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Article 17

Corporations--Promoters--Fiduciaries (McCandless v. Furlaud et al., 296 U.S. 140 (1935))

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that defendant's failure to cause a copy of Section 66 [10] to be printed upon the stock certificate was *ipso facto* sufficient ground upon which to have allowed a recovery by the plaintiff and in the writer's opinion, had a copy of Section 66 been printed on the stock certificate, the question of notice would have been immaterial and plaintiff's action would have failed.

H. T. P.

CORPORATIONS — PROMOTERS — FIDUCIARIES. — In an action brought by the plaintiff receiver to recover profits made by the defendant promoter while sole stockholder of the Duquesne Gas Corporation, an ingenious scheme for mulcting the investing public was unearthed. While in full control, the defendant had entered into two contracts with the corporation and increased its capital stock. By the first contract, the corporation agreed to purchase certain oil tracts in Pennsylvania on which the defendant had previously acquired options the actual value of which was $2,500,000. The corporation was to issue some $5,000,000 in bonds and pay as the purchase price for the oil lands a large block of shares and $4,315,000 in bonds. By the second contract it agreed to sell the remainder of the bonds and stocks to the defendant promoter.

The stage having been set, nothing remained but to manipulate the machinery to unload the bonds and stocks on the investing public. By means of a one-day bank loan secured by the defendant, the deeds to the lands were released from escrow and title vested in the corporation. Immediately, the bonds were released to the eager subscribers, who had been attracted by a prospectus that grossly over-valued the property at $6,500,000. At the close of the transaction, the corporation had been saddled with a $5,000,000 debt represented by the outstanding bonds, and liable for some 1,250,000 shares of non-par stock. The defendant had pocketed the difference. Two years later the corporation was insolvent and the plaintiff was appointed receiver. In an action to recover illicit profits, the Circuit Court [1] had denied a recovery on the theory that the harm was personal to the individual subscribers and that the consent of the stockholders precluded the receiver of the corporation from recovery. *Held,* reversed. The defendant is liable as trustee for the creditors. No assent of the stockholders could legalize a waste of assets which would jeopardize the security of the creditors. *McCandless* v. *Furlaud* et al., 296 U. S. 140, 56 Sup. Ct. — (1935).

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[10] *Supra* note 1.

[1] 75 F. (2d) 977 (C. C. A. 2d, 1935).

It is well settled that promoters of a corporation stand in a fiduciary relation to it, to the extent that they are chargeable as trustees if they deal with it unconscionably or oppressively or in violation of a statute, unless the liability for such misconduct has been effectually released.[2] To what extent the approval of all the stockholders will relieve the promoter is to be determined by the interests affected.[3] By the weight of authority a distinction is drawn between the effect of approval by all the stockholders in the case where a further issuance of stock to subscribers is contemplated and a case where all the shares are issued to the promoters and then sold by them to the public.[4] The Massachusetts rule enunciated in the famous case of *Old Dominion Copper Co.* v. *Bigelow*[5] supports this distinction by voiding the approval in the case of the former.[6] The Federal Court disregarded the distinction in the case of *Old Dominion Copper Co.* v. *Lewisohn*[7] and declared that approval by the outstanding stockholders was binding upon the corporation.[8] This rule invoked a storm of criticism[9] and was limited by subsequent decisions to the case where all stockholders had approved.[10] The instant case limits the rule still further by imposing the condition that the consent will not perpetrate a fraud upon creditors.[11] The defense of approval, it

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[2] Dickerman v. Northern Trust Co., 176 U. S. 181, 204, 20 Sup. Ct. 311 (1900); Yerser v. U. S. Board & Paper Co., 107 Fed. 340 (C. C. A. 6th, 1901); Der Klotz v. Broussard, 203 Fed. 942 (C. C. A. 8th, 1913); Gates v. Megargel, 266 Fed. 817 (C. C. A. 2d, 1920), *cert. denied,* 254 U. S. 638, 41 Sup. Ct. 13 (1920); Commonwealth S. S. Co. v. American Shipbuilding Co., 197 Fed. 797 (Dist. Ct. Ohio 1912); Tilden v. Barber, 268 Fed. 587, 601 (Dist. Ct. N. J. 1920); Brewster v. Hatch, 122 N. Y. 349, 362, 25 N. E. 505 (1890); Erlanger v. New Sombrero Phosphate Co., 3 App. Cas. 1218 (1878); EHRICH, PROMOTERS (1st ed. 1916) § 14.

[3] See the instant case at 157, 56 Sup. Ct. —.

[4] Hinkley v. Sac Oil & Pipe Line Co., 132 Iowa 396, 403, 107 N. E. 629, 632 (1906); Camden Land Co. v. Lewis, 101 Me. 78, 95, 63 Atl. 523, 530 (1905); Mason v. Carrothers, 105 Me. 392, 399, 404 *et seq.,* 74 Atl. 1030, 1033, 1035–36 (1909); Old Dominion Copper Co. v. Bigelow, 188 Mass. 315, 74 N. E. 653 (1905); Old Dominion Copper Co. v. Bigelow, 203 Mass. 159, 89 N. E. 193 (1909); Plaquemines Tropical Fruit Co. v. Buck, 52 N. J. Eq. 219, 27 Atl. 1094 (1893); Wills v. Nehalem Coal Co., 52 Ore. 70, 96 Pac. 528 (1908); Pietsch v. Milbreath, 123 Wis. 647, 657 *et seq.,* 101 N. W. 388, 391–92 (1904); Lagunas Nitrate Co. v. Lagunas Syndicate, 2 Ch. Div. 392, 427, 428, 440–41 (1899).

[5] 188 Mass. 315, 74 N. E. 653 (1905).

[6] *Id.* at 321, 74 N. E. 657.

[7] 210 U. S. 206, 28 Sup. Ct. 634 (1908).

[8] New York seems to follow the Supreme Court of the United States; see Continental Securities Co. v. Belmont, 168 App. Div. 903, 154 N. Y. Supp. 54 (1915); EHRICH, PROMOTERS (1st ed. 1916) § 129.

[9] Weston, *Promoters' Liability: Old Dominion v. Bigelow* (1916) 30 HARV. L. REV. 39; Brockelbank, *The Compensation of Promotors* (1934) 13 ORE. L. REV. 195; EHRICH, PROMOTERS (1st ed. 1916) §§ 128, 129, 130.

[10] Davis v. Las Ovas Co., 227 U. S. 801, 33 Sup. Ct. 197 (1913).

[11] See the instant case at 159, 56 Sup. Ct. —.

seems, would be available if the corporation had brought the action.[12] A receiver, however, acts in behalf of both the creditors and the corporation.[13] This dual representative capacity precludes the promoter from showing the consent of the stockholders.

The court by its decision imposes a fiduciary's duties upon the promoter toward the bondholder who assists in financing the enterprise.[14] It is clear that no wrong was done the corporation as such, since all the stockholders had consented and hence the sole basis for the decision was the creation of a trust relationship between creditor and promoter.[15] It is difficult to sustain that principle on authority.[16] Both the decisions and text-writers have been uniform in maintaining that there is a mere arms-length relationship between creditor and promoter.[17] However, it is difficult to join the minority in the lament that settled principles are being thrown to the wind.[18] The imposition of the fiduciary relationship upon the promoter and the creditor who advances money to finance the enterprise is a welcome addition to corporate law. However, it is doubtful that the trust relationship will be imposed unless the breach of the fiduciary duty shall bring the corporation to the "brink of insolvency". The rule is destined to limitation by subsequent decisions rather than expansion.

J. E. H.

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[12] Old Dominion Copper Co. v. Lewisohn, 210 U. S. 206, 28 Sup. Ct. 634 (1908); Foster v. Seymour, 23 Fed. 65 (C. C. S. D. N. Y. 1885); Stratton's Independence, Ltd. v. Dines, 126 Fed. 968 (C. C. D. Col. 1904); Seymour v. S. F. C. Ass'n, 144 N. Y. 333, 39 N. E. 365 (1895); Blum v. Whitney, 185 N. Y. 232, 78 N. E. 1099 (1906). *Cf.* Old Dominion Copper Co. v. Bigelow, 188 Mass. 315, 325, 74 N. E. 653 (1905).

[13] Grasselli Chemical Co. v. Aetna Explosives Co., 252 Fed. 456 (C. C. A. 2d, 1918); Drennes v. Southern States F. Ins. Co., 252 Fed. 776 (C. C. A. 5th, 1918); Attorney General v. Guardian Mut. L. Ins. Co., 77 N. Y. 272 (1879); Pittsburg Carbon Co. v. McMillan, 119 N. Y. 46, 23 N. E. 530 (1890); Nealis v. American Tube, *etc.*, Co., 150 N. Y. 42, 44 N. E. 994 (1896); *In re* Coleman, 174 N. Y. 373, 66 N. E. 983 (1903).

[14] Cardozo, J., writing for the majority in the instant case at p. 163:
"Confusion of thought is inevitable unless the position of the wrongdoers as trustees is steadily kept in mind. What is here is something more than a tort of fraudulent representations to be redressed by the recovery of damages at the suit of the defrauded creditors. What is here is a tort growing out of the fraudulent depletion of assets by men chargeable as trustees if they have failed to act with honor."

[15] *Ibid.*

[16] Van Weel v. Winston, 115 U. S. 228, 6 Sup. Ct. 22 (1885) (relation between bondholder and president of company); Banque Franco-Egyptienne v. Brown, 34 Fed. 162, 190–91, 196 (C. C. S. D. N. Y. 1888); EHRICH, PROMOTERS (1st ed. 1916) § 14.

[17] *Supra* note 16.

[18] Roberts, J., writing for the minority in the instant case:
"I concur in the view that the Duquesne Gas Corporation took an unconscionable profit * * *. This fact * * * ought not to induce the courts to disregard settled principles in an effort to deprive the respondents of the fruits of their scheme."