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THE DUTY OF DISCLOSURE BY A DIRECTOR PUR- CHASING STOCK FROM HIS STOCKHOLDERS

ROBERTS WALKER

There is no impressive dissent from the proposition that a director or officer¹ of a corporation is to be deemed a trustee for the corporate body, the aggregate of assets, liabilities and business belonging to the stockholders. From this proposition some have argued that each director should be deemed a fiduciary for each individual stockholder. This claim has been most aggressively put forward in cases where a director has direct dealings with a stockholder in matters relating to the corporation. The most frequent case is the purchase of its stock by a director. It has been asserted that, since a director must occupy a better informed, a superior position, he must not only answer all questions but must volunteer all pertinent information in his possession, when bargaining for the shares. As a fiduciary, the argument runs, he must make fullest disclosure before having any business dealings with his *cestui* or ward. And it is claimed that the reported decisions have laid the foundation for this fiduciary doctrine.

But when this body of law is examined, the support for the fiduciary doctrine seems slight indeed. The lack of a clean-cut state of facts, sharply raising the fiduciary question, is the rule rather than the exception and, as in hunting the snark, the bowsprit gets mixed with the rudder sometimes. Law gets jumbled with equity. Deceit, fraud, abuse of position, overreaching of the ignorant, these and the like confuse the judges. Often the courts seem to have failed to observe that trading is full of human nature, a stock trade no less than a horse trade. Buyers and sellers alike may be crafty, and more than one seller has been known to be a welsher. Cases that could and should have been decided on grounds of fraud or deceit have been

¹ Elsewhere in this paper "director" is to be taken as including also "officer," meaning responsible executives such as president, vice-president, secretary, or treasurer.

needlessly dignified by the application of the fiduciary doctrine. On occasions some appealing feature of the case seems to have led to dragging in the fiduciary doctrine as the lesser of two evils.

Historically, the doctrine had every chance to bloom and prosper. When business corporations were new, small and private affairs, directors may well have possessed secret and more accurate information, and have thus been able to buy shares to the disadvantage of other stockholders. But we nevertheless find that the courts began by taking quite the other view. A venerable American decision² announced, somewhat *obiter*, that there is no legal privity between shareholders and directors; "the directors are not the bailees, the factors, agents or trustees of such individual stockholders." The stockholder had brought an action on the case at common law, alleging that his shares had become worthless by the directors' malfeasance. The latter's demurrer was sustained. An early British decision³ had much to say about "a relation of confidence as to property," but the facts were that the directors for years had rendered untrue and depressing accounts of the company's business, whereby the stockholder had at last been induced to sell to them at a great undervalue—a clear case of fraud, in other words. In the first pertinent New York case,⁴ dealings in shares were held not to be within any trust relationship. Here the director gave honest answers to all questions and all the representations made by him were true; but he did not tell that war work then in process might result in large dividends, a prediction that nobody could have made with certainty at the time, but which turned out to be so. Of all the reported decisions, this one seems to strike the fairest balance of good law and common sense. Forty years later, in a dissenting opinion, Judge (afterward Mayor) Gaynor put the subject with equal common sense but in a less inviting aspect:⁵

"That the defendants were selfish is no reason for deciding against them. Political economy from Adam Smith down, and before him, is founded on selfishness, and not on generosity, or Christian charity."

The early Rhode Island case of *Fisher v. Budlong*⁶ was brought, quite properly, as an action on the case for deceit, and the director seems to have been so deceitful that to apply the fiduciary doctrine would have been superfluous. The leading Indiana decision,⁷ after reviewing the above Massachusetts, British, and New York cases, found no actual fraud in the facts before it and decided (one judge of five dissenting)

² *Smith v. Hurd* (1847, Mass.) 12 Metc. 371.

³ *Walsham v. Stainon* (1863, Ch.) 1 DeG., J. & S. 678.

⁴ *Carpenter v. Danforth* (1868) 52 Barb. 581.

⁵ *Von Au v. Magenheimer* (1908) 126 App. Div. 257, 271, 110 N. Y. Supp. 629, 639. The judgment of the court was affirmed in (1909) 196 N. Y. 510, 89 N. E. 1114.

⁶ (1873) 10 R. I. 525.

⁷ *Board of Comrs. of Tippecanoe County v. Reynolds* (1873) 44 Ind. 509.

against the fiduciary theory. Here a county had sold its shares to a railroad president, who later made a profitable resale. That a county was the stockholder well illustrates the circumstance that stockholders are not necessarily of inferior business capacity or entitled to guardianship. A contemporary Tennessee case,⁸ in sustaining a demurrer to the bill, held that directors are free to buy stock on the same terms as other persons.

It is obvious from this summary that the fiduciary doctrine has no ancient origin. Fraud and deceit afforded remedies in proper cases in the earlier law of our land. Chancery seems to have entertained no cases from its viewpoint of fiduciary conduct. But when law and equity began to fuse, some disorder began to appear. It was then that the rather vague idea of a separate, active, fiduciary duty began to take shape: the duty of a director, when buying shares, to reveal all that he knows, hopes, expects, and suspects.

The decisions have been so extensively dissected by law writers that few of them need to be here summarized again. Indeed, one could at best only bring down to date the several admirable studies of this question.⁹ Since the earlier decisions, judicial thought, particularly at a distance from salt water, seems to have beclouded rather than clarified the state of the law. Leaving the safe human ground of fraud or deceit, some courts have gone about establishing an abstract obligation, a commandment or ethical principle. They would ordain that no director may buy stock in his company without first disclosing anything and everything that he then knows or surmises to its advantage, present or future. Anything "bullish," that is to say. For this precept is singularly market-wise. It presupposes that a director would not be buying except for a rise. It would not have him buy unless the stockholder first be told of all the director's reasons for expecting a profit. It reckons not whether the director may be foolish or mistaken. It subjects the director to all possible chances of losing his trade (and possible other trades), not to mention the company's business,¹⁰ by his candid garrulity. Its logic is that the director may reap profits on stock that he already holds, but that he may not buy additional shares without first letting the shareholders in on his knowledge, foresight, reading of the signs of the times, or other motives for buying. And woe betide him if he omit

⁸ *Deaderick v. Wilson* (1874) 8 Baxt. 108.

⁹ E. g., Wilgus, *Purchase of Shares of Corporation by a Director from a Shareholder* (1910) 8 MICH. L. REV. 267; Laylin, *The Duty of a Director Purchasing Shares of Stock* (1918) 27 YALE LAW JOURNAL 731; H. R. Smith, *Purchase of Shares of a Corporation by a Director from a Shareholder* (1921) 19 MICH. L. REV. 698. The diligent Mr. Cook [1 *Stock and Stockholders* (3d ed. 1894) sec. 320, p. 431, note 1] points out *inter alia* that recent editions of Story's *Equity Jurisprudence* omit an earlier adverse criticism of *Carpenter v. Danforth*. Morawetz, *Private Corporations* (2d ed. 1886) sec. 565, p. 537, note 1.

¹⁰ One British case, however, had the sagacity to point out that it might be to the corporation's disadvantage for a director to tell of pending deals, whereof secrecy might be the best discharge of his duty. *Percival v. Wright* [1902] 2 Ch. 421, 426.

to do so. For he may, even to his own astonishment, make a profit on shares bought from Smith, and Smith may then sue him, alleging that the director knew or foresaw, when he bought, this or that feature that explains the rise of the shares. The luckless director may or may not have known it or foreseen it. His "superior knowledge" by virtue of his position as director may, probably will, be held up against him, and he may be deemed to have known or foreseen. At any rate, that is the risk that he runs in states where the fullest disclosure is requisite before a director may lawfully buy shares.

An odd feature of this doctrine is that it is one-sided, lacking a converse. For the selling stockholder seems not to be required to tell anything *he* knows.¹¹ The director's "superior knowledge" counts as omniscience. The stockholder's knowledge or wisdom or obligation of candor is as naught. Courts, in the Mississippi basin especially, seem to cherish a mental picture of shrewd, sharp, scheming directors craftily trading with inexperienced, female, infant, defective stockholders. In a word, the kind of stockholders for whom the law should guarantee bank deposits, prohibit cigarettes, or control reading matter. No account is taken, it would seem, of great aggregations of experience and common sense, which nevertheless are stockholders, such as insurance companies, the Foundations, banks and trust companies, and many other institutions, nor of numerous powerful sagacious individual stockholders who pile up fortunes by judging stock values accurately.

This viewpoint—that a director must disclose ere he buy—would be most unsettling if enforced in financial centers, or respecting great corporations with hosts of stockholders. Particularly so where there are markets or stock exchanges. The New York courts recognized this fifty-five years ago. "As to stocks which have a regularly quoted price or market value, parties generally sell and buy them, with reference to *this* price or value, rather than with reference to their real value, or any opinion of their real value, founded on a knowledge or supposed knowledge of the conditions of the corporations or of their affairs."¹² Prices of such stocks must be deemed to find their price level in the market by the action of a congeries of forces: facts, hopes, beliefs, buying or selling movements, interest rates, and a hundred other factors. There is complete anonymity of buyer and seller. The purchasing director would not know to whom to disclose. His broker does not know the seller behind the selling broker, and *vice versa*. The seller does not seek out the buyer's motive or identity, but sells because he wishes to sell. For practical reasons, if for no others, the doctrine of duty to

¹¹ This seems unduly lop-sided as law though consistent enough logically, in jurisdictions where a vendee has a right to rely on the vendor's representations, even if all means of knowledge be open to the vendee. *Caveat vendor! Fargo Gas Co. v. Fargo* (1894) 4 N. D. 219, 59 N. W. 1066 and *Prescott v. Brown* (1911) 30 Okla. 428, 120 Pac. 991 are cited to this effect in *Halsell v. First Nat. Bank* (1915) 48 Okla. 535, 150 Pac. 489.

¹² *Carpenter v. Danforth*, *supra* note 4, at p. 586.

disclose must, it would seem, vanish where general trading markets exist for the shares. The courts that hold for that doctrine cannot be dealing with that sort of marketed shares. They have before them the relatively small corporations of relatively few stockholders, whose affairs are not bulletined in the daily press nor, as a rule, elaborately set forth in periodical reports to stockholders. In such companies, directors and officers may often possess much "inside information" not available to other shareholders. Even in states where the fiduciary doctrine is held, it would seem unjust to impress an active duty to disclose upon directors or officers of corporations other than such as we have just described. The criterion here suggested is not size merely, but size plus (1) availability to stockholders of information on finances and transactions and (2) the existence of a market in which shares are generally traded.¹³ Bearing in mind these two qualifications, a brief glance at the cases usually relied on as announcing the fiduciary theory and the director's duty to disclose, will discover the relatively parochial circumstances of the corporations involved. Our endeavor has been to select only those cases in which the director or officer was silent or refrained from expressing warrantable enthusiasm as to the prospects of the corporation.

Stewart v. Harris,¹⁴ for example, had to do with a Kansas bank with 500 shares outstanding. Stewart took charge of it when it was exceedingly shaky and he had success in realizing on dubious collateral. It appears that divers accretions in value and realizations on doubtful assets had been carried in the cashier's accounts but not shown on the bank's published statements; this persuasive feature, though not involved in Stewart's trading, doubtless had some effect on the verdict and opinion. So, also, the fact that Harris was a retired business man, 80 years old, who had never been a banker. He owned 12 shares. Stewart was president and majority shareholder. They had several talks, Stewart successively offering \$1,000, \$1,400, and \$2,000 for the shares. Stewart seems to have confined his representations to the sorry state the bank had been in when he took charge of it, and to a "policy" not to pay dividends but to strengthen the bank. Harris finally sold for \$2,000. Later, Stewart having acquired 445 of the 500 shares, a 120 per cent dividend was declared. It appeared that the shares were worth some \$4,200 upon or soon after their purchase by Stewart. The jury having found for Harris, judgment on their verdict was appealed. The charge to the jury was express on the point that Stewart, as president, was Harris's trustee and in duty bound to give Harris all available information as to value. The Supreme Court approving the charge said: "Plaintiff had the right to rely upon the belief that defendant

¹³ Judge Dowling drew this distinction between the small quiet corporation and the large public corporation excellently in *McManus v. Durant* (1915) 168 App. Div. 643, 657, 154 N. Y. Supp. 580, 590.

¹⁴ (1904) 69 Kan. 498, 77 Pac. 277.

would disclose to him the true condition of the affairs of the bank and that he would not be called upon to investigate its affairs before he could with safety sell to defendant his holdings of stock."

The Nebraska case of *Jacquith v. Mason*¹⁵ involved a small insurance company. Plaintiff was a widow. She had talked to the president of the company, who had told her nothing as to the company's condition or the value of its shares. She placed her stock in the hands of a broker, who sold her 201 shares, pursuant to her authorization, at \$75 each, to an agent, from whom it came into the hands of the president's copartner, who resold it at \$110 to a third person. There was some evidence that, as partner at any rate, the president was interested in the resale. Remote as he was from the actual purchase from her, she was allowed to recover damages from the president. He was dealt with as if he had procured her to sell her shares without having first disclosed to her the condition of the company, the value of the shares and, if indeed it existed, the expectation of a sale to the third person at \$110.

This case and the following remind one of Bacon's remark that "revenge is a kind of wild justice." (It will be recalled that Bacon went on, "which the more man's nature runs to, the more ought law to weed it out.")

*Dawson v. National Life Ins. Co.*¹⁶ related to a life insurance company of 1,000 shares controlled by two persons, the other 448 shares being rather widely distributed. The plaintiff, who was chief bookkeeper, owned 3 shares. His shares and other minority shares were bought by the vice-president at \$200 each. The majority shares realized, by a secret agreement with a purchasing insurance company, about \$1,000 each, and the vice-president received a special stipend for getting in the minority shares. The trial court had ruled and had charged the jury that the officers were not bound to make any disclosures as to the impending merger with another company. On appeal from judgment for the defendants, the Supreme Court made a tremendous review of the authorities and held eloquently for the fiduciary duty to disclose. "Power akin to that of an attorney, priest, agent or copartner is conferred on the directors and officers. . . . The fiduciary obligation is to the stockholders in a body. Why not to the component parts represented by the shares?" The judgment was reversed.¹⁷

The foregoing cases are the strongest that can be cited for the fiduciary doctrine, the active duty to disclose even if not asked. Yet two of them¹⁸ have some abhorrent features assimilating them to those hard

¹⁵ (1915) 99 Neb. 509, 156 N. W. 1041.

¹⁶ (1916) 176 Iowa, 362, 157 N. W. 929.

¹⁷ *Oliver v. Oliver* (1903) 118 Ga. 362, 367, 45 S. E. 232, 233, contains the most persuasive analysis of the doctrine and the decisions on it. But the opinion, which is on overruling demurrer to bill, is almost wholly *obiter*, as features of fraud, concealment, and agency would have amply sustained the bill.

¹⁸ *Stewart v. Harris*, *supra* note 14; *Dawson v. National Life Ins. Co.* *supra* note 16.

cases that make bad law; while the third¹⁹ must depend chiefly on the extra-legal principle that a woman may change her mind; on adopting as a legal maxim, "*Heia age. Rumpe moras. Varium et mutabile semper femina*": for, without representations or solicitations made to her, she had authorized the sale by her broker at the very price her shares brought. This unimpressive opinion is the only one even tending to shake the conviction that, where there is neither representation by the director nor disclosure that he is the purchaser, he ought not to be held liable on the ground that he should have disclosed himself, the corporate circumstances, and his reasons for buying.

The cases decided since the latest review²⁰ are few and add little to the development of the doctrine. In a Minnesota case²¹ the court held that the weight of authority "is to the effect that a director or officer does not stand in a fiduciary relation to a stockholder in respect of his stock," and is as free to buy shares as any other stockholder is. The court recognizes that "a minority of the courts" hold for the fiduciary relation and the prerequisite of full disclosure before buying, but adds that impending radical changes in the corporation, kept secret by the director or officer, would usually have warranted recovery by the stockholder without resort to the fiduciary doctrine. The court, that is to say, opts for the "special circumstances" rule²² criticized by Mr. Smith;²³ and their Honors add that it was for the jury to consider whether the director failed to disclose information "which good faith required him to disclose," and thus had been "guilty of fraudulent misrepresentations." The parties to this Minnesota suit had both been connected with the corporate business, they dealt at arm's length, and there was no special development pending, but merely the question of the price of the shares, arrived at by leisurely dickering.

In *Stout v. Cunningham*²⁴ a complaint was attacked by demurrer. The defendant was a general manager. (The court deems this to be a grade lower than that of director or officer. If this indicates that the fiduciary rule must be restricted to directors, president, and vice-presidents, it betrays additional irresolution on the part of judges to make the rule sweeping as to all trusted corporate officials. Yet logic would make the grades and ratings no less fiduciaries than the commissioned officers.) The Idaho court rejected the fiduciary rule, and held that

¹⁹ *Jacquith v. Mason*, *supra* note 15.

²⁰ H. R. Smith, *op. cit.* *supra* note 9.

²¹ *Seitz v. Frey* (1922) 188 N. W. 266.

²² Federal decisions seem to avoid declaring the fiduciary doctrine. *Grant v. Attrill* (1882, C. C. S. D. N. Y.) 11 Fed. 469; *Gillett v. Bowen* (1885, C. C. D. Colo.) 23 Fed. 625, 626. In *Strong v. Repide* (1909) 213 U. S. 419, 431, 29 Sup. Ct. 521, 525, the duty of disclosure is held not to exist because of "relations . . . of . . . a fiduciary nature," but "because of the *special facts*" (author's italics). *Traer v. Clews* (1885) 115 U. S. 528, 6 Sup. Ct. 155, was a plain case of abuse of confidential information obtained in the course of acting as trustee for a bankrupt.

²³ H. R. Smith, *op. cit.* *supra* note 9, at pp. 716, 717.

²⁴ (1921) 33 Idaho, 464, 196 Pac. 208.

failure to disclose information as to value or an impending resale at a profit would not render a director or officer liable to a stockholder in the absence of actual fraudulent misrepresentations. Judgment for defendants on the demurrer was affirmed.

Upon the like demurrer, a complaint was held good in Utah that alleged the officers to have frightened shareholders by reports of the company's bad position, causing plaintiff to sell his shares to another company, from which defendants later acquired them. The doctrine of *Carpenter v. Danforth*²⁵ was approved, but the complaint was deemed adequately to allege fraud.²⁶

The New Jersey case of *Keely v. Black*²⁷ was an instance of a purchase of shares by a director at par, without disclosing an offer made to him for a higher price for the shares. He resold and reaped a profit. He was held to be under no liability to turn over his profits to stockholders. The case, however, is not valuable as authority on our question, for the plaintiff sued in behalf of the corporation, and was not one of the stockholders who had sold to defendant.

If this fiduciary doctrine were fundamentally right or were applicable to the greater part of dealings in shares, it would be a disservice to decry it. But, first, the justice of imposing the fiduciary rule upon what is commonly a matter of free trading, merely because there sometimes are "special facts," is far from being self-evident. And, second, if one would survey the dealings in corporate shares in English-speaking countries and realize how vast is the proportion of shares dealt in upon markets, and how generally market values, not concealed or latent values alone, constitute the accepted prices, he could not escape, it is submitted, conceding that a rule prohibiting directors from buying without first making proclamation of their reasons would in most cases be an absurdity. The usual situation, numerically speaking, is wholly different from that where the director of a small unlisted corporation seeks out his stockholders and makes offers for their shares. In the latter case, let him be careful that he discloses his identity, speaks the truth, answers questions honestly, and does not occupy a superior position by reason of the stockholder's sex, youth, senility, and reposing of trust in him; and let him have no fixed program in his mind adverse to the good of the corporate enterprise. If he avoids the pitfalls of fraud, deceit, misrepresentation, and implied representation, he should be allowed to keep the shares he buys and any profits that he makes upon their resale. Should there be any "special facts," the courts will give them due weight, and can do so without importing the fiduciary doctrine. The preponderance of courts and of the trend of recent decisions seem to be against imposing upon directors this duty of disclosure.

²⁵ *Supra* note 4.

²⁶ *White v. Texas Co.* (1921, Utah) 202 Pac. 826.

²⁷ (1920) 91 N. J. Eq. 520, 111 Atl. 22.