Michigan Law Review

Volume 53 | Issue 3

1955

Corporations - "Personal Interst" of Directors in Corporate Transactions

Richard R. Dailey
University of Michigan Law School

CORPORATIONS—"PERSONAL INTEREST" OF DIRECTORS IN CORPORATE TRANSACTIONS—Serious dissension had developed between two factions of the seven-member board of directors of defendant corporation. Group *A*, consisting of four members, represented a working majority of the outstanding stock recently acquired by a group of investors. Group *B*, consisting of three members, had constituted the active management of the corporation for a number of years. The resignation of group *B* was probable if group *A* continued to dominate the board. It was proposed that stock of the defendant be exchanged for stock in another corporation. Under the overall plan, group *A* was to resign and two members of this group were to sell their stock in the defendant corporation at a price one-third above the market price. Group *B* was to remain with the corporation as officers and directors. This plan was approved unanimously by the board, and was submitted in detail to a special meeting of the stockholders who approved the plan by a vote of 14 to 1 (84% of the issued and outstanding stock voting). Minority stockholders brought a derivative suit against the corporation and its officers to enjoin consummation of the plan. The district court granted the injunction. On appeal, *held,* affirmed. The personal interest of the directors in the plan was such as to deprive the stockholders of the unprejudiced judgment to which they were entitled. *Seagrave Corp. v. Mount, Spain v. Mount,* (6th Cir. 1954) 212 F. (2d) 389.

As a general proposition corporate directors are required to guide the activities of their corporation for the benefit of the stockholders.[1] To this end the courts have been unanimous in declaring that directors are fiduciaries for their corporation.[2] It is also agreed that equity, at the option of the corporation, will enjoin consummation of a transaction which involves a breach of the fiduciary duty owed to the corporation.[3] But conflict among the courts arises in attempting to define what factual situations constitute a breach. The most troublesome cases in this area are those in which a director has a "personal interest" in a corporate transaction.[4] In formulating the legal rules to be applied in each case, protection of the interest of the stockholder in the corporation must be balanced against freedom of corporate business activity. Where a corporate transaction involving an "interested" director has been challenged in the past, the decisions may be divided into four main groups.[5] First, those holding that a director is a trustee with the corporation as the cestui que trust.[6] Under this analogy any corporate transaction involving a director is voidable at the option of the corporation. Second, those holding that transactions involving directors are not voidable if approved by an "uninterested" majority of the board.[7] Third, those holding that in addition to approval by an "uninterested" majority of the board, the transaction must be "fair" (with the burden of proving fairness on the proponent of the transaction).[8] Fourth, those holding that the "fairness" of the transaction is the only test.[9] Under the decisions in the first three groups, if approval

[1] Dodge v. Ford Motor Co., 204 Mich. 459, 170 N.W. 668 (1919); Markovitz v. Markovitz, 336 Pa. 145, 8 A. (2d) 46 (1939); Dwyer v. Tracey, (D.C. Ill. 1954) 118 F. Supp. 289; Brown v. Little, Brown & Co., 269 Mass. 102, 168 N.E. 521 (1929); 3 FLETCHER, CYC. CORP. §838 (1947); Dodd, "For Whom Are Corporate Managers Trustees?" 45 HARV. L. REV. 1145 (1932); Berle, "For Whom Corporate Managers Are Trustees," 45 HARV. L. REV. 1365 (1932).

[2] Gilbert v. McLeod Infirmary, 219 S.C. 174, 64 S.E. (2d) 524 (1951); Paddock v. Siemoneit, 147 Tex. 571, 218 S.W. (2d) 428 (1949); 20 IOWA L. REV. 808 (1935); 3 FLETCHER, CYC. CORP. §838 (1947). In addition the directors may be fiduciaries for the stockholders, Meadows v. Bradshaw-Diehl Co., (W.Va. 1954) 81 S.E. (2d) 63; or for the corporate creditors, Beach v. Williamson, 78 Fla. 611, 83 S. 860 (1919).

[3] City Bank Farmers Trust Co. v. Hewitt Realty Co., 257 N.Y. 62, 177 N.E. 309 (1931); 13 AM. JUR., Corporations §§423, 451 (1938); 97 Am. St. Rep. 29 (1904); Dodd, "Is Effective Enforcement of the Fiduciary Duties of Corporate Managers Practicable?" 2 UNIV. CHI. L. REV. 194 (1935).

[4] "Personal interest" of the director refers to the fact that the director will benefit economically from the corporate transaction. The director's interest may be adverse to the interest of the corporation or directly tied to the interest of the corporation. In either case the director will not be able to give the "unprejudiced judgment" required by the court in the principal case.

[5] This grouping does not include decisions which were governed by state statutes.

[6] Ashman v. Miller, (6th Cir. 1939) 101 F. (2d) 85; Berle, "Corporate Powers as Powers in Trust," 44 HARV. L. REV. 1049 (1931). Since a director does not have legal title to corporate property, the term "quasi-trustee" is commonly used.

[7] U.S. Rolling Stock Co. v. The Atlantic & G. W. R. Co., 34 Ohio St. 450 (1878); Budd v. Walla Walla Printing & Publishing Co., 2 Wash. Terr. 347, 7 P. 896 (1885).

[8] Cases are collected in BALLANTINE, CORPORATIONS §72 (1946); 3 FLETCHER, CYC. CORP. §§935, 936 (1947). The majority of American courts today fall within this group.

[9] Landstreet v. Meyer, 201 Miss. 826, 29 S. (2d) 653 (1947); Monroe v. Scofield, (10th Cir. 1943) 135 F. (2d) 725; Public Service Commission v. Indianapolis, 193 Ind.

by an "uninterested" majority of the board is lacking, a minority stockholder is able to block a transaction which may be mutually beneficial to the corporation and the stockholders. Justification for this control by minority stockholders must rest on the policy consideration which inspired the legal rules, i.e., protection for the stockholders. In the principal case the court found that the proposed plan was not at variance with what sound business judgment would call for under the circumstances. It also found that full disclosure of all material facts concerning the plan had been made to the stockholders prior to the special meeting.[10] In the light of these findings, it is difficult to see what measure of protection was afforded to the stockholders by the present decision.[11] The fact that a majority of the directors would personally benefit from the transaction does not of itself indicate that the interest of the stockholders in the corporation would suffer. Rigid adherence to such a rule may easily defeat the very purpose of the rule. The result of many of the decisions within the first three groups above is to restrict freedom of corporate business activity with no corresponding gain in protection for the stockholders. If, as in the fourth group of cases, the court will review the "fairness" of the transaction, the fact that a majority of the board of directors is personally interested becomes merely another factor to be considered in determining the issue of "fairness."[12] This approach to the problem, together with the traditional legal sanctions against fraud and director's secret profits, would achieve the desired results without unduly restricting business freedom.

Richard R. Dailey

37, 137 N.E. 705 (1922). An inherent danger of this test is the use of "hindsight" by the court; for this reason it has been suggested that the standard should be "the reasonable and uninterested director under the circumstances." 61 HARV. L. REV. 335 (1948).

[10] There is always the possibility of ratification of the transaction by the stockholders. The court in the principal case rejects this idea because of the influence of the majority group of directors in the solicitation and use of the proxies.

[11] From the language of the present opinion it is impossible to tell which of the first three groups given above governed this decision.

[12] In cases involving a contract between two corporations with common directors, a majority of American courts do apply the "fairness" test. BALLANTINE, CORPORATIONS §67 (1946).