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The Fiduciary Relationship of the Corporate Director to the Individual Shareholder

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THE FIDUCIARY RELATIONSHIP OF THE CORPORATE DIRECTOR TO THE INDIVIDUAL SHAREHOLDER[1]

The Washington Supreme Court in a recent decision,[2] greatly extended the scope of the controversial fiduciary relationship existing between the corporate director and the individual shareholder. A corporate president, having obtained for nominal consideration, an option to purchase the building in which the company's offices were located, solicited the interest of a shareholder of the corporation and represented the property to him as a good business investment. The president, although having expressed his interest in the property to the shareholder, indicated that his position necessarily precluded the purchase of the building as his separate property as it would be inappropriate for the president of the company to own the building which housed the company's offices. In offering to negotiate the purchase in behalf of the shareholder, the president represented the purchase price to be a great deal larger than his secured option price. It was suggested that the sale required prompt consummation because of an impending advance in price. As a result of the transaction, a profit of $16,200 was realized by the president. The court in holding the president liable to the shareholder for the profits resulting from the breach of a fiduciary duty owing to the latter, quoted Cardozo's time honored standard of the fiduciary as formulated in *Meinhard v. Salmon*:

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive. . . .[3]

The court in further defining the director's status in relation to the stockholder held:

> Directors, when elected to office, become trustees of the entire body of corporate owners. They owe loyalty not only to the majority stockholders, or to the minority, but to all of them represented by the corporate entity. To disregard the rights of either group, even for a moment, is a violation of their fiduciary obligation.[4]

The existence of a fiduciary relationship between the corporate director and the individual shareholder has been the subject of much disagreement and varied application. Although the authorities are agreed that the relation of directors concerning the affairs and care of the property of the corporation is fiduciary in character and owing to the corporation, and to the corporate stockholders as a whole, there is a conflict of opinion as to whether such a relationship exists between the director and

1. The word director as used in this note includes officers and managers of the corporation.
2. Kane v. Klos, 50 Wash.2d 778, 314 P.2d 672 (1957).
3. 249 N.Y. 458, 164 N.E. 545, 546 (1928).
4. Daloisio v. Peninsula Land Company, 43 N.J.Super. 79, 127 A.2d 885, 891.

the individual shareholder. In almost all instances, the relationship when applied, has been limited to stock transactions between the parties.

The numerical weight of authority in this area of share purchasing has held that directors do not stand in any fiduciary relation to the individual shareholders.[5] Directors may deal with shareholders and purchase their stocks practically on the basis of strangers, and in the absence of actual fraud and misrepresentation, a purchase will not be invalid for failure to disclose any information the directors may have affecting the value of the stock so purchased.[6] The rule states that there is no legal privity, relation, or immediate connection between the holders of the shares in their individual capacity and the directors.[7] The directors are not bailees, agents, or trustees for the individual shareholders.[8]

The minority view, a fiduciary view, was adopted by a few states which held the director a fiduciary to the individual shareholders. In contrast to the majority, the minority view holds generally that the relationship between these parties is that of trustee and cestui que trust,[9] or essentially that of trustee and cestui,[10] or at least quasi-trustee of the shareholders individually.[11] The director stands in a fiduciary relation to the shareholders in regard to their stocks, and when negotiating with shareholders for the purchase of their shares, he is in effect buying an interest in property which has been committed to his control, and he may not profit at their expense by the use of information obtained as a result of his official position. A director may purchase shares from a stockholder, but before doing so, he must, even though no inquiry be made, disclose any information or material facts affecting the value of the shares which he knows because of his position and which the stockholder does not know.[12] He must be able to show that his behavior was "open, honest, and above reproach."[13]

Because stock transactions for the most part take place in the open market, the basis for the so-called majority view is largely predicated on the theory that the price of shares is set with reference to the market value rather than the actual value.[14] To those shareholders with whom

5. Tippencanoe County Commissioners v. Reynolds, 44 Ind. 509, 15 Am.Rep. 245 (1873); Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933); Morrison v. State Bank of Wheatland, 58 Wyo. 138, 126 P.2d 793 (1933).
6. Hooker v. Midland Steel Co., 215 Ill. 444, 74 N.E. 445, 106 Am.St.Rep. 170 (1905).
7. Smith v. Hurd, 12 Metc. 271, 46 Am.Dec. 690 (1847).
8. Ibid.
9. 3 Fletcher, Cyclopedia Corporations § 1168.2 (Perm. ed. 1947); Hotchkiss v. Fischer, 136 Kan. 530, 16 P.2d 531 (1932); Kane v. Klos, 50 Wash.2d 778, 314 P.2d 672 (1957).
10. Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903).
11. Jacquith v. Mason, 99 Neb. 509, 156 N.W. 1041 (1915).
12. Poole v. Camden, 79 W.Va. 310, 92 S.E. 454 (1916).
13. Stewart v. Harris, 69 Kan. 498, 77 Pac. 277, 66 L.R.A. 261 (1904).
14. Since 1934, dealings in securities covered by the Securities Exchange Act of June 6, 1934, are largely taken care of by the provision that any profit realized by a director, corporate officer, or substantial shareholder from a purchase and sale, or sale and purchase of stock within a six month period shall inure to and be recoverable by the corporation at the instance of the shareholder.

the director has had no personal dealings and who are selling with regard to the market, the director should not be required to disclose the information inducing him to buy. In particular instances the majority view encouraged sharp dealing on the part of directors bordering on fraud,[15] and many advocates of this view soon realized that strict adherence to the rule often had and would continue to work an injustice on shareholders unless some limitations were placed thereon. It was felt the situation should be different where the director of a small corporation, unlisted on the major stock exchanges, seeks out his stockholders, and makes offers for their shares. Should there be any *special facts* making it highly inequitable for the director to profit through a personal stock transaction with the shareholder, the courts would give them due weight in holding the director accountable without imparting the fiduciary concept.[16] It was sought to make the director responsible for his actions if in consideration of all existing circumstances involved in the transaction, it became the duty of the director acting in good faith, to disclose the facts known to him, unknown to the shareholder and directly affecting the transaction.

These limitations on the application of the majority rule gave rise to the "special facts rule" first established in *Strong v. Repide*[17] and termed the intermediate between the other views described. It is based on the premise that while in general no fiduciary relationship exists between the director and the individual shareholder, special facts may place the director in a position of confidence that will give rise to the fiduciary rule. The rule has been so broadly applied that it closely approaches the so-called "fiduciary view" and nearly the same result can be reached in either case with minor exceptions.

The Washington case[18] is especially significant, not only because it characterizes the relationship between the director and the individual shareholder as fiduciary, but because it is almost unique in applying the relationship to a personal dealing between the parties other than in a stock transaction. Few other cases have gone quite this far.[19] The case continues, however, to incorrectly term the status of the director as that of trustee and to make him responsible to the stockholders on a same or similar basis. The real confusion in this field of law arises because the majority of the courts having determined that the director is not in a

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15. Von Au Magenheimer, 126 App.Div. 257, 110 N.Y. Supp. 629 (1908).
16. 3 Fletcher, Cyclopedia Corporations § 1171 (Perm. ed. 1947); Federal decisions seem to avoid declaring the fiduciary doctrine. Grant v. Attril, 11 Fed. 469 (C.C.S.D.N.Y. 1882); Gillett v. Brown, 23 Fed. 625, 626 (C.C.D. Colo. 1885); In Strong v. Repide, 213 U.S. 412, 29 S.Ct. 521, 53 L.Ed. 853 (1909), the duty of disclosure is held not to exist.
17. 213 U.S. 419, 29 S.Ct. 521, 53 L.Ed. 853 (1909).
18. Kane v. Klos, 50 Wash.2d 778, 314 P.2d 672 (1957).
19. In Young v. Columbia Oil Co., 110 W.Va. 364, 158 S.E. 675 (1931), the court held that although the corporation was prevented by statutory provisions from obtaining feasible leasing areas which it was organized to secure and develop, the directors owing a fiduciary relation to the individual stockholders of the corporation could not obtain same in their individual capacity without giving the shareholders equal notice and opportunity; Note, 38 W.Va. L.Q. 158 (1932).

true sense a trustee, agent, or managing partner of the individual shareholders, find it necessary to conclude that the director does not therefore stand in a fiducial relation to the stockholder.

It has been suggested that the law of trusts and agency had taken a definite form before the corporation had become a real factor in business.[20] The courts in attempting to solve the numerous new problems to which this unusual type of business gave rise, endeavored to fit the new relations into old forms, notwithstanding that these forms dealt with situations and relationships totally dissimilar. The trouble, which still exists today, began when the courts in attempting to hold the directors to the obligation of fidelity which their position demanded, attempted to fit them into one of the legal pigeon holes established for trusts, agencies, wardships, etc.

It is equally as unnecessary and incorrect to argue that a director must be held to be a trustee or agent of the shareholder in order to call him to account in a court of equity for breach of his duty to act in good faith as it would be to contend that an ordinary agent, executor, attorney, guardian, joint adventurer, partner, etc., cannot be held accountable in equity for breach of his fiduciary duty because each cannot be wholly assimilated with the character of a conventional trustee. It is easier to resolve the problem as a New York court did by terming this relationship as "in a sense fiduciary," to the extent at least that the parties do not deal on equal terms.[21] Basically it appears that in most cases it is the unconscionable, inequitable conduct which sets equity in motion rather than the nomenclature with which lawyers and judges have tagged certain relationships.

There is no real reason why the courts must necessarily fit the director into an established legal relationship to hold him liable for conduct which is unbecoming to his office of trust and good faith. Equity jurisprudence is the source of many doctrines applicable to conditions which are not strictly trusts. Whenever it can be shown that a confidential relation exists, the dealings of the parties with each other and with the subject matter of the relation are governed by the same rules which determine the actual trust relation, and are entitled to the same remedies as are afforded the cestui que trust.[22] A confidential or fiducial relationship exists whenever parties do not deal on equal terms, and trust and rely on one another.[23] A pre-existing state of trust and confidence need not exist between the parties; it may be a status arising at the time of the conveyance or transaction in question.[24] The relation and duties in it need not be legal; they may be moral, social, domestic, or merely personal, and relief is

20. See Johnson, Corporate Directors as Trustees in Illinois, 23 Ill. L. Rev. 653 (1929).
21. Von Au Magenheimer, 126 App.Div. 257, 110 N.Y.Supp. 629 (1908).
22. 4 Pomeroy's Equity Jurisprudence 263 (5th ed. 1941); Dick v. Albers, 243 Ill. 231, 90 N.E. 683 (1909).
23. See Bogert, Confidential Relations and Unenforceable Express Trusts, 13 Corn. L.Q. 248 (1928).
24. Seeberger v. Seeberger, 325 Ill. 47, 155 N.E. 763 (1927); Bogert, Confidential Relations and Unenforceable Trusts, 13 Corn. L.Q. 238 (1928).

granted in all cases in which confidence has been acquired and abused, or reposed and betrayed.[25] It has been applied on the basis of undue influence, or by implied agreement by the fiduciary not to acquire a personal advantage.[26] There is no agreement in the cases as to just what constitutes a confidential relation sufficient to serve as a basis for imposing a constructive trust.[27] Courts of equity have carefully refrained from defining the particular instances of a fiduciary relation in such a manner that other and perhaps new cases might not be excluded.[28]

There appears to be a growing tendency by the courts to abandon presumptions of fiduciary relations and to deal with each situation individually. What amounts to proof by the fiduciary of the manifestation of fair play in dealing with another within the supposed relationship depends upon the facts of each separate case. Courts supposedly following the majority view have repeatedly stated the proposition that a director of a corporation owes no fiduciary duty to a shareholder in regard to his stock; yet, whenever the judgment has gone for the director, it has been because there was no misrepresentation or concealment of a material fact,[29] the shareholder was in fact on equal footing with the director,[30] or the shareholder investigated personally, or for other reasons placed no reliance, or was not entitled to rely on the director's statements.[31] Conversely whenever the judgment has gone for the shareholder, it has been because the facts of the particular case were such that it would have been manifestly unfair to let the director keep the profit he had made at the expense of the unwitting shareholder.[32]

One court in a recent decision has taken a significant step toward clarifying the legal status of the corporate director.[33] The court held that a director was entitled to reimbursement of costs incurred in successfully defending a series of stockholders derivative suits regardless of whether the outcome was of benefit to the corporation. In so doing, the court expressly disregarded the "benefit theory" applied in some jurisdictions to the trustee of an express trust, and by analogy to corporate directors in those jurisdictions where his position to the corporation is related to that of trustee. The court, having in the past endeavored to impose the con-

25. Metcalf v. Leedy, Wheeler and Company, 140 Fla. 149, 191 So. 690 (1939); Hodge v. George, 27 Wyo. 423, 200 Pac. 96, 18 A.L.R. 469 (1921).
26. National Wire Bound Box Co. v. Healy, 189 Fed. 59 (7th Cir. 1911).
27. See Scott, Conveyances Upon Trusts Not Properly Declared, 37 Harv. L. Rev. 653 (1924).
28. 3 Pomeroy, Equity Jurisprudence § 956a (5th ed. 1941).
29. Ryder v. Bamberger, 172 Cal. 791 158 Pac. 753 (1916); Goodwin v. Agassiz, 283 Mass. 358, 186 N.E. 659 (1933); Morrison v. State Bank of Wheatland, 58 Wyo. 138, 126 P.2d 793 (1942); Anderson v. Lloyd, 139 P.2d 244 (Idaho 1943).
30. Stout v. Cunningham, 33 Idaho 464, 196 Pac. 208 (1921); Woodruff v. Cole, 307 Mo. 19, 269 S.W. 599 (1925); Rucker v. Sanders, 182 N.C. 607, 109 S.E. 857 (1921).
31. McCord v. Martin, 47 Cal.App. 717, 191 Pac. 89 (1920); Bacon v. Soule, 19 Cal.App. 438, 126 Pac. 384 (1912); Candler v. Heigho, 208 Mich. 115, 175 N.W. 141 (1919).
32. Strong v. Repide, 213 U.S. 419, 29 S.Ct. 521, 53 L.Ed. 853 (1909); Sauter v .Fulmer, 258 N.Y. 107, 179 N.E. 310 (1932); Buckley v. Buckley, 230 Mich. 504, 202 N.W. 955 (1925).
33. In re E. C. Warner Co., 232 Minn. 207, 45 N.W.2d 288 (1950).

cepts of agency and trusteeship on the corporate director which resulted in confusion only, rejected all such verbiage and proclaimed the status of the director as *sui generis*.

It is suggested that the same or a similar characterization of the corporate director should be applied by the courts when defining his duty to the stockholders in transactions between the parties. The existence of a relationship sufficient to support the fiducial rule should be dependent upon the facts involved in and effecting the transaction.

In the only Wyoming case on the subject,[34] it was held by the Supreme Court that the director of a corporation did not stand in a fiduciary relationship to an individual shareholder with respect to his stock, and the mere failure of an officer or director in purchasing shares from a stockholder to disclose any inside information will not militate against him, so long as he does not actively mislead the shareholder or perpetrate a fraud. Whether the Wyoming Supreme Court has adopted the old majority rule is doubtful as there was much discussion in the case illustrating the non-existence of any facts which may have created a duty to disclose. It was not shown by the shareholder that the directors had, as a result of their position, obtained any inside information affecting the value of the stock which they failed to disclose to the shareholder when purchasing his stocks.

The Wyoming Supreme Court has, in *Hodge v. George*,[35] a case involving a joint adventure, indicated that the relationship necessary to invoke equity jurisprudence must be one from which the law can infer or presume the exercise of undue influence. For establishing a relationship sufficient to support the fiduciary rule, there is no fixed test, but it must appear, as a fact, that there was confidence reposed on the one side and accepted on the other with a resulting dependence by the one party and influence by the other. In the cases dealing with trustee and beneficiary, principal and agent, and the like, the relations being essentially fiduciary, the inference and presumption of undue influence will follow as a matter of course. The court further noted, however, that application of the rule was not confined to these definite instances, but could be invoked in a variety of less definite confidential and trust relations. The fact that such relation existed must be established by evidence, and the burden is on the party asserting it.

Almost none of the problems involving the duties and liabilities of directors to the individual shareholder in personal transactions between the parties have arisen in this state. Whether a relationship existed at the time of such transactions sufficient to command a higher degree of conduct on the part of corporate directors, not required by those acting at arms length, should be determined by the facts of each individual case.

34. Morrison v. State Bank of Wheatland, 58 Wyo. 138, 126 P.2d 793 (1942).
35. 27 Wyo. 423, 200 Pac. 96 (1921).

To provide or to deny equitable relief to a shareholder should not be dependent upon the existence or non-existence of a supposed legal relationship between the parties sufficient to support the fiduciary concept. It is through an approach similar to that presented in the *Hodge* case or to that in the stock transaction cases and known therein as the "special facts rule" that will allow the courts the most latitude in arriving at an equitable result in the cases concerning transactions, stock or otherwise, between corporate directors and individual shareholders. It is through these similar approaches that one could conclude that while in general no legally recognized fiduciary relationship exists between the director and individual shareholders, special facts may place the director in such a position of confidence that their existence will give rise to the fiduciary rule. Such an approach would lead to the same desired result in raising the fiduciary rule when required in personal dealings between these parties without resort to extensive syllogisms in establishing or denying the existence of a fiduciary relationship between these parties.

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FEDERAL TAX LIENS IN MORTGAGE FORECLOSURES

An attorney who is to subject property owned by a judgment debtor or mortgagor to a judicial sale must determine whether the property is incumbered by another lien of any kind and if such a lien exists, its relative priority to the lien sought to be satisfied. In recent years the federal tax lien has appeared in such cases more and more frequently.

I.R.C. Sec. 6321 (1954) creates a lien in favor of the government on all the real and personal property and rights to property which belongs to a taxpayer who neglects or refuses to pay an *assessed* tax upon *demand.*

An assessment, based either upon the return filed by the taxpayer, or an audit by the Internal Revenue Service, can only be made after the taxpayer has waived the right to litigate in the tax court,[1] or, in the case of income, estate, or gift taxes, has litigated in the tax court.[2]

Within sixty (60) days after assessment the District Director of Internal Revenue is required to give notice to the taxpayer of the assessment and demand payment.[3]

If, after the demand is made, the tax is not paid, a general federal tax lien is created and related back to the time of assessment.[4] In determining whether the federal lien has attached to the property sought to be sold, the rule is that the lien attaches to everything subject to ownership,[5]

1. I.R.C. § 6213 (d).
2. I.R.C. § 6212 and § 1213.
3. I.R.C. § 6303 (a).
4. I.R.C. § 6322.
5. Citizens State Bank of Barstow, Tex. v. Vidal, 114 F.2d 380 (10th Cir. 1940).