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THE INTERESTED DIRECTOR IN TEXAS

by John J. Kendrick, Jr.

An officer¹ or director of a corporation occupies a unique position in relation to his company. Although he is an agent of the corporation,² he occupies a higher position, and thus has a higher standard of duty, than the ordinary agent owes his principal. Since the entire management of the corporation is left to the discretion of its board of directors, he is required to act in the utmost good faith and to exercise his "power solely in the interest of the corporation . . . and not for . . . [his] own personal interests."³ This position has been classified as a fiduciary relationship⁴ but it would seem to be more of a quasi-fiduciary relationship⁵ since the director of the corporation is not strictly a trustee and his duties and liabilities are not necessarily identical with those of other fiduciaries.⁶ Directors, unlike trustees, have been allowed to participate to a limited degree in transactions in which their interest is not identical to that of the corporation.

It is this nebulous area where the director is allowed to participate, the so-called "interested director transaction," that this Comment seeks to examine. A director's interest does not turn on any technical form or legal status; it is a substantial fact question to be decided by the trier of fact.⁷ No cases were found which discussed the issue at length or formulate any guidelines as to what is considered interested. Rather, the courts seem to assume the interest and then discuss the appropriate consequences which ought to follow. Therefore, in order to draw any conclusions as to what constitutes "interest" it is necessary to examine the director's relationship to the transaction and from these facts try to ascertain why the court assumed his interest in a particular case. The various examples of director liability and duty are merely used as a vehicle to discover the type of circumstances that may or may not be considered interested and no attempt

¹ Since corporate officers are usually also directors of a corporation, the term director will be used. Admittedly, an officer who is not a director still has a duty to his corporation, but this Comment will not deal with the extent of that duty.

² *Tenison v. Patton*, 95 Tex. 284, 293, 67 S.W. 92, 95 (1902); 3 W. FLETCHER, PRIVATE CORPORATIONS § 838, at 176 (1965).

³ *Perlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955); *Markovitz v. Markovitz*, 336 Pa. 145, 8 A.2d 46 (1939); *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963). See also 19 AM. JUR. 2d *Corporations* § 1272, at 679 (1965).

⁴ E.g., *Paddock v. Siemoneit*, 147 Tex. 571, 218 S.W.2d 428 (1949) (undoubtedly as director and the managing officer of the corporation, Siemoneit occupied the position of a fiduciary toward the company). See also *Tenison v. Patton*, 95 Tex. 284, 67 S.W. 92 (1902).

⁵ *LeMire v. Galloway*, 130 Fla. 101, 177 So. 283 (1937) (director occupies a quasi-fiduciary relationship).

⁶ *Clayton v. James B. Clow & Sons*, 212 F. Supp. 482 (N.D. Ill. 1962); *Paddock v. Siemoneit*, 147 Tex. 571, 577, 218 S.W.2d 428, 431 (1949). Acts which would be considered a breach of trust by other trustees sometimes have been allowed when done by corporate officers or directors. For example, in an ordinary trustee-beneficiary relationship, the trustee is not allowed to have even the slightest interest in a transaction for the benefit of the trust, unless the trust provides otherwise. While such an admirable theory would perhaps be of benefit to a corporation, it would be unworkable in the complex business world of today where directors often have related business interests.

⁷ *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963); *Allen v. Wilkerson*, 396 S.W.2d 493 (Tex. Civ. App. 1965) *error ref. n.r.e.*

will be made to delve into all the intricacies and outer limits of liability that may be imposed after a finding of interest.

I. WHAT IS INTEREST?

Various interests could motivate a director in his dealings with his corporation. For example, a director might refuse to vote for a contract with an individual because of his political or religious convictions; or a director might utilize corporate transactions to gain publicity in order to run for a political office. In either of these instances it could be said that the director was interested in the transactions. Since this type of interest has never been legally recognized, this Comment will not deal with these areas, but rather will deal with the one type of interest for which legal redress has been provided, *viz.*, economic or financial interest. Where the director will actually receive a financial benefit from a transaction involving his corporation, his interest is obvious and the law recognizes it.

The corporation has a right to have the unbiased judgment of its directors in every decision affecting the corporation. When the director is financially interested in the outcome of the decision, there is always the possibility that his judgment may be swayed to reflect this interest. It is this possibility of self-dealing that is the essence of the interested director doctrine.

The most obvious example of an interested transaction is the sale of corporate property to a director of the corporation.⁸ In *Brooks v. Zorn*,⁹ a Texas case, the president of a corporation purchased a block of land from the corporation for \$12,000 and in turn sold one half of the tract to Gordon, another director. The land had been purchased by the corporation as a building site for their offices, but the corporation was unable to obtain sufficient cash to start the building. Brooks paid no cash for the land but rather credited his account for the \$12,000 purchase. When a shareholder instituted a suit on behalf of the bankrupt corporation, the court recognized that Gordon and Brooks were unquestionably interested.¹⁰

Likewise, a director is interested when he sells personally-owned property to his corporation.¹¹ In *Niagara Fire Insurance Co. v. Numismatic Co.*¹² the president sold personally-owned coins to his corporation. The court recognized as "hornbook law" that contracts where an officer (or director) represents both himself and the corporation are subject to scrutiny. The question of interest arose when the insurance carrier of the corporation questioned whether the coins, which were stolen, had been properly sold to the corporation. While the court never stated that this was an interested

⁸ *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963). See *Wing v. Dillingham*, 239 F. 54 (5th Cir. 1917); *Shield v. Shield*, 286 S.W.2d 252 (Tex. Civ. App. 1955) *error ref. n.r.e.*; *Texas Auto Co. v. Arbetter*, 1 S.W.2d 334 (Tex. Civ. App. 1927) *error dismissed*; *Canadian Country Club v. Johnson*, 176 S.W. 835 (Tex. Civ. App. 1915) *error ref.*

⁹ 24 S.W.2d 742 (Tex. Civ. App. 1929) *error dismissed*.

¹⁰ *Id.* at 747.

¹¹ *Niagara Fire Ins. Co. v. Numismatic Co.*, 380 S.W.2d 830 (Tex. Civ. App. 1964) *error ref. n.r.e.*; *Allen v. Hutcheson*, 121 S.W. 1141 (Tex. Civ. App. 1909) *error ref.*

¹² 380 S.W.2d 830 (Tex. Civ. App. 1964) *error ref. n.r.e.*

transaction it clearly regarded it as such.¹³ Since such a sale is usually profitable to the director,¹⁴ the possibility that he will favor his own interests rather than the corporation is obvious.

Any contract between a director as an individual and his corporation also raises the possibility of divided loyalty. In such cases the director will be considered interested. For example, a lease by a director with his corporation, either as lessor or lessee, should be closely examined.¹⁵ Similarly, in *Mercury Life & Health Co. v. Hughes*¹⁶ the directors approved a ten-year management contract for Hughes, a director. Under the contract Hughes and his wife were to receive fifty-one per cent of the net profits of the corporation. Another director was to receive a portion of the profits, and a third was to receive an advertising fee. When Hughes sued to enforce the contract, the court refused to do so since all of the directors had a personal, financial interest in the contract. Thus, the setting of salary,¹⁷ awarding of a bonus,¹⁸ granting of an employment contract,¹⁹ or any other contract from which a director will benefit, is considered an interested transaction.

Another area which involves the possibility of self-dealing is the use of corporate assets for the benefit of a director. If a director uses corporate funds to secure himself against personal obligations,²⁰ or to pay off a personal note,²¹ or to engage in a proxy fight for control,²² he is interested in the transaction. A loan of corporate funds to a director is an interested transaction and may even be prohibited under state corporate law.²³ Since most states have adopted the Model Business Corporation Act,²⁴ which expressly prohibits loans to corporate officers and directors,²⁵ this problem will usually be controlled by state corporate law. In Texas, however, the Business Corporation Act omitted section 42 of the Model Act,²⁶ which makes such loans illegal, thus creating the problem found in *Whitten v. Republic National Bank*.²⁷ In *Whitten* the corporation paid a personal debt of its president in return for which the corporation received his per-

¹³ *Id.* See discussion of interested director cases, *id.* at 835.

¹⁴ A transaction may still be considered interested if unprofitable to the director, but the corporation will seldom desire to avoid it.

¹⁵ *Phil H. Pierce Co. v. Rude*, 291 S.W. 974 (Tex. Civ. App. 1927) *error dismissed*.

¹⁶ 271 S.W.2d 842 (Tex. Civ. App. 1954) *error ref.*

¹⁷ *Popperman v. Rest Haven Cemetery, Inc.*, 162 Tex. 255, 345 S.W.2d 715 (1961); *Bounds v. Stephenson*, 187 S.W. 1031 (Tex. Civ. App. 1916) *error ref.* (since no director voted on his own salary and there was no evidence of collusion to set each other's salary, the salaries were valid).

¹⁸ *A. J. Anderson Co. v. Kinsolving*, 262 S.W. 150 (Tex. Civ. App. 1924) *error dismissed*.

¹⁹ *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563 (Tex. Civ. App. 1962) *error ref. n.r.e.*

²⁰ *Scott v. Farmers' & Merchants' Nat'l Bank*, 97 Tex. 31, 75 S.W. 7 (1903).

²¹ *Duncan v. Ponton*, 102 S.W.2d 517 (Tex. Civ. App. 1937); *Wharton v. Washington County State Bank*, 153 S.W. 699 (Tex. Civ. App. 1913).

²² *Lawyer's Advertising Co. v. Consolidated R.L. & R. Co.*, 187 N.Y. 395, 80 N.E. 199 (1907).

²³ *Cole v. Brandle*, 127 N.J. Eq. 31, 11 A.2d 255 (Ct. Err. & App. 1940). Likewise a loan by a director to the corporation should be considered interested. *Henger v. Sale*, 365 S.W.2d 335 (Tex. 1963); *Bayou Drilling Co. v. Baillio*, 312 S.W.2d 705 (Tex. Civ. App. 1958) *error ref. n.r.e.*

²⁴ ABA-ALI MODEL BUS. CORP. ACT (1953).

²⁵ *Id.* § 42 provides: "No loans shall be made by a corporation to its officers or directors."

²⁶ *Id.*

²⁷ 397 S.W.2d 415 (Tex. 1966), *noted in* 20 Sw. L.J. 861 (1966).

sonal note. The Texas Supreme Court stated that article 2.02A(6)²⁸ of the Texas Business Corporation Act was a limitation on a specific power granted and not a positive prohibition,²⁹ and thus a loan by the corporation to an officer or director was not prohibited but merely ultra vires.³⁰ Possibly the court based this on the omission of section 42 of the Model Act, which they felt indicated an intention not to render loans to officers and directors illegal.³¹ However, the Texas Business Corporation Act does include article 2.41A(4)³² which provides that "the directors who vote for or assent to the making of a loan to an officer or director of the corporation . . . shall be jointly and severally liable to the corporation for the amount of such loans until the repayment thereof."³³ The question that immediately comes to mind is to what extent can the other directors be liable. Can they be forced to personally pay off the loan when made or do they merely become liable if the loan is not eventually repaid? While these questions remain unanswered, a possible solution might be to recognize that a loan is an interested director transaction and therefore may be contested by a shareholder just as in any other interested transaction.

II. INDIRECT INTEREST

Any time a director attempts to deal directly with his corporation the transaction will be considered interested. In addition, when the director is not directly dealing with his corporation, but some other entity with which he is connected deals with his corporation, the same reasoning applies. Therefore, transactions between corporations having directors in common are regarded with suspicion for the same reason that any interested director transaction is so regarded—the possibility of a conflict between personal interest and duty to the corporation. In *Felty v. National Oil Co.*,³⁴ a leading Texas case in this area, an oil lease was transferred by one corporation to another which had identical members on its board of directors. The court remanded the suit which attempted to cancel the transfer, relying on the United States Supreme Court case of *Geddes v. Anaconda Copper Mining Co.*³⁵ In *Geddes* the minority shareholders of Alice Company sought to avoid the sale of its assets to Anaconda Company since the sale was negotiated by two boards of directors, with a common membership, and was for inadequate consideration. The Supreme Court, in holding the price inadequate, stated that:

[T]he relationship of directors to corporations is of such a fiduciary nature that transactions between boards having common members are regarded as

²⁸ TEX. BUS. CORP. ACT ANN. art. 2.02A(6) (1956) provides: "Subject to the provisions of Sections B and C of this Article, each corporation shall have power . . . (6) To lend money to, and otherwise assist its employees, but not its officers and directors."

²⁹ 397 S.W.2d 415, 419 (Tex. 1966).

³⁰ See Note, *Bank Not Liable for Requiring a Corporate Client To Commit an Ultra Vires Act—TBCA 2.04A By-Passed*, 20 Sw. L.J. 861 (1966).

³¹ *Id.* at 865.

³² TEX. BUS. CORP. ACT ANN. art. 2.41A(4) (1956).

³³ *Id.*

³⁴ 155 S.W.2d 656 (Tex. Civ. App. 1941).

³⁵ 254 U.S. 590 (1921).

jealously by the law as are personal dealings between a director and his corporation, and where the fairness of such transactions is challenged the burden is upon those who would maintain them to show their entire fairness and where a sale is involved the full adequacy of the consideration.³⁶

The Court noted that the rule is "founded in soundest morality, and in the soundest business policy."³⁷ The same rationale that applies the interested director doctrine to transactions between corporations having directors in common could be used to find interest in transactions between a director's corporation and another corporation in which he is a shareholder. This seems logical only if the director is the controlling shareholder of the second corporation. If he owns a small percentage of the shares, the treatment seems undeserved since his ability to personally profit from the transaction will be negligible.

The interested director concept has also been applied to transactions by, or on behalf of, the spouse or other close relative of a director. In *Knox Glass Bottle Co. v. Underwood*³⁸ the Mississippi Supreme Court held the wife, sons and trustees for the grandchildren of a director liable for profits resulting from the lease of trucks by them to the corporation. The court stated that "where a fiduciary is barred from making a profit at the expense of a trust or his cestui, the prohibition likewise extends to the wife and other close relatives of the fiduciary."³⁹ While there are few cases dealing with other close relatives of the director,⁴⁰ transactions with the spouse are certainly sufficient to cause interest,⁴¹ especially in community property states. In *Davis v. Nueces Valley Irrigation Co.*⁴² the wife of a director purchased land from the corporation with community funds. The court, finding that the land would become the community estate of both the director and his wife, recognized that the transaction was interested. An earlier case even extended this doctrine to the sale of corporate property to the wife of a director which would not be part of the community estate (purchased with separate funds), since the income from the property would be community property under Texas law.⁴³

Any transaction between a corporation and an entity associated with a director may be questionable, and it is often difficult to discern what relationship to a director is sufficient to "taint" the transaction. It seems clear that a transaction involving a partnership or association of which a director is a member is subject to the same conditions and restrictions as

³⁶ *Id.* at 599.

³⁷ *Id.* See also *Sterling v. Mayflower Hotel Corp.*, 33 Del. Ch. 293, 93 A.2d 107 (Sup. Ct. 1952); *Williams v. Salisbury Ice Co.*, 176 Md. 13, 3 A.2d 507 (1939); *Felty v. National Oil Co.*, 155 S.W.2d 656 (Tex. Civ. App. 1941).

³⁸ 228 Miss. 699, 89 So. 2d 799 (1956).

³⁹ 89 So. 2d at 819.

⁴⁰ *Cf.* *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963). A director in the corporation was held not interested in a contract between the corporation and the director's brother-in-law.

⁴¹ *J. W. Butler Paper Co. v. Robbins*, 151 Ill. 588, 38 N.E. 153 (1894); *National Mfrs. Co. v. Bird*, 97 N.J. Eq. 242, 127 A. 819 (Ch. 1925); *Voorhees v. Nixon*, 72 N.J. Eq. 791, 66 A. 192 (Ch. 1907).

⁴² 103 Tex. 243, 126 S.W. 4 (1910).

⁴³ *Green v. Hugo*, 81 Tex. 452, 17 S.W. 79 (1891).

if made with the director himself.⁴⁴ Likewise an agency controlled by the director could not deal disinterestedly with the corporation.⁴⁵ A sale of property to a trust of which a director is a beneficiary would also seem questionable. Clearly it would be considered interested if the director was making the purchase as trustee.⁴⁶ Other types of indirect interest could also be challenged under proper circumstances. For example, a decision to place the corporation's compensating balance in a bank where the director borrows could be considered "interested" if done to increase the director's borrowing power.

III. USURPATION OF CORPORATE OPPORTUNITY

A corporate director is under a fiduciary obligation not to divert a corporate business opportunity for his own personal gain.⁴⁷ Although this doctrine has not been considered under the interested director doctrine, the two are obviously closely related: both involve profits to a director⁴⁸ and the burden remains on the director to prove the fairness of his actions.⁴⁹ In fact, any transaction involving the use of a corporate opportunity could be classified as interested.

There is authority in most jurisdictions allowing a director to divert a corporate opportunity if the corporation is unable to take advantage of it.⁵⁰ However, if it is determined that a corporate opportunity exists and that the corporation is able to take advantage of it, the possibility of conflict of interest develops. As *International Bankers Life Insurance Co. v. Holloway*⁵¹ pointed out, "[T]ransactions in which a corporate fiduciary derives personal profit, either in dealing with the corporation or its property, or in matters of corporate interest, are subject to the closest examination and the form of the transaction will give away to the substance of what actually has been brought about."⁵² Thus in *Holloway* when two directors received

⁴⁴ *Higgins v. Lansing*, 154 Ill. 301, 40 N.E. 362 (1895) (nor can it make any difference that such purchase was made by him for himself and others as a co-partner). See also 19 AM. JUR. 2d *Corporations* § 1323 (1965); Annot., 13 A.L.R.2d 1172, 1187, 1197 (1950).

⁴⁵ *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963) (director who diverts profit from the corporation in violation of his fiduciary relationship is personally liable even though the profits are acquired by an agency controlled by the director).

⁴⁶ *In re Philadelphia & W. Ry.*, 64 F. Supp. 738, 741 (E.D. Pa. 1946).

⁴⁷ *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963). See also 19 AM. JUR. 2d *Corporations* § 1311, at 717 (1965); Slaughter, *The Corporate Opportunity Doctrine*, 18 Sw. L.J. 96 (1964).

⁴⁸ Although the corporate opportunity doctrine applies to any "insider," it will be discussed here in relation to opportunities taken by a corporate director.

⁴⁹ See note 75 *infra*.

⁵⁰ See Slaughter, note 47 *supra*, at 100 n.18, and authorities cited. A corporation may be unable to take advantage of an opportunity for reasons other than financial. Among these are:

- (1) legal barriers preventing the corporation from taking advantage of an opportunity;
- (2) settled policy of the corporation not to engage in a particular line of business;
- (3) transaction beyond the powers of the corporation;
- (4) refusal of the party disposing of the opportunity to deal with the corporation;
- (5) unsuccessful attempts by the corporation to obtain the opportunity.

See also *DuPont v. DuPont*, 256 F. 129 (3d Cir. 1919); *Urban J. Alexander Co. v. Trinkel*, 311 Ky. 635, 224 S.W.2d 923 (1949). Of course some jurisdictions would not allow the director to take the opportunity even if the corporation is unable to take advantage of it.

⁵¹ 368 S.W.2d 567 (Tex. 1963).

⁵² *Id.* at 577.

commissions from the sale of corporate stock and also sold personally-owned stock at a lower price than that asked by the corporation, the court recognized that it was the duty of the directors to exert all efforts in behalf of the corporation so that the sale of stock would net the corporation the greatest possible return. The realization of a profit by the directors was held to be incompatible with the duty of good faith owed to the corporation by the directors.⁵³ Any personal profit made by a director in violation of his duty of good faith may be claimed for the benefit of the corporation⁵⁴ and is said to be held in constructive trust for the corporation.⁵⁵

A corporate opportunity may arise when a director acquires outstanding obligations of the corporation. Unless the circumstances surrounding the transaction make it inequitable⁵⁶ or unless a statute forbids,⁵⁷ a director has a right to purchase an obligation at par and enforce payment of the same.⁵⁸ However, if the obligation is purchased at less than par the courts are split as to the result. Some courts do not allow the director to enforce the claim for more than he paid for it,⁵⁹ while others follow the general rule that a good faith purchase at a discount may be collected at face value.⁶⁰ However, where a director of an insolvent corporation purchases its assets at a judicial or execution sale for less than true value, he holds the difference in trust for the corporation.⁶¹ A corporate opportunity also exists when a director receives a kickback on contracts made by the corporation. In such a situation, the director is required to refuse the kickback and insist on a lower price for the corporation.

The cases dealing with corporate opportunity hold that the director usurping the opportunity has the burden of proving that his action was not unfair to the corporation.⁶² Once it has been proven that the transaction was fair or that no opportunity existed, the transaction will stand.

IV. CONSEQUENCES OF INTEREST

Once a transaction has been determined to be interested it becomes necessary to ascertain the consequences of such interest. The first question

⁵³ *Id.* at 578.

⁵⁴ Rowland v. Kable, 174 Va. 343, 6 S.E.2d 633 (1940); Hayes Oyster Co. v. Keyport Oyster Co., 64 Wash. 2d 375, 391 P.2d 979 (1964).

⁵⁵ New v. New, 149 Cal. App. 2d 372, 306 P.2d 987 (1957); Durfee v. Durfee & Canning, Inc., 323 Mass. 187, 80 N.E.2d 522 (1948).

⁵⁶ Martin v. Chambers, 214 F. 769 (5th Cir. 1914); Bayou Drilling Co. v. Baillio, 312 S.W.2d 705 (Tex. Civ. App. 1958) *error ref. n.r.e.*

⁵⁷ Weissman v. A. Weissman, Inc., 374 Pa. 470, 97 A.2d 870 (1953); Fowler v. Iowa Land Co., 18 S.D. 131, 99 N.W. 1095 (1904).

⁵⁸ Medford v. Myrick, 147 S.W. 876 (Tex. Civ. App. 1912) *error ref.*

⁵⁹ Martin v. Chambers, 214 F. 769 (5th Cir. 1914); Bramblet v. Commonwealth Land & Lumber Co., 27 Ky. 156, 84 S.W. 545 (1905).

⁶⁰ Manufacturers Trust Co. v. Becker, 338 U.S. 304 (1949); Todd v. Temple Hospital Ass'n, 96 Cal. App. 42, 273 P. 595 (1929).

⁶¹ Tobin Canning Co. v. Fraser, 81 Tex. 407, 17 S.W. 25 (1891). *But cf.* Bunn v. Mackin, 25 S.W.2d 942 (Tex. Civ. App. 1930) *error ref.* (such a sale is voidable not void and can be attacked only by the corporation, its officers or its creditors).

⁶² Chenery Corp. v. SEC, 128 F.2d 303 (D.C. Cir. 1942); Lebold v. Inland Steel Co., 125 F.2d 369 (7th Cir. 1941).

is whether or not such a transaction is void. There are a few older cases that hold any interested transaction void,⁶³ but they are of doubtful value today, even in their own jurisdictions.⁶⁴ The better rule seems to be that such transactions are not absolutely or ipso facto void,⁶⁵ but rather are voidable at the option of the corporation if unfair.⁶⁶ That is, either a suit by the corporation instituted by the other directors, or officers, or a derivative suit by the shareholders in the name of the corporation is necessary to set aside the transaction. Thus, if the corporation makes no attempt to avoid the transaction it will remain in force as a valid contract. The setting aside must be at the instance of the corporation and such transactions are not open to the scrutiny of outsiders.⁶⁷ However, since a suit by the shareholders is a derivative suit, there is also the possibility that creditors could bring the suit if no one else were available to do so.⁶⁸

There is also a line of cases which hold that an interested director transaction is always voidable at the option of the corporation even though fair;⁶⁹ but this is a minority rule and has little support. *Canadian Country Club v. Johnson*,⁷⁰ an early Texas case, held that such a transaction could be "avoided at the corporation's option whether the transaction be fair or not." But this view has not prevailed in later Texas cases.⁷¹

A corporation may cancel an interested transaction only after certain requirements are met. Obviously the corporation will first have to allege and prove that the director is indeed interested in the transaction. A transaction, once determined to be interested, is prima facie voidable at the option of the corporation if unfair to the corporation.⁷²

If a transaction with a director is determined to be interested and therefore potentially voidable by the corporation, the burden is on the director

⁶³ *Wardell v. Railroad Co.*, 103 U.S. 651 (1880); *Green v. Hugo*, 81 Tex. 452, 17 S.W. 79 (1891).

⁶⁴ *Compare, e.g., Green v. Hugo*, 81 Tex. 452, 17 S.W. 79 (1891) with *Tenison v. Patton*, 95 Tex. 284, 67 S.W. 92 (1902) (fact director was interested does not conclusively establish its voidability).

⁶⁵ *Lembeck & Betz Eagle Brewing Co. v. M'Anarney*, 287 F. 927, 933 (W.D.N.Y. 1923); *Stack v. Welder*, 137 Cal. App. 647, 31 P.2d 426 (1934); *Brooks v. Zorn*, 24 S.W.2d 742 (Tex. Civ. App. 1929) error dismissed.

⁶⁶ *In re Cuyahoga Fin. Co.*, 136 F.2d 18 (6th Cir. 1943); *Skinner v. Smith*, 134 N.Y. 240, 31 N.E. 911 (1892); *International Bankers Life Ins. Co. v. Holloway*, 368 S.W.2d 567 (Tex. 1963); *Popperman v. Rest Haven Cemetery, Inc.*, 162 Tex. 255, 345 S.W.2d 715 (1961); *Phil H. Pierce Co. v. Rude*, 291 S.W. 974 (Tex. Civ. App. 1927) error dismissed; *McLendon Hardware Co. v. Black*, 264 S.W. 1011 (Tex. Civ. App. 1924).

⁶⁷ *Mobile Land Improvement Co. v. Gass*, 142 Ala. 520, 39 S. 229 (1904); *Niagara Fire Ins. Co. v. Numismatic Co.*, 380 S.W.2d 830 (Tex. Civ. App. 1964) error ref. n.r.e.

⁶⁸ *See Sutton v. Reagan & Gee*, 405 S.W.2d 828, 834 (Tex. Civ. App. 1966) (under special circumstances, a creditor may, through a creditor's bill brought on behalf of all creditors, enforce the director's liability); *Texas Auto Co. v. Arbetter*, 1 S.W.2d 334 (Tex. Civ. App. 1927) error dismissed (when a director enters into a contract with the corporation, and his vote as a member of the board is necessary to the passage of the resolution authorizing it, this action of the board of directors is sometimes void, and in all cases voidable, at the instance of the corporation, or of its stockholders, or of its injured creditors). *See also Pelletier, Corporations, Annual Survey of Texas Law*, 21 Sw. L.J. 134, 140 (1967).

⁶⁹ *Morgan v. King*, 27 Colo. 539, 63 P. 416, 421 (1900); *Miller v. Brown*, 1 Neb. 754, 95 N.W. 797 (1901).

⁷⁰ 176 S.W. 835 (Tex. Civ. App. 1915).

⁷¹ *See note 66 supra.*

⁷² *Id.*

to prove the fairness of the transaction as well as his own good faith.⁷³ If the director can prove that the transaction was fair and that he participated in good faith the transaction will be allowed to stand. Should the director not try to prove fairness or be unable to do so, the transaction can be cancelled. Regardless of who has the burden of proof as to fairness, the degree of fairness will be determined by the court or jury.⁷⁴

Several factors have been commented on at one time or another as indicative of the fairness or unfairness of the transaction. The first is representation by the director. If the director who has a personal interest is also the only member of the board who represents the corporation in negotiations and contracts relating to the transaction, there is some authority that the transaction is voidable without regard to fairness or bad faith.⁷⁵ However, it seems that this rule is too strict and that this should be only one factor to examine in determining the overall fairness of the transaction. In other words, the degree to which the director represented the corporation should be kept in mind when examining the other factors, but should not be controlling.

Another factor sometimes considered is failure to make full disclosure. If the director involved did not inform either the board of directors or the shareholders of his interest the transaction may be considered unfair or entered into with bad faith.⁷⁶ Likewise, if full disclosure was made the transaction may be considered fair. In *Tenison v. Patton*⁷⁷ the Texas Supreme Court stated:

[H]e can, we think, deal with them [the disinterested directors as representatives of the corporation] as any other trustee can deal with the cestui que trust, if he makes a *full disclosure* of all facts known to him about the subject, takes no advantage of his position, deals honestly and openly, and concludes a contract fair and beneficial to the company.⁷⁸

Still another factor determining fairness is adequacy of consideration, especially in transactions involving a purchase of corporate assets by a director. For obvious reasons a transaction which gave insufficient consideration to the corporation would be considered unfair, and a transaction for full and adequate consideration would be considered fair. In *Wing v. Dillingham*⁷⁹ the directors paid their corporation \$25,000 for timberland valued at \$375,000. The corporation was allowed to set aside the purchase.

The necessity of the transaction to the corporation has also been con-

⁷³ *Conrads v. Kasch*, 26 S.W.2d 732 (Tex. Civ. App.), *aff'd per curiam*, 119 Tex. 449, 31 S.W.2d 630 (1930); *Texas Auto Co. v. Arbetter*, 1 S.W.2d 334 (Tex. Civ. App. 1927) *error dismissed*.

⁷⁴ *Pepper v. Litton*, 308 U.S. 295 (1939); *Twin-Lick Oil Co. v. Marbury*, 91 U.S. 587, 588 (1875).

⁷⁵ *Wishon-Watson Co. v. Commissioner*, 66 F.2d 52, 55 (9th Cir. 1933) (where an officer of a corporation attempts to deal with the corporation the courts will not permit any investigation into the fairness or unfairness of the transaction, nor allow the officer to show that the dealing was for the best interest of the corporation). See also Annot., 24 A.L.R.2d 91 (1952).

⁷⁶ *National Mfrs. Co. v. Bird*, 97 N.J. Eq. 242, 127 A. 819 (Ch. 1925).

⁷⁷ 95 Tex. 284, 67 S.W. 92 (1902).

⁷⁸ *Id.* at 293, 67 S.W. at 95 (emphasis added). See also *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563 (Tex. Civ. App. 1962) *error ref. n.r.e.*; *Dunagan v. Bushey*, 152 Tex. 630, 263 S.W.2d 148 (1953); *Williams & Miller Gin Co. v. Knutson*, 63 S.W.2d 576 (Tex. Civ. App. 1933).

⁷⁹ 239 F. 54 (5th Cir.), *cert. denied*, 244 U.S. 654 (1917).

sidered as a factor in determining fairness. In *Cathedral Estates v. Taft Realty Corp.*⁸⁰ the Second Circuit reasoned that although the director need not show that the transaction was absolutely necessary to the corporation in order to prove fairness, the lack of necessity to the corporation is relevant to indicate that it was a detrimental transaction and therefore not fair.⁸¹

However, certain factors, if present, can change the entire complexion of the suit and may shift the burden of proof. The director should be knowledgeable of these factors and attempt to utilize them whenever he deals with his corporation. The first such factor is approval by a disinterested majority of the board of directors.⁸² In a vote by the board of directors to approve a transaction, an interested director has no right to vote.⁸³ Clearly, before a vote can even be taken properly there must be present a sufficient number of disinterested directors to constitute a quorum.⁸⁴ Even if the interested director did vote, the board's approval will shift the burden of proof to the corporation if his vote was not necessary to pass the resolution.⁸⁵ However, if the vote of the interested director was necessary to pass the resolution approving the transaction, the burden of proving fairness will remain on the director and the transaction may even be voidable because of the vote.⁸⁶

Even if disinterested majority approval is obtained, all that occurs is a shift in the burden of proof from the director to the corporation.⁸⁷ Such approval does not preclude questioning the transaction and it can still be cancelled if proven unfair.⁸⁸ There is also the possibility that the director, although not voting on the resolution, exerted such a domination and control over the other members of the board that the vote could not be

⁸⁰ 228 F.2d 85 (2d Cir. 1955).

⁸¹ *Id.* at 87.

⁸² *Tenison v. Patton*, 95 Tex. 284, 67 S.W. 92 (1902); 14 TEX. JUR. 2d *Corporations* § 307 (1960).

⁸³ *Dunagan v. Bushey*, 152 Tex. 630, 263 S.W.2d 148 (1953); *Tenison v. Patton*, 95 Tex. 284, 67 S.W. 92 (1902); *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563 (Tex. Civ. App. 1962) *error ref. n.r.e.*; *Duncan v. Ponton*, 102 S.W.2d 517 (Tex. Civ. App. 1937); *Brooks v. Zorn*, 24 S.W.2d 742 (Tex. Civ. App. 1929) *error dismissed*; *Texas Auto Co. v. Arbetter*, 1 S.W.2d 334 (Tex. Civ. App. 1927) *error dismissed*; 14 TEX. JUR. 2d *Corporations* § 298 (1960).

⁸⁴ *Williams & Miller Gin Co. v. Knutson*, 63 S.W.2d 576 (Tex. Civ. App. 1933); *McLendon Hardware Co. v. Black*, 264 S.W. 1011 (Tex. Civ. App. 1924).

⁸⁵ *Texas Auto Co. v. Arbetter*, 1 S.W.2d 334, 337 (Tex. Civ. App. 1927) *error dismissed*. See R. STEVENS, *CORPORATIONS* § 156, at 683 (1949); *Liebowitz, Director Misconduct and Shareholder Ratification in Texas*, 6 BAYLOR L. REV. 1, 21 (1953). *But cf.* 1 I. HILDEBRAND, *TEXAS CORPORATIONS* 40, 69 (1942).

⁸⁶ *Winger v. Chicago City Bank & Trust Co.*, 394 Ill. 94, 67 N.E.2d 265, 277 (1946); *Bayou Drilling Co. v. Baillio*, 312 S.W.2d 705 (Tex. Civ. App. 1958) *error ref. n.r.e.*; *Allen v. Hutcheson*, 121 S.W. 1141, 1144 (Tex. Civ. App. 1909) *error ref.* It would seem that this factor alone should not make the transaction voidable, but rather the transaction should be allowed to stand if the director proves it to be fair to the corporation. See *Fountain v. Oreck's, Inc.*, 245 Minn. 202, 71 N.W.2d 646 (1955) (director allowed to vote and be counted for quorum if transaction is fair). Admittedly, there is authority in other jurisdictions that it is voidable without regard to fairness. See *Cathedral Estates v. Taft Realty Co.*, 228 F.2d 85 (2d Cir. 1955) (stating this to be settled Connecticut law).

⁸⁷ Of course there is always the possibility that more than one director is interested and thus unable to vote. *E.g.*, *Brooks v. Zorn*, 24 S.W.2d 742 (Tex. Civ. App. 1929) *error dismissed* (a majority of those present were disqualified from voting, because they were personally and directly interested in the matter at hand).

⁸⁸ *Hill Dredging Corp. v. Risley*, 18 N.J. 501, 114 A.2d 697, 713 (1955).

said to be by a disinterested majority.⁸⁹ In such a situation the burden of proof would remain on the director to prove fairness.

If the transaction is subsequently ratified by a majority of the shareholders, the minority of the shareholders may possibly be precluded from contesting the transaction. However, before such ratification is effective it is clear that there must be full disclosure of the director's interest since ratification must be based on knowledge.⁹⁰ In *Pruitt v. Westbrook*⁹¹ the court stated:

We think the authorities are uniform in holding that, where the actions or transactions of the directors are involved, and the claim is made that the directors were personally interested in consummating the deal against which an attack is made, that such transactions or actions may be ratified by vote or acquiescence of all the stockholders, or even a majority thereof, if such actions or transactions are not inhibited by the common law as against public policy or not inhibited by statute.⁹²

In *Wiberg v. Gulf Coast Land & Development Co.*⁹³ the court upheld an interested transaction, citing *Pruitt v. Westbrook*. The appellee asserted that 100 per cent shareholder approval was required for ratification, but the court rejected this contention.⁹⁴ The court in *Wiberg* noted:

The record before us shows that the commissions charged were reasonable and the contract was *fair, just and beneficial* to the corporation. It was ratified by over a majority of the company's stockholders. No fraud or overreaching was alleged or proved. From the facts it appears that the directors personally interested did not hold back from the company any pertinent information involving the contract.⁹⁵

It is submitted that what the court actually did in *Wiberg* was apply a fairness test rather than basing its decision on shareholder ratification. If this is so, majority ratification may *not* preclude questioning the action, but rather, like approval of a disinterested majority of the board of directors, may merely shift the burden of proof to the dissenting party.⁹⁶

A director can avoid rescission of his transactions if objection is not brought within a reasonable time. However, in *Allen v. Wilkerson*⁹⁷ the director argued that the four-year statute of limitations on written obligations had run against the corporation's right of action against him.⁹⁸

⁸⁹ Greathouse v. Martin, 100 Tex. 99, 94 S.W. 322 (1906); Cowles v. Glass, 30 S.W. 293 (Tex. Civ. App. 1895); 14 TEX. JUR. 2d Corporations § 284, at 388 (1960) (as such, his [a dominated director's] vote is not considered as that of a disinterested director).

⁹⁰ Continental Assurance Co. v. Supreme Constr. Corp., 375 F.2d 378, 383 (5th Cir. 1967); *Wiberg v. Gulf Coast Land & Dev. Co.*, 360 S.W.2d 563, 567 (Tex. Civ. App. 1962) *error ref. n.r.e.*

⁹¹ 11 S.W.2d 562 (Tex. Civ. App. 1928).

⁹² *Id.* at 565 (emphasis added).

⁹³ 360 S.W.2d 563 (Tex. Civ. App. 1962) *error ref. n.r.e.*

⁹⁴ Admittedly if all of the shareholders ratify a transaction it must stand since none of the shareholders would have standing to contest it. *But cf.* text accompanying note 68 *supra*.

⁹⁵ 360 S.W.2d at 567-68 (emphasis added).

⁹⁶ *But cf.* Liebowitz, *Director Misconduct and Shareholder Ratification in Texas*, 6 BAYLOR L. REV. 1 (1953).

⁹⁷ 396 S.W.2d 493 (Tex. Civ. App. 1965) *error ref. n.r.e.*

⁹⁸ See also *Brooks v. Zorn*, 24 S.W.2d 742, 749-50 (Tex. Civ. App. 1929) *error dismissed*: "Suits of this character must be brought within four years after those in whom the cause of action rests know, or in the exercise of due care should know, that the wrong was done them."

The court stated that in order for the statute to run a disinterested majority of the board of directors must have, or be charged with, notice of the transaction.⁹⁹ The court also noted that if there was no disinterested board of directors, "mere notice to shareholders does not start running of limitations against the corporate cause of action"¹⁰⁰ for purposes of precluding a derivative action. In *International Bankers Life Insurance Co. v. Holloway*¹⁰¹ the court admitted that the two-year statute of limitations would bar recovery on profits made by a director if the disinterested directors had knowledge of the transactions. Thus a major question in any interested director transaction is whether the disinterested directors had knowledge of the transaction.

The best protection for a director in his dealings with his corporation is charter or by-law approval of "interested transactions."¹⁰² The approving clause of course would not preclude questioning of any interested director transaction, but it would eliminate any argument that the transaction was void or voidable without regard to fairness. Possibly, like disinterested majority approval, such a clause would shift the burden of proof to the plaintiff to prove unfairness. One New York case, *Everett v. Phillips*,¹⁰³ stated that such a provision, authorizing directors to act even in matters where they have dual interest, has the effect of exonerating the directors, at least in part, "from adverse inferences which might otherwise be drawn against them."¹⁰⁴ While no Texas cases were found on this point, it seems that such a clause would not be binding on the shareholders,¹⁰⁵ but rather would only serve to help the director prove good faith and fairness. At best, the clause could only shift the burden of proof. From a planning standpoint, such a clause should always be inserted to protect the director. The clause would at least show that it was recognized that such transactions are to be expected, especially in a small, closed corporation.

⁹⁹ 396 S.W.2d at 501.

¹⁰⁰ *Id.* at 502.

¹⁰¹ 368 S.W.2d 567 (Tex. 1963).

¹⁰² *E.g.*, 4 AM. JUR. *Legal Forms* § 4:957 (1955):

No contract or other transaction between this corporation and any other corporation and no act of this corporation shall in any way be affected or invalidated by the fact that any of the directors of the corporation are pecuniarily or otherwise interested in, or are directors or officers of, such other corporation; any director individually, or any firm of which any director may be a member, may be a party to, or may be pecuniarily or otherwise interested in, any contract or transaction of the corporation, provided that the fact that he or such firm so interested shall be disclosed or shall have been known to the board of directors or such members thereof as shall be present at any meeting of the board at which action upon any such contract or transaction shall be taken; and any director of this corporation who is also a director or officer of such other corporation or who is interested may be counted in determining the existence of a quorum at any meeting of the board of directors of the corporation which shall authorize any such contract or transaction, and may vote thereat to authorize any such contract or transaction, with like force and effect as if he were not such director or officer of such other corporation or not so interested.

See also E. BELSHEIM, *MODERN LEGAL FORMS* § 2719.1, at 181 (1966).

¹⁰³ 288 N.Y. 227, 43 N.E.2d 18 (1942).

¹⁰⁴ 43 N.E.2d at 22.

¹⁰⁵ *But cf.* *Goldboss v. Reimann*, 55 F. Supp. 811, 819 (S.D.N.Y.), *aff'd*, 143 F.2d 594 (2d Cir. 1943).

V. RELIEF GRANTED

Once a transaction has been determined to be unfair and voidable by the corporation, it appears that the remedy is to put the parties in the same position they were in before the transaction. For example, in *Wing v. Dillingham*¹⁰⁶ the directors had purchased timberland from the corporation for inadequate consideration. The court required the corporation to return all sums of money properly expended by the directors with interest, and required the directors to return the land and timber involved to the corporation.

However, if the court is unable to put the parties in their prior positions by a cancellation of the contract, it appears that the director may be held individually liable for a breach of his fiduciary duty. Since suits to cancel interested director transactions are usually brought derivatively by minority shareholders, the purpose is to regain the property or profits for the benefit of the corporation. Thus no individual recovery is sought and all recovery goes directly to the corporation. In *Dunagan v. Busbey*¹⁰⁷ the Texas Supreme Court required three directors to return corporate assets appropriated by them to their individual use. In addition to the derivative suit the plaintiff also brought suit in his individual capacity. The court remanded this individual claim against the directors to the trial court for submission to a jury, thus indicating that a shareholder might also receive an individual recovery.¹⁰⁸

VI. CONCLUSION

The interestedness or disinterestedness of a director does not turn on any technical form or legal status; it is a substantial fact question to be decided by the trier of fact.¹⁰⁹ While no absolute assurance can be given as to whether a director will be treated as interested, some guidelines can be set out.

A director risks being classified as an interested director when:

- (1) He makes a personal profit from a transaction
 - (a) by usurping a corporate opportunity, or
 - (b) by purchasing obligations of the corporation, or
 - (c) by receiving a kickback on a corporate transaction.
- (2) He purchases assets from the corporation.
- (3) He sells personally-owned property to the corporation.
- (4) He contracts directly with the corporation
 - (a) by setting his own salary, or
 - (b) by leasing property to or from the corporation, or
 - (c) by entering a management contract, or
 - (d) by loaning money to the corporation.

¹⁰⁶ 239 F. 54 (5th Cir.), cert. denied, 244 U.S. 654 (1917).

¹⁰⁷ 152 Tex. 630, 263 S.W.2d 148 (1953).

¹⁰⁸ See *Perlman v. Feldman*, 219 F.2d 173 (2d Cir. 1955).

¹⁰⁹ See note 7 *supra*.

- (5) He uses corporate funds for his own benefit
 - (a) to pay off a personal loan, or
 - (b) by obtaining a loan from the corporation.
- (6) The corporation makes transactions with another corporation in which he is a director or is otherwise interested.
- (7) The corporation transacts with partnerships or associations of which he is a member.
- (8) The corporation transacts with his spouse or close relatives.

Once such a transaction is found to be "interested," it appears that the corporation at the instance of its disinterested directors, shareholders, or creditors can avoid the transaction if unfair. The question of what is fair or unfair can only be determined on the basis of all the facts and circumstances surrounding the transaction. No absolute standards govern what is sufficient proof of fairness; the answer to how much proof is necessary seems to be, "enough." There seems to be little a director can do to avoid questioning of his "interested transactions," and yet on the other hand, such transactions, if fair, should always be upheld.