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INTERESTED DIRECTOR CONTRACTS AT COMMON LAW: VALIDATION UNDER THE DOCTRINE OF CONSTRUCTIVE FRAUD

Norwood P. Beveridge*

I. INTRODUCTION

Until fairly recently, corporate governance circles generally accepted the idea that interested director contracts were prohibited at common law.¹ This notion resulted from an influential 1966 article by Professor Harold Marsh, Jr., which concluded that in 1880, contracts between a corporation and its directors were absolutely voidable at the option of the corporation or its shareholders without regard to the fairness or unfairness of the transaction.² Marsh also claimed that the rule applied to contracts between corporations that shared even a minority of their directors in common.³ He further

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¹. See, e.g., A.L.I. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 5.01 Reporter’s Note 3 at 207 (1994) (stating that transactions were once voidable without regard to fairness).

². See Harold Marsh, Jr., Are Directors Trustees? Conflict of Interest and Corporate Morality, 22 Bus. LAW. 35, 36 (1966). Before the publication of Marsh’s article, the view that director contracts were voidable regardless of fairness was considered to be a discredited minority opinion. See C. T. Drechsler, Annotation, Right of Corporate Officer to Purchase Corporate Assets from Corporation, 24 A.L.R.2d 71, 99-100 (1952); HENRY WINTHROP BALLANTINE, BALLANTINE ON CORPORATIONS § 67 (rev. ed. 1946); 4 WILLIAM MEADE FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 2346 (1918).

³. See Marsh, supra note 2, at 37.
stated that it did not matter if a majority of so-called "disinterested" directors approved a contract. Finally, he claimed to have found only one case during this period which was contrary to the general rule. He then concluded that "this principle, absolutely inhibiting contracts between a corporation and its directors . . . [which] appeared to be impregnable in 1880," had inexplicably disappeared by 1910; it was replaced by a rule that such contracts were valid if fair and approved by a disinterested majority of the board.

Marsh's contention that contracts between a director and the corporation were generally prohibited at common law came under attack in 1992 as completely erroneous. This suggestion has been met with a good deal of interest, but not with a corresponding

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4. See id.
5. See id. at 38. The case was Union Pacific Railroad Company v. Credit Mobilier of America, 135 Mass. 367 (1883), which held that an interested director contract could not be disaffirmed by the corporation in the absence of actual fraud once it had been assigned in good faith to a third party with approval of the corporation's board of directors, even though that third party, also a corporation, might have directors and shareholders in common with the first corporation. See id. at 377-78. This was not, however, the only case contrary to Marsh's "general rule." See, e.g., Ft Payne Rolling Mill v. Hill, 54 N.E. 532 (Mass. 1899) (holding that a fair contract with a director, made by other directors, cannot be avoided by a receiver); Nye v. Storer, 46 N.E. 402, 403-04 (Mass. 1897) (upholding an interested director contract which had been approved by a majority of the shareholders, even though the interested directors voted in their capacity as shareholders); Kelley v. Newburyport & A. H. R. Co., 6 N.E. 745, 748-49 (Mass. 1886) (enforcing an interested director contract where the shareholders' inaction, with knowledge of the facts surrounding the contract, constituted a waiver of their right to object).
7. See id. at 39-40.
8. See generally Norwood P. Beveridge, Jr., The Corporate Director's Fiduciary Duty of Loyalty: Understanding the Self-Interested Director Transaction, 41 DePaul L. Rev. 655, 659-62 (1992) (stating that interested director contracts were not always voidable at common law).
degree of acceptance.\textsuperscript{10} The subject of the corporate director fiduciary duty of loyalty is now as contentious as ever.\textsuperscript{11} Therefore, since an understanding of the origins of the existing system of regulation will be helpful,\textsuperscript{12} the purpose of this Article is to set out at some length the general rules for validation of interested director contracts at common law. Part II discusses the authorities that demonstrate that there was no doctrine of absolute voidability prior to 1910, as Professor Marsh suggested. It then demonstrates that courts addressed concerns about directors taking advantage of their positions under the doctrines of fraud or constructive fraud. Part III analyzes the case law to demonstrate when courts would or would not apply those doctrines to render an interested director contract voidable. Part IV concludes that there is no difference between allowing


10. See Cary & Eisenberg, supra note 9, at 650-51 (concluding that a clear majority of the early cases support Marsh, although a few cases and the leading treatises of the time support Beveridge); Brudney, supra note 9, at 613 n.43 (stating that "there is no doubt that [the prohibition] was pervasive, particularly in industrial states").


12. The debate over the historical common law rule regarding self-interested director contracts has continuing relevance. For instance, it has been argued that the belief in an absolute common law prohibition against such contracts has led to the unnecessary development of mechanical rules in substitution of sound fiduciary analysis. See Beveridge, supra note 8, at 688.
interested director contracts that are fair to survive the doctrine of constructive fraud and simply allowing fair contracts in the first place.\(^\text{13}\)

II. INTERESTED DIRECTORS COULD CONTRACT WITH THEIR CORPORATIONS IN THE NINETEENTH CENTURY ABSENT FRAUD OR CONSTRUCTIVE FRAUD

In the first half of the nineteenth century, the law permitted a corporation to enter into contracts with its members (shareholders)\(^\text{14}\) and directors.\(^\text{15}\) For example, in *Rogers v. Danby Universalist Society*,\(^\text{16}\) the court held that two of the three corporate trustees could contract with the third trustee for services and expenditures made by him in connection with the construction of a meeting house.\(^\text{17}\) This would be subject only to proof of "[p]artiality . . . so gross as to amount to fraud," which would defeat the contract.\(^\text{18}\) Similarly, the court in an earlier Georgia case denied stockholders an injunction in their suit to prohibit bank directors from purchasing treasury stock of the bank, which they proposed to sell on behalf of the corporation.\(^\text{19}\) In doing so, the court held that the directors were not trustees in any sense that would prohibit them from purchasing the stock of the corporation.\(^\text{20}\)

In another case, lien creditors complained that directors of a corporation, liable as endorsers on its notes, had mortgaged corporate

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13. For purposes of this discussion, the year 1910 will generally be used as the ending point, since that was the year Professor Marsh suggested as the beginning of the new era of non-prohibition. See Marsh, *supra* note 2, at 39-40.


15. See id. at 214.

16. 19 Vt. 187 (1847).

17. See id. at 192-93.

18. Id. at 191; see also Stark Bank v. United States Pottery Co., 34 Vt. 144, 148 (1861) (holding that a question of fact existed in a creditor’s suit against the corporation on an assumed debt as to whether interested directors acted in good faith in causing the corporation to assume personal liability of one director for which the others were liable as endorsers).


20. See id. at 265.
property to themselves as security against that liability. The court, however, noted that there was no objection to such a mortgage:

Now there is nothing, either in law or equity, which forbids a member, or even a director, of a corporation, from contracting with it, and like any other individual, he has a right to prescribe his own terms, which the corporation are at liberty to accept or reject, and when the contract is concluded, he stands in the same relation to the other creditors of the corporation, as any other individual would under the same circumstances.

Similarly, a Massachusetts court allowed the trustees of a corporation to authorize the corporate treasurer to give a corporate note to the administrator of the estate of one trustee. There, the members of the corporation had authorized the board of trustees to erect a building to serve as a meeting house. Subsequently, the trustee at issue had personally paid an obligation of the corporation arising out of the construction of the meeting house. The trustees' decision to authorize a note to the administrator was valid even though it was made five years after the members' initial approval of construction.

While directors could deal with their corporations, however, there was an obvious need to prevent directors from taking unfair advantage of their positions as director. In his 1966 article, Professor Marsh stated that the phrase "conflict of interest" did not seem to denote any precise legal category, and the heading "contracts with interested directors" did not seem adequate to describe all director self-interest conflicts. In the nineteenth century, the problem of director self-dealing was not categorized under these headings, but

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22. Id.
24. See id. at 275.
25. See id. at 272.
26. See id. at 276. The court stated that “[t]here can be no doubt that the trustees might lawfully change the liability of the society by creating one debt to pay another, whenever in their opinion it became necessary or expedient.” Id.
27. See Marsh, supra note 2, at 35-36.
28. See id. at 36.
rather as constructive fraud, or fraud presumed in law.\(^{29}\) As stated by a leading text:

Besides that kind of fraud which consists in misrepresentation, express or implied, there is another which will be presumed, when parties to a transaction do not stand upon the equal footing on which parties to a transaction should stand.\(^{30}\)

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If the relation between the parties is one of a fiduciary nature, transactions between them are watched by a court of equity with more than ordinary jealousy. The duty of a person who fills a fiduciary position being to protect the interests which are confided to his care, he may not avail himself of the influence which his position gives him for the purposes of his own benefit, and to the prejudice of those interests which he is bound to protect.\(^{31}\)

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The rule does not, however, go the length of avoiding all transactions between parties standing in a fiduciary relation, and those toward whom they stand in such relation. All that a court of equity requires is, that the confidence which has been reposed be not betrayed. A transaction between them will be supported, if it can be shown to the satisfaction of the court that the parties were, notwithstanding the relation, substantially at arms' length and on an equal footing, and that nothing has happened which might not have happened, had no such relation existed. The burden of proof lies, in all cases, upon the party who fills the

\(^{29}\) See, e.g., Union Pac. R.R. Co. v. Credit Mobilier of Am., 135 Mass. 367, 379 (1883) ("We are all of opinion, upon the facts found, that the case does not call for the application of the rule as to constructive fraud, which in a proper case we should not hesitate to enforce with strictness . . .").

\(^{30}\) William Williamson Kerr, A Treatise on the Law of Fraud and Mistake 143 (New York, Baker, Voorhis & Co. 1872) (citation omitted); see id. at 160-61 (stating that this principle extends to company directors).

\(^{31}\) Id. at 150.
position of active confidence, to show that the transaction has been fair.\textsuperscript{32}

As applied to the directors of corporations, the rules against constructive fraud did not mean that a director could never make a profit from his position; rather, they meant only that he could not make a secret profit from it.\textsuperscript{33} As stated in a leading text:

His duty is not to avoid, wholly, the doing of anything for his own benefit; for the class of trustees we are considering, the directors of corporations, are generally interested in the subject-matter of the trust.\textsuperscript{34}

In the absence of informed consent by or on behalf of the corporation, the transaction was fraudulent as a matter of law and might be voided by the corporation regardless of the fairness or unfairness of the contract.\textsuperscript{35} Thus, where directors were personally interested in contracts which they had authorized on behalf of the corporation, the contracts were voidable at the option of the corporation.\textsuperscript{36} Therefore,

\textsuperscript{32} Id. at 151; see also 1 JAIRUS WARE PERRY, A TREATISE ON THE LAW OF TRUSTS AND TRUSTEES 248-49 (2d ed. 1874) (stating that the same rules apply to contracts of directors with the corporation as to contracts with other fiduciaries).

\textsuperscript{33} See SEYMOUR D. THOMPSON, THE LIABILITY OF DIRECTORS AND OTHER OFFICERS AND AGENTS OF CORPORATIONS 360 (1880).

\textsuperscript{34} Id. (citation omitted).

\textsuperscript{35} See HENRY O. TAYLOR, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 581-85 (2d ed. 1888); 1 VICTOR MORAWETZ, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 489-90 (2d ed. 1886).

\textsuperscript{36} See McGourkey v. Toledo & Ohio Cent. Ry. Co., 146 U.S. 536, 566 (1892) ("A contract of this kind is clearly voidable at the election of the corporation . . . ."); Thomas v. Brownville, 109 U.S. 522, 524 (1883) (stating that no such contract can be enforced in a court of equity where it is resisted, but quantum meruit claim allowed); Wardell v. Union Pac. R.R. Co., 103 U.S. 651, 657-58 (1880) (holding that a scheme by directors to profit from a contract they authorized by forming and taking stock in a new company in order to assume the contract was utterly indefensible and illegal; such contracts are unlawful attempts by directors to profit at the expense of stockholders and creditors); Davis v. Rock Creek L.F. & M. Co., 55 Cal. 359, 364-65 (1880) (voiding corporate notes and mortgage executed by interested president and trustee); Mallory v. Mallory-Wheeler Co., 23 A. 708, 710-11 (Conn. 1891) (voiding employment contracts approved by directors and officers in favor of themselves); European & N. Am. Ry. Co. v. Poor, 59 Me. 277, 278 (1871) (director executing construction contract had interest in it); Flint & Pere Marquette Ry. Co. v. Dewey, 14 Mich. 477, 486-87 (1866) (president and trustee had interest in corporate construction contract authorized by him).
because absolute voidability was not the rule, the key question was
not merely whether a director was interested in the contract, but
rather whether the particular director-interested contract was or was
not voidable.

III. DISTINGUISHING BETWEEN VOIDABLE AND NON-VOIDABLE
DIRECTOR CONTRACTS

Conceding the fiduciary nature of the directors' relationship to
the corporation and its shareholders, the doctrine of constructive
fraud did not require the avoidance of all contracts between the cor-
poration and its directors. According to accepted principles, such
contracts might be proper where disinterested and informed consent
had been given by or on behalf of the corporation. As stated by a
leading nineteenth century text on equity jurisprudence, the majority
rule on dealings between fiduciaries and the persons they represent
was that not all such contracts were invalid:

There are two classes of cases to be considered, which are
somewhat different in their external forms, and are gov-
erned by different special rules, and which still depend upon
the single general principle. The first class includes all
those instances in which the two parties consciously and
intentionally deal and negotiate with each other, each
knowingly taking a part in the transaction, and there results
from their dealing some conveyance, or contract, or gift.
To such cases the principle literally and directly applies.
The transaction is not necessarily voidable, it may be valid;
but a presumption of its invalidity arises, which can only be
overcome, if at all, by clear evidence of good faith, of full
knowledge, and of independent consent and action. The
second class includes all those instances in which one party
purporting to act in his fiduciary character, deals with him-
self in his private and personal character, without the
knowledge of his beneficiary, as where a trustee or agent to
sell, sells the property to himself. Such transactions are
voidable at the suit of the beneficiary, and not merely pre-
sumptively or prima facie invalid.37

37. 2 JOHN NORTON POMEROY, A TREATISE ON EQUITY JURISPRUDENCE
A. Voidable vs. Non-Voidable Director Contracts: The New York Courts

Just after the midpoint of the nineteenth century, the House of Lords in England decided *Aberdeen Railway Co. v. Blaikie Bros.*,[38] a case which greatly influenced the development of the law on director-corporation contracts in the United States. In *Blaikie Bros.*, Thomas Blaikie was both the managing partner of Blaikie Brothers, iron founders in Aberdeen, and the chairman of the board of directors of the Aberdeen Railway Company.[39] While he was acting as chairman, Blaikie "entered into a contract on behalf of the Company with his own firm, for the purchase of a large quantity of iron chairs at a certain stipulated price."[40] In Scotland and England at that time, statutes applicable to companies incorporated by special act of Parliament provided that no person interested in a contract with the company would be qualified to be a director, and any director who entered into such a contract was deemed to have vacated his office as director.[41] In this case, however, the court based its decision on the

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480 (1886). Some authorities believed that the rule of avoidability without regard to fairness should be the same in all cases involving dealings by a trustee with trust property, as opposed to dealings by other fiduciaries. *See* Hoffman Steam Coal Co. v. Cumberland Coal & Iron Co., 16 Md. 456, 506-07 (1860); 1 Joseph Story, Commentaries on Equity Jurisprudence § 311 (13th ed. 1886).

38. 149 Rev. Rep. 32 (H.L. 1854) (appeal taken from Scot.).

39. *See* id.

40. *Id.* at 40.

41. *See* Companies Clauses Consolidation Act, 1845, 8 & 9 Vict., ch. 16, §§ 85-86 (Eng.); 8 & 9 Vict., ch. 17, §§ 88-89 (Scot.). The text of the statutes reads:

85/88. No person shall be capable of being a Director unless he be a Shareholder, nor unless he be possessed of the prescribed Number, if any, of Shares; and no Person holding an Office or Place of Trust or Profit under the Company, or interested in any Contract with the Company, shall be capable of being a Director; and no Director shall be capable of accepting any other Office or Place of Trust or Profit under the Company, or of being interested in any Contract with the Company, during the Time he shall be a Director.

86/89. If any of the Directors at any Time subsequently to his Election accept or continue to hold any other Office or Place of Trust or Profit under the Company, or be either directly or indirectly concerned in any Contract with the Company, or participate in any Manner in the
common law rather than the effect of the statute. The Lord Chancellor stated that the question presented was "whether a director of a Railway Company is or is not precluded from dealing on behalf of the Company with himself, or with a firm in which he is a partner." Holding that the fairness of the contract was no defense, the court decided that the contract could not be enforced.

1. The Cumberland Coal and Iron Company cases

Another influential case during this time was Cumberland Coal & Iron Co. v. Sherman, decided by the New York Supreme Court at Special Term on a motion for an injunction. From 1855 to 1858, the defendant Sherman was a director of the plaintiff corporation, a member of its executive committee, and chair of a special committee of the board empowered to make recommendations regarding the disposition of certain coal properties of the company. With the approval of the Board of Directors, the corporation sold a portion of the coal lands to Mr. Sherman in 1856; at the same time, the company entered into a contract with him for the use of the railroad and other property of the company. The shareholders of the company subsequently approved the deed and contract at a shareholders' meeting in 1857. Following Mr. Sherman's resignation in 1858, the corporation brought suit to nullify the transactions, alleging that the terms of the sale and contract were grossly unfair. The court, however, did not rest its decision on the grounds of unfairness, although it did rule

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Profits of any Work to be done for the Company, or if such Director at any Time cease to be a Holder of the prescribed Number of Shares in the Company, then in any of the Cases aforesaid the Office of such Director shall become vacant, and thenceforth he shall cease from voting or acting as a Director.

This statute did not, however, serve as a model for American legislatures, which followed quite a different approach. See Beveridge, supra note 8, at 662-70.

43. Id. at 39.
44. See id. at 39, 46.
45. 30 Barb. 553 (N.Y. Sup. Ct. 1859).
46. See id. at 554-55.
47. See id. at 556.
48. See id. at 558.
49. See id. at 554-57.
that the fairness of the transaction was no defense. The court stated that the directors were incapable of ratifying a contract with a member of the board, and it found the shareholders' approval of the contract ineffective because the shareholders were uninformed of the facts and because any approval by shareholders needed to be unanimous to bind the company. The court therefore enjoined any transfer or use of the properties and contract.

While the Cumberland decision was widely cited, its conclusions did not become generally accepted as law. In fact, the decision did not even finally determine the rights of the parties. The courts of Maryland ultimately decided the matter since both the real estate and the Hoffman Steam Coal Company, to whom Sherman had transferred the land, were located in Maryland. In Hoffman Steam Coal Co. v. Cumberland Coal & Iron Co., the Maryland Court of Appeals held that it was immaterial whether the contract and conveyance were regarded as voidable without regard to fairness or voidable only for lack of bona fides, since the transaction could not be sustained under either view. Although the defendants claimed that the transaction had been ratified by a majority vote of the stockholders, the court in a later opinion held that the ratification was insufficient because it had not been made with full knowledge of the law and facts.

The Hoffman opinions are ambiguous and could be read to support a rule of voidability in spite of fairness. However, in a subsequent Maryland case involving Sherman and Cumberland, the court soundly rejected such a rule of absolute voidability. In that case, Cumberland had given Sherman a mortgage on certain real property owned by the corporation. The court held that the transaction

50. See id. at 579.
51. See id. at 563-64, 573.
52. See id. at 576-77.
53. See id. at 580.
54. 16 Md. 456 (1860).
55. See id. at 506-07.
57. See Chesapeake Constr. Corp. v. Rodman, 261 A.2d 156, 157-58 (Md. 1970) (stating that these two decisions seem to favor a rule of voidability regardless of the question of fairness to the corporation).
58. See Cumberland Coal & Iron Co. v. Parish, 42 Md. 598 (1875).
59. See id. at 599.
should be voided, not without regard to fairness, but because Mr. Sherman and his assignee had not established “the perfect fairness, adequacy, and equity of the transactions upon which the mortgage professes to be based.” They failed to meet that burden because there was no proof that the mortgage had been authorized by an informed vote of the stockholders, that all of the directors approved the mortgage, or that the supposed loan secured by the mortgage had ever been made or was then due and unpaid.

Having rejected the principle of voidability without regard to fairness in interested director transactions, the courts of Maryland later held in Booth v. Robinson, a stockholders’ derivative action, that a presumption of unfairness or illegality does not arise with respect to dealings between two corporations having a minority of their directors in common. In that situation, the court held that the common directors must be shown to have been guilty of active misconduct in order to fix personal liability upon them. Similarly, where no actual fraud or illegality was shown in a suit brought by a minority shareholder, the Maryland courts also declined to enjoin a contract between two corporations under the control of the same

60. Id. at 607. The defendant Ann Parish was Mr. Sherman’s sister-in-law. See id. at 602. The rule in the Parish case put the burden of proof on the interested director to establish fairness. See Rodman, 261 A.2d at 157-58 (quoting Parish, 42 Md. at 605-06). Under Maryland law, transactions between a fiduciary and the person represented were not necessarily invalid but might be avoided if the fiduciary could not prove fairness. See Pairo v. Vickery, 37 Md. 467, 484-85 (1873) (trustee and cestuis que trust).

61. See Parish, 42 Md. at 610.

62. See id. at 612-13.

63. 55 Md. 419 (1880).

64. See id. at 441; accord United States Rolling Stock Co. v. Atlantic & Great W. R.R. Co., 34 Ohio St. 450, 466 (1878):

We have not, upon the most diligent research, been able to find a case holding a contract made between two corporations by their respective boards of directors invalid, or voidable at the election of one of the parties thereto, from the mere circumstance that a minority of its board of directors are also directors of the other company. Nor do we think such a rule ought to be adopted.

Cf. Goodin v. Cincinnati & Whitewater Canal Co., 18 Ohio St. 169 (1868) (invalidating transfer of corporate property to majority shareholder by directors at grossly inadequate price).

65. See Booth, 55 Md. at 441-42.
majority shareholder. A minority shareholder could, however, maintain an action to restrain a majority shareholder’s self-dealing by alleging actual fraud or illegal or ultra vires acts.

The New York Cumberland decision, like its Maryland counterpart, failed to become the law of the state for a number of reasons. The surface appeal of a prophylactic rule conflicted with existing corporate law and masked underlying difficulties and inequities. For example, the idea of unanimous shareholder approval came from the law of trusts. This idea, however, did not fit the law of corporations, which required unanimous consent of shareholders only for extraordinary transactions. No later case endorsed this idea of unanimous shareholder ratification.

The idea that the directors could not approve a transaction involving a member of the board also found its roots in the law of trusts. The Sherman court, for example, cited Whichcote v. Lawrence, which held that a purchase of lands by a trustee for the benefit of creditors—although approved by three other trustees, one of whom was solicitor for the trust—did not adequately protect the trust

66. See Shaw v. Davis, 28 A. 619, 625-26 (Md. 1894) (court will not second-guess the wisdom of a lease between two corporations controlled by the same individuals).
70. See Sherman, 30 Barb. at 575-77.
71. See id. at 575-76. The court quoted with approval from a treatise on the law of trusts: “When the cestuis que trust are a class of persons, as creditors, the sanction of the major part will not be obligatory on the rest; but the confirmation to be complete, must be the joint act of the whole body.” Id. (quoting THOMAS LEWIN, A PRACTICAL TREATISE ON THE LAW OF TRUSTS 403 (1858)); see also Davoue v. Fanning, 2 Johns. Ch. 252, 267-68 (N.Y. Ch. 1816) (the leading case in New York on the subject of trustee self-dealing at that time).
72. See People v. Ballard, 32 N.E. 54, 59 (N.Y. 1892) (holding that non-consenting shareholders can object to termination of corporate life by sale of all of its assets); Abbot v. American Hard Rubber Co., 33 Barb. 578, 590-93 (N.Y. Sup. Ct. 1861) (holding that directors cannot terminate corporation’s business even with consent of a majority of the stockholders).
73. See Sherman, 30 Barb. at 573 (quoting Whichcote v. Lawrence, 30 Eng. Rep. 1248 (K.B. 1798)).
beneficiaries.\textsuperscript{74} The notion that directors could not approve a contract involving a member of the board did have some appeal; it was not consistent, however, with existing practices in corporate management to insist that the stockholders approve contracts in the ordinary course of business. Unlike trustees, directors were usually shareholders and therefore beneficiaries of their own fiduciary duties.\textsuperscript{75} Since directors were elected by a majority vote of shareholders, usually the same persons, or their nominees, would be present at a shareholders’ meeting as at a board meeting.

However, early cases agreed that the board could not approve its own contracts.\textsuperscript{76} Since the essence of the trust doctrine was a concern with self-dealing, a director was viewed as standing on both sides of the transaction where the director’s vote was necessary for board approval of the director’s contract. Thus, where the company secretary and treasurer, a member of the board, attended a meeting of the board at which his presence was necessary to a quorum, the board could not approve payment of compensation to him, and the directors were held personally liable for the payment in a shareholders’ suit.\textsuperscript{77} Also, directors could not enforce a contract against their corporation where they constituted a majority of the board and then approved a contract to pay themselves $200,000 as individuals for the assignment of a grant to construct a railroad. The contract was accordingly not enforceable by them in a suit against the corporation.\textsuperscript{78}

\textsuperscript{74} See Whichcote, 30 Eng. Rep. at 1254 (“I am sorry to say, there is greater negligence, where there is a number of trustees. But it is the duty of a trustee to correct the negligence, which the number of trustees may occasion.”); see also Shelton v. Homer, 46 Mass. 462, 468 (1843) (holding that one executor cannot sell estate lands to a co-executor, even if he resigns).

\textsuperscript{75} See 1 Morawetz, supra note 35, at 474.

\textsuperscript{76} See sources cited supra note 36.


\textsuperscript{78} See Coleman v. Second Ave. R.R. Co., 38 N.Y. 201 (1868).
While the law of trusts gave rise to the rule preventing directors from voting on their own contracts, the duty of loyalty prevented a director from acquiring an interest in property adverse to the corporation. Thus, a director hired to procure rights of way for a railroad company could not acquire and enforce against the company a lease to premises on which the railroad had built tracks and trestle works.79

The duty of loyalty, however, did not prohibit all transactions relating to property interests. For example, directors were frequently creditors of their corporations and could make and enforce loans and advances, as well as take security for unpaid debts.80 Since the right of the corporation to avoid the transaction could not be exercised in equity without returning the consideration received, the rule of voidability could not apply to the giving of security, even for an antecedent debt, because payment of the debt was a prerequisite to avoidance.81 Thus, where a president and director of a railroad advanced $81,000 to the company and held its bonds as collateral security, it was immaterial that the executive committee directors who authorized the treasurer’s delivery of the bonds were themselves interested.

79. See Blake v. Buffalo Creek R.R. Co., 56 N.Y. 485 (1874) (dismissing suit by director to expel railroad from premises and ordering director to hold lease for company). On the subject of a director’s general duty of loyalty in not competing with the corporation for business opportunities, see Annotation, Fairness to Corporation Where “Corporate Opportunity” Is Allegedly Usurped by Officer or Director, 17 A.L.R.4TH 479 (1982). Cf. Rockford, Rock Island & St. Louis R.R. Co. v. Boody, 56 N.Y. 456, 461-62 (1874) (holding director chargeable with actual fraud in suit by railroad seeking damages for a secret financial interest he had in a construction contract with the company).

80. See Duncomb v. New York, Housatonic & N. R.R. Co., 84 N.Y. 190, 198 (1881). Duncomb involved a suit by trustees for bondholders to foreclose a mortgage of railroad property given to secure bonds. The court found that the president, who was also a company director, was entitled to prove bonds held by him to secure a debt due from the railroad for $81,000 with interest. See id.

81. See id. at 199; cf. Paine v. Irwin, 16 Hun. 390 (N.Y. App. Div. 1878). In Paine, the court found that a receiver for the corporation could not rescind a purchase of land from the trustee since the corporation had constructed a building on the land, for which the trustee could not be compelled to pay. Thus, while the receiver could technically void the contract, the lost value of the improvements would exceed any recovery through rescission and, thereby, make rescission a losing proposition.
in the transaction, having guaranteed the company’s payment of a part of the president’s advances. 82

2. The cases involving Edgar Munson

In attempting to support his thesis of absolute voidability, Harold Marsh quoted Munson v. Syracuse, Geneva & Corning Railway Co. 83 as support for the proposition that a disinterested board of directors could not successfully approve a contract with another board member. 84 A thorough examination of the Munson cases, however, reveals that while they do exemplify situations in which a director contract is voidable, they do not support such an inflexible rule of absolute voidability.

The attempt by Edgar Munson, president, director, and representative of the bondholders of the Sodus Bay & Corning Railroad Company (Sodus Bay), to reorganize the Sodus Bay under new ownership produced a number of cases on the rights of interested directors. 85

Sodus Bay was insolvent, in default on the interest payments on its bonds, and its operations were in suspension. 86 Munson and two associates, George M. Case and John E. Gowen, entered into a contract dated August 13, 1875, with George J. Magee, then president of the Fall Brook Coal Company (Fall Brook). 87 Under the contract, Munson would foreclose the mortgage securing the bonds and transfer Sodus Bay’s properties in foreclosure to a new corporation owned in part by Munson and Magee, of which Munson would

82. See Duncomb v. New York, Housatonic & N. R.R. Co., 88 N.Y. 1, 9 (1882) (holding that the president and director were entitled to enforce bonds held as collateral where trustees for bondholders attempted to foreclose the mortgage given to secure the bonds); see also Converse v. Sharpe, 56 N.E. 69, 71 (N.Y. 1900) (holding that it was not improper for directors to take a pledge of corporate securities to secure loans made to the corporation).
83. 8 N.E. 355 (N.Y. 1886).
84. See Marsh, supra note 2, at 37.
86. See Munson v. Magee, 55 N.E. at 916.
87. The facts and the terms of the contract are most clearly set out in Munson v. Magee, 55 N.E. 916 (N.Y. 1899).
be president and a director. The new company would pay for the properties by issuing its bonds to the bondholders of the old company at the price of fifty percent of the face amount of the old bonds.

With the new company (SG&C) formed, Magee assigned to it the August 13, 1875 contract, which thereby released him from further obligation except for certain undertakings which he duly performed. At a board meeting on August 31, 1875, attended by Munson and Magee, SG&C assumed the August 13, 1875 contract after a unanimous vote by the directors. SG&C then entered into a new contract with Munson on September 14, 1875, which replaced the August 13 contract. Munson signed the new contract both as a seller, in his capacity as an individual, and as a buyer, in his capacity as president of SG&C.

After numerous delays, SG&C located an alternate route for its railroad line, and when Munson tendered Sodus Bay's properties in

88. See id. at 916-17.
89. See id. at 916.
90. See id. at 917. The new company was named the Syracuse, Geneva & Corning Railroad Company. See id.
91. See id.
92. See id.
93. See id. at 918. Munson ran into difficulties at both ends of the transaction. Following his foreclosure and purchase of the properties, a stockholder of the old company sued Munson under a New York statute giving railroad stockholders a right to a pro rata share of the assets bought by a purchaser at a foreclosure sale of the railroad properties. See Pratt v. Munson, 84 N.Y. 582 (1881). The New York Court of Appeals held that the statute had been repealed by implication as a result of two later statutes on railroad reorganization. See id. at 587-88. As such, Munson prevailed in this lawsuit.
Munson also won another suit against him by a stockholder of the old company. See Harpending v. Munson, 91 N.Y. 650 (1883). The stockholder alleged that Munson could not purchase the railroad properties at the foreclosure sale since he was also a director of the company. See id. at 652. The court of appeals held that Munson could enforce his rights as bondholder, including foreclosure. The court also held that his title as conceded purchaser at the sale could not be impeached except as to any equity remaining after payment of the bonds; such an action should be brought by the company, not a shareholder of the company. See id. at 653-54; cf. Hoyle v. Plattsburgh & Montreal R.R. Co., 54 N.Y. 314, 329 (1873) (finding it unnecessary to decide whether director who is purchaser at his own foreclosure sale as execution creditor may have rights to hold the property absolutely against the company).
1877, the tender was refused. The court stated that it was unprepared, without further consideration, to find that the original contract of August 13, 1875, was invalid merely because Munson was a director of the company whose properties were the subject of the contract. However, the court noted that it was unnecessary to reach that question since Munson brought the suit to enforce the contract of September 14, 1875, which clearly was unenforceable against the company due to Munson's self-dealing. The court stated that Munson had participated in SG&C's assumption of the obligation, and it did not matter that nine other directors had voted to assume the August 13 contract.

Frustrated in his attempts to hold SG&C to its obligations, Munson then sued Magee for failure to perform the August 13, 1875 contract and won an award of damages. The court of appeals, however, refused to hold Magee liable, saying that the earlier decision only held that the September 14 contract was voidable because Munson, as president of SG&C, had undertaken to contract with himself as an individual. The earlier decision did not hold that the August 31 resolution was voidable, but even if it were, the company did not elect to avoid the assumption of the August 13 contract, only the September 14 contract. Therefore, there was an effective novation, and Magee was released from any further obligation under the August 13 contract, except for the parts that he duly performed.

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95. See id.
96. See id. at 356.
97. See id. at 358.
98. See id.
100. See id. at 919.
101. See id.
102. See id. The estate of one of Munson's colleagues, John E. Gowen, assigned his interest in the August 13 contract to Robert C. Rudd, who brought suit against the estate of George J. Magee. See Rudd v. Magee, 65 N.Y.S. 65 (N.Y. App. Div. 1900). Once again, an award of damages to the plaintiff was set aside on appeal. The court held that Gowen, though not a director of the new company, had also participated in and affirmed the transactions, which
After reviewing the twenty-five years of litigation in this dispute, it is hard to see any violation of trust by Munson. Sodus Bay was hopelessly insolvent, no equity remained for the shareholders in its properties, and the bondholders were content to take fifty cents on the dollar. Also, SG&C was formed by Munson’s contract with Magee for the express purpose of taking an assignment of the August 13 contract and purchasing the properties of Sodus Bay to be acquired by Munson at the foreclosure sale. Furthermore, Munson and Magee negotiated the contract at arms’ length.

Ultimately, while the Munson cases demonstrate an instance where the courts would void interested director contracts, they do not stand for a rule of absolute voidability. The facts of the case demonstrate instances where the contracts would have been valid. For instance, all Munson had to do was get SG&C’s shareholders to approve the September 14 contract, which would probably have been a simple task, or he could have simply stood on the August 13 contract, which he had every right to do. Regarding the August 31 board meeting, the court of appeals found that there was likely no impropriety in Munson’s participation since he did not have an interest in the assumption of the contract. That was Magee’s problem, since Magee was already bound by the August 13 contract, and it could have made no difference to Munson or the bondholders who performed the contract. Finally, the court said that SG&C could not have avoided its assumption of the August 13 contract without returning to Magee the valuable coal freight contracts which he had procured for the new company in fulfillment of his contractual obligations. These methods demonstrate ways in which the court would uphold such director transactions. Thus, the Munson cases do not stand for an unyielding rule of absolute voidability.

3. The interested director as shareholder

The court of appeals in Munson cited Aberdeen Railway Co. v. Blaikie Bros. in support of the “great rule of law” against thereby constituted a novation, effectively releasing Magee from further liability. See id. at 68.

103. See Munson v. Magee, 55 N.E. at 919.
104. See id.
self-dealing. However, another English case was also influential in the development of the law in New York; *North-West Transportation Co. v. Beatty*, a stockholders’ derivative suit, was influential in expressing the right of directors who are also shareholders to vote their shares in approval of contracts in which they are interested. There, the corporation’s board of directors voted to purchase a steamer from one of the directors, who was not present at the meeting. The shareholders then approved the purchase at a special meeting, with the interested director casting the deciding vote in his capacity as shareholder. Reversing the decision of the Supreme Court of Canada that set aside the contract, the Privy Council upheld the director’s right to approve and enforce the sale, holding that to deny him the power to vote on a pure question of policy would be to allow the minority of the shareholders to control the company.

The New York courts followed this rule allowing interested directors to vote their shares as stockholders in *Gamble v. Queens County Water Co.*, also a stockholders’ derivative suit. In

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(H.L. 1854) (appeal taken from Scot).

108. 12 App. Cas. 589 (P.C. 1887) (appeal taken from Can.).
109. See id. at 595.
110. See id. at 596-98.
112. See North-West Transp. Co. v. Beatty, 12 App. Cas. 589, 601 (P.C. 1887) (appeal taken from Can.). Even without a shareholder vote, the contract might have been permitted by the company’s articles of incorporation. At that time, it was common for the articles to contain a provision that directors might have an interest in contracts with the company. See G. LATHOM BROWNE, A TREATISE ON THE COMPANIES ACT, 1862 391 (1867), where the following form is suggested:

95. No director shall, however, become disqualified for his office as a director by reason of his being a member of any company, co-partnership, or firm which shall enter into a contract with, or shall do any work for this company; but he shall not vote on any such contract or work, and if he so do, his vote shall be counted as given in the negative, and not in the affirmative.

Such clauses had been held to allow a director to participate in contracts with the company. See Costa Rica Ry. Co. v. Forwood, [1901] 1 Ch. 746, aff’g [1900] 1 Ch. 756; Imperial Mercantile Credit Ass’n (Liquidators) v. Coleman, (1873) L.R. 6 H.L. 189, rev’g (1871) L.R. 6 Ch. 558; 4 WILLIAM MEADE FLETCHER, Cyclopedia of the Law of Private Corporations § 2331 (1918).

113. 25 N.E. 201 (N.Y. 1890).
Gamble, the New York Court of Appeals upheld a contract under which a director sold a system of water pipes, which he personally owned, to his corporation.\textsuperscript{114} Citing *North-West Transportation Co.* with approval, the court held that such a contract, when approved by a majority of the shareholders, could not be voided without proof of actual fraud or oppression.\textsuperscript{115} Although the votes of the interested director as shareholder were not necessary to obtain shareholder approval in *Gamble*, the court found nothing wrong with interested directors voting personal shares in favor of their own contracts.\textsuperscript{116}

In the second edition of his influential 1886 treatise, Victor Morawetz commented that in some cases, courts had advanced the view that, even with the approval of a majority of the board, a director could not validly contract with the corporation.\textsuperscript{117} However, Morawetz concluded as follows:

But the weight of authority and of reason appears to indicate that such a contract would be valid. . . . There is no necessary impropriety in a contract between a director and the corporation, if the latter is represented by other agents. On the contrary, such contracts are, in many instances, the natural result of circumstances, and are justified by the approved usages of business men.\textsuperscript{118}

\textsuperscript{114} See id.

\textsuperscript{115} See id. at 202; see also Godley v. Crandall & Godley Co., 105 N.E. 818, 822 (N.Y. 1914) (holding in a stockholders' derivative suit that majority shareholders cannot ratify payment of fraudulent salaries to themselves).

\textsuperscript{116} See *Gamble*, 25 N.E. at 202; see also Skinner v. Smith, 31 N.E. 911 (N.Y. 1892) (holding in an action by trustee to set aside transfer of corporate assets that a contract with interested directors is not voidable where all shareholders approved); Barr v. New York, L. E. & W. R. Co., 26 N.E. 145 (N.Y. 1891) (holding in a stockholders' derivative suit that an interested director contract is not voidable where all shareholders approved); Van Cott v. Van Brunt, 82 N.Y. 535 (1880) (holding in a suit by receiver of corporation to set aside contract by president and director that the contract was not invalid where all directors and stockholders approved); cf. Barnes v. Brown, 80 N.Y. 527, 535-36 (1880) (holding that the director, president and majority shareholder could not acquire an interest in a construction contract with the company, but it was not improper for him to sell his stock and any other interest he might have in the contract to others).

\textsuperscript{117} See 1 Morawetz, supra note 35, at 494.

\textsuperscript{118} Id. at 494-95; see also 1 Charles Fisk Beach, Jr., Commentaries on the Law of Private Corporations § 242, at 401-02 (1891) (stating di-
The validity of this proposition, furthermore, was actually noted by the New York courts in 1892. Commenting on the language, a New York Supreme Court Justice said that, unfortunately, this proposition was in fact the weight of authority in New York. While the court in that case held that the director could not enforce the contract against the corporation, the outcome does not diminish the court's notation of the general rule allowing director contracts; the holding was not based solely on the director's status as director, but rather on the fact that the interested director had presided at the board meeting that approved the contract. Furthermore, in another suit brought by a minority shareholder to set aside a contract between the majority shareholder—a director—and the corporation, the same court held that a minority shareholder could not void the contract unless it were unfair to the corporation.

Rectors may contract with corporation if the directors disclose their positions as adverse parties and do not influence or control the vote; Seward Brice, A Treatise on the Doctrine of Ultra Vires 477-87 (2d ed. 1880) ("[P]rovided all the attendant circumstances are made known, companies and their directors may validly enter into stipulations permitting the latter to have private and personal interests in the companies' contracts."). Some earlier treatises had adopted the holding in Cumberland Coal & Iron Co. v. Sherman, 30 Barb. 553 (N.Y. Sup. Ct. 1859), that the board could not approve a contract with a co-director. See 1 Perry, supra note 32, at 249. Beers v. New York Life Ins. Co., 20 N.Y.S. 788, 794-95 (N.Y. Sup. Ct. 1892) (dismissing suit by director to enforce a board approved, post-resignation, lifetime pension).

See id. This was an alternative holding, since the court had already concluded that the board could not make a contract in consideration of past services, nor could it make a perpetual contract for services. See id. at 792; see also Welling v. Ivoroyd Mfg. Co., 44 N.Y.S. 374, 377-79 (N.Y. App. 'Div. 1897) (holding in suit by assignee of president and director on contracts for sale of goods and salary that contracts were invalid since interested director presided at meetings where they were approved, but allowed recovery for goods in quantum meruit), aff'd per curiam, 57 N.E. 1128 (N.Y. 1900); Anderton v. Aronson, 3 How. Pr. (n.s.) 216, 229 (N.Y. Sup. Ct. 1886) (holding in stockholders' derivative suit that presence of interested director at board meeting authorizing contract and issuance of stock invalidates vote).

4. Contracts between corporations with common directors

In 1884, a lower court judge in New York pronounced the validity of contracts between corporations with common directors to be an open question in both New York and federal courts. In that case, two elevated railroad companies in New York City had, with the approval of their shareholders, leased all of their properties to a third elevated railway company. As a result of miscalculations of the anticipated profits from operations, the terms of the lease were ruinous to the third company, which thereafter became insolvent. Consequently, the boards of directors of the leasing companies agreed to a reduction in the terms of the lease rentals; they did so, however, without obtaining shareholder approval.

After the election of a new board of directors, one of the leasing companies brought an action to set aside the new lease on the grounds that the directors had no authority to modify the lease without shareholder approval, and that three of the directors of the leasing company were also directors of the lessee.

The court first held that since the lease covered all of the corporation’s properties, the amendment of the lease constituted a fundamental change in the business of the corporation, which fell beyond the powers of the board. The court then held that although the common directors made up a minority of the board in each case, their mere presence on the board gave each company the right to avoid the contract without regard to fairness.

ley Railway Co. v. Retsof Mining Co., 36 N.Y.S. 896 (N.Y. Sup. Ct. 1895), a suit by one of two related corporations against the other to restrain interference with a lease, the court refused to set the lease aside on the grounds that the directors of one were interested in the other, saying that “the rule contented for by the learned counsel for the defendant has been considerably relaxed of late years.” Id. at 900 (citing Gamble v. Queens County Water Co., 25 N.E. 201 (N.Y. 1890)).

123. See id. at 392-93.
124. See id. at 396-97.
125. See id. at 409-13.
126. See id. at 427-28.
127. See id. at 485.
128. See id. at 524. The court ignored, disagreed with, or distinguished decisions from other states to the contrary. See TAYLOR, supra note 35, at 593 (“[I]t has been expressly decided in more than one state ... that a contract
The question of whether a corporation could void a contract made with another corporation sharing a common director was later presented in the well-known case of *Globe Woolen Co. v. Utica Gas & Electric Co.*129 There, the defendant corporation entered into what turned out to be very improvident contracts with the plaintiff corporation. A director of the defendant corporation was also the plaintiff corporation's president, controlling stockholder, and a member of its board.130 In a suit for specific performance, the court of appeals voided the contracts because the common director failed to warn and overreached. The contracts were voided even though they had been adopted at meetings of the defendant's executive committee of the board at which the plaintiff's president—the dual director—was present but did not vote.131 The court said that the refusal to vote did, however, have importance: "It gives to the transaction the form and presumption of propriety, and requires one who would invalidate it to probe beneath the surface."132

The New York courts had earlier held that while the presence of common directors might arguably give each corporation the right to disavow a common contract, that right could only be exercised by the corporation through its directors and not by a minority shareholder in a derivative action.133 To hold otherwise would allow a minority of the shareholders to annul a fair contract against the wishes of a majority of the shareholders.134 A dissident minority shareholder could not bring an action to avoid the contract without alleging actual,
rather than constructive, fraud. Professor Marsh treats this as a betrayal of the principle of voidability, but as has already been shown, that supposed principle was only enforced in very limited circumstances where the same directors were on both sides of the contract.

The New York Court of Appeals upheld this principle of nonintervention in a suit brought by a minority shareholder against a majority shareholder to cancel the majority shareholder's contract with the corporation. The court held that the plaintiff was in the same position as all of the minority stockholders, who cannot interfere with the honest management of the corporation by the majority stockholders. It followed from this proposition that even where a majority of the directors are in common, a majority of the shareholders may ratify a contract between the two corporations.

As already noted, directors could not vote on their own salaries as officers where the vote of the interested director was necessary to authorize the payment. The court of appeals subsequently held in a minority shareholder derivative suit that even where the directors were majority shareholders, they could not, as directors, vote themselves salaries as officers. The court cited the following language with approval:

"A director cannot with propriety vote in the board of directors upon a matter affecting his own private interest any more than a judge can sit in his own case; and any

135. See Sage v. Culver, 41 N.E. 513 (N.Y. 1895) (finding that the complaint in a stockholders' derivative action against directors and majority shareholders to avoid a contract with a corporation having common directors states a cause of action when it alleges unfair terms).
136. See MARSH, supra note 2, at 42.
137. See cases cited supra note 36.
139. See id. at 23.
resolution passed at a meeting of the directors at which a director having a personal interest in the matter voted will be voidable at the instance of the corporation or the shareholders, without regard to its fairness, provided the vote of such director was necessary to the result."  

B. Voidable vs. Non-Voidable Director Contracts: The New Jersey Courts

The experience in New Jersey largely followed the course of the New York cases. That is to say, there was no mention of the supposed doctrine of absolute voidability of director contracts prior to 1860. The whole idea seems to have been taken directly from the 1854 English case of Aberdeen Railway Co. v. Blaikie Bros.\textsuperscript{143} In fact, the question of director contracts had been dealt with in the 1832 case of Chandler v. Monmouth Bank,\textsuperscript{144} where the New Jersey Supreme Court had held that the board of directors could employ one of its members as its paid agent to supervise the building of a steamboat for the company.\textsuperscript{145}

However, in 1875, the New Jersey Supreme Court held in Stewart v. Lehigh Valley Railroad Co.\textsuperscript{146} that a contract between a director and the director’s company, even if fair, was voidable at the option of the company if that option was exercised within a reasonable time.\textsuperscript{147} This right was personal to the company, and did not pass to the plaintiff in that case, an assignee of the company’s interest;\textsuperscript{148}

\textsuperscript{142} Jacobson v. Brooklyn Lumber Co., 76 N.E. 1075, 1078 (N.Y. 1906). The language quoted is mistakenly identified in the opinion as being from the AMERICAN & ENGLISH ENCYCLOPEDIA OF LAW. See id. It is actually from \textit{10 Cyclopaedia of Law and Procedure} 790 (1904). See also Godley v. Cran dall & Godley Co., 105 N.E. 818 (N.Y. 1914) (majority shareholders cannot ratify fraudulent payments to themselves); Billings v. Shaw, 103 N.E. 142 (N.Y. 1913) (directors and officers must account for unlawful profits which they made in transactions authorized by them as directors).

\textsuperscript{143} 149 Rev. Rep. 32 (H.L. 1854).

\textsuperscript{144} 13 N.J.L. 255 (1832). See also Stratton v. Allen, 16 N.J. Eq. 229, 232-35 (Ch. 1863) (holding that a director may contract with the corporation as a stranger, but an insolvent corporation cannot make preferential payment to director as creditor).

\textsuperscript{145} See Chandler, 13 N.J.L. at 260.

\textsuperscript{146} 38 N.J.L. 505 (1875).

\textsuperscript{147} See id. at 521-24.

\textsuperscript{148} See id. at 524.
thus, the contract was upheld. The doctrine was further explained in
*Gardner v. Butler*, where minority shareholders sued to avoid
contracts made by the board of directors with the majority share-
holder, Butler, that fixed his compensation. The court held the
contracts voidable, but since Butler was nonetheless entitled to re-
cover upon *quantum meruit*, and since his services were worth at
least what he had been paid, the court dismissed the suit.

Thus, as in New York, where the directors entered into contracts
with themselves, the contracts could be avoided by the corporation
under New Jersey law. However, even where a majority of the di-
rectors were interested in a contract with the corporation, such a
contract could be ratified by the shareholders, and the votes of the
interested directors as shareholders could be counted to make up the
requisite majority. The corollary of this proposition was that an
individual shareholder could not sue to avoid an interested director
contract regardless of its fairness since the decision to bring this
claim was to be made by the shareholders as a group in an assembled

149. 30 N.J. Eq. 702 (1879).
150. See id. at 709.
151. See id. at 721.
152. See id. at 725; see also *Hickman v. Hickman Hose Coupling Co.*, 13
N.J.L.J. 111, 112-13 (1890) (stating that a director may recover in *quantum
meruit* for services as manager).
(contract in which directors had a personal interest could not be enforced
against corporation); *Hayes v. Pierson*, 45 A. 1091 (N.J. 1899) (receiver can
avoid contracts by directors fixing their salaries and contracting with another
company owned by them); *Guild v. Parker*, 43 N.J.L. 430, 435 (N.J. 1881)
(holding that directors improperly redeemed stock held by them at one hundred
and fifty percent of par when it was redeemable at par); *Voorhees v. Nixon*, 66
A. 192 (N.J. Ch. 1907) (reforming contract under which wife of controlling di-
rector sold land for $3000 which she had purchased at $450 when it was found
that the husband was the real party to the transaction in question).
154. See *Hodge v. United States Steel Corp.*, 54 A. 1, 4-5 (N.J. 1903) (un-
derwriting contract with J.P. Morgan & Co. upheld as approved by sharehold-
ers). A majority shareholder could not insulate his own salary as an officer
from review by approving it as shareholder. See *Lillard v. Oil, Paint & Drug
Co.*, 56 A. 254, 256-59 (N.J. Ch. 1903) (stating that the salary must be reason-
able).
meeting. An individual shareholder could only bring suit upon a showing that the contract was ultra vires, fraudulent, or illegal.

With respect to interlocking directors, a common director could not be counted towards a quorum for a meeting of the executive committee to authorize a contract between the two companies. However, action in reliance upon the contract could ratify the contract, thereby creating an estoppel against objections. The mere existence of common directors did not give a minority shareholder the right to enjoin a contract between the two companies. The contract, however, would be enjoined when all of the directors are shown to have an interest in the transaction which would have the effect of perpetuating themselves in office. Minority shareholders might lose their right to challenge the transaction if, knowing of this right, they delay in challenging the transaction. Such knowledge and delay amounts to a defense of laches.

156. See Endicott, 87 A. at 232-33; see also Marr v. Marr, 70 A. 375, 379-80 (N.J. 1908) (holding that a minority shareholder can set aside purchase by director at sheriff's sale of corporate property at half its value); Laurel Springs Land Co. v. Fougeray, 24 A. 499, 503-04 (N.J. Ch. 1892) (holding that a minority shareholder can set aside transfers of property and salaries made by majority shareholder and directors), rev'd on other grounds, 26 A. 886 (N.J. 1893) (receiver will not be appointed); Barry v. Moeller, 59 A. 97, 99 (N.J. Ch. 1904) (compelling directors to account for profits allegedly made by them when the directors had the corporation sell its products to them below cost); Oliver v. Rahway Ice Co., 54 A. 460, 461 (N.J. Ch. 1903) (holding that interested directors cannot purchase stock from themselves at unfair price); Davis v. Thomas A. Davis Co., 52 A. 717, 718 (N.J. Ch. 1902) (holding that directors cannot fix their own salaries); Landis v. Sea Isle City Hotel Co., 31 A. 755 (N.J. Ch. 1895) (holding that minority shareholders can reform transaction where directors purchased land from themselves at a two hundred percent profit).
158. See id. at 911.
159. See Robotham v. Prudential Ins. Co. of Am., 53 A. 842, 856-57 (N.J. Ch. 1903).
160. See id. at 858.
C. Voidable vs. Non-Voidable Director Contracts: Other Jurisdictions

So far, the focus has been on New York and New Jersey cases, since those jurisdictions are most frequently cited for the supposed rule of voidability. However, other jurisdictions also enforced fair interested director contracts during this period. For example, in the 1875 case of *Twin-Lick Oil Co. v. Marbury* the United States Supreme Court upheld an interested director transaction because the corporation had waited too long to challenge the action of the defendant director in acquiring the corporation's properties. The director had obtained the properties at a foreclosure sale under a deed of trust given by the company to secure a loan from him to the company. However, in language frequently cited, the court also said:

While it is true that the defendant, as a director of the [c]orporation, was bound by all those rules of conscientious fairness which courts of equity have imposed as the guides for dealing in such cases, it cannot be maintained that any rule forbids one director among several from loaning money to the [c]orporation when the money is needed, and the transaction is open, and otherwise free from blame. No adjudged case has gone so far as this. Such a doctrine, while it would afford little protection to the [c]orporation against actual fraud or oppression, would deprive it of the aid of those most interested in giving aid judiciously, and best qualified to judge of the necessity of that aid, and of the extent to which it may safely be given.

The lower federal courts also upheld interested director contracts if they were fair, and in other cases, the Supreme Court

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162. 91 U.S. 587 (1876).
163. See id. at 593-94.
164. Id. at 589.
165. See Cowell v. McMillin, 177 F. 25, 38-39 (9th Cir. 1910) (minority shareholder cannot set aside contract with president and director approved by disinterested directors); Wyman v. Bowman, 127 F. 257, 273 (8th Cir. 1904) (fair interested director contracts are enforceable in equity and at law and cannot be avoided by receiver of corporation); Barr v. Pittsburgh Plate-Glass Co., 57 F. 86, 97 (3d Cir. 1893) (refusing in minority shareholders' derivative suit to set aside sale of plant to corporation by majority shareholders, officers, and directors upon approval by majority of minority shareholders); Beach v.
repeated its approval of transactions involving interested directors who acted openly and without fraud.166

The Illinois courts, meanwhile, supported the view that directors might properly contract with their corporations "in the same manner as strangers,"167 although they would not enforce contracts amounting to constructive fraud. Thus, in Harts v. Brown,168 the Illinois Supreme Court upheld bonds and a trust deed securing the bonds issued to a director by his co-directors. The court stated:

Did the directors have power to borrow money of one of their number, and execute to him a mortgage on the corporate property, with a power of sale? We have never known it questioned that a director or stockholder may trade with, borrow from or loan money to the company of which he is

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166. See Leavenworth County Comm'rs v. Chicago, Rock Island & Pac. Ry. Co., 134 U.S. 688, 704-08 (1890) (absent actual fraud, the court would not prevent foreclosure of a trust deed even though the two corporations shared interlocking shareholders, common directors and officers, and one of the trustees was also a director or stockholder of the company foreclosing the deed); Illinois Pneumatic Gas Co. v. Berry, 113 U.S. 322, 326-27 (1885) (company cannot avoid interested director settlement or lease after seven years acquiescence; furthermore, settlement was reached previously); Manufacturing Co. v. Bradley, 105 U.S. 175, 182-83 (1881) (renegotiated bond held by president not voidable since corporation was represented in transaction by other informed directors); Hotel Co. v. Wade, 97 U.S. 13, 21-23 (1877) (where the transaction was approved by shareholders, the fact that directors were lenders was no objection to the foreclosure of a mortgage securing bonds).

167. See Merrick v. Peru Coal Co., 61 Ill. 472, 478 (1871) (allowing the president, director and shareholder to recover on corporate notes).

168. 77 Ill. 226 (1875).
a member, on the same terms and in like manner as other persons.169

The court also held, though, that upon foreclosure he could not purchase corporate property in excess of that required to pay the bonds.170

The directors could not, however, enter into contracts with themselves. During the same term, the Illinois Supreme Court affirmed a lower court decision ordering an accounting of any profits made by directors under a construction contract, which they had authorized, with a company in which they subsequently acquired an interest.171 The court also declared void a majority stock interest in the railroad which the directors issued to the construction company for apparently no consideration.172 No actual fraud was found, but the court stated that the fairness of the contract was no defense;173 nor was shareholder approval of the transaction a defense since the shareholders were unaware that the directors intended to take an interest in the construction company.174

Two Alabama cases that have been cited out of context do not support any contrary rule, when properly examined. In Memphis &

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169. Id. at 230-31; see also Mullanphy Bank v. Schott, 26 N.E. 640, 642 (Ill. 1891) (upholding note and mortgage given to director, stockholder and treasurer). However, in later cases, the court held that an insolvent corporation cannot prefer its directors as creditors ahead of other creditors. See Roseboom v. Warner, 23 N.E. 339, 341 (Ill. 1890); Beach v. Miller, 22 N.E. 464, 467 (Ill. 1889). These cases reflect the majority rule on that question. See Norwood P. Beveridge, Jr., Does a Corporation's Board of Directors Owe a Fiduciary Duty to Its Creditors?, 25 St. Mary's L.J. 589, 612-14 (1994).

170. See Harts, 77 Ill. at 233-34.

171. See Gilman, Clinton & Springfield R.R. Co. v. Kelly, 77 Ill. 426 (1875). This is consistent with the cases cited supra note 36.

172. See id. at 436-37.

173. See id. at 435-36; see also Higgins v. Lansingh, 40 N.E. 362, 381 (Ill. 1895) (holding that fairness was no defense where majority of board was interested in contract approved by them).

174. See Gilman, 77 Ill. at 437; see also Klein v. Independent Brewing Ass'n, 83 N.E. 434, 441 (Ill. 1907) (holding that interested majority shareholders cannot ratify an unfair contract); Chicago Hansom Cab Co. v. Yerkes, 30 N.E. 667, 670-71 (Ill. 1892) (holding that an interested director, officer, and controlling shareholder cannot, as selling agent, sell all property of the corporation to himself, nor as controlling shareholder authorize such a sale at a shareholders' meeting over the objection of the minority).
Charleston Railroad Co. v. Wood,\textsuperscript{175} the Alabama Supreme Court enjoined a railroad company that held a majority of the stock of a competitor from voting its stock due to multiple acts of actual fraud.\textsuperscript{176} The court relied on the 1886 treatise by Victor Morawetz for the authority that directors cannot represent conflicting interests;\textsuperscript{177} however, that authority also notes that directors may contract with the corporation through other directors\textsuperscript{178} and are not prohibited from dealing with another corporation merely because a minority of the directors are in common.\textsuperscript{179} Two years later, the same court held, in O’Conner Mining & Manufacturing Co. v. Coosa Furnace Co.,\textsuperscript{180} that a creditor cannot object to dealings between a corporation and its directors and shareholders in the absence of actual fraud.\textsuperscript{181}

The Texas Supreme Court cogently expressed the rationale underlying the rule of allowing a director to contract with the corporation through fellow directors on fair terms and with full disclosure:

The corporation is a separate entity, for which its board of directors acts. The persons having the beneficial interest in the property are the stockholders, but their rights are centered in the corporation, and are managed and controlled through the board of directors, as the active representative of the company; and it is through it, and not the stockholders, that business dealings are carried on. When a personal interest of one of them springs up, adverse to that of the corporation, it disqualifies him to act concerning it as one of

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\bibitem{175} 7 So. 108 (Ala. 1889).
\bibitem{176} In a later case, the Alabama Supreme Court said that the Wood result was reached to prevent a scheme on the part of the majority shareholder to wreck the competing railroad to build up itself. See South & N.A.R. Co. v. Gray, 49 So. 347, 350-51 (Ala. 1909) (stating that a majority shareholder cannot vote its stock to oppress and defraud the minority).
\bibitem{177} See Memphis & Charleston R.R. Co., 7 So. at 112 (citing to 1 Morawetz, supra note 35, §§ 517, 528-30).
\bibitem{178} See 1 Morawetz, supra note 35, § 527.
\bibitem{179} See id. § 530.
\bibitem{180} 10 So. 290 (Ala. 1891).
\bibitem{181} See id. at 292-93 (holding that nothing was wrong with such dealings, although the corporation and its shareholders may have a right of avoidance in certain circumstances); see also W.A.E., Annotation, Right of Creditors as Against Directors or Officers to Whom Property of a Corporation Has Been Transferred for a Consideration Other Than Payment of Debts Due Them, 9 A.L.R. 1447 (1920).
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the representatives or agents. . . . But the company is represented by those who alone can act for it, and, if they are disinterested, he can, we think, deal with them 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. 182

Two leading treatises published at the turn of the century stated that this was the majority rule in the United States at that time:

On the contrary, most of the courts have held that a director or other officer of a corporation is not precluded from lending it money and taking a mortgage or other security, selling it property, or purchasing property from it, or otherwise contracting or dealing with it, if for the purpose of the transaction he does not represent the corporation at all, but it is adequately represented by its other directors or officers, and the transaction is entirely free from fraud. And by the weight of authority, a transaction between a director or other officer and the corporation, or a transaction in which a director or other officer is interested, is valid, if entirely free from fraud, even when he has acted as a member of the board in authorizing the same, if there were enough of disinterested votes in favor of the transaction to render his vote unnecessary. 183

Many courts . . . hold that if the interested director took no part either in the deliberations or in the voting of the board, but acted in the transaction wholly on his own behalf; the contract will not be voidable merely because of his official relation to the company, if the contract be proved affirmatively to be fair and honest. Such is, indeed, the prevalent American doctrine. But even according to these authorities, the transaction will be closely scrutinized, and the burden

182. Tenison v. Patton, 67 S.W. 92, 95 (Tex. 1902).
183. 3 WILLIAM L. CLARK & WILLIAM L. MARSHALL, A TREATISE ON THE LAW OF PRIVATE CORPORATIONS 2304-05 (1901).
of establishing its complete bona fides rests upon the interested director; and if the interested director, although not guilty of positive fraud, yet failed to disclose some material fact, the transaction will be voidable. So too, if the agreement appear to be unconscionable or unreasonable, it will not be enforceable.\(^\text{184}\)

**IV. CONCLUSION**

The principle that a contract between the corporation and a member of its board can be avoided at the option of the corporation or any shareholder of the corporation regardless of its fairness does not serve a useful function. If a contract is fair, it is hard to say there has been a legitimate injury to the corporation. Furthermore, outright voidability would actually make directors wary of contracting with their corporations and, thereby, limit the corporation's options in situations where there may be no alternative to dealing with a director. For similar reasons, no useful purpose is served by avoiding fair contracts between corporations having a minority of common directors. Thus, avoiding fair contracts that directors honorably and openly entered into is not an appealing option for the average businessperson.

In fact, the history of interested-director contracts reflects this basic concept. The only cases in which corporations sought to invoke the principle of absolute voidability have disclosed some dubious motive, such as a new board of directors seeking to avoid a contract made by their predecessors.\(^\text{185}\) The trust principle of voidability is intended to enforce disclosure to, and consent by, the beneficial owners of trust property; this idea does not translate well into the corporate setting. Furthermore, all authorities after the *Beatty*\(^\text{186}\) decision in 1887 agreed that contracts could be approved by a majority


of the shareholders, including the interested director acting as shareholder.

Holding a shareholders’ meeting, however, takes time and trouble; thus, in the absence of proof of actual fraud or unfairness, basic business principles support the idea that a shareholders’ meeting should not be required for transactions conducted by a disinterested board. The board, after all, presumptively reflects the wishes of a majority of the shareholders. Consequently, fair contracts were generally enforced, even in New York and New Jersey, through a number of devices, such as the doctrine of laches, the impracticability of rescission and the absence of damages, ratification by shareholders, or perhaps most tellingly, the doctrine that fair contracts could be avoided only by the board and not by a minority shareholder.

Ultimately, there is no difference between applying these doctrines to save interested director contracts that are fair and a straightforward doctrine that the board can make a fair contract in the first place. Thus, when looking to the legal history of this subject for guidance in either statutory analysis or fiduciary duty analysis, it is important to realize that there was never a rule that interested director contracts were absolutely voidable. A true understanding of the history of the rule will give needed insight and further the upholding and enforcement of fair and useful contracts between corporations and their directors.