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## Corporations: Power of Equity to Set Aside Incorporation

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## RECENT DECISIONS

**Corporations—Power of Court of Equity to Set Aside the Incorporation of a Partnership on the Ground of Fraud.** — In *Prince v. Sonnesyn*, 25 N.W.2d 468 (1947, Minn.) the court set aside the incorporation of a partnership where it was found that the plaintiffs were induced by fraudulent representations made by the defendant to agree to convert their three way equal partnership into a corporation in which defendant would own 52 per cent of the stock and each plaintiff only 24 per cent. The fraudulent representations were to the effect that defendant was personally liable on certain debts owed to one of the partnership's creditors and that said creditor had told him that unless he controlled the stock the creditor would have to discontinue the discount banking of the company. The relief prayed was that the defendant be required to surrender for cancellation the shares he had over his one-third interest and that those shares be reissued to the plaintiffs share and share alike. In addition, the plaintiffs asked for such other and further relief as is just and equitable in the premises. The court did not grant the specific relief asked, but, instead, set aside everything pertaining to the agreement to incorporate, the incorporation, and the distribution of the stock.

The corporation involved in the Minnesota case was a de jure corporation. When the fact of the existence of a corporation de facto is established, it is settled law that its existence de jure cannot be collaterally attacked, that is, by any other than the state under whose laws its formation was brought about, and only then in a direct proceeding. The cases are legion.<sup>1</sup> As the setting aside of the charter in the above case, did not come about by a direct proceeding brought about by a writ of quo warranto, it would appear at first blush to contradict the general rule. However the general rule is not applicable where the formation of a corporation was a device to defraud another. Here equity power to set aside acts whose foundation lay in fraud was exercised to set the formation of the corporation aside.

Courts of equity have frequently found cause to exercise their broad powers where partners have breached the fiduciary relationship, which the law imposes upon them, in the formation of a corporation. In forming the corporation and transferring to it the assets of property of a partnership or association, the transactions should be free from fraud, either upon the other partners or members, upon the newly created corporation, or upon creditors or others. If in conveying or failing to convey the property and assets to the newly created corporation, fraud is practiced upon it, no doubt it may resort to the

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<sup>1</sup> *Kardo Co. V. Adams* (C.C.A.) 231 F. 950, 1916.

courts for appropriate legal or equitable relief, and partners, associates or others defrauded by sales or transfers to the corporation are likewise entitled to their remedy in the courts.<sup>2</sup>

In a recent New York decision the court stated that a court of equity may disregard the fiction of corporate entity in order to prevent fraud, preserve the rights of creditors or otherwise prevent the commission of a gross injustice.<sup>3</sup> An Idaho court held that whether after a partnership was incorporated into two corporations in which the partners retained the same respective interests, the partnership relation continued so as to impose on the majority stockholder and manager the duty of a fiduciary as to disclosures and entitle the minority stockholder to rescind the sale of his stock to the majority stockholder for failure of the latter to disclose the true value of the stock was an issue of fact.<sup>4</sup>

Where the owners of a partnership business form a corporation and transfer to it the partnership, the former partners being practically the only stockholders therein and the business being conducted in practically the same way as during the partnership, the relation of confidence which existed between them as partners is presumed *prima facie* to continue.<sup>5</sup> In a federal case it was held that the evidence was not sufficient to warrant the rescission of a sale by one partner to the other of his stock in the corporation on the ground that the sale had been induced by false statements and representations of the buyer, it being shown that the relations of personal friendship and confidence which for many years existed between the parties had been broken some time before the sale, making the complainant desirous of terminating their business connection; and that in making the sale he did not act in reliance on any statements or representations made by defendant, but on his own independent knowledge and judgment, and received a price not greatly below the actual value of his interest in the property at the time.<sup>6</sup> In that case, though the court did not grant complainant relief, the court stated that the confidential relation existing between partners may be presumed to have continued after they formed a corporation to which the partnership property was transferred, and in which they were practically the only stockholders, and to have induced one in selling his stock to the other, who was the active manager in the business, to place reliance on the latter's statements in respect to the condition and value of the property to the same extent as though the partnership had continued, in the absence of evidence to the contrary.

<sup>2</sup> Fletcher Cyclopedia Corporations, Vol. 8, Chpt. 47, Sec. 4008, 1931.

<sup>3</sup> *Ditmars Homes v. Logerfo*, 67 N.Y.S. 2d 414, 1947.

<sup>4</sup> *Anderson v. Lloyd*, Idaho, 139 P 2d 244, 1943.

<sup>5</sup> Fletcher Cyclopedia Corporations, Vol. 8, Chpt. 47, Sec. 4018, 1931.

<sup>6</sup> *Sullivan v. Pierce*, 125 Fed. 104, 1903.

Where a partnership has been incorporated the rights subsequently accruing to the partners or joint adventures are not based on the corporate relationship. If a corporation or a formal partnership is a mere agency for convenience in carrying out a joint venture agreement, and independent and innocent third parties, such as creditors or stockholders, are not injured thereby, in determining the rights of the parties, they will be placed in the position each occupied under the original agreement.<sup>7</sup> In a recent Kentucky case where the corporate stock was to be divided equally between complainants and defendants but the defendants attempted to appropriate all of the stock to themselves and attempted to deprive complainants of all beneficial interest in the corporations, the court held that the defendants were liable for one-half of the amount of dividends paid to them with interest from the date of payment and corporate books were required to be corrected to show complainants' interest in unpaid dividends.<sup>8</sup>

Thus it is seen that courts of equity have frequently stepped behind the "corporate veil" and adjusted the rights of former partners where one had taken advantage of the other by fraudulent means. In the case first cited, however, the court went a step further and set aside everything pertaining to the agreement to incorporate, the incorporation, and the distribution of the stock. "As a general rule the right to rescind must be exercised in toto. The contract must stand in all its provisions or fall altogether. Accordingly, a party cannot repudiate a contract or compromise so far as its terms are unfavorable to him and claim the benefit of the residue. A partial rescission, however, may be allowed where the contract is a divisible one".<sup>9</sup> A case appears also in the recent New Jersey Equity Reports where the power of rescission of a charter was similarly exercised. There a corporation had been formed by a deceased partner's widow and the surviving partner thereby defrauding the infant daughter of the deceased partner. The court decreed that the corporation be dissolved and the assets disposed of in a proper manner; the corporation and the incorporators being liable to pay to the guardian of the infant the proportionate share in equity to which she was entitled upon the death of the deceased partner.<sup>10</sup>

The rule to be applied in view of the recited facts is that, since fraud renders voidable everything into which it enters, the court will look through any form of instrument or proceeding in order to prevent a party from profiting by his fraud; that the court will

<sup>7</sup> *Elsbach v. Mulligan*, Cal., 136 P 2d 651, 1943.

<sup>8</sup> *Blue Grass Mining Co. v. Richardson*, 127 F 2d 291, 1942, affirming *Richardson v. Blue Grass Mining Co.*, 29 F. Supp. 658, 1939.

<sup>9</sup> 12 Am. Jur., *Contracts*, I 444, 1938.

<sup>10</sup> *Kanzler v. Smith*, 123 N.J. Eq Reports, 602, 1938.

not take a step to save harmless the party who is guilty of fraud; and that no right can arise out of a fraudulent act.<sup>11</sup>

It appears from the cases indicated above that a court of equity will exercise its powers to protect a partner who has been defrauded by another partner in the conversion of a partnership into a corporation and that the remedy decreed, depending upon the facts of the particular case, may be either a division of dividends in the ratio which would have been proper had the fraud not been perpetrated or a rescission of the corporation in toto and a return to the original partnership arrangement.

Another point to be noted is that the plaintiffs did not ask for a rescission of the charter in conjunction with other relief prayed. It was a result of the court's unsolicited determination of the proper relief to be granted when there has been fraud in the incorporation of a partnership. A court of equity will mould its relief so as to determine the rights of all the parties, and it will not allow the pleadings to prevent it from getting at the heart of the controversy and seeing that a right result is reached. In equity the kinds and forms of specific remedies are as unlimited as the powers of such courts to shape relief awarded in accordance with the circumstances of the particular case.<sup>12</sup>

A court of equity has the power to adapt its decree to the exigencies of each particular case so as to accomplish justice. It is traditional and characteristic of equity that it possesses the flexibility and expansiveness to invent new remedies or modify old ones to meet the requirement of every case and to satisfy the needs of a progressive social condition.<sup>13</sup>

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<sup>11</sup> *Magee v. Odden*, 220 Minn 498, 502, 20 N.W. 2d 87, 89, 1945.

<sup>12</sup> *2 Dunnell*, Dig. P 3138.

<sup>13</sup> *Beliveau v. Beliveau*, 217 Minn. 235, 245, 14 N.W. 2d 360, 366, 1944.