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INTERESTED DIRECTORS IN CORPORATE TRANSACTIONS

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The Youngstown-Bethlehem merger case¹ having awakened a great deal of interest in the problem of the effect of common directors upon intercorporation transactions, and Indiana having made a bid for corporate business by enactment of her General Corporation Act of 1929,² the question of what our courts will do with such transactions justifies inquiry. Cases presenting the problem of transactions between interlocking directors are only one phase, though a large and important one, of the general category of cases in which a board of directors enters into a transaction in which one or more of them have an adverse interest. Indiana, showing remarkable versatility, has announced her adherence in one case or another to almost every possible rule on the subject.³

* See biographical note, p 452.

¹ Common Pleas, Ohio. The opinion is reported in *The New York Times*, Dec. 30, 1930, p. 10, and in *The Wall Street Journal*, Dec. 30, 1930, p. 14.

² Acts 1929, Ch. 215; Schortemeier and McNutt, *Ind. Gen. Corp. Act. Ann.* (1929).

³The holdings of some of the cases are, chronologically: any contract in which a director has an adverse interest is voidable upon mere showing of the interest, whether fraud or unfairness is present or not, *Port v. Russel*, 36 Ind. 60 (1871); such a contract is valid unless fraud is proved, *Hill v. Nisbet*, 100 Ind. 341 (1884); such a contract is governed by principles of agency, requiring honesty from the agent in managing his principal's affairs, *Wayne Pike Co. v. Hammons*, 129 Ind. 368 (1891); such contracts are valid unless fraud is proved, *Evansville Public Hall Co. v. Bank of Commerce*, 144 Ind. 34 (1896), *Smith v. Wells Mfg. Co.*, 148 Ind. 333 (1897); such contracts may be valid, voidable or void, depending upon the contract and the circumstances of its creation. *Wainwright v. Roots Co.*, 176 Ind.

There have been three main doctrines advanced by the courts in attempting to cope with contracts of a corporation entered into on its behalf by a board of directors of which the membership is personally interested. One doctrine is to hold them voidable upon mere proof of personal interest. No showing of fraud or unfairness is necessary.⁴ This has been called the "prophylactic principle."⁵ Corporate directors are in a fiduciary position as to the stockholders,⁶ and on the strength of that relationship equity, according to principles of the strictest morality, will refuse to allow temptation to be put in the way of the fiduciary for fear that human nature will break down under so severe a test. The court will not inquire into the fairness of the transaction.⁷ Directors simply have no power to make such contracts under strict trust rules. Nor does it make any difference whether or not the interested member of the board votes; the transaction will still be voidable *ipso facto*.⁸

682 (1912); such contracts are valid subject to a close scrutiny of the court for absence of good faith, *Bossert v. Geis*, 57 Ind. App. 384 (1914); such a contract is voidable unless good faith and fairness is proved, *Zaring v. Kelly*, 74 Ind. App. 581 (1920); such a contract is valid unless fraud is proved, *Public Service Com'n. v. City of Indianapolis*, 193 Ind. 37 (1922); such a contract is voidable unless good faith and fairness is proved, *Schemmel v. Hill*, Ind. App., 169 N. E. 678 (1930).

⁴ *Port v. Russel*, 36 Ind. 60 (1871); *Munson v. S., G. & C. R. R. Co.*, 103 N. Y. 58 (1886); *Globe Woolen Co. v. Utica Gas Co.*, 151 App. Div. (N. Y.) 184 (1912); Pam, *Interlocking Directorates*, 26 Harv. Law Rev. 467, 473 (1913).

⁵ Ballantine, *Corporations*, 384 (1927).

⁶ *Hill v. Nisbet*, 100 Ind. 341, 353 (1884). A director is, strictly speaking, neither a trustee nor an agent. He may, however, be spoken of as being in a fiduciary position or a position of trust. As to this, see Johnson, *Corporate Directors as Trustees*, 23 Ill. Law Rev. 653 (1929); note in 29 Col. Law Rev. 338, 345 (1929).

⁷ "[The law] does not stop to inquire whether the contract or transaction was fair or unfair. It stops the inquiry when the relation is disclosed, and sets aside the transaction or refuses to enforce it, at the instance of the party whom the fiduciary undertook to represent, without attempting to deal with the question of abstract justice in the particular case. . . . The value of the rule of equity to which we have adverted, lies to a great extent in its stubbornness and inflexibility. Its rigidity gives it one of its chief uses as a preventive or discouraging influence, because it weakens the temptation to dishonesty or unfair dealing on the part of trustees, by vitiating, without attempt at discrimination, all transactions in which they assume the dual character of principal and representative." *Munson v. S., G. & C. R. R. Co.*, 103 N. Y. 58, 74 (1886).

⁸ "Nor is it important that plaintiff's president in the transaction in

Aside from the application of the principles of trusteeship to the conduct of directors, there are certain practical arguments respecting proof which are advanced by the courts that support this doctrine. "It prevents frauds by making them so far as may be impossible, knowing that real motives often elude the most searching inquiry. . . . The law can not accurately measure the influence of a trustee with his associates. . . ."9

This strict trust rule has been applied once in Indiana, in an early case.10 The Ohio court, however, recently made this rule a decisive factor in the *Youngstown Case*.11

The second and most liberal doctrine respecting transactions in the category with which we are dealing, holds them to be valid unless fraud or unfairness is shown. The burden is upon the party seeking to avoid the contract to furnish proof of such fraud or unfairness.12 This rule is generally stated as applying

question represented the defendant silently; that he did not openly advocate or vote for the adoption of the contracts. His negotiation of the same implied and carried with it the force and effect of his approval." *Globe Woolen Co. v. Utica Gas Co.*, 151 App. Div. (N. Y.) 184 (1912).

"In law it should be immaterial how many directors vote in favor of a contract or transaction in which a director, directly or indirectly, has an interest; it should be set aside, and relief granted to the corporation and its stockholders, even though the interested directors refrain from voting." Pam, *Interlocking Directorates*, 26 Harv. Law Rev. 467, 473 (1913).

9 *Munson v. S. & C. R. R. Co.*, 103 N. Y. 58, 74 (1886). "We cannot close our eyes to conditions as they are. We do know, in modern practice, that one individual director frequently, if not in a majority of cases, is the dominant force in the conduct of corporate affairs. We do know that banking firms and banking institutions whose representatives are on boards of directors of different corporations, have a sphere of influence in the deliberations and decisions of such boards of directors that is not measured by the number of votes, but by the power exerted through relations and affiliations of common interest." Pam, *op. cit.*, *supra*, note 8.

10 *Port v. Russel*, 36 Ind. 60 (1871). See also *Ward v. Yarnelle*, 173 Ind. 535, 561-563 (1910), where, in a case in which a director was also a secret partner in a firm that made a contract with his corporation, the court reached the "prophylactic" result on principles of agency.

11 "A director whose official relation with both corporations was such as is in a matter of such vital interest to both could not help, by the very nature of the transaction, but he in adverse relation to one or the other. He could not be neutral. He could not act wholly as a trustee for the selling corporation. . . . No question of the fairness of the transaction or of his acts or intent is necessarily involved. The doctrine which here controls arises solely from the nature of the transaction, the relation of the parties thereto and the director's relation to them." *Supra*, note 1.

12 *Evansville Public Hall Co. v. Bank of Commerce*, 144 Ind. 34 (1896);

in cases in which the interested directors are in a minority.¹³ It is said to be the prevailing view.¹⁴

Since it is an exceedingly liberal rule it is interesting to notice that it was adopted in the three Indiana cases actually involving interlocking directorates, all other cases on the subject being those in which directors had adverse interests as private individuals. Inasmuch as the language used by courts takes color from the factual background into which it is being fitted, the three common director cases will bear examination. The first, *Evansville Public Hall Company v. Bank of Commerce*,¹⁵ was a case in which the directors and officers of a corporation, on its behalf, borrowed money from a bank in which also they were directors, giving a note therefor. When the note was sued on, the court merely touched upon the common directorate, quoting and following a rule from *Thompson on Corporations*, that, "while a contract between two corporations having common directors may be voidable, it is only so when the contract is in fraud of the interests of one of the corporation, and will never be set aside by the courts where the honesty of the transaction is manifest."

In the second case, *Smith v. Wells Manufacturing Company*,¹⁶ X was a common director of A corporation and B corporation. A was indebted to B and also to other creditors to an extent that it was insolvent. X procured a mortgage in favor of B on all of A's property. When A's other creditors protested and threatened to sue to have the mortgage set aside, X was authorized by his fellow directors in B "to do the best he could in the matter." He released the mortgage. Subsequently B's directorate repudiated the release. On an agreed statement of facts it was stipulated that no fraud was involved. The court said that X's acts, both in accepting the mortgage and in releasing it, were valid. "It is held also that the mere fact that a contract is made between two corporations having common directors does not render such contract fraudulent or void."

Smith v. Wells Mfg. Co., 148 Ind. 333 (1897); *Wainwright v. Roots Co.*, 176 Ind. 682, 692 (1912); *Bossert v. Geis*, 57 Ind. App. 384, 390-392 (1914); *Public Service Commission v. City of Indianapolis*, 193 Ind. 37 (1922).

¹³ *Jesup v. I. C. R. Co.*, 43 F. 483, 499 (C. C., N. D. Ill., 1890); *Rolling Stock Co. v. Railroad*, 34 Ohio St. 450, 465-466 (1878). See also notes in 15 Harv. Law Rev. 672 (1902), and 29 Col. Law Rev. 338 (1929).

¹⁴ Ballentine, *Corporations*, 392 (1927).

¹⁵ 144 Ind. 34 (1896).

¹⁶ 148 Ind. 333 (1897).

Public Service Commission v. City of Indianapolis,¹⁷ the third case, involved the merging of seven public utility companies into an eighth, the plan having been approved by the Commission. There were interlocking directorates throughout. The attack on the plan was by the city of Indianapolis. Said the court: "That two corporations have a majority or the whole membership of their boards of directors in common does not necessarily render transactions between them void, in the absence of other facts showing fraud even as against stockholders. . . ."

Three cases better adapted to the application of extreme liberality would be hard to imagine. In the first the common directorate was obviously being used only as a shield against the payment of a fairly owned debt; in the second all question of fraud was excluded by an agreed statement of facts; and in the third the contract had been approved by the Public Service Commission, and was being attacked, not by a stockholder, but by an outside party.

Directors of an insolvent corporation in Indiana are allowed to prefer themselves or those for whom they are sureties as creditors for *bona fide* claims.¹⁸ This is subject at least to the criticism that it allows the directors to use their position for a personal gain which was never intended to be an incident of that position. It does not seem to be the majority view in America.¹⁹

Before criticizing the foregoing doctrines let us consider the third. It is that contracts in which directors are adversely interested are presumptively voidable, the burden being upon those who would uphold the contract to establish its absolute fairness. The doctrine can be supported on principles either of agency²⁰ or of the trust relationship.²¹ It was well stated by the New Jersey court in *Robotham v. Prudential Insurance Company*:²² "The safe rule in most cases in the end will be found to be that the presence of a director or directors on both sides of the trans-

¹⁷ 193 Ind. 37 (1922).

¹⁸ *Nappanee Canning Co. v. Reid, Murdock & Co.*, 159 Ind. 614 (1903); *Adams Co. v. Federal Glass Co.*, 180 Ind. 576 (1913). But see *City Nat. Bank v. Goshen Woolen Mills Co.*, 35 Ind. App. 562 (1904), declaring such arrangements voidable *per se*, which was overruled, however, upon being transferred to the Supreme Court, 163 Ind. 214 (1904).

¹⁹ Fletcher, *Cyclopedia of Corporations*, Sec. 2271 (1919).

²⁰ *Rochester v. Levering*, 104 Ind. 562, 568 (1885).

²¹ *Zaring v. Kelly*, 74 Ind. App. 581, 583 (1920).

²² 64 N. J. Eq. 673, 709-710 (1903). See also note in 16 Harv. Law Rev. 510 (1903).

action under investigation does not give the dissenting stockholder an arbitrary right to an injunction, but may give him a most ample right to subject the transaction to the scrutiny of the court, and may cast upon the corporations or directors concerned the burden of disclosing and justifying the transaction." This rule has also the sanction of the Supreme Court of the United States, where it has found expression in the following language: "The relation of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as jealously by the law as are personal dealings between a director and his corporation; and where the fairness of such transactions is challenged, the burden is upon those who would maintain them to show their entire fairness; and where a sale is involved, the full adequacy of the consideration. . . . This court has been consistently emphatic in the application of this rule, which, it has declared, is founded in soundest morality, and we now add, in soundest business policy."²³

It is submitted that of the three doctrines the third is the soundest. To declare all contracts and transactions in which a director has an adverse interest voidable *per se* too greatly hampers corporation business. Many instances arise in which such transactions are necessary or for the best interests of the enterprise. Moreover, the ultra strictness of the rule, which is supposed to be its dominant virtue, often has an effect exactly contrary to the intended "prophylactic" effect. It may simply cause transactions to take place under cover.²⁴ On the other hand, to declare contracts of the kind we are considering presumptively valid is neither fair nor in accordance with the fiduciary position occupied by directors. It places the burden of showing fraud or unfairness upon the parties who are attacking the contract, usually stockholders, who are in no such advantageous position to marshal evidence respecting corporate trans-

²³ *Geddes v. Anaconda Copper Mining Co.*, 254 U. S. 590, 599 (1921); also, *Corsicana National Bank v. Johnson*, 251 U. S. 68, 90 (1919).

²⁴ "To give the dissenting stockholder the arbitrary right to an injunction in this class of cases often will put a deadly weapon in the hands of the blackmailer and the corporation 'striker.' Such a rule tends to drive the actual wrongdoers to cover, to induce them to seek concealment, while the corporate action is accomplished through apparently impartial directors, who are, in fact, only agents or 'dummies.'" *Robotham v. Prudential Ins. Co.*, 64 N. J. Eq. 673, 710 (1903).

actions as are the directors. The third doctrine, of considering the contract presumptively voidable, places the burden of establishing its fairness upon those who are in command of the evidence, the directors. In the great majority of cases in which the contract actually is fair, they ought to have little trouble in proving it. This rule recognizes the frequent necessity of such transactions, while at the same time it reduces to a minimum the likelihood of undetected perpetration of fraud.

The Indiana Appellate Court has followed the third doctrine in two cases, one of them the most recent pronouncement in the state on the subject.²⁵ It is noticeable that the same rule would have worked equally well in any of the other Indiana cases: in those in which the contract actually was unfair, the decision clearly would have gone against the fundamental parties; and in the cases in which the contract turned out to be *bona fide* and valid, from the situations as set forth in the reports, the directors attempting to uphold the contracts should have been easily able to establish the fact of fairness. Although there seems to be a tendency to hold that contracts by a director with his corporation for lending money to it or performing personal services outside the scope of his official duties, are presumptively valid,²⁶ there would seem to be no reason for this exception to a uniform rule. It is a fact that the corporate director is in a position about as nearly like that of a trustee as is possible without actually being a trustee—a position giving him numberless opportunities to serve himself at the expense of his corporation. This fact is manifest in the large number of cases involving unfair practices of the director.²⁷ Therefore, when

²⁵ "The fiduciary relation of each of the appellants to the company was such that each had the burden of showing that he had acted in good faith with the company, and those concerned with its affairs, and this burden they failed to discharge." *Zaring v. Kelly*, 74 Ind. App. 581, 583 (1920). Cited and followed in *Schemmel v. Hill*, Ind. App. 169 N. E. 678 (1930). See also *Leader Pub. Co. v. Grant Trust Co.*, 182 Ind. 651, 661 (1915).

²⁶ *Twin-Lick Oil Co. v. Marbury*, 91 U. S. 587 (1875); *Kenner v. White-lock*, 152 Ind. 635, 637 (1899); *Wainwright v. Roots Co.*, 176 Ind. 682, 691 (1912); note in 29 Col. Law Rev. 338, 342-343, 347 (1929).

²⁷ Of course the reports of the cases do not and cannot always set forth the full intricacies of the transactions. Such information as is elicited in testimony by directors about their personal profits is usually given reluctantly. But as to what could be and was done by directors at the expense of their corporations in the insurance business before that business came under strict state supervision, see Rep. Joint Com. of Senate and Assembly, N. Y., Assembly Document No. 41, Vol. x, *passim*, and esp. pp. 28-36, 47-48,

he is in possession of all evidence respecting corporate transactions, especially those to which he personally is a party, to ask him to present proof of their fairness is surely no hardship upon him.

One important question remains: should directors who are also shareholders be allowed to vote as shareholders upon questions in which they have a personal interest different from that of the corporation? The prevailing rule says that they should. As stated by the Court of Errors and Appeals of New Jersey: "They [the director-shareholder] voted upon that resolution, not as directors, not in their fiduciary capacity, but solely in the right of the shares of stock held by them. A most valuable privilege, which attaches to the ownership of stock in a corporation, is the right to vote upon it at any meeting of stockholders . . . As stockholders, they owed no greater duty to their co-stockholders than those stockholders owed to them. Like other stockholders, they had a right to be influenced by what they conceived to be for their own interest, and they can not lawfully be denied that right, nor can it be limited or circumscribed by the fact that they occupied the position of directors in the company."²⁸ It is also held, under this rule, that what directors can not do as a board they can sometimes ratify and render valid by voting as stockholders.²⁹

The rule has been criticized by the writer of a note in the *Harvard Law Review*³⁰ on the basis that abrogation of it would affect only a very small class of shareholders and would give corporations a free hand in discarding undesirable contracts. The fallacy in the criticism is that, whereas the interested directors may be a small class of shareholders in point of members, they are by no means always small with respect to the number of shares owned, which after all is a factor of some importance in corporate voting. It is not at all unusual for one or more of the directors to own a majority of the voting stock; so that to take away their voting privilege would be to subject the corporation to minority rule without any practical necessity for so doing.³¹

67-68, 76-78, 80-81, 118-119, 126, 129-132, 138-143 (1906). Charles Evans Hughes, now Chief Justice Hughes, was examining counsel.

²⁸ *U. S. Steel Corp. v. Hodge*, 64 N. J. Eq. 807, 813 (1903). The English rule is in accord, the leading cases being *North-West Transportation Co. v. Beatty*, L. R., 12 A. C. 589 (1887).

²⁹ *Bjorngaard v. Goodhue County Bank*, 49 Minn. 483 (1892).

³⁰ 16 Harv. Law Rev. 587 (1903).

³¹ *Bjorngaard v. Goodhue County Bank*, 49 Minn. 483 (1892); *North-*

Indiana follows the majority view. In *Green v. Felton*,³² there was a shareholders' meeting, duly called, which was attended, however, only by shareholders who were also directors. A by-law was passed authorizing the board of directors to fix salaries for officers and directors. Under the authority of this by-law the board voted themselves an annual salary, which was found to be fair. A suit was brought by minority shareholders to compel the directors to account for sums so paid to them. The court decided for the directors, saying that, although in the absence of the by-law they had no authority to fix their own salaries, the by-law passed by them as shareholders gave them such authority as directors.

Of course, if a majority of the shares in a corporation happen to come into the hands of only one or several persons, who happen also to be directors, and they use the power thus acquired in fraud of the corporation and the minority shareholders, this can be remedied; but they can then be attacked in the courts in their capacity as majority shareholders as well as in their capacity as directors.³³

West Transportation Co. v. Beatty, L. R., 12 A. C. 589 (1887). In the latter case the decision was expressly rested upon the grounds that, "to reject the votes of the defendant upon the question of the adoption of the by-law would be to give effect to the views of the minority, and to disregard those of the majority."

³² 42 Ind. App. 675 (1908).

³³ "Another well recognized exception to the rule of majority control is the doctrine that the majority will not be permitted to exercise their control in such manner as to defraud the minority either by making an unfair profit out of dealings between them and the corporation or by reorganizing the corporation so as to 'freeze out' the minority." Dodd, *Nebraska Business Corporations*, 5 Neb. Law Bull. 380, 395 (1927); also Machen, *Modern Law of Corporations*, Sec. 1306 (1908); Fletcher, *Cyclopedia of Corporations*, Sec. 3973 (1919).