Corporations - Compensation of Promoters - Fraud

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plan may adequately satisfy the needs of the state. The net result is that every state is compelled to adopt a plan modelled along the lines set forth in Titles III and IX and Congress is in effect legislating by remote control. It is suggested, however, that an amendment providing for the earmarking of the tax collected in states having no approved plan for general relief of unemployment hardships in those states be added to the Act. The grant-in-aid title would still be an effective inducement for state plans of the type desired and no state could protest on the ground of discrimination or compulsion.

JOHN L. WADDLETON.

CORPORATIONS—COMPENSATION OF PROMOTERS—FRAUD.—The problem of promoters is one which has long perplexed the courts of this country. There has been little uniformity of opinion on the matter, as is illustrated by the contrary decisions prevalent among the many existing cases. The controversy embraces a wide field of promotional and corporate problems, and though the issue can seldom be determined concerning a specific case without first reviewing the particular circumstances of the case in question, several broad principles have evolved which may serve to enlighten somewhat a consideration of the numerous difficulties which involve this problem.

It is now undisputed that the promoter performs a valuable service in the field of corporate finance. Possessed of a peculiar knowledge of industrial affairs he is able to judge with a fair degree of accuracy the potential possibilities of a proposed venture. He is acquainted with the materials required and their relative value. He is aware of the proper ratio which operating capital must bear to total assets. In these and numerous other matters he supplies the expert advice necessary to the organization of a well planned corporation. That he is entitled to a fair compensation for this service is beyond dispute. How may this compensation be made legally? Under what plan may he be compensated, and what assurance is there that the selected arrangement will not be upset by the courts? If the compensation were a cash payment of an amount fairly estimated as the reasonable value of his services, there could be no question concerning its legality. But, as the newly formed corporation seldom has adequate cash resources to meet other than the urgent requirements of the business, the problem is rarely settled in so simple a manner. The device generally adopted has been one of awarding compensation by giving the promoter an interest in the corporation, either by way of par value stock, no par value stock, or stock purchase warrants. And this is where the parties run afoul of the law.  

1 Gerstenberg, Financial Organization and Management (1924) 415; Lough, Corporation Finance (1909) 156.
2 Mason v. Carrothers, 105 Me. 392, 74 Atl. 1030 (1909); Fitzpatrick v. O'Neil, 43 Mont. 552, 118 Pac. 273 (1911); United German Silver Co. v. Bronson, 92 Conn. 266, 102 Atl. 647 (1917).
4 Hebgen v. Koefier, 97 Wis. 313, 72 N. W. 745 (1897); Franey v. Wauwatosa Park Co., 99 Wis. 40, 74 N.W. 548 (1898); Pietsch v. Milbrath, 123 Wis. 647, 101 N.W. 338 (1904); Richland Oil Co. v. Morriss, 106 Va. 288, 61 S.E. 762 (1908); Mason v. Carrothers, 105 Me. 392, 74 Atl. 1030 (1909).
The use of par value stock as a means of compensation raises the problem of watered stock. The investor has the right to believe that the capitalization of the corporation represents the true value of the assets.\(^5\) Though the promoter contributes something of unquestionable value to the corporation, that something is of an intangible and indefinite nature. The value which he places upon his service, perhaps in entirely good faith, may not correspond with the value that another equally well informed expert might place upon the same service. There is always room for argument as to the true value of the benefit thus conferred. But aside from this problem there is yet another and more serious question. What tangible investment does the stock issued to a promoter in compensation for his services represent? It is listed as a liability upon the books of the corporation, and the courts have frequently held that it must be balanced by some visible asset.\(^6\) Since the work of the promoter has been done prior to the existence of the corporation, he has no contract for remuneration with anyone. The courts have refused to recognize his status or allow any uniform method for his compensation. A payment in par value stock is frowned upon as it increases the capitalization without any equivalent increase in assets, and thus assertedly "waters" the stock of the corporation.\(^7\) The presumption thus follows that the subsequent stockholders and creditors have been deceived into dealing with the corporation through a misrepresentation as to its true financial status.\(^8\)

The use of no par value stock as a method of compensation eliminates the latter objection, unless the stock has been issued under a plan or statute which requires that a definite value be set upon each share.\(^8\) Where no definite value has been given neither the subsequent stockholders nor the creditor can complain that the stock has been "watered." In theory, the assets and profits of the corporation are the only determinants of the value of such stock. Originally it mattered not whether the price to all subscribers was uniform, nor whether any real benefit accrued to the corporation.\(^9\) Subsequently, however, there has developed the principle of equitable contribution, under which one block of such stock may not be issued for a high price and another for a relatively low price unless the discrepancy is justified by some good business reason.\(^10\) In certain states statutory requirements would seem to provide that all no par value stock be issued at the same price.\(^11\)

The stock purchase warrant, a relatively recent development in corporate finance, is apparently the most expeditious method of awarding compensation to the promoter.\(^12\) This device consists of a promise in writing to sell stock to the holder for a specified price at some future

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\(^5\) Hayward v. Leeson, 176 Mass. 310, 57 N.E. 656 (1900); Old Dominion Copper Co. v. Bigelow, 188 Mass 315, 74 N.E. 653 (1905).

\(^6\) Note 5, supra.

\(^7\) United States v. U. S. Steel Corp., 223 Fed. 55, 167 (1915); Dodd, Stock Watering (1930) 5.


\(^9\) Cook, Stock Without Par Value (1921) 19 Mich. L. Rev. 583.


time. Thus the fortunes of the promoter are linked with the fortunes of the corporation. If the corporation does not succeed, the promoter does not profit. If it does succeed, the amount of compensation received will depend upon the relative success of the corporation as reflected in the value of its stock. A further advantage is that the stock purchase warrant does not affect the capitalization of the corporation. No immediate cash or stock payment is contemplated, and therefore the corporation may devote all of its original assets to the operation of its business.

Controversies concerning the compensation of promoters have arisen not so much because of the use of the methods outlined, but because of the abuse of these methods. Fraudulent promotion schemes have induced a skeptical attitude on the part of the courts, and in any controversy the burden of showing that the method of his compensation has in no way prejudiced the rights of stockholders or creditors has come to rest upon the promoter. No problem arises where the promoter, acting at arm's length, has made a truthful and complete disclosure of the facts of incorporation, and where an independent board of directors or all of the stockholders with full knowledge of these facts and without collusion have ratified the method of compensation. The difficulty arises where the promoter, activated by the desire for excessive or fraudulent profit, purchases or manages to control all of the original stock of the corporation. His services or certain property which he has previously acquired may then be sold to the corporation at an excessive valuation, the transaction may be ratified by "dummy" directors or stockholders under his control, and the fraudulent enterprise is complete. Subsequent stock purchasers or creditors will be dealing with a corporation ostensibly legal and sound, but in fact stripped of a major portion of its assets. It is with this problem that courts have been at greatest variance.

Whether the promoter is compensated in par value or no par value stock makes little difference in the latter type of promotion. He has without an equivalent return milked the corporation of a portion of its operating capital. The measure of value of the non par stock to the corporation is the amount at which this stock will sell to the public. It is true that the creditors have not extended credit upon any authorized valuation of this stock and therefore have little cause to complain, but the rights of subsequent stockholders are unquestionably impaired by the resulting diminution in the corporate assets. Here many of the courts have invoked the theory that the promoter bears a fiduciary relationship to the corporation; that the assets are placed with him in trust, to be turned over by him to subsequent stockholders unimpaired.

14 Old Dominion Copper Co. v. Bigelow, 188 Mass. 315, 74 N.E. 653 (1905); Old Dominion Copper Co. v. Lewisohn, 210 U.S. 206, 28 Sup. Ct. 634, 52 L.ed. 1025 (1908).
The Old Dominion Cases\textsuperscript{17} form the background for the law upon the problem in this country. There the promoters, while holding all of the original stock, sold mining property to the corporation for an amount of par value stock far in excess of the true worth of the property. Since the promoters were the shareholders there could be no question as to full knowledge of this excessive price. There was no showing at the trial of a resulting insolvency, a fraud upon creditors, or a violation of any statute. Suit was brought by the corporation to avoid the sale. The Massachusetts court found a fiduciary relationship to exist between the promoters and the corporation.\textsuperscript{18} It rescinded the sale on the ground that the corporation had not been provided with an independent board of directors, and full disclosure of the facts had not been made. It disregarded the status of the promoters as sole shareholders, viewed the corporation as a separate entity, and found that the corporation as such had been injured by the action of the promoters.

The United States Supreme Court, on the same set of facts, found no such separate entity to exist.\textsuperscript{19} The conclusion therein was that since the promoters owned all the original stock, there had been full knowledge of all the facts; that no wrong had been perpetrated at the time of the sale, since the rights of none of the then existing shareholders had been impaired; that the subsequent entry of other shareholders into the corporate structure did not act to create a wrong previously non-existent; and that were recovery allowed the corporation a portion of the benefit would inure to the advantage of original shareholders entirely without claim. The result of such reasoning seems only too clear. It would appear to open the door to uncontrolled fraudulent promotion. Though this decision does not bar the right of the subsequent stockholder to recover from the promoter in a personal action, it virtually nullifies the remedy of the injured stockholders as a group, and the expense resulting from the multiplicity of suits necessary to a complete recovery might well exhaust the subject matter of the controversy and pauperize the litigants.\textsuperscript{20}

The Wisconsin Supreme Court, in considering this question, points out a distinction between the situation in which all of the authorized stock has been issued to the promoters before the time of the excessive sale, and the situation in which, though the promoters own all of the then issued stock, a quantity has been reserved for sale to “outsiders” after the excessive sale has been transacted and approved.\textsuperscript{21} In the first instance the court denies any right of recovery by the corporation in a subsequent action. In the latter instance the court recognizes the right of the corporation to recover on the ground that the fiduciary relationship between promoter and corporation continues to exist until such time as the last share is disposed of, or until some reasonable method of protecting the interests of the corporation has been established.

\textsuperscript{17} Old Dominion Copper Co. v. Bigelow, 188 Mass. 315, 74 N.E. 653 (1905); Old Dominion Copper Co. v. Lewisohn, 210 U.S. 206, 28 Sup. Ct. 634, 52 L.ed. 1025 (1908).
\textsuperscript{18} Old Dominion Copper Co. v. Bigelow, 188 Mass. 315, 74 N.E. 653 (1905).
\textsuperscript{19} Old Dominion Copper Co. v. Lewisohn, 210 U.S. 206, 28 Sup. Ct. 634, 52 L.ed. 1025 (1908).
\textsuperscript{20} Brockelbank, The Compensation of Promters (1934) 13 Or. L. Rev. 195, 209-212.
\textsuperscript{21} Pietsch v. Milbrath, 123 Wis. 647, 655, 101 N.W. 388 (1904).
The point of variance then between the many courts which have considered the problem is briefly this—May a corporation bring an action against the promoters to recover secret profits resulting from transactions perpetrated at a time when the promoters owned or controlled all of the stock? The majority of courts hold that it can, basing its conclusion upon the presumption that there is a continuing fiduciary relationship which exists until the corporation has come into the complete control of those for whom it was originally intended—the subsequent “outside” stockholders.\(^2\) The minority opinion is that expressed by the United States Supreme Court in the Old Dominion Cases.\(^3\)

In the recent case of \textit{McCandless v. Fudaud}\(^4\) the Supreme Court went far toward adopting the majority opinion. Here the promoter sold gas fields to the corporation for an amount greatly in excess of their true value. Payment was made to the promoter in mortgage bonds, mortgage notes, and no par stock, which the promoter offered for sale and immediately disposed of. At the time the sale was transacted the promoter was in control of all of the then issued stock. The circulars which the defendant published to advertise the mortgage bonds and notes stated that the proceeds were to be used to acquire property, and to provide cash for developments, extensions and other corporate purposes. Less than two years after the incorporation the concern was in receivership. The receiver brought this action to compel the promoter to restore illicit gains.

The Court found that the diversion of assets to the promoter had rendered the corporation insolvent from the moment of its inception; that the mortgage bonds and notes, a great portion of the proceeds of which had been diverted to the promoter, had created a lien upon the assets of the corporation far in excess of their true value; that there was here an unconscionable attempt to strip the corporation of its very means for discharging these liens, thereby perpetrating a fraud against the creditors; that the assent of the shareholders was not operative to legalize a depletion of assets which rendered the company insolvent thereby depriving the creditors of their lawful rights and remedies; that the action was in violation of a state statute which provided that “no corporation shall issue stocks or bonds except for money, labor done, or money or property actually received; and all fictitious increase of stock or indebtedness shall be void.”; and that the funds diverted to the promoter would remain with him in trust, to continue so until the depleted assets had fully discharged the liens. Judgment was granted requiring full restitution to the corporation of all illicit gains derived, not only from the mortgage bonds and notes, but from the no par stock as well.

Thus the Court invoked the theory of fiduciary relationship which it had disavowed in the Old Dominion Cases.\(^2\) It is evident that, so far as the mortgage bonds and notes are involved, this case may readily be distinguished from the Old Dominion Cases. In the instant case the

\(^2\) Haywood v. Leeson, 176 Mass. 310, 57 N.E. 656 (1900); Nebraska Mausoleum Co. v. Matters, 108 Neb. 618, 626, 627, 188 N.W. 231 (1922).
\(^3\) 210 U.S. 206, 28 Sup. Ct. 634, 52 L.ed. 1025 (1908).
\(^4\) 56 Sup. Ct. 41 (1935).
promoter not only appropriated the assets of the corporation, he also saddled it with a lien indebtedness which rendered it insolvent. Here the rights of creditors are impaired. In the Old Dominion Cases the shareholders complained. The Court here refused to consider the right of a subsequent stockholder to bring suit in the name of the corporation. On principle, however, it is submitted that there is no essential difference between a suit by a corporation to effect restitution to a defrauded creditor or one to effect restitution to an injured shareholder, so long as there has been in both cases a breach of the fiduciary relationship and a conversion of assets held in trust.

Had the Court ordered restitution only in the amount of the illicit gain derived from the mortgage bonds and notes, the distinction which it sought to draw might more readily be accepted. It would then be evident that the wrong spoken of was one which primarily affected the corporation and indirectly affected the creditors. But the Court did not stop here. It ordered restitution of the amount of illicit gain derived from the no par stock. It has long been recognized that an overissue of no par stock does not materially affect the rights of creditors. How else than by a resort to the theory of a fiduciary relationship may the Court justify its order compelling the promoter to disgorge profit derived from no par stock? The shareholders had agreed to the disposition of the stock with full knowledge as to the facts. There is no showing that the disposition impaired the rights of creditors, other than the subsequent insolvency of the corporation, and the cause of this insolvency was clearly the lien indebtedness. The Court infers that this decision does not controvert the principle of the Old Dominion Cases, but the language used and the result arrived at lend credence to the belief that it does just this.

No valid reason is found to exist which would preclude a rule of law compelling a promoter to surrender up to the corporation excessive or fraudulent profit obtained at the expense or injury of subsequent shareholders. The threadbare suggestion that the shareholders have consented crumbles before the proof of an obvious fraud. It is not contended that the promoter is entitled to no form of profit. Nor is it contended that he bears to the corporation the same fiduciary relationship as does a director. If the promoter strikes a bargain in the purchase of assets which he later turns over to the corporation at a profit, the corporation cannot be heard to complain if it has received its money's worth. It is where the promoter has not delivered an equivalent in value for the compensation he has received, and through subterfuge or artifice has worked an injury upon the corporation, its creditors, or its subsequent stockholders, that a remedy should be provided. It is suggested that a broad application of the theory of fiduciary relationship will not only enable the corporation to protect its creditors and stockholders, but will enforce upon the promoter a strict liability for injury resulting from a breach of trust.

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26 The appropriation of the mortgage proceeds by the promoter had bankrupted the corporation, thus affecting the rights of the creditors.
28 Spaulding v. North Milwaukee T. S. Co., 106 Wis. 481, 81 N.W. 1064 (1900).