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CORPORATIONS — DUTY OF DIRECTOR TO STOCKHOLDER ON STOCK EXCHANGE SALES.

I.

The recent case of *Goodwin v. Agassiz*[1] presents the problem of the duty owed by a director to existing and prospective stockholders in its most typical and difficult form. The defendants were president and general manager, respectively, as well as directors of the Cliff Mining Corporation which owned mineral lands in Northern Michigan. The stock of the corporation was listed on the Boston Stock Exchange. The defendants in their capacity of directors had knowledge of a geologist's report which forecast possible existence of copper deposits in the corporation's lands. The defendants were also directors of another mining corporation owning lands in the same vicinity. The defendants had faith in the geologist's theory but suppressed the information in order to enable the second corporation to secure options on adjacent land at low prices. There was no mention of the report in the annual statement to shareholders which disclosed the termination of previous explorations by the Cliff Corporation. The defendants purchased a considerable amount of the Cliff Mining Corpora-

[1] (Mass. 1933) 186 N. E. 659. Noted in 47 HARV. L. REV. 353 (1933).

tion's stock in the market based on their belief that the report, if true, would cause the market price to rise. Plaintiff, one of the selling stockholders, had read newspaper notices of the statement to stockholders as to the closing of explorations. The defendants were not responsible for these notices. Plaintiff had no knowledge of the geologist's findings. The court found he would not have sold if he had known these facts. The sale was completely anonymous, brokers representing both parties. The subsequent discovery of copper as prophesied caused the stock to increase substantially in value. The plaintiff filed suit, alleging these facts, and claiming that the defendants were liable because of their omission to disclose their knowledge of the geologist's theory to the stockholders. The trial court dismissed the bill for failure to state a cause of action. The dismissal was affirmed by the Supreme Judicial Court of Massachusetts.

The court said that the directors owed a duty to the corporation but none to the individual stockholders as such. It emphasized that the geologist's theory was highly nebulous, and the wisdom of its disclosure was doubtful; that the failure of the theory might have involved the defendants in litigation for deluding the stockholders. The court relied upon the fact that the transaction was not a personal one, but was consummated by means of brokers on the exchange, and that therefore there was no special reason for placing the burden of a fiduciary upon the defendants. The court stated the essential consideration as follows:[2]

> "An honest director would be in a difficult situation if he could neither buy nor sell on the stock exchange shares of stock in his corporation without first seeking out the other actual ultimate party to the transaction and disclosing to him everything which a court or jury might later find that he then knew affecting the real or speculative value of such shares."

2.

It is well settled that a director will be liable to a stockholder in an action of deceit for any fraudulent misrepresentation.[3] In addition, an action of rescission will lie for an innocent misrepresentation.[4] But when there is failure to disclose information acquired in his capacity as director, the majority of courts have held a director to be under no

[2] (Mass. 1933) 186 N. E. 659 at 661.

[3] BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 303 (1932).

[4] BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 308 (1932).

duty to reveal information thus obtained.[5] A minority of courts,[6] mostly in the Southern and Western States, have placed on a director the burden of proving "fair dealing" in such a case. Some of the courts[7] following the majority rule have, however, enunciated what is known as the "special circumstances" doctrine, wherein, for example, a director is held responsible in case of a personal solicitation of a stockholder. The court in the instant case was thus in accord with previous authority. While the writer is not unduly critical of the result in the instant case, it is submitted that the courts have failed adequately to diagnose the corporate picture of today,[8] and have been led astray when they emphasize the impersonal character of stock exchange transactions.

Writers in the Law Reviews have almost unanimously supported the minority rule over a good many years,[9] yet the courts have shown very little change in sentiment. The late Mr. Roberts Walker, an active corporation lawyer and director, argued that directors of large corporations often do not know of conditions that are later raised by disappointed stockholders; that to hold them responsible would be unfair and would tend to unsettle the financing of large corporations.[10] He said that parties bought and sold with reference to market value rather than any inherent value, and that a variety of factors, many of which were not under the director's control, fixed the market value. The complete anonymity of parties, the dealing without any reliance on identity, the availability of the information in the public press, make the fiduciary rule inapplicable to large corporations. The courts apparently share Mr. Walker's beliefs. The presentation of the issue, as Mr.

[5] Thornton, "The Trust Relation Between Corporate Officers and Stockholders Buying of, or Selling Their Stock to Them," 67 CENT. L. J. 452 (1908); Collier, "Liabilities of Directors and Trustees of Beneficial Owners Compared," 74 CENT. L. J. 360 (1912); Bigelow, "The Relation of Directors of a Corporation to Individual Stockholders," 81 CENT. L. J. 256 (1915); Wilgus, "Purchase of Shares of Corporation by a Director from a Shareholder," 8 MICH. L. REV. 267 (1910); Laylin, "Duty of a Director Purchasing Shares of Stock," 27 YALE L. J. 731 (1918); Walker, "The Duty of Disclosure by a Director Purchasing Stock from His Stockholders," 32 YALE L. J. 637 (1923); H. R. Smith, "Purchase of Shares of a Corporation by a Director from a Shareholder," 19 MICH. L. REV. 698 (1921); A. A. Berle, Jr., "Publicity of Accounts and Directors' Purchases of Stock," 25 MICH. L. REV. 827 (1927); 14 MINN. L. REV. 530 (1930); 10 CORN. L. Q. 509 (1925); 45 HARV. L. REV. 1374 at 1389 (1932); L. R. A. 1916B 708; Ann Cas. 1918B 241; 14a C. J. 127 (1921).

[6] See note 5, supra.

[7] See note 5, supra.

[8] See BERLE, STUDIES IN THE LAW OF CORPORATION FINANCE (1928); BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932); W. Z. RIPLEY, MAIN STREET AND WALL STREET (1928); L. D. BRANDEIS, OTHER PEOPLE'S MONEY (1914).

[9] See note 5, supra.

[10] Walker, "The Duty of Disclosure by a Director Purchasing Stock from His Stockholders," 32 YALE L. J. 637 (1923).

Walker sees it, clearly reveals correlation of the problems of corporate publicity and the duty of directors to stockholders.[11] The solution would seem to be a common one.

3.

The fallacy in Mr. Walker's view lies in his major premise that all the information is equally available to the parties, and that the impersonal character of exchange transactions obviates the problem. It would appear on the contrary that the problem becomes most acute when it concerns market transactions of large organizations. The writer believes that Mr. Berle takes a more realistic view of the corporate picture.[12] He points out the phenomenal growth of the corporate form as the material wealth of the country increased. The desirability of securing corporate fees seemed so great that state legislatures vied in their efforts to liberalize their incorporation statutes. This tendency enabled corporate managements to obtain almost unchecked powers over finance as well as operation. The unification in one group of ownership and control, which is the basis of the *laissez faire* philosophy, is not found in the corporation. The stockholders have the legal ownership, but the management group exercises control, and the legal remedies based on the unification of the two do not fit the facts.

With the loss of control, one of the chief concerns of the stockholder became the valuation of his ownership rights upon the exchange and the expectation of distribution of future profits. Space does not permit discussion of the latter aspect of the shareholder's rights. What does the law do to protect this vital interest of the shareholder in the open market appraisal of his right? The fact that liquidation upon the markets is usually his only means of withdrawing from the enterprise when the venture seems uncertain or he is pressed for ready cash, and the widespread use of stock as collateral for loans makes it imperative that the appraisal be a fairly accurate reflection of value; such factors also emphasize the importance of liquidity in modern society. Once the security is floated, the corporation becomes the only source of information for the changing market conceptions of the value of the shares. It is for this reason that the duty of a director to a stockholder is one of the most crucial points in the wide problem of the protection of security values.[13]

[11] BERLE, STUDIES IN THE LAW OF CORPORATION FINANCE, c. 9 (1928).

[12] BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY (1932).

[13] This paper is restricted to the director-stockholder aspect of the problem. The whole problem of corporate disclosure is ably discussed in a recent comment. See 47 HARV. L. REV. 335 (1933).

4.

The great advantage which the men at the source of the information possess over the outsider, be he present or prospective stockholder, would seem to require the insiders to reveal sufficient facts to put the parties on some approximation of equality in their dealing. There are numerous situations in the law where courts have given relief simply because there has not been a "square deal." The directors serve as the representatives of the stockholders simply because of convenience. For these representatives to take information acquired in such a capacity as the basis of trading in the market adversely to the interest of the other proprietors violates the elementary principles of equity. The only possible basis upon which to predicate the denial of some fiduciary relation to the stockholders is the ancient notion of the separate corporate entity. Courts have had slight reluctance in other connections to recognize that the corporation is a mere form under which human beings do business.[14] There seem to be two feasible methods of realizing approximate equality of dealing in this situation. One would be for the courts to require a director to meet the burden of a fiduciary; the other to embody such a rule in a statute. To leave the law in its present state seems inequitable, but, *per contra*, the other extreme of forbidding directors from dealing in their own stock appears unjust and impractical, since in the vast majority of corporations the stock is closely held. It is granted that only with directors of corporations whose stock is widely held would such a scheme be feasible. Reading the cases on this problem leads one to believe that the imposition of the fiduciary rule upon directors would produce a more equitable relation between them and the other shareholders.

In view of the fact that writers have long urged this remedy, and the courts have as long ignored it, it might well be asked what purpose in again belaboring the point? The writer does not intend to restate the many able legal arguments that have been made for the imposition of this liability, but he does believe that the true corporate picture today, as presented by Mr. Berle, leads inevitably to such a conclusion. The direct bearing of such information upon market values would warrant responsibility fully as much as that imposed in the case of the banker's disclosure in the broker's circular.[15] The trend of recent legislation certainly indicates a belief that investors should be given greater protection.[16] The use of the machinery of the open market by the directors would seem to imply an obligation on their part not to use it to the detriment of the other stockholders. The "dangerous instru-

[14] BALLANTINE, PRIVATE CORPORATIONS 26 (1927).

[15] BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, Part III, c. 2 (1932).

[16] See comment, 47 HARV. L. REV. 335 (1933).

mentality" doctrine in tort law furnishes an analogy for the basis of such a duty. The action for slander of title suggests that the law should likewise protect a right in the market appraisal which is so important to the modern shareholder. A fiduciary duty has been imposed in other situations where the parties have not been on an even footing, such as the relief afforded on the grounds of duress and undue influence.

5.

Remedial measures that appear to be half-way between judicial aid and legislative help are the regulations of the New York Stock Exchange, and other exchanges. Through the medium of listing requirements,[17] much has been done to require corporate publicity at the birth of the security, and some effort has been made to force disclosure during its life. In the collateral problem of the purchase of its own shares by the corporation,[18] where many of the same factors of policy apply coupled with the additional danger arising from the reduction of the capital of the corporation, the New York Stock Exchange has recently taken drastic action by requiring a corporation to report its dealings during the month, and total holdings at the end of each month, and in addition has insisted that the company apply for a relisting of the shares acquired, before offering for resale.[19] While a proposal that the practice be forbidden altogether was seriously considered, but rejected as too harsh, yet it is significant that the Stock List Committee said:[20] "The Exchange sees no justification whatsoever for the corporation using its assets to *influence the market quotation of its own shares.*" Such action goes to the heart of the matter and is particularly timely in view of the pending reports on regulation of the exchanges.[21] Congressman Morland of Oklahoma[22] has advocated that directors be required to list their holdings,[23] in order to prevent their selling short

[17] BERLE, CASES ON CORPORATION FINANCE 700 (1930).

[18] See Levy, "Purchase by a Corporation of Its Own Stock," 15 MINN. L. REV. 1 (1930).

[19] N. Y. Times, Thurs., Dec. 28, 1933, p. 29.

[20] N. Y. Times, Thurs., Dec. 28, 1933, p. 29.

[21] Published in the N. Y. Times, Sunday, Jan. 28, 1934, p. 24. Report of the President's Interdepartmental Committee, John Dickinson, Asst. Sec. of Commerce, Chairman. The federal licensing of stock exchanges and a tightening up of existing exchange regulation were recommended. The means suggested was a federal administrative agency with very wide powers of discretion.

[22] N. Y. Times, Wed., Dec. 27, 1933, p. 29.

[23] Since this comment was completed, the "National Securities Exchange Act of 1934" has been submitted to the Congress. See text, N. Y. Times, Sat., Feb. 10, 1934, p. 6. Section 15 of the proposed bill deals specifically with the subject of this comment and requires directors owning more than 5% of any class of security to file a record of their ownership and to record monthly any changes therein. It also provides that no such director may sell any stock he has acquired until 6 months have elapsed with a

before the publication of a poor statement. The taking of a long position is equally dangerous, as the instant case shows only too well.

6.

These recent movements lead to the discussion of statutory enactments of the rule placing a fiduciary duty upon directors in the sale of securities. Corporations that come within the purview of Lord Hale's historical hangover, "affected with a public interest," such as railroads, have been required to use uniform accounting systems in order to render full publicity. The public interest in security of investments might well make regulation reasonable. It would also seem desirable that corporation statutes require directors to hold substantial amounts of stock without the right to sell such amounts unless they terminated their official relation with the corporation. The writer recognizes that the tendency of the "boom" legislation has been to take away the obligation of a director to own stock at all — a notable exception being the Glass-Steagall Act affecting bank directors.[24] The difficulty of getting such legislation within a reasonable time, and the danger of setting too arbitrary a standard make judicial action appear more feasible.

The growth of stock ownership coupled with the divorce of ownership from control, with the consequent reliance of the stockholder upon market appraisal of his interest, make the protection of security values a vital matter. It is but a step from the general feeling of repulsion at the manipulations by Philbin of the Atlas Tack market, and the short selling by Dahl and Wiggin, to recognizing some fiduciary obligation on the part of a director to the stockholder. The elastic judicial process of exclusion and inclusion can, once the significance of the management's position in relation to ownership is perceived, set reasonable limitations. No one would require personal disclosure of everything known or surmised.[25] But matters which can be publicly disclosed without injury to the corporation should not afford a director an advantage over those whose business he directs. Admitting the un-

severe damage stipulation for violation. It also provides that the corporation may recover profit made by any person through confidential information disclosed to such person by a director. The proposed bill is notable for its broad provisions designed to insure corporate publicity. That this feeling is widespread is brought out by comparing the report of the Filene Committee suggesting control and regulation of the security markets in the United States. See N. Y. Times, Friday, Feb. 9, 1934, p. 31. III, 1, provides for federal incorporation of all corporations engaged in interstate commerce. III, 4, provides that officers and directors must record their dealings in their own stock. V demands full and frequent publicity for corporation affairs.

[24] Banking Act of 1933, 73d Cong., 1st Sess., sec. 31. Noted in 47 HARV. L. REV. 324 (1933).

[25] This is the straw man of the opponents of the fiduciary rule. See Walker, "The Duty of Disclosure by a Director Purchasing Stock from His Stockholders," 32 YALE L. J. 637 (1923).

certainty of possible injury to the corporation, the director is only faced with the dilemma of keeping out of the market until publication. His compensation for directing the business, if inadequate, ought to be openly fixed rather than obtained by covert self-help at the expense of his fellow proprietors. The healthy anger of publicity has remedied much corporate mischief where secret profits have inured to the management. Judicial sanction of a director's duty to refrain from market operations until pertinent information is made available to the other shareholders will remove one further temptation from the management.[26]

A. B. M.

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[26] The writer is indebted to John W. Watling, Esq., of Watling, Lerchen & Hayes, Detroit, Michigan, and to his father, Nathan William MacChesney, Esq., of the Chicago bar, for helpful discussion of the points involved.