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Contracts Between a Director and His Corporation

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CONTRACTS BETWEEN A DIRECTOR AND HIS CORPORATION

The law generally recognizes that a director or officer of a corporation occupies a fiduciary relationship to the corporation. This relationship has been described as analogous to that of an agent to his principal or a trustee to his beneficiary.[1] Therefore it is logical that a director cannot deal with his corporation like a stranger at arm's length, but is bound by the rules of fairness and good faith which the courts have imposed on fiduciaries for the protection of those whose interests are confided to their care.[2] The courts are greatly divided as to what rules or standards of fairness will be applied in considering the validity of a transaction where the director contracts in his own behalf with his corporation or in the case of contracts among several corporations with boards having common or interlocking directors. The purpose of this note is to attempt to present, generally, the various rules applied in this situation and, by an evaluation of the decisions, determine where the West Virginia court stands on the proposition.

Generally

Before discussing any rule or standard it is important to be aware of the three situations which may or may not determine how the court will treat such a transaction. The first of these arises when the interested director participates in the board meeting authorizing such contract either by his presence being necessary to make a quorum or his vote essential to approve the transaction. Second, the interested director is present, but his participation is unnecessary to validate the contract; nevertheless he does participate. Third, the interested director in no way participates although he may or may not be present at the board meeting.

Under the strict inflexible view it has been held that, under any of the above listed situations, the contract is voidable at the option of the corporation without regard to its good faith and fairness.[3] The advocates of this rule feel that a corporation is entitled to the disinterested advice of all parties. The strictness is intended as a preventive or discouraging influence which, without attempt at

[1] BALLANTINE, MANUAL OF CORPORATION LAW AND PRACTICE 384 (1930).

[2] *Ibid.*

[3] Cuthbert v. McNeill, 103 N.J. Eq. 199, 142 Atl. 819 (1928); Munson v. Syracuse, 103 N.Y. 58, 8 N.E. 335 (1886); Pearson v. Concord R. Corp., 62 N.H. 537 (1883); *cf.*, Rothenbery v. Franklin Washington Trust Co., 127 N.J. Eq. 406, 13 A.2d 667 (1940).

discrimination, vitiates all transactions in which a director or officer is under temptation.[4] This is definitely a minority view when applied to all the above situations.

Other courts have considered the question of participation by the interested director before deciding which rule to apply in determining the validity of such a contract. It is the general view that if the presence of the interested director is necessary to make a quorum or his vote is essential to approve the contract, he in part represents the corporation, and the action taken is voidable at the option of the corporation without regard to its good faith and fairness.[5] On the other hand in most jurisdictions, such a contract cannot be avoided if the director does not participate by voting or otherwise in the corporate action which results in the making of the contract and if the transaction is a fair one.[6] This fairness test is applied by some courts even where the interested director voted in favor of the transaction if there were enough disinterested voted to render his vote unnecessary.[7]

According to the most lenient rule the validity of such a contract, whether the director participates or not, is a question of fact in each case and depends upon whether the transaction is fair and free from fraud.[8] One case upheld the contract if proven fair, even though the interested directors' votes were necessary to the corporate act of assent.[9] Under this view all contracts made by the board of directors with one of its own members, or indeed with any insider are closely scrutinized in equity and frequently overturned when, if made with strangers, they would be far more liberally viewed.[10]

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[4] BALLANTINE, MANUAL OF CORPORATION LAW AND PRACTICE 385.

[5] New Blue Point Mining Co. v. Weissbem, 198 Cal. 261, 244 Pac. 325, 328 (1926); Hotaling v. Hotaling, 193 Cal. 368, 224 Pac. 455 (1924); Laybourn v. Wrape, 72 Colo. 339, 211 Pac. 367 (1922); Mobile Land Imp. Co. v. Gass, 142 Ala. 520, 39 So. 229 (1905); Hodge v. United States Steel Corp., 64 N.J. Eq. 807, 54 Atl. 1 (1903).

[6] Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1876); Cowell v. McMillin, 177 Fed. 25 (9th Cir. 1910); Wainwright v. P. H. & R. M. Roots Co., 176 Ind. 682, 97 N.E. 8 (1912); Fort Payne Rolling Mill v. Hill, 174 Mass. 224, 54 N.E. 532 (1899).

[7] Schnittger v. Old Home Consolidated Mining Co., 144 Cal. 603, 78 Pac. 9 (1904).

[8] Ransome Concrete Machinery Co. v. Moody, 282 Fed. 29 (2d Cir. 1922); Wyman v. Bowman, 127 Fed. 257 (8th Cir. 1904); Nicholson v. Kingery, 37 Wyo. 299, 261 Pac. 122 (1927).

[9] Minnesota Loan & Trust Co. v. Peteler Car Co., 132 Minn. 277, 283, 156 N.W. 255 (1916).

[10] Ransome Concrete Machinery Co. v. Moody, 282 Fed. 29 (2d Cir. 1922).

As to common or interlocking directors the prevailing view seems to be that the presence at a directors' meeting does not permit the avoidance of a contract by either of the corporate parties, if only a minority are adversely interested and their influence is not controlling and the contract is fair. Where, however, the same persons constitute a majority of the directors of each of them, any transaction would be held voidable by some courts, without regard to the question of benefit or detriment to either, and although fair and open.[11]

The better rule appears to be that the presence of directors on both sides of a transaction does not give the arbitrary right to avoid the transaction, but subjects it to the closest scrutiny of the courts. An interlocking directorate should be not conclusively presumed to have done wrong in every transaction.[12] In these situations where fairness is the determining factor, the burden of showing that the transaction was fair and free from fraud is generally held to be upon the corporation attempting to uphold the contract.[13] However, some courts have held the burden to be upon the plaintiff to prove the contract unfair.[14]

West Virginia

In this jurisdiction we are immediately faced with a statute prohibiting any member of a board of directors to vote on a question in which he is interested otherwise than as a stockholder or be present when the same is being considered, although he may be counted in order to constitute a quorum if he then leaves the meeting.[15] Thus by the language of the statute West Virginia appears to allow some degree of participation by the interested director. The question confronting the West Virginia court is what effect is to be given to a contract entered into in violation of this statutory pro-

[11] Continental Ins. Co. v. New York & H. Ry., 187 N.Y. 225, 238, 79 N.E. 1026 (1907); Alabama Fidelity Mortgage & Bond Co. v. Dubberly, 198 Ala. 545, 73 So. 911 (1916); O'Conner Min. & Mfg. Co. v. Coosa Furnace Co., 95 Ala. 614, 10 So. 270 (1891).

[12] Irving Bank-Columbia Trust Co. v. Stoddard, 292 Fed. 815 (1st Cir. 1923); Glove Woolen Co. v. Utrea Gas & Elec. Co., 224 N.Y. 483, 121 N.E. 378 (1918).

[13] Geddes v. Anaconda Copper Mining Co., 254 U.S. 590 (1921); Irving Bank-Columbia Trust Co. v. Stoddard, 292 Fed. 815 (1st Cir. 1923).

[14] Spiegal v. Beacon Participations, 297 Mass. 398, 8 N.E.2d 895, 905 (1937); Cowell v. Thurlow S.S. Co. v. Crowell, 280 Mass. 343, 182 N.E. 369 (1932).

[15] W. VA. CODE c. 31, art. 1, § 69 (Michie 1955).

vision. At this point the court must decide which of the several aforementioned rules it will adopt.

The West Virginia court considers the relationship between a director and his corporation as being fiduciary and generally speaks of it in terms of a so-called trustee-beneficiary relationship.[16] This is the reason given for denying to a director of a corporation the right to vote on a matter in which he is otherwise interested.[17] It is felt that a corporation is entitled to have the unbiased and uninfluenced judgment of each of its directors.[18]

Several early decisions of our court use language which seems to indicate that the strict or inflexible view will control in this jurisdiction. In one case the stockholders, acting as the board of directors, decided to sell the land and dissolve the corporation. A controversy arose as to how it should be sold since several members of the committee of sale were interested in buying this property and devised a scheme whereby they were able to do so. These parties, by their votes, were able to have this scheme adopted by the corporation over the objection of the minority stockholders. The court, citing an earlier West Virginia decision,[19] held it to be a well settled principle of equity jurisprudence that a party holding a fiduciary relationship to the trust property cannot become the purchaser of such property, either directly or indirectly; and if he does, the sale is voidable and will be set aside at the mere pleasure of the beneficiary, although such fiduciary may have paid a full price and gained no advantage. The court went on to say that this rule is not confined to trustees and fiduciaries in the technical sense of the terms, but extends to every person coming within the reason of the rule, including directors of corporations.[20] Although, in effect, the court was merely following the generally accepted view in this situation of participating directors, the language seems to indicate that the same would be true in all situations regardless of participation. Soon after the *Reilly* case, in an opinion appearing in the same

[16] Young v. Oil Co., 110 W. Va. 364, 158 S.E. 678 (1931); Ravenswood, S. & G. Ry. v. Woodyard, 46 W. Va. 558, 33 S.E. 285 (1899); Sweeny v. Sugar Refining Co., 30 W. Va. 443, 4 S.E. 431 (1887); Reilly v. Oglebay, 25 W. Va. 36 (1884); Hope v. Salt Co., 25 W. Va. 789 (1885). This relationship has also been recognized by the West Virginia court as that of an agent to his principal. Timber Land Ass'n v. Neace, 92 W. Va. 196, 114 S.E. 569 (1922).

[17] Thurmond v. Colliery Co., 82 W. Va. 99, 95 S.E. 816 (1922).

[18] Timber Land Ass'n v. Neace, 92 W. Va. 196, 114 S.E. 569 (1922).

[19] Necomb v. Brooks, 16 W. Va. 32 (1879).

[20] Reilly v. Oglebay, 25 W. Va. 36 (1884).

volume of the reports, the court again considered the problem. While recognizing as the general rule that all contracts involving an interested director are voidable at the election of the part whose interest has been so represented by the party claiming under it, the court indicated that, even where the interested director was not present at the meeting and acted in accordance with the West Virginia statute, the advantages so obtained by such director ought to be held as prima facie fraudulent, yet capable of being purged of the fraudulent taint by clear and convincing proof of its fairness, reasonableness, and absolute freedom from fraud and unfairness.[21] Thus the court seemed to move away from the strict inflexible principle toward a consideration of the fairness of each particular case, at least where the statute is complied with and the interested director is not present at the meeting discussing the transaction.

In a later decision the aforementioned statutory provision was violated and the court held that a resolution of a board of directors passed at the meeting at which the presence of an interested director was necessary to constitute a quorum and the director voted thereof is prima facie fraudulent and void.[22] This is the typical situation where the interested director participated in the action approving his contract with the corporation. Under the majority view as previously set forth, this would be voidable without regard to its fairness. However, it is submitted that in the *Flanagan* case our court indicates that, even though there is a violation of the West Virginia statutes, evidence may be introduced to prove the transaction free from fraud and thereby uphold the contract.

In considering the situation where the interested directors were present at the meeting at which the transaction was ratified but did not vote, the West Virginia court recognized it to be a violation of the statutory provision forbidding interested directors from being present at the meeting and held the transaction prima facie fraudulent and void and it will be so declared unless it can be shown by the most clear and convincing proof that such transaction was not only free from fraud but both fair and reasonable.[23] Later it was held that a transaction between a director or other officer and the corporation, or a transaction in which a director or other officer is interested, is valid if entirely free from fraud, even when he has

[21] Hope v. Salt Co., 25 W. Va. 789 (1885).
[22] Flanagan v. Flanagan Coal Co., 77 W. Va. 757, 86 S.E. 297 (1916).
[23] Hulings v. Hulings Lumber Co., 38 W. Va. 351, 18 S.E. 620 (1893).

acted as a member of the board authorizing the same if there were enough dissenting votes in favor of the transaction to render his vote unnecessary.[24] Thus the court seems to follow the view previously discussed.[25] Several decisions have pointed out that a violation of the beforementioned statutory provision causes a presumption of fraud to arise, but recognize that this presumption may be rebutted by clear and convincing evidence that the transaction was fair and reasonable and wholly free from fraud.[26]

As to the question of dealings between corporations controlled by common directors the West Virginia court has held that such transactions are not unlawful but require close scrutiny in a court of equity, and are voidable. If the appearance of fraud exists, equity will refuse its aid in the enforcement of the contract.[27] The court recognized and approved the general rule that the burden of proving that a contract between corporations having in common the same manager or directors is fair is on the party who would sustain such contract.[28] On this problem of common directors West Virginia apparently stands with the better view in the United States.

In all of these beforementioned situations it is possible for the contract to be ratified by the corporation through its stockholders. In the *Griffin* case our court held that ratification is implied if the corporation accepts or retains the benefit of the transaction with knowledge of the facts. Ordinarily it is for the stockholders collectively to ratify or disaffirm the transaction and an individual stockholder cannot object.[29]

Conclusion

Thus it appears that in nearly every situation the West Virginia court, whether it speaks of such a contract as being prima facie fraudulent and void or merely voidable, still permits the introduction of evidence of fairness and lack of fraud and will decide each case on its particular facts. It would seem that regardless of the

[24] Griffin v. Boom Lumber Co., 55 W. Va. 604, 48 S.E. 442 (1904).

[25] Schnittger v. Old Home Consolidated Mining Co., 144 Cal. 603, 78 Pac. 9 (1904).

[26] Finefrock v. Knove Car Co., 37 F.2d 310 (4th Cir. 1930); Campbell v. Lumber Co., 106 W. Va. 142, 145 S.E. 160 (1928).

[27] Wheeling Dollar Savings & Trust Co. v. Hoffman, 127 W. Va. 777, 35 S.E.2d 84 (1945).

[28] *Ibid.*

[29] Griffin v. Boom Lumber Co., 55 W. Va. 604, 48 S.E. 442 (1904).

language used, the West Virginia decisions indicate a trend toward the more lenient view that the court will scrutinize the facts in each particular case and the question of fairness will govern.

Several cases have suggested that one way to avoid the problems presented in the previous discussion would be to include in the certificate of incorporation a clause expressly validating any such contracts between the director and corporation and any transactions between the corporation and any other corporation having a common or interlocking board of directors. In the absence of bad faith or willfully fraudulent conduct on the part of the director such exculpatory provisions have been upheld although there is very little law concerning this problem.[30] There has been no opinion on this subject expressed by the West Virginia Supreme Court of Appeals.

There seems to be no good reason why such contracts should not be upheld when fair and free from fraud at least where the interested director in no way participates in the action approving his contract; and possibly the court should consider fairness even where the director's participation is responsible for such approval. There is always the possibility that such a contract will be of great benefit to the corporation. However, the director must be scrupulous to see that the corporation knows what he is doing and that it is an honest and fair dealing on his part in the best interests of the corporation.

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[30] Piccard v. Sperry Corp., 48 F. Supp. 465 (N.Y. 1943); Martin Foundation v. North American Rayon Co., 31 Del. Ch. 195, 68 A.2d 313 (1949); Speigal v. Beacon Participations, 297 Mass. 398, 8 N.E.2d 895 (1937).