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Corporations

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Faber,[9] defendant, an experienced mechanical engineer, in consideration of his employment as chief engineer and plant superintendent by plaintiff, an Ohio manufacturer of spray-painting equipment, agreed that he would not engage in or work for any business in competition with that of plaintiff in nineteen states, including Ohio, and in Ontario, Canada, during his employment and for a period of five years thereafter, and also from disclosing to anyone any confidential information of manufacture or of the trade secrets of the plaintiff.

While defendant had worked for plaintiff since 1951, the above agreement was entered into in May, 1953. Defendant voluntarily left the employment of plaintiff in December, 1954, and shortly thereafter was employed by the Roll-Rite Company of Genoa, Ohio, which company at the time was not a competitor of the plaintiff. During the first ten months defendant worked for Roll-Rite, however, it manufactured and delivered two spray-painting machines to a former Ohio customer of plaintiff, and a spray-painting mask to another former customer of plaintiff. All three pieces of equipment substantially incorporated the designs and techniques of the plaintiff's products. The defendant later left the employ of Roll-Rite when that company was advised of the provisions of the employment contract between plaintiff and defendant. Held: the evidence as to a breach of the contract pertains to competitors and customers of the plaintiff in the state of Ohio, and, therefore, plaintiff is reasonably entitled to injunctive relief for the duration of the five-year period. An award of damages was denied on the basis of insufficient evidence as to such damages.

ROBERT C. BENSING

CORPORATIONS

Fiduciary Obligation of Promoter — Secret Profits

During recent years, considerable attention has been devoted to the nature and extent of fiduciary obligations owed in connection with corporate affairs. In *Johndahl v. Columbus Trotting Ass'n., Inc.*,[1] the Court of Appeals of Franklin County was presented with several interesting questions concerning a promoter's fiduciary relationship to the corporation which he has formed.

The key facts in the case may be simply stated. Prior to 1949, a partnership, of which plaintiff was a member, conducted trotting races at Hilliards, Ohio. Plaintiff and certain of his associates then decided to

9. 146 N.E.2d 447 (Ohio Ct. App. 1957).

incorporate the business. Plaintiff became a director, president and manager of the corporation and received, in exchange for his partnership investment, 225 shares of its stock having a par value of $100 each. The value of the partnership assets transferred was fixed at $92,500, per an appraisal prepared by plaintiff.

After serving in such capacity for some two years, plaintiff tendered his resignation (for reasons undisclosed). Shortly thereafter, he took judgment on a cognovit note allegedly issued by the corporation to evidence a loan, the proceeds of which were used by the company to purchase the stock of another shareholder. On motion, the common pleas court suspended the judgment and defendant corporation filed an answer and cross-petition asserting, *inter alia,* that plaintiff had realized a "secret profit" of $10,000 by reason of misrepresentation of his partnership investment.

In reversing judgment for defendant on its cross-petition and remanding the case for further proceedings, the court of appeals held that the evidence was insufficient to sustain the finding that plantiff realized any such undisclosed profits. The court held, however, that plaintiff was a promoter, in that he was instrumental in forming the corporation, negotiated for transfer of the partnership assets and became an officer and director. While the corporation may recover secret profits made by a person occupying the fiduciary relationship of a promoter, by failure to disclose or by actual misrepresentation of the value of assets transferred, the corporation has the burden to prove the amount of the profit reaped by the promoter. To this end, it is first necessary to establish the market value of the partnership assets at the time of transfer, which the corporation failed to do in the trial court.

In reaching this conclusion, the court gave considerable attention to the test to be used in computing "secret profits." In its cross-petition, defendant alleged that the promoter had represented the cost of his partnership interest to be in excess of $22,500, whereas he had in fact invested less than $12,500. The trial court, on the other hand, based its decision on a finding that, at the time of transfer, the market value of the assets was over $20,000 less than the figure determined by the promoter. The court of appeals, after noting that the trial court had departed from the theory set forth in the cross-petition, held that the proper test is not what the promoter and his associates may have paid for the interests of some of the other partners, but the value which they received by such purchases, together with the value of the other holdings of the partnership (as at the time of transfer). The court stressed that

1. 104 Ohio App. 118, 147 N.E.2d 101 (1956), motion to certify the record overruled, October 17, 1956. See, 8 West. Res. L. Rev. 541 (1957).

plaintiff had actually invested $18,500 in cash in partnership assets which were turned over to the corporation, which did not include other valuable assets such as the leasehold, which carried betting privileges, and the concessions.

While the case is complicated by other procedural and evidentiary questions, the decision seems eminently sound in that a realistic fiduciary standard is applied which protects the interests of the corporation without imposing an unduly harsh burden of proof upon the promoter. Such an approach should aid Ohio practitioners and judges alike in resolving future controversies involving fiduciary obligations of promoters.

Non-Profit Corporations — Election of Trustees

Another court of appeals decision[2] illustrates the significance of the code of regulations in corporate affairs. The Prosecuting Attorney of Franklin County brought an action in quo warranto, questioning the validity of the election of trustees of a cemetery association organized in 1923 under the Ohio Non-Profit Corporation Law. The validity of the election depended on whether those who participated and who attempted to participate in the election of trustees were members and entitled to vote at a meeting of the association. Under the code of regulations then in force, a person could become a member of the association by purchasing a family lot, consisting of six grave spaces.

The court denied the writ, holding that the objecting party was not a member within the meaning of this provision and therefore had no right to nominate or challenge the results of an election. The court likewise found no merit to the argument of estoppel arising from the fact that seven out of the eleven trustees, who had served prior to the meeting in question, were not members. They were trustees in fact, since no one challanged their right to serve or their election, but the court pointed out that this fact alone would not constitute them members with authority to vote and participate in meetings.

Officers and Agents — Authority to Bind Corporation

Two cases involved the authority of corporate officers and agents. In *Tenbusch v. L.K.N. Realty Company*,[3] a broker sought to recover a commission for finding a purchaser of improved realty. The president of defendant corporation, with whom the plaintiff had negotiated exclusively,

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2. State *ex rel.* Devine v. Baxter, 153 N.E.2d 452 (Ohio App. 1958), *appeal dismissed,* 168 Ohio St. 559 (1959). By the time the appeal was heard by the Supreme Court of Ohio, the trustees had been re-elected and the Supreme Court thereupon held that the questions presented had become moot.

3. 149 N.E.2d 42 (Ohio App. 1958). See also AGENCY section, *supra.*

was the owner of 220 of the 250 outstanding shares of stock and was also a director and treasurer of the company. His wife and two minor sons owned all other outstanding shares, and the wife was a director and secretary. The other director was also vice-president, but owned no stock in the company.

Under these facts, the court held, as a matter of law, that the president had implied authority to offer corporate property for sale and that the corporation was therefore bound by the president's actions.[4] The court proceeded, however, to reverse a judgment for plaintiff and to render final judgment for defendant on substantive contractual and evidentiary principles.

Guenther v. Downtown Mercury, Inc.,[5] was an action for reformation of a contract for purchase of an automobile, together with an accompanying chattel mortgage and insurance policy. In the execution of the chattel mortgage, the intended surety (plaintiff), by mistake, signed the mortgage on the line denoting him as the purchaser. On the basis of such act, a policy of insurance was issued on his life as purchaser of the car. The actual purchaser (plaintiff's son) died shortly thereafter, and plaintiff found himself obligated for the unpaid balance without the benefit of insurance.

In denying reformation, the majority of the court of appeals held that even though the mistake may have been mutual as to the purchaser, surety, dealer and finance company, there was no clear and convincing evidence that the insurance company had any notice of the mistake. Despite evidence of a very close business relationship between the dealer, finance company and insurance company, the court regarded them as three independent business corporations. A close relationship is not, in itself, proof of authority on the part of agents of one company to bind the others by contract.

The dissenting judge emphasized the practical relationship of agents of the three companies, and particularly those of the finance and insurance companies. In fact, no medical examinations were required by the insurer if the risk was approved by the finance company. On this basis, the dissent would recognize a general contractual relationship between the companies, sufficient to charge the insurance company with notice of the mistake.

Considering the harsh result of the majority holding in light of the

4. *Cf.*, Miller v. The Wick Building Co., 154 Ohio St. 93, 93 N.E.2d 467 (1950), holding that a general manager had, as a matter of law, no authority to enter into an agreement for the sale of corporate property.

5. 105 Ohio App. 125, 151 N.E.2d 749 (1958), motion to certify the record overruled, April 30, 1958. See discussion in INSURANCE section, *infra*.

undisputed facts of the case, there is seemingly considerable merit to the view advanced by the dissenting opinion.

Corporate Obligations — Restrictions on Right of Holder to Bring Suit

In *Lichter v. Land Title Guarantee & Trust Company*,[6] an Ohio Turnpike bondholder brought a class action to hold the title company primarily liable for return of money paid it by the Turnpike Commission, incident to performance by the title company of a contract declared to be void. Judgment for the title company was affirmed, since the bonds contained a provision that no holder of outstanding bonds should have the right to institute suit, unless he previously had given notice to the trustee and unless holders of not less than 10% of the bonds outstanding made written request to the trustee. The plaintiff having failed to comply with such provisions, the court of appeals held simply that the restrictions upon the right of action of an individual holder of a series of corporate bonds were reasonable and therefore valid and enforceable.

Securities Exchange Act — Director's Liability for Short-Swing Profits

The Sixth Circuit Court of Appeals had occasion to decide a suit by a corporation against one of its directors to recover profits resulting from sale of common stock of the corporation within six months after acquisition, under Section 16(b) of the Securities Exchange Act.[7] The defendant acquired convertible preferred stock (traded on the New York Stock Exchange) as a result of a merger, and became a director of the corporation. More than three years later, he exercised the right to convert such shares into common stock, to prevent a loss of about $9.00 per share pursuant to action of the company in redeeming the preferred stock. Within six months, defendant sold part of the common stock and realized a profit on such sale.

Noting that the purpose of the statute is to curb short-swing speculation by insiders, the court regarded the main issue to be whether defendant's acquisition of the common stock, upon conversion of his preferred stock, was a "purchase" within the meaning of Section 16(b). The Sixth Circuit held that this transaction was not a "purchase," since it was dictated by economic necessity and could not lend itself to the speculation encompassed by the Act., The preferred stock, with its undilutable conversion privilege, was "in the objective judgment of the

6. 150 N.E.2d 70 (Ohio App. 1957).
7. Ferraiolo v. Newman, 259 F.2d 342 (6th Cir. 1958) (appeal pending).

market place," the economic equivalent of the common. The court also stressed the fact that a full disclosure was made and all preferred shareholders were treated alike, and concluded:

> While [defendant] could have sold preferred shares on the open market instead of converting them, it can hardly be said that a failure to sell is tantamount to a purchase.[8]

Interestingly, the fact that the director was very inactive and was not privy to any inside information was an entirely irrelevant consideration in this case.

Profit Sharing and Retirement Benefits — Shareholders' Ratification of Directors' Action

Berkwitz v. Humphrey[9] involved a shareholder's derivative suit against Pittsburgh-Consolidation Coal Company, a Pennsylvania corporation, and George M. Humphrey and R. L. Ireland, two of its directors, challenging provisions of a profit sharing and retirement plan (called the "Management Unit Plan") and a sale of Pittsburgh-Consolidation stock to the directors. The shareholders sought an accounting of profits and damages resulting from these transactions.

The Management Unit Plan, adopted by the company in 1946, provided additional annual compensation, without actual purchase by employees of the company's common stock, equal in amount to dividends paid per share of common stock multiplied by the number of "units" held by each employee under the plan. In addition, the plan provided for deferred compensation upon retirement, measured by the increase in the market value of common stock during employment. The market value of the stock was to be determined as of the date of termination of employment or such other date within five years thereafter as the employee might select.

Noting that the question presented was one of first impression, the district court held that the plan was invalid, as to the retirement feature, for failure of the compensation to bear "a reasonable degree of equivalence to the value of services." Likewise, the provision granting an employee the right to defer the valuation date until after his retirement was held to be unreasonable *per se,* since any payment resulting from an increase in value after the employee ceased working would be a gift and a clear misuse of corporate funds. While no affirmative relief could be enforced against employees who were not parties to the action, the court did enter an order restraining Pittsburgh-Consolidation from

8. *Id.* at 346.
9. 163 F. Supp. 78 (N.D. Ohio 1958).

entering into any agreement or issuing any units in the future, pursuant to the plan.

The court further found that the shareholders of the company had never effectively ratified the Management Unit Plan. The proxy statement sent to shareholders, while describing the basic compensation features of the plan, did not set forth numerous significant details, and in essence, sought approval only of a proposal to implement the plan by setting aside stock for issuance and sale from time to time to provide necessary funds. At no time was shareholder approval requested of the plan itself with full knowledge of all pertinent facts.

The second cause of action involved a sale of Pittsburgh-Consolidation stock by an Ohio company to directors Humphrey and Ireland, among others, by means of a sale of the stock to Pittsburgh-Consolidation and immediate resale to the directors, with a large part of the purchase price financed by Pittsburgh-Consolidation at the low interest rate of 2½%. While this action was subsequently ratified by an overwhelming majority of the disinterested shares, the plaintiff shareholders contended that this ratification was nullified by certain omissions from the proxy statement requesting approval of the action taken by the board of directors.

After detailed consideration of each allegation, the district court held that the ratification was effective, despite the omission of the following items from the proxy statement:

(1) Information relative to the extent of ownership of the purchasing directors in the Ohio company selling the stock;

(2) Statement that contemplated dividends of Pittsburgh-Consolidation would enable the directors to pay the principal and interest on the loans; and

(3) Assurance that the directors would continue to be associated with the company.

The court concluded that although the "terms of the loans were unusually favorable to the borrowers," the action was approved by a substantial majority of the disinterested shareholders with full knowledge of all significant terms and conditions.

While the district court stated that its decision was governed by Pennsylvania law, the import of the principles announced and applied therein is nonetheless significant for Ohio lawyers, because of the novelty of the questions presented. The case may well become a landmark decision, particularly in the area of deferred compensation.

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