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PROMOTERS' ABILITY TO SHARE PROFITS OF SUCCESSFUL CORPORATE VENTURES

PROMOTERS[1] frequently experience difficulty in obtaining a proper reward for their initiative in organizing a corporation. This difficulty arises from two well-established principles of corporation law. The first of these rules is that a promoter stands in a fiduciary relation to the corporation, charged with a duty to exercise the utmost good faith, as in cases of other trusts, so that he cannot lawfully make secret profits[2] in transactions relating to the promotion or organization of the corporation, and must account to the corporation for such profits if made.[3] The second rule is that the promoter cannot lawfully receive compensation for his effort unless the corporation gives its approval after its organization has been accomplished.[4]

The promoter performs an indispensable function in the community. He seeks out and discovers new business opportunities, formulates plans to develop the opportunities, and assembles money and materials to put the plans into effect. By performing these functions the promoter increases the wealth and contributes to the economic stability of the community.[5] A promoter often cannot obtain compensation commensurate with the true value of his services if he must fully reveal his trade secrets and is not permitted to resort to the puffing allowed to ordinary tradesmen. A promoter often is required to account for secret profits even though investors have suffered no loss, and in some cases even though investors have realized great gain. Promoters must, of course, receive some form of encouragement if they are to be induced to expend the time and effort necessary to develop their ideas. Therefore the courts, while invariably curbing secret profits that injure innocent investors, have, on occasions, devised methods of circumventing the rule against secret profits if the investor has realized gain through the success of the venture.

Much has been written on the liability of promoters for secret profits.[6] Usually these articles are built around one or two very well

1. "Promoters" includes those persons who undertake to form a corporation and procure for it rights, instrumentalities and capital to carry on its business.
2. The term "secret profits" refers to any benefit the promoter receives in a transaction with the corporation but fails to reveal.
3. CLARK, CORPORATIONS 136, sec. 48 (3rd ed. 1916).
4. FLETCHER, CYCLOPEDIA CORPORATIONS 619, sec. 193 (Per. ed. 1932).
5. STEVENS ON CORPORATIONS 161, sec. 34 (1936).
6. E.g. see Manfred W. Edreich and Lucille C. Bunzl, *Promoters' Contracts*, 38 YALE L. J. 1011 (1929), Notes 31 ILL. L. REV. 392 (1936), 26 ILL. L. REV. 340 (1931), 19 TEX. L. REV. 198 (1941), 3 WIS. L. REV. 442 (1926).

known cases. One of these cases is *Old Dominion Copper Mining and Smelting Co. v. Bigelow.*[7] In that case the promoters planned to capitalize the corporation at $3,750,000; to exchange certain property they had acquired at a cost of $1,000,000 and "intrinsically" worth not over $2,000,000, for stock of the corporation valued at $3,250,-000; and to sell at par for the corporation the remaining $500,000 of the corporation's stock to the general public for cash. The plan was accomplished without providing the corporation with an independent board of directors to pass on its wisdom and without revealing to prospective purchasers of stock the fact that promoter profits were expected. Although the purchase by the corporation of the promoters' property was to be fully completed before any stock was sold to the general public, the promoters, from the time the promotion scheme was evolved, contemplated that the corporation would sell stock to uninformed members of the public. On these facts, the Supreme Judicial Court of Massachusetts held that the promoters were fiduciaries of the corporation and that the sale breached their trust, and wronged the corporation. The court further held this wrong affected all stockholders, present and future, and rendered the promoters liable *to the corporation* for the secret profits made in the transaction.

The nature of the relationship between the promoter and the proposed corporation before organization is completed is not easily expressed. The courts, state and federal, at different times, and under varying circumstances, have referred to promoters as "agents," "mandatories," or "trustees," and have defined their liabilities accordingly.[8] But, regardless of the terms they use in referring to promoters, the courts are consistent in their adherence to the rule that promoters do not have a right to take profits secretly. The rule against secret profits is based on the theory that small investors suffer if promoters are permitted to reap secret benefits. Probably, if the first case to arise had been one in which all the stock offered for subscription had been taken by a single rich man, the doctrine of the promoter's fiduciary duty to the corporation would not have seemed so reasonable.[9]

While a secret profit made through actual fraud or a secret profit resulting in loss to investors relying on a promoter's representations should clearly be restored, the tendency of the courts to find fraud wherever secret profits are made, irrespective of injury to the investor, may be unduly harsh. Nevertheless the courts look at the profit being taken by the promoter and generally hold that the ultimate value of

7. 203 Mass. 159, 89 N. E. 193, 40 L.R.A. (N.S.) 314 (1909).
8. Bovay v. H. M. Byllesby & Co., 38 A. 2d 808 (Del. 1944).
9. R. D. Weston, *Promoters' Liability: Old Dominion v. Bigelow*, 30 HARV. L. REV. 44 (1916).

the property to the corporation is immaterial.[10] The courts feel that the promoter has committed wrong in taking the profit secretly at the expense of his associates, and that is the answer they give to the claim that the property actually proved to be equal in value to the price paid for it.

Although secret profits are officially frowned on, occasionally indirect methods are found to permit promoters to retain them. Sympathetic juries at times will come to the aid of promoters. Whether or not a secret profit has been realized is a question of fact. Naturally, there is considerable variance in the attitude of different juries as to the extent promoters should go in revealing their profits.[11]

The courts themselves have found means of limiting the rule against secret profits. It has been held, for instance, that profits made by an associate of the promoter in direct transactions with the corporation are too remote to constitute secret profits of the promoter, even though they ultimately accrue to his benefit.[12]

Some courts have held that the rule permitting a corporation to sue to recover secret promoter profits does not apply where the promoters hold all the issued stock of the corporation at the time of their transactions with it. This method of promotion became an early device to evade liability for secret profits. In *Old Dominion Copper Mining and Smelting Co. v. Lewisohn*,[13] the facts of which are identical with those of the *Bigelow* case, previously discussed, the United States Supreme Court held that the corporation did not have a cause of action against the promoters because fraud could not be committed where the promoters were the only stockholders of the corporation. The court felt that it would be illogical to allow subsequent stockholders to disregard the previous assent to the transaction, which the corporation, with continuing identity, had made.

The authorities generally hold that where the promoters organize a corporation and transfer property to it in exchange for *all* its capital stock, the corporation has no right of action to recover secret profits made by the promoters.[14] This rule is not applied by a majority of the courts, however, to cases where the stock received by the promoters does not comprise all the stock which the corporation contemplates issuing.[15] On the other hand, more recent decisions in a minority of courts hold that corporate consent necessarily includes assent of contemplated future stockholders and that therefore the corporation

10. Victor Oil Co. v. Drum, 184 Cal. 226, 193 Pac. 243 (1920).
11. Boxrud v. Ronning Machinery Co., 217 Minn. 518, 15 N. W. 2d 112 (1944).
12. Koppitz-Melchers Inc. v. Koppitz, 315 Mich. 582, 24 N. W. 2d 220 (1946).
13. 210 U. S. 206, 52 L. Ed. 1025, 28 S. Ct. 643 (1908).
14. Hamilton v. Hamilton Mammoth Mines, 110 Or. 546, 223 Pac. 926 (1924).
15. Old Dominion Copper Mining and Smelting Co. v. Bigelow, (*supra* Note 7).

does not have a cause of action even in this situation.[16] Where the promoters take all the stock but give part of it back to the corporation so that the corporation can sell it to the public to raise funds for the operation of the business, the gift has been considered in itself evidence of a fraudulent intent to circumvent the fiduciary responsibility.[17]

The corporation's right of action to recover promoters' profits should be limited to situations in which injury results to stockholders who have an interest in the corporation during the period of promotion. Any injury to stockholders must result from the fact that they rely on the invitation of the promoters to purchase stock and that the promoters failed to reveal a material fact, namely, their contemplated profits. That uninformed investors purchase stock in the corporation after the scheme of promotion has been consummated should not be sufficient to create a right of action in the corporation. Any remedy that the subsequent purchasers of stock might have should be against their immediate vendors.[18] Property put into a new venture by promoters may, by its combination with other units or by efficient utilization, attain a value which it did not have at the time it was transferred to the corporation. A feeble, uncertain venture may ripen into a stable, prosperous concern. No reason is apparent why promoters should not be permitted to sell stock in a corporation which they have launched successfully without subjecting themselves to later liability to the corporation based on a transaction with the corporation at a time when only the promoters were interested in the venture. The courts frequently allow a promoter to sell property to the corporation for any price he can secure, providing only that he make no false representation.[19]

Another devise which can be used by promoters to realize a profit in a transaction with the corporation is to provide the corporation with an independent board of directors.[20] By selecting reasonably competent directors who act independently in the transaction with honesty and integrity, the promoter can sell his plan to the public for whatever price he can convince them it is worth. This device, however, will not avoid liability when it is evident that the directors are not acting in genuine independence or honesty. The courts are inclined to examine the boards of directors carefully to eliminate possible agreements between promoters and directors.

Even if there is an actual overvaluation of the promotor-vendor's interest, it does not necessarily follow that the corporation is entitled

16. Note, 49 HARV. L. REV. 785 (1936).
17. McCandless v. Furlaud, 296 U. S. 140, 56 S. Ct. 41, 80 L. Ed. 121 (1935).
18. Jeffs v. Utah Power and Light Co., 136 Me. 454, 12 A. 2d 592 (1940).
19. BALLANTINE ON CORPORATIONS 166, sec. 49 (1937).
20. Downey v. Byrd, 171 Ga. 532, 156 S. E. 259, 79 A.L.R. 345 (1930).

to relief. When the venture is of a highly speculative nature, the investors usually should know that the venture is speculative and that the promoters expect sizeable profits if it happens to succeed.[21] The corporate books are open to their inspection. Before a corporate right of action is recognized, proof should be made that the investors relied on misrepresentations by the promoters. By this logic, some promoter profits which have not resulted in loss to the investor have been allowed.

Simply disclosing the fact of the profit to prospective stockholders in the new corporation is sufficient to avoid promoter liability.[22] Promoters have a right to organize a company and make a profit in the sale to the company of the property they have bought, even though they have secured it for the company, provided they disclose the fact that they will make a profit. Such disclosure eliminates the secrecy in the transaction. When the property proves worth the price asked for it, there is no breach of fiduciary duty. By injecting into this approach the proposition that a reasonable investor in a scheme, which is at all speculative, will realize that the promoter asks something more than the established value of his plan at the time of the transaction, a wide field opens for the allowance of promoter profits which are now considered secret.

Belief in the truth of a statement in a prospectus has long been a defense against actions for deceit.[23] As long as the representation is made bona fide, want of due care does not destroy the defense. While those who put before the public a prospectus to induce them to enter a commercial enterprise should be vigilant to make their representations in accordance with fact, yet carelessness is not fraud. Honest belief is a defense even if there is lack of care in making the representation. Under the *Securities Act of 1933* the promoter issuing a prospectus containing false information has the burden of proving his good faith.[24]

Some courts are not so rigid in their demand for a full and open revelation of all the benefits that the promoter expects to reap. Where the promoter's margin of profit becomes smaller, fraud is more difficult to isolate. Thus a promoter's profit of $3,000 in a transaction involving $12,500, but only $500 of the promoter's funds, was held not to constitute fraudulent promoter profits.[25] This court was able to find value for the property purchased by the corporation, especially

21. Miller v. Youmans-Burke Oil and Gas Co., 278 Mich. 647, 270 N. W. 819 (1937).
22. Henderson v. Plymouth Oil Co., 16 Del. Ch. 347, 141 Atl. 197 (1928).
23. Derry v. Peek, L. R. 14 App. Cases 337 (1889). See PROSSER ON TORTS 726 (1941) for modifications of this rule.
24. 48 STAT. 74 (1933), 15 U.S.C.A. sec. 77 (1941). *Cf.* Kountze v. Kennedy, 147 N. Y. 124, 41 N. E. 414 (1895).
25. Masberg v. Granville, 201 Ala. 5, 75 So. 154 (1917).

since the actual price the corporation paid was in reality a good investment.

Property is not considered overvalued in sales by promoters to corporations merely because it subsequently turns out to be so.[26] There is, of course, a limit beyond which the courts will not go in sustaining the issue of stock for property taken at overvaluation. Consequently, if the property turned in is practically worthless, or is unsubstantial and shadowy in its nature, the courts will hold that there is no payment at all. On the other hand, when the property turns out to be a very good investment, consideration for the price paid should not be difficult to find.

One decision has been so blunt as to base liability on whether the corporation or any of its stockholders suffer tangible wrong or injury.[27] That the promoters who thought of the plan reaped greater profits than the other stockholders was considered immaterial. This decision was based on the reasoning that fraud, to be actionable, must result in injury, and since the property sold to the corporation proved to be worth the price paid, no injury resulted. The courts readily uphold the right of a corporation to force promoters to permit it to utilize a promotion plan which the promoters wish to withdraw and use for their own personal benefit.[28] The courts in effect recognize that the consolidation of properties may result in an increased value, one much greater than the sum of the costs of the individual pieces of property. The ability of the promoter to foresee that a few small tracts of mineral land belonging to many owners are worth much more in the hands of one owner results in an increase in the value of the properties. Since such value is recognized for the purpose of requiring a promoter to deliver properties to a corporation, perhaps it should also be recognized for the purpose of allowing the promoter to benefit from his foresight.

Stock subscribers should be charged with the realization of the speculative nature of their investment.[29] Every subscriber to stock in a new venture should realize that any return therefrom would be dependent upon its development. The stock which is issued, especially in cases of promotion of new ideas of the development of mineral fields, are virtually worthless at the time of issue, and will continue so unless the property or idea is developed. A promoter must work diligently, often for several years, to prepare the idea he is developing in a form acceptable to the public, and much effort is required to sell the plan to the public. Therefore, those who subscribe to the

26. Smith v. Schmitt, 112 Or. 687, 231 Pac. 176 (1924).
27. Roberson v. Draney, 53 Utah 263, 178 Pac. 35 (1919).
28. Moore v. Warrior Coal & Land Co., 178 Ala. 234, 59 So. 219 (1912).
29. Burneagle Coal and Coke Corp. v. Henritze, 139 Va. 442, 124 S. E. 224 (1924).

stock should be charged not only with knowledge of all that the records show and all that the statements to the corporation commission disclose, but also with the knowledge that the promoters expect in some way to be paid for their diligent and persistent effort.

In all the methods which the courts utilize to allow the promoter to make a profit in his transactions with the corporation, it should be noted that the true object in securing approval by the corporation of the transactions or in charging it with knowledge of the profit the promoter makes is in every case to allow the promoter in effect to avail himself of the rule that a principal may condone a breach of trust committed by the agent.[30] In view of the harshness of strictly enforcing the rule against secret promoters profits, and the occasional attempts to find some way of circumventing it in order to reach a more equitable result, it is suggested that a modification of the rule be adopted in cases where the property proves to be worth the sale price.

Reasonable people should recognize that initiative must be rewarded. So-called "secret profit" cases usually turn on a technical point hidden by some well-worn term such as "fiduciary relationship" or "trust." In truth, the rule against secret profits when strictly applied often merely changes the rewards from one person desiring as large a share as he can get to the hands of another equally greedy person who has found a way to get more than his bargain. If courts were free to look beyond this rule and seek true justice in a direct way, a great handicap on business venture would be eliminated. So long as a promoter must reveal in detail each item of benefit he expects to reap, he will be at the mercy of those investors to whom the information is revealed.

Even if there is a relaxation of the necessity of full revelation and a narrowing of the term "secret profits" as applied to promoters' profits, the public will still be adequately protected by the tests of active deception and actual over-valuation. At the same time, the necessary incentive to induce the continued development of promotion schemes will be achieved and the public will thereby reap a substantial benefit.

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30. Comment, 34 MICH. L. REV. 1189 (1936).