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CORPORATIONS—LIABILITY OF PROMOTERS FOR SECRET PROFITS—In view of the peculiar position of control which a promoter occupies in relation to the proposed corporation, with resultant opportunities for making unconscionable profits, courts have uniformly regarded him as standing in a fiduciary relationship toward the corporation.[1] Accordingly, when a promoter seeks to make a profit from a transfer of property to the corporation, he must obtain the consent of the latter under penalty of having to disgorge such profit at a later time at the suit of the corporation itself or persons acting in the latter's behalf.[2] Such liability is to be distinguished from the liability of a promoter to purchasers individually for fraudulent misrepresentation in the sale of corporate securities.[3] And it is not to be confused with the totally different rule that creditors of an insolvent corporation may recover from promoters where stock has been issued to the latter in exchange for property put in at gross overvaluations.[4]

I.

Having taken a secret profit, a promoter may pursue one of four courses in order to secure corporate approval:[5] (1) He may provide an independent board of directors, not under his control directly or indirectly, and make full disclosure to the corporation through them;[6] (2) he may make a full disclosure to each original subscriber of shares

[1] EHRICH, PROMOTERS 171-174 (1916); 18 L. R. A. (N. S.) 1106 (1909).

[2] EHRICH, PROMOTERS 185-186 (1916); 85 A. L. R. 1262 (1933).

[3] If the promoters are guilty of concealment or misrepresentation toward a subsequent stockholder or bondholder in the sale of corporate securities, the latter's injury, if any, is personal to himself and does not affect the corporation or the collective rights of the stockholders, and his remedy is by individual action against the promoters, and not in the name of the corporation. See Foster v. Seymour, (C. C. N. Y. 1885) 23 F. 65.

[4] BALLANTINE, PRIVATE CORPORATIONS 653-685 (1927). It should be noted that liability under this doctrine is not imposed upon the promoter, as promoter, but rather upon him as stockholder. Manhattan Trust Co. v. Seattle Coal and Iron Co., 19 Wash. 493, 53 P. 951 (1898). The body of law as to stockholders' liability to creditors on bonus and watered stock is inapplicable in the case of issuing no-par stock. BALLANTINE, PRIVATE CORPORATIONS 685-694 (1927).

[5] The four methods which follow in the text were laid down by Rugg, J., in Old Dominion Copper Mining and Smelting Co. v. Bigelow, 203 Mass. 159, 89 N. E. 193 (1909).

[6] "The legalization of promoters' profits by means of a disclosure to an independent board of directors, appears upon careful consideration to be a matter of theory rather than of practice. The cases must indeed be rare where a promoter, having acquired property or the control thereof, is willing to go to the labor and expense of organizing a corporation to take it off his hands, and then, without any inquiry as to their views in the matter, to select a board of directors quite free from his control to decide upon the advisability of consummating the transaction." EHRICH, PROMOTERS 207 (1916).

in the corporation; [7] (3) he may procure a ratification of the transaction after disclosing its circumstances by vote of the stockholders of the completely established corporation; [8] and (4) he may be himself the real subscriber to all shares of capital stock contemplated as part of the promotion plan.[9]

Whatever course is followed, it should be noted that the ultimate objective of the promoter in securing corporate approval[10] is in each instance to avail himself of the rule that a principal may condone a breach of trust committed by his agent.[11] However, it should not be assumed that the problem of getting corporate approval has been conclusively solved by simply following the one or the other rule, for, not infrequently, a promoter may find himself accountable to the corporation, in spite of the fact that he could show a technical compliance with the rules governing condonation.[12]

The cases dealing with the liability of promoters for failure to disclose secret profits may be classified in accordance with certain types of promotion plans commonly in use.[13] Thus, where the entire capital stock has been issued to the promoters at the time of the transaction complained of, it has generally been held that the corporation has no cause of action against them.[14] Similarly, the promoters are not liable

[7] Who are *original* subscribers within the meaning of this rule? See Allenhurst Park Estates v. Smith, 101 N. J. Eq. 581, 138 A. 709 (1927), where the court said at page 596:

> "even where all of the stock of the corporation is issued to the promoter in return for property transferred to the corporation by him, if he has in advance sold any portion of that stock to the public . . . the purchaser is then one of the real parties in interest at the time of the transaction, and without his consent the transaction will not be permitted to stand. . . . *Such a purchaser is considered an original subscriber to stock notwithstanding the fact that the stock is in the first instance issued to the promoter. . . .*" (Italics the writer's.)

[8] See EHRICH, PROMOTERS 227-232 (1916).

[9] It will be seen that the crucial problem here turns on the meaning of the words *real subscriber*. Cases involving this point may be found in 85 A. L. R. 1289-1296 (1933). Cf. note 7, supra.

[10] EHRICH, PROMOTERS 201 (1916).

[11] BALLANTINE, PRIVATE CORPORATIONS 166-171 (1927).

[12] In Torrey v. Toledo Portland Cement Co., 158 Mich. 348, 122 N. W. 614 (1909), the promoters had formally subscribed for all the stock of the corporation, but immediately returned it to the corporation to be sold as treasury stock to uninformed outsiders. Held, the promoters are liable for failure to disclose secret profits to innocent purchasers of the stock.

[13] See annotation in 85 A. L. R. 1262 (1933).

[14] See Hays v. The Georgian, Inc., 280 Mass. 10 at 17, 181 N. E. 765 (1932), in which Rugg, C. J., stated the rationale of the rule as follows:

> "The reason . . . is that all persons contemplated as having a present or potential interest in the corporation as original subscribers of capital have assented to the profit or, knowing of it, have failed to repudiate it. Buyers of stock from such

to the corporation where, at the time of the transaction complained of, only a part of the capital stock has been issued to them, there being no present intention on the part of the promoters to have the corporation issue further stock to outsiders.[15]

On the other hand, where the promotion plan contemplates the issuance of further stock to the public,[16] the courts have divided on the question whether the assent of future stockholders is necessary to condone the promoter's breach of trust.[17] Under the Massachusetts rule [18] the promoter's duty of disclosure extends not only to those persons who were stockholders at the time of the transaction complained of, but also

> original subscribers take it subject to its incidents and burdens in the hands of the vendors. Such subsequent transferees may sustain an injury personal to themselves, but that is not an injury to the corporation or to all the stockholders collectively."

The rule laid down in Hays v. The Georgian is subject to certain qualifications based upon the question of good faith attending the issuance of the entire stock to the promoters. Thus, where the entire issue of stock has been taken by the promoters and then returned to the corporation as treasury stock to be sold to innocent purchasers in pursuance of the preincorporation scheme, the promoters have been held liable to the corporation. Similarly, where there exists at the time of the transaction in question, in addition to the intention of the promoter to invite the public to take stock in the corporation in the future, an actual sale or agreement to sell shares to innocent outsiders, the promoters have been held liable, although they held all of the stock that had been formally issued at the time of the transaction. See 85 A. L. R. 1289-1296 (1933).

[15] Re British Seamless Paper Box Co., 17 Ch. D. 467 (1881). Promoters issued part of the capital stock to themselves, having no intention to invite outsiders to purchase stock. Subsequently, additional capital being required, the balance of the stock was sold to outsiders without disclosure of profits that had been made by the promoters during the formation of the corporation. In holding the promoters not liable in a suit by a liquidator on behalf of subsequent stockholders, Brett, L. J., said at page 478:

> "at the time when this transaction was entered into and completed not only did every member of the company know of the transaction and accept it, but it was not in the mind of anybody that anyone else should become a member of the company. If that was the intention of all the parties at the time, it is impossible to say that there was any secrecy, and there being no secrecy, and everybody consenting, there could be no fraud."

[16] The manner of determining whether or not a given promotion scheme contemplates a future issue of stock to the public, within the meaning of this rule, was discussed by the court in Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 159, 89 N. E. 193 (1909), in which Rugg, J., pointed out that the question was one of "intention" of the promoters. If they actually intend at the time the company is brought into existence to remain its sole owners and that it shall not receive the money of outsiders to furnish capital, then the assent of future stockholders who may become such by reason of the exigencies of the company with regard to additional capital is not necessary to condone the taking of secret profits.

[17] EHRICH, PROMOTERS 263-265 (1916); 85 A. L. R. 1276-1288 (1933).

[18] Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 159, 89 N. E. 193 (1909), is the leading case in support of this rule and appears to be sustained by the weight of authority. A collection of cases may be found in 85 A. L. R. 1276-1277 (1933).

to future stockholders within the pale of the original promotion plan.[19] However, under the federal rule announced in *Old Dominion Copper Mining & Smelting Co. v. Lewisohn*,[20] if all of the then existing stockholders have assented to the promoter's profit with full knowledge of the facts, the issue of corporate approval is closed, and the rights of the corporation are not changed by the fact that innocent members may be subsequently induced to come in.[21]

2.

The recent case of *McCandless v. Furlaud* [22] raises the interesting question, among other things, whether or not the doctrine of the *Lewisohn* case [23] has been abandoned by the Supreme Court of the United States. In the former case the promoters caused certain properties, held under options, to be transferred to the corporation, and issued to themselves all the stock,[24] mortgage bonds and notes [25] of the corporation in payment therefor. In order to provide cash to pay the vendors of the properties, the promoters undertook to sell the securities to the public, applying the proceeds in part to acquire title to the properties and pocketing the excess. At the time of the transaction all existing stock that had been issued was held by the promoters and their associates. The effect of the promoters' conduct was virtually to make the company insolvent at the outset of its business life.[26] Shortly there-

[19] The Massachusetts courts have held promoters not liable to the corporation where the entire issue has been taken by them. See Hays v. The Georgian, Inc., 280 Mass. 10, 181 N. E. 765 (1932), and note 14, supra. This divergence in results has been criticized. "Substantial rights should not be made to turn upon mere matters of form. If it is a fraud for promoters to make a profit out of the promotion without a disclosure to the directors or stockholders, it can make but little difference whether such profit is taken immediately before or immediately after the subscriptions are obtained, or whether the subsequent shareholders are brought in as original subscribers or as purchasers from the promoters." EHRICH, PROMOTERS 266 ff. (1916).

[20] 210 U. S. 206, 28 S. Ct. 634 (1908).

[21] Cf. Davis v. Las Ovas Co., 227 U. S. 80, 33 S. Ct. 197 (1913).

[22] 296 U. S. 140, 56 S. Ct. 41 (1935).

[23] 210 U. S. 206, 28 S. Ct. 634 (1908).

[24] The stock involved in the Furlaud case was without par value. On the question of liability of stockholders to creditors for bonus or watered stock without par value see BALLANTINE, PRIVATE CORPORATIONS 685-694 (1927).

[25] The duty of disclosure imposed upon a promoter, as a fiduciary, does not run in favor of creditors of the corporation, inasmuch as the latter have no voice, as such, in the management of the affairs of the corporation. The duty in any case extends only to those who contribute to the share capital. However, as was pointed out in note 3, supra, a promoter may be liable to bondholders for fraudulent misrepresentation in an action for deceit. See Allenhurst Park Estates v. Smith, 101 N. J. Eq. 581, 138 A. 709 (1927).

[26] Justice Cardozo admitted that there was no specific finding in the court below to the effect that the company was insolvent at the outset; but he was convinced from

after, the company being in the hands of a receiver, suit was brought to compel the promoters to disgorge their profits. The majority of the Court, speaking through Justice Cardozo, allowed the receiver to recover.[27] The *Lewisohn* case [28] was distinguished on the ground that there was no evidence in the latter to indicate that the effect of the transaction was to make the company insolvent or to work a fraud upon its creditors by diverting the assets for private advantage. On the contrary, it appeared that the promoters in the *Lewisohn* case believed in the enterprise, having paid for the property with their own money, and that there were no creditors to be affected by anything they did.

Distinguishing the case at bar, Justice Cardozo said: [29]

> "This is not a case where at the time of issuing the securities the shareholders and the promoters were the only ones concerned. Here at the moment of the conveyance the interests of bondholders and noteholders were put in jeopardy by a division of the proceeds that would make their mortgage worthless. . . . It was not within the power of the shareholders to legalize this waste to the detriment of others. . . . Consent in such conditions, so far as it gives approval to conduct in fraud of the rights of others, is a word and nothing more. . . . There is no occasion to consider whether the corporation itself at the instance of new shareholders would be permitted to disaffirm the fraud and maintain a suit in equity for appropriate relief. We put that question by. Enough that the receiver has the requisite capacity. . . ." [30]

A more limited view of the facts seems to have been taken by Justice Roberts in the dissenting opinion. Briefly summarized, his

the inferences that might be drawn from the record that "the company was made insolvent at the outset when the proceeds of the subscriptions were devoted to the use of promoters."McCandless v. Furlaud, 296 U. S. 140 at 159, 56 S. Ct. 41 (1935). But Justice Cardozo was willing to afford the relief granted even though the company was not literally insolvent. "There would be a wrong to bondholders and noteholders if assets were depleted to the very brink of insolvency. . . . " 296 U. S. 140 at 163, 56 S. Ct. 41 (1935).

[27] The result reached by the majority was not rested solely on the theory of "injury to creditors." The Court also discussed the question of the effect of issuing the securities in the face of the provision of the Pennsylvania Constitution (Art. 16, § 7) which provided that "no corporation shall issue stocks or bonds except for money, labor done or money or property actually received; and all fictitious increase of stock or indebtedness shall be void."

[28] Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U. S. 206, 28 S. Ct. 634 (1908).

[29] McCandless v. Furlaud, 296 U. S. 140 at 159, 56 S. Ct. 41 (1935).

[30] The language quoted does not make it clear whether Justice Cardozo has taken the view that the corporation had a cause of action against the promoters or not. The writer has suggested two possible interpretations of this language. See text in connection with notes 33 and 34, infra.

argument proceeded as follows: Since, at the time of the transaction complained of, all the stockholders then in existence had knowledge of the facts, the corporation, under the doctrine of the *Lewisohn* case,[31] had no cause of action against the promoters; and since the receiver's right could rise no higher than that of the corporation, it followed that the receiver was without standing to recover from the promoters. From these conclusions Justice Roberts reasoned that to permit the receiver to bring suit, as was done by the majority of the Court, was to admit that the corporation had a cause of action, and hence to deny efficacy to the assent given by all the existing stockholders at the time of the transaction. By this process he was impelled to the conclusion that the decision of the majority in the *Furlaud* case in effect overruled the *Lewisohn* case.

It will be seen that the foundation for Justice Roberts' pronouncement upon the present status of the *Lewisohn* case depends upon the validity of the assumption that a receiver's right may rise no higher than the right of the corporation.[32] However, it is submitted that the holding of the majority in the *Furlaud* case may, without in the least repudiating the doctrine of the *Lewisohn* case, be sustained upon two independent grounds: (1) it is open to interpret the decision as declaring that the rights of a receiver may rise over and above the rights of the corporation, in spite of the fact that the corporation would itself have no cause of action,[33] and (2) assuming, even, that the receiver's right is to be measured by the right of the corporation, the consent of the stockholders, having been given at a time and in a manner so as to injure the rights of creditors, should under the circumstances be regarded as nugatory.[34]

If the first interpretation be the true ground upon which the decision rests, it is obvious that the discrepancy between the majority and minority of the Court is not rooted in the question involved in the *Lewisohn* case, but rather in the question of the extent of a receiver's

[31] Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U. S. 206, 28 S. Ct. 634 (1908).

[32] The question of the right of a receiver to bring suits on behalf of creditors is discussed in this issue. See p. 1196 ff.

[33] See the comment in this issue, p. 1196.

[34] In the text of the opinion in the Furlaud case Justice Cardozo supported his conclusions by the following, rather convincing language:

> "No consent of shareholders could make such conduct lawful when challenged by the receiver as the representative of creditors. If the shareholders and the directors had combined with the promoters to despoil the corporation and defeat the remedies of creditors by a gift of half the assets, the gift could have been annulled either by the creditors directly or in their behalf by a receiver [cases cited]. The distinction between such a situation and the present is one solely of degree. . . ." McCandless v. Furlaud, 296 U. S. 140 at 159, 56 S. Ct. 41 (1935).

right to bring suit on behalf of creditors of the corporation.[35] If, however, the second interpretation is to be adopted, that would not necessarily violate the doctrine of the *Lewisohn* case with respect to the binding effect of stockholders' consent upon the corporation. It is believed that a proper consideration of the equities of creditors should furnish a sufficient basis for disregarding the stockholders' approval in the *Furlaud* case, and thus distinguish it from the *Lewisohn* case. In fact, the *Lewisohn* case itself contains language which would seem to indicate that the Court did not intend to lay down an immutable rule that stockholders' consent would be conclusive and binding upon the corporation under any and all circumstances. The late Justice Holmes, speaking for the Court, said:[36]

> "When, *as here*, after it [the corporation] really exists, it consents, we at least shall require *stronger equities than are shown by this bill to allow it to renew its claim at a later date* because its internal constitution has changed."[37]

Finally, the numerous cases in which courts of equity have looked behind the mere formal consent in quest of those persons who were the *real original* subscribers[38] would seem to weaken the force of the contention that stockholders' approval, once given, is so sacrosanct as to be beyond the scope of judicial inquiry.[39]

J. H. J.

[35] See the comment in this issue, p. 1196.

[36] Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U. S. 206 at 216, 28 S. Ct. 634 (1908).

[37] Italics the writer's. Although the reference in this context was to "equities" of future stockholders, it is believed that the "equities" of creditors as they arose in the Furlaud case present an *a fortiori* case.

[38] See 85 A. L. R. 1289-1296 (1933) and particularly California-Calaveras Mining Co. v. Walls, 170 Cal. 285, 149 P. 595 (1915), where the court said at page 299 ff.:

> "It is true that upon the organization of this corporation the form of the transaction respecting the transfer of the property to it was one between Manson as owner of all its stock and himself as having received in effect an option on the mining property transferred by him to it. The mere form, however, which the transaction between Manson and the corporation took may not be interposed to defeat what was the evident purpose and intent of all the parties interested in the organization of the corporation and the acquirement of the property by it. The court will look beyond the form which the transaction took and to its substance and the obvious intent of the parties in the entire matter for the purpose of preserving and securing the rights of the real parties in interest and to circumvent fraud."

[39] The receivership question involved in McCandless v. Furlaud, 296 U. S. 140, 56 S. Ct. 41 (1935), is treated in a comment in this issue at p. 1196.