CORPORATIONS-OFFICERS AND DIRECTORS-EFFECT OF STATUTES ON CONTRACTS BETWEEN CORPORATIONS WITH COMMON DIRECTORS

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COMMENTS

CORPORATIONS—OFFICERS AND DIRECTORS—EFFECT OF STATUTES ON CONTRACTS BETWEEN CORPORATIONS WITH COMMON DIRECTORS—Two recent decisions on the question of the validity of contracts between corporations having common directors are of interest for their interpretations of the relevant statutes of Rhode Island and California. In *Duncan Shaw Corp. v. Standard Machinery Co.*,[1] corporation *X*, a marketing company, and corporation *Y*, a manufacturing company, formed *XY* corporation as an intermediary with the idea of obtaining certain tax and other advantages. Of *XY*'s five directors, two were also directors of *X* and two were also directors of *Y*. *X*, *Y*, and *XY* entered into a perfectly fair tripartite contract on which *Y* eventually defaulted, causing *X* and *XY* to bring this suit. Since a disinterested majority of *Y*'s board of directors had not ratified the contract as a Rhode Island statute[2] required for contracts between corporations having common directors, *Y* claimed it was not bound by its agreement. The Court of Appeals for the First Circuit, construing the statute as making such contracts only voidable, held that the shareholders of *Y* had waived their right to avoid the contract by accepting its benefits. As an alternative ground for its decision, the court declared the statutory requirements inapplicable, viewing the arrangement as in effect a contract between *X* and *Y*, who had no directors in common.

In *Remillard Brick Co. v. Remillard-Dandini Co.*,[3] *X* and *Y* corporations entered into two contracts by which the sales operations of *X* were transferred to *Y*, thereby preventing *X* from making a profit on that aspect of the business. *Y* was wholly owned by persons who were also majority directors and majority shareholders of *X*. Suit was brought by a minority shareholder of *X* to rescind the contracts as voidable under the California Corporations Code.[4] In setting aside the contracts,

[1] (1st Cir. 1952) 196 F. (2d) 147.

[2] R.I. Gen. Laws (1938), c. 116, §21: "Any corporation may contract for any lawful purpose with one or more of its directors or with any corporation having with it a common director or directors, if the contract is entered into in good faith and is approved or ratified by a majority vote at any meeting of its board of directors: *Provided*, that the contracting or common director or directors shall not vote on the question and shall not be counted in ascertaining whether or not a quorum is present for this purpose at the meeting. A contract made in compliance with the foregoing provisions shall be voidable by the corporation complying with said provisions only in case it would be voidable if made with a stranger."

[3] 109 Cal. App. (2d) 405, 241 P. (2d) 66 (1952).

[4] Cal. Corp. Code (1947), §820 [substantially identical to former Cal. Civ. Code (1931), §311]: "Directors and officers shall exercise their powers in good faith, and with a view to the interests of the corporation. No contract or other transaction between a corporation and one or more of its directors, or between a corporation and any corporation, firm or association in which one or more of its directors are directors or are financially interested, is either void or voidable because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes or approves such contract or transaction, or because his or their votes are counted for such purpose, if the circumstances specified in any of the following subdivisions exist:

"(a) The fact of the common directorship or financial interest is disclosed or known to the board of directors or committee and noted in the minutes, and the board or comthe California court stated that even though the majority directors of *X* had disclosed their interest in *Y* and had ratified the contracts as majority shareholders of *X*, thus (supposedly) satisfying subdivision (b) of the statute, there was an additional requirement of good faith which had not been met.

I

Mindful that a corporate director, when dealing with his corporation either as an individual or as director of another corporation, may be tempted to put his own interests above those of his corporation, the common law imposed upon him the obligations of a fiduciary.[5] Originally this fiduciary duty was analogized rather stringently to that of a trustee and the director was prevented from dealing with his corporation at all. Contracts which he made with it or in the making of which he participated for another corporation were voidable without regard to fairness, even though they might have been approved by a disinterested majority of the board, excluding his vote.[6]

The exigencies of modern business eventually necessitated a recasting of the balance in favor of permitting a corporation freedom to con-

mittee authorizes, approves, or ratifies the contract or transaction in good faith by a vote sufficient for the purpose without counting the vote or votes of such director or directors.

"(b) The fact of the common directorship or financial interest is disclosed or known to the shareholders, and they approve or ratify the contract or transaction in good faith by a majority vote or written consent of shareholders entitled to vote.

"(c) The contract or transaction is just and reasonable as to the corporation at the time it is authorized or approved.

"Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves, or ratifies a contract or transaction."

The statute is commented on in Ballantine, "Questions of Policy in Drafting a Modern Corporation Law," 19 CALIF. L. REV. 465 (1931).

[5] Contracts between corporations having common directors, rather than those between a corporation and a director as an individual, will be emphasized in this comment. For general treatment of the subject see BALLANTINE, CORPORATIONS §§66-72 (1946); 3 FLETCHER, CYC. CORP. §§961-964 (1947); note, 23 CORN. L.Q. 445 (1938); Pam, "Interlocking Directorates, the Problem and its Solution," 26 HARV. L. REV. 467 (1913); Bowman, "The Validity of Contracts between Corporations Having Interlocking Directors," 4 MICH. L. REV. 577 (1906); note, 51 HARV. L. REV. 327 (1937); SPELLMAN, CORPORATE DIRECTORS, c. 9 (1931); DODD AND BAKER, CASES AND MATERIALS ON CORPORATIONS 438 ff. (1951); BERLE AND MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, Bk. II, c. 5 (1932); 114 A.L.R. 299 (1938).

[6] See BALLANTINE, CORPORATIONS §§66, 67, 72 (1946); 3 FLETCHER, CYC. CORP. §930 (1947). This is still the rule in New Jersey as to contracts with interested directors; Stewart v. Lehigh Valley R. Co., 38 N.J.L. 505 (Ct. Err. & App. 1875) (dictum, but leading case). New Jersey nevertheless does not permit an otherwise fair contract to be set aside in a minority stockholder suit, and holds that even the majority shareholders may waive their right by acquiescence with knowledge of the interest, U.S. Steel Corp. v. Hodge, 64 N.J. Eq. 807, 54 A. 1 (1903).

tract with all parties, recognizedly at the sacrifice of a certain amount of the protection which had been afforded stockholders by the older rule. By the weight of authority today, a contract between corporations having even a majority of directors in common is not void or voidable if fair,[7] although the burden of proving fairness is generally placed on the party seeking to uphold the contract.[8] A somewhat stricter rule is followed for contracts between an individual director and his corporation, perhaps because they present a greater risk of self-dealing; such contracts are voidable though fair, by the prevailing view, unless approved by a disinterested majority of the board of the corporation sought to be held to the agreement.[9] Approval by a disinterested majority is likewise required in a minority of jurisdictions today for contracts between corporations having common directors.[10] The fairness of either class of contract is a matter which the courts will subject to careful scrutiny.[11]

II

Applying equally to contracts between a corporation and one of its directors and between two corporations having a common director, the

[7] Everett v. Phillips, 288 N.Y. 227, 43 N.E. (2d) 18 (1942) (suit by minority shareholder to compel directors to demand repayment of loan to another corporation in which they were also interested); Evansville Public Hall Co. v. Bank of Commerce, 144 Ind. 34, 42 N.E. 1097 (1896) (action on a note); cases cited at 114 A.L.R. 299 (1938). See also BALLANTINE, CORPORATIONS §72 (1946); DODD AND BAKER, CASES AND MATERIALS ON CORPORATIONS 474-476 (1951); 3 FLETCHER, CYC. CORP. 440 (1947).

[8] Taking the view that burden of proving bad faith or unfairness is on complainant: Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 8 N.E. (2d) 895 (1937) (stockholders' suit to hold directors liable for loss resulting from purchase of notes of another corporation in which they were also interested); Buck v. Tuxedo Land Co., 109 Cal. App. 453, 293 P. 122 (1930) (stockholder suit to set aside contract). Taking majority view that burden is on party seeking to uphold the contract: Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 41 S.Ct. 209 (1921) (stockholder action to rescind sale of entire assets); Mich. Stat. Ann. (1937) §21.13(5).

[9] Schnittger v. Old Home Consolidated Mining Co., 144 Cal. 603, 78 P. 9 (1904). *Contra:* Minnesota Loan & Trust Co. v. Peteler Car Co., 132 Minn. 277, 156 N.W. 255 (1916). See BALLANTINE, CORPORATIONS 171 (1946), and cases cited. See also note, 19 CALIF. L. REV. 304 (1931).

[10] Alabama Fidelity Mortgage & Bond Co. v. Dubberly, 198 Ala. 545, 73 S. 911 (1917); Pearson v. Railroad, 62 N.H. 537, 13 Am. St. Rep. 590 (1883). It has been stated that courts never concern themselves with the proportion of interested directors in the non-complaining corporation, though if only a minority of its directors are interested there is little likelihood of unfairness. See note, 51 HARV. L. REV. 327 at 328 (1937). But a subsequent case in New York, sustaining a loan contract between two corporations having a majority of directors in common, noted that since the common directors had a much greater proportionate investment in the complaining corporation than they did in the non-complaining corporation, it was unlikely that they would approve a contract less favorable to the former than the latter. Everett v. Phillips, 288 N.Y. 227, 43 N.E. (2d) 18 (1942).

[11] Baker v. Hellner Realty Co., 265 Mich. 625, 251 N.W. 793 (1933); Corsicana Nat. Bank v. Johnson, 251 U.S. 68, 40 S.Ct. 82 (1919); cases collected at 114 A.L.R. 308 (1938).

Rhode Island statute restates the majority view of the modern law as to the former, but adopts the minority view as to the latter. It requires that a corporation must have approved a contract by a disinterested majority in "good faith"[12] in order irrevocably to be bound by it. The statute is phrased in terms of what steps a corporation must take so that the contract will not be "voidable by the corporation,"[13] i.e., what safeguards must be maintained in the interest of minority shareholders not represented on the board in order to prevent them from setting aside the contract by derivative action.[14] The policy of establishing strict requirements for contracts between corporations with common directors has strong appeal to a legislature which, as Rhode Island's apparently was, is particularly concerned about protecting minority shareholders. The consensus of scholars, however, is to the effect that the advantage to a corporation of being freely able to deal with its directors and particularly with its less than wholly-owned subsidiaries outweighs the risk to the minority shareholder of unfair dealing.[15]

This strict statutory rule appears most vulnerable to criticism in the situation where, as in the *Duncan Shaw* case, an unscrupulous corporation is using it to renege on its fair obligations.[16] In that case the board of the corporation sought to be held had not approved the contract by a disinterested majority, as the Rhode Island statute requires. The First Circuit, in holding defendant to its contract despite the fact that it was not properly ratified, relied on a doctrine which may often prove useful in obviating the harshness of the strict rule in states adhering to it.

[12] R.I. Gen. Laws (1938), c. 116, §21.

[13] Ibid.

[14] The Rhode Island statute was previously construed in Matteson v. Wm. S. Sweet & Son, Inc., 58 R.I. 411, 193 A. 171 (1937), an action by a receiver of a lessee corporation to set aside a lease with a lessor corporation because of a common directorship; the court held that the burden of proving compliance was on the lessor and that the statute provides the exclusive method for upholding such contracts. Goldberg v. Peltier, 75 R.I. 314, 66 A. (2d) 107 (1949), interpreted the statutory dictum that an interested director shall not vote to mean only that his vote cannot be counted in making up a majority for approval.

[15] See Ballantine, "Major Changes in California Corporation Law," 6 CALIF. S.B.J. 159 at 164 (1931); notes, 51 HARV. L. REV. 327 (1937); 23 CORN. L.Q. 445 (1938). Expressing skepticism: 3 FLETCHER, CYC. CORP. 437 (1947) (declaring better view to be that contract between two corporations is voidable unless approved by disinterested majority); note, 26 IOWA L. REV. 334 (1941) (stating that interested director should not be allowed to vote or be present at meeting); note, 38 COL. L. REV. 348 (1938) (emphasizing need for protection of minority shareholders); Pam, "Interlocking Directorates, the Problem and its Solution," 26 HARV. L. REV. 467 (1913) (criticizing liberal view).

[16] Another criticism of the statute is that by its language, a corporation cannot be held to a fair contract even though approved by a disinterested majority if its board did not enter into it in good faith. While this appears salutary from the standpoint of the minority shareholder, it would conceivably allow a board to use its own bad faith as a defense to a proper action to enforce the contract brought by the other party to it. See note 2 supra.

After a preliminary determination that the statute made the contract voidable rather than void, the court applied the common law rule that a statute designed to protect a certain class (here the shareholders) may be deemed waived by the class by acquiescence or acceptance of benefits.[17] This doctrine enables a court to hold a corporation to any fair contract under which its shareholders have knowingly received benefits, without putting any obstacle in the path of a vigilant minority shareholder seeking to set aside an unfair contract in a derivative action. The only objection to utilizing this idea in Rhode Island is that the supreme court of that state, in a case previous to the *Duncan Shaw* case and similar on its facts, declared that the receipt of benefits under a contract does not extinguish the right to avoid it.[18] The First Circuit failed adequately to distinguish this leading Rhode Island precedent.

The court in the *Duncan Shaw* case found a second ground for holding defendant corporation to its proper obligations by viewing the arrangement as in substance one between the marketing and the manufacturing corporations, which had no common directors. The intermediary corporation, with whom defendant did have directors in common, was regarded as only a subordinate instrument in the relations between its creators. This analysis is sound as to that part of the tripartite contract encompassing the obligations of defendant (*Y*) to the marketing corporation (*X*), but cannot be reconciled with the language of the statute as to that part of the agreement relating to defendant and the intermediary corporation (*XY*).[19]

III

Before the enactment of its General Corporation Law in 1931, California seemed to follow the majority or liberal rule on intercorporate contracts, upholding those found to be fair whether or not they happened to have been approved by a disinterested majority.[20] The California statute does not alter the common law doctrines upholding contracts between corporations with common directors, but sets out three

[17] 3 FLETCHER, CYC. CORP. §984 (1947); BALLANTINE, CORPORATIONS §71 (1946). The contract may of course be expressly ratified, and the vote of interested directors may be counted in making up a majority; U.S. Steel Corp. v. Hodge, 64 N.J. Eq. 807, 54 A. 1 (1903).

[18] Matteson v. Wm. S. Sweet & Son, Inc., 58 R.I. 411, 193 A. 171 (1937). See note 14 supra.

[19] See note 2 supra.

[20] Buck v. Tuxedo Land Co., 109 Cal. App. 453, 293 P. 122 (1930); note, 19 CALIF. L. REV. 304 (1931).

supplementary methods by which such contracts can be made without fear of avoidance.[21] The procedures set out apply also to contracts with individual interested directors.

Subdivision (a) states the first set of circumstances in which a contract is immune to avoidance: approval in "good faith" by a disinterested majority of the board of directors, to whom full disclosure of interest or common directorship has been made. This rule gives the board of directors somewhat broader discretion than the similar common law rule, since if good faith is shown, the fairness of the contract may not be subjected to inquiry.[22] This subdivision has never been fully construed, but the vague requirement of good faith seems to present just as difficult problems of proof as the "fairness" test[23]—perhaps greater, since it is more subjective.

Subdivision (b) upholds any contracts where the interest is disclosed to the shareholders and they ratify in good faith by a majority vote or written consent. Shareholding directors are permitted to vote, but the section does not alter the rule that shareholders cannot ratify fraudulent acts of directors.[24] Fairness or reasonableness of the contract is once again an irrelevant consideration provided the other requirements of the subdivision are met. Since the section was not intended to be exclusive, it is probable that shareholders may ratify by acquiescence or acceptance of benefits without any written vote or consent.[25]

Subdivision (c)[26] immunizes any "just and reasonable" contract from attack, regardless of any action by the board or shareholders. In deciding the fairness and reasonableness of the contract, a court will probably inquire into the matter of disclosure of interest, but the section does not make it a requirement that disclosure be made.[27] The

[21] See note 4 supra.

[22] Note, 29 CALIF. L. REV. 480 at 486 (1941).

[23] See note, 61 HARV. L. REV. 335 (1948). See note 27 infra.

[24] BALLANTINE AND STERLING, CALIFORNIA CORPORATION LAWS 103 (1949); note, 29 CALIF. L. REV. 480 at 482 (1941).

[25] See Brainard v. De La Montanya, 18 Cal. (2d) 502, 116 P. (2d) 66 (1941), noted in 30 CALIF. L. REV. 193 (1942).

[26] Construed in Caminetti v. Prudence Mut. Life Ins. Assn., 62 Cal. App. (2d) 945, 142 P. (2d) 41 (1943); see also Pece v. Tama Trading Co., 22 Cal. App. (2d) 219, 70 P. (2d) 652 (1937), and Union Die Casting Co. v. Anderson, 25 Cal. App. (2d) 195, 76 P. (2d) 703 (1938), which, however, are of little help in interpreting the subdivision. The "good faith" requirement of the first part of section 820 would seem to apply to contracts sought to be upheld under subdivision (c).

[27] Even before the enactment of the statute, California did not make disclosure an absolute requirement of fairness; Schnittger v. Old Home Consolidated Mining Co., 144 Cal. 603, 78 P. 9 (1904). Cf. Annotation, "Right of Corporate Officer to Purchase Corporate Assets from Corporation," 24 A.L.R. (2d) 71 (1952).

merit of this liberal rule is that it allows the corporation to make fair contracts with anyone it chooses, while at the same time preventing such corporations as the defendant in the *Duncan Shaw* case from renouncing their legitimate obligations.[28] The statute does, however, make it difficult for a minority shareholder to set aside an unfair contract in a derivative action, particularly in view of the fact that it leaves the common law burden of proof on the one attacking the contract.[29]

In the *Remillard* case, the first one construing subdivision (b), defendant corporation contended that the contract could not be set aside since the requirements of that subsection had been met. Apparently overlooking the requirement of good faith explicitly stated in subdivision (b), the court agreed with defendant that the subdivision had been "technically" satisfied, but said that the contract was nevertheless voidable since the statute ". . . does not operate to limit the fiduciary duties owed by a director. . . ."[30] The court then gave further evidence that its examination of the statute was at best a cursory one, stating that an "unfair" contract can be avoided even though the requirements of one of the subdivisions have been met.[31] The California court apparently has confused good faith with fairness, for as the above discussion has indicated, only the former is a necessary element in all cases.

IV

Legislative policy-making on the subject of contracts between corporations having interlocking directorates has required a balancing of the interest of corporate enterprise in the flexibility of business relations against the interest of minority shareholders in protection against self-dealing by corporate managers. California has favored the former interest by requiring, as a minimum, that contracts with interested parties be fair and made in good faith. Rhode Island is apparently more concerned with the latter interest, and has codified one of the stricter

[28] The Michigan statute, except as to burden of proof, seems by its terms to approximate §820(c); see Mich. Stat. Ann. (1937) §21.13(5). But apparently it will be applied only ". . . where the corporation is represented by a quorum of disinterested directors . . ."; Veeser v. Robinson Hotel Co., 275 Mich. 133 at 137, 266 N.W. 54 (1936).

[29] Buck v. Tuxedo Land Co., 109 Cal. App. 453, 293 P. 122 (1930). See note 8 supra. See also note, 29 CALIF. L. REV. 480 at 493 (1941).

[30] Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. (2d) 405 at 418, 241 P. (2d) 66 (1952).

[31] Ibid.

common law rules. It is submitted that the California view provides sufficient protection against self-dealing, while at the same time preserving advantageous intercorporate links and preventing the fact of common directorship from being used as a sham defense to proper contract liability.

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