Comment

CORPORATIONS: THE DOCTRINE OF CORPORATE OPPORTUNITIES

When do directors misappropriate corporate opportunities for personal gain? The doctrine of "corporate opportunity" is one phase of the rule of undivided loyalty on the part of corporate fiduciaries. The rule against diversion of corporate opportunities by directors and officers is stated in an important New York case as follows: "One who occupies a fiduciary relation to a corporation may not acquire, in opposition to the corporation, property in which the corporation has an interest or tangible expectancy or which is essential to its existence."

Officers and directors are frequently held accountable to the corporation where they have taken advantage of a business opportunity which should have been offered first to the corporation. Where the opportunity is essential to the existence of the corporation the fiduciary duty is apparent. But courts are reluctant to apply the doctrine where the opportunity does not have a close and peculiar relationship to immediate corporate interests and needs. Here it is safer to rely

2 BALLANTINE, CORPORATIONS (1927) § 122a.
3 Carper v. Frost Oil Co. (1922) 72 Colo. 345, 211 Pac. 370; Lancaster Loose Leaf Tobacco Co. v. Robinson (1923) 199 Ky. 313, 250 S. W. 997; McDermott Mining Co. v. McDermott (1903) 27 Mont. 143, 69 Pac. 715; Litwin v. Allen (1940) 25 N. Y. S.
upon the particular circumstances of a case than upon abstract principles or general language used in the decisions.\(^4\)

The factors to be considered in determining what is properly a corporate opportunity and when a corporate representative violates his fiduciary duty are as follows: (1) Is the opportunity to acquire real estate, patents, etc., of special and unique value, or needed for the corporate business and its expansion? (2) Did the discovery or information come to the officer by reason of his official position? (3) Was the company in the market, negotiating for or seeking such an opportunity or advantage and if so, has it abandoned its efforts in this regard? (4) Was the officer especially charged with the duty of acquiring such opportunities for his enterprise? (5) Did he utilize corporate funds or facilities in acquiring or developing it? (6) Does taking the opportunity place the director in an adverse and hostile position to his corporation? Did he intend to resell to the corporation? (7) Was the corporation in a favorable position to take advantage of the opportunity or was it financially or otherwise unable to do so? Factors such as these must be weighed and balanced, but it is not possible for the most part to lay down any hard and fast rules as to their effect and various results are reached.\(^5\)

No problem is presented where a director has taken for himself a venture which he was expressly authorized to acquire or develop for his company. Under the principles of agency he would be compelled to account for the profits.\(^6\) The difficulty arises where the project is "potentially profitable" to the company but the only basis for imposing liability is that the opportunity relates to the general scope of the corporate business. \textit{Colorado & Utah Coal Co. v. Harris},\(^7\) for example, rejected the contention that an opportunity existed which properly belonged to the corporation and should have been held in trust for it where its president acquired coal lands in an area where it had already been negotiating for tracts.

A different result should obtain, however, where the opportunity is more than "potentially profitable" to the company. This is clearly the situation where the director takes a lease or purchases the reversion on property currently rented and occupied by his company.


\(^5\) "Just when this fiduciary relationship ends and personal rights attach in ordinary business dealings is sometimes difficult of definition. . . . No hard and fast rule can be laid down as to the line of demarcation." Young v. Columbia Oil Co. (1931) 110 W. Va. 364, 371, 158 S. E. 678, 681.

\(^6\) \textit{MECHEN, AGENCY} (2d ed. 1914) § 1224.

\(^7\) (1935) 97 Colo. 309, 49 P. (2d) 429.
There the courts impose a constructive trust on the interest acquired by the director or officer and require him to account for the profits, on the ground that the corporation has an "interest or expectancy" in the renewal of the existing lease of the premises involved. Although the result is unquestioned, particular objection has been made to the use of "expectancy" or "property right" as a test, when in fact the term is employed "as a label or device to reach a desired conclusion rather than as a reason compelling that conclusion." In *News-Journal Corporation v. Gore* a corporate officer purchased the tract of land on which the building occupied by the corporation was located and proceeded to charge increased rent for its use. He also acquired a vacant lot adjoining the premises, and used for entrance thereto, for purposes of leasing it to his company. Since both tracts were vital in carrying out the business of the corporation, which could have financed their purchase, the court properly impressed a trust in its favor as to both, although it could scarcely be said that it had an "expectancy" as to the vacant lot which it had been using without the permission of the owner.

The same fundamental considerations reappear in balancing the director's duty to the corporation and his right as an individual to serve his own interests where he has acquired patents or other rights necessary or important to the future conduct of the business. In *Farwell v. Pyle-National Electric Headlight Co.*, a frequently cited case of this character, it was held the directors were not entitled to profit from the private purchase of the royalty rights in certain patented articles which their corporation was manufacturing and selling under a license agreement. The directors were not permitted to obtain any payments in excess of the purchase price of these royalty rights because they had made this acquisition for personal benefit without disclosure of the business opportunity when the corporation was financially able to take advantage of it. In the absence of a continuing relation between the corporation and the previous owner

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9 Fuller, *Restrictions Imposed by the Directorship Status on the Personal Business Activities of Directors* (1941) 26 Wash. U. L. Q. 189, 192. When the court has decided not to impose a trust or require an accounting for profits, it has simply announced that the plaintiff had no expectancy or interest. Tierney v. United Pocahontas Coal Co., supra note 3; Lawrence v. Sutton-Zwolle Oil Co. (1939) 193 La. 117, 190 So. 351; Lincoln Stores Inc. v. Grant, supra note 1.

10 (1941) 147 Fla. 217, 2 So. (2d) 741.

11 (1919) 289 Ill. 157, 124 N. E. 449.

12 The presence of financial ability without more would not be sufficient to warrant the imposition of a duty to offer the opportunity to the corporation before an officer or director could take it for himself, although its absence probably should serve as a defense. See discussion, infra.
of the patents in question, as the license agreement in the Farwell case, or some special circumstance such as the use of corporate funds for the purchase, it is not certain whether the subject matter of the action must be essential to the continuance of the business, or only "extremely advantageous."

If the latter position is adopted, should the further step be taken that any opportunity to expand or increase the present business must be turned over to the corporation? In Guth v. Loft Inc., a retailer which marketed soft drinks and candies of its own manufacture was seeking a cola syrup which would be less expensive than the one it was currently purchasing. Its president personally acquired the Pepsi-Cola formula and with the aid of funds and facilities of Loft Inc. created the prosperous Pepsi-Cola enterprise as a separate corporation. The opportunity was deemed so essentially related to the line of business of the corporation that the officer had no right to acquire it for himself. In view of the discussion in the opinion, it is not an unreasonable conclusion that the same result would have been reached even though the corporate facilities had not been used to develop the enterprise.

Not all courts, however, are willing to impose a duty in similar situations. An unduly lax judicial attitude which is sometimes taken where a desirable projected acquisition is cut off is illustrated by Lagarde v. Anniston Lime & Stone Co. There directors and officers were allowed to retain the benefits of the purchase for themselves of an outstanding one-third interest from M in a quarry, in which the company already owned one-third. Their information was gained by their official position. The fact that the company was the lessee of another interest in the same property under contract and lease from C and that prior negotiations had taken place for the outstanding

13 Irving Trust Co. v. Deutsch (C.C.A. 2d, 1934) 73 F. (2d) 121.
14 "Both because defendant made profits from his personal use of the corporate funds, and because the patents and patent rights purchased by him were highly desirable for the . . . Company's purposes, he must account accordingly." Bailey v. Jacobs (1937) 325 Pa. 187, 194, 189 Atl. 320, 325.
16 (Del. 1939) 5 A. (2d) 503.
17 "The real issue is whether the opportunity to secure a very substantial stock interest in a corporation to be formed for the purpose of exploiting a cola beverage on a wholesale scale was so closely associated with the existing business activities of Loft, and so essential thereto, as to bring the transaction within that class of cases where the acquisition of the property would throw the corporate officer purchasing it into competition with his company. . . ." Ibid. at 513.
18 (1899) 126 Ala. 496, 28 So. 199.
19 The court held that the officers were liable for breach of duty as to the purchase of the reversion of the land of C already held by the company under lease.
interest of M, indicates that this opportunity was important to the corporation. Attempts to solve this phase of the corporate opportunity situation on the theory of "expectancy" ignore the real basis for decision. This involves an analysis of the circumstances of each case to determine whether the opportunity is so closely connected with the corporate business and prospects that it should fairly be deemed to belong to the enterprise carried on by the company.20

The failure by a court to recognize this underlying principle leads to judicial sanction of types of destructive competition which are inconsistent with the fiduciary status of the management. The statement is often made that a director or officer is not precluded from engaging in distinct enterprises of the same general class of business as that which his corporation is engaged in, so long as he acts in good faith.21 But just what is meant by competition in good faith? Certainly an officer cannot be said to enter bona fide into a competing enterprise which cripples or injures the business of the corporation of which he is an officer.22 A distinction has been made between major industries where the demand exceeds the supply,23 and a highly competitive enterprise within a relatively restricted area in which any successful competition is bound to result in consequent decrease in business.24 The importance which the element of harm to the existing business plays in this connection25 is illustrated by the fact that no

21 Lincoln Stores v. Grant, supra note 1; Greer v. Stannard (1929) 85 Mont. 78, 277 Pac. 622; New York Automobile Co. v. Franklin (1905) 49 Misc. 8, 97 N.Y.S. 781. See also Bump Pump Co. v. Waukesha Foundry Co. (1941) 238 Wis. 643, 300 N.W. 500. This discussion is not concerned with the situation where the right to engage in a competing business is reserved by agreement. Anderson v. Dunneigan (1933) 217 Iowa 672, 250 N.W. 115.
24 Red Top Cab Co. v. Hanchett (N.D. Cal. 1931) 48 F. (2d) 236.
25 There may be other grounds for preventing economic harm to the corporation in addition to the directorship status of the defendant, as in the case of "unfair competition". Hall v. Dekker, supra note 22, (customers' list obtained by director and officer of plaintiff company who organized and helped to finance a directly competing company); Red Top Cab Co. v. Hanchett, supra note 24 (similar name given to new company by president of taxi company who diverted employees and customers from the latter).

Where such "unfair competition" exists the court will grant relief, even though the officer or director had terminated his connection with the corporation. Dodge Stationery Co. v. Dodge (1904) 145 Cal. 380, 78 Pac. 879, involving situation where a similar name was used in an effort to mislead customers of old corporation by former official who formed a new company with a store in the same block; Southwest Pump & Machinery Co. v. Forslund, supra note 15, where customers' lists were taken from files by president and general manager of corporation who thereupon resigned.
restriction is imposed upon the director to organize or affiliate with a competing company where his corporation fails to engage in business because of inability to raise the required capital at the outset or where it later becomes insolvent. A qualification to the criterion of harm due to the competition engaged in by an officer or director against his company, should be made where he uses knowledge which he has obtained in the course of the corporate business. In *Louisiana Mortgage Company v. Pickens*, the director was required to account to the corporation for profits derived from disclosing information concerning corporate assets to a judgment creditor of the company, notwithstanding the fact that no injury was suffered since the director could have been compelled to give such information by supplementary proceedings. The more usual rule, however, is one where the use of knowledge of corporate affairs by an officer for his personal profit results in material detriment.

Although a business opportunity may arise, it cannot be said that this is a true corporate opportunity if because of various conditions the company is not in a position to take advantage of it. Under these circumstances it is generally held that a director or officer may take up the venture in his own behalf. Accordingly where the third party refuses to deal with the corporation the director is free to negotiate with him in his individual capacity. However, collusion between the director and a third party resulting in the refusal of the latter to do business with the company should be sufficient reason for holding the director accountable. If the project is deemed inadvisable or unsound as a matter of policy by the management, the rejection is a complete defense in an action against an officer. Where the enterprise is not within the purposes authorized by the articles, or if there is a dis-

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21 Murray v. Vanderbilt (N.Y., 1863) 39 Barb. 140. See Columbus Outdoor Advertising Co. v. Harris (C.C.A. 6th, 1942) 127 F. (2d) 38, where a purchase of stock in a competing corporation by a president and director was justified on the ground, *inter alia*, of the inability of the company to purchase said stock through lack of funds.
22 (La. App., 1938) 182 So. 385.
23 Nebraska Power Co. v. Koeng (1913) 93 Neb. 68, 139 N.W. 839; Southwest Pump & Machinery Co. v. Forslund, *supra* note 15; *Fuller, op. cit., supra* note 9, at 193.
24 In Pioneer Oil & Gas Co. v. Anderson (1933) 168 Miss. 334, 151 So. 161, the following conditions were held to constitute a defense in an action to compel a director to convey a fractional interest in a lease which he had acquired for himself: 1) financial inability of the company; 2) unwillingness of the third party to deal with it; 3) inadvisability of the venture.
tinct legal disability, the corporation is not permitted to object. There is a general recognition of the principle that insolvency of the corporation constitutes a defense. But it has been held that, although the company has been adjudicated bankrupt, a director may not renew a lease for his own interest on the ground that the expectation of a renewal is an interest valuable to the assignee in bankruptcy. The question is raised, however, whether financial inability short of insolvency is a sufficient basis to allow participation by an officer in his own behalf. While there is strong authority for the proposition that such inability will operate as a defense, the court in Irving Trust Co. v. Deutsch adopted a prophylactic view, holding corporate officers accountable even though the company was financially unable to undertake a business opportunity. There the corporation had an option to purchase stock in another company, the exercise of which would entitle it to the use of certain essential patents. Its president reported to the board of directors that the corporation was unable to obtain funds to exercise the option. Whereupon a syndicate, consisting of the president and two directors, acquired the stock, which was resold resulting in large individual gains. Although the result appears to be a harsh one in view of the apparent inability of the company to obtain funds, on the other hand it would be dangerous to permit officers in every case to appropriate a profitable venture on a mere showing of inability. Directors

34 An unusual result was reached in Young v. Columbia Oil Co., supra note 5, where a legal disability of the corporation was involved. The company could not acquire patents on three 160-acre tracts of oil lands because each "person" was limited to an entry of twenty acres only. Thereupon the directorate formed a partnership, entered the lands, and upon discovery of oil formed another corporation, resulting in large individual gains. It was held that, although the directors were not accountable to the company, they violated their duty to the shareholders in their failure to allow the latter to participate in the venture. This conclusion is indeed questionable.

35 Jasper v. Appalachian Gas Co. (1913) 152 Ky. 68, 153 S.W. 50; Murray v. Vanderbilt, supra note 27.

36 Pike's Peak Co. v. Pfuntner, supra note 8.


38 Irving Trust Co. v. Deutsch, supra note 13. In a recent House of Lords case, Regal (Hastings) Ltd. v. Gulliver [1942] 1 All E. R. 378, noted (1942) 58 L. Q. Rev. 434, a company brought an action against several of its former directors for an accounting of profits realized upon the acquisition and sale of shares in a subsidiary. The acquisition was made by the directors in good faith. The company was financially unable to acquire the entire issue so the directors purchased a portion on their own account. A harsh view was taken by the House of Lords, reversing the court of appeal, holding that the directors purchased the shares by use of a fiduciary position. It was not necessary for the company to show that it was a corporate opportunity or that it was possible for the company to obtain it.

39 The term "apparent inability" is used since Deutsch owed his company $125,000 and no attempt had been made to realize on the collateral.
and officers should be required to use a high degree of diligence to obtain sufficient funds to promote an essential enterprise; otherwise they may be tempted too often to abandon the opportunity needlessly to their own exploitation.

Under the prevailing rule a director may ordinarily enter into any contract with the company, provided that the transaction is fair and has been approved by a disinterested majority of the board of directors or by the shareholders. In California a showing of fairness is the only limitation even if the director actually participates in authorizing the contract. If these requirements are not satisfied the corporation may elect to rescind. But a further complication is added where the contract is for sale of property to the corporation which the director acquired for the purpose of such resale. While its purchase of property might be rescinded if the company so elects, can it retain the property and still compel the director to account for the profits from the transaction? This issue was raised in the Canadian case of *Burland v. Earle*, appealed to the Privy Council. The president and manager was allowed to retain a profit of approximately two hundred per cent in the sale of a plant which he acquired for the express purpose of immediate resale to his company. In *New York Trust Company v. American Realty Company*, the court reached a contrary result, declaring that if a director purchased property in contemplation of resale at a time when it was his duty to act only for it, he can be held to account for all his profit even though the company does not elect to rescind its purchase and the price to it was fair. It was further indicated that a different result would obtain where the property involved might have been retained or sold to a stranger. This view is supported by considerable authority. Its justification lies chiefly on the ground that if such activity were permitted corporate officers "... would be continually subjected to the unwholesome temptation of stifling beneficial managerial suggestions until they were in a position to benefit personally from them." The contention has been made, however, that the rule followed in *Burland v.*

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40 Ballantine, loc. cit. supra note 2; Notes (1941) 29 Calif. L. Rev. 480; (1942) ibid. 193.
42 (1902) App. Cas. 83.
43 (1926) 244 N. Y. 209, 155 N. E. 102.
44 Bliss Petr. Co. v. McNally (1931) 254 Mich. 569, 237 N.W. 53; Golden Rod Mining Co. v. Burvich (1939) 103 Mont. 569, 92 P. (2d) 316; Hauben v. Morris (1938) 255 App. Div. 35, 5 N.Y.S. (2d) 721 (seller would not have been willing to sell to the corporation and it would have been impossible or improvident for the corporation to purchase for itself at that time); Jno. Dunlap's Sons, Inc. v. Dunlap (1939) 172 Misc. 66, 14 N.Y.S. (2d) 452. Cf. Highland Park Inv. Co. v. List (1915) 27 Cal. App. 761, 151 Pac. 162.
45 Fuller, op. cit. supra note 9, at 207.
Earle is not an unreasonable one, because in any event the corporation may rescind if the sale is unfair. Although the argument may have some plausibility, it fails to take cognizance of the requirement of loyalty under circumstances where it is most essential. If a director upon information gained through his official position acquires property with a view to resale, his act constitutes a frank admission of the needs of the company. The desirability of meeting future requirements by the acquisition of such property makes rescission an inadequate remedy. But, if the company elects not to rescind, the company must pay its officer an additional compensation when in the first instance his duty was to act for it.

A similar conflict arises between the duty of the management of a corporation in connection with discharge of its obligations to third persons, and the personal interest of individual officers or directors in purchasing corporate claims at a discount. An early California case, *Davis v. Rock Creek L. F. & M. Co.*, makes the statement that officers and directors are subject to the principles of equity applicable to trustees in that they are absolutely prohibited from purchasing corporate obligations at a discount and collecting the face value from their corporation. Many of the cases which hold that a director or officer purchasing claims against the corporation at a discount may not enforce the obligation for more than the purchase price, lay stress upon the insolvency of the corporation at the time of acquisition, so that no doubt existed as to the necessity of selling outstanding claims even where they had not matured. If a director or officer purchases the obligations of his corporation actually undergoing reorganization, it has been stated that he should be held to strict account regardless of his good intentions and regardless of the legal or financial inability of the debtor corporation to buy those obligations. Apparently the financial condition of the company must hover between solvency and insolvency to serve as a defense. If it is to the interest of the corporation to buy its bonds or other obligations at a discount, and it is financially able to do so, a director will not be permitted to buy those

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46 Highland Park Inv. Co. v. List, *supra* note 44.
47 (1880) 55 Cal. 359, 364.
48 See also Duncomb v. New York, H. & N. R. Co. (1881) 84 N. Y. 190, 202.
claims and enforce payment in full against the corporation.\textsuperscript{51} The special status of the director does not appear to warrant the application of the strict trust law indicated in \textit{Davis v. Rock Creek L. F. \& M. Co.}, and the better rule is where the corporation is solvent, and no special equities against such a purchase or present duty to acquire the corporate debts or securities exist,\textsuperscript{62} a director or officer acting in good faith may buy liquidated corporate obligations from third parties and enforce them at par.\textsuperscript{53}

The restrictions upon the freedom of a director or officer to buy up claims against the corporation at a discount possess a counterpart in the restrictions imposed upon his freedom to accept profits or other compensation in consideration of his using official influence to assist third persons in acquiring the corporate property.\textsuperscript{54} The same result will obtain whether directors sell shares previously owned or subsequently acquired by them for the purpose at a premium as an indirect method of transferring the control of corporate assets,\textsuperscript{63} or sell the assets themselves.

Apart from the transfer of corporate property to third persons with a consequent personal benefit to the management, a director or officer is held accountable where he receives profits or commissions as consideration for exercising his power of management in favor of those seeking to do business with the company. Some courts speak of


\textsuperscript{54} Elggren v. Wooley (1924) 64 Utah 183, 228 Pac. 906, where a contract between a director of an insolvent corporation and a third person by which the latter was to reimburse the former on account of his investment in the corporation in consideration of his using his official influence to have corporate property transferred to the third party was held unenforceable as against public policy.

\textsuperscript{55} Levy v. Feinberg (1941) 29 N.Y.S. (2d) 550 (president and director of a corporation of which he was also the majority stockholder compelled to account for profits from secret sale of his stock at a premium of three times the market value when this transfer of control allowed purchaser to loot corporate assets); Commonwealth Title Ins. & Trust Co. v. Seltzer (1910) 227 Pa. 410, 76 Atl. 77 (constructive trust imposed on profits realized by sale of corporate stock to party originally intending to purchase the assets of the corporation, for the benefit of the old stockholders whose shares had been acquired for the purpose below the sale price, rather than for the benefit of the corporation which was then in the hands of the purchaser).
the gains paid to the officer or director as being part of the consid-er-
tation which is owed to the corporation under the contract with the
third party.\(^5^6\) This does not seem to be an accurate statement nor
will it serve to explain many of the cases of this type.\(^5^7\)

A rather strict view was taken by the court in Blum v. Fleish-
hacker\(^5^8\) where the president and director of a national bank who
recommended that it make a loan to individuals desiring to bid for
the purchase of surplus steel from the United States government and
in turn received one-half of the stock of a corporation organized to
conduct the venture without making any investment of his own was
held accountable for his share of the profits realized from the sale of
the steel purchased. The loan had been approved by the finance
committee of the bank largely on the strength of the president's
recommendation, but there had been nothing unfair about its terms,
and gain rather than injury resulted to the bank. The absence of
harm together with the fact that the president might have been able
to borrow the money from the bank personally and loan it to the
individuals,\(^5^9\) did not alter the opinion of the court that the defendant
had violated his "trust" to the bank and its stockholders. Neither
was it influenced by the argument of counsel that the profits were not
recoverable from an officer where, as here, the line of endeavor in
which the money was made was \textit{ultra vires}, that is, beyond the pur-
poses of the corporation.\(^6^0\)

It is not surprising that this problem of inequitable profits is the

\(^{56}\)Risvold v. Gustafson (1941) 209 Minn. 357, 296 N.W. 411. There the officers and
directors received a "commission" of 4/24ths interest in connection with the sale to their
own corporation of a 16/24ths interest in an option on gold mining property. The court
said the corporation was entitled to the benefit of the entire 20/24ths, because the
officers' share was in fact purchased with the money of the corporation. See also
Rowland v. Kable (1940) 174 Va. 343, 6 S.E.(2d) 633, where the director of a corpora-
tion owning a military academy was required to account for "commissions" paid to the
president of a corporation to induce purchase of uniforms from the director, although
the school admittedly resold the uniforms to the students at a profit notwithstanding the
price charged to it by the director.

\(^{57}\)In Western States Life Insurance Co. v. Lockwood (1913) 166 Cal. 185, 135 Pac.
496, for example, a newly organized insurance corporation employed a firm to sell its
stock at a fixed net price. Thereafter the president of such company made a contract
by which he was to receive a percentage of the net profits realized from sales in excess
of the fixed price. It was held that he could be compelled to account for the profits
received because the contract was said to place him in a position which was antagonistic
to his duty to the prospective shareholders.

\(^{58}\) (N.D. Calif., 1937) 21 Fed. Supp. 527, citing Farmers Loan & Trust Co. v.
Downey (1879) 53 Cal. 466, 31 Am. Rep. 62.

\(^{59}\)This was in 1919 before the 1933 Congressional amendment to the National
Banking Act which prohibited loans to executive officers of a bank. 48 Stat. 182, 12

\(^{60}\)See Blackburn's Administrator v. Union Bank & Trust Co. (1937) 269 Ky. 699,
108 S.W.(2d) 806, where the president of a bank personally charged borrowers a fee in