Washington Law Review

Volume 12 | Issue 1

1-1-1937

Accountability of Promoters to the Corporation for Profits

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COMMENTS

ACCOUNTABILITY OF PROMOTERS TO THE CORPORATION FOR PROFITS

The Washington cases involving the question of the corporation's right of action against promoters who reap secret profits, do not yet cover the complete scope of legal principles developed on this subject. The cases state general conclusions and are inadequately discussed. In order that the Washington cases may be better evaluated, a brief summary of the general rules as applied in other jurisdictions, will first be presented.

A common rationalization is used for deciding most of the cases; namely, whether under the facts and circumstances of a particular case, it can be said that the corporation had knowledge of, or assented to, the overvaluation. The two real landmark cases, *Old Dominion Copper Mining & Smelting Co. v. Lewisohn et al*,[1] and *Old Dominion Mining & Smelting Co. v. Bigelow*,[2] differ in the application of this test. The *Lewisohn* case, known as the U. S. view, holds that the corporation has a right of action against promoters who sell property to it, greatly overvalued, if the sale was made at a time when the promoters owned all the issued shares of the corporation—even though there is an intention to invite the public to subscribe for part of the original shares. The U. S. Supreme Court rationalized their holding by saying that the corporation assented to the transaction with full knowledge of the facts by all those concerned in it; and, therefore, the corporation was not damaged. The *Bigelow* case, known as the Massachusetts view, holds that when subsequent shareholders are contemplated, the promoter is liable to the corporation by virtue of his fiduciary relation, because the corporate entity's assent, having been given by a non-independent board of directors, was invalid. England and the great weight of authority in the U. S.[3] are in accord with the *Bigelow* case. The Massachusetts view seems better, because it serves more efficiently to prevent the use of corporate organizations as instruments of fraud in deceiving the public, since there seems to be no reason for overvaluing property unless the issue of shares to the public is intended; because it prevents a multiplicity of suits by allowing the corporation to sue in place of all the individual shareholders; and, finally, because it enables individuals, who might not otherwise be in a position to afford the costs and expenses of litigation, to secure redress.

When the set-up is similar to the *Dominion* cases, but the promotion plan does not contemplate the issuance of any shares by the corporation to innocent outsiders, and there is no intention to invite the public to subscribe for shares; the English and American courts uniformly deny a recovery to the corporation.[4]

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[1]210 U. S. 206, 28 Sup. Ct. 634, 52 L. ed. 1025 (1907).

[2]188 Mass. 315, 74 N. E. 653 (1905).

[3]85 A. L. R. 1276; BALLANTINE, PRIVATE CORPORATIONS, (1927) § 50 at 180.

[4]85 A. L. R. 1273; BALLANTINE, *op. cit. supra*, note 3, § 50 at 176.

In a third class of cases where there are innocent shareholders at the time the promoters obtain their secret profits, again knowledge and assent are important factors. The courts here uniformly grant a recovery to the corporation,[5] on the basis of fraud, since disclosure of the secret profit was made only to the group in control. Fraud may never be perpetrated on a minority in a corporation, so that even if there is one innocent, existing shareholder, the corporation will recover.[6]

There is a fourth group of cases, where the promoters subscribe to all of the authorized shares, and then sell their own shares on the market, without disclosure of their large gains. Here, again, on the theory that all the original subscribers have assented to the transaction, the corporation is denied recovery.[7] This result seems contrary to the Massachusetts view, because, unquestionably, subsequent shareholders were contemplated. Furthermore, this result seems to be one of form rather than substance, and it merely allows the shrewd promoter to utilize a convenient device to circumvent the law.

A fifth group of cases occurs where, with future innocent shareholders being contemplated, the promoter subscribes to all of the authorized shares, and, pursuant to a pre-incorporation scheme, donates some of the shares back to the corporation to be sold as treasury stock. By throwing aside this subterfuge; the corporation should recover on an analogy to the Massachusetts view. However, unfortunately, there is a conflict of authority here.[8] In a very interesitng and curious case, *Piggly Wiggly Delaware Inc. v. Bartlett*,[9] the promoters issued to themselves all of the shares of *no par* value. The promoters had the corporation sell the shares under the guise of treasury stock, but the proceeds were turned over to the promoters. It was held that the promoters were not liable to the corporation, although, if the shares had had a par value, the court said that a different question would have arisen. Without doubt this case should have fallen within the perview of the Massachusetts rule—this was merely a clever device to mislead those on the outside. But, aside from this criticism, it is hard to see how the no par feature of these shares could make any difference. There is the same possibility for overvaluation whether they be par or no par value shares. The nominal value of shares is utterly immaterial; the real value of the shares is their intrinsic, actual, or proprietary value.

With this general background in mind, the Washington case may be discussed chronologically. The first case that arose, *Inland Nursery and Floral Co. v. Rice*,[10] seems to be the leading case in this state, since it is quoted and relied on most frequently in the later opinions. The question arose on a demurrer to the corporation's complaint praying for a cancellation of shares fraudulently exchanged by the promoters for property taken at an overvalua-

[5]BALLANTINE, *op. cit. supra*, § 50 at 176-7.
[6]1 FLETCHER, CYCLOPEDIA OF CORPORATIONS, § 194 at 628-9.
[7]85 A. L. R. 1263; BALLANTINE, *op. cit. supra*, note 3, § 50 at 185.
[8]A. L. R. 1289-93; BALLANTINE, *op. cit. supra*, note 3, § 50 at 186-8.
[9]97 N. J. Eq. 469, 129 Atl. 413 (1925).
[10]57 Wash. 67, 106 Pac. 499 (1910).

tion. In sustaining the demurrer, the court used the following significant language, which the later cases quote freely:[11]

> ". . . there is no sufficient allegation of facts . . . it does not appear but that subsequent stockholders purchased with full opportunity for investigation into the condition and assets of the company, and that the stock they purchased was fully worth the sum paid therefor."

This statement stresses the fact that recovery can not be obtained without proof of damage; and also that subsequent shareholders have knowledge of the overvaluation—a factor which only a *Bigelow* jurisdiction would consider. However, in the scope of the opinion, the court said:[12]

> "The appellant here having placed its own valuation on the property at the time of the transfer for its stock, cannot now complain upon the ground of an overvaluation."

This language sounds very much like the *Lewisohn* case, and, in fact, the court quoted from the *Lewisohn* case in a different portion of the opinion. But the case certainly cannot be considered authority for the U. S. view, because the only question actually decided was one of sufficiency of the pleadings.

In the next case, *Eureka Mining, Smelting & Power Co. v. Lively,*[13] the promoters paid for their shares with property, and then had the corporation use the proceeds of treasury stock to "repay" the promoters for the money they exnended in purchasing the property. This, of course, was flagrantly fraudulent, because it is contemplated that money received for treasury stock becomes an asset of the corporation; accordingly the corporation recovered. The Washington court obviously did not have to resort to the "secret profit" cases in arriving at this decision.

In the third case, *Mangold v. Adrian Irrigation Co.,*[14] which arose on a demurrer to the evidence, a promoter held land under option, and contracted to sell the land to the corporation. The corporation waited until the term of the option expired, and then bought the land directly at a low figure. The promoter brought an action against the corporation for fraud, and the court held for the corporation on the sensible ground that the promoter was a trustee and owed a fiduciary duty to the corporation. The court "bolstered" its decision by citing the *Lewisohn* and *Inland Nursery* cases, which do not seem to be in point.

In the fourth case, *Kennedy Drug Co. v. Keyes,*[15] the promoter turned in no property at all for his shares, and it was held that the promoter cannot keep his shares and that a receiver should be appointed. This holding was correctly based on the fiduciary duty of the promoter, and the flagrant fraud.

In the fifth case, *Gold Ridge Mining and Development Co. v. Rice,*[16] a corporation was organized with 300,000 shares of stock,

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[11] *Id.* at 69, 106 Pac. at 499.
[12] *Id.* at 70, 106 Pac. at 500.
[13] 59 Wash. 550, 110 Pac. 425 (1910).
[14] 60 Wash. 286, 111 Pac. 173 (1910).
[15] 60 Wash. 337, 111 Pac. 175 (1910).
[16] 77 Wash. 384, 137 Pac. 1001 (1914).

and 100,000 shares were given to each of two promoters in return for their overvalued property. In an action by the promoters against the corporation to recover the proceeds of 7,000 shares sold by the corporation's secretary-treasurer with the consent of the corporation, and retained by the corporation under an agreement allowing the promoter to draw against it, the promoter recovered. The case went through a full trial, and on its facts, it is, without question, squarely in accord with the *Lewisohn* case, since there were 100,000 authorized shares not issued to the promoters, who undoubtedly contemplated having this stock issued in the future. The court used *Lewisohn* language when it said:[17]

> "The appellant and Hammer [the promoters] were on both sides of the bargain. The respondent was also represented by its third trustee. No one was wronged and no rule of public policy was violated. The holders of the bond (the overvalued property) knew what they were selling, and the respondent knew precisely what it was buying. The deal was made in the open, and the transaction was valid as between the parties."

The case is, of couse, incomplete in analysis, for this quotation constitutes the court's entire discussion upon this point. Also, it will be seen that the court quotes the *Inland Nursery* case for authority when, in fact, as already shown, that case is authority for a pleading question only. Furthermore, the court failed to mention the important factor of contemplated future innocent shareholders.

In the sixth case, *Eggleston v. Pantages*,[18] the result reached was orthodox, but the means of reaching it were superficial. D promoted a corporation and subscribed for all the shares and paid for it with property. Subsequently, P bought some shares from D, and then brought this action alleging failure by D to pay for his shares. The court held for D, mainly on the basis of the *Inland Nursery* case. How the *Inland Nursery* case, which, doctrinely, involved an action by a corporation, and, besides, was decided on the pleadings, can serve as precedent for this suit by a purchaser of shares from the promoter, seems rather incredible. Of course, it is conceded that from the court's language, a dictum, in the *Inland Nursery* case, quoted above, the result here is justifiable. The law generally distinguishes sharply between the corporation and the individual shareholder bringing the action, and different principles, broadly speaking, are applied to each situation.[19] Individual shareholders may maintain actions against a promoter of a corporation to recover for individual frauds as contrasted with frauds on the corporation.

In the seventh case, *Shaw v. Carr*,[20] the promoters took all the shares in return for their property, and then turned some back to the corporation as treasury stock, so that working capital could be raised. P, a purchaser of the treasury stock, brought an action against the promoter to rescind their subscription, and to get a

[17] *Id.* at 387, 137 Pac. at 1002.
[18] 93 Wash. 221, 160 Pac. 425 (1916).
[19] BALLANTINE, *op. cit. supra*, note 3, § 51 at 192; FLETCHER, *op. cit. supra*, note 6, § 196.
[20] 93 Wash. 550, 161 Pac. 345 (1916).

return of the consideration paid the corporation, on the ground that the property paid into the corporation by the promoters was worthless. In another highly superficial opinion, the court held for D. The court again failed to state concisely that this case was a suit by an individual shareholder, as distinguished from the corporation, and cited the *Inland Nursery* case again as direct authority. At the same time, the court made a very unfortunate, though far-reaching statement:

> "To measure the value of such a contract is exceedingly difficult. For that reason, we have followed the rule where the facts invite it, of *Old Dominion Copper Mining & Smelting Co. v. Lewisohn.*"

In the eighth case, *Ennis v. New World Life Insurance Co.*,[21] the promoter took a stock purchase warrant in organizing the corporation, and when the shares passed par, attempted to enforce it against the corporation. In holding for the corporationn, in a well reasoned opinion, the court stressed the fiduciary nature of the promoter, the fraud, and the public policy involved in insurance.

In the ninth case, *Colville Valley Coal Co. v. Rogers*,[22] in a situation involving the *Dominion* cases' question, the promoters turned property over to the P corporation, for 95% of the shares. The corporation and subsequent stockholders joined in an action against the promoters, and it was held for the promoters. The court, although distinguishing between the action of the corporation and the subsequent shareholders, again cited the *Inland Nursery* case in support of their holding against all of the plaintiffs, and also cited the *Golden Ridge* case against the corporation. This case, like the *Inland Nursery* case, cannot be considered as direct authority, for it arose on a demurrer to P's evidence.

The tenth case was *Metcalfe v. Mental Science Industrial Ass'n.*[23] This was an action against the promoters by the purchaser of shares from the promoter, who had obtained these particular shares by turning property over to the corporation; it was held for the promoter. The court cited the *Lewisohn, Inland Nursery, Gold Ridge,* and *Colville Valley* cases.

In the final case, *Connor v. Robinson*,[24] decided on the pleadings, the promoter subscribed to all the shares and then turned about one-half back to the corporation to be sold as treasury stock. The case involved an action by a receiver to recover from the promoters in order to pay off creditors, so that any statements relative to the solvent corporation's recourse against the promoters would be dicta. The court did indulge in a dictum, and stated that the corporation would not be able to recover from the promoters, and cited only the *Inland Nursery* and *Colville Valley* cases, the two cases decided on the pleadings. It should also be noticed that the court overlooked the treasury stock feature here, which was discussed in the fifth class of cases *supra.*

[21] 97 Wash. 122, 165 Pac. 1091 (1917).
[22] 123 Wash. 360, 212 Pac. 732 (1923).
[23] 127 Wash. 50, 220 Pac. 1 (1923).
[24] 137 Wash. 672, 243 Pac. 849 (1926).

A review of these Washington cases will reveal that the only class of cases, outlined above, directly passesd upon in Washington is the *Dominion* type of case; that there is an indirect holding on the treasury stock situation; that flagrant fraud will not be tolerated; and that the promoter owes a fiduciary duty to the corporation. Unfortunately, by an explicit statement, numerous dicta, and a direct holding in the *Gold Ridge* case, Washington seems lined up with the *Lewisohn* case. But since the cases as a whole contain little elaboration and discussion, especially of the conflicting policies and interests involved, it is hoped that the Washington court will allow this question to be reopened, with the consequent result of a turning over to the more desirable Massachusetts, *Bigelow* view.

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COMPETENCY OF PROOF OF "CUSTOMARY" NEGLIGENCE IN SUPPORT OF CHARGE OF SPECIFIC ACT OF NEGLIGENCE

It is no doubt accurate to say that the bar of this state has heretofore assumed (and justifiably so, in view of prior decisions of the court) that, generally speaking, a specific charge of negligence (e.g. excessive speed) may not be established by proof of prior or similar acts of negligence, nor even by proof of customary or habitual negligence of the same sort. Consequently, the opinion of the Washington Supreme Court in *Sheddy v. Inland Motor Freight*,[1] is of more than passing interest.

The case involved a head-on collision between the automobile in which the plaintiff was riding and a truck owned and operated by the defendant. Negligence was predicated, among other things, upon an allegation of excessive speed. As corroborative of plaintiff's own direct testimony on the point, he offered testimony to the effect that defendant's fleet of trucks was engaged in transporting steel from the railroad at Coulee City to the dam; that the steel was hauled on a tonnage basis, and that the compensation of defendant's drivers depended, in part, at least, upon the mileage which each made; that approximately five loads were transported each day, and that "more or less of a schedule had to be maintained on each trip, in order to obtain efficient results" for the defendant and for its drivers.

Evidence was also offered as to the speed capacity of the truck in question, the time "regularly" required to drive the truck, loaded as it was on this occasion, "from terminus to terminus, or from junction to junction, and the nature of the road as to curves grades and straight-aways."

All of this testimony was admitted by the trial court, and in affirming the judgment, the Washington Supreme Court found the evidence relevant and competent as "creating a background from which the inference could be drawn that, on a straight-away with a down grade, a speed of fifty miles per hour or thereabouts *would be customary*", and that the testimony "tended rather strongly to

[1]89 Wash. Dec. 41, 68 P. (2d) 430 (1936).