

## Private Corporations

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## PRIVATE CORPORATIONS

ELMER W. ROLLER.

### THE RELATION OF THE DIRECTORS TO THE CORPORATION AND THE STOCKHOLDERS

The books are replete with loose and conflicting definitions of the term director. On the one hand we find many cases which hold that the directors of a corporation are trustees for the stockholders. On the other hand there are some cases holding that directors are mere agents of the corporation and the principles of the law of agency are applicable to them. *Briggs vs. Spaulding*, 141 U. S. 132. Opposed to both these views is the view that the directors are neither trustees nor agents, but are in the position of managing partners appointed to fill that position by a mutual arrangement between all the shareholders. *Automatic, etc., Syndicate Co., Ltd. vs. Cunninghame*, L. R. (1906) 2 Ch. Div. 34.

Wormser in his text says that directors are not trustees in the technical sense of the word. These definitions lead to the conclusion that the relation of directors to the corporation and the stockholders is a distinct fiduciary relation partaking of the elements of both trusts and agency. This peculiar relation which the directors bear to the corporation and the shareholders arises out of the inability of the corporation to act (with reference to ordinary business) except through the directors, and in this sense they are the agents of the corporation; while on the other hand as to the ordinary and usual business of the corporation, the directors are supreme and can do acts contrary to the wishes of the stockholders and in this sense they are trustees.

Referring to the duties of directors, a federal judge once said: "The idea is not to be tolerated that they serve as merely gilded ornaments of the institution, to enhance its attractiveness, or that their reputations should be used as a lure to customers." *Gibbons vs. Anderson*, 80 Fed. 345. But the cases are uniform in holding that the directors can perform only such services as are within the usual and ordinary business of the corporation. *Commercial Nat. Bank vs. Wienhard*, 192 U. S. 243; *Railway Co. vs. Allerton*, 18 Wall. 233; *People ex rel. Manice vs. Powell*, 201 N. Y. 194, 94 N. E. 634; *Goetz vs. Knie*, 103 Wis. 366.

By the great weight of authority, with reference to the ordinary and usual business, the directors are required to exercise ordinary care and prudence, which is the care and prudence that reasonable

men exercise under similar circumstances. *Vide Coggs vs. Bernard*, 1 Salk. 26; *Briggs vs. Spaulding*, 141 U. S. 132; *Hun vs. Cary*, 82 N. Y. 65, 37 Am. Rep. 564; *Swentzel vs. Penn Bank*, 147 Pa. St. 140, 23 Atl. 405; *Johnson vs. Stoughton Wagon Co.*, 118 Wis. 438. They are not responsible for loss resulting to their corporation from mere mistakes of judgment, where they have acted in good faith, within their authority and have exercised reasonable diligence and prudence. *Yates vs. Jones National Bank*, 206 U. S. 158. Nor are they insurers of the fidelity of the agents whom they have appointed, unless they have neglected to exercise ordinary care in the appointment of the agents. *Morawetz*, sections 151 et. seq. The law is well settled in Wisconsin by the case of *North Hudson, etc., Loan Assn. vs. Childs*, 82 Wisconsin 460, 476, 52 N. W. 600, in which Justice Pinney said: “\* \* \* and the degree of care they (directors) are bound to exercise is that which ordinarily prudent and diligent men would exercise under similar circumstances in respect to a like gratuitous employment, regard being had to the usages of business and the circumstances of each particular case; that they are not liable, in the absence of fraud or intentional breach of trust, for negligence, mistakes of judgment, and bad management in making investments on doubtful or insufficient security.”

Directors are, however, liable for loss resulting to the corporation from their own fraud, embezzlement or wilful misconduct. *Spering's Appeal*, 71 Pa. St. 11, 10 Am. Rep. 684.

What constitutes culpable negligence is never the same for all cases. As is said by the court in *First Nat. Bank vs. Ocean National Bank*, 60 N. Y. 278, the degree of care required depends upon the particular objects to which it is to be applied. Manifestly the degree of care required in case of a quantity of iron would not be the same as that degree of care required in case of a valuable jewel. *General Rubber Co. vs. Benedict*, 215 N. Y. 18.

As to whether directors are liable for a violation of the charter or acts beyond their authority, there is a division of opinion. One line of authorities holds that directors are not liable for a violation of the corporate charter where such violation was through mistake, unless of course, such mistake was occasioned by a failure to exercise reasonable care. *Hodges vs. New England Screw Company*, 1 R. I. 312.

Opposed to these cases are a line of decisions which hold that when directors overstep their authority and authorize an act beyond their powers, they are liable “whether they acted negligently

or with due care, in bad faith or in good faith, honestly or fraudulently." *Holmes, Booth & Haydens vs. Willard*, 125 N. Y. 75; *Cullerne vs. London, etc., Society*, L. R. 25 Q. B. D. 485; *Hill vs. Murphy*, 212 Mass. 1.

The reason why directors are held to no more than ordinary care and diligence is, because if more were required of them it would become very difficult to find responsible persons to assume the duties of directors. *Campbell vs. Watson*, 62 N. J. Eq. 396; *Carrington vs. Thomas C. Basstor Co.*, 111 Md. 419.

The rule then is, that there is a fiduciary relationship, such as exists between a trustee and *cestui que trust*, existing between the directors and the corporation and stockholders. Since there exists this peculiar trust relation between the directors and the corporation and shareholders, the law holds the directors to the utmost good faith in corporate transactions. *Johnson vs. Stoughton Wagon Company*, 118 Wis. 438. They are bound to secure the best terms for the corporation and are forbidden to take part in any transactions in which their interests are adverse to those of the corporation. *Morawetz*, vol. 1, section 517.

The common law rule held directors absolutely incapacitated from dealing with their corporation. This strict rule held all contracts between the directors and their corporation absolutely void, regardless of their reasonableness or unreasonableness.

In the leading case of *Aberdeen Railway Co. vs. Blaikie Brothers*, 1 Macqueen's App. Cas. 461, action was brought by Blaikie brothers against the railway company for performance of a contract whereby the railway company agreed to purchase certain iron chairs from Messrs Blaikie. The defense set up was that Thomas Blaikie was at the time the contract was entered into, a director of the railway corporation and consequently incapacitated from dealing with the corporation. The House of Lords (1854) held the contract void without even considering whether it was fair and reasonable. The principal case has been followed in *Metropolitan Elev. Railway Co. vs. Manhattan Elev. Railway Co.*, 11 Daly (N. Y.) 373; *Duncomb vs. the N. Y. Housatonic & Northern R. Co.*, 84 N. Y. 180. In the latter case, the court approving of *Aberdeen R. Co. vs. Blaikie Brothers, supra*, said: "Nor is it at all questioned that, in such cases, the right of the beneficiary, or those claiming through him, to avoidance, does not depend upon the question whether the trustee in fact has acted fraudulently or in good faith and honesty, but it is founded on the known weakness of human nature, and the peril of permitting any sort of col-

lision between the personal interests of the individual and his duties in his fiduciary character. I think therefore, that the undoubted rule of law in this state is, that every contract entered into by a director with his corporation may be avoided by the corporation within a reasonable time, irrespective of the merits of the contract itself." Thus in *Higgins vs. Lansingh*, 154 Ill. 301, 40 N. E. 362, it was held that where a corporation has secured the benefits of a contract with a director for a period of nine years, it is thereby estopped from recinding the contract, nine years being an unreasonable time.

In *Hatch vs. Hatch*, 9 Ves. 297, Lord Hardwicke said, "It is not enough for the trustee to say, 'You cannot prove any fraud,' as it is in his power to conceal it."

In *Whelpdale vs. Cookson*, 1 Ves. Sr. 8, Lord Jeffrey said, "It is *presumptio juris et de jure*, that where a person stands in these inconsistent positions of both buyer and seller, there are dangers, and it is not relevant to say that it is impossible that there could be any in the particular case."

The case of *Higgins vs. Lansingh*, 154 Ill. 301, 40 N. E. 362, adopts a slightly different rule in holding that the directors of a corporation without the consent of the stockholders have no right to contract for the corporation with themselves, or for the benefit of themselves, and if they do contract without the sanction of the stockholders, the contract may be avoided by the corporation or its stockholders not consenting thereto, whether such contract appears to be fair or not.

The weight of authority, however, tends toward a more liberal rule. This liberal rule regards contracts entered into by a director with his corporation as voidable only. If the director has acted in good faith in making the contract, if the contract is a fair and reasonable one, if no undue advantage has been taken of the corporation, the contract will be upheld. The court in determining the validity of such contracts will inquire into two things, first, whether the contract has been made in good faith, and secondly, whether it is fair and reasonable. In the case of *Fort Payne Rolling Mill vs. Hill*, 174 Mass. 224, 54 N. E. 532, the court found that the contract made by the director with his corporation was made in good faith and was not improvident. Justice Holmes in speaking for the court said: "It (contract) was not illegal or void because made with a director, the only person likely to be willing to make it. In this country it very generally has been deemed impracticable to adopt a rule which absolutely prohibits such contracts. *Nye vs.*

*Storer*, 168 Mass. 53, 55. Whatever small conflict of interest between himself and the company there may have been, was no greater or other than that between a broker paid by a percentage and his principal." *Stratton vs. Allen*, 16 N. J. Eq. 229; *Twin Lick Oil Co. vs. Marbury*, 91 U. S. 587; *Beach vs. Miller*, 130 Ill. 162, 17 Am. St. 291; *Pauly vs. Pauly*, 107 Cal. 8, 48 Am. St. 98; *Schnittger vs. Old Home, etc., Mining Co.*, 144 Cal. 603, 78 Pac. 9.

This question has been passed upon in Wisconsin in the case of *Spaulding vs. North Milwaukee Town Site Co.*, 106 Wis. 481, in which our court held that the directors can deal with their corporation (sell property) provided the transaction is fair and open and made in good faith.

Directors are prohibited from using their positions of trust to further their own private interests. *Liquidators of Imperial Mercantile Credit Assn. vs. Coleman*, L. R. 6 Eng. and Ir. App. Cas. 189; *Klein vs. Independent Brewing Assn.*, 231 Ill. 594, 83 N. E. 434; *Landes vs. Hart*, 131 App. Div. (N. Y.) 6, 115 N. Y. St. 337; *Parker vs. Nickerson*, 112 Mass. 195; *Timme vs. Kopmeier*, 162 571.

An early New York case, *Metropolitan Elev. Railway Co. vs. Manhattan Elev. Railway Co.*, 11 Daly 373, held that a contract between two corporations having interlocking directors was invalid and void, on the ground that the allegiance of the directors was divided and therefore it was impossible for them to serve the interests of both corporations. This is not the prevailing rule. The weight of authority is to the effect that contracts between corporations having interlocking directors are voidable only. If the contract was entered into in good faith and is a fair and reasonable one, the courts will uphold its validity. Corporations have the right to deal with one another and they ought not to be deprived of this right merely because they have directors common to both. Interlocking directors "owe the same degree of fidelity to both corporations and there is no presumption that they will deal unfairly with either." *San Diego, etc., Co. vs. Pacific Beach Co.*, 112 Cal. 53, 44 Pac. 333; *Adams Co. vs. Senter*, 26 Mich. 73; *McComb vs. Barcelona, etc., Assn.*, 134 N. Y. 598, 31 N. E. 613; *Leavenworth Co. vs. Chicago R. Co.*, 134 U. S. 688.

While the cases are almost uniform in holding that the directors stand in a fiduciary relation to the stockholders collectively, as a unit, it seems that by the weight of authority the directors sustain no such relation to the stockholders as individuals. Thus it is held that where a director buys stock on the open market from a

stockholder of the corporation, the director is acting in his individual capacity and is not bound to disclose to the stockholder, any facts affecting the value of the stock, of which he, the director, may have knowledge.

The leading case on this subject is the case of *Board of Comm. of Tippecanoe County vs. Reynolds*, 44 Ind. 509, 15 Am. Rep. 245. It appears in that case that the president of a corporation being also director and having knowledge by reason of his official position, that the company's stock was worth more than the market price, purchased stock from a shareholder without disclosing his knowledge as to the real value of the stock. The court in holding that the purchase was valid since there was no relation of trust existing between the director and the individual stockholder, said: "\* \* \* for some purposes the directors of a corporation, stand in a relation similar to that of trustees for the shareholders. This seems to be the case with reference to the management, by directors, of the property and general affairs of the corporation. The matters are usually entrusted to the directors, and in respect to which they are empowered to act, and their action affects the whole body of shareholders, beneficially or injuriously, in respect to dividends upon, or the value of, their stock. But stock in a corporation held by an individual is his own private property, which he may sell and dispose of as he sees proper, and over which neither the corporation nor its officers have any control. It is the subject of daily commerce and is bought and sold in market like any other marketable commodity. The directors have no control or dominion over it whatever or duty to discharge in reference to its sale and transfer, unless it be to see that proper books and facilities are furnished for that purpose." The decisions in accord seem to go on the theory that the directors have absolutely no control or dominion over the stock of the shareholders and have no duties to perform with reference to the stock, which is the private property of the individual stockholders.

All cases, however, recognize the liability of directors for actual fraud in purchasing stock from the shareholders. *Rothmiller vs. Stein*, 143 N. Y. 581.

The case of *Carpenter vs. Danforth*, 52 Barb. 581, was an action by a stockholder to have a sale of his stock to a director declared void on the ground of fraud and undue influence. The court held that the relation of trustee and *cestui que trust* did not exist between the director and the individual shareholder and that the director was under no duty to disclose all facts within his knowl-

edge material to the value of the stock, not known to the seller. To the same effect are *Bawden vs. Taylor*, 254 Ill. 464, 98 N. E. 941; *Stark vs. Soule*, 9 N. Y. St. Rep. 555.

The case of *Krumbhaar vs. Griffiths*, 151 Pa. St. 223, 25 Atl. 64; is directly in point. The action in that case was brought by a stockholder for the purpose of rescinding a sale of stock to the secretary of the corporation. It appeared from the evidence that at the time of the sale there were no fraudulent representations as to the value of the stock, but a few days after the sale the exercise of a certain option to lease, the existence of which was known to both parties, caused the stock to increase in value. The court held that as between the officer of the corporation and the individual shareholder, there was no relation of trust or confidence. "They dealt together simply as seller and purchaser of the stock in question. \* \* \* The mere fact that G. was an officer of the company did not preclude him from buying the plaintiff's stock. He had as much right to buy it of the plaintiff directly, provided he made no misrepresentations, and he took no undue or unfair advantage, as to purchase the plaintiff's stock in the open market, or through a broker."

*Deaderick vs. Wilson*, 67 Tenn. (8 Baxt.) 108, held that the directors and officers of a railway corporation have a "perfect right" to purchase the shares of stockholders at less than par value, and then sell them to another corporation at a profit.

*Perry vs. Pearson*, 135 Ill. 218, 25 N. E. 636, a case often cited, is not directly in point, since in that case both parties to the sale of stock were directors and were equally well acquainted with the affairs of the corporation and any facts which might affect the value of the stock.

But the rule laid down by the principal case, *Board of Comm. of Tiptecanoe County vs. Reynolds*, *supra*, has been repudiated in several later cases. These cases work out a trust relation between the directors and individual stockholders. Thus in the case of *Oliver vs. Oliver*, 118 Ga. 362, p. 367-8, 45 S. E. 232, the court said: "No process of reasoning and no amount of argument can destroy the fact that the director is, in a most important and legitimate sense, trustee for the stockholder. *Jackson vs. Ludeling*, 21 Wall. 616; 2 Pomm. Eq. Jur. (2d ed.) section 1090. Not a strict trustee since he does not hold title to the shares; not even a strict trustee who is practically prohibited from dealing with his *cestui que trust*; but a quasi trustee as to the shareholder's interest in the shares. If the market or contract price of the stock should

be different from the book value, he would be under no legal obligation to call special attention to that fact; for the stockholder is entitled to examine the books, and this source of information, at least theoretically, is equally accessible to both. It might be that a director is in possession of information which his duty to the company requires him to keep secret; and if so, he must not disclose the fact even to the stockholder; for his obligation to the company overrides that to an individual holder of the stock. \* \* \* The very fact that he cannot disclose prevents him from dealing with one who does not know, and to whom material information cannot be known. If, however, the fact within the knowledge of the director is of a character calculated to affect the selling price \* \* \* the director before he buys, is bound to make a full disclosure."

In *Stewart vs. Harris*, 69 Kansas 98, 77 Pacific 277, the court in criticizing *Board of Comm. of Tippecanoe County vs. Reynolds, supra*, says: "The position taken leaves the stockholder's interest in the corporation and all matters affecting its value wholly in charge and keeping of the managing officers of the corporation, and leaves the stockholders their legitimate prey."

The case of *Strong vs. Repide*, 213 U. S. 419, 53 L. ed. 853, after considering both rules as to the relation existing between the directors and the individual stockholders, does not directly affirm either but holds that under the particular circumstances of that case, "there was a legal obligation on the part of the defendant" to make certain disclosures of facts affecting the value of the stock purchased from the agent of the stockholder.