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Corporations—Validity of Contracts Between Director and His Corporation.—Buck v. Northern Dairy Co

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Corporations—Validity of Contracts Between Director and His Corporation.—*Buck v. Northern Dairy Co.*[1]—Dr. Samuel H. Buck was a director, president and owner of the controlling stock interest in Northern Dairy Co. Pursuant to an agreement with the corporation entered into in 1943, Buck was being paid $187.50 monthly for life in consideration of his performance of various managerial duties. In 1956, as the result of an option secured from Buck by a director of the corporation, Buck agreed to sell his stock, on the condition that the corporation pay Buck $150 monthly for life. In the event of his death in less than six years, then, for the balance of the six years, payment was to be made to his estate. At a meeting of the board of directors, with all present, the issue was discussed, and then with Buck and another director abstaining from voting, a resolution was adopted by unanimous vote of the other directors approving the payment to Buck of the condition in the option. Buck sold the stock and the corporation made the payments for twenty-six months. Thereafter, the corporation refused to perform and demanded repayment of sums already paid. Buck then sued for specific performance of the agreement.

The Circuit Court granted specific performance and denied defendant's prayer for recovery of amounts already paid. On defendant's appeal, the Supreme Court affirmed, by an equally divided court. HELD: (1) The board voting was disinterested by virtue of the fact that each director exercised his own independent judgment in the best interests of the corporation; and (2) the contract was valid because there was adequate consideration flowing to the corporation in the change from the 1943 to the 1956 agreement. The dissenting opinion, hereafter referred to for convenience as the minority, declared the board was interested because the director, who secured the option, and two other directors, whom he controlled, voted; hence the contract was voidable. The minority also held the agreement invalid for lack of sufficient consideration, inasmuch as it was payment for past services.

When a director contracts with his corporation, there is a conflict over the tests to be employed in order to determine the validity of the agreement. There are four fact situations which could arise when a director contracts with his corporation, and the result of each would depend on the prevailing rule of director contracts in the respective jurisdiction. These situations are: (1) interested board-unfair contract; (2) interested board-fair contract; (3) disinterested board-unfair contract; and (4) disinterested board-fair contract. With regard to all four situations, there is some authority to the effect that any contract between a director and his corporation is void.[2] This is a strict minority view and needs no further discussion. In the first two situations, where there is an interested board, the general view is that the action taken is voidable at the option of the corporation, regardless of

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[1] 364 Mich. 45, 110 N.W.2d 756 (1961).

[2] See, e.g., Pearson v. Concord R. Corp. 62 N.H. 537 (1883); Cuthbert v. McNeil 103 N.J. Eq. 199, 142 Atl. 819 (1928); Berle, Corporate Powers in Trust, 44 Harv. L. Rev. 1049 (1931).

fairness.[3] A more lenient view relies on the fairness of the contract even where the board is interested.[4] Thus, in some jurisdictions it is unnecessary to inquire into fairness, while in others, fairness is the only issue. There is disagreement, also, on whom the burden of proving fairness lies. The majority of courts insist that it is on the party asserting the contract's validity,[5] while a minority say the complaining party should prove its unfairness.[6]

In situations (3) and (4), where there is a disinterested board passing on the contract, the majority view still seems to be that an inquiry into the fairness of the contract is necessary.[7] However, in opposition to the "fairness" test, there are a few cases which appear to substitute a business judgment rule when a disinterested board has voted on the contract.[8] It seems to be the opinion of these courts that, in the entangled economic problems of modern corporations, courts are ill-equipped to solve or even grapple with these problems.[9] Hence, if the board is disinterested, the court will allow the business judgment of the directors to stand. This appears to be a sound position, in view of the fact that as between the two, the court and the disinterested board, the board has a greater opportunity to determine when a contract is fair and beneficial to the corporation.

The present Michigan rule on director contracts is unclear from a reading of this case. The minority opinion rejected the prior rule as stated in *Veeser v. Robinson Hotel Co.*,[10] that such contracts are void unless authorized by a disinterested quorum of the corporation's board of directors, and seems to have adopted the rule that director contracts are voidable at the election of the corporation on a showing that they were authorized by an interested board.[11] The minority decided there was an interested board in the instant case because the director who had secured the option from Buck also controlled two other directors from whom he had secured options to buy their stock, which options were, conditioned upon the acceptance of the Buck contract. The minority then went on to hold, however, that, in any

[3] See, e.g., In re Franklin Brewing Co., 263 Fed. 512 (2d Cir. 1920); Mobile Land Imp. Co. v. Gass, 142 Ala. 520, 39 So. 229 (1905); New Blue Point Mining Co. v. Weissbem, 198 Cal. 261, 244 Pac. 325, (1926); Laybourn v. Wrape, 72 Colo. 339, 211 Pac. 367 (1922); Jacobsen v. Brooklyn Lumber Co., 184 N.Y. 152, 76 N.E. 1075 (1906).

[4] See, e.g., Ransome Concrete Machinery Co. v. Moody, 282 Fed. 29 (2d Cir. 1922); Wyman v. Bowman, 127 Fed. 257 (8th Cir. 1904); Minnesota L. & T. Co. v. Petilor Car Co. 132 Minn. 277, 156 N.W. 255 (1916); Nicholson v. Kingiry, 37 Wyo. 299, 261 Pac. 122 (1927).

[5] See, e.g., Pepper v. Litton, 308 U.S. 295 (1930); Veeser v. Robinson Hotel Co., 275 Mich. 133, 266 N.W. 54 (1936); Helfman v. American Light and Traction Co., 121 N.J. Eq. 1, 187 Atl. 540 (1936).

[6] See, e.g., Wentz v. Scott, 10 F.2d 426 (6th Cir. 1926); Crowell & Thurlow S.S. Co. v. Crowell, 280 Mass. 343, 182 N.E. 569 (1932).

[7] See cases cited note 9 supra.

[8] See, e.g., Winkelman v. General Motors Corp., 39 F. Supp. 826 (S.D.N.Y. 1940); Beard v. Elster, 160 A.2d 731 (Del. 1960); Heller v. Boyland, 29 N.Y.S.2d 653 (1941).

[9] Heller v. Boyland, supra note 8.

[10] 275 Mich. 133, 266 N.W. 54 (1936).

[11] Supra note 1, at 757-58.

event, the contract was unfair to the corporation, because there was inadequate consideration flowing to it, inasmuch as Buck's agreement with the defendant provided for payment to him of a pension for past services only. If the rule is as stated above, an inquiry into the fairness of the contract would seem to be superfluous,[12] and in any situation where the court found an interested board, the corporation could avoid the contract. An investigation into the fairness of the contract would be necessary only where a disinterested board was found and the corporation was trying to avoid the contract. Thus, it would appear that the minority took an extra and unnecessary step in determining the question of fairness.

The controlling opinion, on the other hand, seems, in part at least, to support the *Veeser* rule.[13] Since, in the opinion of the majority, the three directors whose interests were in question were motivated by the best interests of the corporation and not by self-interest, the action by the directors was adjudged not invalid; rather it comes within the meaning of *Veeser*, in that the resolution had the support of a majority of the disinterested directors. This approach appears to employ a "business judgment" test, in that if the board is disinterested and the directors show that they thought the contract was advantageous to the corporation, the court will not inquire into the fairness of the agreement.[14] Yet the court did inquire into the fairness, as mentioned earlier. This step would appear to be unnecessary, where a disinterested board is found and a "business judgment" test is used.

If the four situations mentioned above arose in a Michigan court, it is unquestionable that both the majority and minority views would reject the contract in situation (1), where the board is interested and the contract unfair, and support the contract in situation (4), where the board is disinterested and the contract fair. Under the minority view, it is unclear whether a situation (2) contract, *i.e.*, fair contract entered into by an interested board would be upheld or rejected. A situation (3) contract, *i.e.*, an unfair contract entered into by a disinterested board, probably would be voidable. Similarly, the majority would probably support the contract in situation (2), but in a situation (3) it is uncertain whether they would accept or reject.

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Labor Law—Applicability of LMRA to the "Foreign-Flag-Fleet."—*Empresa Hondurena de Vapores v. McLeod.*[1]—Plaintiff, a Honduran steamship corporation, is a wholly owned subsidiary of the United Fruit Company (UFCO), a New Jersey corporation. The bulk of UFCO's trade is between Central and South American sites and United States ports. It deals almost entirely through foreign subsidiaries such as plaintiff. UFCO

[12] Supra note 2.
[13] Supra note 1, at 762.
[14] Supra note 8.

[1] — F.2d —, 49 L.R.R.M. 2443 (2d Cir. 1962).