Michigan Law Review

Volume 39 | Issue 4

1941

CORPORATIONS - OFFICERS AND DIRECTORS - DUTY TO INVESTIGATE PURCHASERS OF CONTROLLING INTEREST

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CORPORATIONS — OFFICERS AND DIRECTORS — DUTY TO INVESTIGATE PURCHASERS OF CONTROLLING INTEREST — Plaintiff corporation, an investment trust specializing in shares of small life insurance companies, brought an action against its former officers and directors, referred to as "the management group," who in 1937 owned twenty-seven per cent of the outstanding stock of the corporation. This group sold all their stock at an inflated price to another group, referred to as "the Boston group," who on the resignation of the management group immediately elected themselves to the control of the corporation. By this control the Boston group obtained access to the portfolio and proceeded systematically to rob the corporation of all its securities. At the time the stock was sold the management group had some inkling of the purposes of the Boston group. No investigation of the purchasers was made, though the vendors were warned of their possible liability. The court assumed the situation should have awakened the suspicion of prudent men, and adequate facilities to make an investigation were available. *Held*, under these circumstances the transaction must be treated as a sale of the control of the corporation, not a mere sale of its stock; and as the vendors of that control had not made a reasonably adequate investigation of the purchasers, though put on guard, they must be liable for the harm that resulted to the corporation. *Insuranshares Corporation of Delaware v. Northern Fiscal Corp.*, (D. C. Pa. 1940) 35 F. Supp. 22.

The directors and officers of a corporation, having control of its assets and affairs and possessing the ability to inflict great harm upon it, occupy a fiduciary position.[1] As regards third persons they are treated as agents of the corporation, but as to the corporation itself equity holds them liable as trustees, though they are not such in a technical sense.[2] It is this fiduciary duty which requires the officers and directors to investigate the motives of those who seek to purchase

[1] Gochenour v. George & Francis Ball Foundation, (D. C. Ind. 1940) 35 F. Supp. 508; Bosworth v. Allen, 168 N. Y. 157, 61 N. E. 163 (1901).

[2] 55 L. R. A. 751 (1902); 13 AM. JUR. 948 (1938); 14A C. J. 97 (1921).

the control of the corporation.[3] An outright sale of an official position in the corporation is a definite breach of trust by the directors and officers [4] as is similarly the sale of positions on the board of directors,[5] even though the sale may ostensibly be a sale of shares of stock in the corporation. For these breaches of trust there must be an accounting to the corporation.[6] Removal from office will ordinarily terminate this fiduciary duty and the former officers and directors can deal with the corporation as strangers,[7] but if an act was started while they were in office its completion is still regarded as their act.[8] Also, a conspiracy to rob the corporation will give a continuing liability to officers and directors of such a nature that they will be required to account for the malfeasance of their successors.[9] However, there is nothing unlawful in officers and directors dealing in the securities of their corporation.[10] As individuals, they have the same right to sell their shares as have all other stockholders.[11] They may even make an additional profit from the sale of their shares [12] but it must not be made at the expense of the corporation.[13] The important thing is that they make a bona fide sale of stock. Where the owners of the control of the corporation are seeking indiscriminately the highest selling price for their shares as a block, completely

[3] Field v. Western Life Indemnity Co., (C. C. Ill. 1908) 166 F. 607; and principal case.

[4] Field v. Western Life Indemnity Co., (C. C. Ill. 1908) 166 F. 607, affd. Moulton v. Field, (C. C. A. 7th, 1910) 179 F. 673.

[5] McClure v. Law, 161 N. Y. 78, 55 N. E. 388 (1899); Heineman v. Marshall, 117 Mo. App. 546, 92 S. W. 1131 (1905); Oil Shares v. Kahn, (C. C. A. 3d, 1938) 94 F. (2d) 751, reversed on other grounds, sub nom. Oil Shares v. Commercial Trust Co., 304 U. S. 551, 58 S. Ct. 1059 (1938).

[6] Some cases hold that the officer-vendor has only to account for the amount of the purchase price he received. Field v. Western Life Indemnity Co., (C. C. Ill. 1908) 166 F. 607; McClure v. Law, 161 N. Y. 78, 55 N. E. 388 (1899); Heineman v. Marshall, 117 Mo. App. 546, 92 S. W. 1131 (1905). But there is authority that he is liable for the full extent of the injuries caused to the corporation by his successors. Oil Shares v. Kahn, (C. C. A. 3d, 1938) 94 F. (2d) 751; Moulton v. Field, (C. C. A. 7th, 1910) 179 F. 673; and see principal case.

[7] Holmested v. Annable, (Saskatchewan, 1914) 18 Dom. L. R. 3.

[8] Hooker, Corser & Mitchell Co. v. Hooker, 88 Vt. 335, 92 A. 443 (1914).

[9] As part of a preconceived plan the officers and directors replaced themselves with the actual malfeasors. Bosworth v. Allen, 168 N. Y. 157, 61 N. E. 163 (1901).

[10] Miles v. Aqua Pura Co., 208 Ky. 816, 271 S. W. 1101 (1925); Seitz v. Frey, 152 Minn. 170, 188 N. W. 266 (1922). Some authorities require in the purchase of stock of a corporation that a director disclose any facts affecting the value of the stock, though others feel that the officer is a fiduciary only to the corporation and not to the stockholders. Cf. Seitz v. Frey, supra.

[11] 13 AM. JUR. 966 (1938); 19 C. J. S. 171 (1940); Trisconi v. Winship, 43 La. Ann. 45, 9 So. 29 (1891); Insurance Agency Co. v. Blossom, (Mo. App. 1921) 231 S. W. 636; Donaldson v. Anderson, 300 Pa. 312, 150 A. 616 (1930).

[12] Porter v. Healy, 244 Pa. 427, 91 A. 428 (1914); Stanton v. Schenck, 142 Misc. 406, 252 N. Y. S. 172 (1931).

[13] Stanton v. Schenck, 142 Misc. 406, 252 N. Y. S. 172 (1931). It is also felt that a director cannot make an additional secret profit from the sale of his stock where he is selling all the stock of the corporation as a complete sale of the corporation. Porter v. Healy, 244 Pa. 427, 91 A. 428 (1914).

disregarding the character of the purchasers and their means of payment, there is a strong indication that a sale of control rather than a sale of stock is contemplated.[14] Immediate resignation by the vendors from the office of directors, with succession by the purchasers, following the sale of shares is further indicative of such a sale of control.[15] Both these factors were present in the principal case, so it was to be expected that the court would deem the transaction a sale of control giving rise to a fiduciary duty to investigate the designs of the purchasers. Since the duty was breached when no investigation was made, the vendors are liable for the losses caused by the acts of the purchasers. The apparent willingness of the former officers and directors to permit their successors a free hand with the corporate assets might further be treated in the nature of a conspiracy to rob the corporation. This theory gives additional support to the decision of the principal case that the corporation could recover from the former officers and directors to the full extent of the malfeasance of their successors.[16]

[14] See principal case.

[15] McClure v. Law, 161 N. Y. 78, 55 N. E. 388 (1899); Heineman v. Marshall, 117 Mo. App. 546, 92 S. W. 1131 (1905).

[16] See note 6, supra.