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Corporations - Derivative Suits - Liability of Directors and Strangers Who Acquire Business Opportunities Open to the Corporation

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CORPORATIONS—DERIVATIVE SUITS—LIABILITY OF DIRECTORS AND STRANGERS WHO ACQUIRE BUSINESS OPPORTUNITIES OPEN TO THE CORPORATION

A number of interesting questions relating to derivative suits against directors for breach of fiduciary relation, and against strangers to the corporation, incidentally, have been discussed in a recent case in the Federal District Court for the Southern District of New York.*

In this case the plaintiff, Craftsman Finance and Mortgage Co., was a minority stockholder of the American Distilling Company, which in turn owned 50% of the stock of American Spirits, Inc. It brought an action to require the defendants to account for profits obtained, and losses sustained by the two corporations, all caused by the defendants' diverting business and business opportunities from the two corporations. These defendants included the majority stockholders and directors of American Spirits, Inc. and of American Distilling Company, the attorney for the two firms, and several strangers to the corporation who allegedly combined with the officers in their scheme. The transactions set forth in the complaint were four in number, and similar in kind. In the first case, referred to in the opinion as the Ozark Mountain Distilling Co. transaction, the defendant Kessler, president of American Spirits, Inc., had been sent by one of the corporations to investigate the advisability of buying out the Ozark Mountain Distilling Co. He returned with a favorable report. Shortly thereafter Kessler combined with others of the defendants to buy the business in question for the benefit of the group. The complaint further charged that the defendants had since realized large profits from this enterprise, and had the use of the funds, credit, good will and trade connections of the American Distilling Company in carrying on this business. The second transaction, relating to Ben Burk, Inc., differed in that American Distilling Company had purchased the business and inventory of Ben Burk, and thereafter sold a forty per cent interest to the defendants, who continued the business under the name of Foster & Company. In a third charge the facts set forth that American Distilling had made a large down payment on the majority stock interest of the Country Distillers Products, Inc., which interest was thereafter sold to Foster & Company, and that the defendants obtained the money to finance the stock purchase by inducing customers of the defendant Distilling Company to make advance payments on future deliveries of liquor, the customers having been led to believe that they were dealing with Distilling and that their orders would be filled by that company, when in reality Foster & Company were acquiring the orders for themselves. It is further alleged that a contract was then entered into between Distilling and

Foster & Company for the blending and bottling of certain stocks acquired by the partnership and for the use of trade names and labels of the corporation, which contract was not negotiated at arms length, and was unfair to Distilling. The fourth transaction concerned a business opportunity of which the individual defendants took advantage. The complaint did not allege that the corporation had taken any steps toward acquiring it for itself, although it had knowledge of the opportunity, and it was through corporate business and records that the defendants became aware of the possibility of purchase. Various motions to dismiss were entered by individual defendants; the first to dismiss the complaint for failure to state a cause of action, and others on the ground that the plaintiff did not have the capacity to sue: (a) because it had since gone into voluntary dissolution, and (b) because it was not a stockholder prior to February 25, 1944, before which time all the transactions complained of had taken place. With respect to the latter contention, the plaintiff, in May, 1939, owned twenty-five shares of preferred stock of the American Distilling Company, which stock was called for redemption as of December 20, 1943, although plaintiff continued to hold it after that date. On May 8, 1939, there were issued to plaintiff thirty-three shares of common stock of American Commercial Alcohol Corporation, which, as a result of a reorganization plan, were to be exchanged for an equal number of shares of Distilling stock, and were thereafter at all times exchangeable for such stock. The plaintiff, however, did not transfer its Commercial stock for that of Distilling, but continued to hold it until December of 1943, when it placed it in the hands of a broker. Through the broker its number of shares was reduced to three, evidenced by a certificate issued by the American Distilling Company which appeared to have been issued in the name of the broker. This certificate was in plaintiff's hands at the time of the commencement of the suit. There were further motions not of importance in this discussion. The court held that the complaint stated a cause of action; that plaintiff had at all times been the equitable owner of stock in the American Distilling Company, and was, at the commencement of the suit, the owner of three shares thereof, and competent to bring the action for the benefit of American Distilling Company, American Spirits, Inc., and on behalf of the stockholders of both; that because of the situation which existed within both corporations, it was not necessary for the plaintiff to make any demands upon the directors of the two firms; and that although now in the process of liquidating, the plaintiff corporation still existed under the law for the purposes of this suit.

The motions presented to the court in this case raised a number of important points, which may be divided roughly into two general questions. The first of these is whether the pleadings set forth a cause of action, and the second is whether the plaintiff had the capacity to sue, if such cause existed, and under what conditions it might bring its suit. This discussion is limited to a consideration of the first question; and there a further subdivision is necessary, since the suit was brought against two classes of persons, one group composed of officers, directors and majority stockholders of the corporations involved, and the other of strangers to the corporations who were also alleged to have profited by the ventures.

Liability of Those Within The Corporation[1]

The law places a heavy burden of responsibility upon a director, predicated upon the fact that he has voluntarily accepted a position of trust and has taken upon himself the control of property interests of others. Some writers and courts class him as a trustee, others as an agent, while a third group attempt to explain his position by calling him a fiduciary.[2] However classed, it still remains true that a

*Craftsman Finance and Mortgage Co. v. Brown, 64 F. Supp. 168 (1945).

[1] This group included the defendants, Kessler and Siskind, president and vice-president respectively of American Spirits, Inc., owners of fifty per cent of the stock of that firm, and members of the board of directors thereof; Rothberg, vice-president of Distilling and a director; and Cole and Seymour, directors of Distilling, the latter also acting as counsel for the corporation. These defendants were charged both with breaching their trust in failing to obtain the various companies and assets for the corporations, and with subsequently acquiring some or all of them for themselves. Kessler was also active in Foster & Company, the partnership which took over most of the business refused by the directors for the corporations. Charged with allowing the foregoing to carry out their plans without opposition were the remaining directors of Distilling. The complaint also alleged that this group, or members of it, were to share secretly in the profits of the transaction, although outwardly they were to have no active part in it. In this connection the following quotation from 13 Ab. Jur. 946 might be considered: "Directors are not liable for the wrongful acts of their co-directors if they do not connive at them, and if ordinary care on their part would not have averted the loss; ... On the other hand where two or more officers join or participate in the wrongful act, they are as a general rule jointly and severally liable. It seems, however, that a director is not severally liable for the act of a majority of the board, *although he voted with it,* (italics added); if the directors composing the majority are liable at all, they are jointly liable." In the light of this statement, it would seem that an actual sharing in the profits would have to be proved with regard to the last mentioned group of directors before liability would attach.

[2] See "Liability of Directors for Taking Corporate Opportunities, Using Corporate Facilities, or Engaging in a Competing Business," 39 Col. L. Rev. 219 at 225 (1939), where the author points out the discrepancies between the powers and duties of a true trustee and those of a director, and inclines toward the view that the director is most logically classed as an agent. *Conversely,* see 19 C.J.S. 82: "While powers of director have been regarded as delegated powers, according to some cases, the powers of the board of directors are, in a very important sense, original and undelegated, and directors do not exercise delegated authority in the same sense as other agents." In 13 Am. Jur. 966 this conflict is explained by the statement: "While the courst of law generally treat the directors as agents, courts of equity treat them as trustees."

director has been placed in a position where he may be either of immeasurable value or harm to large groups of people. In determining whether or not the director has lived up to his trust, three tests are commonly used; (1) whether he has acted in good faith, (2) whether he has acted with due care and diligence, and (3) whether such acts as are being considered lay within the scope of his authority.[3]

In the instant case the gravamen of the complaint against the directors is to be found in their non-action. They failed to obtain or retain for the benefit of the corporations profitable business opportunities and enterprises, and as individuals, they acquired for themselves and benefited by these same enterprises which they had refused or failed to acquire or hold for the corporations. In passing upon the liability of the directors in such a situation, the matter of good faith will be of paramount importance, and it is usually a question of fact to be determined upon a weighing of the evidence. It is also true that since the law generally presumes honesty, rather than fraud, the burden of proving a breach of trust and lack of good faith will rest heavily upon the plaintiff.[4]

With regard to the matter of due care and diligence, more than evidence is required to reach a decision, as the question of what is due care in this particular type of case must first be answered. The majority viewpoint is that a director may use his discretion in good faith without fear of liability for honest error of judgment. This is sometimes referred to as the Business Judgment Rule, and when what is known as "business judgment" is shown to have been exercised, the courts will not interfere, even though it later develops that the decision of the board of directors was not a sound one.[5]

> Regardless of the ultimate results of a particular corporate transaction, all that the law requires is that it shall have been initiated and consumated honestly and in good faith. In the management of corporate affairs directors and officers have a wide measure of discretion. Mere differences of judgment are not sufficient to warrant equity interference.[6]

The Business Judgment Rule and the matter of good faith will play an important role in the final decision in the present case, and will be of special importance in determining whether the directors

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[3] 13 Am. Jur. 939. The question of scope of authority is not discussed in connection with the instant case. It was nowhere touched upon in the briefs, and no doubt failed to arise because of the fact that the acts complained of were voidable only, and were ratified by virtue of a suit to recover the profits therefrom.

[4] Greer v. Stannard, 85 Mont. 78, 277 Pac. 622, 64 A.L.R. 722 (1929).

[5] Uhlman, "The Duty of Corporate Directors to Exercise Business Judgment," 20 Boston U. L. Rev. 488 (1940). This liberal rule does not apply with regard to ministerial matters where the agent is held strictly accountable.

[6] Leslie v. Lorillard, 110 N.Y. 519, 18 N.E. 363 (1888).

were at fault in not obtaining valuable business assets (in the Ozark Mountain Distilling Co. and the James Sullivan, Inc. transactions), or in not continuing to hold them (in the Ben Burk, Inc. and the Country Distillers Products, Inc. cases). Undoubtedly it will be argued by the defense in the final hearing of the case that it was considered unwise for the corporations to expand in these directions, and if it can be shown that such decisions were reached in good faith, this defense may well release the directors from any liability in later purchasing the property for their individual uses.[7]

A further charge against the defendant directors was that they not only purchased property in which the corporation was interested, but they engaged in competing enterprises to the detriment of the corporation. However, such conduct is not forbidden under all circumstances. Again good faith is generally made the criterion, or more definitely:

> It is sometimes said that a director may compete 'in good faith', but this is not entirely accurate. If a general statement is to be made, it is more accurate to say that a director may not engage in a competing business that actually injures the corporation or one which puts a director in a position where he may, in the future, be tempted to sacrifice corporate gain on the altar of personal achievement.[8]

One author places the types of business opportunities open to a director in three general categories: (1) those entirely extraneous to the corporation's business, (2) those in the same or a direct line with it, and (3) those complementary to it. He further states that those of the first group will probably not be held to have been corporate opportunities, although a director might be held liable for the use of corporate facilities in connection with their development. Businesses of the third group may or may not be infringements on the rights of the corporation, depending on the circumstances, while those of the second group are apt to be.[9] Obviously the situation in the instant case is one which falls within the scope of this second group, as the directors in each one of the four transactions engaged in activities closely related to the charter purposes of the corporations with which they were originally connected.

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[7] See "Fiduciary Duty of Officers and Directors Not to Compete with the Corporation," 54 Har. L. Rev. 1191 at 1192 (1941), where the author states that such a defense is no longer recognized by some courts, which fear "that the judgment of those who determined whether the corporation was financially able to undertake the enterprise was warped by the temptations to act for themselves."

[8] "Liability of Directors for Taking Corporate Opportunities, Using Corporate Facilities, or Engaging in a Competing Business," 39 Col. L. Rev. 219 at 225, (1939).

[9] *Ibid.* at 220.

However such classification is not of itself controlling,[10] and many other factors, as variable as the cases themselves, must be taken into consideration. A corporation has no right to object to the competition offered by a diretcor in his management of a similar business, if it has given him permission to enter into that field,[11] but he may not act for himself if he has first been made a special agent of the corporation to acquire for it the opportunity in question.[12] He may not take over an opportunity "necessary for continued corporate existence or prosperity",[13] although directors have been allowed to enter into the same field of business in cases where the market is almost unlimited,[14] and under certain restraints.[15] Neither is a director necessarily precluded from a business venture because the corporation has negotiated for it,[16] although he will be, if it has acquired an "interest" or "expectancy" therein.[17] The fact that he gained the knowledge on which he acted through his directorship does not necessarily condemn him, although the use of pressure on other directors and the corporation to divert opportunities to himself,[18] or the use of corporate funds, customer lists, or good will[19] may well cause the court to impress a constructive trust in favor of the parent corporation.

[10] Note Greer v. Stannard, *Supra*, Note 4, in which the court refused to impress with a trust certain oil leases which directors of a corporation had acquired, although the corporation was engaged in similar enterprises, and it was contended that the defendants had learned of this business opportunity through their official positions. Also Beatty v. Guggenheim Exploration Co. *et al*, 167 App. Div. 864, 153 N.Y.S. 757 (1915), in which the court declared that a consulting engineer and general manager had acted in good faith in buying up property which he had explored for and recommended to the firm for purchase.

[11] 39 Col. L. Rev. 219, *Supra*, Note 8, at 226.

[12] 54 Har. L. Rev. 1191, *Supra*, Note 7. It has been held however that an officer who has merely been sent by the corporation to determine the advisability of purchasing a business or property is not barred from acquiring it for himself at a later date on this ground alone. Beatty v. Guggenheim Exploration Co., *Supra*. This point arises in connection with the first transaction complained of in the principal case. There the defendant Kessler had returned a favorable report on the Ozark Mountain property, which he had been sent by the corporation to investigate.

[13] 39 Col. L. Rev. 219 at 222, *Supra*, Note 8.

[14] See Barr v. Pittsburgh Plate Glass Co., 57 Fed. 86, 6 C.C.A. 260, 17 U.S. App. 124 (1892), in which the court approved the action of directors, who, after giving notice to the corporation, entered into a similar business in a field where the demand far exceeded the supply of goods.

[15] A number of these limitations are listed in Ramsey, "Director's Power to Compete with His Corporation," 18 Ind. L.J. 293 at 300 (1943).

[16] Lagarde v. Anniston Lime & Stone Co., 126 Ala. 496, 28 So. 199 (1900).

[17] See 39 Col. L.J. 219 at 221, *Supra*, Note 8, for a discussion of the forms such an interest may take.

[18] 39 Col.L. Rev. 219, *Supra*, Note 8.

[19] *Ibid.* at 227. It is here suggested that, having taken advantage of the corporation in such regard, the director might be estopped from setting forth other defenses which he might have. Similar charges are made against the defendants in the instant case, in the Ozark Mountain transaction, where they are accused of making use of the credit, good will, and trade connections of Distilling, and in the Country Distillers enterprise where they supposedly had access to the customer lists for their own benefit.

Applying these considerations to the transactions set forth in the complaint in the instant case, it seems apparent that a cause of action against the directors has been stated, although the charges are more serious in some instances than others.[20] Since the pleadings, on a motion to dismiss, must be construed in favor of the pleader, it is evident that the motion was properly denied. On trial, however, the task of the plaintiff will be much harder, as is generally the case when questions of intent, diligence, and good faith are involved.

LIABILITY OF STRANGERS COMBINING WITH DIRECTORS[21]

The alleged liability of the strangers to the corporation presents a more difficult problem. The cases are replete with statements that an outsider who knowingly combines with a director to aid the latter in violating his fiduciary relationship to the corporation is liable with him for the profits made. However very little attempt seems to have been made to justify this rule.[22] In the present case the stranger defendants formed a partnership with one of the directors charged with misconduct. However the liability of these defendants does not seem to rest solely on that relationship. Instead it appears to be based on a principle of agency that an agent who knowingly and wrongfully receives money for his principal is jointly and severally liable with him for such moneys.[23] It it a little difficult, however, to conceive of a principal-agent relation in such a situation, where neither party is subordinate to the other or bound by his directions, and especially in view of the present case in which the principle is extended to include the partnership itself as a party defendant. The cases cited in the brief in support of this liability speak of forcing such defendants to

[20] Insofar as entering into a competing business is concerned, the Ozark Mountain and the Country Distillers transactions seem to be most serious; probably because they are combined with a siphoning of corporation assets into the newly organized firms for the benefit of the individual directors.

[21] This group included Foster and Westermann, who were in no way connected with the corporations. They, together with Kessler, formed the patrnership of Foster & Company, which took over and made use of most of the opportunities denied to the corporation. They were active in all the transactions complained of, except that concerning the Ozark Mountain Distilling Company.

[22] See Emory v. Parrott, 107 Mass. 95 (1871), in which a stranger united with an agent of the vendor of property to sell this property at a profit to a corporation in which the agent of the vendor was also acting as an agent of the stockholders. Although the court plainly stated that no fiduciary relation existed between the stranger and the plaintiff stockholders, it held that he was equally liable with his partner to account for the profits of the transaction. See also Zinc Carbonate Co. v. First National Bank of Shullsburg, 103 Wis. 125, 79 N.W. 229 (1899), in which the defendant bank was held equally liable with the individual officers of the plaintiff corporation, Savage and Hayden, in a case in which these officers combined with the bank, a stranger to the corporation, to sell to it property which had been grossly overvalued. In this case however Savage was cashier of the defendant bank. Also Jackson v. Smith, 254 U.S. 586, 41 S.Ct. 200, 65 L.Ed. 418 (1921); Irving Trust Co. v. Deutsch, 73 F. (2d) 121, 2 F. Supp. 971 (1934).

[23] 2 C.J. 823.

"disgorge the secret gain"[24] and of an equitable action to "charge them as trustees of their ill-gotten gains",[25] but no basic reasons are advanced which would justify the application of such a drastic remedy. These defendants of themselves had no conncetion with the corporation, and no liability would attach merely because they competed with the corporation in obtaining business advantages. Of course they could not draw on the assets, trade names, and customer lists of the corporation for their own uses, but the plaintiffs here seek to hold them liable for more than that.[26] Certainly the application of the rule of principle and agent is a strained one, and seems to offer more protection to the corporation than is justified in the circumstances.

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[24] Emery v. Parrott, *Supra,* Note 22.

[25] Zinc Carbonate Co. v. The First National Bank of Shullsburg, *Supra,* Note 22.

[26] The prayer for relief in the complaint asks, "That the individual defendants and each of them and the defendant Foster & Company be required to account for the profits, benefits and emoluments obtained and secured by them or by any of them and for the damages and losses sustained by the American Distilling Company, and American Spirits Inc. by reason of the premises." This request seems to demand more than merely a return of that portion of the profits which might be accountable to the use of corporate facilities in the carrying on of the partnership business. Evidently the plaintiff stockholders are asking for the whole of the profits on the theory that the partnership has acquired a business opportunity which the corporation might have had.