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Casenotes: Corporations — Fiduciary Duty — Circumstances Held Not Sufficiently Suspicious to Invoke Majority Stockholder's Duty to Investigate Purchasers Prior to Sale of Stock. *Clagett v. Hutchison*, 583 F.2d 1259 (4th Cir. 1978)

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CORPORATIONS — FIDUCIARY DUTY — CIRCUMSTANCES HELD NOT SUFFICIENTLY SUSPICIOUS TO INVOKE MAJORITY STOCKHOLDER'S DUTY TO INVESTIGATE PURCHASERS PRIOR TO SALE OF STOCK. *CLAGETT v. HUTCHISON*, 583 F.2d 1259 (4th Cir. 1978).

I. INTRODUCTION

In *Clagett v. Hutchison*,¹ the United States Court of Appeals for the Fourth Circuit held that a majority controlling stockholder owes a duty to minority stockholders to investigate the moral character and financial status of potential purchasers of his shares of stock where the circumstances surrounding the transfer would arouse the suspicions of a reasonable person as to the likelihood of fraud on the corporation or the remaining minority stockholders.² In the instant case, the court held that the circumstances surrounding the sale of the majority shares of stock were not sufficiently suspicious to indicate the likelihood of fraud, and therefore the seller was not under a duty to investigate.³ In addition, the court ruled that the

1. 583 F.2d 1259 (4th Cir. 1978).

2. *Id.* at 1262. This rule, now widely accepted, was originally promulgated in the leading case of *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940).

3. 583 F.2d at 1262. Under the early view, a majority stockholder was not held to be under a fiduciary duty when selling his stock to outsiders. Recently, however, courts have recognized that a majority or controlling stockholder in a corporation may occupy a fiduciary relationship toward the minority. The nature of this relationship and the extent of its attendant duties have not been clearly defined. Consequently, a majority stockholder wishing to sell his stock is often without a clear understanding of his duty to minority stockholders. *See, e.g.*, *Pepper v. Litton*, 308 U.S. 295, 306 (1939); *Southern Pacific Co. v. Bogert*, 250 U.S. 483, 491-92 (1919); *Swinney v. Keebler Co.*, 480 F.2d 573, 577-78 (4th Cir. 1973); *McDaniel v. Painter*, 418 F.2d 545, 547 (10th Cir. 1969); *Seagrave Corp. v. Mount*, 212 F.2d 389, 395 (6th Cir. 1954); *Box v. Northrop Corp.*, 459 F. Supp. 540, 547 (S.D.N.Y. 1978); *Harman v. Willbern*, 374 F. Supp. 1149, 1157 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*, 35 F. Supp. 22, 25 (E.D. Pa. 1940); *DeBaun v. First Western Bank and Trust Co.*, 46 Cal. App. 3d 686, 696, 120 Cal. Rptr. 354, 359-60 (1975); *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 108, 460 P.2d 464, 471, 81 Cal. Rptr. 592, 599 (1969); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 650 (1941). *See generally* H. HENN, LAW OF CORPORATIONS §§ 240-41 (2d ed. 1970); W. KNEPPER, LIABILITY OF CORPORATE OFFICERS & DIRECTORS § 1.02 (2d ed. 1973); Note, *Fiduciary Duties of Majority or Controlling Stockholders*, 44 IOWA L. REV. 734 (1959); Note, *The Fiduciary Duty of Controlling Shareholders*, 7 W. RES. L. REV. 467 (1956).

For a discussion of the fiduciary duties of corporate officers and directors, *see generally* H. HENN, LAW OF CORPORATIONS § 235 (2d ed. 1970); W. KNEPPER, LIABILITY OF CORPORATE OFFICERS & DIRECTORS § 1.02 (2d ed. 1973); Miller, *The Fiduciary Duties of a Corporate Director*, 4 U. BALT. L. REV. 259 (1975).

Questions frequently arise as to the duty of a majority or controlling stockholder with respect to management of corporate property. For a discussion of the history and issues involved in claims of mismanagement by a majority stockholder *see* Note, *The Fiduciary Duty of Controlling Shareholders*, 7 W. RES. L. REV. 467, 470-75 (1956).

This casenote does not consider the dominant shareholder's accountability to the minority for any profit or bonus received when selling his stock to outsiders.

seller of a controlling block of shares does not owe a duty to minority shareholders to afford them an equal opportunity to sell their shares, or a pro rata portion of their shares, on the same terms as the majority stockholder.⁴

II. THE FACTS

Defendant Richard Hutchison, Jr., president and controlling shareholder of Laurel Harness Racing Association, Inc.,⁵ a Maryland corporation, entered into an agreement with Steven and James Sobeco and Joseph Shamy, also defendants in this suit, to sell them his stock for \$43.75 a share.⁶ The prevailing market price of the stock fluctuated between \$7.50 and \$10.00 a share, thus securing for Hutchison a sale price approximately 400% over the market price.⁷ Hutchison also caused the buyers' offer to be extended to a designated group of minority shareholders.⁸ The closing of the transfer was not to occur for six to twelve months after the agreement to sell.⁹ Additionally, the seller agreed to preserve the financial condition of Laurel pending the transfer.¹⁰ Plaintiffs, those minority shareholders not included in the sale, were not alerted to

For a discussion of cases concerning this issue see Annot., 38 A.L.R.3d 738 (1971). There are generally two forms of relief available when a majority or controlling stockholder breaches his duty of care: accountings for excess profits and damages. Where the amount of looting is greater than the amount of the premium, accounting for excess profits will not adequately compensate the plaintiffs. Some courts, therefore, award damages equal to the injury caused by the breach. "To hold a seller liable only for the premium he received for selling control would allow him a worthwhile gamble, with nothing to lose but the profit he would make if not caught." Note, 51 TEX. L. REV. 1234 n.1 (1973). See also F. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS § 4.06 (1975) (remedies under Rule 10b-5). See generally Annot., 77 A.L.R.3d 1005 (1977).

4. 583 F.2d at 1263-64. See generally Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420 (1965); Note, *Duties of Controlling Shareholders in Transferring Their Shares*, 54 HARV. L. REV. 648 (1941).
 5. See text accompanying notes 82-87 *infra*.
 6. During the period in controversy there were 125,000 shares of common stock issued and outstanding. These shares were held by approximately 300 stockholders and only thinly traded on the public market. 583 F.2d at 1261.
 7. *Id.*
 8. *Id.*
 9. The delay in closing was predicated upon the receipt of a loan through a pledge of personal assets on the part of the purchasers. *Id.* at 1262.
 10. Hutchison covenanted that pending closing: Laurel's business would be conducted only in the ordinary course; no change would be made in Laurel's charter, by-laws or issued and outstanding shares; no dividend would be paid in excess of that declared in 1974; no increase would be made in officer or employee compensation; no contract or commitment extending beyond August 31, 1975 would be made on behalf of Laurel; and Hutchison's best efforts would be used to preserve Laurel's business organization intact.
- Brief for Appellant at 5, *Clagett v. Hutchison*, 583 F.2d 1259 (4th Cir. 1978).

the pending transfer, but discovered it shortly before closing through a newspaper article.¹¹

The Sobeckos and Shamy subsequently transferred a portion of their shares to defendant Brown, and these four later transferred the entire block of shares to defendant Rizk.¹² The plaintiffs brought suit in the United States District Court for the District of Maryland, alleging that the purchasers diverted corporate funds to their personal use, thereby causing a diminution in the value of the plaintiffs' stock.¹³ More particularly, the plaintiffs alleged that defendant Hutchison breached his fiduciary duty to the minority shareholders by failing to investigate the purchasers of his controlling interest.¹⁴

Defendant Hutchison moved to dismiss the complaint, contending that under Maryland law there was no fiduciary relationship between a controlling stockholder and minority stockholders with respect to ownership of stock, and that, consequently, he was under no duty to investigate potential purchasers of his stock.¹⁵ In support of this contention, Hutchison relied upon *Goodman v. Poland*,¹⁶ which, although holding that no fiduciary relationship exists between majority and minority stockholders, was decided in the context of the purchase of stock from minority shareholders. The court in *Goodman* held that under Maryland law a majority stockholder owes no duty to a minority stockholder to disclose inside information when *purchasing* the minority stockholders' shares.¹⁷ The district court stated that *Goodman* was not dispositive of the issue of whether a majority controlling stockholder owes a fiduciary duty to the minority stockholder when *selling* his stock.¹⁸

11. 583 F.2d at 1261.

12. With respect to the stock transfer to Brown, the court stated that as there was no allegation of a transfer of control, there could be no duty to investigate. As to the later transfer to Rizk, the Fourth Circuit agreed with the district court that there were no allegations of suspicious circumstances upon which to place a duty to investigate. 583 F.2d at 1263.

13. The plaintiffs alleged that the Sobeckos and Shamy looted the corporation's assets by causing it to make unsecured, interest-free loans to themselves and others in amounts totaling \$200,000, diverting a \$75,000 payment made to Laurel, causing Laurel to pay attorneys' fees to Shamy in an amount much greater than incurred in prior years, and causing Laurel to pay to themselves and others salaries and compensation in amounts substantially greater than that paid in prior years. Brief for Appellant at 6, *Clagett v. Hutchison*, 583 F.2d 1259 (4th Cir. 1978).

14. 583 F.2d at 1261. Brief for appellant at 2, *Clagett v. Hutchison*, 583 F.2d 1259 (4th Cir. 1978).

15. *Clagett v. Hutchison*, No. HM76-1204 (D. Md. Jan. 20, 1977).

16. 395 F. Supp. 660 (D. Md. 1975).

17. *Id.* at 680-81.

18. *Clagett v. Hutchison*, No. HM76-1204, slip op. at 3 (D. Md. Jan. 20, 1977).

The trial court found that a majority controlling stockholder may owe a duty to minority stockholders.¹⁹ Nonetheless, the court granted the defendants' motion to dismiss, holding that the circumstances alleged by the plaintiffs were insufficient to invoke a seller's duty to investigate.²⁰ The circumstances alleged to have been indicative of the likelihood of fraud were (1) payment of a premium sale price for the controlling block of shares; (2) delay of the closing of the transaction for six to twelve months after the initial agreement; (3) an agreement to preserve the financial condition of the corporation pending closing; and (4) designation of a select group of minority shareholders to participate in the sale.²¹ In addition, the court declined to adopt the equal opportunity rule.²² The Fourth Circuit, Judge Butzner dissenting, affirmed the decision.²³

The remainder of this Note will examine the nature and scope of the fiduciary relationship between majority controlling stockholders and minority stockholders, particularly as viewed in light of the *Clagett* decision.

III. THE FIDUCIARY DUTY

A. *The Existence of the Duty*

Shares of stock are the private property of shareholders and are generally accorded free alienability.²⁴ Thus, under ordinary circum-

19. *Id.* at 5.

20. *Id.*

21. 583 F.2d at 1261.

22. 583 F.2d at 1264. The court noted in a footnote that this case presented a corollary issue to the equal opportunity rule — whether a majority stockholder can make an offer available to *some* of the minority stockholders, but not to others. *Ferraioli v. Cantor*, 281 F. Supp. 354, 356 (S.D.N.Y. 1968), suggests that it may create a cause of action under Rule 10b-5. The *Clagett* court, however, found that the plaintiffs in *Clagett* had no standing to raise this issue under MD. CORP. & ASS'NS CODE ANN. § 11-301, which is virtually identical to rule 10b-5, because that statute protects an injured *buyer* of securities. "In similar vein, we find no support in existing case law for importation of a *Ferraioli*-inspired common law cause of action where plaintiffs have neither purchased nor sold their stock in reliance upon alleged misconduct." 583 F.2d at 1264 n.5. See generally Brune, *Rule 10b-5 and the General Law as to Deceit in Securities Transactions in Maryland*, 33 MD. L. REV. 129, 138-41 (1975).

23. 583 F.2d at 1260.

24. *E.g.*, *Harman v. Willbern*, 374 F. Supp. 1149, 1157 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 649 (1941). See generally Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420 (1965); Note, *The Fiduciary Duty of Controlling Shareholders*, 7 W. RES. L. REV. 467, 476 (1956).

Business convenience and the concept of private property mandate the free alienability of shares of stock, but as ownership of the majority block of shares entails the power to control the corporation, some restraints are necessary to protect the minority from a fraudulent sale of that control. Note, *Duties of Controlling Shareholders in Transferring Their Shares*, 54 HARV. L. REV. 648 (1941); Note, *The Fiduciary Duty of Controlling Shareholders*, 7 W. RES. L. REV. 467, 476 (1956). See generally Annot., 77 A.L.R.3d 1005 (1977).

stances, an owner of stock may sell his shares at any time and for any price.²⁵ Such a rule has broad implications when a majority stockholder wishes to sell his stock, for the nature of a corporation often clothes one individual, by virtue of his ownership of a majority block of shares, with the inherent power to exert control over the property of others.²⁶ It is this position of control that has been held to create a fiduciary duty on the part of a majority stockholder,²⁷ and not the mere ownership of stock.²⁸ This fiduciary relation, coupled

25. *E.g.*, *Swinney v. Keebler Co.*, 480 F.2d 573, 577 (4th Cir. 1973); *McDaniel v. Painter*, 418 F.2d 545, 547 (10th Cir. 1969); *Roby v. Dunnett*, 88 F.2d 68, 69 (10th Cir. 1937); *Harman v. Willbern*, 374 F. Supp. 1149, 1158 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); *Tyron v. Smith*, 191 Ore. 172, 178, 229 P.2d 251, 254 (1951); *Alderman v. Alderman*, 178 S.C. 9, 43, 181 S.E. 897, 911 (1935). See generally 3 W. FLETCHER, *CYCLOPEDIA OF CORPORATIONS* § 900 (perm. ed. 1970).

26. The essence of the majority shareholder's control comes from his ability to vote his shares to elect the board of directors who, in turn, are vested with management of the corporate business. In that respect, the majority shareholder can control the corporation and its assets. *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 649 (1941). See generally H. HENN, *LAW OF CORPORATIONS* §§ 188-89 (2d ed. 1970); *Berle, The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628 (1965).

The term "majority" can also connote the "effective control" exercised over corporate affairs by use of proxy or by capitalizing upon widespread stockholder apathy. Note, *The Fiduciary Duty of Controlling Shareholders*, 7 W. RES. L. REV. 467, 468 (1956).

In *Clagett*, Hutchison occupied the dual fiduciary roles of president and majority stockholder, a position giving him almost virtual control over the corporation.

27. See *Southern Pacific Co. v. Bogert*, 250 U.S. 483, 492 (1919).

In the sense that the business which a majority stockholder transacts is for the benefit of the corporation or the minority shareholders, he acts in a fiduciary capacity. In this capacity, the majority shareholder stands in a relation of trust and confidence, and owes a high degree of good faith. Note, *The Fiduciary Duty of Controlling Shareholders*, 7 W. RES. L. REV. 467, 468 (1956).

28. *E.g.*, *Swinney v. Keebler Co.*, 480 F.2d 573, 577 (4th Cir. 1973); *Harman v. Willbern*, 374 F. Supp. 1149, 1158 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622, 649 (1941).

[A] dominant or majority stockholder does not become a fiduciary for other shareholders by reason of mere ownership of stock. It is only when one steps out of the role as a stockholder and acts in the corporate management, with disregard for the interests and welfare of the corporation and its stockholders that he assumes the burden of fiducial responsibility.

McDaniel v. Painter, 418 F.2d 545, 547 (10th Cir. 1969). See generally 13 W. FLETCHER, *CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS* § 5805 (perm. ed. 1970).

Traditionally, the sale of stock has been considered a private act, as opposed to those acts done on behalf of the corporation. See *Ace Development Co. v. Harrison*, 196 Md. 357, 76 A.2d 566 (1950); *Llewellyn v. Queen City Dairy, Inc.*, 187 Md. 49, 48 A.2d 322 (1946). In *Llewellyn*, the court held that the defendants, directors of the corporation, were not acting for or on behalf of the corporation in the purchase of stock, but were acting as individuals and, therefore, had a right to make the purchases. *Id.* at 61, 48 A.2d at 328.

Ordinarily, a director possesses the same right as any other stockholder to deal freely with his shares of stock and to dispose of them at such a

with concepts of fundamental fairness, imposes restraints on a controlling stockholder's otherwise unfettered right to dispose of his stock.²⁹

The fiduciary role of the majority stockholder may require that he take affirmative action to protect the interests of the minority stockholder. In the leading case of *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*,³⁰ suit was brought against the controlling group of shareholders in an investment company who sold their shares to a syndicate that subsequently looted the corporation. Finding that those in control owe a duty to the corporation with respect to the transfer of control, the court established the rule which has become widely accepted: "[T]he owners of control are under a duty not to transfer control to outsiders [without first conducting a reasonably adequate investigation] if the circumstances surrounding the proposed transfer are such as to awaken suspicion and put a prudent man on his guard . . ." ³¹ that fraud is intended or likely to result.

Because no Maryland statute or decision has addressed directly the issue posed in *Clagett*, the court relied on its prior decision in

price as he may be able to obtain, provided the director acts in good faith, since the corporation as such has no interest in its outstanding stock or in dealing in its shares among its stockholders. In other words, the mere fact that a man accepts the position of a director or an official in a corporation should not as a rule deprive him of his right to dispose of his stock as he sees fit and to make any profit that he might gain, provided in the sale of that stock he has done nothing to injure the corporation and its stockholders.

3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 900 (rev. perm. ed. 1975). In *Ace Development Co. v. Harrison*, 196 Md. 357, 365-66, 76 A.2d 566, 570, the court stated that:

[T]he acts of an agent of a corporation in matters not involving corporate affairs are separate and distinct from corporate acts even though such acts may affect the corporation. A director or agent, not acting as such but in his private capacity, may, in good faith, buy stock of his corporation

Under the early view, each stockholder represented his own interest in corporate affairs, and thus even a majority stockholder could act upon personal motives even if his acts were adverse to the interests of the other shareholders. Courts were particularly emphatic in holding that there was no duty owed when a majority stockholder sold his shares to outsiders. Note, *The Fiduciary Duty of Controlling Shareholders*, 7 W. RES. L. REV. 467, 469 (1956).

29. See *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 110, 460 P.2d 464, 471, 81 Cal. Rptr. 592, 599 (1969). See generally Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420 (1965); Comment, *Sales of Corporate Control and the Theory of Overkill*, 31 U. CHI. L. REV. 725 (1964); 9 AM. JUR. PROOF OF FACTS 2d 261 (1976).

30. 35 F. Supp. 22 (E.D. Pa. 1940).

31. *Id.* at 25. The standard established in *Insuranshares* has been widely accepted. E.g., *Swinney v. Keebler Co.*, 480 F.2d 573, 577-78 (4th Cir. 1973); *McDaniel v. Painter*, 418 F.2d 545, 547 (10th Cir. 1969); *Seagrave Corp. v. Mount*, 212 F.2d 389, 395 (6th Cir. 1954); *Harman v. Willbern*, 374 F. Supp. 1149, 1157 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975).

Swinney v. Keebler Co.,³² which recognized that a majority stockholder owes a duty to minority stockholders under certain circumstances. The *Swinney* court, however, acting under the guidance of *Insuranshares*, did not impose an absolute duty to investigate, but rather a qualified one:

[I]f the sellers of control are in a position to foresee the likelihood of fraud on the corporation, . . . or on the remaining stockholders, at the hands of the transferee, their fiduciary duty imposes a positive duty to investigate the motives and reputation of the would-be purchaser; and unless such a reasonable investigation shows that to a reasonable man no fraud is intended or likely to result, the sellers must refrain from the transfer of control.³³

Relying upon *Swinney*, the *Clagett* court held that a controlling stockholder may be under a duty to investigate potential purchasers of his shares of stock.

In theory there are at least three possible standards for invoking a seller's duty to investigate: (1) no duty absent actual knowledge of a purchaser's wrongful intent; (2) a duty to investigate where circumstances suggest the likelihood of fraud; and, (3) an absolute duty to investigate. The *Clagett* court adopted the second standard, ruling that when it is foreseeable to a reasonable person that fraud is intended or likely to result, the fiduciary relationship requires an investigation of the purchaser in order to reduce the likelihood of harm befalling the corporation and minority stockholders.³⁴

In adopting this standard, the court did not consider the two alternative positions. One court has stated that no duty to investigate arises absent actual knowledge of the purchaser's wrongful intention.³⁵ This position has been criticized as creating an atmosphere conducive to fraud by placing "a premium on the 'head

32. 480 F.2d 573 (4th Cir. 1973).

33. *Id.* at 578 (4th Cir. 1973); 583 F.2d at 1262.

34. 583 F.2d at 1262.

35. *Levy v. American Beverage Corp.*, 265 A.D. 208, 38 N.Y.S.2d 517 (1942).

A stockholder, in selling his stock to a stranger, is not a trustee for other stockholders. This would seem to be so though a stockholder sold a majority of the stock . . . Of course, a majority stockholder may not knowingly use his position to wrongfully injure one who holds a minority interest, and will incur liability when he does so. The test of common honesty would seem to be a sufficient one to apply in order to determine when a wrong is being done. To apply the rigid rules limiting a fiduciary, and to say further that the failure to investigate the moral character, or financial ability of the purchaser of one's stock is an actionable wrong, is to place an unwarranted burden upon the ownership of stock.

Id. at 216, 218; 38 N.Y.S.2d 524, 526.

in the sand' approach to corporate sales."³⁶ As Judge Friendly stated, "[t]o hold the seller for delinquencies of the new directors only if he knew the purchaser was an intending looter is not a sufficient sanction."³⁷ The other alternative is to impose an absolute duty upon the seller to investigate whenever he sells stock. This theory is premised upon the belief that this would avoid the inherent imprecision of the likelihood standard by eliminating the problem of determining when circumstances are sufficiently suspicious.³⁸ The courts have not been receptive to this view because of the burdensome effect it would have on sellers, which could discourage many potentially beneficial sales.³⁹

The position taken by the *Clagett* court is consistent with that adopted by other jurisdictions that have considered the issue.⁴⁰ This standard offers the greatest possibility for compatibility between the rights and interests of the parties because it allows the majority shareholder to retain all rights and benefits inuring to an individual stockholder, subject only to the requirement that he refrain from using his position to the detriment of the minority. This standard also protects the minority from fraudulent acts of the majority stockholder.

B. *The Imposition of the Duty*

Fundamental to a determination of the scope of a seller's duty to investigate potential purchasers of his stock is a weighing of the competing interests involved. The *Clagett* court, following the lead of other courts that have adopted the likelihood of fraud standard, chose to favor the interests of the majority stockholder. The Fourth Circuit's ruling that the circumstances alleged were insufficient to invoke the duty to investigate illustrates the limited nature of the

36. *Swinney v. Keebler Co.*, 480 F.2d 573, 577 n.6 (4th Cir. 1973).

37. *Essex Universal Corp. v. Yates*, 305 F.2d 572, 581 (2d Cir. 1962) (Friendly, J., concurring).

38. 51 TEX. L. REV. 1234, 1239 (1973). At least one court has suggested that there may be a duty to investigate even absent suspicious circumstances. See *Northway, Inc. v. T.S.C. Industries, Inc.*, 512 F.2d 324, 342 (7th Cir. 1975), *rev'd on other grounds*, 429 U.S. 810 (1976).

39. The courts have traditionally been reluctant to place any burden on the free alienability of stock. See generally Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1, 38-39 (1956); 51 TEX. L. REV. 1234, 1238 (1973); Note, *The Fiduciary Duty of Controlling Shareholders*, 7 W. RES. L. REV. 467, 480 (1956).

40. *E.g.*, *Swinney v. Keebler Co.*, 480 F.2d 573 (4th Cir. 1973); *McDaniel v. Painter*, 418 F.2d 545 (10th Cir. 1969); *Harman v. Willbern*, 374 F. Supp. 1149 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940); *Tyron v. Smith*, 191 Ore. 172, 229 P.2d 251 (1951); *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (1941). *But see Levy v. American Beverage Corp.*, 265 A.D. 208, 38 N.Y.S.2d 517 (1942) (holding that a majority stockholder was not under a fiduciary duty to the minority when selling his stock).

duty actually imposed upon a seller of a majority block of shares.⁴¹ Although this court, as well as other courts, has failed to articulate any guidelines for recognizing the existence of suspicious circumstances, it is clear that only a limited set of circumstances will be considered sufficient to indicate a likelihood of fraud. The mere possibility of fraud will not suffice to impose a duty on the seller; there must be a likelihood of fraud.⁴² Moreover, what often on its face purports to be a likelihood standard is, in effect, an imposition of a duty only where circumstances are so suspicious as to lead to no explanation other than fraud.⁴³

The *Clagett* court's narrow interpretation of the fiduciary duty is consistent with the heavy burden imposed by the Fourth Circuit in *Swinney v. Keebler Co.*⁴⁴ In *Swinney*, holders of debentures⁴⁵ brought suit against the seller of the company for payment of the debentures or damages resulting from an alleged breach of its duty to investigate the purchaser. The lower court held the seller liable based upon the facts shown to be known to the seller at the time of the sale.⁴⁶ The appellate court reversed, holding that the seven circumstances alleged by the plaintiffs to be indicative of fraud did not give the seller sufficient knowledge to foresee the likelihood of fraud,⁴⁷ particularly as there were many positive indications of the

41. This is particularly true in view of the fact that this case was dismissed on the pleadings pursuant to FED. R. Civ. P. 12(b)(6). In considering a motion to dismiss, the allegations of the complaint are to be construed most favorably to the pleader. *Scheuer v. Rhodes*, 416 U.S. 232, 236 (1974). See generally 1 J. HUNTER, FEDERAL CIVIL RULES IN THE FOURTH CIRCUIT § 12 (1975).

In his dissent, Judge Butzner challenged the propriety of the dismissal on the pleadings, claiming that the majority reached its conclusion by "erroneously construing the allegations against, rather than in favor of, the complainants." 583 F.2d at 1265.

42. See, e.g., *Swinney v. Keebler Co.*, 480 F.2d 573, 577-78 (4th Cir. 1973); *McDaniel v. Painter*, 418 F.2d 545, 547 (10th Cir. 1969); *Harman v. Willbern*, 374 F. Supp. 1149, 1157-58 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*, 35 F. Supp. 22, 25 (E.D. Pa. 1940).

43. See 51 TEX. L. REV. 1234, 1241 (1973). The standard imposed, however, need not meet the actual knowledge standard of *Levy v. American Beverage Corp.*, 265 A.D. 208, 38 N.Y.S.2d 517 (1942).

44. 480 F.2d 573 (4th Cir. 1973).

45. In *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (1941), the court recognized that creditors have an interest in the corporation which deserves protection from wrongful acts by controlling stockholders. The extension of the *Insuranshares* duty to creditors "is justified because stockholders have some chance . . . to protect their own interests. Having no comparable opportunity, creditors must rely on the judgment and care of those in charge of the corporation." Note, 51 TEX. L. REV. 1234, 1235 (1973).

46. *Swinney v. Keebler Co.*, 329 F. Supp. 216, 224 (D.S.C. 1971), *rev'd*, 480 F.2d 573 (4th Cir. 1973).

47. These circumstances were: (1) no one from the purchasers had any experience in the candy business; (2) at the time the sales contract was executed no one had inspected the company's operations; (3) by the time of closing, only the purchaser's accountant had examined the company to any extent; (4) the

purchaser's good intentions.⁴⁸ In so holding, the *Swinney* court implied that more than a mere scintilla of evidence of fraud is required to impose the duty to investigate.⁴⁹ The *Claggett* court also found "positive" explanations for each allegedly suspicious circumstance and, influenced by the implied quantum of proof requirement of *Swinney*, held that the plaintiffs had not pleaded any facts upon which to base recovery.⁵⁰

The first suspicious circumstance alleged by the plaintiffs in *Claggett* was that the 400% premium paid to Hutchison was so exorbitant as to arouse the suspicions of a reasonable person, and thus warranted an investigation.⁵¹ The *Claggett* court found that the premium payment was justified, viewing the premium as the price paid for control. Speaking for the majority, Judge Hall stated that "it seems farfetched to pay a 400% premium for stock simply in order to acquire control of a corporation in order to loot it."⁵² Furthermore, the court stated that the premium was justified because "Laurel was a commercial business subject to further development as an on-going business. Thus, the premium price paid to Hutchison cannot be said to be so unreasonable as to place him on notice of the likelihood of fraud"⁵³

It is accepted that the sale of controlling shares of stock for more than book value is not evidence of fraud because the purchaser of majority stock is acquiring not only stock, but also control incident thereto.⁵⁴ Generally, a majority stockholder will not be required to refrain from accepting a premium for his stock.⁵⁵ For example, in

company did not have a market of its own and any apparent profits could not be accepted at face value; (5) no attempt had been made by the purchaser to retain key employees; (6) the sale had been conducted with dispatch; and (7) the purchaser had inquired as to the availability of company funds for payment of the purchase price. *Swinney v. Keebler Co.*, 480 F.2d 573, 578 (4th Cir. 1973).

48. *Swinney v. Keebler Co.*, 480 F.2d 573, 580 (4th Cir. 1973).

49. *See id.*

50. 583 F.2d at 1262.

51. *Id.* at 1261.

52. *Id.* at 1262.

53. *Id.*

54. *See, e.g.,* *McDaniel v. Painter*, 418 F.2d 545, 547 (10th Cir. 1969); *Tyron v. Smith*, 191 Ore. 172, 180, 229 P.2d 251, 254 (1951).

The most important reason a purchaser might pay a premium for controlling shares, and one that has to be met squarely, is that an investment in controlling shares is a more promising, or at least a safer, investment than one in noncontrolling shares for the simple reason that it will enable the investor to implement what he believes to be the best policies in the management of his investment.

Andrews, Stockholder's Right to Equal Opportunity in the Sale of Shares, 78 HARV. L. REV. 505, 526 (1965). According to Professor Andrews, even if the majority stockholder does not change the management of the corporation, "control increases the value of the investment by protecting it." *Id.*

55. *See Tyron v. Smith*, 191 Ore. 172, 180, 229 P.2d 251, 254 (1951). *See generally* Comment, *Sales of Corporate Control and the Theory of Overkill*, 31 U. CHI. L. REV. 725 (1964) ("It would be economically unsound to impose liability for the

McDaniel v. Painter,⁵⁶ minority shareholders brought an action against the sellers and purchasers of the majority block of stock, alleging that their stock had diminished in value as a result of the seller's failure to investigate the purchasers. That court held that the sale of controlling stock for a premium was not evidence of fraud because majority stock is generally more valuable than minority stock.⁵⁷ The rationale underlying cases that have held that price is not indicative of fraud is that the premium paid is consideration for control, which attaches to ownership of stock.⁵⁸

Where, however, the premium is paid solely for the element of control, that is, control which is separate and distinct from ownership of a majority of stock, the seller will be held liable to the corporation or its minority stockholders for resulting damages.⁵⁹

premium in every case involving a sale of controlling shares.”); Javaras, *Equal Opportunity in the Sale of Controlling Shares: A Reply to Professor Andrews*, 32 U. CHI. L. REV. 420 (1965).

56. 418 F.2d 545 (10th Cir. 1969).

57. *Id.* at 548. In *Tyron v. Smith*, 191 Ore. 172, 229 P.2d 251 (1951), former minority stockholders in the 1st National Bank of Eugene, Oregon brought suit against Smith, the former president and director, who, with others, owned seventy percent of the capital stock, to recover for alleged fraud in the sale of stock. The purchasers bought stock from Smith for \$460 per share, but were told by Smith that they would have to deal directly with the minority stockholders if they wanted to purchase minority shares. The purchasers proceeded to pay the minority stockholders \$220 per share. The court held that “majority stockholders may sell their stock at any time and for any price obtainable without informing other stockholders the price or terms of the sale, provided they act in good faith.” *Id.* at 178, 229 P.2d at 254. The court also stated that the mere fact that Smith received more money was not evidence of fraud in view of the general rule that “majority stock is more valuable than minority stock.” *Id.*

58. See *McDaniel v. Painter*, 418 F.2d 545 (10th Cir. 1969); *Christophides v. Porco*, 289 F. Supp. 403 (S.D.N.Y. 1958); *Tyron v. Smith*, 191 Ore. 172, 229 P.2d 251 (1951).

59. See generally Hill, *The Sale of Controlling Shares*, 70 HARV. L. REV. 986 (1957). The essence of control is the power to choose directors and management of the corporation, and, therefore, the transfer of control by means other than the sale of stock should not be condoned. Often, the buyer of the corporation thinks he can be more successful with the corporation than the old management. In such a case, the transfer should prove beneficial to all stockholders. It has been argued that the power going with control is an asset which belongs to the corporation and payment for that power should go into the corporate treasury. Berle, *The Price of Power: Sale of Corporate Control*, 50 CORNELL L.Q. 628 (1965). See generally Comment, *Sales of Corporate Control and the Theory of Overkill*, 31 U. CHI. L. REV. 725 (1964); Jennings, *Trading in Corporate Control*, 44 CALIF. L. REV. 1 (1956); H. HENN, *LAW OF CORPORATIONS* § 241 (2d ed. 1970); F. O'NEAL, *OPPRESSION OF MINORITY SHAREHOLDERS* § 4 (1975).

In *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940), the defendants maintained that what occurred was a sale of stock, with the passing of control being merely incidental to the sale. The court disagreed, stating that “this transaction was a sale of control, to which the stock sale was requisite, but nevertheless, a secondary matter.” Control in that case entailed power under the bylaws to sell, exchange or transfer all of the securities

Although no guidelines have been formulated for determining when price is sufficiently suspicious to invoke the duty to investigate, one approach of the courts⁶⁰ that have held price to be a suspicious circumstance is to analyze the nature of the corporation and the ease with which the corporation's assets can be looted.⁶¹ Where the assets are highly liquid, courts are more likely to find an inflated price to be sufficiently suspicious. For instance, in the leading case of *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*,⁶² the court held that the circumstances surrounding the sale of stock were sufficient to awaken the suspicions of a prudent person.⁶³ One

in the corporation's portfolio, as well as access to and physical possession of them. *Id.* at 24.

Essex Universal Corp. v. Yates, 305 F.2d 572 (2d Cir. 1962), involved a sale of stock with a provision giving the purchaser an option to require a majority of existing directors to replace themselves with a majority designated by the purchaser. The court stated that:

It is established beyond question under New York law that it is illegal to sell corporate office or management control by itself (that is, accompanied by no stock or insufficient stock to carry voting control) The rationale of the rule is undisputable: persons enjoying management control hold it on behalf of the corporation's stockholders, and therefore may not regard it as their own personal property to dispose of as they wish.

Id. at 575. Furthermore, the court stated that while it is illegal to sell a corporate office or management control by itself, it was legal to pay for the immediate transfer of control to one who has the majority share control but would not otherwise be able to convert it into operating control for a period of time. *Id.* at 576.

60. *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940); *Gerdas v. Reynolds*, 28 N.Y.S.2d 622 (1941).

61. *Compare Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*, 35 F. Supp. 22 (E.D. Pa. 1940) (investment trust company) and *Gerdas v. Reynolds*, 28 N.Y.S.2d 622 (1941) (investment company) with *Swinney v. Keebler Co.*, 480 F.2d 573 (4th Cir. 1973) (candy company).

Although the nature of the corporation's assets was not a determinative factor in the court's decision in *Harman v. Willbern*, 374 F. Supp. 1149 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975), the court in its attempt to distinguish *Insuranshares* and *Gerdas* noted that the assets in *Harman* "were neither easily salable nor highly liquid, but rather, consisted primarily of real estate and chattel mortgages." 374 F. Supp. at 1159.

62. 35 F. Supp. 22 (E.D. Pa. 1940).

63. The alleged suspicious circumstances were:

- (1) the defendants' probable knowledge that the purchase was to be financed by a pledge of the corporation's assets, (2) the corporation's president's clear predisposition to allow a sale to be financed by pledging those assets as security, (3) the defendant's awareness of the purchaser's plan to have a large part of the corporation's assets converted into cash prior to the sale, (4) the inflated price or premium paid for control, especially given the nature of the business . . . , (5) warnings from the seller's attorneys as to their potential liabilities for dealing with little-known purchasers, and (6) the fact that the corporation had been looted five years before by a different group who had gained control by using the same method of financing.

Swinney v. Keebler Co., 480 F.2d 573, 577 (4th Cir. 1973).

In *Gerdas v. Reynolds*, 28 N.Y.S.2d 622 (1941), sale of the majority's shares of stock in an investment corporation was held invalid where (1) all officers and

circumstance cited by that court was the price paid for the stock. The *Insuranshares* court suggested that an inflated price should put a seller on notice of the likelihood of fraud.⁶⁴ The district court in *Clagett* distinguished *Insuranshares* on the basis that it involved an investment company and thus was "a corporation with the equivalent of cash at the buyer's fingertips."⁶⁵ Similarly, in *Gerdes v. Reynolds*,⁶⁶ another case involving an investment company with liquid assets, the court held that a premium price was significant in determining the existence of suspicious circumstances.⁶⁷

The plaintiffs' second contention was that the six to twelve month delay in closing was a suspicious circumstance.⁶⁸ According to the plaintiffs, it could be inferred that the purpose of the delay was to give the purchasers an opportunity to use the agreement and the shares of Laurel to be purchased as collateral for a loan.⁶⁹ The court rejected this argument, finding that the agreement was to give the purchasers time to obtain a personal loan through a pledge of personal assets in order to finance the purchase of the stock, and stated that this constituted a prudent business practice.⁷⁰ In contrast, in *Insuranshares*, where the sale was to be financed through a pledge of the corporation's assets as security, the court held that this was a suspicious circumstance⁷¹ and stated,

[I]f Hepburn had good reason to suspect that the purchase was to be financed in toto with the corporation's assets, it would be fair warning of the fraudulent nature of the whole thing. So, in considering whether the circumstances of this sale called for a real investigation, one matter of importance is what was known or to be inferred as to the manner in which the purchase was to be financed.⁷²

directors were to resign immediately; (2) only a portion of the purchase price had been paid at the time of the sale; and (3) the sale price was greatly in excess of the value of the stock.

64. The court asked why a purchaser would be willing to pay so much for control, suggesting that such a thought might well occur to the seller. 35 F. Supp. 22, 26 (E.D. Pa. 1940).

65. *Clagett v. Hutchison*, No. HM76-1204, slip op. at 6 (D. Md. Jan. 20, 1977). It does not necessarily follow, however, that whenever a corporation has the "equivalent of cash at the buyer's fingertips" that price is a suspicious circumstance.

The district court found it significant that the court in *Insuranshares* stated that if the corporation in that case "had been an industrial, mining, or commercial enterprise, whose physical assets and business might have potentialities which a purchaser might believe he could develop if given control," the inflated price would not have been a significant factor in determining the existence of suspicious circumstances. *Id.*

66. 28 N.Y.S.2d 622 (1941).

67. *Id.* at 654.

68. 583 F.2d at 1262.

69. Brief for Appellants at 14, *Clagett v. Hutchison*, 583 F.2d 1259 (4th Cir. 1978).

70. 583 F.2d at 1262-63.

71. 35 F. Supp. at 25 (E.D. Pa. 1940).

72. *Id.*

In *Swinney v. Keebler Co.*,⁷³ however, the Fourth Circuit held that inquiries made by the purchaser to the seller as to the availability of the company's funds for payment of the purchase price were insufficient to require the seller to investigate where the seller made clear that the sale must be financed with the purchaser's funds and the purchaser had the "apparent ability to finance the transaction with its own monies."⁷⁴

The plaintiffs' third contention was that the agreement to prevent any changes in the corporation's financial status was a suspicious circumstance.⁷⁵ The court rejected this argument, stating that far from being sufficiently suspicious to invoke a duty to investigate "[t]he agreement essentially preserved the *status quo* of Laurel . . .,"⁷⁶ which the court found to be a prudent business practice.⁷⁷

The plaintiffs' final contention was that Hutchison's designation of certain minority stockholders to be included in the sale was a suspicious circumstance.⁷⁸ The majority disposed of this contention on the ground that Hutchison was conducting a private transaction and had the right to include others in it.⁷⁹ In his dissent, Judge Butzner disagreed with the majority, reasoning that Hutchison's use of his position to include other minority shareholders in the sale justifies an inference "at least at this stage of the proceedings" that Hutchison foresaw the impending disaster of the corporation.⁸⁰ Furthermore, Judge Butzner stated that the court in *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*⁸¹ "suggests that the nature of the corporation's business is a factor to be considered in assessing the majority stockholder's duty to investigate the persons who wish to acquire control."⁸² In Judge Butzner's opinion, Laurel's

73. 480 F.2d 573 (4th Cir. 1973).

74. *Id.* at 580. Compare *DeBaun v. First Western Bank and Trust Co.*, 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (1975) (bank was aware that the only funds available to the purchaser to finance the sale were the assets of the corporation) with *Swinney v. Keebler Co.*, 480 F.2d 573 (4th Cir. 1973).

75. 583 F.2d at 1261-62.

76. *Id.* at 1263.

77. *Id.*

78. *Id.* at 1261, 1263.

79. "Selling one's own stock and including others in such a sale is a private act, sanctioned in law, and not alone 'suspicious.'" *Id.* See *Llewellyn v. Queen City Dairy, Inc.*, 187 Md. 49, 60, 48 A.2d 322, 327 (1946). Cf. *Ace Development Co. v. Harrison*, 196 Md. 357, 365-66, 76 A.2d 566, 569-70 (1950) ("[T]he acts of an agent of a corporation in matters not involving corporate affairs are separate and distinct from corporate acts, even though such acts may affect the corporation.").

80. 583 F.2d at 1266. Judge Butzner argued that "holders of the same class of stock are to be treated equally by the corporation and its management." *Id.* Judge Butzner cited *Hagerstown Furniture Co. v. Baker*, 155 Md. 549, 142 A. 885 (1928), as supportive authority, and believed that this alleged discrimination stated a claim sufficient to survive a motion to dismiss. *Id.*

81. 35 F. Supp. 22 (E.D. Pa. 1940). See text accompanying notes 57-60 *supra*.

82. 583 F.2d at 1263 (Butzner, J., dissenting).

“unique status as a racetrack licensee” dictated the imposition of a fiduciary duty to investigate in the present case.⁸³ Noting that the operating license was one of the most valuable assets of the corporation and could be revoked “for any cause whatsoever” by the Maryland Racing Commission, Judge Butzner stated,

Since the competency and integrity of new owners will have an important bearing on the future of the corporation, it seems to me that majority stockholders who sell control of a race track have a fiduciary obligation to make a sufficient investigation to assure the minority that the license will not be placed in jeopardy by the new owners.⁸⁴

The *Clagett* court might justifiably have imposed a duty to investigate upon Hutchison based on the fact that Laurel was a gambling operation highly regulated by state law,⁸⁵ which could lose its license if the new owners proved to be incompetent or corrupt.⁸⁶ The majority opinion, however, did not address this factor in assessing the seller’s duty to investigate.

Although there are no established criteria for identifying circumstances that are sufficiently suspicious to give rise to the duty to investigate, courts have pointed to several factors.⁸⁷ For instance, where a corporation had been looted five years earlier by a group that had financed their purchase of the corporation in the same general way as the defendants, such a circumstance was deemed to be highly suspicious.⁸⁸ In addition, payment for the mass resigna-

83. *Id.*

84. *Id.*

85. MD. ANN. CODE art. 78B, §6 (1975 & Supp. 1978) requires all persons conducting any meeting in the State where horse racing is permitted “for any stake, purse, or reward” to have a license. Section 10 of the article subjects the license to regulations and conditions imposed by the Racing Commission and provides for the suspension or revocation of the license for any cause the Commission deems sufficient. Section 13 of the article requires each licensee to maintain records of the owners of stock of the licensee.

[T]he General Assembly has established a broad policy of prohibiting the commercial exploitation of the public’s gambling instinct It is apparent that the legislature deliberately imposed grave responsibility upon the Racing Commission in order that this exception to the antigambling laws of the State be kept within proper limits.

Southern Maryland Agricultural Ass’n of Prince George’s County v. Magruder, 198 Md. 274, 279–80, 81 A.2d 592, 594 (1951).

86. 583 F.2d at 1267.

87. See generally Annot., 77 A.L.R.3d 1005 (1977); 9 AM. JUR. PROOF OF FACTS 2d 261 (1976).

88. Insuranshares Corp. of Delaware v. Northern Fiscal Corp., 35 F. Supp. 22 (E.D. Pa. 1940). Noting that the seller had knowledge of all of the details of the prior looting, the court stated that “[t]his, of course, is not proof that new group would do the same thing, but it certainly was a vivid reminder of the special dangers to which these small and helpless investment trusts were constantly exposed.” *Id.* at 25.

tion of the board of directors has also been found to be indicative of fraud where the purchaser bargains for immediate control and not merely the right incident to the ownership of the majority of the stock.⁸⁹ One court has cited the occurrence of other fraudulent acts by the same purchaser as giving rise to the investigative duty.⁹⁰ After a review of those cases that have found that such a duty exists, one is left with the impression that no single circumstance controls, but rather that a court will view the entire tenor of the transaction to determine whether to impose the duty to investigate. Once the duty is found to exist, the resulting investigation must satisfy a reasonable man that no fraud was intended or likely to result.⁹¹

IV. EQUAL OPPORTUNITY

The second theory upon which the plaintiffs predicated their right of recovery was that Hutchison, as majority stockholder, owed a fiduciary duty to the minority stockholders to afford them an equal opportunity to sell their shares, or a pro rata portion of their shares, on the same terms offered to Hutchison.⁹² The court rejected this contention, however, and distinguished the cases upon which it was based.⁹³

89. *Gerdes v. Reynolds*, 28 N.Y.S.2d 622 (1941). Generally no illegality will be found in the mere fact of a sale of a majority change in the personality of those who by reason of stock ownership have the right to choose the directorate. In this case, however, it indisputably was a condition of the sale that all the officers and directors then in office should forthwith resign and that under their power to fill vacancies they should forthwith elect an entirely new directorate chosen wholly by the purchaser of the stock Immediate and complete control in advance of payment . . . was thus specifically bargained for and accorded. The officers and directors were made specifically aware of the fact that what the purchaser . . . wanted was immediate and actual control, and not merely the right to elect directors which incidentally follows from a sale of a majority of voting stock.

Id. at 651. See also *Essex Universal Corp. v. Yates*, 305 F.2d 572 (2d Cir. 1962). See generally, F. O'NEAL, *OPPRESSION OF MINORITY SHAREHOLDERS* § 4.02 (1975).

90. *DeBaun v. First Western Bank and Trust Co.*, 46 Cal. App. 3d 686, 120 Cal. Rptr. 354 (1975). The Court in *DeBaun* held the seller liable for failure to investigate citing several circumstances that should have alerted the seller as to the likelihood of fraud: (1) the Dun & Bradstreet report revealed the failure of prior entities controlled by the purchaser; (2) The Bank knew that the purchaser would use the corporation's assets to finance the sale; (3) an officer in the Bank had personal knowledge that the purchaser had been guilty of a fraud on the Bank's predecessor in interest on at least one occasion. *Id.* at 697, 120 Cal. Rptr. at 360.

91. *Swinney v. Keebler Co.*, 480 F.2d 573, 577 (4th Cir. 1973); *Harman v. Willbern*, 374 F. Supp. 1149, 1158 (D. Kan. 1974), *aff'd*, 520 F.2d 1333 (10th Cir. 1975); *Insuranshares Corp. of Delaware v. Northern Fiscal Corp.*, 35 F. Supp. 22, 25 (E.D. Pa. 1940).

92. 583 F.2d at 1263.

93. The plaintiffs claimed "that the equal opportunity rule should properly follow from Maryland law which prohibits a controlling stockholder from using his control for some ulterior purpose adverse to the interests of the corporation and its stockholders." *Id.* See, e.g., *Baker v. Standard Lime and Stone Co.*, 203 Md.

In at least one case, *Donahue v. Rodd Electrotpe Co. of New England, Inc.*,⁹⁴ it was held that the failure of controlling shareholders to offer minority shareholders an equal opportunity to sell their shares constitutes a breach of their fiduciary duty. *Donahue*, however, involved the majority shareholders' use of their voting power to cause the corporation to redeem their shares. More importantly, it involved a close corporation. The *Donahue* court stressed that a close corporation requires a more rigorous application of the fiduciary duty of directors and shareholders than do other corporations and stated that where the stockholder whose shares were being purchased was a member of a controlling group in a close corporation, the controlling shareholder must cause the corporation to offer each shareholder an equal opportunity to sell his shares.⁹⁵ *Clagett* did not involve a close corporation, nor did it involve the majority shareholder's use of his voting power to cause the corporation to act to the detriment of the minority.

The *Clagett* court noted that the equal opportunity rule has been soundly rejected,⁹⁶ citing *McDaniel v. Painter*,⁹⁷ in which the United States Court of Appeals for the Tenth Circuit found that majority

270, 283, 100 A.2d 822, 829 (1953) (dictum); *Cooperative Milk Service, Inc. v. Hepner*, 198 Md. 104, 81 A.2d 219 (1951).

The plaintiffs also cited three cases from other jurisdictions in support of the rule. *Pertman v. Feldmann*, 219 F.2d 173 (2d Cir.), cert. denied, 349 U.S. 952 (1955); *Jones v. H.F. Ahmanson & Co.*, 1 Cal. 3d 93, 460 P.2d 464, 81 Cal. Rptr. 592 (1969); *Donahue v. Rodd Electrotpe Co. of New England, Inc.*, 367 Mass. 578, 328 N.E.2d 505 (1975). The district court distinguished all three cases, ultimately rejecting the adoption of the equal opportunity rule.

In *Jones*, the defendants created a holding company to which they sold their shares. They subsequently turned the holding company public. The minority shareholders were not offered an equal opportunity to sell their stock to the holding company before it went public. "The course they chose affected the minority stockholders with no less finality than does dissolution . . ." 1 Cal. 3d at 115, 460 P.2d at 476, 81 Cal. Rptr. at 604. At least one commentator has suggested that *Jones* supports adoption of the equal opportunity rule. See W. KNEPPER, *LIABILITY OF CORPORATE OFFICERS & DIRECTORS* § 6.04 (2d ed. 1973).

Pertman involved the sale of stock of a corporation engaged in producing steel sheets for sale to manufacturers of steel products. Feldmann, the director and dominant shareholder of the corporation, sold his stock to a corporation that was an end-user of steel. The court found that the sale, which took place in the face of a steel shortage precipitated by the Korean War, was not a mere sale of stock, but was an unlawful sale of control. The court stated that the purchasers were interested in obtaining a continuing source of steel, and predicated liability upon misappropriation of a corporate asset. Feldmann was held accountable to the minority shareholders to the extent that the price paid represented the right to control the distribution of the corporate asset.

94. 367 Mass. 578, 328 N.E.2d 505 (1975). The opinion in *Donahue* affords a good discussion of the nature of a close corporation.

95. 367 Mass. at 598, 328 N.E.2d at 518.

96. But see *Andrews, Stockholder's Right to Equal Opportunity in the Sale of Shares*, 78 HARV. L. REV. 505 (1965) (Professor Andrews believes that the vitality of a free market and the purpose that it serves are enhanced rather than impaired by equal opportunity).

97. 418 F.2d 545 (10th Cir. 1969).

stockholders do not have to make an offer to purchase ratably available to all stockholders particularly when the sale is made in good faith. "To condemn the kind of transaction involved in this case would tend strongly to discourage stock investments and would be a menace to the efficient management of corporate business."⁹⁸ As one court has stated, "there is no obligation to share and share alike."⁹⁹

V. CONCLUSION

Early case law held that a controlling shareholder owed no duty to minority shareholders with respect to the sale of his stock. A constantly growing and increasingly complex securities market, however, forced the courts to reexamine their earlier position. Today, the courts recognize that a majority-controlling stockholder owes a fiduciary duty to the minority. One consequence of this duty is that the right of a majority-controlling stockholder to sell his shares at any time and for any price to anyone he chooses is circumscribed by the requirement that he not do so if circumstances surrounding the transfer would alert the suspicions of a prudent person as to the likelihood of fraud.

The *Clagett* case revealed that only a limited set of circumstances will give rise to the duty to investigate. The standard is a difficult one for a plaintiff to surmount because if the defendant can justify his failure to investigate questionable circumstances, courts are likely to find that no duty arises. Thus, the final determination in any situation remains to be decided on a case by case basis. Nevertheless, the practicing attorney representing a client who wishes to divest himself of his controlling stock ought to be cognizant of the potential liability attendant to such transfers.

Sherry A. Aarons

98. *Id.* at 548.

99. *Christophides v. Porco*, 289 F. Supp. 403 (S.D.N.Y. 1968).