Rights of a Corporation in Missouri against Promoters for Secret Profits

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It is an interesting and, perhaps, little known fact that at the time the famous case of Erlanger v. The New Sombrero Phosphate Co.¹ was being litigated before the English courts and the House of Lords a similar case as yet unreported was pending before the courts of this state. This was the case of The St. Louis & Utah Silver Mining Co. v. James A. Jackson,² which was decided in the Circuit Court at St. Louis by Judge Boyle in 1877. In these cases, there was considered the duties resting upon persons who sell to a corporation that they have promoted, property which they have purchased or on which they have secured an option to purchase, for a consideration less than that for which the sale to the corporation is made.³ The new-old questions presented in these cases are constantly arising before the courts. In fact, they were before the Supreme Court of the United States in a case in November of last year,⁴ and as one writer said, the Court in that case was called upon to solve "one of the most important problems of corporate law ever decided by that Court.⁵"

The purpose of this paper is to discuss the obligations of promoters in selling property to the corporation that they promote, and the remedies available to the corporation when the promoters fail to meet these obligations. This discussion does not cover the possible liability of promoters to individuals or other corporations who may be injured by their actions. The subject is treated with special reference to the Missouri law, while the law of other jurisdictions is contrasted and compared with the law of this state.

The fundamental proposition upon which the duties of promoters rest in this connection is that they stand in a fiduciary relationship to the corpora-

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1. L. R. 3 A. C. 1218 (1878) affg 5 Ch. D. 73 (1877).
2. St. Louis Circuit Court, No. 38396, old series (1877). The report of this unpublished case was taken from the original record by the writer. See (1877) 5 CENT. L. J. 317.
3. This problem is discussed by the following writers: BALLENTINE, CORPORATIONS (1927) 166-193; 1 FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS (1917) §§ 134-147; 1 MACHEN, MODERN LAW OF CORPORATIONS (1908) §§ 365-399; and (1919) 14 C. J. §§ 335, 336, 341-346.

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tion which "arises out of the nature of the transaction," and which is often likened to the relationship between a trustee and a cestui que trust. The corporation is brought into being, so to speak, under their control. They, therefore, occupy "a position of trust and confidence to the subscribers and also to the proposed corporation." It follows from this fiduciary relationship that where the promoters wish to make a sale to the corporation of property purchased by them with the intention of selling it to the corporation at a profit, they are under a duty to make a full and fair disclosure to an independent body acting for the corporation, of all relevant facts pertaining to the property, including the price they paid for it. If they do not do this the corporation is wronged, and it has standing in court to right the wrong.

There are four situations in which this problem may arise and which have presented themselves to the court:

I. The promoters may arm the corporation with an independent board of directors and make a full disclosure of all the facts to it. Such a disclosure to such a board is sufficient, and no disclosure to the stockholders is required. The corporation is not wronged here, for it has given its approval to the transaction through an independent board acting for it. It is a two-party transaction, a binding contract.

II. Where there is no disclosure to an independent board of directors, but where all existing stockholders have notice of the facts and no future stockholders are contemplated. Here the corporation has no standing in

7. South Joplin Land Co. v. Case, 104 Mo. 572, 16 S. W. 390 (1891); Seehorn v. Hall, 130 Mo. 257, 32 S. W. 643 (1895); Exter v. Sawyer, 146 Mo. 302, 47 S. W. 951 (1898); South Missouri Pine Lumber Co. v. Cromner, 202 Mo. 504, 101 S. W. 22 (1906); Vogeler v. Punch, and Copper Crown Mining Co., 205 Mo. 558, 103 S. W. 1001 (1907); Luft v. Strobel, 322 Mo. 955, 19 S. W. (2d) 721 (1929); Garrett v. Wannfried, 67 Mo. App. 437 (1896); Wiano Land & Improvement Co. v. Webster, 75 Mo. App. 457 (1898); Reynolds v. Title Guaranty Trust Co., 196 Mo. App. 21, 189 S. W. 33 (1916); Knauinke v. Strobel, 3 S. W. (2d) 400 (Mo. App. 1928); Dickerman v. Northern Trust Co., 176 U. S. 181 (1900); Yeiser v. United States Board & Paper Co., 107 Fed. 340 (C. C. A. 6th, 1901); South Penn Collieries Co. v. Sproul, 52 F. (2d) 557 (C. C. A. 3d, 1931); Lomita Land & Water Co. v. Robinson, 154 Cal. 36, 97 Pac. 10 (1908); Yale Gas Stove Co. v. Wilcox, 64 Conn. 101, 29 Atl. 303 (1894); Hayward v. Leeson, 176 Mass. 310, 57 N. E. 656 (1900); Colton Improvement Co. v. Richter, 26 Misc. 26, 55 N. Y. Supp. 486 (1898); and Pietsch v. Milbrath, 123 Wis. 647, 102 N. W. 342 (1904).
court for relief. The unanimous approval of its stockholders is its approval. Hence, it has not been wronged. Here again it is simply a party to a binding contract.

III. Where there are existing stockholders who have no notice and full disclosure is not made to an independent board of directors. Here the corporation has standing in court to right the wrong. No independent group—directors or stockholders—has acted for the corporation. It is a one-party transaction.

IV. Where there is no disclosure to an independent board of directors and the stockholders existing when the sale is made to the corporation have notice, but it is planned to take in more stockholders in the future and such stockholders are taken in. In this situation, the authorities are divided on the question of whether the corporation may sue. Where there were creditors who did not have notice, relief has likewise been granted to a receiver for the corporation.

These four situations will be considered in the order in which they have just been presented.

I

When there is full disclosure to an independent board of directors.

For the reasons already stated, where full disclosure is made to a board of directors acting independently of the promoters, the approval of the corporation is given, it has suffered no wrong, and it has no standing to upset the transaction.

II

Where there is no disclosure to an independent board of directors and all existing stockholders have notice of the facts, and no future stockholders are contemplated as part of the plan of organization nor are later brought in.

Where all existing stockholders have notice of the facts and there is no intention of taking in additional stockholders as a part of the scheme of organization, and none are later brought in, the universal rule is that the cor-


12. Most of the cases that have arisen in Missouri are in this group, and will be discussed at the appropriate place. See, also: Lomita Land & Water Co. v. Robinson, 154 Cal. 36, 97 Pac. 10 (1908); Colton Improvement Co. v. Richter, 26 Misc. 26, 55 N. Y. Supp. 486 (1898).

13. The two leading cases are Old Dominion Copper Mining & Smelting Co. v. Lewisohn, 210 U. S. 206 (1908), which denies recovery, and Old Dominion Copper Mining & Smelting Co. v. Bigelow, 203 Mass. 159, 89 N. E. 193 (1909), which allows recovery. See (1933) 85 A. L. R. 1283-1289.

poration has no standing for relief even though no disclosure is made to an independent board of directors. The notice to all the stockholders is notice to the corporation, so that it is not in a position to complain; hence, it has no standing to sue. Two Missouri cases must be noticed in this connection.

In Richard Hanlon Millinery Co. v. Mississippi Valley Trust Co., the Supreme Court clearly intimates that it would follow the universal rule. After noticing that no creditor was involved, and after indicating that every person holding stock in the plaintiff corporation had notice of the arrangement of the promoters, the court observed that such a stockholder had no valid claim, and that the corporation had no greater rights than he had. However, relief was denied for other reasons.

In Brooker v. Wm. H. Thompson Trust Co., the Supreme Court applied the rule even though one stockholder did not have actual notice, since it was shown that he was charged with notice of the facts. In this case, the defendants secured options on all the title plants in the city of St. Louis, which, under an underwriting agreement, they were to sell to the proposed corporation and receive a bonus of $500,000 for services in procuring the consolidation. The stock subscription agreement recited that a copy of this underwriting agreement was attached to it. All of the original subscribers signed this agreement. All the subscribers knew of the plan, except one, and it is contended that when he signed the subscription agreement, the underwriting agreement was not attached and that he did not have actual notice of the provision for the bonus. The Court, however, denied relief to the corporation. It noted that all the means of information were ostentatiously spread out before this subscriber, but he refused to look, and that he could not escape the imputation of the knowledge he purposely avoided. The rule was applied in this case as against a purchaser of the stock from the subscriber who was charged with notice. Since the corporation was not injured when the sale was made to it, since all stockholders had notice or were charged with notice, it was not wronged when a subscriber later sold his stock to another. If there was any wrong at all, it was to the subsequent purchaser of the stock.

III

Where there is no disclosure to an independent board of directors nor to all existing stockholders.

We have seen that in this situation, the corporation may sue in Missouri and in all jurisdictions, because the wrong is done to it. There are not two parties to the bargain, the promoters on the one hand, and persons acting

16. 251 Mo. 553, 158 S. W. 359 (1913).
17. The presence of creditors who had no notice was considered a factor of great importance in McCandless v. Furlaud, 56 Sup. Ct. 41, 80 L. Ed. 74 (1935). This case will be discussed presently.
18. 254 Mo. 125; 162 S. W. 187 (1914).
for the corporation independent of the promoters, on the other. Several Missouri decisions will illustrate the application of the rule in this situation.

There are no reported decisions by the Supreme Court of Missouri or by the Courts of Appeal on this question until 1891\(^1\); but in 1877, the case of *The St. Louis \& Utah Silver Mining Co. v. Jackson*\(^2\), the unreported case already referred to, was decided in the Circuit Court at St. Louis. In this case, the defendants agreed with the owners of mining property in Utah to purchase the property and to organize a corporation to develop it. They agreed to give the vendors $30,000 in stock of the corporation and $10,000 in cash for the property. Then they solicited others to become subscribers for stock in the proposed corporation, stating that they were to give the vendors $30,000 in stock and $30,000 in cash. After the corporation was organized, this statement was repeated to the subscribers. The property was purchased, the defendants taking a corporate check for $30,000. In order to procure the deed, they gave $10,000 to the vendors. Then they conveyed the property to the corporation and divided the remaining $20,000 among themselves. This was a suit brought by the corporation to rescind the sale and to recover the amount that it had expended for and upon the property. There was a decree for the plaintiff. The court said:

"In as much then as it was the duty of the defendants to make a full and candid disclosure of all the facts within their knowledge concerning this transaction and that they have not only failed in this duty, but by actual misrepresentation have deceived the company and thereby induced it to purchase the property and expend money upon it which had it been in possession of all the facts, it would not have done, it seems to me that the measure of the relief to which plaintiff is entitled is the restoration, so far as practicable, to that condition in which it would have been but for the deception practised upon it by the defendants."

The court ordered the defendants "to pay the company the sum of $30,000 with 6 per cent interest thereon from August 27th, 1873, the date at which this sum was paid to one of the defendants, and also the further sum of $6816, the amount expended by the company upon the property including interest at 6 per cent from the date of the several payments", while the plaintiff was required, of course, to restore the property. This case is of unusual interest not only because it was the pioneer in the field, but also because of the broad relief allowed—rescission in equity of the whole transaction, and recovery by the corporation of the consideration it had paid, as well as its expenditures on the land, upon the restoration by it of what it had received from the

\(^{1}\) The first Missouri decision reported is South Joplin Land Co. v. Case, 104 Mo. 572, 16 S. W. 390 (1891).

\(^{2}\) For a brief comment of this case, see (1877) 5 CENT. L. J. 317.
promoters. In all the reported Missouri cases, a different form of relief is given. However, none of these cases intimate that this form of relief is no longer available to the wronged corporation in this state.21

The earliest decision by the Supreme Court of Missouri on this problem is the case of *The South Joplin Land Co. v. Case.*22 This is one of the leading American cases. It is cited in practically all of the opinions and discussions of this subject. The defendant Case, having in contemplation the organization of a corporation to take certain lands, procured an option to purchase the lands and certain promissory notes for $30,000. He then employed one Redburn to organize the corporation and the latter represented that the price to be paid was $32,000 and that the proposed corporation would get the land and the notes. Some of the subscribers did not know at the time that Case had anything to do with the matter, but Case was aware of the representations made by Redburn. After incorporation, Case gave the vendor the corporation's check for $32,000 for the purchase. Case took back from the vendor the notes and a check for $2,000 and gave Redburn $666. This was a suit in equity to recover from Case and Redburn the value of the notes, and the petition was amended to include a demand against Case for the $2,000. The circuit court gave a decree for the plaintiff, which was affirmed on appeal, requiring the defendants to account to the corporation for the profits. The court said:

"... where persons form such an association, or begin or start the project of one, from that time they do stand in a confidential relation to each other and to all others who may subsequently become members or subscribers and it is not competent for any of them to purchase property for the purpose of such company, and then sell it at an advance without a full disclosure of the facts."23

The Court adds:

"Case occupied a position of trust and confidence to the subscribers and also to the proposed corporation, and it became his further duty to make full disclosure of profits which he intended to make in respect to the transfer of the property. This he did not do. . . . It, therefore, follows from what has been said that the $2,000 and the notes belonged to the company, and the court was right in making the defendants account therefor."24

It is to be noted that in this case, there were, at the time of the sale to the corporation, innocent subscribers who did not have notice of the scheme of the

21. For decisions in other jurisdictions allowing rescission, see: Cortes Co. v. Thannhauser, 45 Fed. 731 (S. D. N. Y. 1891); Hegben v. Koeffler, 97 Wis. 313, 72 N. W. 745 (1897). For discussions of this remedy generally, see: Ballantine, Corporations (1927) § 51; 1 Machen, Modern Law of Corporations (1908) §§ 368, 370, 383.
22. 104 Mo. 572, 16 S. W. 390 (1891).
23. *Id.* at 579, 16 S. W. at 392.
24. *Id.* at 581, 16 S. W. at 393.
promoters. There is no intimation of any effort to uphold the transaction because of any disclosure to the directors, one of whom was the defendant Redburn, and there was no disclosure to the subscribers.

In *Wiano Land & Improvement Co. v. Webster*, the defendant represented to certain persons that a specified tract of land could be purchased for $5,500 and proposed that they join with him in forming a corporation to purchase, subdivide into lots, improve and resell this land at a profit. At this time he had an option to purchase the land for $4,750, which he exercised, but he had the deed recite a consideration of $5,500. Believing the transaction to be an honest one, several persons subscribed for stock and paid their subscriptions over to the defendant, who kept $750 as profit for himself. On this part of the case, there was a judgment for the plaintiff corporation which was affirmed on appeal. The St. Louis Court of Appeals held that by concealing the fact that defendant then held an option to buy the land at $4,750, he deceived and misled the other parties as to the price of the land. "... his gain was acquired by subterfuge and deceit, and he should be made to account to the corporation (to the stockholders of which the profit money justly belongs)."

In *Exter v. Sawyer*, the defendant Sawyer, who was associated with others to form a corporation, secured an option to purchase land for $35,100 which he exercised and then sold the land to the corporation for $50,000. He also executed a similar transaction in connection with another tract. Plaintiff Exter, who was one of the original stockholders, did not learn of these facts until the transactions were completed. The directors refused to act when he requested them to sue to cancel the deeds and certain notes which were given to the defendant. Exter, along with several other innocent stockholders filed this bill as co-plaintiffs, joining the corporation and Sawyer as defendants. The circuit court found for the plaintiffs and rendered a decree in trust for the corporation and against Sawyer for the amount of his secret profits, from which decree Sawyer appealed. The Supreme Court affirmed the decree. Speaking through Judge Burgess, it said:

"This action is not bottomed upon the ground of fraud practiced upon the company. ... As Sawyer was the agent of the company in the purchase of the lands and transferring them to it, for a much larger sum than he had paid without disclosing to the company the amount paid for them by him, he was guilty of fraud, upon which a cause of action accrued to the company regardless of the fact that he may never have stated to the company at any time the amount paid by him for the land."
From these cases, it is clear that where there are subscribers existing when the sale is made to the corporation who had no notice of the promoter's plan to make a profit out of the sale to the corporation, and where the promoter does not make a full disclosure of the facts to an independent board of directors, the corporation may sue.

*A fortiori*, the promoters may not recover on notes which are given as part of the consideration received by them, if disclosure is not made. This is the converse of the situation presented in the cases just discussed. Such notes are subject to the defense of fraud. This is true as to notes given by innocent stockholders to the defrauding promoters to induce them not to sue the corporation on notes that they received as a part of the purchase price of the property sold to it.29

IV

*Where there is no disclosure to an independent board of directors, and all stockholders at the time of the sale have notice, but where as a part of the original plan future stockholders are to be brought in and they are actually brought in later.*

In the cases discussed under Part III, there were innocent stockholders or subscribers at the time of the sale. Our next question is whether the corporation has a cause of action when there is no disclosure to an independent board of directors and when all stockholders or subscribers existing when the sale was made were aware of the facts, but where it is a part of the original plan to bring additional stockholders into the corporation in the future and such stockholders are actually brought in without notice. Is there such a wrong to the corporation as will give it standing because these future stockholders are brought in without notice? This situation has not yet arisen in this state; and the authorities are divided in those jurisdictions where it has arisen.

In the famous case of *Erlanger v. The New Sombrero Phosphate Co.*30 the corporation paid the promoters in stock and cash. The House of Lords held that the corporation had a cause of action. Stock was issued and money paid out of the treasury to the promoters at a time when either there had already been sales of stock to the public or such sales were contemplated.

In this fourth situation, the battle has been waged around two famous cases. In one-*Old Dominion Copper Mining & Smelting Co. v. Lewisohn*31—the United States Supreme Court denied relief to the corporation, while in a suit arising out of the same transaction, the Supreme Court of Massachusetts in *Old Dominion Copper Co. v. Bigelow*32 allowed the corporation to sue. These

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30. L. R. 3 A. C. 1218 (1878) aff'd 5 Ch. D. 73 (1877).
two cases have been the leading cases for the two lines of authorities for more than a quarter of a century. Whether the Lewisohn case would be followed by the Supreme Court of the United States today, however, is doubtful in view of a decision of that Court in November of last year, namely, McCandless v. Furlaud.33

In the McCandless case, the promoters, who, of course, had notice, held all the outstanding shares at the time of the sale from which their undisclosed profits were made. The sale of additional shares to the public was contemplated and arrangements had been made for the sale of bonds and notes to the public. Property purchased for $2,573,989 was sold to the corporation for $3,015,000 in cash, bonds of the par value of $1,300,000 and 535,000 non-par shares. Other profits were also made by the promoters. Within two years, the corporation was in the hands of a receiver. This was a suit by the receiver to compel the promoters to restore their illicit gains. Recovery was allowed in the Federal District Court,34 but this was reversed by the Circuit Court of Appeals,35 which followed the Lewisohn case. In a 5 to 4 decision, the Supreme Court held that the receiver was entitled to recover, chiefly because the corporation was rendered substantially insolvent by the breach of a fiduciary relation by the promoters which impaired the security of the creditors, and because a provision of the Constitution of Pennsylvania, the state of incorporation, was violated.36 According to the view of the majority, these factors were sufficient to distinguish the case from the Lewisohn case, since at the time the promoters were the only shareholders, so that all existing shareholders had notice.37

In the McCandless case, the interests of creditors were involved, the constitutional provision was violated, and the suit was brought by a receiver, while in the Lewisohn case, no creditors were involved, no statute or constitutional provision was violated, and the suit was brought by the corporation itself. These are points on which the cases may possibly be distinguished. The

33. 56 Sup. Ct. 41, 80 L. Ed. 74 (1935), rev’d 75 F. (2d) 977 (C. C. A. 2d, 1935). The bill had been dismissed on grounds with which we are not concerned here (68 F. (2d) 925 [C. C. A. 2d, 1934]), but this ruling was reversed and a determination of the merits ordered in 293 U. S. 67 (1934). This case has been discussed in the following periodicals: (1935) 14 Tex. L. Rev. 79; Comment (1936) 45 Yale L. J. 511; Note (1936) 84 U. of Pa. L. Rev. 409; (1936) 22 A. B. A. J. 41.
34. Discussed in (1933) 33 Col. L. Rev. 1065.
35. 75 F. (2d) 977 (C. C. A. 2d, 1935).
36. Pa. Const. art. 16 § 7. ‘‘No corporation shall issue stocks or bonds except for money, labor done, or money or property actually received; and all fictitious increase of stock or indebtedness shall be void.’’ See Mo. Const. art XII, § 8, for a similar provision. Mo. Rev. Stat. (1929) § 4546 provides: ‘‘The stock or bonds of a corporation shall be issued only for money paid, labor done or money or property actually received. . . . All fictitious issues or increases of stocks or bonds of any corporation shall be void.’’
37. Mr. Justice Roberts wrote the dissenting opinion in which Mr. Justices McReynolds, Sutherland, and Butler concurred.
McCandless case raised some doubt, however, as to whether the doctrine of the Lewisohn case would be reaffirmed. Although it is impossible to predict the result that the Supreme Court would reach today if the facts of the Lewisohn case were again presented to it, yet this recent decision gives rise to the hope that it will refuse longer to follow that case and will follow the Bigelow case. In discussing the violation of the constitutional provision and policy (which is not an infrequent provision) Mr. Justice Cardozo refers to the interests of future shareholders as follows:

"The shareholders were not at liberty, at all events to the prejudice of creditors or other shareholders, present or prospective, to set that policy at naught. If the effect of what they did was to put illicit profits in the pockets of trustees, their consent will not avail to block pursuit and reclamation."

In the opinion of the writer the Lewisohn case should be overruled. When it was decided, it was severely criticized as being "unnecessarily technical." As a practical matter, it is evident that the injury to the corporation is as great in this situation as in the case where innocent stockholders exist at the time of the sale to the corporation. Under the Lewisohn case, prospective interests "were apparently doomed to complete disregard." At any rate, the McCandless case marks a further limitation on the doctrine of the Lewisohn case by granting relief where the interests of creditors are impaired, notwithstanding the fact that all existing shareholders have consented.

It has been suggested that "in every case where the promoter fraudulently overvalues property the fictional consent [the consent of the corporation] may be disregarded." This result may be reached at some time in the future, and, perhaps, it should be, but the rule is not applied this broadly today even in Massachusetts. The Massachusetts rule is believed to be the desirable one, and the new decision by the Supreme Court of the United States looking in that direction is gratifying. Should this problem ever be presented to the courts of this state, it is hoped that the Bigelow case will furnish the rule of the decision.

Remedies available to the corporation when it has standing to sue.

When the corporation is allowed to sue as having been wronged, it has several remedies. A brief summary of these remedies will suffice:

1. We have seen from the case of The St. Louis & Utah Silver Mining Co. v. Jackson, that the corporation may rescind the sale of land made to it and

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38. It is submitted that the Bigelow case represents the better view. See (1909) 23
HARY. L. REV. 147.
42. Unreported. See supra note 2.
recover the amount it had paid for it, as well as the money that it had expended upon the land, by reconveying, of course, the land to the promoters. This remedy simply restores the *status quo*.

2. The corporation may allow the transaction to stand, and sue the promoters for secret profits. This was decided in the cases of *The South Joplin Land Co. v. Case*,43 and *Wiano Land & Improvement Co. v. Webster*.44

3. The corporation may allow the transaction to stand and sue the promoters for damages.45 While no case has come up in Missouri in which this remedy was asked for, the recovery of damages would, of course, be allowed in an appropriate case.

4. If the corporation does not initiate suit itself when it has standing to sue, an innocent stockholder may bring a minority stockholder’s suit, joining the corporation as a nominal party defendant. This was allowed in *Exter v. Sawyer*.46

The remedy sought will, of course, depend entirely upon expediency. It might be to the advantage of the corporation in one case to confirm the sale and sue either for damages or secret profits, or both; in another case, it might be to its interest to rescind the sale and restore the *status quo*; while in still another case, it might wish to rescind and ask for damages, if the facts warrant this form of relief.

43. 104 Mo. 572, 16 S. W. 390 (1891), cited note 22, *supra*.
44. 75 Mo. App. 457 (1898), cited note 25, *supra*.
45. BALLENTINE, CORPORATIONS (1927) § 51; EHRICH, PROMOTERS (1916) § 165.
46. 146 Mo. 302, 47 S. W. 951 (1898), cited note 27, *supra*.