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ARKANSAS CORPORATE FIDUCIARY STANDARDS—INTERESTED DIRECTORS' CONTRACTS AND THE DOCTRINE OF CORPORATE OPPORTUNITY

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INTRODUCTION

> The occasions for the determination of honesty, good faith and loyal conduct are many and varied, and no hard and fast rule can be formulated. The standard of loyalty is measured by no fixed scale.[1]

An officer, director, or majority shareholder of a corporation owes to the corporation and its shareholders a duty to act in good faith for the benefit of the corporation, but all too often this fiduciary obligation is in direct conflict with or otherwise runs afoul of personal interests. One treatise even asserts that this conflict of interest is a natural outgrowth of the separation of ownership from control that characterizes the corporate form of doing business.[2]

Modern incorporation statutes recognize the fiduciary relationship and dictate that certain responsibilities and liabilities will flow from it,[3] but no statutory scheme can possibly determine the boundaries of the corporate fiduciary's duties. Any attempt to codify directors' fiduciary duties would create more problems than it would solve, and majority shareholders have demonstrated that there are innumerable ways to benefit personally by controlling a corporation to the detriment of the corporation or its shareholders while remaining within statutory guidelines.

Recent decisions demonstrate that the United States Supreme Court is reluctant to expand the application of federal securities laws to breaches of corporate fiduciary duty.[4] As a result, state common law and statutes frequently provide the only remedies.

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1. Guth v. Loft, 23 Del. Ch. 255, 270, 5 A.2d 503, 510 (1939).
2. A. BERLE & G. MEANS, THE MODERN CORPORATION AND PRIVATE PROPERTY 112-16 (rev. ed. 1967).
3. *E.g.*, ARK. STAT. ANN. § 64-308 (1980).
4. *E.g.*, Santa Fe Industries, Inc. v. Green, 430 U.S. 462 (1977); Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

This article presents the Arkansas courts' treatment of two basic areas of director conflicts of interest. Because the Arkansas courts have not addressed many of the issues, the presentation is not a complete discourse on the law in either area. To give the reader some general background and to put the Arkansas decisions in a comparative perspective, law from other jurisdictions is included.

The first topic presented is interested directors' contracts, those in which the corporate fiduciary contracts with his corporation or causes another business in which he is interested to contract with it. Because the standard for upholding these self-dealing contracts is fairness, courts have had to determine what is fair and who should carry the burden of proof. Although a number of Arkansas decisions concern self-dealing transactions, the standards applied in Arkansas have not been uniform, perhaps because the Arkansas Supreme Court has failed always to distinguish between transactions attacked by corporate creditors and those attacked by the corporation or its shareholders.

Although the relief sought most often in these cases is avoidance of the transaction, in some instances the plaintiff seeks to "pierce the corporate veil" to reach beyond the corporate assets for satisfaction of corporate obligations. Therefore, a discussion of piercing the veil as a remedy for wrongful self-dealing is included. The Arkansas decisions granting this remedy seem sound, although piercing the veil decisions in other jurisdictions have been the subject of much scholarly criticism.

Finally, self-dealing contracts for directors' compensation receive special attention, for they are the subject of specific statutory treatment in Arkansas and elsewhere. Some of the Arkansas pre-statute decisions on this type of contract are discussed to determine whether they retain any value as precedent for cases involving other types of self-dealing contracts unaffected by statute.

The second topic is corporate opportunity, a situation in which the corporate fiduciary appropriates for his own benefit a business opportunity which is allegedly that of the corporation. More than one judicial test exists for determining when a business opportunity is a corporate one. There is only one definitive Arkansas decision in this area, and it involved a clear breach of fiduciary duty. The direction Arkansas would take in a closer case remains to be seen, and cases from other jurisdictions provide a variety of precedents.

Included in the corporate opportunity category are cases involving a director's purchase of claims against the corporation.

There is authority, not universally accepted, that such a purchase can constitute a breach of the director's fiduciary duty to a solvent corporation. However, authorities are in agreement that a director of an insolvent corporation may not purchase claims against the corporation at a discount and recover more than he has paid for them. The two Arkansas decisions related to this problem involved insolvent corporations, and one decision seems unsound.

There are other areas of director conflicts of interest which are not included in this article. For example, no mention is made of cases involving liability for sale of the controlling interest of a corporation, or for mismanagement resulting from conflicts of interest which do not entail self-dealing or usurpation of a corporate opportunity. Statutes and decisions governing nonprofit corporations, banks, and insurance companies are not within the scope of this article unless they apply to business corporations generally. Federal and state securities laws and regulations are also excluded.

Although this article frequently refers to corporate directors, much of what is said also applies to corporate officers. So many of the cases researched involved close corporations in which the defendants were both officers and directors that the distinction seemed unimportant. Moreover, many cases refer to an officer *or* a director.[5]

I. INTERESTED DIRECTORS' CONTRACTS

The validity of a contract between a corporation and one of its directors or between corporations with interlocking directorates is traditionally determined by considerations of fairness to the corporation, ratification by disinterested directors or by shareholders, and disclosure.[6] As in most other jurisdictions,[7] the standards applied in Arkansas have not been uniform, and the Arkansas legislature has not dealt with the problem by statute,[8] except to restrict the author-

5. For a discussion of the merits of distinguishing between officers and directors with regard to the extent of their fiduciary obligations, see Note, *Corporate Opportunity*, 74 HARV. L. REV. 765, 769 (1961).

6. H. HENN, CORPORATIONS § 238 (2d ed. 1970); N. LATTIN, CORPORATIONS § 80 (2d ed. 1971). Professor Henn indicates that rules governing contracts between corporations with common directors might be less strict. H. HENN, *supra* at 465. For example, the Supreme Court of Delaware has said self-dealing between parent and subsidiary corporations occurs when "the parent has received a benefit to the exclusion and at the expense of the subsidiary." Sinclair Oil Corp. v. Levien, 280 A.2d 717, 720 (Del. 1971).

7. A thorough treatment of the development of the law in the United States in this area appears in Marsh, *Are Directors Trustees?*, 22 BUS. LAW. 35, 36-48 (1966).

8. For analyses of statutory treatment of this problem, see Bulbulia & Pinto, *Statutory*

ity of corporations to enter into contracts of guaranty or suretyship for the benefit of officers, directors, and ten-percent shareholders.[9]

A. *Directors as Trustees and Development of the "Fairness" Standard*

Whether directors are trustees and for whom they are trustees are questions that have received a considerable amount of attention over the years.[10] In the context of self-dealing, the prevailing rule in the United States in the latter part of the nineteenth century was that a director was a "trustee" for the corporation and its shareholders, and therefore a contract between a director and his corporation was voidable at the instance of the corporation or its shareholders without regard to the good faith of the director or fairness to the corporation.[11] This rule was based on the principle that a director could not simultaneously be an agent for the corporation and an adverse party without violating his fiduciary responsibilities to the corporation. Approval by disinterested directors had no effect.[12] This is also the English rule, which renders voidable a self-dealing transaction unless it is expressly permitted by the articles of incorporation.[13]

For reasons not altogether clear, this rule had been abandoned in most American jurisdictions by 1910, by which time the prevailing view was that a contract between a director and his corporation was valid if it was approved by a disinterested majority of the board and if it was fair and not fraudulent to the corporation.[14] By the 1960s most jurisdictions had eliminated the requirement of approval by a disinterested majority of the board and upheld such contracts if

Responses to Interested Directors' Transactions: A Watering Down of Fiduciary Standards?, 53 NOTRE DAME LAW. 201 (1977); De La Garza, *Conflict of Interest Transactions: Fiduciary Duties of Corporate Directors Who Are Also Controlling Shareholders*, 57 DEN. L.J. 609 (1980); Comment, *"Interested Director's" Contracts—Section 713 of the New York Business Corporation Law and the "Fairness" Test*, 41 FORDHAM L. REV. 639 (1973); Note, *Section 21-2040.01: Interested Director Transactions and Considerations of Fairness*, 58 NEB. L. REV. 909 (1979).

9. ARK. STAT. ANN. § 64-104(B)(3) (1980).

10. *See* Dodd, *For Whom Are Corporate Managers Trustees?*, 45 HARV. L. REV. 1145 (1932); Berle, *For Whom Corporate Managers Are Trustees: A Note*, 45 HARV. L. REV. 1365 (1932).

11. Marsh, *supra* note 7, at 36-39.

12. *Id.* Professor Marsh quotes from the decision in Wardell v. Union Pacific R.R., 103 U.S. 651 (1880).

13. N. LATTIN, *supra* note 6, at 291.

14. Marsh, *supra* note 7, at 39-40.

they were fair to the corporation.[15]

Even under the older rule the effect of shareholder ratification was to validate a self-dealing transaction if there was no fraud or unfairness. Fairness was adopted as the test for validating an interested director's contract, so the importance of shareholder ratification has diminished.[16]

Some states have dealt with interested directors' contracts by statute. Many of these statutes are similar to section 41 of the Model Business Corporation Act,[17] the wording of which raises the question whether an unfair contract may be sustained if the shareholders or disinterested directors have ratified it after full disclosure. The consensus appears to be that the requirement of fairness remains despite the wording of the statute.[18]

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15. *Id.* at 43. Jurisdictions retain various statutory and common-law rules with regard to the voidability of a transaction in which the interested director has voted or where his presence was necessary to establish a quorum. *See* H. HENN, *supra* note 6, § 209, at 421. The Model Act allows an interested director to be counted to establish a quorum and even upholds a transaction in which the interested director voted, as long as his vote was not necessary for approval. MODEL BUSINESS CORP. ACT ANN. 2d § 41 (1971).

16. Marsh, *supra* note 7, at 48-50. *See also* W. KNEPPER, LIABILITY OF CORPORATE OFFICERS AND DIRECTORS § 2.09, at 60-61 (3d ed. 1978).

17. MODEL BUSINESS CORP. ACT ANN. 2d § 41 (1971) reads as follows:

> No contract or other transaction between a corporation and one or more of its directors or any other corporation, firm, association or entity in which one or more of its directors are directors or officers or are financially interested, shall be either void or voidable because of such relationship or interest or because such director or directors are present at the meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction or because his or their votes are counted for such purpose, if:
>
> (a) the fact of such relationship or interest is disclosed or known to the board of directors or committee which authorizes, approves or ratifies the contract or transaction by a vote or consent sufficient for the purpose without counting the votes or consents of such interested directors; or
>
> (b) the fact of such relationship or interest is disclosed or known to the shareholders entitled to vote and they authorize, approve or ratify such contract or transaction by vote or written consent; or
>
> (c) the contract or transaction is fair and reasonable to the corporation.
>
> Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or a committee thereof which authorizes, approves or ratifies such contract or transaction.

At last count, twenty-six states had adopted statutes governing interested director's transactions. MODEL BUSINESS CORP. ACT ANN. 2d § 41 ¶¶ 3.01, 3.02 (1971, Supp. 1973 & Supp. 1977).

18. The first case to hold that fairness remains a requirement was Remillard Brick Co. v. Remillard-Dandini Co., 109 Cal. App. 2d 405, 241 P.2d 66 (1952), which interpreted former CAL. CORP. CODE § 820 (West 1955) (repealed 1975, effective Jan. 1, 1977), a provision similar to section 41 of the Model Act. Most jurisdictions interpreting similar interested directors' statutes have followed the *Remillard* decision. For a discussion of decisions see Bulbulia & Pinto, *supra* note 8, at 209; Note, 58 NEB. L. REV., *supra* note 8, at 912-17.

A corporation and its shareholders are not the only parties that may void a self-dealing transaction. A creditor may set aside a corporate transaction on grounds that it was fraudulent in regard to that creditor,[19] whether or not the transaction involved self-dealing. Many decisions, particularly older ones, recite the rule that the assets of a corporation are a "trust fund" for the benefit of corporate creditors.[20] This rule apparently originated in Justice Story's opinion in *Wood v. Dummer*,[21] which involved a situation in which ordinary principles governing fraudulent conveyances would have sufficed without resort to a "trust fund" theory. Since that decision, the "trust fund" rule has been criticized or modified on numerous occasions.[22] It is unfortunate that this theory ever developed, because it leads to confusion of a director's duties to the corporation and the shareholders with the requirement that a debtor refrain from entering into transactions to defraud creditors. The corporation holds property in trust for creditors to no greater extent than does a natural person.[23] The corporate debtor is no more an agent or trustee for creditors than is the debtor who is a natural person. Nonetheless, this "trust fund" theory is the apparent basis for the adage that directors are trustees for corporate creditors.

In decisions involving the validity of interested directors' contracts, the Arkansas Supreme Court has frequently recited the principle that corporate directors are trustees for the shareholders and for corporate creditors.[24] However, the court has never applied the strict rule that contracts between the corporation and its directors

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19. *E.g.*, Sweet v. Lang, 14 F.2d 762, 766 (8th Cir. 1926); MacQueen v. Dollar Sav. Bank Co., 133 Ohio St. 579, 11 Ohio Ops. 302, 15 N.E.2d 529, 531 (1938).

20. *See, e.g.*, Wilson v. Lucas, 185 Ark. 183, 186-87, 47 S.W.2d 8, 10 (1932); Wesco Supply Co. v. El Dorado Light & Water Co., 107 Ark. 424, 155 S.W. 518 (1913); Jones, McDowell & Co. v. Arkansas Mechanical and Agricultural Co., 38 Ark. 17 (1881).

21. 30 F. Cas. 435 (C.C.D. Me. 1824).

22. *See, e.g.*, Hollins v. Brierfield Coal & Iron Co., 150 U.S. 371, 382-386 (1893); Wabash, St. Louis & Pac. Ry. v. Ham, 114 U.S. 587 (1885) (corporate assets are a "trust fund" in that creditors are entitled to payment before distribution of assets to stockholders when the corporation is dissolved or is insolvent); Sweet v. Lang, 14 F.2d 762, 766 (8th Cir. 1926) (assets are impressed with a trust only after the corporation becomes insolvent and a court of equity has taken possession of them); American Exch. Nat. Bank v. Ward, 111 F. 782 (8th Cir. 1901); Hospes v. Northwestern Mfg. & Car Co., 48 Minn. 174, 178, 50 N.W. 1117, 1119 (1892).

23. Hospes v. Northwestern Mfg. & Car Co., 48 Minn. 174, 193, 50 N.W. 1117, 1119 (1892) (citing Graham v. Railway Co., 102 U.S. 148 (1880)).

24. *E.g.*, Mothershead v. Douglas, 215 Ark. 519, 521, 221 S.W. 2d 424, 425-26 (1949); Clark-McWilliams Coal Co. v. Ward, 185 Ark. 237, 247, 47 S.W.2d 18, 22 (1932); Harris v. United Serv. Co., 182 Ark. 779, 781, 32 S.W.2d 618, 619 (1930); Nedry v. Vaile, 109 Ark. 584, 160 S.W. 880 (1913).

are voidable at the instance of the corporation or its shareholders without regard to fairness. The rule applied in *Nedry v. Vaile*[25] is that when a director purchases the assets of the corporation, the transaction is voidable only "at the instance of some party in interest for fraud."[26] Later the court applied this rule to other types of contracts between a director and the corporation[27] and validated transactions found to be fair and entered into in good faith.

In early decisions the Arkansas Supreme Court never enunciated its reasons for failing to follow the strict rule that interested directors' contracts are voidable without regard to fairness, although it did recognize but refused to follow authority to the effect that such contracts are absolutely void.[28] One reason given for abandonment of the rule in other jurisdictions is that although a trustee is prohibited from dealing with the trust assets, he is not prohibited from dealing with the cestui que trust after full disclosure.[29] Another justification for a more lenient rule is that the analogy between a trustee and a director is inappropriate because from a legal standpoint they are in different positions. A trustee holds legal title to the trust assets, while a director does not hold legal title to corporate assets, and a trustee does not exercise his powers pursuant to a general authority to manage, as does a director.[30] Perhaps the best explanation for abandonment of the rule was the realization that contracts involving self-dealing, if fair, can be of great benefit to the corporation, particularly when a director has loaned money to the corporate entity.[31] Furthermore, Professor Lattin has noted that

25. 109 Ark. 584, 160 S.W. 880 (1913). For this rule the court cited two earlier decisions: Wesco Supply Co. v. El Dorado Light & Water Co., 107 Ark. 424, 155 S.W. 518 (1913), and Jones, McDowell & Co. v. Arkansas Mechanical and Agricultural Co., 38 Ark. 17 (1881).

26. Nedry v. Vaile, 109 Ark. 584, 590, 160 S.W. 880, 882 (1913). The party seeking to void the sale was a creditor, but the case has been cited as authority where the corporation was seeking to void the transaction. This is discussed below.

27. Geominerals Corp. v. Grace, 232 Ark. 524, 532, 338 S.W.2d 935, 941 (1960) (secured loan to corporation voided); Harris v. United Serv. Co., 182 Ark. 779, 32 S.W.2d 618 (1930) (lease of building to corporation upheld); Oliver v. Henry Quellmalz Lbr. & Mfg. Co., 170 Ark. 1029, 282 S.W. 355 (1926) (sale of land to director upheld); Walker-Lucas-Hudson Oil Co. v. Hudson, 168 Ark. 1098, 272 S.W. 836 (1925) (assignment of oil lease to director upheld).

28. Nedry v. Vaile, 109 Ark. 584, 590, 160 S.W. 880, 883 (1913); Ward v. McPherson, 87 Ark. 521, 523, 113 S.W. 42, 43 (1908).

29. Marsh, *supra* note 7, at 40.

30. Note, *The Fairness Test of Corporate Contracts with Interested Directors*, 61 HARV. L. REV. 335 (1948).

31. This was pointed out in Twin-Lick Oil Co. v. Marbury, 91 U.S. 587 (1876), and in Monroe v. Scofield, 135 F.2d 725, 728 (10th Cir. 1943).

"there has been the surprising discovery in some quarters that directors, for the most part, are not bent on skulduggery."[32]

Although the "fairness" standard is now the generally accepted one for determining the validity of interested directors' contracts, it is not without its critics. One authority argues that interested directors' transactions have been given the benefit of the doubt because of the uncertainty and confusion surrounding the fairness standard.[33] This seems to be the case in Arkansas, where more interested directors' contracts have been upheld than invalidated.

It has been suggested that fairness alone is not enough, but that fairness coupled with complete and full disclosure would provide sufficient protection to the corporation and those interested in it.[34] Harold Marsh has even suggested that the Securities Exchange Act of 1934[35] be amended to require SEC approval of certain transactions between interested directors (or their corporations, partnerships, and families) and their corporations.[36] He claims that a court's "careful scrutiny" to determine the fairness of an interested director's contract does not provide the necessary protection, given that such scrutiny is unlikely to be exercised until a shareholder brings a derivative suit,[37] to which procedural barriers, such as the requirement for posting security for costs,[38] have been imposed.

The flexible nature of the fairness standard is only one aspect of the criticism directed at developments in modern corporation law generally, which is often viewed as favoring managerial discretion over enforcement of fiduciary standards.[39] The law in this area is and will remain a focal point of criticism by authorities who desire more uniformity in corporate standards among the jurisdictions and a reversal of the trend toward expansion of managerial discretion.

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32. N. LATTIN, *supra* note 6, at 290-91.

33. Hetherington, *Trends in Legislation for Close Corporations: A Comparison of the Wisconsin Business Corporation Law of 1951 and the New York Business Corporation Law of 1961*, 1963 WIS. L. REV. 92, 150 (1963).

34. *Id.*

35. 15 U.S.C. §§ 78a-78hh-1 (1976 & Supp. IV 1980).

36. Marsh, *supra* note 7, at 73.

37. *Id.* at 54-56.

38. *E.g.*, ARK. STAT. ANN. § 64-223 (1980).

39. *See* Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974); Folk, *State Statutes: Their Role in Prescribing Norms of Responsible Management Conduct*, 31 BUS. LAW. 1031 (1976). *But see* Arsht, *Reply to Professor Cary*, 31 BUS. LAW. 1113 (1976).

B. *What Is Fair?*

Whatever its weaknesses, fairness is the standard by which interested directors' contracts are validated. But what is fair?[40] It has been suggested that the fairness of a director's contract with his corporation should be measured by the length of the chancellor's foot.[41] Although less arbitrary tests exist, determining fairness to the corporation under a given set of facts can be exceedingly difficult.[42]

One test for fairness that has received a good deal of attention is the "arm's length bargain" test[43] applied in *Pepper v. Litton*[44] to a loan to the corporation by a controlling shareholder. A similar standard for fairness is "whether the proposition submitted would have commended itself to an independent corporation" or to "a wholly independent board of directors."[45] New York has applied more than one test, including a test which determines fairness by looking to whether the expectations of the parties to the contract have been fulfilled.[46]

The widely-used "arm's length bargain" test and similar approaches assume that it is always possible to ascertain what action a disinterested board of directors would take in an arm's length bargain. This assumption is not always warranted, particularly in close corporations. Furthermore, what is fair under the arm's length bargain test might not be what is best for the corporation.[47] For example, if a director causes his corporation to purchase from him an automobile for less than market price, it might be said that the transaction is fair as an arm's length bargain. However, if the corporation does not need the automobile, the transaction has not been what is best for the corporation. Obviously, it would have been best

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40. In this discussion fairness to the corporation is the question. Fairness to creditors is determined by traditional rules governing fraudulent conveyances. *See, e.g.*, MacQueen v. Dollar Sav. Bank Co., 133 Ohio St. 579, 11 Ohio Ops. 302, 15 N.E.2d 529 (1938).

41. Note, 61 HARV. L. REV., *supra* note 30, at 337.

42. Standards for fairness for various categories of transactions are set out in Note, 61 HARV. L. REV., *supra* note 30, at 337-39. *See also* Note, *Corporations—Interested Directors Dealing with the Corporation—The Fairness Doctrine*, 37 MO. L. REV. 531 (1972).

43. *See* H. HENN, *supra* note 6 at 467 n.7, for cases applying this test.

44. 308 U.S. 295, 306 (1939).

45. E. FOLK, THE DELAWARE GENERAL CORPORATION LAW 86 (1972) (quoting Johnston v. Greene, 35 Del. Ch. 479, 490, 121 A.2d 919, 925 (1956), which concerned usurpation of corporate opportunity). The test was also applied in Harris Trust & Sav. Bank v. Joanna-Western Mills Co., 53 Ill. App. 3d 542, 555, 368 N.E.2d 629, 639 (1977), which applied Delaware law to a contract between a corporate fiduciary and the corporation.

46. *See* Comment, 41 FORDHAM L. REV., *supra* note 8, at 663. The "expectations" test arguably does not adequately protect the interests of minority shareholders. *Id.*

47. Marsh, *supra* note 7, at 57.

for the corporation not to have purchased the automobile at all.[48]

The corporation's loss of money as a result of the transaction might have some bearing on fairness. However, corporations often lose money as a result of transactions that do not involve self-dealing and that were entered into by a board of directors exercising its good-faith, independent business judgment. On the other hand, that a corporation has not lost money in an unfair transaction should not preclude its recovery of profits reaped by the fiduciary.[49]

Any consideration of fairness should properly embody how the transaction was initiated, negotiated, and presented to the board of directors.[50] It is also necessary to consider what alternatives were available at the time of the transaction and how the transaction compares with other, similar transactions taking place under similar conditions at the same time.[51]

Whether a disinterested board of directors or shareholders have ratified the transaction[52] has a bearing on fairness, as does disclosure.[53] Disclosure should not be limited to the fact that the director is interested in the transaction, but should be full disclosure of "all facts which might effect [sic] the directors' judgment or aid those approving the transaction."[54] However, ratification and disclosure cannot operate to validate an unfair contract.[55]

The Arkansas court has never declared a standard or test for

48. In Shlensky v. South Parkway Bldg. Corp., 19 Ill. App. 2d 268, 166 N.E.2d 793 (1960), the court listed the corporation's need for the property as being one of the factors to be considered in determining fairness. *See also* Fill Buildings, Inc. v. Alexander Hamilton Life, 39 Mich. 453, 241 N.W.2d 466 (1976).

49. State *ex rel.* Hayes Oyster Co. v. Keypoint Oyster Co., 64 Wash. 2d 375, 385, 391 P.2d 979, 985 (1964); Lutherland Inc. v. Dahlen, 357 Pa. 143, 151, 53 A.2d 143, 147 (1947).

50. Moore, *The "Interested" Director or Officer Transaction*, 4 DEL. J. CORP. L. 651, 676 (1979).

51. Hetherington, *supra* note 33, at 149-50 n.232.

52. The general rule is that interested shareholders may vote for shareholder ratification. H. BALLENTINE, CORPORATIONS § 71 (rev. ed. 1946). The MODEL BUSINESS CORP. ACT ANN. 2d § 41 (1971) does not require that shareholders who ratify be disinterested. *Cf.* OHIO REV. CODE ANN. § 1701.60 (Page 1978).

53. H. BALLENTINE, *supra* note 52, § 71, at 179. In State *ex rel.* Hayes Oyster Co. v. Keypoint Oyster Co., 64 Wash. 2d 388, 391 P.2d 979 (1964), the corporate fiduciary's nondisclosure rendered a contract unfair. *See also* Voss Oil Co. v. Voss, 367 P.2d 977, 979 (Wyo. 1962).

54. Comment, 41 FORDHAM L. REV., *supra* note 8, at 669. Another possible test for adequacy of disclosure might be whether there was disclosure of all "material facts," which for purposes of federal proxy rules are "all facts which a reasonable shareholder *might* consider important." TSC Industries, Inc. v. Northway, 426 U.S. 438, 445 (1976) (emphasis in original).

55. This was not only the rule at common law but is the generally accepted interpretation of statutes similar to section 41 of the Model Business Corporation Act.

fairness such as the arm's length bargain test.[56] Instead, it has stated that contracts involving interested directors are more closely scrutinized than ordinary contracts and will be upheld if fair.[57] Furthermore, it has sometimes, but not always, distinguished transactions which were attacked by creditors from those attacked by the corporation or by shareholders. Necessarily, the issue of fairness can be decided only after examination of the circumstances of each case.

In *Nedry v. Vaile*[58] and in *Oliver v. Henry Quellmalz Lumber & Manufacturing Co.*[59] the Arkansas court upheld sales of corporate property to fiduciaries. In both cases the sale had been authorized by an independent board of directors. In *Nedry* the sale of all the assets was to satisfy the commercial debts of the company, and the purchasing fiduciary paid those debts and lost $2,000. In *Oliver* the record showed that the sale of land owned by the corporation to the corporation's president was to complete a transfer of the land to the defendant lumber company, which paid a valuable consideration to the corporation. In both *Nedry* and *Oliver* the parties attacking the transaction were creditors. The opinion in *Oliver* shows that a transaction that might be unfair to the corporation and its shareholders might not be unfair to creditors:

> The doctrine which prevents directors from binding a corporation by contract in which they have an interest adverse to that of the corporation does not of itself give the creditors of the corporation the right to attack such a transaction in cases where the corporation or its stockholders could attack it. . . . [Creditors] must show that the corporation was insolvent at the time of the transaction, or that it was entered into with the intent to hinder, delay or defraud them.[60]

When the corporation is attacking the transaction, two Arkansas cases demonstrate that notice or knowledge can defeat its cause

56. The Arkansas court recognized the arm's length bargain test in Geominerals Corp. v. Grace, 232 Ark. 524, 531, 338 S.W.2d 935, 939-40 (1960), in which the court upheld a contract between a minority shareholder and the corporation, noting that it was an "arm's length bargain."

57. *E.g.*, Geominerals Corp. v. Grace, 232 Ark. 524, 532, 338 S.W.2d 935, 940 (1960); Harris v. United Serv. Co., 182 Ark. 779, 781, 32 S.W.2d 618, 619 (1930); Walker-Lucas-Hudson Oil Co. v. Hudson, 168 Ark. 1098, 1103, 272 S.W. 836, 838 (1925); Ward v. McPherson, 87 Ark. 521, 523, 113 S.W. 42, 43 (1908); Jones, McDowell & Co. v. Arkansas Mechanical and Agricultural Co., 38 Ark. 17 (1881).

58. 109 Ark. 584, 160 S.W. 880 (1913).

59. 170 Ark. 1029, 282 S.W. 355 (1926).

60. *Id.* at 1034 (quoting 8 FLETCHER'S CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 5052, at 8664 (1924)).

of action. In *Harris v. United Service Co.*[61] a consolidated corporation alleged that a lease between a director as lessor and the merged corporation as lessee was unfair. The basis for the court's decision upholding the lease was that the new corporation had full knowledge of the terms of the lease when the consolidation took place and even paid rent according to the lease for a few months. Although the court did not discuss the fairness of the terms of the lease, it must have found them fair because the opinion states that "[if] there had been no merger, no doubt no question would ever have been raised about the validity of the lease or the amount of the rental."[62]

In *Walker-Lucas-Hudson Oil Co. v. Hudson*[63] the court found that the plaintiff corporation was barred by laches from voiding a contract between the corporation and one of its directors. The contract was the assignment of an oil and gas lease to the director and was prompted by the inability of the corporation to raise funds sufficient to pay for the lease. Since the date of the assignment the defendant had spent time and effort in drilling a producing well. Because the corporation and its shareholders were put on inquiry notice of the facts surrounding the transaction, laches barred any cause of action.

From the decisions in *Harris* and *Walker-Lucas-Hudson Oil Co.*, one can conclude that a corporation will be unsuccessful in an effort to set aside an interested director's transaction if it knew of the director's interest at the time of the transaction or if it had been placed on inquiry notice and delayed assertion of its cause of action. Such a result is consistent with the requirement of fairness. This leads to the question whether ratification[64] by a disinterested majority of the board or by shareholders, after full disclosure, helps to insulate the contract from subsequent attack.

In analyzing the Arkansas decisions in this regard, it is necessary to consider who is attacking the transaction, the corporation or its shareholders on the one hand, or creditors on the other. The Arkansas decisions which mention ratification all involve plaintiffs who were creditors. In *Nedry* and *Oliver* the board of directors had

61. 182 Ark. 779, 32 S.W.2d 618 (1930).

62. *Id.* at 781-82. This decision was consistent with an earlier case in which a reorganized corporation attacked a contract to sell property to a director. Little Rock & Ft. Smith Ry. v. Page, 35 Ark. 304 (1880).

63. 168 Ark. 1098, 272 S.W. 836 (1925).

64. For purposes of determining fairness, there is no need to distinguish prior authorization from ratification.

ratified the sale of corporate property to a director, but because creditors were the plaintiffs in those cases, ratification by the board should have had no effect upon whether the sales were unfair to creditors. This reasoning could also be applied to the decision in *Ward v. McPherson*,[65] in which the board of directors ratified an oral lease and executed a written lease of the corporation's quarry to its principal shareholder and general manager. The court found that the transaction was a fraud upon two creditors who had obtained judgments against the insolvent corporation before execution of the written lease. Because this case involved a garden variety fraudulent conveyance, its holding does not reach the question whether a shareholder, as opposed to a creditor, will be allowed to attack an unfair transaction which nevertheless has been ratified by a disinterested board. Presumably, Arkansas would require that the transaction be fair, since no decision has ever held that the fairness requirement can be eliminated by board action.

In a case in which the corporation was the plaintiff, *Geominerals Corp. v. Grace*,[66] the court's opinion does not mention whether a contract between a director and his corporation was ratified or approved by a disinterested board or by shareholders, but the court allowed the corporation to avoid the contract on grounds that the director had not proved fairness to the corporation. The transaction involved the corporation's agreement to exchange stock for cancellation of its note secured by the stock and payable to the defendant director, who failed to prove that the value of the stock was not greater than the amount of the note.[67]

These cases show that in Arkansas ratification by the board of directors is not effective to bar attacks by creditors. However, no case decides whether ratification by a disinterested board has any effect upon determining the fairness of an interested director's contract attacked by the corporation or its shareholders.

Furthermore, no Arkansas decision has ever recognized explicitly that disclosure of a director's interest in a transaction has a bearing on the fairness of that transaction. However, one case has come close. In *Smith v. Citation Manufacturing Co.*[68] the defendant, Citation's president and director, failed to disclose that another company which he owned would probably be unable to pay for goods it

65. 87 Ark. 521, 113 S.W. 42 (1908).

66. 232 Ark. 524, 338 S.W.2d 935 (1960).

67. The decision exonerated another defendant, a minority shareholder. *Id.* at 531, 338 S.W.2d at 939 (1960).

68. 266 Ark. 591, 587 S.W.2d 39 (1979).

was purchasing on credit from Citation. The court found the defendant director liable for breach of fiduciary duty, which included failure to disclose. Presumably the court could have found simply that the defendant was liable on grounds that the transaction was unfair to Citation because not all "facts which might affect the directors' judgment"[69] were disclosed. This case recognizes implicitly that "disclosure" means more than disclosure of the director's conflict of interest; it refers as well to disclosure of other material facts and circumstances known to the interested fiduciary.[70] Instead of characterizing the nondisclosure as bearing on the fairness of the transaction, the court's opinion indicates that the nondisclosure violated the defendant's duty to exercise ordinary care in managing the corporation.[71]

The foregoing cases indicate that Arkansas has not adopted a comprehensive test to determine fairness of an interested director's contract, and that fairness will necessarily be decided on a case by case basis. When the issue is fairness to the corporation, the case by case approach is probably best because of the many considerations involved. When the issue is fairness to a creditor, however, the problem becomes that of determining whether a contract was entered when the corporation was insolvent or under such circumstances as to "hinder, delay, or defraud"[72] creditors. Arkansas has not decided whether ratification of an interested director's contract by a disinterested board of directors operates in favor of a finding of fairness, but there is no reason to believe that our courts would not consider, in determining fairness, that the board had ratified the contract. After all, the board of directors is charged with the duty of managing the corporation with reasonable care. Likewise, the courts have never decided that disclosure should be considered in determining fairness, although the Arkansas Supreme Court did consider nondisclosure in holding that a defendant breached his fiduciary duty in *Smith v. Citation Manufacturing Co.*[73]

69. Comment, 41 FORDHAM L. REV., *supra* note 8, at 669.

70. MODEL BUSINESS CORP. ACT ANN. 2d § 41 apparently requires only disclosure of the fact that the director is interested. Delaware requires disclosure of "the material facts as to his interest and as to the transaction." DEL. CODE ANN. tit. 8, § 144(a)(1)(2) (1974).

71. 266 Ark. 591, 587 S.W.2d 39 (1979).

72. Oliver v. Henry Quellmalz Lbr. & Mfg. Co., 170 Ark. 1029, 1034, 282 S.W. 355, 357 (1926).

73. 266 Ark. 591, 587 S.W.2d 39 (1979).

C. *Burden of Proof*

It is clear that "no blueprints are furnished" for fairness.[74] Therefore, where the burden of proof on fairness lies might determine the outcome of litigation. The general rule is that the burden of proof to show that a self-dealing transaction is fair lies with the party seeking to sustain the transaction.[75] In jurisdictions that have adopted statutes similar to Model Act section 41[76] ratification by a disinterested board or by shareholders after full disclosure might shift the burden of proof to the party asserting unfairness.[77] Apparently there has been no consensus on this point.[78] Even in the absence of a statute, shareholder ratification might shift the burden of proof.[79]

A minority rule is the so-called "Massachusetts Rule," which places the burden of proof on the party seeking to avoid the transaction.[80] A third approach is to require the party seeking to avoid the transaction to produce evidence showing unfairness and to shift the burden of proof to the party seeking to sustain the transaction if any evidence of unfairness has been produced.[81]

A number of Arkansas cases recite the majority rule that the burden of proving the fairness and good faith of a self-dealing contract is on the party seeking to sustain the contract.[82] This was the approach taken by the decisions in *Harris, Geominerals*, and

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74. Heller v. Boylan, 29 N.Y.S.2d 653, 679 (1941), *aff'd*, 263 A.D. 815, 32 N.Y.S.2d 131 (1942).

75. *E.g.*, Geddes v. Anaconda Copper Mining Co., 254 U.S. 590, 599 (1921). This rule stems from a presumption that self-dealing contracts are unfair to the corporation. Mardel Sec., Inc. v. Alexandria Gazette Corp., 183 F. Supp. 7 (E.D. Va. 1960). This burden probably does not shift after full disclosure and ratification by a majority of disinterested directors. H. HENN, *supra* note 6, at 466.

76. MODEL BUSINESS CORP. ACT ANN. 2d § 41 (1971).

77. *See* Note, 58 NEB. L. REV., *supra* note 8, at 917-20; Comment, 41 FORDHAM L. REV., *supra* note 8, at 648-49; Note, *The "Unfair" Interested Directors' Contract Under the New York Business Corporation Law*, 16 BUFFALO L. REV. 840 (1967).

78. *Compare* Holi-Rest, Inc. v. Treloar, 217 N.W.2d 517 (Iowa 1974) *with* Cohen v. Ayers, 449 F. Supp. 298 (N.D. Ill. 1978) (applying New York's statute).

79. Marsh, *supra* note 7, at 50.

80. *E.g.*, Durfee v. Durfee & Canning, Inc., 323 Mass. 187, 80 N.E.2d 522 (1948).

81. This was the approach adopted in Mayflower Hotel Stockholders Protective Comm. v. Mayflower Hotel Corp., 73 F. Supp. 721 (D.D.C. 1947), *rev'd*, 173 F.2d 416 (D.C. Cir. 1949). However, in that case the articles of incorporation contained a provision allowing interested director transactions.

82. *E.g.*, Geominerals Corp. v. Grace, 232 Ark. 524, 532, 338 S.W.2d 935, 940 (1960); Harris v. United Serv. Co., 182 Ark. 779, 781, 32 S.W.2d 618, 619 (1930); Walker-Lucas-Hudson Oil Co. v. Hudson, 168 Ark. 1098, 1103, 272 S.W. 836, 838 (1925); Ward v. McPherson, 87 Ark. 521, 523, 113 S.W. 42, 43 (1908).

Walker-Lucas-Hudson Oil Co., for example. In those cases, and in others reciting this rule, a shareholder or the corporation sought to avoid the transaction. In contrast, language in *Nedry* and *Oliver* indicates that the burden of proof lies on the party attacking the transaction, although the court did not directly discuss the issue of burden of proof. For example, in *Nedry* the court said that the plaintiffs should have developed the facts to establish their claim that a transfer of assets to the defendants was fraudulent.[83] In *Oliver* the opinion states that when creditors are attacking a transfer of land to a director "they must show that the corporation was insolvent at the time of the transaction, or that it was entered into with the intent to hinder, delay or defraud them."[84] From these two decisions it is possible to conclude that when creditors, as opposed to the corporation or shareholders, are attacking the transaction, the burden of proof is on the creditors to prove unfairness. Arguably this conclusion is not supported by the decision in *Ward*, which applied the majority rule when creditors of the corporation were alleging unfairness. *Ward* is distinguishable, however, because there the corporation was insolvent at the time of the transaction, and therefore the transaction is presumed fraudulent[85] and the burden of proof should be on the party seeking to sustain it.

Therefore, it appears that the Arkansas court applies the majority rule to contracts attacked by the corporation or by shareholders, but requires creditors to prove unfairness[86] unless fraud can be presumed from insolvency at the time of the transaction. This is a reasonable approach, but the Arkansas court has not enunciated it and frequently has not distinguished contracts attacked by the corporation or by shareholders from those attacked by creditors. For example, in *Harris* and *Walker-Lucas-Hudson*, both of which involved contracts attacked by the corporation, the court cited as authority the decision in *Nedry*, which involved a contract attacked by a creditor. Similarly, in *Ward*, in which the plaintiff was a creditor, the

83. 109 Ark. 584, 592, 160 S.W. 880, 883 (1913).

84. 170 Ark. 1029, 1034, 282 S.W. 355, 357 (1926).

85. *See* United States v. Johnston, 245 F. Supp. 433, 440 (W.D. Ark. 1965) and cases cited on the presumption of fraud.

86. *See, e.g., id.* The burden of proof in establishing a conveyance as fraudulent is on the party seeking to set it aside. Bank of Sun Prairie v. Hovig, 218 F. Supp. 769 (W.D. Ark. 1963); Harris v. Shaw, 224 Ark. 150, 154, 272 S.W.2d 53, 55 (1954); Holloway v. Bank of Atkins, 205 Ark. 598, 603, 169 S.W.2d 868, 871 (1943). If the plaintiff can prove insolvency of the defendant at the time of the conveyance, however, fraud is presumed. United States v. Johnston, 245 F. Supp. 433 (W.D. Ark. 1965).

court cited as authority a case[87] in which the plaintiffs were not creditors. In turn, the opinion in *Ward* was quoted in subsequent decisions, such as *Harris, Geominerals*, and *Walker-Lucas-Hudson Oil Co.*, in which the plaintiffs were the corporations. Typical is the language in *Geominerals*: "[Interested directors' contracts] are more closely scrutinized than ordinary contracts; and the burden is upon those claiming under them to prove that they are made in good faith and fair to the corporation."[88]

Despite this language, the rule applied to a creditor seeking to set aside a conveyance as fraudulent is clearly to the contrary[89] unless fraud is presumed from circumstances such as insolvency at the time of the transaction.[90] Burden of proof can be extremely important when applied to any issue, but it is especially important when the issue is something as elusive as the fairness of a contract. The Arkansas cases confuse these two types of cases unduly, although the results seem fair.

The effect of a provision in the corporation's articles or bylaws allowing interested directors' transactions and absolving directors of liability for conflict of interest in the absence of fraud may be to shift the burden of proof from the interested director to the person attacking the transaction as unfair.[91] This type of clause will not preclude a court's careful scrutiny of the transaction to determine whether it is fair.[92] However, in one New York case, it was held that such a provision had the effect of partially exonerating the directors "from adverse inferences which might otherwise be drawn against them."[93] The validity of these clauses has generally been upheld as long as there is disclosure.[94] The Arkansas decisions have addressed

87. Town of Searcy v. Yarnell, 47 Ark. 269, 1 S.W. 319 (1886). Also cited was a case in which the plaintiff was a creditor, Jones, McDowell & Co. v. Arkansas Mechanical and Agricultural Co., 38 Ark. 17 (1881).

88. 232 Ark. 524, 532, 338 S.W.2d 935, 940 (1960).

89. *See supra* note 86.

90. *See supra* note 85.

91. Miller, *The Fiduciary Duties of a Corporate Director*, 4 U. BALT. L. REV. 259, 263 (1975). For this proposition Miller cites Spiegel v. Beacon Participations, Inc. 297 Mass. 398, 417, 8 N.E.2d 895, 907 (1937), which can be read as applying the rule that the burden of proving misconduct (as opposed to fairness of a self-dealing transaction) is on the plaintiff. *Id.* at 412, 8 N.E.2d at 905.

92. Miller, *supra* note 91, at 263 (citing Abeles v. Adams Eng'g Co., 35 N.J. 411, 173 A.2d 246 (1961)).

93. Everett v. Phillips, 288 N.Y. 227, 237, 43 N.E.2d 18, 22 (1942) (quoting Spiegel v. Beacon Participations, Inc., 297 Mass. 398, 417, 8 N.E.2d 895, 907 (1937)). This case is noted in 11 FORDHAM L. REV. 311 (1942) and is discussed in Comment, 41 FORDHAM L. REV., *supra* note 8.

94. Miller, *supra* note 91, at 263 (citing Piccard v. Sperry Corp., 48 F. Supp. 465

neither the validity of such clauses nor whether they place the burden of proving unfairness on the party attacking the transaction.

D. *"Piercing the Veil" as a Remedy*

Most self-dealing cases involve the issue whether the transaction should be voided for unfairness. Occasionally, however, plaintiffs injured by self-dealing find this remedy inadequate and seek to disregard the corporate entity, or "pierce the corporate veil," to reach shareholders or affiliated corporations for payment of corporate obligations. "Piercing the veil" is a remedy applied in numerous situations which do not involve self-dealing,[95] but all cases involve the same general considerations. A brief discussion of the general status of "piercing the veil" as a remedy follows.

Because limited liability is a corporate attribute supported by public policy, the general rule is that the corporate entity will be disregarded only if the corporation has been used as an "agent" or "instrumentality" of the defendant,[96] or if its identity and the defendant's identity are essentially the same,[97] and if the plaintiff has suffered or will suffer unfair harm if the corporate entity is not disregarded.[98]

Authorities have criticized cases on piercing the veil on two general grounds. First, they are difficult to analyze. No one has ever been able to list with certainty the circumstances which give rise to disregard of the corporate entity. In 1931 Professor Powell listed the elements most often cited by courts as reasons to pierce the veil, but he indicated that no single element in the list alone would

(S.D.N.Y. 1943), *aff'd per curiam*, 152 F.2d 462 (2d Cir.), *cert. denied*, 328 U.S. 845 (1946) and Sterling v. Mayflower Hotel Corp., 33 Del. Ch. 293, 93 A.2d 107 (1952)).

95. *See* Comment, *Disregarding the Corporate Entity: Contract Claims*, 28 OHIO ST. L.J. 441, 441 n.2 (1967); Note, *Liability of a Corporation for Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122, 1123 n.2 (1958).

96. New York has adopted this approach in some of its cases. *See, e.g.*, Walkovszky v. Carlton, 18 N.Y.2d 414, 417-18, 223 N.E.2d 6, 7-8, 276 N.Y.S.2d 585, 587-88 (1966). One authority categorized theories based on shareholder control as "instrumentality" rules, and those based on unity of interest and failure to observe formal barriers as "identity" rules. Dobbyn, *A Practical Approach to Consistency in Veil-Piercing Cases*, 19 U. KAN. L. REV. 185, 186 (1971).

97. California has adopted this "identity" approach. *See, e.g.*, Automotriz Del Golfo De California v. Resnick, 47 Cal. 2d 792, 796, 306 P.2d 1, 3 (1957); Minton v. Cavaney, 56 Cal. 2d 576, 364 P.2d 473, 15 Cal. Rptr. 641 (1961).

98. *See, e.g.*, N. LATTIN, *supra* note 6, at 86-87; Barber, *Piercing the Corporate Veil*, 17 WILLAMETTE L.J. 371, 376 (1981); Hamilton, *The Corporate Entity*, 49 TEX. L. REV. 979, 983 (1971); Note, *Liability of a Corporation for Acts of a Subsidiary or Affiliate*, 71 HARV. L. REV. 1122, 1125 (1958).

be sufficient to pierce the veil.[99]

Many cases involving piercing the veil are difficult to analyze because courts frequently state conclusions that the corporation was the defendant's "alter ego" or "instrumentality" without giving reasons.[100] Likewise, it is frequently difficult to determine whether a court pierced the veil because the corporation was an "instrumentality" of the defendant or because the corporation and the defendant shared the same identity.[101]

A second general basis for criticism of piercing the veil cases is that courts frequently concentrate on irrelevant factors in determining whether to pierce the veil.[102] Use of metaphors denoting that the corporation is an agent of the defendant tends to indicate that the basis for liability is agency alone. But agency is not the real basis for piercing the veil. If the corporation is in fact the agent of the defendant, there is no need to pierce the veil to hold the defendant liable, because a principal is liable for the contracts entered by an agent as long as the agent has not exceeded his authority.[103] Fur-

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99. F. POWELL, PARENT AND SUBSIDIARY CORPORATIONS § 6 (1931). The factors listed are:

a. The parent corporation owns all or most of the capital stock of the subsidiary.
b. The parent and subsidiary corporations have common directors or officers.
c. The parent corporation finances the subsidiary.
d. The parent corporation subscribes to all the capital stock of the subsidiary or otherwise cause its incorporation.
e. The subsidiary has grossly inadequate capital.
f. The parent corporation pays the salaries and other expenses or losses of the subsidiary.
g. The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation.
h. In the papers of the parent corporation or in the statements of its officers, the subsidiary is described as a department or division of the parent corporation, or its business or financial responsibility is referred to as the parent corporation's own.
i. The parent corporation uses the property of the subsidiary as its own.
j. The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take their orders from the parent corporation in the latter's interest.
k. The formal legal requirements of the subsidiary are not observed.

Id.

100. Hamilton, *supra* note 98, at 979.

101. N. LATTIN, *supra* note 6, at 86-87, does not make the distinction in discussing the "alter ego" doctrine, and perhaps it makes little difference, if any. Professor Dobbyn suggests that the "identity" and "instrumentality" approaches both have a "full complement of labels," such as "alter ego," "dummy," "puppet," and "shell" as well as agent. Dobbyn, *supra* note 96, at 186-87. For a full list of the "epithets and metaphors" used by courts in these cases, *see* H. HENN, CASES AND MATERIALS ON CORPORATIONS 243 (1974).

102. *See, e.g.*, Dobbyn, *supra* note 96, at 187-88.

103. Barber, *supra* note 98, at 401; Comment, 28 OHIO ST. L.J., *supra* note 95, at 462.

thermore, if the corporation were deemed always to be an agent of those who control it, there would be no limited liability.[104]

By using terms of agency to find the defendant liable, courts make it easy to confuse liability based on agency rules with liability based on piercing the veil, which requires unfairness to the plaintiff as well as a finding that the corporation was the "agent," "alter ego," or "instrumentality" of the defendant. Probably as a result of this confusion, some courts concentrate on the relationship between the defendant and the corporation instead of the injustice to the plaintiff.[105] For example, failure to follow corporate formalities is frequently cited as a reason for piercing the veil on grounds that failure to observe formalities results in the corporation and the defendant having the same identity.[106] Unless the plaintiff can show that he has been misled or otherwise injured by the lack of formalities, however, he should not be allowed to pierce the veil.[107]

Another area of confusion arises from courts' failure to distinguish between contract and tort claims in determining whether to pierce the veil.[108] For example, a tort claimant, who generally has had no prior dealing with the corporation, might be able to show injury as a result of undercapitalization of the corporation, a frequently cited reason for piercing the veil. On the other hand, a contract claimant who willingly entered the contract with the corporation should not be allowed to pierce the veil on grounds that he was injured by undercapitalization when, in absence of fraud, he had opportunity to investigate the financial condition of the corporation before contracting with it.[109]

Arkansas has its share of "piercing the veil cases," most of which recite a rule to the effect that the corporate entity will be disregarded only "when the privilege of transacting business in corporate form has been illegally abused to the injury of a third

104. Comment, 28 OHIO ST. L.J., *supra* note 95, at 462.

105. Dobbyn, *supra* note 96, at 189.

106. *Id.*; Hamilton, *supra* note 98, at 990.

107. Hamilton, *supra* note 98, at 990-91.

108. *See, e.g.*, Walkovszky v. Carlton, 18 N.Y.2d 414, 223 N.E.2d 6, 276 N.Y.S.2d 585 (1966), a tort case, wherein Weisser v. Mursam Shoe Corp., 127 F.2d 344 (2d Cir. 1942), a contract case, is cited.

109. *See* Hamilton, *supra* note 98, at 985-89; Comment, 28 OHIO ST. L.J., *supra* note 95, at 459-60; Barber, *supra* note 98, at 387-89. The holding in Yacker v. Weiner, 109 N.J. Super. 351, 263 A.2d 188 (1970), shows that a defendant is not always successful in arguing that the plaintiff had opportunity to investigate the corporation's financial situation before contracting with it.

person."[110]

In Arkansas the veil has been pierced in diverse cases, including those involving insurance coverage,[111] workers' compensation,[112] torts,[113] and contracts.[114] Like other courts, the Arkansas courts have used terms such as "tool,"[115] "alter ego,"[116] and "instrumentality"[117] to describe the relationship of the corporation with its shareholders or affiliated businesses to justify piercing the veil.

Against the general background of "piercing the veil" are cases in which the plaintiff seeks to pierce the veil on grounds that the defendant, who is either a principal shareholder or an affiliated corporation,[118] has abused control through self-dealing and should be liable for the obligations of the corporation. Whether the defendant is a shareholder or an affiliated corporation should make no difference to the principles governing liability.[119]

If the plaintiff has a contract claim, in some jurisdictions it might be significant whether the self-dealing transaction took place before or after the plaintiff's contract with the corporation. For example, in *Bartle v. Home Owners Cooperative, Inc.*[120] a cooperative corporation was formed to provide low-cost homes for its members. It formed a subsidiary, Westerlea Builders, Inc., to build the houses, and contracted with Westerlea for less than the ultimate cost of the houses. After Westerlea ran into financial difficulties, some of its

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110. Rounds & Porter Lumber Co. v. Burns, 216 Ark. 288, 290, 225 S.W.2d 1, 2-3 (1949). *See also* Eagle Star Ins. Co. v. Deal, 474 F.2d 1216 (8th Cir. 1973); Green v. Equitable Powder Mfg. Co., 95 F. Supp. 127, 131 (W.D. Ark. 1951); Starr Farms, Inc. v. Southwestern Elec. Power Co., 271 Ark. 137, 141, 607 S.W.2d 391, 393 (1980); Woodyard v. Arkansas Diversified Ins. Co., 268 Ark. 94, 99, 594 S.W.2d 13, 17 (1980); Thomas v. Southside Contractors, Inc., 260 Ark. 694, 698, 543 S.W.2d 917, 919 (1976); Shipp v. Bell & Ross Enter., Inc., 256 Ark. 89, 98, 505 S.W.2d 509, 515 (1974); Don G. Parker, Inc. v. Point Ferry, Inc., 249 Ark. 764, 768, 461 S.W.2d 587, 590 (1971); Banks v. Jones, 239 Ark. 396, 399, 390 S.W.2d 108, 110 (1965); Black & White, Inc. v. Love, 236 Ark. 529, 535, 367 S.W.2d 427, 432 (1963); Humphries v. Bray, 271 Ark. 962, 966, 611 S.W.2d 791, 793 (Ct. App. 1981).

111. Eagle Star Ins. Co. v. Deal, 474 F.2d 1216 (8th Cir. 1973).

112. Humphries v. Bray, 271 Ark. 962, 611 S.W.2d 791 (Ct. App. 1981).

113. Black & White Inc. v. Love, 236 Ark. 529, 367 S.W.2d 427 (1963).

114. Henderson v. Rounds & Porter Lumber Co., 99 F. Supp. 376 (W.D. Ark. 1951); Rounds & Porter Lumber Co. v. Burns, 216 Ark. 288, 225 S.W.2d 1 (1949).

115. Woodyard v. Arkansas Diversified Ins. Co., 268 Ark. 94, 99, 594 S.W.2d 13, 17 (1980).

116. Humphries v. Bray, 271 Ark. 962, 611 S.W.2d 791 (Ct. App. 1981).

117. Henderson v. Rounds & Porter Lumber Co., 99 F. Supp. 376, 381 (W.D. Ark. 1951).

118. For a discussion on the theory by which the corporate entity is disregarded in order to reach the assets of the whole business entity, which might be composed of affiliated corporations, *see* Berle, *The Theory of Enterprise Entity*, 47 COLUM. L. REV. 343 (1947).

119. *See* Comment, 28 OHIO ST. L.J., *supra* note 95, at 446.

120. 309 N.Y. 103, 127 N.E.2d 832 (1955).

creditors assumed construction responsibilities pursuant to an extension agreement, but Westerlea was adjudged a bankrupt four years later. The trustee in bankruptcy sought to pierce the veil to hold Home Owners liable for Westerlea's debt, but was denied relief on grounds that corporate formalities were followed to keep the affairs of parent and subsidiary separate, that the creditors were not misled, that there was no fraud, and that creditors were estopped by the extension agreement. A persuasive dissenting opinion took the position that Westerlea was "merely an agent of Home Owners," since it was controlled in such a fashion that it could not make money, but at best could only break even.[121]

In a case very similar to *Bartle* on its facts, *Yacker v. Weiner*,[122] a group of shareholders formed two corporations, Mar and Middlesex. Middlesex purchased property and contracted with Mar to build an apartment complex. The contract price was greatly below the actual cost of the project, some of Mar's subcontractors were not paid, and Mar became insolvent. Mar's receiver successfully pierced its veil to reach Middlesex. The court said that the incorporators had perpetrated a fraud upon the subcontractors and had caused Middlesex to be a participant in the fraud. Although the plaintiff's claim was based on contract and the creditors arguably should have known the financial condition of Mar, the court said that the subcontractors "were justified in assuming that the general contract was for an amount which reasonably could be expected to cover the cost of the construction" and that it was "unreasonable to expect each subcontractor and supplier to compute the cost of the whole job to determine if the general contract price was adequate."[123]

Admittedly *Yacker* and *Bartle* are difficult to distinguish, because in each case the plaintiff was claiming harm from a self-dealing transaction which arose before the plaintiff had contracted with the corporation.[124] Arkansas has never decided on liability in such a situation.

121. *Id.* at 105, 127 N.E.2d at 834.

122. 109 N.J. Super. 351, 263 A.2d 188 (1970). Both these cases are presented in H. HENN, CASES AND MATERIALS ON THE LAWS OF CORPORATIONS, 250-56 (1974).

123. 109 N.J. Super. at 357, 263 A.2d at 191 (1970).

124. One possible way to distinguish *Yacker* from *Bartle* is to look to what each court means by "fraud." In finding that the defendant had perpetrated a fraud, the *Yacker* court quoted authority on equitable fraud, which "includes all acts, omissions or concealments which involve a breach of a legal or equitable duty, trust or confidence justly reposed, and are injurious to another, or by which an undue or unconscientious advantage is taken of another." 109 N.J. Super at 357, 263 A.2d at 191 (1970). In finding that there had been no

In cases in which the plaintiff's contract with the corporation took place before the defendant's self-dealing, the defendant cannot contend that the plaintiff knew or should have known of the self-dealing and the resulting financial condition of the corporation.[125] In this respect the contract plaintiff is like the tort plaintiff.

The two Arkansas cases involving piercing the veil because of wrongful self-dealing arose from the same situation and concerned self-dealing which took place after the plaintiffs had contracted with the corporation.

In *Rounds & Porter Lumber Co. v. Burns*[126] a creditor of the bankrupt Taylor Oak Flooring Company sought to pierce its veil to reach the assets of Rounds and Porter, the parent corporation. The claim of the plaintiff antedated the formation of the flooring company and the defendant's interest in it. The court affirmed a judgment against the parent, saying that there was "convincing evidence of fraud."[127] The evidence showed that after it gained control of the flooring company, the defendant caused the flooring company to sell lumber to the defendant at an apparent loss and at a price substantially lower than that charged to third persons, that the flooring company was solvent when the defendant gained control over it, and that as a result of the self-dealing the flooring company's assets were drained by the defendant, resulting in the flooring company's insolvency. Citing *Lange v. Burke*[128] for authority that directors cannot lawfully manage the affairs of one corporation in the interest of another,[129] the court affirmed the chancellor's finding that the parent had "wrongfully manipulated the flooring company to its own advantage, at the expense of the [plaintiff]."[130]

In a federal case arising from the same circumstances, *Henderson v. Rounds & Porter Lumber Co.*,[131] the court again pierced the veil to find Rounds and Porter liable for the debts of the flooring company. The trustee in bankruptcy and creditors of the flooring company recovered on the same theory as did the plaintiff in the

fraud, the *Bartle* court might have been applying a narrower definition, one which requires misrepresentation before the plaintiff entered into the transaction.

125. For a discussion of the bases of liability in this situation, *see* Comment, 28 OHIO ST. L.J., *supra* note 95, at 456-57.

126. 216 Ark. 288, 225 S.W.2d 1 (1949).

127. *Id.* at 291, 225 S.W.2d at 3. The court never defined "fraud."

128. 69 Ark. 85, 61 S.W. 165 (1901).

129. 216 Ark. at 290, 225 S.W.2d at 3 (1949).

130. *Id.* at 293, 225 S.W.2d at 4.

131. 99 F. Supp. 376 (W.D. Ark. 1951).

earlier state proceeding. In an extremely well-written opinion Judge Miller wrote that the test was whether

> the defendant dominated and manipulated the affairs of the Flooring Company for its own interest, rather than the best interest of the Flooring Company as a separate corporate entity, and used the latter as a mere agency or instrumentality for the advancement of its own interest, and in the process of so doing inflicted damage upon these plaintiffs. . . .[132]

The opinion states that it is immaterial when the plaintiffs' debts arose.[133] The defendant had argued that because the plaintiffs' debts were incurred prior to the date when the defendant assumed complete control, the plaintiffs had no standing to sue the defendant.[134]

Unlike most situations in which the veil of the subsidiary is pierced to reach the assets of the parent, in this case the defendant was not technically a parent because it never owned more than fifty percent of the stock of the flooring company, although it did gain complete control of that company after the other stockholder was forced out of the business. Recognizing that this presented an unusual case, Judge Miller wrote that the "real basis of liability is actual control and manipulation . . . , whether that control and manipulation be exercised by virtue of stock ownership or otherwise."[135]

These two Arkansas decisions are sound because they recognize that the true basis for liability should be whether the defendant has abused the privilege of doing business in the corporate form by manipulating control of the corporation to the detriment of a third party. Implicitly these cases indicate that creditors of a corporation may reasonably rely on their expectations that those in control will manage the corporation in the corporation's best interest, not in the interest of another entity.

E. *Contracts for Directors' Compensation*

At one time courts took the position that directors should not receive any compensation for their services as directors,[136] and it is still the law that directors' compensation must be authorized by stat-

132. *Id.* at 381.
133. *Id.* at 384.
134. *Id.* at 383. Apparently this argument is based on the assumption that in order to have a cause of action against the defendant, the plaintiffs must show some prior misrepresentation by the defendant.
135. *Id.* at 383-84.
136. H. BALLENTINE, *supra* note 52, at 187.

ute, by-law, the articles, or shareholder resolution.[137] As with other contracts with interested directors, the general rule is that a contract for compensation is voidable if the director votes for it or if his presence is necessary to establish a quorum.[138] A minority of jurisdictions hold that under such circumstances, a contract for compensation is absolutely void, not merely voidable.[139] It is now common for statutes to authorize directors to determine their own compensation,[140] and some statutes provide that this compensation must be reasonable.[141] Presumably, the intent of such statutes is to allow directors to set their own compensation not only for their services as directors, but also for their services as officers or other employees of the corporation.[142]

In Arkansas it is provided by statute that directors may fix their own compensation.[143] Although the statute does not require that the compensation be reasonable and there are no cases so interpreting it, the statute should not be construed as allowing directors to set unreasonable compensation for themselves.[144]

Before the adoption of this statute, which is based on the Model Business Corporation Act and is part of the Arkansas Business Corporation Act adopted in 1965, Arkansas adhered to the minority view that a contract for directors' compensation was void, not voidable, when the director's vote was necessary for the adoption of the contract or if his presence was necessary to establish a quorum.[145]

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137. N. LATTIN, *supra* note 6, at 265.

138. *Id.*

139. *Id.*

140. *See, e.g.*, MODEL BUSINESS CORP. ACT ANN. 2d § 33 (1971).

141. *See, e.g.*, OHIO REV. CODE ANN. § 1701.60 (Page 1978).

142. Marsh, *supra* note 7, at 59-60.

143. ARK. STAT. ANN. § 64-301 (1980). Decisions handed down before the adoption of this statute recognized that although a director may not receive compensation for his services as a director, he may be entitled to a salary for services performed outside his duties as director, either by contract or upon *quantum meruit*. Mt. Nebo Anthracite Coal Co. v. Martin, 86 Ark. 608, 613, 111 S.W. 1002, 1003 (1908). *See also* Corning Custom Gin Co. v. Oliver, 171 Ark. 175, 179, 283 S.W. 977, 978 (1926); Red Bud Realty Co. v. South, 96 Ark. 281, 301, 131 S.W. 340, 348-49 (1910).

144. In Clark-McWilliams Coal Co. v. Ward, 185 Ark. 237, 247, 47 S.W.2d 18, 23 (1932), it was held "a breach of trust to the other stockholders for the managing directors to obtain an undue advantage to themselves by way of excess salaries." Nothing in the statute indicates an intent to overrule this decision. According to Professor O'Neal, it is common for majority shareholders to breach their duty to the minority by paying salaries to themselves and by not employing the minority. H. O'NEAL, OPPRESSION OF MINORITY SHAREHOLDERS § 3.07, at 85-87 (1975). An additional problem arising from excessive salaries is that the IRS treats any excess over reasonable compensation as a dividend to the recipient. *See* I.R.C. § 161(a).

145. National Oil Co. v. Reeves, 228 Ark. 664, 671, 310 S.W.2d 242, 247 (1958); Morten-

There are several decisions enunciating this rule, and they are clearly overruled by the statute allowing directors to set their own compensation. With one exception discussed below, these decisions are the only ones in Arkansas which address the effect of the voting of an interested director or the effect of counting his presence to establish a quorum. From them it is possible to conclude that if a director votes on a matter in which he is interested, or if his presence is necessary to establish a quorum at a meeting in which the board votes on a matter in which he is interested, the transaction is void. For example, in *Mortensen v. Ballard*[146] the board of directors voted a salary for one of the directors who was also assistant manager. At the meeting only three members of the five-member board were present, including the interested director. The court held that the interested director, who was disqualified from voting on his own salary, could not be counted to establish a quorum, and that the action was void. Now that the statute allows interested directors' contracts for compensation, the case has been overruled. However, whether its holding applies to interested directors' contracts that do not involve compensation is not clear.

If contracts for salaries were merely another variety of interested directors' contracts, there is reason to believe that the holdings of these decisions would apply to contracts not involving director compensation. However, contracts for compensation are not merely another variety of interested directors' contracts. They have traditionally been treated differently. First, directors traditionally had no right to compensation for their services as directors. Second, in jurisdictions such as Arkansas a pre-statute contract for compensation was void absolutely if the interested director voted or if his presence was necessary to constitute a quorum. Arkansas has never held that any other type of interested directors' contract is absolutely void, but only voidable.[147] Furthermore, in *Consumers' Ice & Coal Co. v. Security Bank & Trust Co.*[148] the Arkansas Supreme Court declared that a mortgage was voidable, but not absolutely void, because an interested director had voted for it.

Although the Arkansas court has never distinguished between

sen v. Ballard, 218 Ark. 459, 463-64, 236 S.W.2d 1006, 1009 (1951); Stout v. Oates, 217 Ark. 938, 944, 234 S.W.2d 506, 510 (1950); Cook v. Malvern Brick & Tile Co., 194 Ark. 759, 769, 109 S.W.2d 451, 455-56 (1937); Oil Fields Corp. v. Hess, 186 Ark. 241, 247, 53 S.W.2d 444, 446 (1932).

146. 218 Ark. 459, 236 S.W.2d 1006 (1951).

147. *See* text at note 145.

148. 170 Ark. 530, 280 S.W. 677 (1926).

contracts for compensation and other contracts in determining whether the vote of an interested director renders them void or only voidable, the court has found only contracts for compensation to be void absolutely. Therefore, it is doubtful that Arkansas would follow these pre-statute compensation cases to void some other type of interested director's contract on grounds that the director voted for it or was counted to establish a quorum.

II. CORPORATE OPPORTUNITY

A. *Business Opportunities*

When a corporate fiduciary appropriates a corporate business opportunity for his own benefit, he is breaching his duty of loyalty to the corporation and will be liable to the corporation for the profits generated from usurpation of the opportunity.[149] A constructive trust may be imposed upon the property constituting the opportunity,[150] and the fiduciary might also be liable for damages for harm to the corporation.[151]

Courts have devised several tests for determining when a corporate opportunity exists. The "interest or expectancy" test enunciated in *Lagarde v. Anniston Lime & Stone Co.*[152] restricts corporate officers and directors from acquiring "property wherein the corporation has an interest already existing, or in which it has an expectancy growing out of an existing right," and applies as well "to cases where the officers' interference will in some degree balk the corporation in effecting the purposes of its creation."[153] This test has been adopted by New York[154] and a few other jurisdictions,[155] but it has been criticized as too vague[156] or too lax.[157]

149. Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939); 3 W. FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 861.1 (rev. perm. ed. 1975).

150. Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939); Weissman v. A. Weissman, Inc., 374 Pa. 470, 97 A.2d 870 (1953).

151. *E.g.*, Raines v. Toney, 228 Ark. 1170, 313 S.W.2d 802 (1958); International Bankers Life Ins. Co. v. Holloway, 368 S.W.2d 567 (Tex. 1963).

152. 126 Ala. 496, 28 So. 199 (1900).

153. *Id.* at 502, 28 So. at 201.

154. *E.g.*, Burg v. Horn, 380 F.2d 897 (2d Cir. 1967); Blaustein v. Pan Am. Petroleum & Transp. Co., 293 N.Y. 281, 56 N.E.2d 705, 713-14 (1944).

155. *E.g.*, Colorado & Utah Coal Co. v. Harris, 97 Colo. 309, 49 P.2d 429 (1935); Lincoln Stores v. Grant, 309 Mass. 417, 34 N.E.2d 704 (1941); Solimine v. Hollander, 128 N.J. Eq. 228, 16 A.2d 203 (Ch. 1940).

156. *See, e.g.*, Walker, *Legal Handles Used to Open or Close the Corporate Opportunity Door*, 56 Nw. U.L. REV. 608 (1961); Comment, *The Corporate Opportunity Doctrine*, 18 Sw. L.J. 96, 97 (1964).

157. *See, e.g.*, Rosenblum v. Judson Eng'g Corp., 99 N.H. 267, 109 A.2d 558 (1954); Comment, 18 Sw. L.J., *supra* note 156, at 98.

For the past three or four decades the trend has been toward a corporate opportunity doctrine which places more restraint on directors and officers in their acquisition of property which could benefit the corporation. As a result, the "line of business" and "fairness" tests have gained recognition.[158]

The "line of business" test incorporates the "interest or expectancy" test, but also includes other opportunities which would not be corporate opportunities under the latter test. The frequently-cited decision in *Guth v. Loft, Inc.*[159] enunciated this approach:

> Where a corporation is engaged in a certain business, and an opportunity is presented to it embracing an activity as to which it has fundamental knowledge, practical experience and ability to pursue, which, logically and naturally, is adaptable to its business having regard for its financial position, and is one that is consonant with its reasonable needs and aspirations for expansion, it may be properly said that the opportunity is in the line of the corporation's business.[160]

More simply stated, this test includes as a corporate opportunity any opportunity "closely associated with the existing and prospective activities of the corporation."[161] Under strict application of this test, a corporate fiduciary can breach his duty even when his acquisition of an opportunity is not unfair to the corporation.[162]

The third test, that of "fairness," applies ethical standards to the facts surrounding the opportunity.[163] According to some authorities, *Guth v. Loft, Inc.* supports the fairness test as well as the line of business test.[164] The fairness test is not really independent of the other two tests, because it should be applied only if the opportunity

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158. *See, e.g.*, Comment, 18 Sw. L.J., *supra* note 156, at 98-99; Note, 74 HARV. L. REV., *supra* note 5, at 766.

159. 23 Del. Ch. 255, 5 A.2d 503 (1939).

160. *Id.* at 279, 5 A.2d at 514.

161. Rosenblum v. Judson Eng'g Corp., 99 N.H. 267, 273, 109 A.2d 558, 563 (1954) (quoted in Note, 74 HARV. L. REV., *supra* note 5, at 768)).

162. Comment, 18 Sw. L.J., *supra* note 156, at 98.

163. *E.g.*, Durfee v. Durfee & Canning, 323 Mass. 187, 199, 80 N.E.2d 522, 529 (1948).

164. *E.g.*, American Inv. Co. v. Lichtenstein, 134 F. Supp. 857 (E.D. Mo. 1955); Miller v. Miller, 301 Minn. 207, 222 N.W.2d 71 (1974); Comment, 18 Sw. L.J., *supra* note 156, at 99. *Guth v. Loft, Inc.* involved a director and president of a corporation engaged in the business of selling soft drink syrups. Because of a dispute with Coca-Cola, he investigated selling Pepsi at the corporation's chain of soda fountains. Pepsi went bankrupt, and he appropriated the opportunity to acquire the business for himself and used the corporation's facilities in so doing. The court found that he wrongfully seized a corporate opportunity.

is a corporate one under one of the other tests.[165]

Under either the "interest or expectancy" or the "line of business" approach there are certain considerations that might affect the corporate fiduciary's liability for acquisition of a business opportunity to the corporation.[166] Basically these factors relate to fairness to the corporation and demonstrate that the so-called "fairness" test overlaps the other two. For example, if the corporation has rejected the opportunity by action of a disinterested board or shareholders not induced by fraud or misrepresentation, it is no longer a corporate opportunity, and corporate fiduciaries may take the opportunity for themselves.[167] If the board is not disinterested or if it is dominated by the fiduciary who seizes the opportunity for himself, rejection is no defense.[168] In a similar vein, disclosure of the opportunity by the corporate fiduciary before taking it for himself helps insulate him from liability for usurpation of a corporate opportunity,[169] no doubt because prior disclosure gives the corporation a chance to take the opportunity for itself.

The corporation's financial inability to avail itself of the opportunity may permit an officer or director to take the opportunity without violation of his duty,[170] although some cases, which apply more strictly the analogy that a director is a trustee, hold to the contrary.[171] In any event, it is clear that the corporate fiduciary has no obligation to lend his own resources to the corporation in order to enable it to take advantage of the opportunity.[172]

Other factors affecting a director's or officer's liability for usurpation of a corporate opportunity include whether the corporation had negotiated for the opportunity,[173] whether the opportunity was

165. *See* Miller v. Miller, 301 Minn. 207, 224, 222 N.W.2d 71, 81 (1974).

166. *See generally* Comment, 18 Sw. L.J., *supra* note 156, at 100-10.

167. *E.g.*, Gaynor v. Buckley, 203 F. Supp. 620 (D. Or. 1962); Franco v. J.D. Streett & Co., 360 S.W.2d 597 (Mo. 1967).

168. *See* Greene v. Allen, 35 D. Ch. 242, 114 A.2d 916 (1955), *rev'd sub nom.* Johnston v. Greene, 121 A.2d 919 (Del. S. Ct. 1956) (discussed in Comment, 18 Sw. L.J., *supra* note 156, at 105-06).

169. Note, 74 HARV. L. REV., *supra* note 5, at 772; Comment, 18 Sw. L.J., *supra* note 156, at 104.

170. *E.g.*, Schildberg Rock Prod. Co. v. Brooks, 258 Iowa 759, 140 N.W.2d 132 (1966); Hart v. Bell, 222 Minn. 69, 82, 23 N.W.2d 375, 382, *supplemented per curiam*, 222 Minn. 69, 24 N.W.2d 41 (1946); Canion v. Texas Cycle Supply, Inc., 537 S.W.2d 510 (Tex. Civ. App. 1976).

171. *E.g.*, Irving Trust Co. v. Deutsch, 73 F.2d 121 (2d Cir. 1934); Faraclas v. City Vending Co., 232 Md. 457, 194 A.2d 298 (1963).

172. *See, e.g.*, A.C. Petters Co. v. St. Cloud Enter., Inc., 301 Minn. 261, 222 N.W.2d 83 (1974); Hart v. Bell, 222 Minn. 69, 23 N.W.2d 375 (1946).

173. *See* Comment, 18 Sw. L.J., *supra* note 156, at 102, in which the author concludes

offered to the corporation instead of the individual fiduciary,[174] whether the corporate fiduciary learned of the opportunity through his position with the corporation,[175] and whether the fiduciary used corporate facilities to advance the opportunity for his own purposes.[176] These and other considerations actually relate to whether the director's usurpation of the opportunity was fair to the corporation, although they have frequently been considered in determining whether the opportunity was a corporate one under the "line of business" or "expectancy" tests.

Whether the opportunity belongs to the corporation and whether the defendant's usurpation of it was fair are separate issues. This was recognized by the Minnesota Supreme Court in *Miller v. Miller*[177] in which the court first applied the "line of business" test to determine whether the opportunities in question belonged to the corporation. Concerning those opportunities that were not corporate, the inquiry ended. Concerning those that were corporate opportunities, the court applied the "fairness" test to determine whether the defendants should be liable to the corporation for seizing them for personal gain.[178] In bifurcating these issues, the court contributed a valuable formula for the analysis of corporate oppor-

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that negotiation by the corporation is not by itself sufficient to render an opportunity a corporate one, but that the case against a corporate fiduciary is strengthened if there has been such negotiation.

174. Guth v. Loft, Inc., 23 Del. Ch. 255, 275-76, 5 A.2d 503, 512-13 (1939); Miller v. Miller, 301 Minn. 207, 222 N.W.2d 71 (1974); Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940); *e.g.*, Note, 74 HARV. L. REV., *supra* note 5, at 776; Comment, 18 SW. L.J., *supra* note 156, at 103.

175. Miller v. Miller, 301 Minn. 207, 222 N.W.2d 71 (1974); Litwin v. Allen, 25 N.Y.S.2d 667 (Sup. Ct. 1940). *See* Comment, 18 Sw. L.J., *supra* note 156, at 103-04, in which the author cites Colorado & Utah Coal Co. v. Harris, 97 Colo. 309, 49 P.2d 429 (1935), and Diedrick v. Helm, 217 Minn. 483, 14 N.W.2d 913 (1944), as showing that factors other than this alone should be present before the officer or director will be held liable.

176. Guth v. Loft, Inc., 23 Del. Ch. 255, 5 A.2d 503 (1939); Miller v. Miller, 301 Minn. 207, 222 N.W.2d 71 (1974).

177. 301 Minn. 207, 222 N.W.2d 71 (1974), noted in 2 J. CORP. L. 405 (1977).

178. In ascertaining fairness, the court listed as factors for consideration the following:

> [T]he nature of the officer's relationship to the management and control of the corporation; whether the opportunity was presented to him in his official or individual capacity; his prior disclosure of the opportunity to the board of directors or shareholders and their response; whether or not he used or exploited corporate facilities, assets, or personnel in acquiring the opportunity; whether his acquisition harmed or benefited the corporation; and all other facts and circumstances bearing on the officer's good faith and whether he exercised the diligence, devotion, care, and fairness toward the corporation which ordinarily prudent men would exercise under similar circumstances in like positions.

301 Minn. 207, 226, 222 N.W.2d 71, 81-82 (1974).

tunity problems.[179]

However, the *Miller v. Miller* approach is useful only if one concludes that the seizure of a corporate opportunity must be unfair before the fiduciary will be liable. If one regards the corporate official as a trustee, his liability to the corporation should not hinge on fairness, but only on the question whether he has taken an opportunity which belongs to the corporation.[180] This approach is not favored and is similar to the now disfavored rule that a director's contract with his corporation is voidable without regard to fairness.[181] Although strict application of the "interest or expectancy" test or "line of business" test arguably imposes liability without regard to fairness, courts frequently include fairness as a consideration in applying these tests to determine liability. Whether courts take the *Miller v. Miller* approach by admitting that fairness is a consideration, or whether they simply apply the interest or expectancy or line of business test, they usually do not apply a "strict-trust" rationale to impose liability in absence of unfairness.[182]

Raines v. Toney[183] is the only Arkansas decision directly involving usurpation of a corporate opportunity. In that case the defendant, Sam P. Raines, was vice president, director, and general manager of an insurance company, the E.E. Raines Company. He assumed control after his father, E.E. Raines, became ill. While in control of the corporation, he solicited on behalf of a new partnership composed of himself and others the representation of two groups of insurance carriers which were currently being represented by the E.E. Raines Company. Without revealing his actions or plans to the company, he caused the insurance carriers to terminate their relationship with the company and to divert their business to the new partnership. As a result, the E.E. Raines Company was left without insurance carriers to represent and was eventually dis-

179. The *Miller* approach is not without its critics, however. *See* Brudney and Clark, *A New Look at Corporate Opportunities*, 94 HARV. L. REV. 997, 999 n.2 (1981).

180. *See* Note, *Corporate Opportunity*, 2 J. CORP. L. 558 (1977), in which the author advocates this "strict-trust" rationale.

181. *See* text at note 145.

182. Note, 2 J. CORP. L., *supra* note 180, at 565 n.69, lists corporate opportunity cases that have applied the strict-trust rationale. The term "strict-trust" is from Bayne, *Corporate Control as a Strict Trustee*, 53 GEO. L.J. 543 (1965).

183. 228 Ark. 1170, 313 S.W.2d 802 (1958). Another Arkansas decision, Loewer v. Lonoke Rice Milling Co., 111 Ark. 62, 161 S.W. 1042 (1913), involved an overlap of self-dealing and corporate opportunity. There a director who was a rice buyer for his company was not allowed to recover from the corporation a profit from rice he claimed to have sold to the corporation, but which he had purchased as agent of the corporation to rectify his original purchase.

solved. A group of minority shareholders in the E.E. Raines Company brought a derivative action against Sam P. Raines, his partners in the new partnership, and the two groups of insurance carriers to recover damages for loss of business. In affirming a judgment against Sam P. Raines, the court said that a corporate fiduciary " 'may not acquire, in opposition to his corporation, property in which the corporation has an interest or tangible expectancy or which is essential to its existence.' "[184] Noting that a corporate fiduciary may engage in a competing enterprise as long as he does so in good faith,[185] the court said:

> Sam P. Raines . . . cannot be said to enter in good faith into a competing enterprise which crippled, injured and destroyed the business of his corporation which he was then serving, and at the same time terminate the property interests of his corporation and appropriate them to his own use through his competing enterprise.[186]

The court placed a good deal of emphasis on Raines' failure to disclose his actions to the corporation,[187] indicating that his duty of disclosure was greater than usual because he was general manager.[188] The decision does not say that full disclosure would have exonerated him from liability, but it makes clear that his nondisclosure constituted a breach of his fiduciary duty to his corporation.[189]

From *Raines v. Toney* one can conclude that Arkansas subscribes to the "interest or expectancy" test to determine whether a corporate opportunity exists and, further, considers disclosure a very important element in ascertaining whether a corporate fiduciary will be liable for usurpation of a corporate opportunity. It happened that the breach of duty by Sam P. Raines was substantial under any of the tests discussed herein, and the narrow "interest or expectancy" approach was sufficient to render him liable. Whether the Arkansas courts would apply a broader "line of business" test in an appropriate case remains to be seen.

Presumably Arkansas would follow the *Miller v. Miller* decision

184. Raines v. Toney, 228 Ark. 1170, 1179, 313 S.W.2d 802, 808 (1958) (quoting Blaustein v. Pan Am. Petroleum & Transp. Co., 263 App. Div. 97, 125, 31 N.Y.S.2d 934, 962 (1941)).

185. 228 Ark. at 1179, 313 S.W.2d at 808.

186. *Id.* at 1179, 313 S.W.2d at 808-09.

187. *Id.* at 1181, 313 S.W.2d at 810.

188. *Id.* at 1181, 313 S.W.2d at 809-10.

189. One of Raines' partners, a stranger to the corporation, was held liable for aiding and encouraging Raines in the breach of his duty.

by imposing liability for usurpation of a corporate opportunity only if the usurpation has been unfair to the corporation. This conclusion is based upon the fact that Arkansas has never applied a "strict-trust" rationale to directors in self-dealing cases and would probably refrain from doing so in a corporate opportunity case. Furthermore, the *Raines* decision indicates that an important factor to consider in imposing liability is nondisclosure, which relates to fairness.

B. *Purchase of Claims Against the Corporation*

There is some divergence of views concerning whether a director may purchase, at a discount, the claims of corporate creditors and recover the full amount without violating his fiduciary duty to the corporation.[190] A few cases take the position that the director's duty of loyalty includes an obligation to pass on to the corporation any benefit derived from purchasing corporate debts at a discount.[191] This view is consistent with the principle that directors are trustees, and that any profits generated by speculation in the liabilities of the corporation are held for the benefit of the cestui que trust, the stockholders.[192]

On the other hand, there is substantial authority for the view that the director or officer does not breach his fiduciary duty to the corporation merely by purchasing at a discount the claims of its creditors.[193] One reason for this rule is that the director is not dealing with the corporation when he purchases the claim, but is dealing with a third person.[194] Therefore, there should be no presumption that the director's purchase of the claim is unfair to the corporation.

Even in states following the more lenient approach, the director's right to purchase claims against the corporation is limited, and he will not be allowed to profit by exercising it under all circumstances. When he has a duty to purchase or settle corporate obliga-

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190. When the claim is represented by a security of the corporation, the corporate fiduciary might be subject to federal and state insider trading laws, violation of which leads to liability to the corporation. *See, e.g.*, § 16(b) of the Securities Exchange Act of 1934. Liability under insider trading laws is outside the scope of this article.

191. *E.g.*, Davis v. Rock Creek L.F. & M., 55 Cal. 359, 36 Am. Rep. 40 (1880); Weissman v. A. Weissman, Inc., 374 Pa. 470, 97 A.2d 870 (1953). *But cf.* Weissman v. A. Weissman, Inc., 382 Pa. 189, 114 A.2d 797 (1955) (mortgage debt not extinguished when former corporate fiduciary paid full amount to acquire the mortgage).

192. Chouteau Ins. Co. v. Floyd, 74 Mo. 286, 291 (1881).

193. *E.g.*, Monroe v. Scofield, 135 F.2d 725 (10th Cir. 1943); Martin v. Chambers, 214 F. 769 (5th Cir. 1914); Kroegher v. Calivada Colonization Co., 119 F. 641 (3d Cir. 1902).

194. Hornor v. New South Oil Mill, 130 Ark. 551, 558, 197 S.W. 1163, 1165 (1917); Bejot v. Ainsworth Lodge No. 130, I.O.O.F., 128 Neb. 631, 259 N.W. 745 (1935).

tions for the benefit of the corporation, he may not purchase them for himself and keep the profits.[195] As with other business opportunities, whether the corporation has been given the opportunity to purchase the claims and whether it is financially able to do so may have a bearing on whether it is permissible for the corporate fiduciary to purchase them.[196] If the director or officer has a duty to refrain from purchasing corporate claims for his own benefit, he may not escape this duty by having a partnership in which he is interested purchase them[197] or by having friends or members of his family purchase them.[198]

With very few exceptions,[199] when the corporation is insolvent a corporate officer or director may recover from the corporation only what he has paid for the claim.[200] To allow recovery of the full claim would prejudice other creditors.[201]

Two Arkansas cases concerning purchase of claims against the corporation involved insolvent corporations. In *Hornor v. New South Oil Mill*[202] Ready, a vice president and director of an insolvent corporation, was appointed to a corporate committee formed to settle the claims of corporate creditors. Although unsecured creditors were offered 33⅓ cents on the dollar for their claims, these claims were not settled when Ready filed suit to dissolve the corporation. Shortly thereafter, Ready proceeded to act as an agent for a partnership in purchasing claims against the corporation for 33⅓ cents on the dollar. When the partnership filed its claim for the full amount of the debt with the corporation's receiver, shareholders filed exceptions to the partnership's claims on grounds that Ready

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195. Kroegher v. Calivada Colonization Co., 119 F. 641 (3d Cir. 1902); Punch v. Hipolite Co., 340 Mo. 53, 72, 100 S.W.2d 878, 887 (1936).

196. Martin v. Chambers, 214 F. 769, 771 (5th Cir. 1914); Rankin v. Frebank Co., 47 Cal. App. 3d 75, 121 Cal. Rptr. 348 (1975).

197. Hornor v. New South Oil Mill, 130 Ark. 551, 558, 197 S.W. 1163, 1165 (1917); Davis v. Rock Creek L.F. & M. Co., 55 Cal. 359, 364, 36 Am. Rep. 40, 42-43 (1880).

198. Manufacturers Trust Co. v. Becker, 338 U.S. 304, *aff'g In re* Calton Crescent, Inc., 173 F.2d 944 (2d Cir. 1949); Canton Roll & Mach. Co. v. Rolling Mill Co., 168 F. 465, 478 (4th Cir. 1909).

199. *E.g., In re* Calton Crescent, Inc., 173 F.2d 944 (2d Cir. 1949), in which the court allowed the fiduciary to claim the full amount of the debt purchased during insolvency but when the corporation was still a "going concern." This decision was affirmed in Manufacturers Trust Co. v. Becker, 338 U.S. 304 (1949).

200. Monroe v. Scofield, 135 F.2d 725, 728 (10th Cir. 1943); Martin v. Chambers, 214 F. 769 (5th Cir. 1914); Canton Roll & Mach. Co. v. Rolling Mill Co., 168 F. 465 (4th Cir. 1909).

201. Martin v. Chambers, 214 F. 769, 771 (5th Cir. 1914).

202. 130 Ark. 551, 197 S.W. 1163 (1917).

had purchased the claims for his own benefit. The partnership was composed of Ready's wife and one Doughtie.

The Arkansas Supreme Court recognized that as a director of the insolvent corporation, Ready could not buy its debts for his own benefit and hold the corporation responsible for paying him the full amount.[203] The opinion states that it would be fraudulent for Ready to conceal his interest in the transaction by having a partnership in which he was interested purchase the claims.[204] However, the court found that the evidence overcame any inference of fraud, relying particularly on the testimony of Ready and Doughtie and the fact that Doughtie's bidding at the sale of the corporate assets caused the sale price to be sufficient to pay all creditors' claims.[205]

The court pointed out that this case did not present a situation in which the director acted for both the corporation and as an agent for a party contracting with the corporation, and that it was not a case involving a contract between corporations with interlocking directors.[206] The court reasoned that if the partnership had a legal right to purchase the claims, this right was not defeated by its use of the services of the director of the corporation. It seems that the court merely overlooked director Ready's conflict of interest. Ready was obligated as a member of the committee to attempt to purchase creditors' claims for the corporation. When he purchased those claims for the partnership and not for the corporation, he clearly breached his duty to the corporation, whether or not he owned an interest in the partnership. If the partnership induced or aided this breach, it should not be allowed to recover the full amount of the claims.[207]

The other Arkansas decision involving a director's purchase of claims against the corporation is *Mothershead v. Douglas*.[208] The plaintiff, a shareholder in the corporation, alleged that directors of the corporation had purchased a $45,000 mortgage on corporate property for $15,000. The property was sold at a foreclosure sale for $42,500. The court held that the directors were trustees and that their fiduciary obligation required that they exercise the "utmost good faith to these shareholders who elected them. They could not,

203. *Id.* at 557, 197 S.W. at 1165.
204. *Id.* at 560, 197 S.W. at 1165.
205. *Id.* at 560, 197 S.W. at 1165-66.
206. *Id.* at 559-60, 197 S.W. at 1165.
207. *See* Raines v. Toney, 228 Ark. 1170, 313 S.W.2d 802 (1958), in which a defendant was held liable for aiding and abetting the breach of a corporate fiduciary duty.
208. 215 Ark. 519, 221 S.W.2d 424 (1949).

therefore, take advantage of the company's insolvent condition to purchase claims against it for their own personal benefit, contrary to the trust imposed upon them."[209] The directors were allowed to recover from the corporation only the amounts they spent for the purchase of the mortgage.

These Arkansas decisions make clear that when the corporation is insolvent, a director may not purchase its debts at a discount and personally profit by recovering from the corporation their full amount. There are no Arkansas cases concerning purchase of debts of a solvent corporation. However, even with a solvent corporation, a director's duty of loyalty should prohibit his purchase of corporate debts at a discount without first offering this opportunity to the corporation.[210] It should make no difference whether he has been charged with the duty of compromising debts for the corporation. The Pennsylvania decision in *Weissman v. A. Weissman, Inc.*[211] held that a director and officer who purchased at a discount a mortgage on corporate property could recover from the corporation only what he had paid. There was no indication that the corporation was insolvent:

> An officer of a corporation does not have the right to make acquisitions for his own account which are essential or would be advantageous to the corporation. And, when such acquisitions are made, even with the officer's own money, they are subject to a constructive trust for the benefit of the corporation.[212]

Adoption of the *Weissman* approach would not only insure that corporations are given the opportunity to purchase debts at a discount, but it would further remove directors from the temptation to manage and manipulate the affairs of a corporation in such a fashion that corporate creditors are willing to sell their claims at a discount.

CONCLUSION

The Arkansas standards governing interested directors' contracts are consistent in that they enunciate the rule that such contracts are only voidable and will be upheld if they are fair to the corporation. Old cases on contracts for compensation of directors,

209. *Id.* at 521, 221 S.W.2d at 425-26.

210. This is analogous to a corporate business opportunity, which should be offered to the corporation before the corporate fiduciary takes personal advantage of it.

211. 374 Pa. 470, 97 A.2d 870 (1953).

212. *Id.* at 474, 97 A.2d at 872.

which are now overruled by statute, should not survive as precedent to void non-compensation contracts regardless of fairness.

The Arkansas courts have had only a few opportunities to discuss the elements of fairness, but because "fairness" defies simple definition it is probably advisable for the courts to continue their case by case analysis without adopting a rigid fairness test. Unfortunately, the Arkansas Supreme Court has cited cases in which the plaintiff was a corporation or a shareholder as precedent for cases in which the plaintiff was a creditor, and vice versa. Fairness to the corporation is not to be equated with fairness to a creditor. In addition, the rules governing burden of proof on fairness depend upon whether the plaintiff is the corporation or a shareholder, on the one hand, or a creditor, on the other. Certainly burden of proof on fairness can be a crucial factor when fairness is difficult to evaluate.

The doctrine of corporate opportunity in Arkansas has not yet developed beyond recognition of the "interest or expectancy" test. But the Arkansas Supreme Court appears to have recognized fairness as a consideration in determining liability for usurpation of a corporate opportunity. As for the purchase of claims against the corporation, the Arkansas courts have not decided a case in which the corporation was solvent. Because of the lack of burdensome precedent in the corporate opportunity area, the courts in Arkansas should be extremely careful in outlining the standards applicable in the appropriate decisions. Until then, counsel must look to other jurisdictions for guidance.