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CORPORATIONS-MAJORITY SHAREHOLDER'S FRAUD IN THE PURCHASE OF STOCK

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COMMENTS

CORPORATIONS—MAJORITY SHAREHOLDER'S FRAUD IN THE PURCHASE OF STOCK—Whether or not there has been fraud in the purchase of property, due to either affirmative statements or mere non-disclosure, may well depend upon the relation of the purchaser to the vendor. The recent case of *Speed v. Transamerica Corporation*[1] presents two questions relative to this problem in the purchase of corporation shares: first, whether the price quoted in an offer to purchase can ever be the basis of an action for fraud and deceit; and second, whether the majority shareholder of a corporation occupies a fiduciary relation to minority shareholders in the purchase of their stock. Defendant was the majority stockholder of the Axton-Fisher Tobacco Company and had, pursuant to its written offer, purchased stock of plaintiff, a minority stockholder in such company, at a price quoted in the offer. From the evidence presented in a deceit action brought by plaintiff, the court found that the defendant had devised a scheme whereby it intended to acquire the holdings of the minority shareholders at a price much less than the real value thereof and thereafter to capture for itself the appreciated value of the leaf tobacco inventory of Axton-Fisher by liquidation. The court felt that in making the offer the defendant had impliedly represented the price quoted to be fair, when in the presence of an existing intent to liquidate, the true value of the shares was far greater. The offer, therefore, viewed as a representation as to value, was false and as such was held to be a

[1] (D.C. Del. 1951) 99 F. Supp. 808. Various phases of the litigation have already been reported in Speed v. Transamerica Corporation, (D.C. Del. 1945) 5 F.R.D. 56; (D.C. Del. 1947) 71 F. Supp. 457.

misrepresentation upon which a common law action for fraud and deceit could be based. The court did not appear to ground its decision on a finding of the existence of any fiduciary relationship nor, as a corollary, a finding of the existence of a duty to make affirmative disclosures. It is not the purpose of this comment to explore all the possible ramifications of either the reasoning of the court or the correctness of the ultimate finding of defendant's liability to respond in damages.[2] Moreover, it will be assumed that the evidence supported the inference that at the time the offer was made there did exist an intent to liquidate. Instead, this comment will concern itself with but two questions: namely, whether the price quoted in the offer to purchase was an actionable misrepresentation, and whether, as a possible alternative ground for recovery, the relation of the parties was such as would convert non-disclosure of the intent to liquidate into actionable fraudulent concealment.

I. Offer of Price as Representation of Value

In holding that the offer to purchase at the quoted price constituted a representation as to value, the District Court of Delaware, in language at least, did not seem to attach much importance to the relation of the parties.[3] Instead, the question was treated as one involving the usual vendor-purchaser case of deceit framed in terms of actionable misrepresentation. The court did not find that the defendant, because of its position as majority shareholder, was under a duty to speak and make disclosure of the contemplated liquidation; rather, it found that the defendant had spoken and that the statement as to price made in the offer to purchase were, when viewed with the accompanying circumstances, affirmative misrepresentations as to the value of the

[2] In addition to the fraud and deceit count of plaintiff's complaint, there were three other counts charging violation of §10 (b), as amended, of the Securities Exchange Act of 1934, 15 U.S.C. (1946) §78j (b), and Rule X-10B-5 promulgated thereunder. It should be noted that the principal reason for the court's decision was based on these three counts, with the question of common law deceit being but a minor issue.

[3] There were various factors present, other than the discrepancy in the quoted price, which undoubtedly influenced the court as it spoke of the so-called "badges of fraud." Among these were the inclusion in the offer of the condition that the offer was to be contingent upon acceptance by a certain number of shareholders and upon acceptance before a certain date; the failure of defendant to disclose the recent increased earnings and the increased value of the tobacco inventory; and also, refusal of defendant to answer inquiries concerning the offer. These factors were not considered as constituting possible actionable misrepresentations, but instead were treated as important only insofar as they aided in answering the primary inquiry as to whether there was any pre-existing intent to capture the inventory profit.

shares. In so doing, the court did not purport to limit this reasoning to sales involving majority and minority stockholders, but seemingly the reasoning applied to every vendor-purchaser case regardless of parties and regardless of subject matter. The possible implications of the court's reasoning and language are far-reaching and certainly open to question as transgressing the limits of established law. Absent some sort of fiduciary relation or other similar relation of trust and confidence between the parties, statements as to value made by the purchaser during negotiations cannot generally be made the basis of a charge of fraud.[4] Such statements are statements of opinion, and therefore, even if an offer is construed as a representation as to value, reliance upon it, absent some particular relation between the parties, would hardly seem justified.[5] The ordinary contract of sale is not intrinsically fiduciary; each party is trying to make the best bargain possible and if the purchaser belittles the worth of the subject matter of the sale, whether it is in his offer or otherwise, this should be no more a misrepresentation as to value than the vendor's exaggerated statements as to its worth.[6] To say that a purchaser who offers x dollars for some shares or chattels or realty, represents that the subject matter of the sale is worth x dollars, seems not only unrealistic, but startling as well.

II. Relationship of Parties as Affecting Duty to Disclose

In cases of fraud and deceit, the relationship of the parties is a factor which must be considered. Oftentimes the turning point on the question of liability depends on whether the parties are complete strangers

[4] Where the subject matter of the sale is stock, see 12 FLETCHER, CYC. CORP. §5586 (1932); where the subject matter is land, see 56 A.L.R. 429 (1928), 27 R.C.L., Vendor and Purchaser §90 (1920) and 5 WILLISTON, CONTRACTS §1498 (1937). See also Laidlow v. Organ, 2 Wheat. (15 U.S.) 178 (1817). The usual example given in cases involving land is the one where one person knows of valuable mineral deposits on the land of another who is ignorant of such fact.

[5] "Thus, a false opinion, exercised intentionally by the buyer to the seller, of the value of the property offered for sale, where there is no special confidence or relation or influence between the parties, and each meets the other on equal grounds, relying on his own judgment, is not sufficient to avoid a contract of sale." 1 STORY, EQUITY JURISPRUDENCE, 14th ed., §279 (1918); also 3 POMEROY, EQUITY JURISPRUDENCE, 5th ed., §878a (1941). Wessel v. Union Savings and Loan Assn., 198 La. 219, 3 S. (2d) 594 (1941) and Markey v. Hibernia Homestead Assn., (La. App. 1943) 13 S. (2d) 791, wherein the court held that an offer to purchase plaintiff's stock at so much on the dollar did not indicate that the offeror considered that amount to be the value of the stock. See also Moore v. Steinman Hardware Co., 319 Pa. 430, 179 A. 565 (1935).

[6] BOWER, THE LAW OF ACTIONABLE MISREPRESENTATION §51a (1927). On the treatment of commendatory trade talk, see 23 AM. JUR., Fraud and Deceit §33 (1939).

to each other or whether instead there is some particular relationship existent between them. Thus, whether reliance upon a statement of opinion is justified or whether there is a duty to speak may depend on whether there is a fiduciary relation or special confidence between the parties. In cases involving the sale of stock, there is certainly a factual difference between sales involving two parties, strangers both to each other and to the corporation, and sales involving two parties one of whom is an insider, whether he is an officer, director, or controlling shareholder, either majority or minority, of the company. If there are affirmative misstatements as to material facts, or if the vendor makes inquiry and receives false information, there would of course be liability in either case.[7] Assuming, however, the case where the purchaser remains silent, the question of fraud, in terms of fraudulent concealment, depends on the effect of non-disclosure. Mere non-disclosure as such does not amount to fraud unless there is found a duty to speak followed by a suppression of the truth, and the presence or absence of such a duty may well depend on the relationship of the parties.[8] Under ordinary circumstances, in the case involving two strangers, there is no duty on the purchaser to disclose facts, advantageous to the vendor, concerning the thing to be sold which would enhance its value or cause the vendor to demand a higher price and the like.[9] There being no duty to speak, failure to disclose would not amount to fraudulent concealment. On this the law seems clear. When the purchaser, however, is an insider, the law, although not confused, is at least very unsatisfactory.[10] Most of the cases which arise involve the purchase of corporate shares of stock by a director of the corporation from an individual stockholder, who subsequently sues the director alleging concealments. On this question, although the courts are not in agreement, the majority view is that the director has the same right to buy stock without disclosure from a shareholder as

[7] "In determining what constitutes fraud in the sale of stock, the general principles on the subject of fraud are to be applied." 12 FLETCHER, CYC. CORP. §§5580, 5581 (1932). Poole v. Camden, 79 W. Va. 310, 92 S.E. 4454 (1916) and Buckley v. Buckley, 230 Mich. 504, 202 N.W. 955 (1925).

[8] 3 POMEROY, EQUITY JURISPRUDENCE, 5th ed., §§901, 903 (1941), and 23 AM. JUR., Fraud and Deceit §77 (1939). See also the comment in 15 TEX. L. REV. 1 (1936) on the general subject of concealment and non-disclosure.

[9] 12 FLETCHER, CYC. CORP. §5589 (1932).

[10] 3 FLETCHER, CYC. CORP., revised volume, §§1168-1171 (1947); BALLANTINE, CORPORATIONS §80 (1946); and 2 THOMPSON, CORPORATIONS, 3d ed., §1363 (1927). On the subject see, de Funiak, "Fraud or Misrepresentation by Purchaser Inducing Sales of Shares of Stock," 26 KY. L.J. 285 (1938).

has anyone else.[11] There is no fiduciary responsibility imposed which precludes the officer or director from buying or selling the corporation's stock merely because he is an officer or director of that corporation. Diametrically opposed to this view, which certainly shocks the moral sense of justice, is the view of the minority of courts which hold that a director cannot purchase stock from a shareholder without giving him the benefit of any official knowledge he possesses which may increase the value of the stock.[12] In effect, the directors are fiduciaries, much the same as trustees, for the individual stockholders with respect to their stock. Between these two extremes is the intermediary "special facts" doctrine which is applicable in cases involving special circumstances, where the use of inside information would give the director a great and unfair advantage in bargaining position.[13] Under this view, the special facts may give rise to a limited fiduciary duty to disclose and a director will not be allowed to purchase stock from a stockholder without making known any official knowledge which he may possess in relation to the corporation's affairs or affecting the value of the stock. From this it can be seen that although a director may be looked upon as a fiduciary in some respects, the courts are hesitant, with the exception of those that adhere to the minority view, to find such relationship in cases involving purchase of shares by the director. This is also true in the case wherein it is the controlling shareholder who has made the purchase. The courts here, analogizing the case to one involving a director, more often than not will say that there is no duty to disclose and consequently no liability for concealment. Thus, although there most certainly is a factual difference where one of the parties is an insider, there seems to be little legal difference in the eyes of a majority of the courts.

III. Conclusions

The law as stated in the above discussion relative to the question of fraudulent concealment seems far from consonant with principles of

[11] See treatises cited in note 10 supra. 1 COOK, CORPORATIONS, 7th ed., §320 (1913); BOWER, THE LAW RELATING TO ACTIONABLE NON-DISCLOSURE 165 (1915); and 84 A.L.R. 615 (1933). The Board of Commissioners of Tippecanoe County v. Reynolds, 44 Ind. 509 (1873); Moore v. Steinman Hardware Co., 319 Pa. 430, 179 A. 565 (1935); and Waller v. Hodge, 214 Ky. 705, 283 S.W. 1047 (1926).

[12] See treatises cited in note 10 supra. See also Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903), and the able argument of Judge Ladd in Dawson v. National Life Ins. Co., 176 Iowa 362, 157 N.W. 1929 (1916).

[13] See treatises cited in note 10 supra. For the leading case in support of this view, see Strong v. Repide, 213 U.S. 419, 29 S. Ct. 521 (1909).

justice and fair dealing. A legal premium should not be given to the insiders in active control of the corporation who possess, because of their official positions, superior knowledge and means of information and who, because of their strategic position of dominance, control the destinies of the corporation and its individual shareholders.[14] Because of position and concomitant control of the corporation, the director or controlling shareholder does stand in a particular relation to the individual stockholders.[15] He occupies a peculiar position of trust and confidence, and as such should be considered a fiduciary bound to exercise the utmost good faith and to refrain from making any misrepresentation, either affirmatively or negatively, which would mislead or deceive the other party for the purpose of advancing his own interests. Admittedly, a majority shareholder, by virtue of his stock ownership, has a right to control the corporation, but when that right is exercised as a legal power over the community of interests of all the shareholders, the law should not permit an unconscionable exercise in favor of one group at the expense of another.[16] Whether or not there is a duty to speak really presents a question of fair conduct under the circumstances, and surely the principles of justice, equity, and fair dealing should have made disclosure incumbent on the defendant in the principal case. It is submitted, therefore, that the ultimate finding of liability was undoubtedly correct, but it is believed that the better approach would have been in terms of breach of a fiduciary duty to make affirmative disclosures rather than in terms of affirmative actionable misrepresentations.

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[14] As to the privilege of non-disclosure, see 2 CONTRACTS RESTATEMENT §472(1) (1932).

[15] Merger Mines Corp. v. Grismer, (9th Cir. 1943) 137 F. (2d) 335; Lebold v. Inland S.S. Co., (7th Cir. 1936) 82 F. (2d) 351, rehearing den. (7th Cir. 1941) 125 F. (2d) 369, noted in 28 VA. L. REV. 1132 (1942); Jones v. Missouri-Edison Electric Co., (8th Cir. 1906) 144 F. 765; Nave-McCord Mercantile Co. v. Ranney, (8th Cir. 1928) 29 F. (2d) 383; Pergament v. Frazer, (D.C. Mich. 1950) 93 F. Supp. 13; Alster v. British Type Investors, (D.C. N.Y. 1949) 83 F. Supp. 949; Hirshhorn v. Mine Safety Appliances Co., (D.C. Pa. 1948) 8 F.R.D. 11; Overfield v. Pennroad Corp., (D.C. Pa. 1941) 42 F. Supp. 586; and Backus v. Finkelstein, (D.C. Minn. 1924) 23 F. (2d) 531.

[16] STEVENS, CORPORATIONS, 2d ed., 126 (1949); 13 FLETCHER, CYC. CORP. §§5810, 5811 (1943); 1 MORAWETZ, THE LAW OF PRIVATE CORPORATIONS §477 (1886); and Rohrlich, "Suits in Equity by Minority Shareholders as a Means of Corporate Control," 81 UNIV. PA. L. REV. 692 (1933). Southern Pacific Co. v. Bogert, 250 U.S. 483, 39 S.Ct. 533 (1919); Soderstrom v. Kungsholm Baking Co., (7th Cir. 1951) 189 F. (2d) 1008; Mayflower Hotel Stockholders Protective Committee v. Mayflower Hotel Corp., (D.C. Cir. 1949) 173 F. (2d) 416.