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FRAUD OR MISREPRESENTATION BY PURCHASER
INDUCING SALE OF SHARES OF STOCK

By William Q. de Funiax*

In the majority of cases involving the right to rescind a sale of property induced by fraud or misrepresentation, or to recover damages therefor, the fraud or misrepresentation involved is that of the seller. However, there is a very considerable amount of authority, particularly in regard to the sale of land, wherein the fraud or misrepresentation inducing the sale is that of the purchaser.¹

In sales of shares of stock, leaving aside the considerable number of cases involving misrepresentation by a corporate officer or director in inducing the sale to him, the overwhelming majority of cases concern misconduct of the seller in inducing the purchaser to buy. It is true, of course, that the majority view,² followed in Kentucky,³ is that a director does not by virtue of his office sustain any fiduciary relation to a stockholder of the company, and may deal with him and purchase his stock on the same terms as a stranger. Thus such cases provide authority for the application of legal principles to the scant number of cases where the purchaser inducing the sale to himself is in fact a stranger to the seller.

The recent case in the Ohio Court of Appeals, Hamilton County,⁴ involving the former Banco Kentucky company, presents the somewhat unusual and interesting situation where a purchaser, who was not a director, was accused by the seller of inducing the sale of stock by misrepresentations as to its value.

In that case, the facts show that the Banco Kentucky owned practically all the stock of two Cincinnati banks which were

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² See Note (1928), 56 A. L. R. 429, on duty of purchaser of realty to disclose to vendor facts or prospects affecting value of property.


members of the Cincinnati Clearing House Association. Banco Kentucky pledged the stock to a New York bank as collateral to secure a loan. When Banco Kentucky was in financial difficulties due to the collapse of Louisville banks, whose stock it held, the New York bank threatened to sell the collateral. Thereupon, Banco Kentucky and the New York bank entered into negotiations with the Cincinnati Clearing House Association, for the sale to it of the stock of the Cincinnati banks, and the sale was consummated.

Thereafter, the receiver of Banco Kentucky brought suit against the clearing house, alleging (and the court stated that there was evidence to substantiate such claim) that the clearing house represented the Cincinnati banks to be in a more serious condition than the facts warranted, that the Banco Kentucky was under heavy pressure, and relied upon the representations of the clearing house and gave it the full benefit of its contents, and sold the stock at the sum set by the clearing house. It appeared that the clearing house had later sold these Cincinnati banks to a member bank for a sum largely in excess of the amount it had paid to Banco Kentucky, which excess was the subject of the litigation.

The receiver contended that the clearing house had become unjustly enriched by reason of the purchase and sale and had violated its fiduciary duty to its two member banks involved in the sale, that the clearing house had stated (which the court declared to be true) that it did not desire to make a profit, that the two Cincinnati banks were solvent, and that if the clearing house had supported them they would have remained unimpaired (which the court also admitted to be true). The receiver likewise alleged that under financial stress and by reason of fatigue undue advantage was taken of the vendors of the stock.

The court declared that any fiduciary duty that the clearing house owed was to its member banks and not to the Banco Kentucky, the virtual owner of the two banks. Disregarding corporate fiction revealed the actual ownership of the two Cincinnati banks to be in Banco Kentucky to whom the clearing house owed no duty because it was a foreign bank.

As to the contention of undue advantage, the court said:

"The plain situation here presented is that the vendors of the stocks relied upon statements made by the vendee concerning the
value of the stocks owned by such vendors. It is certainly a new doctrine that a vendor may hold a vendee to account for unjust enrichment, because he sells what he owns at a loss, because he relied upon misstatements of the vendee as to the value of that which he sells."

The court further stated that it knew of no principle of law or equity permitting recovery upon the statement of facts in the petition, that in many instances the charges of misrepresentations were not sustained, and that it was not shown that the vendors could have made a better bargain elsewhere. The court also pointed out that in another proceeding by the receiver against stockholders and directors of Banco Kentucky, the loss alleged by reason of the sale of the stock was attributed to other causes, and while that might not amount to an election of remedies by the receiver, his position was at least inconsistent.

It would seem that this case may be subjected to some criticism. Thus, why should it be necessary that the vendors show that they could have made a better bargain elsewhere? It is true that such a showing would be of evidentiary force as indicating that the value placed on the stock by the clearing house was too low, but the resale of the stock at a much higher price by the clearing house would indicate that fact just as well. If it is argued that the only market for the stock was by sale to the clearing house, and that accordingly any price offered by the clearing house would constitute a "market value", it may be pointed out that the clearing house did not confine itself to a mere negative attitude, but affirmatively represented the condition of the banks to be more serious than it actually was, that it did not desire to make any profit from the transaction, etc.

Objection may also be made to the statement of the court that it is certainly a new doctrine that a vendor may hold a vendee to account because he sells what he owns at a loss, relying upon misstatements of the vendee as to the value of that which he sells. Aside from any question of fiduciary duty on the part of a vendee, situations may certainly arise wherein a vendee by positive acts takes advantage of an innocent vendor.5

The court held, it will be recalled, that while the clearing house owed a fiduciary duty to the two member banks, disregard of corporate fiction showed that a foreign bank was the actual owner of the two Cincinnati banks, and to such foreign bank the

5 Supra, note 1.
clearing house owed no fiduciary duty while dealing with it for the purchase of the stock. Upon analysis, this will be found to be very similar to the situation of a director of a corporation. While he occupies a trust relation to the corporation which he directs, he sustains no fiduciary duty to a stockholder in transacting a purchase of stock from the stockholder. However, if the director is questioned concerning the condition of the corporation by the stockholder, he must give truthful replies, and if he undertakes to tell the stockholder about the value of the stock, the earning power of the corporation, etc., he must adhere to the truth.

The application of such a rule to the Banco Kentucky case might well have brought about a different result in the decision of the case.

The writer knows of no Kentucky case involving precisely similar facts as that of the Banco Kentucky case discussed above. There are, however, several cases involving the contention that an officer or director of a corporation, by fraud or misrepresentations, induced a stockholder to dispose of his stock to such officer or director. Reference has already been made in the footnotes to Waller v. Hodge, and Barth v. Fidelity & Columbia Trust Co. In both of these cases there was found to be no fiduciary duty on the part of a director to a stockholder from whom he purchased stock, nor was there any concealment or misrepresentation on the part of such director. The stockholders appear to have made no inquiries or sought any information, and in the Waller case the stockholder took the initiative in approaching the director, and also set the price at which he would sell.

In Simrall v. Williamson, however, the president of a corporation, organized to build a bridge over the Ohio River, had been empowered by the directors to negotiate for funds to effect

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7 Supra, notes 2 and 3.
8 Fletcher Cyc. Corp. (Perm. Ed.), § 1172; and supra, note 3.
10 Supra, notes 3, 6, and 7.
11 To same effect, see opinion of United States Circuit Court of Appeals for Sixth Circuit in Blakeslee v. Wallace, 45 F. (2d) 347 (C. C. A. 6th, 1930).
the construction. While occupying that position he induced a stockholder to surrender his stock, by representing that he had been unable to secure funds for construction, that he despaired of obtaining any contract which would return any profit, and that he had made arrangements with certain persons by which all stockholders would be reimbursed by such persons upon surrendering their stock. Within a few days after this transfer, the president closed a very favorable contract for the construction of a bridge.

In the suit by the stockholder to rescind the stock transfer, the court held that no citation of authority was necessary to show that the stockholder was entitled to rescission. The court pointed out that the president was acting in the capacity of a trustee, and it was not so much the duty of the stockholder to inquire into the facts for himself, as it was the duty of the trustee to disclose them in full, and that he could not make any statement of fact to mislead or deceive the stockholder.13

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13 Another suit against the president of this corporation, upon his promise to transfer stock in the corporation in return for the prospective stockholder canceling a bridge construction contract which he held, is reported in Williamson v. Krohn, 13 C. C. A. 668, 66 Fed. 655 (1895).