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Corporations—Fiduciary Duty of Director of Full and Frank Disclosure in Adversary Proceedings.—Alleghany v. Kirby

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a manufacturer who simply refuses to deal with a retailer selling below a minimum price does not act illegally.[16] As *Parke, Davis* points out, it is only when the manufacturer applies coercion above and beyond the simple refusal to deal that illegality arises. However, it should be noted that courts have not been at a loss to find the necessary coercion.[17] In view of this and the holding in the present case, it would appear that if there is any element of coercion used to enforce prices fixed by a consignment agreement, the courts will find a violation of the Sherman Act.

It is difficult, however, to conceive of a consignment agreement covering many retailers in which a court could not detect coercive measures. Indeed, even if a legal, non-coercive agreement could be drafted, it would invite expensive litigation. Therefore, it would seem that gasoline suppliers will in the future have to depend upon competition to maintain steady prices or else operate their own stations with their own employees. The latter solution appears to be preferrable in light of *United States v. Standard Oil Co.*[18] where the government noted that gasoline companies have the right to operate their own stations and to sell in them any products they manufacture or distribute.

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Corporations—Fiduciary Duty of Director of Full and Frank Disclosure in Adversary Proceedings.—*Alleghany v. Kirby*.[1]—In December, 1949, Kirby, president of the Alleghany Corporation, and three other officers and directors voted to exchange their personally held shares of Alleghany preferred stock for Alleghany's holdings of Investment Diversified Services, Inc. (IDS). Kirby transferred his Alleghany stock to Alleghany for 24,062 shares of IDS priced at slightly over $8. In 1954 the IDS stock had risen to $200 per share and Kirby had profited by more than $4,500,000. Several suits were brought against Kirby and others in state and federal courts in 1954-1955 by stockholders of Alleghany. Ten of these suits were consolidated under the title, *Zenn v. Anzalone*.[2] The consolidated complaint alleged a conspiracy by Kirby and others to enrich themselves at the expense of Alleghany and fraudulently to induce the stockholders to ratify such acts by misrepresenting the financial picture of IDS in proxy statements used at the stockholders' meeting of May 3, 1950. The focal point of the *Zenn* suit was the IDS stock deal and the inside knowledge of the defendants concerning the enormous prospective increase in earnings of IDS.

A settlement stipulation was drafted in July, 1955. After notice was given to all stockholders, a referee began a hearing on the merits of the fairness and adequacy of the settlement, which was, in effect, a hearing on the merits

16 Klein v. American Luggage Works, Inc., 323 F.2d 787 (3d Cir. 1963).

17 See 5 B.C. Ind. & Com. L. Rev. 687 supra note 8 for some conditions relied on by the courts to find this element of coercion.

18 78 F. Supp. 850 (S.D. Cal. 1948).

1 333 F.2d 327 (2d Cir. 1964).

2 17 Misc.2d 897, 191 N.Y.S.2d 840 (Sup. Ct. 1959).

of the suits. Kirby was never served process to appear at the hearing. After protracted negotiations, the defendants' offer of $3,000,000 cash and return of control of IDS to Alleghany was accepted and judgement upon the settlement was ordered by the Supreme Court, N.Y.C. in December, 1959.

The appellant-stockholder in the noted case, seeking to overturn the judgment on the *Zenn* settlement, introduced before the district court documents which were not in evidence in the *Zenn* hearings. These documents, found subsequent to the settlement, were allegedly withheld by Kirby from the referee in *Zenn*. The appellant claims that Kirby was under an affirmative duty to disclose such facts and that his nondisclosure constitutes fraud sufficient to warrant vacation of the judgment on the *Zenn* settlement. The court found that the plaintiff failed to establish that Kirby committed a fraud upon the state court or its referee in failing to produce documents which were not called for at the hearings and most of which were not in his possession but rather in the possession of IDS.[3] Appeal was taken to the Court of Appeals for the Second Circuit. HELD: A director's fiduciary duty of disclosure of material facts to the stockholder ceases when action is brought against him by the stockholders. A director becomes an ordinary adversary with no greater obligation of disclosure than that required by court process.[4]

The court reasoned that because derivative suits are based upon the belief that wrongdoing directors will not confess their wrongful acts, they cannot be considered fiduciaries once suit is commenced against them. The stockholders no longer consider them fiduciaries in relation to the subject matter of the suit, and therefore the directors have every right to defend themselves as ordinary adversaries. The court further reasoned that the plaintiffs representing the interests of the firm had sufficient opportunity to press the suit against the director. In addition, if the appellant's theory were accepted, the finality of suits would be seriously threatened, because in a trust or fiduciary situation any newly discovered evidence which a director did not bring forward and which might have changed the result would be enough to overturn a judgment.

The dissent maintained that it could perceive no principle which would lessen the director's duty because of a derivative suit. The director's obligation of full and frank disclosure to disinterested co-directors and stockholders should continue even in the adversary situation of a stockholder's action against the director. This is particularly true when the director remains in control of the corporation, its officers and its relevant files. The director is, in effect, in control of the outcome of the suit. The director should not have to search out information against himself, but should be under a duty to bring before the court material facts within his own knowledge.

There is a practical need for extending the present fiduciary duties of a director to the area of an adversary situation, and there is also a legal basis

3 Alleghany Corp. v. Kirby, 218 F. Supp. 164, 188 (S.D.N.Y. 1963).

4 The court also held that "nondisclosed" evidence must be such as would require a new trial in order to support a collateral attack on a state court judgment. Cumulative evidence of fraud giving rise to the original suit is not enough.

for the extension in the trend toward rising standards of director loyalty[5] in analogous areas. These shall be discussed in turn below. This extension of a director's duty would produce one basic change. Under present case law, when any transaction by a director is challenged by the corporation and stockholders on the grounds of self-dealing, the director is under the burden "not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein."[6] If a director is subjected to the new duty of full and frank disclosure of material facts during a suit against him, he would be required to bring forth evidence proving not only the fairness of his action, but also its unfairness, if any existed. Under this new duty nondisclosure would, upon discovery by a plaintiff-stockholder, be grounds for setting aside any judgment obtained by a director, because his action would constitute a breach of trust.

Because there is no direct authority supporting the theory of extending a director's fiduciary duty of full and frank disclosure to an adversary situation, it is necessary to draw support from analogous areas in which the trend is to increase the standard of loyalty expected of a director. In one instance, because of "flagrant betrayal of their fiduciary duties by directors and officers . . ."[7] with regard to the use of confidential information gained in their fiduciary capacity, Congress enacted Section 16 of the Securities Exchange Act of 1934.[8] Under section 16, a director's opportunity to profit by his inside knowledge of the corporation's activities is severely restricted. Before 1934 a director was relatively free to trade in company securities, and most courts found no duty running from a director to the stockholder under the circumstances of a wholly personal transaction.[9] There was, however, some authority for the proposition that a director might owe a fiduciary duty to an individual stockholder.[10] This duty was based upon the director's superior position with regard to inside knowledge of the corporation's activities, and cases upholding such a duty required disclosure by the director to the stockholder of material facts bearing on the value of the securities. Under section 16 a director is now required to report to the Securities Exchange Commission all securities he owns in the registered corporation[11] and to return to the corporation all "short swing" profits made on the purchase and sale of company securities within any six month period.[12] The arbitrary strictness of the act is shown by the fact that no actual *use* of inside information or intention to get out on a "short swing" is required

5 See, e.g., Kohler v. Kohler Co., 208 F. Supp. 808 (E.D. Wis. 1962); Brophy v. Cities Service Co., 31 Del. Ch. 241, 70 A.2d 5 (1949).

6 Pepper v. Litton, 308 U.S. 295, 306 (1939).

7 S. Rep. No. 1455, 73d Cong., 2d Sess. 55 (1934).

8 Securities Exchange Act of 1934 § 16, 48 Stat. 896 (1934), 15 U.S.C. § 78p (1958).

9 See, e.g., Blabon v. Hay, 269 Mass. 401, 407, 169 N.E. 268, 271 (1929).

10 Oliver v. Oliver, 118 Ga. 362, 45 S.E. 232 (1903).

11 Securities Exchange Act of 1934 § 16(a), 48 Stat. 896 (1934), 15 U.S.C. § 78p(a) (1958).

12 Securities Exchange Act of 1934 § 16(b), 48 Stat. 896 (1934), 15 U.S.C. § 78p(b) (1958).

in order to give rise to liability under section 16.[13] The duty of a director to disclose all material facts to the court during a derivative suit, if adopted, would parallel section 16 in two major respects. First, the corporation and stockholders would be protected from the director's ability to profit by inside information and the standard of disclosure would be strict. Second, the duty of disclosure, like the requirement of return of profits under section 16, would apply regardless of a director's intent; for a breach of the new duty would not be judged by a director's mental state concerning the nondisclosure, but by the materiality of the facts not brought before the court during litigation.

Another supporting analogy may be drawn from the area of stockholder ratification, in which disclosure of inside knowledge of a director is again of major importance. A director has a duty to disclose all improper transactions and material facts concerning his own actions or ratification by stockholders will not be upheld by a court of law.[14] A director might otherwise be able to camouflage improper transactions under a blanket approval by stockholders without the benefit of specific information concerning the transactions they are called upon to ratify. To require full and frank disclosure by a director in regard to stockholder ratification and then to allow him to obtain a court judgement for the breach of such a duty without the same requirement of full and frank disclosure seems inconsistent and does not provide the stockholder and corporation with adequate means of protecting their interests. A director will not be deterred from making fraudulent proxy statements or taking other illegal actions so long as he knows that once in court he will be relieved of the duty of disclosing any material facts that the plaintiff shareholders have not been able to uncover. By requiring a director to observe the standard of full and frank disclosure throughout court proceedings, the chances of retaining profits fraudulently acquired would be reduced; and directors in some instances could conceivably be deterred from fraudulent practices in the first place, with a resultant decline in derivative suits by stockholders. Granting that the finality of judgments on suits or settlements would be threatened by the adoption of the new duty, the overall effect might be a net decline in litigation.

A third analogous area is that of corporate opportunity, in which the courts have recently begun to consider a director's role from an even more demanding point of view. There is developing in this area an advanced notion of affirmative duties in that a director ". . . cannot use his power for his personal advantage . . . no matter how meticulous he is to satisfy technical requirements"[15] of his office. Early cases imposed constructive trusts on profits and property which directors gained by taking personal advantage of opportunities, such as options, which were available to the corporation and in which the corporation had some *existent right*.[16] If the corporation had no present interest in an opportunity coming to the attention of a director, he was under no legal obligation to tender it to the corporation. In the later

[13] Rheem Mfg. Co. v. Rheem, 295 F.2d 473 (9th Cir. 1961).
[14] Atlas Coal Co. v. Jones, 245 Iowa 506, 61 N.W.2d 663 (1953).
[15] Pepper v. Litton, supra note 6, at 311.
[16] Lagarde v. Anniston Lime & Stone Co., 126 Ala. 496, 28 So. 199 (1900).

case of *Rosenblum v. Judson Eng'r Corp.*[17] defendant directors and officers of a corporation which manufactured wheel alignment devices set up a partnership to manufacture a wheel-balancing machine and other equipment for use in wheel alignment. The court held that tender of the opportunity of entering this new field to the corporation was demanded despite the corporation's lack of a vested interest in it. The opportunity was considered to be *too closely associated* with the existing and prospective activities of the corporation to be withheld. It has been held that even a corporation's incapacity to accept an opportunity does not give the director a right to take it.[18] The House of Lords has said that if an opportunity to purchase comes to directors solely by reason of their being directors, they are liable to the corporation for any profit derived from it.[19] It is immaterial that the corporation is unable to make the purchase itself. Justice Cardozo said, "Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions."[20] Considering the foregoing, the exception to a director's undivided loyalty allowed by the courts during derivative suits seems unwarranted.

During litigation a trustee is under a duty to disclose all material facts, or the judgment will be overturned upon proof of nondisclosure.[21] The appellant, in the noted case, argues that the comparison drawn between a trustee and a director in pre-litigation activities ought to be carried over into the area of litigation where the duty of disclosure upon the trustee is strict.[22] The appellee argues that the defendant-director appears in a derivative suit solely in an individual capacity whereas the trustee is acting during any litigation in his fiduciary capacity.[23] The strength of this argument depends upon the efficacy of a derivative suit to represent the corporate interests. If derivative suits adequately represent the corporate interest, there is no necessity for the courts to treat directors as trustees with the correspondingly stricter standard of disclosure.

The corporate interest, however, is not adequately represented during derivative suits for many reasons. Most importantly, the average stockholder who suspects wrongdoing by directors will not be able to obtain detailed information and proof of the specific wrongs.[24] Despite discovery, the stockholder-plaintiff will have difficulty in obtaining information on complex transactions. The expense of litigation and difficulties in organizing shareholders for collective action are clearly not outweighed by the prospects of a successful suit, for all benefits of such a suit accrue to the corporation.[25] Even when the plaintiff has substantial proof, as in the noted case, the

17 99 N.H. 267, 109 A.2d 558 (1954).

18 E.g., Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d Cir. 1934).

19 Regal v. Gulliver, [1942] 1 All E.R. 378 (H.L.).

20 Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928).

21 Matter of Lautz, 128 Misc. 710, 220 N.Y. Supp. 782 (Surr. Ct. Erie County 1927).

22 Brief for Appellant for Rehearing en Banc, Appendix A, pp. 1-18.

23 Brief for Appellee, pp. 43-52, 65, 66, Alleghany v. Kirby, 333 F.2d 327 (2d Cir. 1964).

24 See, e.g., Davis v. Cohn, 260 App. Div. 624, 23 N.Y.S.2d 104 (1940).

25 Swanson v. Traer, 354 U.S. 114 (1957).

plaintiff comes under great pressure to settle.[26] The great consumption of time in a derivative suit and the prospect of losing all if the case is litigated on the merits frequently leaves the plaintiff-shareholder with little choice but to settle. Recovery by corporations in New York court settlements amounts on the average to three per cent of the amount sued for.[27] The unrepresentative nature of derivative suits severely undercuts the theory of the majority's opinion in the noted case. Because the corporate interest must be represented, and because the ordinary derivative suit does not fulfill the task, the burden of sustaining the corporate welfare logically should devolve upon the director. By requiring the director to observe the standard of full and frank disclosure during litigation, derivative suits would be made more effective, because a director's ability to control litigation and to effect an outcome favorable to himself would be lessened considerably.

In summary, because of the lack of precedent bearing on this issue, the courts will have to weigh the two contrary viewpoints on the director's duties during derivative suits. Balanced against the threat to the finality of judgments is a desirable strengthening of the stockholder's position in derivative suits. Although imposition of this duty may not produce immediate compliance by wrongdoing directors, the remedies of stockholders will not be cut off by an adverse decision. If a director withholds material evidence of his wrongdoing, it will constitute a breach of duty and provide the stockholder with the procedural means of overturning an unjust decision favoring the wrongdoer. The adoption of this new duty seems clearly in line with the trend in case law toward a higher standard of loyalty of directors to their corporation and stockholders.

JOHN A. DONOVAN

Damages—Income Taxes—Compensation Basis for Wrongful Death Act.—*Cunningham v. Rederiet Vindeggen A/S.*[1]—While unloading cargo, a longshoreman was killed by a falling hatch boom on defendant's vessel which was moored in New York territorial waters. His administratrix brought this admiralty action in the United States Court for the Southern District of New York[2] to recover her damages as the wife-beneficiary under the New York wrongful death act.[3] Finding defendant's equipment unseaworthy, the trial court was required to compute fair and just compensation for the pecuniary injuries to the wife as a result of the wrongful death.

26 Report of the SEC on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees, 675-76 (1937), pt. 1.

27 Hornstein, Legal Controls for Intracorporate Abuse—Present and Future, 41 Colum. L. Rev. 405, 426 (1941).

1 333 F.2d 308 (2d Cir. 1964).

2 Although the longshoreman's widow did not qualify for the admiralty provisions of the Death on the High Seas Act, 41 Stat. 537 (1920), 46 U.S.C. §§ 761-68 (1958), admiralty in personam remedies which follow New York law were available on account of death within the territorial waters of that state. The Tungus v. Skovgaard, 358 U.S. 588 (1959); Western Fuel Co. v. Garcia, 257 U.S. 233 (1921).

3 N.Y. Decedent Estate Law §§ 130-35.