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Corporations—Effect of Statements Made In Stock Prospectus

In the case of *United Funds, Inc. v. Carter Products, Inc.*,[1] the City Circuit Court of Baltimore, Maryland, handed down a decision which "broke new legal ground."[2] The case, involving the effect of statements made in stock prospectuses on a corporation's future actions, has provoked surprisingly little discussion by legal commentators,[3] and none at all on the "new" ground it broke.[4] The purpose of this comment is to examine the *Carter Products* decision, to attempt to place it in proper legal perspective, and finally to evaluate it as a new development in the law.

In 1957 certain shareholders of Carter Products, Inc., including one Hoyt, offered stock for sale to the public. The prospectus by which the shares were sold said that "the Company intends to make application for the listing of the Common Stock on the New York Stock Exchange."[5] Plaintiffs, three investment companies, bought stock in that offering. Shortly thereafter the stock was listed on the Exchange. The Exchange warned Carter that if it later created a class of non-voting common stock it would be delisted. In spite of this warning, Carter's board of directors (controlled by Hoyt, who owned over fifty per cent of the outstanding stock) adopted a resolution that Carter issue four million shares of non-voting common stock. Plaintiffs brought this action to enjoin the issuance of the non-voting stock.

At the trial, plaintiffs introduced evidence tending to show that (1) delisting would damage both Carter and its shareholders in a variety of ways,[6] especially by causing a sharp decrease in the market value of Carter stock;[7] (2) plaintiffs purchased Carter stock in reliance upon the prospectus and the Exchange listing;[8] and (3) the purpose of the creation of the non-voting stock was to enable Hoyt to sell Carter stock without losing his voting control.[9] Plaintiffs relied on several

1. CCH FED. SEC. L. REP. ¶ 91,288 (Baltimore, Md., City Cir. Ct., May 16, 1963).
2. United Funds, Inc. v. Carter Prods., Inc., CCH FED. SEC. L. REP. ¶ 91,316, at 94,362 (Baltimore, Md., City Cir. Ct., Jan. 8, 1964). This was a later stage in the case, in which the court awarded complainants reimbursement from the corporation for counsel fees.
3. Only two articles were found: 77 HARV. L. REV. 757 (1964); 49 VA. L. REV. 1216 (1963).
4. It was dismissed in a footnote in one article. 49 VA. L. REV. 1216, 1217 n.3 (1963): "[T]he propriety of applying the doctrine on these facts would seem to be highly doubtful, especially since the promise is implied rather than expressed."
5. United Funds, Inc. v. Carter Prods., Inc., *supra* note 1, at 94,281.
6. See Brief for Complainants pp. 7-17, United Funds, Inc. v. Carter Prods., Inc., *supra* note 1.
7. *Id.* at 10-17.
8. *Id.* at 17-18.
9. *Id.* at 22-28.

theories,[10] most of which were adopted by the court.[11] However, although the court later stated that it based its decision on alternative grounds,[12] it said at the beginning of the opinion that it considered two questions dispositive of the cause: First, does the prospectus give the plaintiffs a legal or equitable right? Second, does the proposed creation of a non-voting common stock violate such a right?

Looking to custom and usage in the field of securities,[13] the court said:

> the statement in the prospectus as to Carter's intent to apply for listing of its stock with the N.Y.S.E. had a meaning established by generally known usage and practice in the financial world. Under this usage and custom, such a statement of intent is meant to be and is accepted as a promise that the company making it will apply for listing, with a strong implication, which in this case was true, that there is good reason to believe the application will be accepted . . . . [A]lso . . . the statement was meant to be and accepted as a promise that the listing would be continued.[14]

The court then pointed out that the rules of the New York Stock Exchange permit the voluntary delisting of stock, but require a two-thirds vote of the shareholders in favor of such action and also require that less than ten per cent of the shareholders dissent. Delisting is also used as a penalty—in the case of Carter it was to be the penalty for the issuance of non-voting common stock. Viewed in the light of the Exchange's rules, said the court, the meaning of the promise to continue the listing was that "Carter would not voluntarily take any action which, under the N.Y.S.E. rules, would result in delisting, unless that action was necessary to achieve a proper corporate purpose."[15]

Having determined the content of the promise, the court turned to

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10. Including the following: that the majority shareholders have a fiduciary duty not to carry out this action for their personal benefit to the detriment of the corporation and of the minority; that it constituted the waste of a corporate asset; that it was based on a shareholder vote procured by use of a misleading proxy.

11. However, the opinion rejects the theory of an express contract between tho parties to this effect. United Funds, Inc. v. Carter Prods., Inc., *supra* note 1, at 94,285-86.

12. "The right of the complainants to relief is based upon the violation of both the defendants' contractual obligations and of Hoyt's duties as a fiduciary." *Id.* at 94,293. By "contractual" the court meant "arising from promissory estoppel."

13. Counsel for complainants has stated that: "The contractual point was quite difficult and, so far as I know, without direct precedent. . . . We relied on the listing requirements of the Exchange and also on the custom and usage of the trade. I went to great pains to try to develop evidence on the custom and usage of the trade, and the Court in its opinion placed some real emphasis on custom and usage." Letter From Mr. Richard W. Emory, Venable, Baetjer & Howard, Baltimore, Maryland, April 16, 1964.

14. United Funds, Inc. v. Carter Prods., Inc., *supra* note 1, at 94,283.

15. *Id.* at 94,285.

the doctrine of promissory estoppel to ascertain its effect.[16] In this case, the court noted, the requirements of promissory estoppel were met: "The promise inherent in the statement of Carter's intent to list the stock was reasonably expected by Carter to induce action on the part of prospective purchasers . . . and did induce such action by them."[17] Thus the shareholders had a right to have the promise enforced:

> In this case . . . injustice can be avoided only if the contractual obligations of Carter and Hoyt are enforced by a court of equity. The damages to the complainants are substantial but not susceptible of pecuniary evaluement. If Carter is not enjoined from consummating its proposed action, the complainants cannot be restored to the position which they now occupy as holders of listed stock, purchased in reliance upon the promise.[18]

Only two decisions have been found which are directly in point with the *Carter Products* case. In *Jacobs v. Batavia & General Plantations Trust, Ltd.*,[19] defendant company (the "Trust") issued a prospectus offering deposit notes for subscription. The prospectus stated that "in the event of the sale of the Rio Bravo estates . . . the directors will set aside out of the proceeds of such sale a sufficient sum to redeem all the notes then outstanding and will give the holders the option of being then paid off in cash . . . ."[20] The prospectus also stated that an option had been granted on the purchase of the Rio Bravo estates. In response to the prospectus, and in reliance thereon, plaintiff sent in application forms for deposit notes and requested allotment "subject to the terms of the prospectus." Subsequently plaintiff received the notes, which bore on their face a promise to pay principal and interest, but which did not include the promise made in the prospectus with regard to accelerated payment upon sale of the Rio Bravo estates.

When the Trust sold the Rio Bravo estates without giving notice of the sale to the shareholders, plaintiff commenced an action to get (1) a declaration that the Trust was bound to set aside out of the proceeds of the sale a sum sufficient to pay off the notes, and (2) an injunction restraining the Trust from using the proceeds of the sale without setting aside such a sum. The Trust defended on the ground that the notes contained the entire contract between the parties. The court gave judgment for the plaintiff, holding that the notes did not contain the whole bargain, but only part of it, with the promise in the prospectus expressing the rest of it. The court then

16. The court adopted § 90 of the *Restatement of Contracts* as its model for promissory estoppel.
17. United Funds, Inc. v. Carter Prods., Inc., *supra* note 1, at 94,286.
18. *Id.* at 94,291.
19. [1924] 1 Ch. 287 (1923).
20. *Id.* at 288-89.

ruled the promise enforceable on either of two grounds: that the whole contract for the sale of the deposit notes was contained in the two documents; or that the promise in the prospectus constituted a collateral contract, the consideration for which was plaintiff's entering into a contract to take the notes.[21]

In another English decision, *In re Chicago & N.W. Granaries Co.*,[22] the court denied relief on facts similar to those of the *Jacobs* case. A prospectus issued in connection with the sale of debentures said that the debentures were "redeemable within seventeen years by half-yearly drawings," and that the company would apply a sinking fund of £ 5000 per annum for this purpose. The debentures stated that the company would establish a sinking fund of £ 2500 per half-year to pay off the bonds at a £ 10 premium plus a half-year's interest to those redeemed. For several years the company put into a sinking fund each half-year the sum of £ 2500 plus an amount sufficient to pay a half-year's interest on the bonds that £ 2500 would redeem. Then the company changed its policy and began to put only £ 2500 in the fund each half-year. Plaintiff-bondholder brought suit for himself and others similarly situated, arguing as follows: If the company put up £ 2500 plus interest each half-year, it would be able to pay off all the bonds within seventeen years. But if it put up only £ 2500, it would not be able to pay all bonds until the end of the seventeenth year. And the prospectus said *within* seventeen years.

The court gave judgment for defendant company. First, it said, the debenture was the whole contract; the prospectus could not be consulted to learn the terms of that contract.[23] However, it continued, conceding that part of the contract was contained in the prospectus, the plaintiff's construction of that instrument was erroneous. The word "redeemable" in the prospectus meant "liable to redemption" —not "will be redeemed."[24]

The *Jacobs* case can be distinguished from the *Chicago & N.W. Granaries* decision. In the latter, two alternatives are presented: either the language in the debentures was inconsistent with that in the prospectuses, or else it was consistent therewith. In the first instance, it could be maintained that by accepting the debentures the plaintiff agreed to the altered terms. In the second, where the language of the prospectus is so construed as to be consistent with that in the debenture (as the court did), there is no cause of action. In *Jacobs*, on the other hand, there was no possibility of inconsistency; the notes were silent as to the sale of the Rio Bravo estates. To the extent

21. The court found it clear that the corporation originally intended to honor its promise. *Id.* at 298.
22. [1898] 1 Ch. 263 (1897).
23. *Id.* at 266.
24. *Id.* at 267.

the two cases cannot be so reconciled, the *Jacobs* case is the more recent authority.

The few American decisions dealing with prospectus promises are in the area of fraud, used as a ground for the recovery of amounts paid for stock. *Edward Brockhaus & Co. v. Gilson*[25] was an action to void a sale of stock. The prospectus had said that "the company has agreed to make application to list this stock on the Chicago Curb Exchange." It also said that the "proceeds from the sale of this stock are to be used for the acquisition of property, purchase of machinery, and to provide working capital." Listing was not obtained, and property and machinery were not acquired. The court gave judgment for the defendant on the ground that the evidence did not show that the representation was made with the knowledge that there was no intention to do what was represented. In *Hilliker v. Jewel Oil & Gas Co.*,[26] the prospectus had said that the "'corporation [was] to be organized under the laws of the State of Michigan.'"[27] In fact, the corporation was organized under the laws of Delaware. Holding for defendant in an action to recover amounts paid under a subscription contract, the court said that the mere failure to incorporate as promised, where not shown to be part of a scheme to defraud, is not sufficient to justify recovery. Finally, in *Benedict v. Guardian Trust Co.*,[28] the prospectus included a promise that the stock would pay a one and one-half per cent dividend on the first and fifteenth of each month. Allowing a shareholder recovery in fraud when the promised dividends failed to materialize, the court said that "the mere expression of an intention to pay dividends would not furnish the basis for actionable fraud . . . . [but that here the representation] was preceded with the statement of actual earnings . . . . [and] such representations were false . . . ."[29]

A number of American decisions deal with the question of when an unfulfilled promise or statement as to future events constitutes fraud so that a subscription for stock made in reliance thereon may be rescinded and amounts paid thereunder recovered, or a suit on the subscription successfully defended.[30] The general rule is that fraud cannot be based on "'mere' unfulfilled promises or statements as to future events."[31] Thus a promise that the corporation will pay

25. 263 Ky. 509, 92 S.W.2d 830 (1936).
26. 277 Mich. 96, 268 N.W. 825, *aff'd on rehearing*, 277 Mich. 615, 270 N.W. 158 (1936).
27. *Id.* at 101, 268 N.W. at 826.
28. 91 App. Div. 103, 86 N.Y. Supp. 370, *aff'd without opinion*, 180 N.Y. 558, 73 N.E. 1120 (1904).
29. *Id.* at 107, 86 N.Y. Supp. at 373.
30. See Annots., 51 A.L.R. 46 (1927); 68 A.L.R. 635 (1930); 91 A.L.R. 1295 (1934); 125 A.L.R. 879 (1940); 27 A.L.R.2d 14 (1953).
31. 4 FLETCHER, PRIVATE CORPORATIONS § 1667 (1931).

dividends in the future,[32] or that it will erect a manufacturing plant[33] or establish a branch office,[34] will ordinarily not constitute fraud merely because not made good. But the general rule is subject to exceptions (1) where the statements are intended as representations of fact and involve matters peculiarly within the speaker's knowledge, (2) where the promises or predictions involve misstatements or concealment of existing facts, (3) where the promise is made without present intention to perform, and (4) where the promise is a device to defraud.[35] Thus a statement that the company "was doing a tremendous business and . . . had the money available to do so and would declare a 15 per cent dividend on its capital stock in February, 1923" constituted fraud where in fact the company did not have the money and did not intend to declare a dividend.[36] And where a corporation stated that it intended to erect a plant with the proceeds of the stock, a finding of fraud was sustained on the ground that the jury could have found that the corporation in fact had no such intention.[37]

As to remedy, the general rule is that a shareholder may not by injunction control the discretion of the directors and officers of a corporation in running its internal affairs and conduct.[38] This rule is subject to a number of exceptions.[39] For example, a shareholder may enjoin a merger carried out in violation of statutory safeguards.[40] And acts in violation of the agreement under which the corporation was formed may be enjoined.[41] Thus, where plaintiff financed the organization of a corporation under an agreement that he would designate nine of the eleven directors and that his nominee would be taught certain secret processes involved in the corporation's business, but that no one else would be taught these processes, it was held that he could enjoin the teaching of the secret processes to others.[42]

Section 90 of the *Restatement of Contracts* reads as follows: "A

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32. See, *e.g.*, Zeh v. Alameda Community Hotel Corp., 122 Cal. App. 366, 10 P.2d 190 (Dist. Ct. App. 1932).
33. See, *e.g.*, Steele v. Coleman, 120 S.C. 158, 110 S.E. 836 (1922).
34. See, *e.g.*, McCoy v. Bankers' Trust Co., 200 S.W. 1138 (Tex. Civ. App. 1918).
35. 4 FLETCHER, *op. cit. supra* note 31, § 1669.
36. H. W. Smith, Inc. v. Swenson, 105 Cal. App. 60, 286 Pac. 1050 (Dist. Ct. App. 1930).
37. "It is a matter of daily observation that the publication of a statement that a corporation will, at a stated future time, declare a large dividend is accepted by the buying public as a statement of a fact, and results in a great increase in sales of the corporation's capital stock." *Id.* at 63-64, 286 Pac. at 1052.
38. 10 FLETCHER, *op. cit. supra* note 31, § 4860, at 350-51 (rev. vol. 1961).
39. See 2 HORNSTEIN, CORPORATION LAW AND PRACTICE § 627 (1959).
40. Farris v. Glen Alden Corp., 393 Pa. 427, 143 A.2d 25 (1958).
41. 2 HORNSTEIN, *op. cit. supra* note 39, § 627.
42. Alley v. Positype Corp. of America, 224 App. Div. 603, 231 N.Y. Supp. 461 (1928).

promise which the promisor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of the promisee and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise." The Baltimore City Circuit Court found this principle dispositive of the *Carter Products* case. The English court of chancery applied the closely related collateral contract doctrine in the *Jacobs* case. The question next to be considered is the scope of application of promissory estoppel to the prospectus promise context. That is, when a promise has been made in a prospectus, when should the courts say that the promisor "should reasonably expect" his promise to induce action or forbearance? In addition, assuming promissory estoppel applies, when should injunctive relief be granted?

In answering these questions, a balance must be found between several conflicting interests. The buyer of stock is bound to be influenced to some degree by promises in the prospectus. His interest is to have these promises enforced. But a corporation may promise in a prospectus to do something which later appears to be unwise. One advantage of the corporate entity is centralized management and resultant flexibility of action. The majority shareholders have an interest in maintaining this flexibility. For example, a soap manufacturer may attempt to raise money for diversification. The prospectus might state that the proceeds of the stock issue would be used to buy a bleach factory. If the Justice Department subsequently warns of possible liability under the Clayton Act, the corporation should be free to back out of the deal. Finally, to permit such actions might open the door to harassment. For example, suppose a prospectus states that the company manufactures drugs. Is this a promise that it will continue to manufacture drugs? That it will manufacture only drugs? That it will not engage in the retail sale of drugs?

When the breaking of a prospectus promise constitutes fraud,[43] an injunction should issue to enjoin the breaking of the promise. Neither a corporation nor a promoter should be allowed to sell stock by means of fraudulent promises, and then evade performance of the promises by pointing to the need for corporate freedom of action.[44] Outside the area of fraud, however, general rules are less readily apparent.

43. See text accompanying note 35 *supra*.

44. Texas provides by statute that "actionable fraud . . . with regard to transactions . . . in stock in corporations shall consist of . . . false promise to do some act in the future which is made as a material inducement to another party to enter into a contract and but for which promise said party would not have entered into said contract. Whenever a promise thus made has not been complied with . . . within a reasonable time, it shall be presumed that it was falsely and fraudulently made" and the burden of proof shall shift to the promisor. VERNON'S TEX. CIV. STAT. ANN. art. 4004 (1961).

Thus, the balance of interests in a newly formed corporation may be somewhat different from that in a going concern. For one thing, in selling stock in a newly formed corporation statements of future action are apt to be relatively more conjectural and uncertain. Again, there is relatively more need for leeway in "puffing" to sell the stoek of an embryonic enterprise. Corporate promoters may be unable to assess objectively the prospects for future actions by the corporation they have brought into existence. On the other hand, subscribers to stock in a newly formed corporation should be a little more cautious than in the case of a going concern, and should be held to have assumed a certain amount of risk as to future developments. As in the case of newly formed corporations, the balance of interests in close corporations may also involve special considerations.[45] Assuming a small close held corporation for which a prospectus has been required,[46] if the stock is not publicly traded there may be a relatively greater need for protection for the shareholder against the violation of prospectus promises. His stock will be harder to sell, and he thus has less chance to recover his investment, if the corporation breaks prospectus promises.

The character of the promise involved will affect whether or not the shareholder can reasonably be expected to act in reliance thereon. Thus, where a corporation states in a prospectus that it will use the proceeds of the stock issue to build two wood processing plants, and it later decides to build only one, making it double the originally planned capacity, the shareholder should not be able to interfere. On the other hand, if it builds no wood processing plants, but instead sets up a taxicab company, perhaps the shareholders should be able to interfere. Perhaps there should be a difference between the result when the promise concerns future financial policy of the corporation and the result when the promise concerns future business activity. There may be less need for flexibility in the former than in the latter, and in the latter the corporation's actions are more apt to be influenced by circumstances beyond its control but to which it must react.

The result in *Carter Products* is undoubtedly correct. Apart from the alternative grounds for the decision, the balancing of interests completely justifies the application of promissory estoppel. There was no valid business or financial motive behind the issuance of non-voting stock. To have issued voting stock would have satisfied the corporate purpose just as well. On the other hand, injustice was sure

45. Special as opposed to the case of a large publicly-held corporation.

46. For example, under Tennessee law a small closely-held corporation is not exempt from the blue-sky law unless it has thirty or fewer subscribers to the issue aud the issue involves no morc than one hundred thousand dollars. TENN. CODE ANN. § 48-1632 (1956).

to result if the non-voting stock were issued and the common stock delisted. In general, application of promissory estoppel to the prospectus promise situation seems justifiable. Intelligent application of that doctrine by using a balancing approach will not unduly hamper corporate freedom of action. While there may be uncertainty at first, rules will rapidly become settled which block out large areas. At least one of these rules will probably be the following: In the absence of fraud, violation of prospectus promises will not subject the corporation to liability in a suit based on promissory estoppel when the violation is made necessary by valid business reasons. The stock purchaser is justified in relying on a promise only to that extent.