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COMMENTS

CORPORATIONS—THE FIDUCIARY DUTY OF DIRECTORS IN THE ISSUANCE OF STOCK SUBJECT TO PREEMPTIVE RIGHTS — In *Gord v.*

Iowana Farms Milk Co.,[1] a stockholder protested the issue to the defendant of certain shares of stock in a closely held corporation. At the time of the sale, the plaintiff was a director and secretary-treasurer of the corporation with access to the corporate books and knowledge of the corporate assets. At the meeting at which the stock was issued, the plaintiff signed a statement saying "at the present time I do not elect to purchase any stock. . . ."[2] The stock, sold for $15 a share, had a value variously estimated at $50 to $103.22. The plaintiff alleged that defendants as directors breached their fiduciary duty by not disclosing that the issuance price was substantially less than the reasonable value, and that the effect of the issuance would be to dilute the value of his holdings. The trial court dismissed the petition, noting that the plaintiff was an educated, skilled man, that plaintiff in his capacity as an officer and director knew all the facts on which he could make his own mathematical computation of the stock worth, and that there was no fraud or fraudulent concealment. On appeal, *held*, reversed. There was a breach of the fiduciary duty of the directors in failing to disclose the value of the stock and the diluting effect of such issuance.

It is acknowledged that directors are fiduciaries as to stock subject to preemptive rights.[3] Thus when directors issue new stock to a minority fraction, giving the majority group no opportunity to subscribe, there is a clear breach of fiduciary duty,[4] and the shareholder may use the traditional equitable remedies to enforce these obligations.[5] The purpose of this comment is to examine the nature of the director's duty in the issue of stock subject to preemptive right in the following areas: the issuance price, the notice to shareholders, the time limitations in exercising preemptive rights, and the disclosure of relevant facts. In addition, the effect of shareholder waiver or discharge, and of bad faith or fraud by the directors will be noted.

I. *Duty as to Issuance Price*

Obviously, directors cannot discriminate against shareholders by offering the stock to them at a price higher than that at which the same stock is later offered to the public. More obscure, however, are the

1 (Iowa 1953) 60 N.W. (2d) 820.

2 Id. at 824.

3 Schmidt v. Pritchard, 135 Iowa 240, 112 N.W. 801 (1907). In some cases, the preemptive right is created essentially as a remedy when directors have breached their duty. Federal Reserve Life Ins. Co. v. Gregory, 132 Kan. 129, 294 P. 859 (1931).

4 Rowland v. Times Pub. Co., 160 Fla. 465, 35 S. (2d) 399 (1948).

5 Adams, "Remedy for Denial of the Stockholder's Preemptive Right," 6 N.Y. UNIV. INTRAMURAL L. REV. 126 (1951).

judicially imposed maximum and minimum limits on the issuance price of stock. The Wisconsin Supreme Court has stated that sale of stock of a small closely held corporation at a price far below its value would be questionable even though preemptive rights are attached; a sale at such a materially decreased price was deemed "evidence of an oppressive scheme."[6] But since shareholders get first opportunity to buy the new stock, it is difficult to see the "oppression." In those corporations where the stock is widely enough traded that a sale of subscription rights by the shareholder is possible, the shareholder has additional protection. A judicially imposed minimum sale price seems an unnecessary restriction on corporate action.

There has been considerable divergence as to the establishment by the courts of a maximum on the sale price of stock subject to preemptive right, i.e., are holders of preemptive rights entitled to buy additional stock at par or may they be obliged to pay a "bonus" for their shares? Michigan and Pennsylvania courts are on record as forcing the directors to sell stock to the holders of preemptive rights at par, the rationale given being a question-begging "right" in shareholders to subscribe at par, plus the alleged danger of "squeezing out" the original shareholders.[7] Other courts have held that the shareholder has no preemptive "right" to purchase at par, the interest in the corporation to raise increased funds plus the ability of the shareholder to sell his subscription rights being cited as reasons for the rule.[8] This latter view is superior. There is a danger of some shareholders being unable to raise funds, but this problem exists to some degree in the issuance of additional stock at any price. Admittedly, even an ability to sell subscription rights is not complete protection because the shareholder loses his proportionate voting interest from the sale. But overbalancing this possible loss to a few shareholders is the economic advantage to the corporation and thereby to the whole body of shareholders in being able to raise additional funds and in being unhampered by an arbitrary par limit on the sale price of new stock.

[6] Steven v. Hale-Haas Corp., 249 Wis. 205, 23 N.W. (2d) 620 (1946). It should be noted that the corporation involved was closely held, the stock value was difficult to appraise, and there was no great sale of subscription right. Moreover, the sale price was not deemed to be materially below par, so the above principle is dictum.

[7] Hammond v. Edison Illuminating Co., 131 Mich. 79, 90 N.W. 1040 (1902); Cunningham's Appeal, 108 Pa. 546 (1885). Pennsylvania also provides authority for the effect that a bonus, even though invalid, cannot be recovered once it is paid by the shareholder. De La Cuesta v. Ins. Co. of North America, 136 Pa. 62, 658, 20 A. 505 (1890).

[8] Stokes v. Continental Trust Co., 186 N.Y. 285, 78 N.E. 1090 (1906); McClanahan v. Heidelberg Brewing Co., 303 Ky. 739, 199 S.W. (2d) 127 (1947) (a Kentucky statute requiring full value for shares issued was used as a partial basis for the decision); Van Slyke v. Norris, 159 Minn. 63, 198 N.W. 409 (1924).

II. *Duty to Provide Notice and Allow Reasonable Time to Subscribe*

In general the shareholder of stock having preemptive rights must be given the opportunity to subscribe.[9] This involves giving notice of the sale of new shares and allowing ample time for the shareholder to make application.

It is not necessary that actual notice reach the shareholder, it being sufficient that the notice has a "reasonable" likelihood of arriving. The shareholder who by a journey puts himself beyond the power of the corporation to give notice cannot complain when a letter sent to the last address left with the corporation fails to reach him.[10] It would be an intolerable burden to force the corporation to provide actual notice to all its shareholders of the impending issue. Accordingly, a standard of diligence is imposed on the shareholder to furnish his correct address to the corporation and to remain in contact with that address.[11]

If the directors fail to allow a reasonable time for the shareholder to subscribe, it is a breach of their fiduciary duty.[12] Allowing only five days has been deemed unreasonable.[13] Although as few as ten days have been deemed reasonable,[14] thirty to sixty days are more frequently sustained as adequate. Such factors as the number of shareholders, the corporate need for immediate funds, and the ability of the shareholder to communicate with the corporation are factors considered under the "reasonableness" test.[15] However, in a New York case[16] the

[9] Shareholders must always have this opportunity to subscribe in preference to outsiders. An attempt to issue stock to the highest bidder under sealed bid was held invalid in Electric Co. of America v. Edison Electric Illuminating Co., 200 Pa. 516, 50 A. 164 (1901).

[10] Hoyt v. Great American Ins. Co., 201 App. Div. 352, 194 N.Y.S. 449 (1922).

[11] If the corporation could easily ascertain the correct address, and if the shares are still available, the shareholder may exercise his preemptive rights although he failed to subscribe within the stated time limits because of failure to receive notice. James v. Buena Ventura Nitrate Grounds Syndicate, Ltd., [1896] 1 Ch. 456. This may be part of the general tendency to relax the shareholder standard of diligence where the stock is still available. See cases cited at note 18 infra.

[12] Discrimination through extending the time to one shareholder but not to others is a breach of duty. Tarlow v. Archbell, 47 N.Y.S. (2d) 3 (1943), affd. 296 N.Y. 757, 70 N.E. (2d) 556 (1946).

[13] Bennett v. Baum, 90 Neb. 320, 133 N.W. 439 (1911); Jones v. Morrison, 31 Minn. 140, 16 N.W. 854 (1883) (11 days held unreasonable when the mail service took 18 days).

[14] Sommer v. Armor Gas & Oil Co., 71 Misc. 211, 128 N.Y.S. 382 (1911), affd. 207 N.Y. 739, 101 N.E. 1122 (1913). The approval of 10 days was dictum in this case since the court determined that the tardy shareholder could recover so long as the stock was still unissued.

[15] If the notice specifies that the subscription must be made within a given period, this is interpreted to mean that only a binding acceptance, not payment, need be made within the time limits. Hart v. St. Charles Street R. Co., 30 La. Ann. Rep. 758 (1878).

[16] Dusenberry v. Sagamore Development Co., 164 App. Div. 573, 150 N.Y.S. 229 (1914).

notice of issue of new stock was mailed October 26 and the date for acceptance was set at November 1. After that date the stock was sold to an antagonistic group which thereby gained control of the corporation. The court did not consider the question of whether this was a reasonable time to subscribe but rather emphasized the fact that the shareholder was tardy in making his application. In rejecting his claim the court said:

> "This complaint was not of an opportunity denied, but rather of an opportunity overlooked, and the grievance does not seem to arise over a lost investment, but rather over the power of control over the corporation gained by others more vigilant."[17]

The need for the corporation to obtain capital by disposing of shares of stock has caused the courts to impose a standard of diligence on the shareholder to act within the time limit. If the stock is not sold, however, the reason for the time limit disappears, and the tardy shareholder may still sue to purchase the stock. In other words, the failure of the shareholder to exercise his right within the specified time only bars him from contesting the sale of the stock to someone else.[18]

III. *Duty of Disclosure*

In any transaction between trustee and beneficiary, the trustee is obligated to show that he exercised the "utmost fairness," which ordinarily involves disclosure to the beneficiary of all relevant facts known to the trustee and any other conduct necessary to enable the beneficiary to decide intelligently upon a full consideration of the pertinent facts.[19] The superior position of the trustee in knowledge, skill, and influence is the basis for the rule.[20] Applying this rule to corporation directors,

[17] Id. at 232.

[18] Sommer v. Armor Gas & Oil Co., 71 Misc. 211, 128 N.Y.S. 382 (1911); Oppenheimer v. Wm. F. Chiniquy Co., 335 Ill. App. 190, 81 N.E. (2d) 260 (1948); 47 MICH. L. REV. 805 (1949).

[19] BOGERT, HANDBOOK OF THE LAW OF TRUSTS, 3d ed., §96, p. 398 (1952). For application in the corporate field of the full disclosure standard, see Levy v. Pacific Eastern Corp., 153 Misc. 488, 275 N.Y.S. 291 (1934).

[20] It might be argued that there is a duty of loyalty which precludes the directors from purchasing the stock for themselves. See 1 TRUSTS RESTATEMENT §170, comment *b* (1935) where it is stated that ". . . A trustee with power to sell trust property is under a duty not to sell to himself either by private sale or at auction, whether the property has a market price or not, and whether or not the trustee makes a profit thereby."

This doctrine has not been applied to the corporate director. If the shareholder fails to satisfy a reasonable standard of diligence, sale of the stock to the other directors is permitted. Van Slyke v. Norris, 159 Minn. 63, 198 N.W. 409 (1924) (shares finally sold to the directors after an attempt to sell to outsiders failed); Dusenberry v. Sagamore Development Co., 164 App. Div. 573, 150 N.Y.S. 229 (1914) (the president himself purchased the shares and thereby gained control of the company).

the Iowa court in the principal case held that the failure to disclose the book value of the new stock and the diluting effect of the issuance was a breach of the fiduciary duty. It is submitted that such an application in the area of corporate fiduciaries is unwarranted.[21] Shareholders of listed stocks have access to financial statements from which they can easily estimate the value of stock.[22] Moreover, for stock traded on an exchange, the market value is readily determinable. For unlisted stock, the required standard of full disclosure of book value may be of some value when the shareholder has no access to corporate financial statements.[23] But when such information is available to the stockholder, as in the principal case where the plaintiff-shareholder was secretary-treasurer of the corporation, there is no reason why the stockholder cannot compute his own estimate of value. Moreover, to force the corporation to disclose book value may be misleading because book value often bears little relation to real stock worth. In certain types of corporations, e.g., merchandising concerns having a rapid turnover of inventory, book value is practically worthless as a yardstick of stock worth.

In brief, in those areas where only the directors have access to relevant information, the requirement of full disclosure is warranted. But when the relevant facts are accessible to the shareholder and it only remains to estimate the stock's value based on these facts, it is difficult to see why the directors should assume the responsibility for making

[21] Conventional trust principles distinguish between cases where the beneficiary has given his consent to the transaction and cases where no consent has been given. In the latter case the trustee is under the following duty set forth in 1 TRUSTS RESTATEMENT §170 (1935), where it is stated: "(2) The trustee in dealing with the beneficiary on the trustee's own account is under a duty to the beneficiary to deal fairly with him and to communicate to him all material facts in connection with the transaction which the trustee knows or should know."

Even if the beneficiary has given his consent, however, he may still hold the trustee liable, according to 1 TRUSTS RESTATEMENT §216(2)(b) (1935), if ". . . the beneficiary, when he gave his consent, did not know of his rights and of the material facts which the trustee knew or should have known and which the trustee did not reasonably believe that the beneficiary knew. . . ."

Thus, in the event of consent, a reasonable belief that the beneficiary knew the material facts discharges the duty. In the principal case, the plaintiff gave his consent by signing a waiver and the other directors had a "reasonable" belief that the plaintiff would know the relevant facts. Thus, even under strict trust law, the decision of the Iowa Court was unjustified.

[22] Merely having access to the corporate books was not deemed sufficient disclosure in Cahall v. Lofland, 12 Del. Ch. 299, 114 A. 224 (1921), affd. 13 Del. Ch. 384, 118 A. 1 (1922).

[23] When stock was offered to the highest bidder, and when the shareholder failed to bid because the corporate books were so incomplete and fragmentary that the real value could not be ascertained, it was not termed a waiver of preemptive right. Dunn v. Acme Auto & Garage Co., 168 Wis. 128, 169 N.W. 297 (1918).

such an estimate.[24] Such a requirement may provoke not only actions alleging breach of the fiduciary duty of a director but also unwarranted litigation based on misrepresentation.

IV. *Waiver or Discharge*

The shareholder's express refusal to buy additional stock relieves the directors from any further duty to sell to this shareholder.[25] Even if the stock is still on hand a year later, the shareholder cannot revoke his waiver and purchase the stock.[26] The principal case, however, holds that an express waiver containing no time limit may be revoked until a notice of the withdrawal of the preemptive right to purchase is given by the corporation.

Under certain conditions, the courts will discharge the fiduciary of his duty by means of a "constructive waiver." Where no time limits are imposed on subscription, the shareholder may be held to have waived his right if he delays in purchasing the new stock while the corporation is in urgent need of funds and then demands his preemptive rights when the corporation's financial outlook improves.[27] Where the exercise of a preemptive right would result in the breach of a contract not to acquire the majority of the stock, the courts find a "waiver" of preemptive right.[28] In general, the bad faith or fraud of the shareholder will discharge the duty of the directors to issue the stock to this shareholder if it will work injury to the corporation.

V. *Bad Faith of the Director*

All of the above comments have been based on situations where no bad faith or fraud could be shown. Once actual bad faith on the part of the directors is shown, the standard of diligence imposed on the shareholder is removed. Thus a shareholder may collect damages for

[24] In the cases surveyed, only the principal case has implied that the value of the stock must be disclosed. The absence of litigation on this point would indicate that such disclosure has not been required. For a case where there was no disclosure of value and yet the shareholder was denied recovery under a reasonableness test, see Noble v. Great American Ins. Co., 235 N.Y. 589, 139 N.E. 746 (1923).

[25] Hoyt v. Shenango Valley Co., 207 Pa. 208, 56 A. 422 (1903).

[26] Hall v. Hall, 20 Ohio Cir. Dec. 826 (1908), affd. 79 Ohio St. 456, 87 N.E. 1136 (1908).

[27] Seaman v. Ironwood Amusement Corp., 283 Mich. 220, 278 N.W. 51 (1938); Conklin v. United Construction & Supply Co., 166 App. Div. 284, 151 N.Y.S. 624 (1915), affd. 219 N.Y. 555, 114 N.E. 1063 (1916).

[28] Heylandt Sales Co. v. Welding Gas Products Co., 180 Tenn. 437, 175 S.W. (2d) 557 (1943). At times this general doctrine of shareholder bad faith is expressed in the "clean hands" requirement of equity.

his inability to exercise his preemptive rights even after a six year delay if the directors had originally acted in bad faith.[29] A waiver by the shareholder may be ignored if the sale of stock is "tainted by fraud."[30]

VI. *Conclusion*

The duty of the director in the issuance of stock with preemptive rights is distinguishable from that of the ordinary trustee. A standard of diligence is imposed upon the beneficiary-shareholder, who must, for example, furnish notice of his address, remain in contact with this address, and subscribe within the specified time limits. In the absence of fraud or bad faith by the director, the courts should recognize that his duty is to the entire group of shareholders, and that too rigid a doctrine of trustee duty would enable a minority to block or delay the necessary action of increasing corporate capital. The creation of an overly strict duty of disclosure in the principal case represents an unfortunate departure from the general status of the law.[31]

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[29] Strickler v. McElroy, 45 Pa. Super. 165 (1911); Morris v. Stevens, 178 Pa. 563, 36 A. 151 (1897) (two years delay held no bar).

[30] Upton v. Southern Produce Co., 147 Va. 937, 133 S.E. 576 (1926).

[31] It is significant that the principal case awarded the plaintiff only the stock which remained unissued. The judgment might thus be reconciled with those decisions which relax the standard of diligence for shareholders when the stock remains unissued. Nevertheless, the reasoning and principles set forth in the case are subject to the criticism noted above.