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CORPORATIONS-REDEEMABLE STOCK-FIDUCIARY DUTY OF DIRECTORS

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COMMENTS

CORPORATIONS—REDEEMABLE STOCK—FIDUCIARY DUTY OF DIRECTORS—A federal district court judge introduced an opinion on the fiduciary obligation of corporate directors by stating that "the doctrine of the fiduciary relation is one of the most confused and entangled subjects in corporation law."[1] In *Zahn v. Transamerica Corporation*[2] the fidu-

[1] Geller v. Transamerica Corp., (D.C. Del. 1943) 53 F. Supp. 625 at 629.
[2] (C.C.A. 3d, 1947) 162 F. (2d) 36.

ciary duties of corporate directors were discussed extensively by the Third Circuit Court of Appeals. The court not only failed to terminate the confusion and clear the entanglement but may well have added to it by using the fiduciary concept in a new field.

A. *Zahn v. Transamerica Corporation.* Plaintiff, a Class A stockholder of Axton-Fisher Tobacco Company, a Kentucky corporation, sued individually and on behalf of all stockholders similarly situated to recover damages for alleged fraud of defendant, a Delaware corporation, in causing Axton-Fisher to redeem its Class A stock instead of permitting the Class A stockholders to participate in liquidation of the company. The Axton-Fisher charter provided, inter alia, that (1) each share of Class A stock was convertible at the option of the shareholder into one share of Class B stock; (2) all or any shares of Class A stock were callable by the corporation at any quarterly dividend date upon sixty days' notice to the shareholders, at $60 per share with accrued dividends; and (3) upon liquidation of the company and the payment of sums required by the preferred stock, Class A stock was entitled to share with Class B stock in the distribution of the remaining assets, but the Class A stock was entitled to receive twice as much per share as the Class B stock. The following facts were considered admitted by defendant's motion to dismiss. In 1941 defendant started purchasing stock of Axton-Fisher Company. By March of 1943, defendant had almost 80 per cent of the Class B stock and about 66 2/3 per cent of the total amount of Class A stock. Defendant acquired additional shares of Class B stock and converted its Class A stock so that by May, 1944, defendant owned virtually all of the outstanding Class B stock. In the spring of 1943, the principal asset of Axton-Fisher was its leaf tobacco which cost and was carried on the books at $6,361,981. Unknown to the public holders of Class A stock the market value of the tobacco had increased to about $20,000,000. Defendant determined to effect a dissolution or merger of Axton-Fisher so that it might appropriate to itself virtually all of the benefits of the extraordinary rise in market value of the tobacco inventory. On April 30, 1943, defendant caused its representatives, the board of directors of Axton-Fisher, to call for redemption all Class A stock issued and outstanding on July 1, 1943 at $80.80 per share. On May 31, 1944, defendant caused Axton-Fisher to be dissolved. Some of the assets were sold and warehouse receipts representing the remainder of the tobacco were distributed to the Class B stockholders. If Class A stock had not been called, plaintiff, upon liquidation of Axton-Fisher, would have received not less than $240 per share.

Plaintiff charged that when defendant caused the Class A stock to be called for its self aggrandisement it violated its fiduciary obligation to Class A stockholders. Plaintiff contended further that since redemption of Class A stock was not made in good faith or in contemplation of continuance of Axton-Fisher as a going concern it was a fraudulent act and hence invalid.

The district court viewed the "real basis of plaintiff's argument" as being that under Kentucky law both the majority stockholders controlling the board of directors and the board of directors have a fiduciary obligation to minority stockholders. The complaint was dismissed, the court taking the position that Kentucky law imposed no fiduciary duty toward minority stockholders on the board of directors, or the majority shareholders controlling the board of directors, and that the Axton-Fisher charter provision on redemption of Class A stock was complete in itself and not limited by the section giving Class A stock liquidation rights.[3] The circuit court of appeals reversed and held plaintiff entitled to the difference between the amount received by him for the shares already surrendered and the amount which he would have received on liquidation of Axton-Fisher if he had not surrendered his stock. The court pointed out that under the Delaware conflict of laws rule it must refer to Kentucky law to determine the relationship between Transamerica, as majority stockholder controlling the board of directors, and the minority stockholders. It concluded, however, that it was necessary to resort to federal law and to the law in other states to resolve the case because the question presented was sui generis. This approach was rationalized by stating that Kentucky imposed "the same fiduciary relationship in respect to the corporation and to its stockholders as is imposed generally by the laws of Kentucky's sister States or which was imposed by federal law prior to Erie R. Co. v. Tompkins. . . ."[4]

The decision proceeded upon a direct application of trust concepts to which opinions have so frequently paid lip-service. The court relied heavily upon federal cases which state the rule that the board of directors owes a fiduciary duty to minority stockholders. Reliance was also placed on cases applying tests that corporate directors may be held strictly accountable for individual profits that result because of their official position. Thus, while the legality of calling stock prior to dissolution was conceded, the court nevertheless held that the calling of the Class A stock was to profit defendant corporation, and, therefore, a breach of fiduciary duty.

The result reached by the circuit court of appeals might well have been arrived at by construing the charter provision giving Axton-Fisher the right to redeem Class A stock in connection with the section in the charter allowing Class A stock liquidation rights. Such a construction

[3] Zahn v. Transamerica Corp., (D.C. Del. 1945) 63 F. Supp. 243.

[4] 162 F. (2d) 36 at 42.

would seem fair and reasonable.[5] If the redemption provision of a charter is regarded as independent of the liquidation feature of the charter, absent fiduciary principles, the holder of the redeemable stock will receive liquidation rights only when such rights are less than the redemption price.

The purpose here is to consider what, if any, fiduciary duty is owed by the controlling stockholders and board of directors to the minority stockholders, and the possible application of such a doctrine to the redemption of preferred stock. Attention will also be given to the fiduciary obligation of the board of directors to the corporation, and how the rule affects the right of the corporation to redeem preferred stock.

B. *Fiduciary Duty of the Board of Directors to Individual Shareholders.* While there is substantial agreement among the courts with regard to the fact that directors stand in a fiduciary relation to the entire body of stockholders, there exists a divergence of opinion as to whether they are in a similar position of trust with respect to the individual stockholders.[6] The problem of individual shareholders has most frequently arisen in connection with the purchase of shares by a director from a stockholder. The issue usually is whether or not the purchasing director is under a duty to divulge his intimate knowledge of the corporate affairs, in order to notify the stockholders of the facts and circumstances which tend to increase the value of the company's shares. According to the majority view no such duty exists.[7] Dealing in stock, it is said, constitutes no corporate function and the fiduciary concept is therefore not applicable thereto. Consequently, the director is not bound to volunteer information and, like an outsider, may deal with the stockholder at arms' length. The minority view regards the shareholders as really constituting the corporation and holds that a director owes a duty of disclosure to individual shareholders in dealings regarding corporate stock.[8] The harshness of the majority rule has been mitigated to some extent by courts that deny its application when special

[5] It is generally understood that the redemption of stock contemplates the calling of stock by a corporation as a going concern and not redeeming it as an incident of dissolution and liquidation. Dodd, "Purchase and Redemption by a Corporation of its Own Shares: The Substantive Law," 89 UNIV. PA. L. REV. 697 (1941); 11 FLETCHER, CYC. CORP., perm. ed., § 5309 (1932); 88 A.L.R. 1131 (1934).

[6] Berle, "Publicity of Accounts and Directors' Purchases of Stock," 25 MICH. L. REV. 827 (1927); Laylin, "The 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); 3 FLETCHER, CYC. CORP., perm. ed., § 1168 (1947); 84 A.L.R. 615 (1933).

[7] Connolly v. Shannon, 105 N.J. Eq. 155, 147 A. 234 (1929); Gladstone v. Murray Co., 314 Mass. 584, 50 N.E. (2d) 958 (1943); supra, note 6.

[8] Humphrey v. Baron, 223 Iowa 735, 273 N.W. 856 (1937); Jacquith v. Mason, 99 Neb. 509, 156 N.W. 1041 (1916); supra, note 6.

facts make it inequitable for directors to withhold pertinent information. The leading case on what is frequently referred to as the "special facts" doctrine is *Strong v. Repide.*[9] Other courts have used the "special facts" doctrine when dissolution, merger or consolidation was contemplated.[10]

Erie R. Co. v. Tompkins[11] precluded the use of the "special facts" doctrine in deciding the principal case. Kentucky cases adhere to the strict rule that directors do not owe a fiduciary duty to individual shareholders.[12] Although the district court dismissed plaintiff's complaint on the basis of these Kentucky cases the circuit court of appeals ignored them and did not discuss the possible application of the doctrine to the instant case.

If the problem presented in the *Zahn* case were to arise in a state which holds that directors are fiduciaries for the individual shareholders, or in a state following the "special facts" doctrine, it could be resolved for the plaintiff without unduly extending the fiduciary concept. *Strong v. Repide,* and other cases following that doctrine, appear to be based on the idea that a fiduciary duty will be imposed upon the board at the time of dissolution, sale of assets, merger or consolidation, because at that time all stockholders are to receive equal treatment.[13]

Some courts have asserted generally that directors are in a fiduciary relation with minority shareholders.[14] A number of federal cases ex-

[9] 213 U.S. 419, 29 S.Ct. 521 (1909), negotiations for the sale of property to the government at a very favorable price were pending at the time the director purchased the stock.

[10] Hotchkiss v. Fischer, 136 Kan. 530, 16 P. (2d) 531 (1932); Buckley v. Buckley, 230 Mich. 504, 202 N.W. 955 (1925); 84 A.L.R. 615 at 623 (1933).

[11] 304 U.S. 64, 58 S.Ct. 817 (1938).

[12] Barth v. Fidelity & Columbia Trust Co., 188 Ky. 788, 224 S.W. 351 (1920); Waller v. Hodge, 214 Ky. 705, 283 S.W. 1047 (1926), noted in 25 MICH. L. REV. 459 (1927).

[13] Buckley v. Buckley, 230 Mich. 504, 202 N.W. 955 (1925). An interesting result could be reached by accepting the doctrine of Strong v. Repide, but following the view of the district court in Zahn v. Transamerica Corporation, that charter provisions for redemption and liquidation are independent and not to be read together. In such a case it might well be held that the corporation could redeem preferred stock as an incident to dissolution and liquidation, but that the board of directors owes a duty to holders for preferred stock to disclose the intention to dissolve and liquidate the corporation. The holders of preferred stock would have the option of converting preferred stock to common stock, if the charter provided for conversion rights, or accepting the redemption price. In the principal case such a ruling would have given holders of Class A stock $120 per share rather than $240, the liquidation value of Class A stock.

[14] Southern Pacific Co. v. Bogert, 250 U.S. 483, 39 S.Ct. 533 (1919); Hyams v. Calumet & Hecla Mining Co., (C.C.A. 6th, 1915) 221 F. 529; Lebold v. Inland Steel Co., (C.C.A. 7th, 1941) 125 F. (2d) 369; Weisbecker v. Hosiery Patents, 356 Pa. 244, 51 A. (2d) 811 (1947); Garrett v. Reid-Cashion Land & Cattle Co., 34 Ariz. 482, 272 P. 918 (1928).

press this view. It is reasonably clear, however, that the courts are usually merely overstating the rule that directors owe a fiduciary obligation to the corporation.[15] Mr. Berle, an ardent advocate of increased duties on the board of directors, concedes that "any fair statement of the law would have to be based on the theory that the fiduciary duties of the directors were limited to the corporation. . . ."[16]

C. *Fiduciary Duty of the Board of Directors to the Corporation.* Numerous cases reiterate the proposition that directors occupy a fiduciary relation to the corporation and to the stockholders as a body.[17] Directors are the real managers of the corporate property. They are obligated to act with diligence and care and in good faith in discharging their duties. For failure to act in accordance with these basic rules, they become liable to compensate the corporation for losses which it suffers through such failure. The corporation is obligated to bring suits against directors to recover for losses sustained as the result of a breach of fiduciary duty. But when the corporation defaults in discharging this duty, stockholders may, under certain circumstances, sue in the corporate name on behalf of the corporation to enforce it.[18]

The law has gone to great lengths to insure a clean and high standard of management on the part of the board of directors. In addition to being liable to the corporation for acts in excess of their authority, directors are liable to the corporation for losses that result from certain acts of negligence.[19] If a director is to purge himself from liability he must be reasonably careful and reasonably able.[20] Liability has been imposed upon directors for negligently failing to attend meetings,[21] permitting officers who have been guilty of inefficiency to remain in office,[22] failing to discover defalcation of a cashier,[23]

[15] See cases cited supra, note 14.

[16] BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 226 (1932).

[17] Equity Corporation v. Groves, 294 N.Y. 8, 60 N.E. (2d) 19 (1945); SPELLMAN, CORPORATE DIRECTORS, § 6 (1931). For a collection of cases see: 2 THOMPSON, CORPORATIONS, 3d ed., § 1320 (1927); 3 FLETCHER, CYC. CORP., perm. ed., § 838 (1947); 13 AM. JUR., Corporations, § 997.

[18] Ashwander v. Tennessee Valley Authority, 297 U.S. 288, 56 S.Ct. 466 (1935); Wineburgh v. United States Steam & Street R. Adv. Co., 173 Mass. 60, 53 N.E. 145 (1899); 13 AM. JUR., Corporations, § 461; 59 A.L.R. 1099 (1929).

[19] Hicks v. Steel, 142 Mich. 292, 105 N.W. 767 (1905); Patterson v. Stewart, 41 Minn. 84, 42 N.W. 926 (1889); Baker v. Allen, 292 Mass. 169, 197 N.E. 521 (1935); Chicago Title & Trust Co. v. Munday, 297 Ill. 555, 131 N.E. 103 (1921); 3 FLETCHER, CYC. CORP., perm. ed., § 1029 (1947).

[20] Hunt v. Aufderheide, 330 Pa. 362, 199 A. 345 (1938); Home Life Ins. Co. v. Arnold, 196 Ark. 1046, 120 S.W. (2d) 1012 (1938); 13 AM. JUR., Corporations, § 989.

[21] Briggs v. Spaulding, 141 U.S. 132, 11 S.Ct. 924 (1891).

[22] La Monte v. Mott, 93 N.J. Eq. 229, 107 A. 462 (1921).

[23] Bowerman v. Hamner, 250 U.S. 504, 39 S.Ct. 549 (1919).

failing to advise associates of information known to the director that would have saved the corporation from loss had it been made available to the rest of the board,[24] making bad investments,[25] and for selling corporate property at a loss.[26] However, this does not mean that directors are liable for all losses that they cause the corporation to suffer. Courts will not intervene in the corporation's affairs when directors have made mistakes of judgment providing they used reasonable intelligence and care.[27]

Another group of cases arising in connection with the duties and liabilities of directors involve acts of directors in connection with corporate property which are not intended for the benefit of the corporation as a whole.[28] The temptation is often great to exercise corporate powers to achieve selfish ends. The occasions have not been infrequent where a corporate power has been exercised primarily to strengthen the control of a particular group or primarily to benefit one group of stockholders over another, or primarily to aid a subsidiary.[29] If it can be proved that corporate powers were exercised to promote some selfish interests of the directors or of particular groups of stockholders, liability will usually be imposed upon those directors.[30] This rule has been used to hold a director liable where excessive bonuses were approved,[31] where a director organized a new corporation and used old corporations' trade secrets,[32] where a director engaged in a competing business to the detriment of the corporation[33] and where a director ob-

[24] Reid v. Robinson, 64 Cal. App. 46, 220 P. 676 (1923).

[25] Howland v. Corn, (C.C.A. 2d, 1916) 232 F. 35.

[26] Mobley v. Faulk, 42 Ga. App. 314, 156 S.E. 40 (1930); Prudential Trust Co. v. McCarter, 271 Mass. 132, 171 N.E. 42 (1930).

[27] Besseliew v. Brown, 177 N.C. 65, 97 S.E. 743 (1919); Savings Bank of Louisville v. Caperton, 87 Ky. 306, 8 S.W. 885 (1888); 2 A.L.R. 867 (1919).

[28] For a collection of cases falling within this general category see: 2 THOMPSON, CORPORATIONS, 3d ed., § 1327 (1927); 3 FLETCHER, CYC. CORP., perm. ed., § 1012 (1947); SPELLMAN, CORPORATE DIRECTORS, 536 (1931); 13 AM. JUR., Corporations, § 998.

[29] Luther v. C. J. Luther Co., 118 Wis. 112, 94 N.W. 69 (1903); Albert E. Touchet, Inc. v. Touchet, 264 Mass. 499, 163 N.E. 184 (1928); Schemmel v. Hill, 91 Ind. App. 373, 169 N.E. 678 (1930); Rose v. First National Bank of Stigler, 93 Okla. 120, 219 P. 715 (1923).

[30] Atkins v. Hughes, 208 Cal. 508, 282 P. 787 (1929); Cahall v. Burbage, 14 Del. Ch. 55, 121 A. 646 (1923); Rankin v. Bates County Inv. Co., 238 Mo. 399, 141 S.W. 1118 (1911); Hazard v. Wright, 201 N.Y. 399, 94 N.E. 855 (1911).

[31] Central Consumer Wine & Liquor Co. v. Madden, (N.J. Eq. 1908) 68 A. 777; Rogers v. Hill, 289 U.S. 582, 53 S.Ct. 731 (1933).

[32] Vulcan Detinning Co. v. American Can Co., 72 N.J. Eq. 387, 67 A. 339 (1907).

[33] Jasper v. Appalachian Gas Co., 152 Ky. 68, 153 S.W. 50 (1913); Cases are collected in 64 A.L.R. 782 (1929).

tained a profit by speculation with corporate funds.[34] The duty not to profit personally by use of his office as a director, the same as the obligation to use due care, is a duty owed to the stockholders as a group, that is, to the corporation. Ordinarily a stockholder cannot enforce the obligation by individual suit but must resort to a derivative suit in the name of the corporation.[35]

D. *Fiduciary Duty of the Board of Directors and Redeemable Stock.* In the principal case the circuit court of appeals approached the problem by finding that a fiduciary relation exists between the board of directors and majority stockholders on the one side and the minority stockholders on the other. Cases similar to those referred to above, were cited in support of the proposition that the fiduciary relation is violated when directors and majority shareholders profit by virtue of their official position.[36] The conclusion reached was that the fiduciary principle may be applied to the action of the board of directors in redeeming stock when the redemption profits the directors and majority stockholders. There is nothing in the opinion suggesting that the court intended to limit the decision to the facts at issue. Dissolution and liquidation were considered relevant only in so far as that happened to be the means used to realize the profit. Redemption of stock as an incident to dissolution and liquidation was not regarded as illegal per se even though the majority would profit by the redemption and the holders of redeemable shares would suffer a loss. Redemption was viewed as subject to attack by holders of redeemed stock on the ground that it is designed solely to profit holders of common stock at the expense of holders of preferred stock even though it may be unassociated with dissolution and liquidation.[37]

The court also stated that the intention of the framers of Axton-Fisher's charter was that the board would make the call with due regard to its fiduciary obligation not to profit by use of its official position.[38]

A question may be raised as to the authority of an "interested" board of directors to redeem preferred stock of a prosperous corporation even though at the time of the call there is no thought of liquidation. For example, suppose that when the Class A stock of Axton-Fisher was redeemed, instead of liquidating the corporation the board of directors had distributed the extraordinary profits as special dividends. In such a case Class B stock would have profited by virtue of the

[34] Home Fire Ins. Co. v. Barber, 67 Neb. 644, 93 N.W. 1024 (1903).

[35] Supra, note 18.

[36] Covington & Lexington R. Co. v. Bowler's Heirs, 72 Ky. 468 (1872); Graham v. Tom Moore Distillery Co., (D.C. Ky. 1941) 42 F. Supp. 853; Venus Oil Corporation v. Gardner, 244 Ky. 176, 50 S.W. (2d) 537 (1932).

[37] 162 F. (2d) 36 at 46.

[38] Id.

call just as effectively as Class B stock profited by liquidation in the principal case. This situation would appear to come within the doctrine set forth in the instant case. On the other hand, it is almost inconceivable that any court would use fiduciary principles to void such a redemption.

A large number of preferred share contracts contain provisions making the shares callable or redeemable at the option of the corporation, generally at a premium. Such provisions are ordinarily exercisable when it becomes advisable for purposes of corporate financing. The reason they are inserted is to make it possible for the corporation to call the stock if changes in prosperity of the enterprise or in interest rates have made the dividend rates unnecessarily high, or some provision in the contract has made it inconvenient. It is ordinarily expected that such provisions may prove beneficial to the common shareholders and to the enterprise as an economic unit.[39] The practical result of applying fiduciary concepts to the action of the board of directors in calling preferred stock would all but do away with the advantages of making preferred stock redeemable.[40]

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[39] Dodd, "Purchase and Redemption by a Corporation of Its Own Shares: The Substantive Law," 89 UNIV. PA. L. REV. 697 at 724 (1941); BALLANTINE, CORPORATIONS, rev. ed., 618 (1946); 11 FLETCHER, CYC. CORP., perm. ed., § 5309 (1932).

[40] DEWING, FINANCIAL POLICY OF CORPORATIONS, 3d ed., 48-52, 77 (1934). The Zahn case was cited in Langfelder v. Universal Laboratories, Inc., (D.C. Del. 1946) 68 F. Supp. 209 at 211, as standing for the proposition that the liquidation section of Kentucky corporation law is not complete in itself but its validity is in a measure dependent upon other sections of that state's corporation law. It should be observed, however, that this citation was made prior to the reargument and decision of the Zahn case. Leading articles in the general field are: Berle, "Corporate Powers as Powers in Trust," 44 HARV. L. REV. 1049 (1931); Dodd, "For Whom Are Corporate Managers Trustees?" 45 HARV. L. REV. 1145 (1932); Dodd, "Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?" 2 UNIV. CHI. L. REV. 194 (1934); Lattin, "Equitable Limitations on Statutory or Charter Powers Given to Majority Stockholders," 30 MICH. L. REV. 645 (1932).