing shareholders, including matured shareholders; (3) Dissenting shareholders or those who did not consent to or join

19Under the new Building and Loan Code it would seem that dues paid in after an order of segregation by the Banking Department cannot be reached by creditors. Sec. 808 provides: "Such segregated fund shall not be subject to any attachment issued on a judgment obtained by any creditor or shareholder of the association."


21Bell’s Appeal, 115 Pa. 88 (1886).

22Nice Ball Bearing case, p. 569: "Only those who assented to the merger . . . became members of the new association, entitled to all its assets and to all profits subsequently made, subject (1) to debts due to public authorities; (2) to the creditors whose claims did not arise by reason of their having once been shareholders; and (3) to the creditors whose claims did thus arise."

23p. 271.
the merger; (4) Assenting shareholders, or those who joined the merged company.

Even this simple order of distribution may carry with it complex problems of administration when the liquidation involves an association which is a merger of more than one other association. Suppose you have the A, B, C and D Associations, merged into E Association at different times. What are the relative rights between non-assenting and dissenting shareholders of the A Association as between creditors of B and C Associations on a liquidation of E Association? What are the rights between creditors of A and creditors of D as to the assets of E? The Supreme Court has indicated that it is a problem of marshalling of assets. "There may be a clash between creditors of the constituents and those of the merged company. We do not pass on this question. Nor do we pass on the right of a creditor of a merged association as opposed to rights of dissenting and withdrawing members of a constituent. All these contests may become a question of marshalling of assets." 24

Technically, however, it is no such problem. The rule of marshalling does not prevail except where there are funds or properties in the hands of a common debtor, on both of which funds one creditor has a claim or lien. 21 In a merged association there is only one fund and the creditor of the constituent may claim it. His rights, however, are no higher than the other creditors. 26 If a non-assenting shareholder of A could become a real creditor of B, then it would seem that he should share equally with other creditors. But the law is clear that a creditor whose claim arises through the ownership of shares is deferred to general creditors. 27 He is not a real creditor. His payments on shares must be regarded as his capital investment, and until it can be withdrawn from the business, it remains subject to the payment of all creditors. This can only be defended if the conception of partnership be kept in mind. 28

It is a hardship on a non-assenting shareholder of A to be held off, to have any execution process on a judgment stayed, and to be required to wait even until the general creditors of D and E are paid. The hardship, however, is inevitable. There is no personal liability on his part, but the fund which he has entrusted to the association is liable to the full extent. Creditors who have had no part of the venture are entitled to be paid first. 29 The shareholder as a partner took a chance on profits and he must assume the risk

24Weinroth case, p. 272.
25Knoup's Appeal, 91 Pa. 78 (1879); Taylor's Appeal, 81 Pa. 460 (1876); Schwartz’s Estate, 290 Pa. 420 (1927).
28See Uniform Partnership Act, March 26, 1915, P. L. 18, sec. 40, on Distribution: "The liabilities of the partnership shall rank in order of payment as follows: I. Those owing to creditors other than partners." Sec. 41. " . . . . if the business is continued without liquidation of the partnership affairs, creditors of the first or dissolved partnership are creditors of the partnership so continuing the business."
of a loss. The only protection afforded such a shareholder is in a proper liquidation. The Banking Department is always in the background to interfere and control if the liquidation is not properly conducted.\(^{30}\)

As between shareholders themselves, the law is clear that the non-assenting one is to be preferred as against the consenting.\(^{31}\) Suppose, however, the assets of A, upon liquidation of E, prove to be a total loss. The non-assenting shareholders of A must be accorded prior rights to the extent of their interest. The E association must be deemed to have taken it over at the value set in the merger, which value they must pay.\(^{32}\) The merger or marriage was for better or for worse. In a way it is carrying out the principle enumerated that a shareholder is not responsible for losses accrued after his rights matured by notice of withdrawal or maturity of stock. But this rule cannot be carried out to its logical conclusion. Suppose shareholder No. 1 in A Association has given notice of withdrawal on January 1st. His rights mature January 31st. Shareholder No. 2 has matured shares as of February 15th. Shareholder No. 3 has dissented to a merger as of March 15th. Suppose the A Association has decided to drop a property as of February 1st. Can it really be said that the loss accrued February 1st and shareholder No. 1 is not chargeable with it. The seed of loss is planted when the investment is first taken. For practical purposes the rights of shareholders No. 1, 2 and 3 cannot be distinguished. They cannot by notice or by some simple act remove their capital from the danger of the investments made years back. Reserves which were set up have been usually found inadequate. On a merger, however, the rights of the non-assenting shareholders or dissenting ones are determined, and to that extent they are no longer chargeable with losses that occur.\(^{33}\) At all times, nevertheless, their investment is still subject to claims of creditors and the proportionate expense of administration, for to that extent such expenditures must be deemed for their benefit as well as those who remain in the merged association.\(^{34}\)

There may still be difficulties in valuing the contribution of the shareholders who did not go along with the merger. Suppose shareholder No. 1 has paid in $150. On the merger agreement it is valued at $100. On final liquidation the assets of A prove to be worth one-half of their appraisement at the time of the merger. How much should shareholder No. 1 be allowed as to the assets of E? It should be $100 less a proportionate charge for ad-

---

\(^{30}\)Publicker v. Potash B. & L. Association, supra: "They (Banking Department) may be relied on to keep the affairs of the concern on an even keel and prevent over-reaching, if any is attempted."

\(^{31}\)See Nice Ball Bearing case, p. 569.


\(^{34}\)In Sharp v. Homer B. & L. Association, supra. Judge Keller said: " . . . . no person whose claim arose by reason of his being a shareholder should be permitted to prejudice the superior rights of creditors who are preferred to him, or obtain advantage over others occupying the same relationship as himself."
ministration expenses. It is the value set in the merger and to that extent it is a burden which the merged association has taken over and to which the consenting shareholders agree.\textsuperscript{56}

In unscrambling the rights, the hardships are many. The new Building and Loan Code contemplates that even creditors might be restrained from executing on their judgments. It is provided that all creditors should be paid in equal proportion.\textsuperscript{59} This undoubtedly means that no one creditor should be allowed to obtain a preference by execution process. The courts have the power to prevent even such a creditor whose claim does not arise through the ownership of shares of stock from disturbing orderly liquidation.\textsuperscript{57} But, in particular, the hardship is severe on a matured shareholder or a withdrawing shareholder who may find their apparent security gone. But is there really the hardship that appears on paper? Technically, there may be enough to pay the non-assenting shareholder, nevertheless, a forced liquidation would in all probability result in a terrific shrinkage and loss.\textsuperscript{58} Likewise, a consenting shareholder who has faith in the future and is willing to try to work out the problem may be penalized for that very thing. These problems are problems which all partners have in a business which they have set up. Because there may be a hardship does not mean that there is a corresponding injustice. Until the instruments by which justice is measured are made finer, when losses in investments and real estate may be measured by accurate machines, and the assets mechanically and simultaneously turned into cash, all we can approximate in unscrambling the rights is a rough justice. To reach such a justice, it is submitted, that a partnership conception will be helpful.

\textsuperscript{56}The distinction must be between taking the assets for liquidation and taking it for the purpose of continuing in business, as in a merger. In Adams v. Hubbard, 221 Pa. 511 (1908), an account was stated upon a partnership dissolution. Held, that the amount of the account could be reduced by a subsequent shrinkage in the value of the assets, because liquidation of assets was contemplated.

See also Friedman v. Southern Co-operative B. & L. Association, supra; Budd v. Logan Home Buyers B. & L. Association, supra.

\textsuperscript{58}See Adams v. Hubbard, supra.

\textsuperscript{58}See Adams v. Hubbard, supra.