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Fiduciary Duty And Implied Promises In Prospectus

*United Funds, Inc. v. Carter Products, Inc.*¹

The Carter Products Company, prior to July, 1957, was a closely held corporation engaged in the manufacture and marketing of proprietary and toiletry articles. The principal and controlling interest in the company was held by H. H. Hoyt, who had been encouraged by a large minority interest to establish a public market for the Carter stock. The company filed a registration statement with the Securities and Exchange Commission on July 1, 1957, and the preliminary and final prospectuses were distributed to the public for the purpose of publicizing the sale.² Included

¹ DAILY RECORD, September 23, 1963 (Md. 1963).

² The reader should note that the prospectus referred to herein is the one in effect at the conclusion of the so-called "waiting period", which normally extends twenty days from the date of filing. The preliminary and summary prospectuses do not give rise to either contractual or tort liability prior to the effective date of registration. 1 LOSS, SECURITIES REGULATION 182 (2d ed. 1961); 3 LOSS, SECURITIES REGULATION 1722 (2d ed. 1961).

in the prospectus was the statement, "The Company intends to make application for the listing of Common Stock on the New York Stock Exchange." Listing on the Exchange was achieved in October of 1957, subsequent to the effective date of registration. Approximately four years after the public offering, the Board of Directors, upon the recommendation of Hoyt, adopted a resolution amending the Charter to create a class of non-voting stock. The amendment was approved by the required two-thirds vote of the stockholders. The issuance of non-voting stock would have subjected Carter Products to delisting by the Exchange.³

In an action filed in the Circuit Court of Baltimore City, minority stockholders sought to enjoin the issuance of the non-voting common stock. The court confined its examination of the issues to whether the statement of intent in the prospectus constituted a continuing obligation to maintain listing on the Exchange, and, whether the delisting was a breach of a fiduciary duty, owing to the complainants as minority stockholders. Judge Oppenheimer, in examining the question of fiduciary duty, considered the delisting as an act of waste, in view of the fact that the purpose behind the issuance of the non-voting stock was the perpetuation of Hoyt's majority control, as revealed by his own testimony. The court found that the acts of waste constituted a breach of fiduciary duty, and established its right to intervene in the internal affairs of the corporation on the ground that the action taken by the fiduciary was unfair to the minority stockholder.⁴

The most formidable obstacle to establishing a contractual relationship based on the statement of intent in the prospectus was the alleged absence of privity of contract between the contestants.⁵ The court avoided the problem of privity by invoking the doctrine of promissory estoppel, which recognizes that an obligation is created when a promise is made with the intent of inducing reliance, and the promisee, having acted in reliance, would be substantially injured by the promisor's default. Delisting might impair a corporation's ability to raise new capital and injure the individual stockholder by a depreciation in the market value of the stock. The court stated that the

³ 2 CCH N.Y. Stock Exch. Guide ¶ 2499.10(3).

⁴ *Winchell v. Plywood Corp.*, 85 N.E. 2d 313 (1949); *Lebold v. Inland S.S. Co.*, 82 F. 2d 351, 354 (7th Cir. 1936); *Geddes v. Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921); *Elliott v. Baker*, 80 N.E. 450 (1907).

⁵ The complainants had purchased their holdings directly from the underwriters so that the necessary privity existed between them and not between the plaintiffs and Carter Products.

language in the prospectus constituted an implied promise to continue listing on the Exchange *as long as it was in the best interests of the corporation*, and concluded that Hoyt's personal objective of perpetuating his majority control was inconsistent with a "proper corporate reason".⁶

Before *Carter*, the establishing of a contractual relationship by means of a prospectus was without precedent in Maryland, and the only decision assigning such contractual significance to a corporate prospectus was that of the Supreme Court of Delaware in *Salisbury v. Credit Service, Inc.*⁷ Through its agents the defendant corporation had issued a prospectus to the public which contained a clause stating that a "customer market is maintained by Credit Service, Inc., at 100 less 2% brokerage, after one year from purchase."⁸ The complainant bondholder purchased the security on the representation in the prospectus and brought suit when she was unable to sell the bonds at the agreed price. The court held that the prospectus was issued by the corporation's selling agents for the purpose of promoting the bond issue, and the "language of the customer market clause, if in any sense promissory in its nature was . . . a part of the contract of sale."⁹ In effect, the court concluded that the prospectus constituted an offer of sale with a promise to maintain a specified market price for the bond, and the purchase of the bond furnished the necessary consideration and created a binding contract. Moreover, the fact that the bonds had been sold to an intermediary party and the prospectus issued through an agent of the corporation did not prevent Credit Service, Inc., from making a direct representation to the public.¹⁰

In the *Salisbury* case, the words "a customer market is maintained" were interpreted as a promise that the market

⁶ DAILY RECORD, September 23, 1963 (Md. 1963).

⁷ 39 Del. 377, 199 Atl. 674 (1937).

⁸ *Id.* at 676.

⁹ *Id.* at 682-83.

¹⁰ The *Carter* prospectus was issued exclusively on behalf of the corporation with the authorized signatures of its officers. However, the holding of the Delaware court is limited somewhat by the unique factual situation. There, the court concluded that the close association between Credit Service, Inc., and its intermediary, Credit Service Assoc., Inc., was sufficient to constitute an agency relationship, even though the bonds had been sold to the underwriter. In the instant case, the underwriters purchased the issue, assuming full liability for the unsold stock. There was no evidence that the underwriters were acting in an agency capacity. However, there is another type of agreement between the underwriter and issuing corporation in which the former does not assume any liability but agrees only to make a "best effort" to sell the stock. 2 DEWING, FINANCIAL POLICY OF CORPORATIONS 1095 (5th ed. 1953). The "best effort" agreement might be construed as a principal-agency relationship between issuing corporation and underwriter, thereby giving even greater scope to the *Salisbury* decision.

"will be maintained". A similar clause was found in the Carter prospectus in which the words "intends to make application . . ." were held to constitute a promise that the company would list its stock on the Exchange. In *Carter*, the Maryland court went one step further in establishing an implied promise that the listing would continue, based on the general custom and usage of the trade.

There is no reason to treat the implied promise to continue listing as distinct from the promise to list on the Exchange. If the intention of the company were to induce the sale of stock, acquire the capital and delist as quickly as possible, the issuing of non-voting stock clearly would have constituted a fraudulent act. The Maryland court did not find any evidence of fraud, but supported its conclusion on the ground that the Carter Company was not issuing the stock for a legitimate corporate purpose, and thereby breached its implied contractual duty to continue listing.

Although courts have not declined entirely to apply the doctrine of promissory estoppel to commercial transactions,¹¹ it has been given its greatest recognition in cases involving repudiation of promises of *gratuities* threatening "substantial" injury to the party acting in reliance.¹² It is applicable to transactions, either donative or commercial, in which the only substantive basis for enforcing the promise is the prevention of an injustice to the party acting in reliance.¹³

It may be questioned whether there is any need to invoke promissory estoppel to enforce a promise expressed in a corporate prospectus. A prospectus, like the SEC

¹¹ *Schafer v. Fraser*, 206 Ore. 446, 290 P. 2d 190 (1955); *Northwestern Eng'r Co. v. Ellerman*, 69 S.D. 397, 10 N.W. 2d 879, 884 (1943); *Robert Gordon, Inc. v. Ingersoll-Rand Co.*, 117 F. 2d 654, 661 (7th Cir. 1941).

¹² Annot., 48 A.L.R. 2d 1069 (1954). *Boyer, Promissory Estoppel: Requirements and Limitations of the Doctrine*, 98 U. PA. L. REV. 459, 469 (1950); *Boyer, Promissory Estoppel: Principle From Precedents: I*, 50 MICH. L. REV. 639, 655 (1952).

¹³ *Boyer, supra* note 12. See also, *James Baird Co. v. Gimbel Bros., Inc.*, 64 F. 2d 344, 346 (2d Cir. 1933); *Anderson v. Truitt*, 158 Md. 193, 148 Atl. 223 (1930). In the *Anderson* case, the plaintiff purchased a two-thirds interest in a furniture store from defendants, who owned the property as tenants by the entirety. The parties entered into a covenant whereby the original owners agreed to refrain from engaging in a business of a similar nature within a specified period of time and geographical location. In answer to the defendant's contention that he had contracted only to the extent of releasing his dower interest, the Maryland Court of Appeals held that the promise was binding if, upon the faith of it, the consideration is parted with to another as beneficiary. The transaction in the *Anderson* case was of a commercial nature, but the essential fact was the justifiable reliance of the plaintiff on the promise of the covenantor, which the court enforced in order to prevent an injustice.

registration statement, emanates from the issuing corporation and contains the signatures of its representatives. The contents of such a circular might range from a general description of the stock to a specific offer of sale, but its primary function is to encourage the reader to purchase the security. When the prospectus constitutes an offer of sale coupled with a specific promise, the subsequent purchase of the security supplies the required consideration. Under the Delaware view, the existence of an intermediary party to purchase and distribute stock to the public does not detract from the fact that the buyer understands the prospectus to be a representation of the issuing company. The Securities and Exchange Act provides some support for this view.¹⁴

However, the lower court's application of the doctrine of promissory estoppel has important ramifications. The decision not only adopts the position that undertakings expressed in a prospectus can be enforced against the issuing corporation by a purchaser of the stock offered, but also provides an alternative method of establishing an enforceable obligation in situations wherein privity of contract is somewhat attenuated.

The court's recognition of a contractual relationship between the corporation and the stockholder raises a basic question. Does the court's decision establish the stringent requirement of unanimous stockholder approval of any corporate act which might result in the delisting of its stock? The lower court interpreted the statement of intent in the prospectus as a promise that the company would list on the Exchange, and maintain listing, unless "proper corporate reason" justified the delisting.¹⁵ Therefore, the individual stockholder's right of recourse against the corporation for breach of contract does not rest merely on the fact of delisting, but also necessitates evidence that the action, which resulted in delisting, was instituted without "proper corporate reason". In the instant case the court found that the issuance of non-voting stock was achieved only for the

¹⁴ 48 Stat. 74 § 11a (1933), 15 U.S.C. § 77(k) (1958). Although Section 11a is concerned with the question of misrepresentation in a registration statement or prospectus, the fundamental approach to the privity concept appears to be applicable to the present situation. The statute extends liability for misstatements to the parties affixing their signatures to the statement, the underwriters, and any party who can be shown to be in control of the aforementioned individuals. A leading authority on security regulation has expressed the opinion that Section 11a provides the ultimate investor with the right to sue both the issuing corporation and underwriter where the prospectus has influenced the consumer's purchase. LOSS, *op. cit.* *supra* note 2, §§ 1722, 1731, 1769.

¹⁵ DAILY RECORD, September 23, 1963 (Md. 1963).

purpose of perpetuating control. But if the majority stockholder had acted in the best interests of the corporation, there is every indication that the court would not have intervened. The decision of the lower court does not provide the stockholder with unlimited power to obstruct a course of action approved by two-thirds of the stockholders. To the contrary, the burden of proof remains on the party seeking to sustain a breach of contract that the defendants were not acting in the interest of the corporation.

Since breach of the implied promise occurs only when the delisting is without proper corporate purpose, the court has, in effect read fiduciary duty into the contract. In each case, therefore, the complainant must establish that the course of action, resulting in corporate delisting, was not in the best interests of the corporation and, thereby, constituted a breach of that duty. The absence of proper corporate reason becomes the condition precedent to establishing a breach of contract, and the contract action becomes superfluous. The only apparent advantage to a contract action over a derivative suit is the individual stockholder's ability to sue directly rather than in behalf of the corporation, and this is outweighed by the need to establish not only a breach of fiduciary duty, but also the basic ingredients of a contract. Even when a contract is established between the corporation and stockholder, there is serious doubt as to the appropriateness of an individual suit in the case of corporate delisting. While the individual stockholder may bring suit against the corporation or its directors in order to prevent or redress a wrongful act, the injury must directly and peculiarly affect the complainant.¹⁶ The only "substantial" injury in the present case sufficient to satisfy the requirement of promissory estoppel, or in any situation involving the delisting of stock, would be the possible depreciation in market value of the security. The Maryland court, however, has refused to recognize depreciation of stock accruing from a wrongful act as a basis for a personal action against the corporation or its officials.¹⁷ When viewed in terms of the wasting of cor-

¹⁶ *Kohler v. McClellan*, 77 F. Supp. 308, 313 (E.D. La. 1948); *Wells v. Dane*, 101 Me. 67, 63 Atl. 324 (1905); 13 FLETCHER, CYCLOPEDIA CORPORATIONS §§ 5913, 5915 (rev. vol. 1961).

¹⁷ *Kohler v. McClellan*, *supra* note 16; *Waller v. Waller*, 187 Md. 185, 189, 49 A. 2d 449 (1946); *Wells v. Dane*, *supra* note 16; 13 FLETCHER, *op. cit. supra* note 16, § 5913. The court in the *Waller* case stated: "It is a general rule that an action at law to recover damages for an injury to a corporation can be brought only in the name of the corporation itself acting through its directors, and not by an individual stockholder though the injury may incidentally result in diminishing or destroying the value of the stock. The reason for this rule is that the cause of action for injury

porate assets, the cause of action is exclusively the corporation's, without regard to an existing contractual relationship between stockholder and corporation.¹⁸ In the *Carter* case the more appropriate action would seem to have been a derivative suit in behalf of the corporation.¹⁹ This is particularly important because of the limited situations in which minority stockholders could prove that the injury they allegedly suffered was not likewise experienced by the other stockholders. The derivative suit appears to provide substantial advantage to the stockholder by eliminating the necessity for establishing privity of contract, and, at the same time, by permitting the individual stockholder to enjoin or redress the wrongful act.

While the holding of the *Carter* decision is faulty in part, it does have the important effect of giving clear recognition to the basic concept underlying Federal security regulation: that the corporation and its representatives are held to the highest standards of care and good faith in their dealings with the public. The corporation is not only liable for its misrepresentations, but is contractually bound by the language of its prospectus where it is reasonably construed as a statement of intent.

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to the property of a corporation or for impairment or destruction of its business is in the corporation, and such an injury, although it may diminish the value of the capital stock, is not primarily or necessarily a damage to the stockholder, and hence the stockholder's derivative right can be asserted only through the corporation." *Waller v. Waller, supra.*

¹⁸ 13 FLETCHER, *supra* note 17.

¹⁹ *Id.* § 5829.