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Corporations Right to Profits Made by Directors

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CORPORATION'S RIGHT TO PROFITS MADE BY DIRECTORS

JUST how far a director's duty to his corporation operates to prevent him from entering into private transactions which might have been advantageously entered into by his corporation, is not only an interesting legal question but one ever recurring and of grave importance in modern business. Undoubtedly there is a large field for individual activity lying outside the duty of the director and still within the scope of the corporate business.[1] A recent Illinois decision goes into this "No Man's Land" lying between the director's duty to his corporation and his right as an individual to promote his own interests, and seems at first glance to restrict materially the director's personal business freedom. A corporation had entered into a contract with certain persons under which the corporation secured a license to manufacture and sell certain patented articles, paying as royalties therefor a per cent of the gross receipts from sales. Certain directors of the corporation privately purchased the licensor's royalty rights for their own benefit, without disclosing to the corporation the opportunity to make the purchase although the corporation was financially in a position to take advantage of it. The court held that the directors were not entitled to collect from the corporation any royalties beyond the amount necessary to reimburse them for the purchase price, apparently on the ground that they were to be deemed as having purchased the contract rights in trust for the corporation.[2]

It is everywhere agreed that a director occupies a fiduciary relation to his corporation.[3] But although the courts and writers speak of the director as a trustee for his corporation and for the body of the stockholders,[4] they are not in accord as to the extent

[1] See note 13 Col. L. R. 431, 432; 4 Fletcher, Cyc. Corp., sec. 2282.

[2] Farwell v. Pyle-National Electric Headlight Co., (Ill. 1919) 124 N. E. 449.

[3] 2 Machen, Modern Law of Corp., sec. 1564; Perry on Trusts, 6th ed., sec. 207.

[4] Hoffman Steam Coal Co. v. Cumberland Coal & Iron Co., (1860) 16 Md. 456, 77 Am. Dec. 311; Taylor v. Mitchell, (1900) 80 Minn. 492, 83 N. W. 418; Hooker v. Midland Steel Co., (1905) 215 Ill. 444, 451, 74 N. E. 445, 106 A. S. R. 170; 10 Cyc. 787.

of the trusteeship or of the duty this imposes upon him with respect to transactions where his individual interests may rival the interests of his corporation. It was contended in the recent Illinois case that the mere fact that an investment would be beneficial to the corporation, the corporation being in a position to take advantage of it, raises a duty in the director to offer it to his company before taking it for himself. Statements in text-books[5] and dicta of judges[6] appear to support this contention, but the cases therein cited do not bear them out. For in each of the cases cited there was not only an investment which would have been to the interests of the corporation, but the corporation, by its nature or otherwise, had been actually committed to the investment, to the director's knowledge, so that he was under a specific duty to procure it for his corporation or at least to give it the first opportunity to make the investment.[7] In one of these cases the distinction is clearly brought out by the peculiar facts of the case. A quarrying corporation which held an undivided one-third interest in certain quarry lands and a lease of another third of the same lands, secured a contract for the conveyance of the leased one-third as soon as good title could be given. Two directors of the corporation purchased for themselves the outstanding one-third interest and also the title to the leased one-third. The court declared the directors trustees for the benefit of the corporation as to the leased one-third but refused to do so as to the remaining one-third although it would have been to the corporation's interest to buy it, and although the corporation had previously tried to purchase it, and the directors gained an appreciation of its value through their position as directors, the court saying:

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[5] 2 Machen, Modern Law of Corp., sec. 1620; 3 Pomeroy's Equity Jur., 4th ed., sec. 1077; Cook, Corp., 6th ed., sec. 660.

[6] Kavanaugh v. Kavanaugh Knitting Co., (N. Y. 1919) 123 N. E. 148; Leader Pub. Co. v. Grant, etc., Co., (1915) 182 Ind. 651, 108 N. E. 121.

[7] These cases in which directors were held as trustees for the company, were of directors purchasing or leasing for themselves when commissioned to purchase or lease for the corporation; claiming investments for themselves when made as corporate officers in corporate employ and apparently with corporate money; acquiring for themselves property known to be essential to the existence of the corporation, or to carry out its objects; acquiring property for themselves and thereby ousting the corporation of a valuable property right, or of a valuable expectancy of acquisition or of renewal of a lease. See cases cited in footnote 5, (p. 1340) to sec. 1620, Machen, II, supra; and in footnote 1, (p. 1340) to sec. 660, Cook, II, supra. When the corporation has resolved to make a certain investment, the director cannot go out and secure it for himself. Kroegher v. Calivada Coloniz. Co., (1902) 119 Fed. 641; Acker, etc., Co. v. McGraw, (1907) 106 Md. 536, 68 Atl. 17.

"Good faith to the corporation does not require of its officers that they steer from their own to the corporation's benefit enterprises or investments which, though capable of profit to the corporation, have in no way become subject to their trust or duty."[8]

This, though perhaps an extreme case; illustrates the prevailing tendency which the court in a later case thus expressed:

"Whether in any case an officer of a corporation is in duty bound to purchase property for the corporation, or to refrain from purchasing property for himself, depends upon whether the corporation has an interest, actual or in expectancy, in the property, or whether the purchase of the property by the officer or director may hinder or defeat the plans and purposes of the corporation in the carrying on or development of the legitimate business for which it was created."[9]

Some writers have gone so far as to say that the director will be held to have taken the property in trust for the corporation only when he was under a present specific duty to purchase the property for the corporation.[10] It is submitted that this inaccurately states the question, which is rather whether he was under a duty to offer the investment to his corporation and give it the opportunity to accept or refuse before taking it for himself;[11] and that the test as to whether there was such a duty depends upon whether, as between the director and the corporation, the opportunity belonged to the corporation, on account of the necessities of its business, or some definite action already taken by it or by another in proposals to it. If the transaction is not so appropriated to the corporation, it would seem that the director may legally take it for himself.[12] Although he is always required to use the utmost good faith when dealing with his corporation, a director certainly should not be required to become a self-sacrificing "Good Samaritan" in handing business over to it, simply because such business would be beneficial to it.

Before proceeding to a discussion of transactions where the director has purchased rights under an assignment of a con-

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[8] Lagarde v. Anniston, etc., Co., (1900) 126 Ala. 496, 502, 28 So. 199.

[9] Zeckendorf v. Steinfeld, (1909) 12 Ariz. 245, 262, 100 Pac. 784; see also a very similar statement in Lagarde v. Anniston, etc., Co., (1900) 126 Ala. 496, 502, 28 So. 199.

[10] See note 13 Col. L. R. 431 at 432; also 4 Fletcher, Cyc. Corp., sec. 2282.

[11] When the corporation is clearly unable to enter upon the transaction, the reason for the rule is gone and the director's specific duty does not arise. Crittendon & Cowler Co. v. Cowler, (1901) 66 N. Y. App. Div. 95; see McDermott Mining Co. v. McDermott, (1902) 27 Mont. 143, 69 Pac. 715.

tract to which the corporation is a party, it is necessary to notice a difference often apparent between the basis for raising a constructive trust where the director has purchased a contract right against his corporation and the basis for the trust where he has merely purchased property which would have been beneficial to the corporation. The constructive trust, of course, arises in both cases from the breach of some duty growing out of the fiduciary relationship. But where the circumstances are not such as to have entitled the corporation to priority, the basis for raising the constructive trust must arise, if at all, from other considerations, and must rest in the principle that equity will not permit a director to place himself in a position where his personal interests are adverse to the best interests of his corporation and where those interests may lead him to take advantage of his official position as a director to advance his own interests to the prejudice of the corporation. He is under a duty to refrain from engaging in transactions which will so place him. It must be apparent, however, that this doctrine ordinarily cannot be invoked in the case of purchases of real or personal property, while it often can and should be invoked where the director has, by assignment, become a party to an executory contract with his corporation.

Transactions involving the assignment to the director of a contract with his corporation may be divided for the purposes of this discussion into two general classes: (1) liquidated claims, and (2) valuable executory contracts and unliquidated claims. The courts regard the former, at least, in the same light as purchases of property, which in fact they are, and where a constructive trust is imposed, allow the director to realize from his venture no more than is necessary to reimburse him for what he has actually paid.[13] The cases of this type usually arise where the director has purchased a claim against his corporation at a discount and is attempting to enforce it at its face value. Since the situation is practically the same as where he has purchased property which he desires to realize a

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[12] In such case the fact that the director gained an appreciation of his bargain because of his connection with his company raises no such duty. Lagarde v. Anniston, etc., Co., (1900) 126 Ala. 496, 28 So. 199; Zeckendorf v. Steinfeld, (1909) 12 Ariz. 245, 100 Pac. 784; although this should be carefully distinguished from the use for personal advantage of corporate knowledge entrusted to him as a corporate officer. See Du Pont v. Du Pont, (1907) 242 Fed. 98, 136.

[13] Kroegher v. Calivada Coloniz. Co.. (1902) 119 Fed. 641; The Telegraph v. Lee, (1904) 125 Ia. 17, 98 N. W. 364.

profit upon, it would seem that he should be permitted to enforce the claim at par when due, unless facts are shown to have existed which appropriated the investment to the corporation and imposed upon the director in the exercise of good faith the duty to offer it to his corporation before buying it in personally. In line with this view, the weight of authority supports the purchase by directors of corporate securities from third persons at a discount and their enforcement against the corporation at par, provided the directors owed no present duty to discharge or buy them;[14] and the better text writers[15] and a majority of the courts support the purchase by directors of general debts of the corporation under the same conditions.[16]

The contrary view is stated by Cook in his work on Corporations, in which he limits the rule to bonds, saying:

"It is a fraud on the corporation and corporate creditors for directors to buy up at a discount outstanding debts of the corporation and compel it to pay the full face value thereof."[17]

A majority of the cases he cites to sustain this statement were of directors who bought up claims against their corporation when it was insolvent.[18] It is, of course, well settled that a director of an insolvent corporation cannot buy up outstanding obligations at a discount and enforce them at par, thus working a preference in his behalf to the prejudice of creditors for whom he then stands as a quasi-trustee.[19] A few early cases, however, hold squarely that whenever a director buys obligations against his corporation at a discount, the purchase inures to the benefit of the corporation;[20] and the reasoning of

[14] Seymour v. Spring Forest Cemetery Ass'n., (1895) 144 N. Y. 333, 344, 39 N. E. 365, 26 L. R. A. 859; Camden Safe Deposit & Trust Co. v. Citizens Ice & Storage Co., (1905) 69 N. J. Eq. 718, 61 Atl. 529, aff'd 71 N. J. Eq. 221, 65 Atl. 980. Yet contrary intimations are sometimes found. See 10 Cyc. 798.

[15] Morawetz, Priv. Corp., sec. 521; Machen, Modern Law of Corp., sec. 1623.

[16] Inglehart v. Thousand Is. H. Co., (1884) 32 Hun (N.Y.) 377, 383; St. Louis, etc., R. Co. v. Chenault, (1886) 36 Kan. 51, 22 Pac. 303; Glenwood Mfg. Co. v. Syme, (1901) 109 Wis. 355, 85 N. W. 432; McIntyre v. Ajax Min. Co., (1904) 28 Utah 162, 171, 77 Pac. 613; Martin v. Chambers, (1914) 214 Fed. 769.

[17] 2 Cook, Corp., 6th ed., sec. 660.

[18] As Bulkley v. Whitcomb, (1890) 121 N. Y. 107, 24 N. E. 13. See cases cited in footnote, (p. 1949) to sec. 660, Cook, supra.

[19] Bulkley v. Whitcomb, (1890) 121 N. Y. 107, 24 N. E. 13; Bonney v. Tilley, (1895) 109 Cal. 346, 42 Pac. 439. See Martin v. Chambers, (1914) 214 Fed. 769 (dictum), and Morawetz, Corp., sec. 787.

[20] Hill v. Frazier, (1853) 22 Pa. St. 320; Moses v. Ocoee Bank, (1878) 1 Lea (Tenn.) 398, follows strict rule but disapproves; Davis v. Rock Creek, etc., Co., (1880) 55 Cal. 359, 36 Am. Rep. 40; Bramblett v. Com.

these cases would seem to apply as well to bonds as to other obligations. They are based on the principle to which reference has already been made, that a director is a trustee and cannot be allowed to acquire interests adverse to his cestuis.[21] The reason for the application of the principle was that equity would not allow a director to take part in a transaction which might tempt him to make use of the power of his official position to injure his corporation for the advancement of his personal interests. As more and more of the business of the country has come to be carried on by corporations, it has become evident that the application of this strict trust accountability rule unwisely limits the activities of directors and is impracticable. And since the reason for the rule can hardly be said to be present where the corporation is solvent and the claim is a liquidated amount fixed before the director purchased it, the courts have gradually relaxed the rule[22] in such cases to the end that the directors be given the greatest possible freedom compatible with strict fairness to the corporation.[23]

& Lumber Co., (1904) 26 Ky. L. Rep. 1176, 83 S. W. 599; (1905) 27 Ky. L. Rep. 156, 84 S. W. 545, is the onlv late case found which clings to the strict trustee view.

[21] "A trustee . . . cannot buy up a debt or encumbrance to which the trust estate is liable, for less than is actually due thereon, and make a profit to himself." Perry, Trusts, 6th ed., sec. 428. See Davis v. Rock Creek, etc., Co., (1880) 55 Cal. 359, 36 Am. Rep. 40; Bramblett v. Com. & Lumber Co., (1904) 26 Ky. L. Rep. 1176, 83 S. W. 599; 27 Ky. L. Rep. 156, 84 S. W. 545; 10 Cyc. 798.

[22] This gradual relaxation from strict trustee accountability is evidenced by the changed view taken by the courts toward direct contracts by directors with their corporations. Thus it was originally held that such contracts were voidable regardless of their fairness; Munson v. S. G. & C. Ry. Co., (1886) 103 N. Y. 58, 8 N. E. 355; see leading Scotch case of Aberdeen Ry. Co. v. Blaikie Bros., (1886) 1 Macqueen 461; later such contracts while prima facie voidable when proved fair have been held valid in the United States, if the director's vote was not necessary to procure the corporation's acceptance; Schnittger v. Old Home, etc., Co., (1904) 144 Cal. 603, 78 Pac. 9; and the modern tendency is that even though the interested directors' votes are necessary to procure its acceptance, such a contract, if proved fair, is valid. Minn. Loan & Trust Co. v. Peteler Car Co., (1916) 132 Minn. 277, 156 N. W. 255. The last case is a far cry from the early view.

[23] In the recent Illinois case it was stated that, "If it is for the interest of the corporation to buy its bonds at a discount, and it is financially able to do so, a director will not be permitted to buy those bonds at a discount and enforce payment in full against the corporation." This statement was supported by reference to two previous Illinois cases in which there were dicta to this general effect, but in both cases there were other circumstances which clearly raised the specific duty to offer the corporation first chance. Higgins v. Lansingh, (1895) 154 Ill. 301, 40 N. E. 362; Harts v. Brown, (1875) 77 Ill. 226. No reason is seen here why the bare fact that the purchase of the obligation might be beneficial to the corporation which is in a position to make it should raise a duty in the

It should be noticed, however, that where the claim has reached maturity before the director has purchased, there are strong reasons for holding that the purchase is appropriated to the corporation and that the director therefore violates a present specific duty when he purchases for himself without first offering the opportunity to his corporation, since the corporation is under a present existing obligation to pay the claim.[24]

The purchase by directors of valuable executory contracts and unliquidated claims against their corporation, on the other hand, creates a relationship in which the rights and duties of the parties are not always definitely fixed beyond the power of the director to change. That the contract in the recent Illinois case was of this nature is evidenced by the fact that the case arose over a dispute between the directors and the corporation as to the amount of money as royalties due the directors under the contract. Does a director's position permit him to purchase such a contract against his corporation? For some reason this appears to be an obscure point upon which little is said in the texts and in adjudication of which we have comparatively few cases. One text states that if a director may purchase bonds of the company and enforce them, he may presumably purchase from a contractor a supposedly valuable contract with the company.[25] But the one case cited in support of this passage, though not strictly in point, states in dictum that the director in such case would not be permitted to make a profit from the contract. Another text affirms that when an officer of a corporation has made a contract on behalf of his corporation with a third person, he will not be allowed afterwards to take an assignment of the contract from the latter or otherwise acquire an interest therein adverse to the corporation, without its consent.[26] It is submitted that the cases[27] and correct reasoning

director first to offer it to the corporation, any more than in the case of the purchase of other property.

[24] Some cases clearly recognize this point. Seymour v. Spring Forest Cemetery Ass'n, (1895) 144 N. Y. 333, 39 N. E. 365, 26 L. R. A. 859; Glenwood Mfg. Co. v. Syme, (1901) 109 Wis. 355, 85 N. W. 432. Yet other cases appear to ignore it. Inglehart v. Thousand Is. H. Co., (1884) 32 Hun (N.Y.) 377; McIntyre v. Ajax Min. Co., (1904) 28 Utah 162, 77 Pac. 613.

[25] 2 Machen, Modern Law of Corp., sec. 1623.

[26] 4 Fletcher, Cyc. of Corps., sec. 2284.

[27] The cases though few and not recent are not conflicting. Paine v. Lake Erie, etc., R. Co., (1869) 31 Ind. 283; European, etc., Ry. Co. v. Poor, (1871) 59 Me. 277; Risley v. Ind. B. & W. R. Co., (1875) 62 N. Y. 240; Gilman, C. & S. R. Co. v. Kelly, (1875) 77 Ill. 426, directors breached duty in becoming shareholders in contractor company; Barnes v. Brown, (1880) 80 N. Y. 527, (dictum).

go even farther and preclude a director from receiving, without the consent of his corporation, profits derived from the assignment of any contract which would place him in such a position that he might have the power as a director to injure his corporation in the pursuit of his own interests. Such injury, we have seen, would not ordinarily be possible in the case of the purchase of liquidated claims against the corporation, wherein the rights and duties of the parties are in no way subject to the judgment of the director. But it would be possible in the case of purchases by directors of executory contracts and contracts involving unliquidated claims, because in such cases a further exercise of judgment is necessary on the part of the corporation, respecting the enforcement of the contract, the fullness of performance, and other considerations; and the director's position is such that he might, in the pursuit of his own interests, induce his corporation to act against its best interests. And it is a sound equitable principle that no one occupying a fiduciary position of any kind has the right, without the permission of his beneficiary, to place himself in such a position that he may have an incentive together with a power to injure his beneficiary.[28]

The true rule governing all the transactions herein considered would then seem to be this: If the transaction, under all the circumstances, is in no way appropriated to the corporation so that the director is under a specific duty to offer it to the corporation before taking it for himself, he may legally enter upon it personally for his own benefit, unless in so doing he will place himself in such a position that he will have an incentive together with the power to induce his corporation to act against its best interests in order to promote his adverse personal interests.

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[28] 3 Pomeroy's Eq. Juris., sec. 1077, (p. 2473).