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Corporations - Effect of a Provision in Articles of Incorporation Permitting the Counting of Interested Directors for Quorum Purposes

James W. Callison S.Ed.
University of Michigan Law School

CORPORATIONS — EFFECT OF A PROVISION IN ARTICLES OF INCORPORATION PERMITTING THE COUNTING OF INTERESTED DIRECTORS FOR QUORUM PURPOSES —Plaintiffs, minority stockholders, sought to restrain the consummation of a merger agreement between defendant Mayflower and Hilton corporations because the plan had not been approved by a quorum of disinterested directors of Mayflower.[1] Defendants relied upon a provision in Mayflower's articles of incorporation which stated that " . . . any director may be counted in determining the existence of a quorum at any meeting of the Board of Directors of this Corporation for the purpose of authorizing any contract or transaction [between this Corporation and any other corporation in which any director or officer of this Corporation is pecuniarily or otherwise interested or is a director, member or officer of such corporation] with like force and effect as if he were not so interested, or were not a director, member or officer of such corporation. . . ."[2] In reply, plaintiffs contended that because this provision was contrary to the Delaware common law rule precluding the counting of interested directors for quorum purposes it was in violation of the corporation statute which permitted only provisions consistent with the law of the state to be included in articles of incorporation.[3] On appeal, *held,* such a provision does not violate the Delaware statute, at least in situations where the action

[1] Generally a director is deemed to be "interested" in a transaction when, as a result of the action taken by the board of directors, he may receive a financial benefit or be subjected to a financial loss, directly or indirectly. See SPELLMAN, CORPORATE DIRECTORS 465 (1931), and 2 FLETCHER, CYC. CORP., perm. ed., 213 (1931). In the principal case, Hilton owned 83% of Mayflower's stock. The court does not set out with clarity the interest which the Mayflower directors had, except to note they were all "nominees of Hilton." If they were not financially interested in Hilton, it may be doubted whether the mere fact that Hilton elected them would make them "interested" directors. It is not clear that even holding stock in Hilton would disqualify them. See 2 FLETCHER, CYC. CORP., perm. ed., 213 (1931).

[2] Principal case at 117, n. 3.

[3] Delaware General Corporation Law §5(8), Del. Rev. Code (1935) §2037(8). This provision is now found in Del. Code Ann. (1953) tit. 8, §102(b)(1).

taken by the board of directors must be submitted for stockholders' approval.[4] *Sterling v. Mayflower Hotel Corp.*, (Del. 1952) 93 A. (2d) 107.

In the absence of a contrary provision in the pertinent corporation statute, articles of incorporation or by-laws, a majority of the board of directors of a corporation constitutes a quorum.[5] When a quorum is present, a majority of the directors attending the meeting has power to decide any question coming before that meeting.[6] Nevertheless, a director who has a personal interest[7] in a contract or transaction with his corporation is generally not qualified to act for the corporation concerning such contract or transaction.[8] Thus, in the absence of a contrary provision in the corporation statute or articles of incorporation, it is held that a director cannot vote on a resolution affecting the subject of his interest, at least if his vote is necessary to carry or defeat the resolution.[9] This in turn has led the overwhelming majority of our courts to declare that an interested director cannot be counted for quorum purposes if the board is about to consider a question involving his interest.[10] Where an interested director attempts to act for the corporation, the approach is different from that taken where the court is considering the result of relations between a director, acting solely for himself, and his corporation. In the former situation, the director is usually held to be completely disqualified to act, without regard to his good faith or the fairness of his actions, while in the latter the fairness of the contract or transaction is of prime importance.[11] Although there is general agreement as to these basic rules, there is a remarkable lack of authority on the validity of a provision in corporate articles purporting to authorize the counting

[4] There was no provision in the Delaware statute relative to the right of an interested director to be counted for quorum purposes or to vote. Compare the Michigan General Corporation Act, Mich. Comp. Laws (1948) §450.13, ¶5, which may inferentially authorize certain interested directors to vote or be counted toward a quorum. It should be noted that the merger plan in the principal case was later approved by a majority of the Mayflower stockholders, which may have removed the necessity for prior action by the board of directors. The court assumed it did not in deciding the question presented.

[5] 2 FLETCHER, CYC. CORP., perm. ed., 204 (1931); SPELLMAN, CORPORATE DIRECTORS 338 (1931).

[6] 2 FLETCHER, CYC. CORP., perm. ed., 210 (1931).

[7] See note 2 supra.

[8] See the cases cited in notes 9 and 10 infra.

[9] Many cases are collected in SPELLMAN, CORPORATE DIRECTORS 471 (1931); 175 A.L.R. 577 at 596 et seq. (1948).

[10] The Delaware decision relied upon by plaintiffs in the principal case is Blish v. Thompson Auto. Arms Corp., 30 Del. Ch. 538, 64 A. (2d) 581 (1948). Many cases in support of the majority rule are collected in SPELLMAN, CORPORATE DIRECTORS 472 (1931); 2 FLETCHER, CYC. CORP., perm. ed., 211 (1931); and 175 A.L.R. 577 (1948). The few cases allowing the interested director to be counted for quorum purposes include Leavitt v. Oxford & G.M.S. Co., 3 Utah 265, 1 P. 356 (1883); Buell v. Buckingham & Co., 16 Iowa 284 (1864); Gumaer v. Cripple Creek Tunnel, etc., Co., 40 Colo. 1, 90 P. 81 (1907). The Colorado decision seems to have been overlooked by later Colorado cases, however. See cases cited in 175 A.L.R. 577 at 596 (1948). Some courts even hold that an interested director cannot be present during the discussion and vote on a matter involving his interest. See 175 A.L.R. 577 at 596 et seq. (1948).

[11] See excellent discussion in SPELLMAN, CORPORATE DIRECTORS 465 (1931).

of an interested director for quorum purposes. Specifically, the question is whether the stockholders may contract in opposition to the common law rule.[12] A provision similar to that in Mayflower's articles has been upheld by one other court.[13] There is also some authority which, while not squarely deciding this question, indicates that a similar result would be reached if the issue were raised. For example, there are some decisions, resting in part upon provisions authorizing interested directors to vote, which have approved action taken at meetings where there was an obvious lack of a disinterested quorum, although the quorum question was not specifically considered.[14] Jurisdictions which as a general rule do not permit interested directors to be counted for quorum purposes have sustained action taken in the absence of a disinterested quorum in particular instances.[15] Although broad language is used, these results usually rest upon some strong policy consideration such as the fact that an opposite decision would unduly delay corporate action without any countervailing advantage to the objecting stockholder. A by-law has been upheld which provided that directors originally counted as part of a quorum might withdraw when matters in which they had an interest were to be considered, and that the meeting, although thereafter made up of less than the number originally required for a quorum, might proceed with its business.[16] There are some considerations which indicate the soundness of these results. First, the common law rule appears to have been developed for the protection of stockholders. However, where the stockholders are notified in advance of the removal of the interested director's disabilities, it would seem they should have little complaint when the director acts for the corporation. They should be estopped from attacking bona fide action of the board merely because some or all of the directors counted for quorum purposes were interested in the result of the action.[17] Second, approval of the action taken would seem quite justified in a situation like the one presented in the principal case. Otherwise corporate action on an advantageous transaction might be forestalled merely because a majority of the board is interested in the subject of the transaction.[18] Finally, where the action taken

[12] The validity of these provisions, which are more common than the number of decisions would indicate, is seldom questioned unless most or all of the directors acting on a particular matter were interested, and even then the attack usually forms part of a fight by one group of stockholders to block action desired by another.

[13] Piccard v. Sperry Corp., (D.C. N.Y. 1943) 48 F. Supp. 465. Even this case is not a clear decision because it rested in part upon lack of applicable state authority. Faint authority will also be found in Adams v. Mid-West Chevrolet Corp., 198 Okla. 461, 179 P. (2d) 147 (1946), and Francis v. Brigham Hopkins Co., 108 Md. 233, 70 A. 95 (1908).

[14] Spiegal v. Beacon Participations, Inc., 297 Mass. 398, 8 N.E. (2d) 895 (1937); Everett v. Phillips, 288 N.Y. 227, 43 N.E. (2d) 18 (1942). As to the effect of such a clause when the result of a transaction is under scrutiny, compare Whalen v. Hudson Hotel Co., 183 App. Div. 316, 170 N.Y.S. 855 (1918).

[15] Kirn v. Kraus Plumbing Co., 12 Ohio App. 55 at 60-62 (1919); Meyer v. Fort Hill Engraving Co., 249 Mass. 302, 143 N.E. 915 (1924).

[16] El Cajon Portland Cement Co. v. Wentz Engineering Co., (6th Cir. 1908) 165 F. 619.

[17] See SPELLMAN, CORPORATE DIRECTORS 474 (1931).

[18] The problem of forestalling corporate action is particularly acute when a fight

by the board is specifically subject to stockholder approval, as it was in the principal case, there would seem to be little reason for not giving effect to a clause allowing interested directors to be counted for quorum purposes or even to vote on questions touching the subject of their interest.[19]

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develops in a closed corporation where the members of the board are the sole stockholders. It is no doubt possible for an interested board of directors to resign or be removed and a disinterested board elected in its place, but such would entail difficulties for the corporation, especially if time was of the essence. Further, the result more often than not would be the election of a mere dummy board, which from a technical standpoint might answer the interested quorum problem but which would be of little actual aid to objecting minority stockholders.

[19] If action by an interested board or quorum is sanctioned, the result of the transaction is still open to scrutiny, and it is only right that the burden of proving the fairness be placed upon the defendants. See principal case at 109-110.