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Corporations -- Interested Directors -- Fiduciary Duty and the Business Judgment Rule

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Pennsylvania statute, the court, of necessity, will have less latitude in taking the circumstances of each case into account than will other courts that apply the majority rule. Regardless of the size of the corporation, the nature of it, the number of directorships a particular director holds, the compensation received, or the demands of the director's own affairs, a director in Pennsylvania must always use the care a prudent man uses in his own affairs.[32]

Where directors, as is the case in some large and some close corporations, are, in reality, independent, highly paid professional managers, the "own affairs" standard is not completely objectionable; but, this is not the universal situation. In the future should the court find occasion to apply the statute literally and should it reach a result different from the common law, corporations will be forced into employing experienced, professional directors at adequate compensation. Without compensation or a personal interest in the corporation's success, it is unlikely that one would be willing to take on the responsibility of a directorship in a corporation of any complexity.

ALBERT VICTOR WRAY

Corporations—Interested Directors—Fiduciary Duty and the Business Judgment Rule

The business judgment rule is a defense to directors who, in the exercise of their discretionary powers, cause corporate losses through errors in judgment.[1] It is based on the assumption that the directors, elected by the shareholders for this purpose, are in the best position to decide corporate policy and that a court, less familiar with the problems involved, should not substitute its judgment for that of the directors.[2] The shareholders have no right to appeal to the courts

[32] For a criticism of the Pennsylvania statute as too subjective, see Adkins 819. The comments to the NEW YORK BUSINESS CORPORATION LAW § 717 expressly recognizes the need for a flexible, comparative standard of care: "The adoption of the standard prescribed by this section will allow the court to envisage the directors' duty of care as a relative concept, depending on the kind of corporation involved, the particular circumstances and the corporate role of the director."

[1] See Briggs v. Spaulding, 141 U.S. 132 (1891); Otis & Co. v. Pennsylvania R.R., 61 F. Supp. 905 (E.D.Pa. 1945), *aff'd per curiam* 155 F.2d 522 (3d Cir. 1946); Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 8 N.E.2d 895 (1937); Abrams v. Allen, 297 N.Y. 52, 74 N.E.2d 305 (1947).

[2] See Coffman v. Maryland Publishing Co., 167 Md. 275, 173 Atl. 248

for relief from the decisions made by the directors if such decisions are made in good faith,[3] with due care,[4] and in accordance with applicable fiduciary duties owed the corporation and its shareholders.[5]

While the shareholders do assume this risk of errors in judgment, they should not be held to assume the risk of disloyalty. The rule does not protect directors who act in their own personal interest.[6] Directors owe a fiduciary duty to the corporation and its minority shareholders to act in the best interest of the corporation.[7] They cannot use their position of trust to benefit themselves or a particular group of shareholders at the expense of the corporation or its other shareholders.[8] A recent decision by the Delaware Supreme Court illustrates how the business judgment rule will occasionally be expanded into this area of fiduciary duty to uphold an otherwise suspect transaction by interested directors.

In *Warshaw v. Calhoun*[9] the plaintiff was a minority share-

(1934); Helfman v. American Light & Traction Co., 121 N.J. Eq. 1, 187 Atl. 540 (1936); Pollitz v. Wabash R.R., 207 N.Y. 113, 100 N.E. 721 (1912); Marony v. Applegate, 266 App. Div. 412, 42 N.Y.S.2d 768 (1943).

[3] See Dumont v. Raymond, 49 N.Y.S.2d 865 (Sup. Ct. 1944); Howell v. McClosky, 373 Pa. 100, 99 A.2d 610 (1953).

[4] Casey v. Woodruff, 49 N.Y.S.2d 625 (Sup. Ct. 1944).

[5] Evans v. Armour & Co., 241 F. Supp. 705 (E.D.Pa. 1965); Abrams v. Allen, 297 N.Y. 52, 74 N.E.2d 305 (1947); Steinberg v. Altschuler, 158 N.Y.S.2d 411 (Sup. Ct. 1956); Howell v. McClosky, 375 Pa. 100, 99 A.2d 610 (1953).

[6] Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1920); Alster v. British Type Investors, 83 F. Supp. 949 (S.D.N.Y. 1949); Shlensky v. South Parkway Bldg. Corp., 19 Ill. 2d 268, 166 N.E.2d 793 (1960); Bayer v. Beran, 49 N.Y.S.2d 2 (Sup. Ct. 1944).

[7] SEC v. Chenery Corp., 318 U.S. 80 (1942); Perlman v. Feldmann, 219 F.2d 173 (2d Cir. 1955), *cert. denied* 349 U.S. 952 (1955); Zahn v. Transamerica Corp., 162 F.2d 36 (3d Cir. 1947); Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941), *cert. denied* 316 U.S. 675 (1942); Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952); Guth v. Loft, 23 Del. Ch. 255, 5 A.2d 503 (Sup. Ct. 1939); Kavanaugh v. Kavanaugh Knitting Co., 226 N.Y. 185, 123 N.E. 148 (1919).

[8] He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. . . . He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements.

Pepper v. Litton, 308 U.S. 295, 311 (1939).

[9] 221 A.2d 487 (Del. 1966).

See also Case v. New York Central R.R., 15 N.Y.2d 150, 204 N.E.2d 643, 256 N.Y.S.2d 607 (1965), reversing 19 App. Div. 2d 383, 243 N.Y.S.2d 620 (1963). This case involved a suit by minority shareholders in a Central subsidiary challenging an agreement between the two linked corporations. The agreement, entered into by interlocking directors, provided holder in Western Insurance Securities Co. Securities, a personal holding company, was organized for the purpose of controlling Western Casualty and Surety Co.; its only substantial asset being a controlling block of stock in Casualty. The individual defendants, majority shareholders in Securities,[10] were officers and/or directors of both companies. In 1953, when it became necessary to obtain additional capital and to broaden the public ownership of Casualty, the defendants approved a plan to issue new stock with the purchase rights going to Casualty shareholders. The defendants, in their capacity as directors of Securities, then rejected Securities' rights in the issue and sold the rights to the underwriters handling the issue for Casualty. Similar new issues were made by Casualty in 1959 and 1962 and again Securities sold its rights. These combined transactions led to a reduction of Securities' holdings in Casualty from 92 to 41 per cent and a corresponding reduction in the equity Securities' shareholders had in the profits of Casualty. The loss suffered by the shareholders was magnified by the fact that Securities' stock had always sold at a 25 to 50 per cent discount from the value of its assets. The Supreme Court of Delaware, affirming the Chancellor's grant of summary judgment for defendants,[11] held that the plaintiff was not entitled to an accounting from the individual defendants for losses resulting from the transaction or to the appointment of a receiver for the liquidation or reorganization of Securities.[12]

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for the allocation to Central of almost all of the tax savings realized from the consolidation of the tax returns of the two companies. The Court of Appeals, reversing the Appellate Division, held that the transaction was fair when analyzed from the viewpoint of the "system" as a whole, indicating that what was good for the system of railroads was good for the constituent parts. While the court did not specifically mention the business judgment rule, it would seem that this decision also offers an illustration of the expansion of the rule into the traditional area of fiduciary duty.

[10] The defendants held fifty-five per cent of the stock in Securities. The fact that a majority of the stock in the corporation was owned by less than five shareholders and that Securities sole income was from dividends earned on its holdings in Casualty led to its classification as a personal holding company. The retained earnings of a personal holding company are taxed at a confiscatory rate. See Int. Rev. Code of 1954, §§ 541-42.

[11] Warshaw v. Calhoun, 213 A.2d 539 (Del. Ch. 1965).

[12] The plaintiff sought to have a receiver appointed to liquidate, reorganize, or merge Securities with Casualty in order to eliminate the disadvantages inherent in Securities corporate form. The court held that the severe tax consequences of the personal holding company status did not justify the appointment of a receiver and that the continuation of the corporation in this form was not illegal. The court indicated that the plaintiff's

There were sound business reasons advanced by defendants that, on the face of the transaction, would seem to justify the application of the business judgment rule. Securities, a personal holding company,[13] was subject to a confiscatory tax[14] on retained earnings and was without the necessary funds to exercise the rights itself. The underwriter advised that a plan to pass the rights on to the shareholders of Securities would increase the cost and risk the success of the underwriting. Also the plan would defeat one of the primary purposes of the new issue, *i.e.* to broaden the public ownership of Casualty stock. The court listed these factors and said, "Whether or not this be so, we think that the decision as to what Securities should do with its rights to subscribe to Casualty stock was a matter to be decided in accordance with the sound business judgment of the directors of Securities."[15]

The court gave only passing reference to the plaintiff's claim that defendants were remiss in not transferring the rights to Securities' shareholders and that this was done in order to perpetuate defendants' control over Casualty through their control of Securities. There would seem to be sufficient evidence of a conflict of interest such as would hamper defendants in giving the transaction the disinterested consideration required for application of the business judgment rule.[16] Where there is such a taint on a transaction, the court should examine all of the circumstances surrounding the decision to determine if in fact it was in the best interest of the corporation.[17] Here the court should have weighed the possible increased cost and threatened risk involved in passing the rights on to the shareholders against the loss suffered. The court should have also determined if there were other means of accomplishing the purpose of the issues without depleting the shareholders interest. If these factors had been considered the court may have determined that the directors did not act in the best interest of the corporation.

Cheff v. Mathes[18] offers another example of this use of the business judgment rule to uphold a transaction blocking a potential

remedy was to withdraw from the corporation by the sale of her stock. Discussion of this aspect of the case is beyond the scope of this note.

[13] See Int. Rev. Code of 1954, § 542.

[14] See Int. Rev. Code of 1954, § 541.

[15] 221 A.2d 487, 492 (Del. 1966).

[16] See note 7 *supra* and accompanying text.

[17] See note 23 *infra* and accompanying text.

[18] 199 A.2d 548 (Del. 1963).

shift in control. Here the plaintiff brought a derivative suit to hold the directors of Holland Furnace Corporation liable for losses resulting from the allegedly improper use of corporate funds to purchase the corporation's own stock. The controlling shareholders, who were members of the corporation's founding family and who made up the board of directors, learned that one Maremont was buying large quantities of Holland stock on the market. Maremont had a reputation for realizing quick profits from the sale or liquidation of corporations he acquired and there was some indication that he intended to change corporate policy. The board of directors, fearing such a take over, caused the corporation to purchase Maremont's shares at a price in excess of the market value. Plaintiff, a minority shareholder, attacked the transaction, alleging that its sole purpose was the perpetuation of the incumbent directors' control. The Vice Chancellor, agreeing with the plaintiff, disallowed the purchase on the grounds that there was no substantial evidence that any real threat was posed to the corporation.[19] The Supreme Court of Delaware reversed, holding that the directors, having satisfied the burden of proof by showing that they had reasonable grounds to believe that a substantial threat to the corporation or its policies existed, would not be penalized for an honest mistake in judgment.

The direct effect of this transaction was to insure that the control held by the incumbent directors was preserved through the use of corporate funds. A purchase by the corporation of its own shares in order to maintain control is an abuse of corporate power and a breach of fiduciary duty,[20] yet the court did not give full consideration to the question of conflicting interest. One commentator has questioned the immediacy of the threat because it would be necessary for Maremont to obtain a majority of the stock or support from a majority of the shareholders before he could control the board of directors and influence corporate policy.[21] Also, before upholding such a transaction it would seem that the court should have determined if there were other means, using non-corporate funds, to have eliminated the danger. The founding family should have resorted to their own resources before those of the corporation.

One possible explanation of the holdings in these cases is that

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[19] Mathes v. Cheff, 190 A.2d 524 (Del. Ch. 1963).

[20] See Kahn v. Schiff, 105 F. Supp. 973 (S.D. Ohio 1952); Yasik v. Wachtel, 25 Del. Ch. 247, 17 A.2d 309 (1941).

[21] Note, 50 CORNELL L.Q. 302 (1965).

the plaintiffs purchased shares in corporations with well established control patterns. In *Warshaw,* Securities was organized by the defendants as a device to insure their control over Casualty while in *Cheff* the founding family had set corporate policy and controlled the corporation from the outset. It may be that by using the business judgment rule in these cases the court is merely saying that the plaintiffs accepted these circumstances when they purchased their shares and cannot now complain.[22] If so, the court is overlooking the realities involved in a stock purchase. The purchaser does not agree to future action by those in control that will cause corporate losses in an effort to maintain that control.

The court in each of these cases probably reached the correct result as the challenged transactions, all factors considered, may well have been in the best interest of the corporations. By using the business judgment rule, however, the courts avoided analysis of the essential question presented—the possible self-dealing of the directors. The basis of the rule is to allow directors freedom to act without fear of being "second-guessed" by a court should they make a mistake. Where the loss is caused by such a conflict of interests that the directors are deprived of their ability to exercise impartial judgment this reason for the rule fails. In this situation the courts, in order to protect the minority shareholders, have a duty to "second-guess" the directors and to carefully scrutinize the transaction.[23]

[22] In Goodman v. Futrovsky, 213 A.2d 899 (Del. 1965), the court was faced with an attack by a minority shareholder on an arrangement whereby a concern owned by the majority shareholders was the sole supplier of the supermarket corporation's produce requirements. Prior to 1959, when there was a public issue of supermarket stock, the majority shareholders owned both businesses. The prospectus for the issue set forth this relationship between the two companies and explained the interest of the majority shareholders. The court held that because the present holders of supermarket stock trace their title to the purchase of the 1959 issue "they are bound by their acquiescence, with full knowledge, of their predecessors and are now precluded from attacking the . . . relationship. *Id.* at 903. The court in *Warshaw and Cheff* may have been thinking along these lines in deciding those cases.

[23] *Cf.* Litwin (Rosemarin) v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940) where the court said that a director

> owes loyalty and allegiance to the corporation—a loyalty that is undivided and an allegiance that is influenced in action by no consideration other than the welfare of the corporation. Any adverse interest of a director will be subjected to a scrutiny rigid and uncompromising. He may not profit at the expense of his corporation and in conflict with its rights; he may not for personal gain divert unto himself the opportunities which in equity and fairness belong to his corporation. He is required to use his independent judgment.

The minority shareholder in a modern corporation is essentially without a voice in the management of the corporation.[24] The one remaining device with which he can protect his investment from the self-dealing of those in control is through a shareholders derivative action on behalf of the corporation. Through such an action he can enforce the fiduciary duties owed by the management. The courts, by permitting the expansion of the business judgment rule into the traditional enclave of the director's "duty of loyalty," are removing a substantial portion of this protection. In most situations where directors enter into such a transaction, they will be able to put forth plausible business reasons in its support, but they may not always be able to satisfy the demands of undivided loyalty.

REED JOHNSTON, JR.

Criminal Law—Committed Patient's Right to Treatment in Public Mental Hospitals

Nineteenth century attitudes toward insanity were responsible for the conception of a lunatic asylum as an institution for the public safety. The conditions in the asylums reflected the wild beast notion of mental illness[1]—the essential function of the asylum was

Id. at 677.

In the analogous situation where the directors contract with their own corporation, or where corporations with common directors contract together, the majority rule calls for close scrutiny of the contract to insure its fairness. See Bank of United States v. Cuthbertson, 67 F.2d 182 (4th Cir. 1933), *cert. denied* 291 U.S. 665 (1933); Guaranty Trust Co. v. United States, 44 F. Supp. 417 (E.D. Wash. 1942), *aff'd* 139 F.2d 69 (9th Cir. 1942); Tucson Federal Sav. & Loan Ass'n v. Aetna Inv. Corp., 74 Ariz. 163, 245 P.2d 423 (1952); Kennedy v. Emerald Coal & Coke Co., 28 Del. Ch. 405, 42 A.2d 398 (1944); Everett v. Phillips, 288 N.Y. 227, 43 N.E.2d 18 (1942).

[24] The modern large American corporation enjoys almost complete independence from its stockholders, the principal source of external intereference. While lip service is always paid to democratic control by the owners, it is recognized in practice that any extensive and effective interference by stockholders in management would be exceedingly damaging.

GALBRAITH, ECONOMIC DEVELOPMENT IN PERSPECTIVE, 65-66 (1962).

Ownership of wealth without appreciable control and control of wealth without appreciable ownership appear to be the logical outcome of corporate development.

BERLE & MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY, 69 (1933).

[1] Rex v. Arnold, 16 How. St. Tr. 695, 764 (1742).