

DUTY OF A DIRECTOR NOT TO COMPETE WITH HIS CORPORATION

The right of a director to compete with his corporation¹ involves the nature and extent of the director's fiduciary obligation² to the corporation and its shareholders.³ While the general rule may be said to be that a director must act fairly in all transactions affecting the corporation,⁴ failure to indicate how this rule is to be applied has made the facts of each case more important than may be desirable.⁵ Generally it is said that if directors act in good faith, they may engage for their own profit in the same business as the corporation.⁶ Conversely a director cannot compete with his corporation if this violates a "legal or a moral duty."⁷ The "legal or moral duty" may be said to be violated under the following circumstances: (1) If a corporation has contemplated a specific enterprise, it then is entitled to priority over its directors who will not be allowed to com-

¹ Cases involving the right to compete must be distinguished from those cases which prohibit a director from acquiring an interest adverse to his corporation. See *Pasadena Mercantile Finance Corporation v. De Besa*, 122 Cal. App. 575, 10 P. (2d) 492 (1932); 4 Minn. L.Rev. 513, 516 (1920).

² Directors are fiduciaries for the corporation and perhaps for the shareholders. *Long v. Wilson Stove & Mfg. Co.* 277 Ill. App. 57 (1934); 3 *Fletcher, Cyclopedia of the Law of Corporations* (perm. ed. 1931), 149, §838. The nature and extent of this fiduciary relationship is similar to that of trustee-beneficiary, but it differs in many important respects, and is less well defined. 3 *Fletcher, Cyclopedia of the Law of Corporations* (perm. ed. 1931), 155, §847; 21 *Harv. L.Rev.* 51, (1907); *Johnson, Corporate Directors as Trustees in Illinois*, 23 *Ill. L.Rev.* 653 (1929); *James, Interested Directors in Corporate Transactions*, 6 *Ind. L. J.* 413 (1931); 8 *Wis. L.Rev.* 342, (1933).

³ It has been suggested that directors are in the position of managing partners with duties analogous to that of a partner of all the shareholders. *Automatic Self Cleansing Filter Syndicate Co., Ltd. v. Cunninghame*, 94 L.T.Rep. 651, [1906] 2 Ch. 34; see 14 *Minn. L. Rev.* 530, 535 (1930). See *Young v. Columbia Oil Co.*, 158 S.E. 678 (W. Va. 1930).

⁴ 2 *Thompson, Corporations* (3d ed. 1927), 855. ⁵ See 81 *Univ. Pa. L.Rev.* 601, 608 (1933).

⁶ *Lagarde v. Anniston Lime & Stone Co.*, 126 Ala. 496, 28 So. 199 (1900); *Carper v. Frost Oil Co.*, 72 Colo. 345, 211 Pac. 370 (1922); *Lancaster Loose Leaf Tobacco Co. v. Robinson*, 199 Ky. 313, 250 S.W. 997 (1923); cf. *New York Automobile Co. v. Franklin*, 49 *Misc.* 8, 97 *N.Y. Supp.* 781 (1905).

This is true even though a statute in the jurisdiction might prohibit similar activity by a trustee as adverse to the best interests of the trust. *Greer v. Stannard*, 85 *Mont.* 78, 277 *Pac.* 622 (1929).

⁷ *Red Top Cab Co. v. Hanchett*, 48 F. (2d) 236 (D.C.N.D. Cal. 1931); *Loewer v. Lonoke Rice Milling Co.*, 111 Ark. 62, 161 S.W. 1042 (1913); *Higgins v. Lansingh*, 154 Ill. 301, 40 N.E. 362 (1895); *Hussong Dyeing Mach. Co. v. Morris*, 81 N.J.Eq. 256, 89 Atl. 249 (1913); *Blake v. Buffalo Creek R.R.Co.*, 56 N.Y. 485 (1874); *Averill v. Barber*, 6 N.Y. Supp. 255 (1899); see *Davis v. Pearce*, 30 F. (2d) 85, 89 (C.C.A 8th 1928); *Albert E. Touchet, Inc. v. Touchet*, 264 *Mass.* 499, 163 N.E. 184 (1928); *Rose v. First Nat. Bank of Stigler*, 93 Okla. 120, 219 *Pac.* 715, 719 (1923); *Ballantine, Private Corporations* (1927); 379; 3 *Fletcher, Cyclopedia of the Law of Corporations* (perm. ed. 1931), 168 § 855.

pete for that enterprise.⁸ But if the corporation has not indicated its desire, the mere fact that the enterprise is within the scope of the corporation's business and would be advantageous, without further facts will not bar the director from competing.⁹ While it is clear that the corporation should be able to gain its priority without having secured a contract first, the presence of such a contract, even though the corporation is not performing it, may tend to increase the duty of the director not to compete, particularly if competition would result in an appropriation of the contract.¹⁰ (2) It has been suggested that a director will be barred from competing only when he had the "specific duty to transact that particular business for the corporation."¹¹ While this rule seems too narrow, the fact that the director was designated to inform the corporation of those advantages which he secretly secures for himself would seem to establish a duty not to compete.¹² (3) But even if the director is not instructed to act for the corporation, he violates his duty if he purports to act for the corporation and is aided by the corporation's good will in securing his private bargain.¹³ (4) If the director has informed the corporation that he will not compete and the corporation has relied, it would seem that the director would be held to his word.¹⁴

Assuming that the director would ordinarily not be allowed to compete, he may be permitted to do so under certain conditions. He may have reserved that right under a valid contract.¹⁵ The activity in which the director engages may be beyond the charter power of the corporation.¹⁶ It will ordinarily be a

⁸ *Lagarde v. Anniston Lime & Stone Co.*, 126 Ala. 496, 28 So. 199 (1900); see *Kroegher v. Calivada Colonization Co.*, 119 Fed. 641 (C.C.A. 3d 1902); *Acker, Merrall & Condit Co. v. McGraw*, 106 Md. 536, 68 Atl. 17 (1907); 4 *Minn. L.Rev.* 513, 516 (1920); but see 13 *Col. L.Rev.* 431 (1913).

⁹ *Zeckendorf v. Steinfeld*, 12 Ariz. 245, 100 Pac. 784 (1900).

¹⁰ *Irving Trust Co. v. Deutsch*, 73 F. (2d) 121 (C.C.A. 2d 1934); see *Loewer v. Lonoke Rice Milling Co.*, 111 Ark. 62, 161 S.W. 1042, 1048 (1913); cf. *Pikes Peak Co. v. Pfuntner*, 158 Mich. 412, 123 N.W. 19 (1909); *Wallace v. Oceanic Packing Co.*, 25 Wash. 143, 64 Pac. 938 (1901).

¹¹ 13 *Col. L.Rev.* 431 (1913).

¹² See *Carper v. Frost*, 72 Col. 345, 211 Pac. 370 (1922); *Mackley v. Burns*, 16 Col. App. 6 (1901); *New York Automobile Co. v. Franklin*, 49 Misc. 8, 97 N.Y. Supp. 781 (1905); cf. *Grand Bay Land Co. v. Simpson*, 205 Ala. 347, 87 So. 186 (1920); *Beaudette v. Graham*, 267 Mass. 7, 165 N.E. 671 (1929).

¹³ *De Bardeleben v. Bessemer Land & Improvement Co.*, 140 Ala. 621, 37 So. 511 (1904) (cf. *Rudisill Soil Pipe Co. v. Eastham Soil Pipe & Foundry Co.*, 210 Ala. 145, 97 So. 219 (1923)); *Coleman v. Hanger*, 210 Ky. 309, 275 S.W. 784 (1925); *Bliss Petroleum Co. v. McNally*, 254 Mich. 569, 237 N.W. 53 (1931); *Pioneer Oil & Gas Co. v. Anderson*, 168 Miss. 334, 151 So. 161 (1933); *Kendall v. Webster*, 14 B.C. 390 (1909); *Cook v. Deeks*, [1916] 1 A.C. 554, 560; see 13 *Col. L.Rev.* 431 (1913); 11 *Mich. B.J.* 193 (1931); 12 *Mich. B.J.* 219 (1933); 64 *A.L.R.* 784 (1929).

¹⁴ See *Irving Trust Co. v. Deutsch*, 73 F. (2d) 121, 123 (C.C.A.2d 1934).

¹⁵ *Anderson v. Dunnegan*, 217 Ia. 1210, 250 N.W. 115 (1933).

¹⁶ *Barr v. Pittsburgh Plate Glass Co.*, 51 Fed. 33 (C.C.W.D.Pa. 1892), affirmed in 57 Fed. 86 (C.C.A.3d 1893).

good defense that the third party has refused to deal with the corporation.¹⁷ And insolvency of the corporation will usually be a good defense.¹⁸ And the fact that the corporation is not legally able to purchase the property, or that an independent board has decided that the corporation does not wish to have the property seems sufficient to allow the director to secure the property for himself.¹⁹ Whether a lack of sufficient ready money on the part of a solvent corporation will also free the director from his duty not to compete has been raised for the first time²⁰ in a recent case.²¹ The court refused to allow the defense of financial inability of a solvent corporation. In that case, directors purchased stock in another corporation; stock which their own corporation had contracted to buy, and the decision might have been placed on the ground that this constituted an appropriation by the directors of a contract right with a consequent breach of duty.²² If the decision is to be placed on the broader ground that a

¹⁷ *Davis v. Pearce*, 30 F (2d) 85 (C.C.A. 8th 1928); *Keokuk Northern Line Packet Co. v. Davidson*, 95 Mo. 467, 8 S.W. 545 (1888); *Greer v. Stannard*, 85 Mont. 78, 277 Pac. 622 (1929); *Crittendon & C. Co. v. Cowles*, 66 App. Div. 95, 72 N.Y. Supp. 701 (1901). But see *New York Auto Co. v. Franklin*, 49 Misc. 8, 17, 97 N.Y. Supp. 781, 787 (1905), where the court said "It can hardly be that a director, intrusted with the duty of making a specific contract for his company, can be allowed to act in his own behalf and defend himself, when called to account, by the claim that he could not succeed in obtaining a contract for his company." Cf. *Jacksonville Cigar Co. v. Dozier*, 53 Fla. 1059, 43 So. 523 (1907); *Railroad Co. v. Stubbs*, 77 Me. 594 (1885).

¹⁸ *Jasper v. Appalachian Gas Co.*, 152 Ky. 68, 153 S.W. 50 (1913); *Grand Amusement Co. v. Palladium Amusement Co.*, 315 Mo. 907, 287 S.W. 438, 441 (1926); *Murray v. Vanderbilt*, 39 Barb. (N.Y.) 140 (1863).

¹⁹ *Thilco Timber Co. v. Sawyer*, 236 Mich. 401, 210 N.W. 204 (1906); See *Cummings v. Parker* 250 Mo. 427; 157 S.W. 629 (1913); *The Strathcona*, [1925] P. 143.

²⁰ In two cases where directors have not been held liable, lack of ready money on the part of a solvent corporation possibly may have been the ground for the decisions. *Pioneer Oil & Gas Co. v. Anderson*, 168 Miss. 334, 151 So. 161 (1933); *Hannerty v. Standard Theatre Co.*, 109 Mo. 297, 19 S.W. 82 (1892). And where directors have been held liable for competing, the fact has been mentioned that no inability to purchase on the part of the corporation has been shown. *Farwell v. Pyle-National Electric Headlight Co.*, 289 Ill. 157, 124 N.E. 449 (1919). The rule that a director may compete if his corporation is unable to perform has been stated in terms sufficiently broad to include lack of ready money where the corporation is solvent. *Fletcher*, *Cyclopedia of the Law of Corporations* (1931), 221, § 886; 13 Col. L.Rev. 431 (1913).

²¹ *Irving Trust Co. v. Deutsch*, 73 F. (2d) 121, 123 (C.C.A. 2d 1934). The Sonora Products Corporation contracted to buy shares of stock for \$100,000 in another corporation in order to obtain certain essential patents. Deutsch, director and president of the Sonora Corporation bought the stock himself and resold it to third parties at a profit. His defense was that the Sonora Corporation though solvent was financially unable to perform the contract. At the time Deutsch owed the corporation a disputed claim of \$125,000, and no effort was made to realize on the collateral or to collect the debt. The court held that Deutsch must account to the corporation for the profit, stating that they would not allow "directors of a solvent corporation to take over for their own profit a corporate contract on the plea of the corporation's financial inability to perform."

²² The court seems to indicate that it might have allowed the defense of financial inability of the solvent corporation, if there had not been a present contract. *Irving Trust Co. v. Deutsch*, 73 F. (2d) 121, 124 (C.C.A. 2d 1934). It has been suggested that the fiduciary duty of a di-

solvent corporation's financial inability to perform is never to be a defense where a director competes with the corporation, it seems to represent a desire to increase the fiduciary obligations of directors.²³ One court has increased the fiduciary obligations of directors by holding that even if the corporation is unable to perform, and therefore there is no breach of duty to it, there still remains the duty which the director owes the shareholders, and he will be liable to them if he does not give them an opportunity to participate in the venture.²⁴

rector should be greater where the corporation has a present contract, which is not an option contract, because the corporation is bound to perform. See *Loewer v. Lonoke Rice Milling Co.*, 111 Ark. 62, 161 S.W. 1042, 1048 (1913). But it is clear that the fiduciary duty exists where the corporation merely has an expectancy. *Pikes Peak Co. v. Pfuntner*, 158 Mich. 412, 123 N.W. 19 (1909).

²³ The court said that a contrary decision would tempt directors "to refrain from exerting strongest efforts," 73 F. (2d) 121, 124. But directors would always be under a duty not to cause intentionally the inability of the corporation to perform. See *McDermott Mining Co. v. McDermott*, 27 Mont. 143, 69 Pac. 715 (1902); *Hannerty v. Standard Theatre Co.*, 109 Mo. 297; 19 S.W. 82 (1892). And the failure to attempt to collect the debt owed by the director or to realize on the collateral may have been a breach of the duty of loyalty to the corporation. The desire to increase the fiduciary obligation of directors may be indicated by recent statutes. See 34 Col. L.Rev. 1090 (1934).

²⁴ *Young v. Columbia Oil Co.*, 110 W. Va. 364, 158 S.E. 678 (1931); 34 West Va. L. Quart. 158 (1927-28); see *Crittenden & Cowler Co. v. Cowler*, 66 App. Div. 95, 72 N.Y. Supp. 701 (1901) which stresses the fact that all shareholders had notice. See 14 Minn. L.Rev. 530, 533 (1930). This may find an analogy in the duty imposed by some courts to disclose full information when a director buys stock from a shareholder. See 19 Corn. L. Quar. 103 (1934). It adds weight to the suggestion that directors are in the position of managing partners. *Automatic Self-Cleansing Filter Syndicate Co., Ltd. v. Cuninghame*, 94 L. T. Rep. 651, [1906] 2 Ch. 34. But where there is a breach of duty to the corporation by a competing director, an offer to all the shareholders to participate in the venture is evidently not sufficient. See *Coleman v. Hanger*, 210 Ky. 309, 275 S.W. 784 (1925).