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Corporation Law--Promotors' Fiduciary Duty--Corporate Right of Recovery

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delay in arraignment, even with a person of low mentality, destroys freedom of choice is, at best, a tenuous connection. Following the Court's reasoning, five days, or three, or even one day of illegal delay in arraignment might easily result in reversal of a conviction, and the drift away from the real issue would become more perceptible. If the Court reverses a conviction when the universally recognized elements of coercion are present, it is acting within its proper scope. But in doubtful cases, like *Fikes,* when there appears to be no close tie-up between the voluntary character of the confession with the reprehensible police methods, the Court should respect the opinion of an impartial trier of the facts. The Court cannot hear the defendant on the witness stand, listen to the police officers, or, if necessary, call psychiatrists; all the Court has before it is the printed record.

THOMAS A. DUGAN

CORPORATION LAW — PROMOTORS' FIDUCIARY DUTY — CORPORATE RIGHT OF RECOVERY

Defendant and other promoters organized the plaintiff corporation for the purpose of exploring and developing leased uranium claims. The lease was obtained by them under an agreement to explore and develop the claims and to pay royalties; no money consideration was paid. Once the corporation was organized, the lease was assigned to it in return for 300,000 shares of stock, par value $3,000, and a promissory note for $25,000. An additional 300,000 shares of stock were issued to several other promoters for "promotional services rendered." The remaining stock (599,000 shares, one cent par value, at 50 cents per share) was then issued to the public under an S.E.C. exemption.[1] The offering circular published and distributed by the corporation disclosed the issuance of the shares to the promoters and the execution of the note, without fully disclosing the circumstances of the original acquisition of the lease by the promoters. The proceeds from the sale of the stock were used to discharge the promissory note held by one of the promoters. The cash thus obtained was invested by the promoter in a home to which the defendant took title.

The corporation brought an action to establish an equitable lien on the real property owned by defendant. Thus the court had to decide whether the corporation could recover secret profits realized by its promoters, a question which has plagued the courts of this country ever since the diametrically opposing results were reached in the famous *Old*

[1] 17 C.F.R. §§ 230.220-230.224 (1949)) (S.E.C. Regulation A. General Exemptions).

Dominion litigations.[2] The court of appeals[3] reversed the judgment of the district court, which had dismissed the complaint for failure to state a claim upon which relief could be granted.[4]

Fundamentally, the existence of a corporate right of action has been predicated upon whether or not the promoters had adequately disclosed their gains to the corporation. Promoters have been held at liberty to profit from their dealings with the corporation — and the profits may be either modest or unreasonably large — so long as the corporation was adequately informed.[5] Since promoters have been classified as fiduciaries in their dealings with the corporation, it is their duty not to refrain absolutely from making profits, but only to reveal all the facts to the *cestui*.[6]

Where promoters have realized profits from selling their own property to the corporation at a price in excess of what they themselves had paid, the form of the promotional scheme has governed the corporate right of recovery.

1) No corporate right of action is allowed where the promoter takes all the stock that was ever issued. The basis for such holding is that all shareholders are fully informed, and they assent to the transaction.[7]

2) Where the promoter receives only part of the stock issued, and the remainder is taken or subscribed to at the same time by parties who were unaware of the profits, the presence of such uninformed interest precludes the fictitious "corporate assent" which would later bar the corporation from suing.[8]

3) Where the promoter obtains all the presently issued shares, but the corporation retains additional shares, intended to be issued directly to the public at a later date, the courts are in disagreement as to whether the promoter's fiduciary duty extends to incoming subscribers so as to

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[2] Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U.S. 206 (1908); Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 150, 89 N.E. 193 (1909), *aff'd*, 225 U.S. 111 (1912).

[3] San Juan Uranium Corporation v. Wolfe, 241 F.2d 121 (10th Cir. 1957)

[4] The litigation was controlled by Oklahoma law and was apparently a question of first impression in that state. The Oklahoma Business Corporation Act of 1947, OKLA. STAT. ANN., Title 18, Chapter A (1953) contains no specific provision regulating the promoter in the organization of corporations.

[5] 13 AM. JUR., *Corporations* § 116 (1938)

[6] McGowan, *Legal Controls of Corporate Promoters' Profits*, 25 GEO. L. J. 269 (1937)

[7] Hayes v. The Georgian Inc., 280 Mass. 10, 181 N.E. 765 (1932); *In re* Ambrose Lake Tin and Copper Mining Company, 14 Ch. D. 390 (1880).

[8] Hughes v. Cadena de Cobre Mining Co., 13 Ariz. 52, 108 Pac. 231 (1910); Jarvis v. Great Bend Oil Co., 66 Okla. 179, 168 Pac. 450 (1917)

make the non-disclosure of profits to them a basis for corporate recovery.[9] A slight majority follows the doctrine which the Massachusetts court established in the *Old Dominion Cases* and extends the promoter's fiduciary duty to the corporation, both as presently constituted and as it would be after additional shares of stock were sold in the future. The Supreme Court of the United States, on the same facts, refused so to hold on the ground that the advent of additional shareholders did not negative the "corporate assent" previously given by all the then shareholders.

In the instant case, the majority of the court felt that deceptive representations had been made by the promoters to prospective shareholders to induce them to purchase the stock, the proceeds of which were to be paid to the promoters in furtherance of a fictitious scheme. This constituted a flagrant breach of the trust obligation imposed upon the promoters to those whom they induced to invest in the corporation. The technical assent of the corporation through its promoters was held to be no defense to the action by the corporation when freed of the promoters' influence, the court relying on the Massachusetts doctrine in rendering its judgment.

The dissent would have affirmed the district court's dismissal of the complaint, predicating its holding upon the federal doctrine. At the time the lease was assigned to the corporation, no cause of action came into being in the corporation; all of the then stockholders had full and complete knowlodge of the facts and assented to the transaction. No corporate right of recovery, said the dissent, arose thereafter by reason of subsequent stockholders' purchasing stock in the corporation without a full disclosure to them of the consideration paid for the lease. In addition, the dissent expressed doubt as to whether any fraud had been perpetrated on the subsequent stockholders. The following information had been published in the offering circular:

> The Corporation has acquired by assignment a lease on the mining properties. Consideration for this lease assignment is $25,000 in cash and 300,000 shares of the Corporation's common stock. 300,00 shares of the common stock have been issued , as part of the consideration for the acqusition of the mining lease and option owned by the Corporation.
>
> The Company intends to carry on a preliminary exploratory program to establish the extent and possible value of uranium and vanadium ore located on the above leased mining claims.[10]

This disclosure, the dissent felt, sufficiently informed prospective investors of the wholly undeveloped and unproven nature of the mining lease, and of its purely speculative value. But even if fraud had been

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[9] See note 2 *supra.*

[10] San Juan Uranium Corporation v. Wolfe, 241 F.2d 121, 124, (10th Cir. 1957).

proved,[11] while it may have given rise to a personal cause of action, it did not bring into existence a cause of action in the corporation which had not theretofore existed.[12]

Were the acts or omissions of the promoters of such nature as to be deemed fraudulent? A broad rule has been laid down that it is the duty of the promoter not only to abstain from stating as a fact that which is not so, but not to fail to state any fact within his knowledge the existence of which might in any form affect the extent or the quality of the advantages held out as an inducement.[13] Statements may be found that a promoter's duty is fulfilled where he discloses the fact that he is the real vendor, and that he is not bound to make known the price at which he purchased the property, so long as he does not actively or passively mislead his associates.[14] An examination of decisions cited in support of such statements reveals that the owners of the property acquired it prior to becoming promoters of a corporation, and before any promotional scheme was conceived.[15] It appears that the "fiduciary" status of the promoters placed them under an affirmative duty to disclose the price at which they had originally obtained the mining lease.

That "the exact legal status of the promoter has appeared a mischievous puzzle to the jurists,"[16] and still does, is well illustrated by the instant case. The difficulty lies in finding a common-law pigeonhole for a status which is a by-product of a legislative creature: the private corporation.[17] Various attempts to assign to the promoter a legal position of agent, partner, fiduciary, trustee or outsider have led to embarrassment and confusion.[18] Where the fiduciary concept has been followed, the form of the promotional scheme may govern the corporate right of recovery. Thus the promoters in the instant case could have easily defeated a corporate recovery had they stuck to the approved rule of taking all the authorized shares of stock themselves, and selling it to innocent purchasers at a latter date. The application of this doctrine is

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[11] On July 19, 1955, the S.E.C. issued an order temporarily suspending the corporation s exemption, 20 FED. REG. 5295 (1955); the order was based in part upon "untrue statements of material facts" in the offering circular, and that the offering operated "as a fraud or deceit upon the purchasers."

[12] The defrauded shareholders could also bring an action as a spurious class suit under Rule 23(a)(3) of the Federal Rules of Civil Procedure.

[13] 13 AM. JUR., *Corporations* § 117 (1938).

[14] *Ibid.*, citing 8 B.R.C. 907 (1919)

[15] Burbank v. Dennis, 101 Cal. 90, 35 Pac. 444 (1894); Spaulding v. North Milwaukee Town Site Co., 106 Wis. 481, 81 N.W 1064 (1900); See Exeter v. Sawyer, 146 Mo. 302, 47 S.W 951 (1898)

[16] 1 DEWING, THE FINANCIAL POLICY OF CORPORATIONS 425 (4th rev. ed. 1941).

[17] Isaacs, *The Promoter: A Legislative Problem,* 38 HARV. L. R. 887 (1925).

[18] *Id.* at 898.

well illustrated by the decision of the Massachusetts court in *Hays v. The Georgian Inc.*,[19] which doctrine has always represented the law in this country.

The Federal Securities Acts[20] do not make any direct provisions concerning the liability of promoters to a corporation. The Securities Act of 1933 empowers the S.E.C. to issue a stop order suspending the effectiveness of a registration statement which

> includes untrue statements of a material fact or omits to state any material fact required to be stated therein or necessary to make statements therein not misleading. [21]

Such enables the Commission to control promoters' profits by forcing disclosure within reasonable limits. The benefits of the federal enactments do not oftentimes inure to the small, uniformed investor to whom S.E.C.-exempt "penny stock" is made palpable. It is this casual investor whom certain investment circles are trying to reach of late, and who appears to be most in need of protection.

Though comment, criticism and advice has not been lacking in the past,[22] it still remains for an enlightened legislature to give the promoter a legal status commensurate with his importance in today's world of business corporations.

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[19] 280 Mass. 10, 181 N.E. 765 (1932).

[20] Securities Act of 1933, 48 STAT. 74 (1934), as amended, 15 U.S.C. §§ 77a-77aa (1947); Securities Exchange Act of 1934, 48 STAT. 881, 15 U.S.C. §§ 78a-78jj (1947).

[21] 48 STAT. 79, 80 (1934), 15 U.S.C. § 77h(d) (1947).

[22] Notes 6, 16, 17 *supra.*