CHAPTER FIVE

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Section 5.01 Generally

Generally, each corporation has a board of directors which possesses full power and authority to manage the corporation. RCW 23B.08.010(1) & (2).

> **NOTE:** Washington does not require that every corporation have a board of directors. The articles of incorporation may dispense with the board of directors by describing who will perform all of the duties normally performed by the board of directors. RCW 23B.08.010(3). Likewise, the shareholders of a non-public corporation may enter into an agreement pursuant to RCW 23B.07.320 to eliminate the board of directors and otherwise change many of the fundamental rules which normally would govern a corporation. *See:* Section 4.07 of this book. However since these options are seldom exercised, nearly every corporation has a board of directors.

"The board of directors of a corporation represents the corporate body, and the directors are entrusted with authority to conduct and manage the corporate affairs." *Mease v. Warm Mineral Springs, Inc.*, 128 So2d 174, 179 (Fla 2d DCA), *cert denied*, 132 So2d 291 (Fla 1961). The "general business" of a corporation is "under the control and management of a board of directors. Under this statute the directors have full authority to act for the corporation, and represent it in all matters related to corporate business." (citation omitted) *Crowe v. Gary State Bank*, 123 F2d 513, 516 (7th Cir 1941).

Although the shareholders "own" the corporation, normally their power to manage the corporation is extremely limited. Their management

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power is generally limited to electing directors and voting on certain extraordinary events, such as mergers, dissolutions, the sale of all corporate assets, and the like. The shareholders may not assert direct management authority over a corporation which they own, even if a majority of shareholders so vote. *Kelly v. Galloway*, 156 Or 301, 66 P2d 272, 68 P2d 474 (1937). Shareholders "have no direct power to manage the affairs of the corporation" and "must function through the board of directors." *Lycette v. Green River Gorge, Inc.*, 21 Wash 2d 859, 862, 153 P2d 873, 875 (1944).

***A. Collective power, not individual power*.**

The power possessed by directors is collective, not individual. A corporate board of director may only act by collectively deliberating and acting. *Twisp Mining & Smelting Co. v. Chelan Mining Co.*, 16 Wash 2d 264, 133 P2d 300 (1943), *cert denied*, 320 US 705, *cert denied*, 320 US 716 (1944), *cert denied*, 325 US 837 (1945). A director "exercises his corporate office only through the collective action of the Board of which he is a member." *Georgia Casualty and Surety Co. v. Seaboard Surety Co.*, 210 F Supp 644, 651 (ND Ga 1962), *affirmed*, 327 F2d 666 (5th Cir 1964). "The directors were wholly without authority to act in a representative capacity except as a board of directors." *Flick v. Jordan*, 74 Ind App 314, 319, 129 NE 42, 44 (1920). "[A] member of the board of directors, acting as such, cannot legally contract for the corporation." *Beall v. Pacific National Bank of Seattle*, 55 Wash 2d 210, 212, 347 P2d 550, 551 (1959).

> The law believes that the greatest wisdom results from conference and exchange of individual views, and it is for that reason that the law requires the united wisdom of a majority of the several members of the board in determining the business of a corporation. *Ames v. Goldfield Merger Mines Co.*, 227 F 292, 301-2 (WD Wa 1915).

See also: Fradkin v. Ernst, 571 F Supp 829 (ND Ohio 1983); *Delaney v. Georgia-Pacific Corp.*, 278 Or 305, 564 P2d 277, *supplemented*, 279 Or 653, 569 P2d 604 (1977), *appeal after remand*, 42 Or App 439, 601 P2d 475 (1979).

***B. Directors are not corporate agents*.**

The proper function of the board of directors is to deliberate and decide; the board of directors does not itself act to implement these decisions. Corporate officers and agents implement the decision of the board of directors.

NOTE: The proper form for a board of director resolution sets out the board's decision and then authorizes corporate agents to

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implement that decision. For example:

> RESOLVED, that the corporation enter into a lease agreement with Smith and that the president is authorized to execute such lease agreement on behalf of the corporation.

The role of a board of directors is that of policy maker. An individual director has little power beyond that of deliberating, persuading and, ultimately, casting a vote on board decisions. *Farrar v. Pesterfield*, 216 Ga 311, 116 SE2d 229 (1960). Once a board of directors sets a policy, that policy is then implemented by the corporation's officers, employees, and other agents, not by the board itself or by an individual member of the board.

Individual directors have no inherent right to act on behalf of the corporation since a corporation acts through its officers, employees and agents, generally not through individual directors. "[A] member of the board of directors, acting as such, cannot legally contract for the corporation. *Beall v. Pacific National Bank of Seattle*, 55 Wash 2d 210, 212, 347 P2d 550, 551 (1959). *See also: Twisp Mining & Smelting Co. v. Chelan Mining Co.*, 16 Wash 2d 264, 133 P2d 300 (1943), *cert denied*, 320 US 705, *cert denied*, 320 US 716 (1944), *cert denied*, 325 US 837 (1945).

Although unusual, a corporation may confer actual authority upon a director to act individually as a corporate agent. *United States v. Everett Monte Cristo Hotel, Inc.*, 524 F2d 127 (9th Cir 1975).

> **NOTE:** Some of the issues discussed in this Chapter do not necessarily apply to corporations which have dispensed with or limited the authority of its board of directors pursuant to RCW 23B.08.010(3) or in which the shareholders have entered into an agreement to eliminate or restrict the power of the board of directors pursuant to RCW 23B.07.320. Shareholder agreement pursuant to RCW 23B.07.320 are discussed in Section 4.07 of this book.

Section 5.02 Number and Qualification

A. Size of board of directors.

A Washington corporation may have any number of directors, including only one director. RCW 23B.08.030(1). This was not always true.

A board of directors is a body where *collective* decision-making occurs. *Ames v. Goldfield Merger Mines Co.*, 227 F 292, 301-2 (WD Wa

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1915). "Collective" implies more than one. Previously Washington, and most other states, required that a board consist of at least three individuals.

To prevent deadlock, an odd number of directors is recommended, but not required. In the event of a deadlock, the status quo generally prevails. *Jackson v. Nicolai-Neppach Co.*, 219 Or 560, 348 P2d 9 (1959). For instance, in the event of deadlock, the person last appointed president would likely remain president indefinitely. Deadlock is one ground for the judicial dissolution of a corporation. RCW 23.14.300(2)(a). A court's power to dissolve a corporation in the event of deadlock is discretionary. Courts are reluctant to dissolve corporations. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *Baker v. Commercial Body Builders, Inc.*, 264 Or 614, 507 P2d 387 (1973). *See:* Sections 7.12 and 12.06 of this book.

The number of directors may be specified in, or fixed in accordance with, either the articles of incorporation or the bylaws. RCW 23B.08.030(1). Since a corporation may wish to vary the number of directors from time to time, and since the bylaws may be amended much more easily than may the articles of incorporation, it is common practice to specify the number of directors in the bylaws.

***B. Qualifications*.**

At one time, director qualifications were common. Statutes often required directors to be shareholders and/or to be a resident of the state of incorporation. *Moore v. Los Lugos Gold Mine*, 172 Wash 570, 21 P2d 253 (1933); *Tefft v. Schaefer*, 148 Wash 602, 269 P 1048 (1928); *Silsby v. Strong*, 38 Or 36, 62 P 633 (1900); *Annotation*, 30 ALR 248; *Annotation*, 130 ALR 156. For instance, Washington once required that at least one director be a Washington resident and that a majority of the directors be a citizen of the United States. *Hastings v. Anacordes Packing Co.*, 29 Wash 224, 69 P 776 (1902).

Washington law long ago eliminated most qualification requirements. Today, a director must be an "individual," not another corporation or other entity. RCW 23B.08.030(1). Otherwise, the Washington Business Corporation Act contains no qualifications for directors. In fact, the Act specifically states that directors need not be shareholders or residents of Washington. RCW 23B.02.020(4)(c) and RCW 23B.08.020. Although some state statutes specifically mention an age requirement, Washington's Act is silent on this issue.

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Even though Washington law imposes no qualifications on directors, a corporation may do so by including director qualifications in its articles of incorporation or in its bylaws. RCW 23B.08.020.

The shareholders are prohibited from electing a director who does not qualify to be a director. If a statute, the articles of incorporation or the bylaws impose a director qualification, and if a person elected as a director does not meet that qualification, the election of the non-qualifying director is void. *Silsby v. Strong*, 38 Or 36, 62 P 633 (1900). When a qualification requirement appears in a statute, in the articles of incorporation or in the bylaws, and when a director stops meeting that qualification requirement, that person immediately ceases to be a director. *Oudin & Bergman Fire Clay Min. & Mfg. Co. v. Conlan*, 34 Wash 216, 75 P 798 (1904); *Smith v. Great Basin Grain Co.*, 98 Idaho 266, 561 P2d 1299, 1311 (1977); *In re Andrews*, 265 Mich 661, 252 NW 482 (1934).

Section 5.03 Election & Term

A. Election.

A corporation's initial board of directors may either: (i) be named in the articles of incorporation, or (ii) be elected by the incorporator(s). RCW 23B.02.020(5)(a) and RCW 23B.02.050(1).

Once the organizational meeting has occurred and subscriptions for shares accepted, shareholders elect directors at the first annual meeting and at each annual meeting thereafter. RCW 23B.08.030(2). "The right to participate in the election of the governing board of a corporation is one of the most important rights incident to stock ownership." *State ex rel Lidral v. Superior Court*, 198 Wash 610, 615, 89 P2d 501, 503 (1939). *See also: State ex rel Swanson v. Perham*, 30 Wash 2d 368, 191 P2d 689 (1948); *Hinckley v. Swaner*, 13 Utah 2d 93, 368 P2d 709 (1962).

Unless the articles of incorporation provide otherwise, "[d]irectors are elected by a plurality of the votes cast by shares entitled to vote." RCW 23B.02.020(3)(x).

Unless the articles of incorporation provide otherwise, directors are elected by cumulative voting under RCW 23B.07.250. RCW 23B.02.020(3)(w).

The board of directors can establish procedures governing the counting of votes, such as a provision to recount the ballots at the conclusion of the shareholder meeting. *Grip v. Buffelen Woodworking Co.*, 73 Wash 2d 219, 437 P2d 915 (1968).

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***B. Term*.**

The terms of the initial directors "expire at the first shareholders' meeting at which directors are elected." RCW 23B.08.050(1). RCW 23B.08.030(2) provides that this is to occur no later that the first annual meeting. The election need not occur at the first meeting of shareholders, only at the first meeting of shareholders at which there is an election of directors or at the first annual meeting, whichever occurs first.

Thereafter, directors are to be elected at each annual meeting of shareholders and hold office until the next annual meeting of shareholders. RCW 23B.08.050(2). Exceptions exist in the case of vacancies or in the case where directors are elected to staggered terms. Both exceptions are discussed below.

Despite the expiration of a director's term, the director continues to serve until a successor is elected. RCW 23B.08.050(5). Thus, in the event of shareholder deadlock, or in the event that the annual shareholder meeting is not held as required, the existing directors continue to serve indefinitely. *Levine v. Beem*, 608 So2d 373 (Ala 1992); *Jackson v. Nicolai-Neppach Co.*, 219 Or 560, 348 P2d 9 (1959); *State ex rel Brewster v. Ostrander*, 212 Or 177, 318 P2d 284 (1957).

If an election of new directors is held to be invalid, the prior directors are deemed to have continued in office. *Blue Ridge Property Owners Association, Inc. v. Miller*, 216 Va 611, 221 SE2d 163 (1976); *Dillon v. Scotten, Dillon Co.*, 335 F Supp 566 (D Del 1971)(applying Delaware law). In order to have an election declared invalid, a disappointed shareholder must show both that irregularities occurred and also that these irregularities effected the outcome of the vote. *Booker v. First Federal Savings and Loan Association*, 215 Ga 277, 110 SE2d 360, *cert denied*, 361 US 916 (1959).

Certain corporations registered under the Investment Company Act of 1940 may elect directors for more than a one year term. RCW 23B.05.050 & RCW 23B.08.050(2).

***C. Vacancies*.**

A vacancy on the board of directors is deemed to exist either if a director fails to finishing his/her term or if the size of the board of directors increases. One decision indicates that a vacancy may be deemed to exist if there is a tie in the vote for a director position. *Grip v. Buffelen Woodworking Co.*, 73 Wash 2d 219, 437 P2d 915 (1968).

Vacancies may be filled either by the shareholders or by the board

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of directors, unless the articles of incorporation provide otherwise. RCW 23B.08.100(1).

If there is less than a quorum of directors left on the board of directors, the remaining directors may act to fill the vacancy by majority vote. RCW 23B.08.100(1)(c).

RCW 23B.08.100(1) permits either the board of directors or the shareholders to fill vacancies on the board of directors. The statute does not indicate what would happen if the shareholders and board of directors each independently act to elect a different person to fill the vacancy. Arguably, the first director to be elected would assume office and there would no long be a vacancy to be filled by the time the second group voted.

A director who is elected to fill a vacancy is elected only for the unexpired term of that position. *In the Matter of Greater Atlanta Apartment Hunter's Guide, Inc.*, 40 BR 29 (ND Ga 1984).

If a corporation uses class voting for directors, only shareholders of the class or classes which originally elected the director whose position is to be filled are eligible to vote to fill that vacancy. RCW 23B.08.100(2). This section differs from the Revised Model Act in that only the specified shareholders, and not the directors, may fill such vacancies.

***D. Staggered terms*.**

The articles of incorporation may provide for the election of directors to staggered terms. RCW 23B.08.060. If the corporation chooses to elect directors to staggered terms, the directors are elected to two or three year terms with the number elected each year being as near as possible to equal. If such a procedure is selected, each year one such group must stand for election. Thus if there are two such groups, each group holds office for a two-year period with one of the two groups standing for election in each alternate year. If there are three such groups, each group holds office for a three-year period with one group standing for election each year for a three-year term. A corporation may have no more than three such director groups.

Normally, staggered terms may be used even if a corporation has only two directors. But this does not apply if the corporation uses cumulative voting. In such a case, no fewer than three directors may be elected at each annual shareholders' meeting. RCW 23B.08.060(2).

No director may be elected for a term of more than three years.

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Section 5.03

E. Cumulative voting.

In electing directors, a corporation may use one of two methods: straight voting or cumulative voting.

> Two basic types of shareholder voting in the election of corporate directors are generally acknowledged, one type called "straight voting" and the other type called "cumulative voting." Under straight voting each shareholder votes the number of shares he owns for as many candidates as may be elected. If two directors are to be elected, the shareholder may vote the number of shares he owns for each of the two candidates. Under this procedure, the man who owns a majority of the shares can elect the entire board of directors. Under cumulative voting, which is a procedure designed to give some control to minority shareholders, each shareholder gets a block of votes equal to the number of shares he owns multiplied by the number of directors to be elected. The shareholder may then cast his entire block for one candidate or may distribute his votes among any number of candidates in whatever proportion he desires. *Givens v. Spencer*, 232 Ga 806, 806, 209 SE2d 157, 157 (1974).

In Washington, directors are elected by cumulative voting, unless the articles of incorporation provide otherwise. RCW 23B.07.280(1) & RCW 23B.02.020(3)(w); *Washington State Labor Council v. Federated American Insurance Co.*, 78 Wash 2d 263, 474 P2d 98 (1970).

Unless modified by the articles of incorporation, cumulative voting means that:

> shareholders entitled to vote at any election of directors are entitled to cumulate votes by multiplying the number of votes they are entitled to cast by the number of directors for whom they are entitled to vote and to cast the product for a single candidate or distribute the product among two or more candidates. RCW 23B.07.280(1).

The candidates receiving the most votes win, up to the number positions to be filled at that election by the shares voting in that election. RCW 23B.07.280(2).

In 1933, Washington first adopted the provision which provided for cumulative voting, unless the articles of incorporation provided otherwise. *State ex rel Swanson v. Perham*, 30 Wash 2d 368, 191 P2d 689 (1948).

Washington is in the minority on this issue. The Revised Model Act and the Business Corporation Acts of most other states provide that directors are elected by straight voting unless the articles of incorporation specifically provide for cumulative voting. RMBCA § 7.28(b).

> **NOTE:** It is good practice to include language in the articles of incorporation stating whether or not cumulative voting is to be used in director elections.

Cumulative voting is one device used to protect minority shareholders by guaranteeing the minority participation on the board of

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directors.

> **EXAMPLE:** ABC, Inc. has issued and outstanding 300 shares of a single class of stock. The board of directors consists of three directors. A owns 100 shares. B owns 100 shares. C owns 100 shares.
>
> If straight voting is used, each shareholder casts 100 votes in the three separate elections for the three directorships. If A and B wish to exclude C from the board, A and B's combined votes in each of the three elections will prevent any of C's nominees from being elected. A and B will be able to cast 200 votes in each election, beating C's 100 votes every time.
>
> If cumulative voting is used, however, there will be only one election and C will have 300 votes (100 shares times the 3 director positions). Since the top three vote-getters will be elected and since C has 300 of the 900 possible votes, C can cast all 300 votes for a single candidate, guaranteeing C's candidate will garner enough votes to win one of the three open positions.

The mechanics of cumulative voting become very cumbersome if there are many shareholders. As a consequence, cumulative voting becomes less common as the total number of shareholder increase, particularly when the total number of shareholders exceeds the total number of directors to be elected.

Cumulative voting does little to protect shareholders whose percentage ownership of stock is small in comparison to the number of directors. For instance, even with cumulative voting, a twenty percent shareholder will not be assured of a directorship if there are three or fewer directorships available.

***F. Voting by class*.**

Unless the articles of incorporation provide otherwise, "[d]irectors are elected by a plurality of the votes cast by shares entitled to vote." RCW 23B.02.020(3)(x).

If there is more than one class of shares outstanding, all classes vote as a single class in electing directors, unless the articles of incorporation provide otherwise. RCW 23B.08.040.

Alternatively, the articles of incorporation may provide for the election of directors by means of voting by class. RCW 23B.08.040; *Walden Investment Group v. Pier 67, Inc.*, 29 Wash App 28, 627 P2d 129

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(1981). In such case, the classes may be treated the same for all other purposes, or the classes may have other specified differences. RCW 23B.06.010(3)(a).

> **EXAMPLE:** A, B, and C decide to form a corporation. Based upon their respective contributions, they agree on an ownership split as follows: A - 60%; B - 30%; C - 10%. In order to assure each shareholder the right to select one of the three directors, they create three classes of stock. Each class is alike in all respects except that Class A has the right to elect one director, Class B has the right to elect one director, and Class C has the right to elect one director. Thus, although distributions will be allocated 60%/30%/10%, each shareholder will be able to select one of the three directors.

> **EXAMPLE:** A receives 100 Class A shares and B receives 300 Class B shares. Class A has the right to elect two directors and B the right to elect one director. If the rights of the Class A and Class B stock were otherwise the same, A would be able to elect a majority the directors but B would have the right to 75% of the distributions. If the articles of incorporation require a unanimous vote of the board of directors on issues related to employee compensation and contracts with shareholders, B could prevent A (despite A's two to one majority on the board of directors) from receiving a disproportionate share of the corporate profits through salaries, leasing contracts, and the like.

If a corporation has more than one class of stock, it may be precluded from making an S corporation election if the classes have different rights as to distributions or liquidation; differences as to voting rights alone will not disqualify a corporation from electing S corporation status. 26 USC § 1361(b)(1)(D) & § 1361(c)(4). *See also:* Treas Reg § 1.1361-1(l)(1); *Pollack v. Commissioner*, 47 TC 92 (1966), *affirmed*, 392 F2d 409 (5th Cir 1968).

G. Oath of office.

Many states once required directors to take an oath upon taking office. *Hunt v. Ketrell*, 197 Or 659, 253 P2d 272 (1953); *Swenson v. McFerson*, 91 Colo 519, 17 P 530 (1932). This is no longer true. Washington does not require either a director or an officer to take an oath upon taking office.

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Section 5.04 Meetings

***A. Organizational meeting*.**

A corporation my hold its organizational meeting after its articles of incorporation have been filed with the Secretary of State's office. RCW 23B.02.030 & RCW 23B.02.050. *See also:* Section 3.03 of this book. A majority of the initial directors are authorized to call the organizational meeting. RCW 23B.02.050. The Washington Act does not specifically authorize the incorporator to call a meeting of the initial directors.

If the articles of incorporation contain the names of the initial directors, these initial directors conduct the organizational meeting. At this meeting, these directors appoint officers, adopt bylaws, and carry on any other business brought before the meeting. RCW 23B.02.050(1). The organization of a corporation is only complete when the initial directors have met, accepted shareholders, adopted bylaws, and appointed officers. RCW 23B.02.050; *R.A.C. Realty Co. v. W.O.U.F. Atlanta Realty Corp.*, 205 Ga 154, 52 SE2d 617 (1949); *Nickum v. Burckhardt*, 30 Or 464, 47 P 788 (1897).

If the articles of incorporation do not contain the names of initial directors, the organizational meeting is conducted by either the incorporator or the directors elected by the incorporator. RCW 23B.02.050(1)(a) and (1)(b)(ii).

Even if the incorporator conducts the organizational meeting, some matters must await a meeting of board of directors. For instance, RCW 23B.02.050(1)(a) does not give the incorporator authority to accept subscriptions. Under RCW 23B.06.210, this power rests with the board of directors.

> **NOTE:** RCW 23B.06.210(1) provides that the articles of incorporation may provided that the power to accept subscriptions may be reserved for the shareholders. If this power is reserved for the shareholders, the Act is silent on who accepts the subscriptions of the original shareholders.

In any event, the preferred method is for the directors, not the incorporators, to hold the organizational meeting.

A more complete discussion of the organizational meeting appears in Section 3.03 of this book.

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Section 5.04

***B. Regular meetings*.**

Board of director meetings may be classified as annual, regular or special.

"Regular" meetings are meetings held at a pre-established time, date, and place on a re-occurring basis, whether annually, quarterly, monthly, or otherwise. The time, date, and place may be established in the bylaws, by board resolution, by custom, or otherwise. If the directors vote to hold a meeting at the corporate offices at 7:00 pm on the first Monday of every month, all such meetings are regular meetings.

Many corporations have bylaws which specify that a director meeting will occur immediately following the annual shareholder meeting, although there is no requirement corporations do so. This meeting is technically a "regular meeting," but is sometimes referred to as the "annual meeting of directors."

Regular meetings may be held without notice of the date, time, place, or purpose of the meeting. RCW 23B.08.220(1). Case law holds that directors are deemed to have notice of regular meetings. *White v. Penelas Mining Co.*, 105 F2d 726 (9th Cir 1939); *Doernbecher v. Columbia City Lumber Co.*, 21 Or 573, 28 P 899 (1892).

***C. Special meetings & notice*.**

All board of director meetings which are not regular meetings are "special meetings."

Notice of a special director meeting must be given to directors at least two days in advance of the meeting, unless the articles of incorporation or bylaws provide for a longer or shorter period. RCW 23B.08.220(2). This notice must contain the date, time, and place of the meeting. The notice need not describe the meeting's purpose, unless required to do so by the articles of incorporation or by the bylaws. RCW 23B.08.220(2); *Homan v. Fir Products Co.*, 123 Wash 260, 212 P 240 (1923).

Notice of a special director meeting must be in writing, unless the articles of incorporation or bylaws provides that oral notice is expressly permitted under the circumstances. RCW 23B.01.410(1).

RCW 23B.01.410(2) sets out several methods by which notice may be delivered and contains the methods for determining the effective date of each such notice.

The articles of incorporation and/or the bylaws may prescribe notice requirements not inconsistent with RCW 23B.01.410(7).

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As a practical matter, the notice requirement becomes important only if there is a dissenting director. For example, RCW 23B.08.230 provides that a director may waive notice either: (i) by signing a written waiver and delivering it to the corporation for filing with the minutes or filing with the corporate records; or (ii) by attending or participating in a meeting (unless the director objects to the meeting upon arrival and thereafter does not vote or assent to any action at the meeting). In addition under some circumstances, a properly noticed board meeting may later ratify acts undertaken at the earlier, defective meeting. *Johnson v. Busby*, 278 F Supp 235 (ND Ga 1967); *Wright v. McLaury*, 81 F2d 96 (7th Cir 1936).

RCW 23B.02.070 and 23B.03.030 bestow emergency powers on a board of directors, including the power to modify notice requirements. These emergency powers are effective in anticipation of, or during, some emergency or catastrophic event.

In general, a special director meeting is not valid if a corporation fails to notify one or more directors and the unnotified director fails to attend. *Lycette v. Green River Gorge, Inc.*, 21 Wash 2d 859, 153 P2d 873 (1944). "Legally there could be no such special meeting in the absence of some form of notice served on each member of the Board, affording him or her an opportunity to participate and vote." (footnote omitted) *Knox v. Commissioner of Internal Revenue*, 323 F2d 84, 88 (5th Cir 1963).

> As to special meetings of the board of directors of a corporation, the general rule in Pennsylvania is that such a meeting held without notice to some or any of the directors and in their absence is illegal, and action taken at such a meeting, although by a majority of the directors, is invalid absent ratification or estoppel. *Stone v. American Lacquer Solvents Co.*, 463 Pa 417, 345 A2d 174, 177 (1975).

Directors have a right to persuade other directors. A dissenting director is unable to persuade other directors if the dissenting director does not receive notice of the meeting and does not attend. Thus, a special meeting without notice is invalid even if the number of directors present and voting favorably on an issue would have been sufficient to pass that issue over the objection of the unnotified director. If a director is not notified of a meeting and does not attend, there is no way to determine if the dissenting director would have been successful in persuading a sufficient number of directors to adopt an alternative course of action.

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On the other hand, even though not all directors have been properly notified of a meeting, proper notice will deemed waived if all the directors attend and fail to object to the improper notice. *Turpin v. Dunis*, 66 Wash 2d 749, 405 P2d 239 (1965); *Holman v. Fir Products, Inc.*, 123 Wash 260, 212 P 240 (1923).

Under some circumstances, an action taken at an improperly held meeting may be ratified by subsequent action of the board of directors or of the shareholders. *Johnson v. Busby*, 278 F Supp 235 (ND Ga 1967); *Wright v. McLaury*, 81 F2d 96 (7th Cir 1936).

One older case indicates that notice might not be necessary when the unnotified director is "out of state or inaccessible." *Doernbecher v. Columbia City Lumber Co.*, 21 Or 573, 28 P 899 (1892). Another case indicates that notice is not required for a director who would have been disqualified from taking part in the meeting by reason of personal interest. *State ex rel Howeth v. D.A. Davidson & Co.*, 163 Mont 355, 517 P2d 722 (1973). It is better practice to notify all directors.

***D. Written consent in lieu of meeting*.**

Unless the articles of incorporation or bylaws provide otherwise, a board of directors may dispense with a meeting and instead act through a written consent signed by **all** (not just a majority) of the directors. RCW 23B.08.210(1). This is consistent with the earlier RCW 23A.08.345, but reverses older case law which required directors to act only through meetings. *Trethewey v. Green River Gorge, Inc.*, 17 Wash 2d 697, 136 P2d 999 (1943).

An action taken by written consent becomes effective on the date the last director signs the consent, unless a later date is specified in the consent. RCW 23B.08.210(2).

> **NOTE:** Directors often forget to date their signatures. It is important to verify that all director signatures are dated before the consent is filed away in the corporate book.

***E. Telephone meetings*.**

RCW 23B.08.200(2) provides that director meetings may take place using "any means of communication by which all directors participating can hear each other during the meeting."

Under this provision, speaker telephones and conference calls are permitted. Passing the telephone back and forth among directors in the same room probably is not permitted.

The articles of incorporation or the bylaws may prohibit such

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telephone (or internet) participation.

***F. Location*.**

Director meetings may be held inside or outside the state of Washington. RCW 23B.08.200(1).

The notice of a special meeting must contain the location of the meeting. RCW 23B.08.220(2). Directors are deemed to know the location of a regular meeting and notice of a regular meeting is implied.

***G. One director; one vote*.**

Generally, each director has one and only one vote at a meeting of directors. *Geiman-Herthel Furniture Co. v. Geiman*, 160 Kan 346, 161 P2d 504 (1945). This is true regardless of the number of shares owned by a director, or by the shareholders who elect that director.

There is exception. The Washington Business Corporation Act permits the shareholders to enter into an agreement which provide for weighed voting rights for directors under certain circumstances. Any such agreement must meet the strict requirements of RCW 23B.07.320.

***H. Director proxies*.**

Unlike shareholders, directors generally may not vote by proxy. *Dowdle v. Central Brick Co.*, 206 Ind 242, 189 NE 145 (1934); *In re Acadia Dairies, Inc.*, 15 Del Ch 248, 135 A 846 (1927); Orlinsky, *Conduct unbecoming a stockholder?*, 8 BUS L TODAY 20 (Jan/Feb 1999). A director may not delegate judgement and discretion to another person.

> A director of a corporation cannot delegate his power to vote in the board of directors by giving his proxy to another person. He must be present in person for the purpose of consultation. Directors are elected to meet and confer and interchange ideas. They cannot vote or act in any other manner. A director, of course, cannot act or vote by proxy. *First Nat. Bank of Omaha v. East Omaha Box Co.*, 2 Neb 820, 90 NW 223, 228 (1902).

There is an exception. The Washington Business Corporation Act permits shareholders to enter into a written agreement which permits directors to vote by proxy under certain circumstances. Any such agreement must meet the requirements of RCW 23B.07.320.

***I. Attendance by attorneys*.**

It is unclear whether an individual director has a right to have the director's attorney present during a meeting. Some cases and authorities believe that a director has this right.

> The Court is also of the opinion that, as a general rule, an individual director has the right to the presence and the advice of his own counsel when he deems it necessary. (citations omitted) *Selama-Dindings Plantations, Ltd. v. Durham*, 216 F Supp 104, 115 (SD Ohio 1963)(which

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> nevertheless barred such attorneys based upon language in the corporation's bylaws).

See also: 2 FLETCHER CYC CORP § 418 (Perm Ed 1998); Orlinsky, *Conduct unbecoming a stockholder?*, 8 BUS L TODAY 20 (Jan/Feb 1999).

Other courts believe this issue is a matter for internal corporate management.

> The additional relief sought by petitioner - directions that he may have the aid of counsel and a stenographer at meetings of the board of directors - are matters of internal corporate management upon which [the court] properly declined to rule. *Jacobson v. Moskowitz*, 27 NY2d 67, 313 NYS2d 684, 261 NE2d 613, 615 (1970).

See also: Burt v. Irvine Co., 224 Cal App 2d 50, 36 Cal Rptr 270 (1964)(applying West Virginia law).

Section 5.05 Quorum

A. Generally.

A quorum is the number of directors who must be present in order for an action of the board of director to be binding. BLACK'S LAW DICTIONARY; *Griffith v. Sprowl*, 45 Ind App 504, 91 NE 25 (1910). Without a quorum present at a board of director meeting, some cases hold that actions taken at that meeting are "void and of no force and effect." *Schoen v. Consumer United Group, Inc.*, 679 F Supp 367, 377 (DDC 1986)(interpreting Delaware law). *See also: Doyle v. Chladek*, 240 Or 598, 401 P2d 18, *modified*, 403 P2d 381 (1965). Other cases hold that actions taken at board meetings lacking a quorum are voidable, but can by later ratified by the shareholders or at a meeting at which a quorum is present. *Sanders v. E-Z Park*, Inc., 57 Wash 2d 474, 358 P2d 138 (1960); *Weiss Medical Complex, Ltd. v. Kim*, 87 Ill App 3d 111, 408 NE2d 959 (1980); *Burton v. Lithic Mfg. Co.*, 73 Or 605, 144 P 1149 (1914).

A quorum consists of a majority of the number of directors specified, or fixed, in accordance with the articles of incorporation or the bylaws. RCW 23B.08.240(1); *Twisp Mining & Smelting Co. v. Chelan Mining Co.*, 16 Wash 2d 264, 133 P2d 300 (1943); *Rugger V. Mt. Hood Electric Co.*, 143 Or 193, 20 P2d 412, 21 P2d 1100 (1933); *Silsby v. Strong*, 38 Or 36, 62 P 633 (1900).

A quorum is not just half of the directors; a quorum requires more than half of the directors. *Broughton v. Jones*, 120 Mich 462, 79 NW 691 (1899).

A quorum is the total number of directors present, not just the

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number voting favorably on the motion. RCW 23B.08.240(3). To pass, a resolution must be approved by a majority of the quorum present, not a majority of all directors. *Id.*

> But the very idea of a "quorum" is that, when that required number of persons goes into session as a body, the votes of a majority thereof are sufficient for binding action. *Benintendi v. Kenton Hotel, Inc.*, 294 NY 112, 60 NE2d 829, 831-2 (1945).

This is true even if the bylaws state that board decisions are made by "a majority of the directors." Case law holds that such bylaw language means that a majority of the quorum present, not a majority of all directors, is necessary to pass a motion.

> the number of directors of a corporation necessary to constitute a quorum may be fixed in the by-laws, if not incompatible with the articles or statutory law, and that a majority of that quorum may decide any question coming properly before such meeting, although the number of directors present may be less than a majority of the entire board. *Twisp Mining & Smelting Co. v. Chelan Mining Co.*, 16 Wash 2d 264, 290, 133 P2d 300, 311 (1943).

A quorum is measured at the time of the vote, not just at the start of the meeting. RCW 23B.08.240(3). This is different than the quorum rule for shareholder meetings. *See:* RCW 23B.07.250(2).

***B. Changes to quorum requirement*.**

A Washington corporation may reduce the quorum necessary for the board of directors to conduct business by appropriate language in its articles of incorporation or in its bylaws. But the quorum may not be reduced to fewer than one-third of the directors. RCW 23B.08.240(2).

At common law, corporations could set a higher quorum requirement.

> Though a majority is the implied norm for a quorum in the absence of provision to the contrary, it has been recognized frequently that requirement of a larger proportion is not unreasonable and is valid. *Olincy v. Merle Norman Cosmetics, Inc.*, 200 Cal App 2d 260, 19 Cal Rptr 387, 391 (1962).

This is true today. A Washington corporation may increase its quorum necessary for the board of directors to conduct business by appropriate language in its articles of incorporation or its bylaws. RCW 23B.08.240(1). No maximum is described; the articles of incorporation could require a quorum of 100% of the directors.

***C. Effect of vacancies*.**

The minimum number of directors necessary for a quorum is usually not reduce by vacancies on the board of directors. *Rugger V. Mt.*

Hood Electric Co., 143 Or 193, 20 P2d 412, 21 P2d 1100 (1933); *Burton v. Lithic Mfg. Co.*, 73 Or 605, 144 P 1149 (1914). Thus, if the articles of incorporation or bylaws provides for a seven-director board, a quorum is four, even if there are three vacancies. If there are more than three vacancies, the board of directors cannot have the quorum necessary to conduct business.

If the bylaws provide that a quorum consists of a majority of the directors "for the time being in office," two vacancies on a seven-person board will reduce the quorum requirement from four directors to three. *Twisp Mining & Smelting Co. v. Chelan Mining Co.*, 16 Wash 2d 264, 133 P2d 300 (1943).

If the number of director positions is increased, the quorum requirement does not increase until those positions are filled. *Rocket Mining Corp. v. Gill*, 25 Utah 2d 434, 483 P2d 897 (1971); *Gearing v. Kelly*, 15 AD2d 219, 222 NYS2d 474 (1961).

Even though vacancies have reduced the number of directors below the number necessary for a quorum, the remaining directors can still act to fill the vacancies by majority vote. RCW 23B.08.100(1)(c).

D. Effect of conflicts of interest.

Prior to adoption of the Revised Model Act, most courts held that a director, disqualified by his/her interest in a vote, could not be counted as part of the quorum for that vote.

> It has frequently been held by this court that there is no legal quorum of directors present when action is attempted to be taken on matters as to which one of the directors requisite to make the quorum is interested. *Hein v. Gravelle Farmers Elevator Co.*, 164 Wash 309, 316, 2 P2d 741, 744 (1931).

In another decision, the court stated:

> In Illinois, a director who has a personal interest in a subject under consideration is disqualified to vote on the matter and may not be counted for the purpose of making a quorum. (citations omitted) *Weiss Medical Complex, Ltd. v. Kim*, 87 Ill App 3d 111, 408 NE2d 959 (1980).

See also: Partson v. Tacoma Smelting & Refining Co., 25 Wash 492, 65 P 765 (1901); *Rugger V. Mt. Hood Electric Co.*, 143 Or 193, 20 P2d 412, 21 P2d 1100 (1933).

Under the present Washington Act, when there are interested directors on a particular vote, a quorum consists of a majority, but no fewer than two, of the disinterested or "qualified" directors. RCW 23B.08.720. A "qualified director" means:

> with respect to a director's conflicting interest transaction, any director

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> who does not have either (a) a conflicting interest respecting the transaction, or (b) a familial, financial, professional, or employment relationship with a second director who does have a conflicting interest respecting the transaction, which relationship would, in the circumstances, reasonably be expected to exert an influence on the first director's judgment when voting on the transaction. RCW 23B.08.720(4).

Thus, on a seven-person board with two interested directors, three "qualified" directors constitute a quorum.

If a quorum is lacking due to the fact that interested directors are improperly counted, most courts have held that the action taken was voidable, not void. Such actions may be ratified at a subsequent board meeting at which a quorum of directors is present or such actions may be ratified by a subsequent vote of the shareholders. *Sanders v. E-Z Park, Inc.*, 57 Wash 2d 474, 358 P2d 138 (1960); *Burton v. Lithic Mfg. Co.*, 73 Or 605, 144 P 1149 (1914). *But see: Schoen v. Consumers United Group, Inc.*, 670 F Supp 367, 377 (D DC 1986).

Section 5.06 Minutes of Meetings

A board of directors is required to record and permanently keep minutes of all of its meetings and to keep a record of all of its actions taken without a meeting. RCW 23B.16.010(1). A board of directors is required to delegate to an officer the responsibility for keeping minutes of its meetings and that person usually also records attendance, discussion, resolutions, and votes. RCW 23B.08.400(3). Usually, this responsibility for preparing minutes is delegated to an officer known as the "secretary," but Washington no longer requires that such person hold the title of "secretary." Even though the board or the bylaws designates these task to a particular person, that person may usually delegate the taking of minutes to a subagent, such as the corporation's attorney. *Teiser v. Swirsky*, 137 Or 595, 2 P2d 920, 4 P2d 322 (1931).

The Washington Supreme Court once stated that a gathering of all directors "at a casual and informal meeting of which no record was kept [does] not constitute a legal meeting of the board of directors." *Lycette v. Green River Gorge, Inc.*, 21 Wash 2d 859, 863, 153 P2d 873, 875 (1944). But other decisions take a more lenient view. *Anderson v. Wallace Lumber & Mfg. Co.*, 30 Wash 147, 70 P 247 (1902).

While the holding of formal meetings and the keeping of formal minutes is good practice, many courts have recognized board actions without these formalities, at least in close corporations and family-owned corporations. *Block v. Olympic Health Spa, Inc.*, 24 Wash App 938, 604

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P2d 1317 (1979); *Barrett v. Joseph Mayer & Bros.*, 119 Wash 323, 205 P 396 (1922); *Roles v. Roles Shingle Co.*, 147 Or 365, 371, 31 P2d 180, 182 (1934). *But see:* RCW 23B.16.010(1) which provides that a "corporation shall keep as permanent records minutes of all meetings of it shareholders and board of directors."

> The fact that the corporate record book contained no minutes of directors authorizing the guaranty or any minutes after the organization of the company is not significant. It is recognized that officers and directors of a closed corporation frequently act informally, but nevertheless have authority to bind the corporation. *In re B-F Building Corp.*, 284 F2d 679, 681 (6th Cir 1960).

Another decision, recognizing a more lenient attitude toward close corporations, stated:

> It would admittedly facilitate judicial supervision of corporate behavior if a strict adherence to the provisions of the Business Corporation Act were required in all cases without regard to the practical exigencies peculiar to the close corporation. However, courts have long ago quite realistically, we feel, relaxed their attitudes concerning statutory compliance when dealing with close corporate behavior, permitting "slight deviations" from corporate "norms" in order to give legal efficacy to common business practice. (citations omitted) *Galler v. Galler*, 32 Ill 2d 16, 203 NE2d 577, 584 (1964).

The minutes of directors' meetings are required to be kept at the corporation's principal office. RCW 23B.16.010(5). The shareholders have a right to inspect these board minutes upon reasonable notice. RCW 23B.16.020. *See:* Section 5.08 of this book.

Board resolutions and minutes become part of the permanent history of a corporation. Future boards and third parties generally may rely on them.

> A corporation commonly speaks through its records. The minutes of the meetings of a corporation's board of directors are a part of such corporate records, through which a corporation speaks, and are prima facie evidence of the facts stated. (citations omitted) *Stipe v. First National Bank of Portland*, 208 Or 251, 278, 301 P2d 175, 176-177 (1956).

Minutes may be offered at trial as evidence of an action taken at a meeting of the board of directors. *Matteson v. Ziebarth*, 40 Wash 2d 286, 242 P2d 1025 (1952).

While the minutes are prima facie evidence of board resolutions, they are not conclusive and may be supplemented or disproved by competent testimony. *Acmer Corp. v. State Transport Co.*, 275 Or 1, 549 P2d 1114 (1976); *Tripp v. Pay 'n Pac Stores, Inc.*, 268 Or 1, 518 P2d 1298 (1974); *Phoenix Finance Corp. v. Iowa-Wisconsin Bridge Co.*, 16

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A2d 789, 794 (Del Supr 1940). Parol evidence is admissible to prove that a board of directors adopted or rejected a resolution. *Houck v. Martin*, 82 Ill App 3d 205, 402 NE2d 421 (1980); *Myrtle Point Mill & Lumber Co. v. Clarke*, 102 Or 533, 203 P 588 (1922).

Section 5.07 Removal and Resignation

A. Removal, generally.

The shareholders may remove a director, with or without cause, unless the articles of incorporation specifically provide that a director may only be removed for cause. RCW 23B.08.080(1).

Shareholders may only remove a director at a special shareholder meeting called for that purpose. RCW 23B.08.080(4). Notice for such a meeting must state that the purpose, or one of the purposes, of the meeting is the removal of a director. *Id.*

B. Voting for removal.

In the event a corporation uses the cumulative voting method for electing directors, a reverse procedure must be used for removal. RCW 23B.08.080(3). Class voting for directors also necessitates a reverse removal procedure. RCW 23B.08.080(2). Thus, if a minority shareholder group has the right to elect a director, the majority cannot turn around and remove the director elected by the minority without the agreement of that minority.

Otherwise, a director may be removed by the shareholders only if the number of votes cast to remove the director exceeds the number of votes cast against removal. RCW 23B.08.080(3).

C. Directors removing directors.

As a general rule, only the shareholders can remove a director. The board of directors may not vote to remove one of its own members, absent authority in the articles of incorporation. *M/V La Conte, Inc. v. Leisure*, 55 Wash App 396, 777 P2d 1061 (1989); *Dillon v. Berg*, 326 F Supp 1214 (D Del), *affirmed*, 453 F2d 876 (3d Cir 1971)(interpreting Delaware law); *Horn v. Kaupp*, 82 SD 437, 147 NW2d 607 (1967).

One case impliedly accepted the removal of a director at a directors' meeting, but in this case, all of the shareholders were directors and the vote for removal would have been the same had the director meeting been a shareholder meeting instead. *Iwasaki v. Iwasaki Bros., Inc.*, 58 Or App 543, 649 P2d 598 (1982).

D. Removal by court order.

A director may be removed by order of the court. RCW 23B.08.090

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permits the superior court for the county in which a corporation's principal office in Washington is located (or if no such office exists, then where its registered office is or last was located) to remove a director if the court finds that:

(a) The director engaged in fraudulent or dishonest conduct with respect to the corporation; and
(b) Removal is in the best interest of the corporation.

Such a procedure may be initiated either by the corporation or by shareholders holding ten percent or more of the corporation's stock.

NOTE: Washington did not adopt the RMBCA provision permitting a court to remove a director for "gross abuse of authority or discretion." RMBCA § 8.09.

***E. Failure to qualify*.**

Today, there are no statutory qualification requirements for an individual to be elected a director. However, the articles of incorporation or the bylaws may include a qualification requirement. RCW 23B.08.020. In such case, once a director ceases to meet the qualification requirement, that director immediately ceases to be a director. *Oudin & Bergman Fire Clay Min. & Mfg. Co. v. Conlan*, 34 Wash 216, 75 P 798 (1904); *Smith v. Great Basin Grain Co.*, 98 Idaho 266, 561 P2d 1299, 1311 (1977); *In re Andrews*, 265 Mich 661, 252 NW 482 (1934).

***F. Resignation*.**

Most states follow the rule that a director's resignation is effective upon delivery of the resignation to the board of directors, not at the later point when the board acts to accept the resignation. *Dillon v. Berg*, 326 F Supp 1214 (D Del), *affirmed*, 453 F2d 876 (3d Cir 1971)(interpreting Delaware law); *Eurich v. Korean Foundation, Inc.*, 31 Ill App 2d 474, 176 NE2d 692 (1961); *Steffens v. Sinkey*, 43 Ohio App 355, 183 NE 288, *affirmed*, 126 Ohio St 66, 183 NE 866 (1932).

The current Washington Act adopts this view. RCW 23B.08.070.

There is an exception. If the resignation specifies a later date, the resignation is effective on the date specified. RCW 23B.08.070(2).

Section 5.08 Duties

The principal duty of a corporate board of directors is to manage the corporation on behalf of the shareholders.

The bedrock of corporate law is "the rule that the business and affairs of a corporation are managed by and under the direction of its board." *Pogostin v. Rice*, 480 A2d 619, 624 (Del Supr 1984).

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> The power of management of the corporate affairs and the power to contract so as to bind the corporation is vested primarily in the board of directors and not in the stockholders. *Trethewey v. Green River Gorge, Inc.*, 17 Wash 2d 697, 724, 136 P2d 999, 1010 (1943).

"The board of directors and not the shareholders is the original and supreme authority to make corporate contracts, and all authority for business transactions should normally be traced back, in the absence of statute, to the directors." BALLANTINE, LAW OF CORPORATIONS 119 (1946).

RCW 23B.08.010(2) provides that:

> All corporate powers shall be exercised by or under the authority of, and the business and affairs of the corporation managed under the direction of, its board of directors, subject to any limitation set forth in the articles of incorporation.

Unless the shareholders enter into an agreement restricting the power of the board of directors and otherwise comply with the requirements of RCW 23B.07.320, or unless the articles of incorporation restricts that power, the power to manage corporate affairs rests in the board of directors, not in the shareholders. *Twisp Mining & Smelting Co. v. Chelan Mining Co.*, 16 Wash 2d 264, 133 P2d 300 (1943), *cert denied*, 320 US 705, *cert denied*, 320 US 716 (1944), *cert denied*, 325 US 837 (1945); *Levine v. Smith*, 591 A2d 194 (Del Ch 1991); *Carter v. Portland General Electric Co.*, 227 Or 401, 362 P2d 766 (1961); *Baillie v. Columbia Gold Mining Co.*, 86 Or 1, 166 P 965, 167 P 1167 (1917).

Commentators have indicated that a corporation's board of directors has six basic management functions.

> The basic management functions of directors have been summarized as including (1) The selection of the chief executive and senior officers and seeing that able young executives are being developed; (2) Control of executive compensation, pension and retirement policies (3) Delegation to the chief executive and subordinate executives authority for administrative action; (4) Fixing policies as to pricing, labor relations, expansion and new products; (5) Determining dividend payments, financing and capital changes; (6) Supervision and vigilance for the welfare of the whole enterprise. 2 FLETCHER CYC CORP § 505 (Perm Ed 1998)(citing J.C. BAKER, DIRECTORS AND THEIR FUNCTION, 131).

In order to exercise these duties properly, directors have the duty to exercise ordinary care and to keep themselves informed of the assets and activities of the corporation. *Schwarzmann v. Association of Apartment Owners of Bridgehaven*, 33 Wash App 397, 655 P2d 1177 (1982); *Barnes v. Eastern & Western Lumber Co.*, 205 Or 553, 287 P2d 929 (1955).

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Section 5.08

NOTE: Some of the issues discussed in this Section may not apply to corporations in which the shareholders have entered into an agreement to eliminate or restrict the power of the board of directors and otherwise complied with the requirements of RCW 23B.07.320.

A. Power reserved to shareholders.

Few duties are specifically reserved to the shareholders by the Washington Business Corporation Act.

One exception is that directors are without power to enter into a contract to sell all corporate assets outside the ordinary course of business without approval of two-thirds of the shareholders. *Carson v. Isabel Apartments, Inc.*, 20 Wash App 293, 579 P2d 1027 (1978). Other exceptions include:

Shareholders elect directors and may vote to remove them. RCW 23B.08.030 & RCW 23B.08.080.

Shareholders holding ten percent of all votes entitled to be cast on any issue may demand that a special meeting of the shareholders be called. RCW 23B.07.020(1)(b).

A shareholder vote is required in connection with certain extraordinary events, such as non-ministerial amendments of the articles of incorporation, mergers, and dissolutions. Such extraordinary actions generally may not be initiated by the shareholders themselves, but rather, the board of directors must initiate the process and refer the matter to the shareholders for their concurrence. RCW 23B.10.030; RCW 23B.11.030; & RCW 23B.14.020.

Virtually all other corporate power rests in the board of directors.

One early case indicates that where all of the shareholders are also all of the directors, the shareholders may authorize acts normally required to be authorized by the directors. *Steeple v. Max Kuner Co.*, 121 Wash 47, 208 P 44 (1922).

B. Example of board's duties - dividends.

The declaration of a dividend or other distribution is the exclusive function of the board of directors. RCW 23B.06.400(1); *Baillie v. Columbia Gold Mining Co.*, 86 Or 1, 166 P 965, 167 P 1167 (1917); *Stipe v. First National Bank of Portland*, 208 Or 251, 301 P2d 175 (1956). Even a "sole shareholder is not entitled to demand the profits of a corporation until they have been set aside and ordered by the corporation to be paid." *Central of Georgia Ry. Co. v. Central Trust Co. of New York*, 135 Ga 472,

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491, 69 SE 708, 717 (1910). *See also: Cole Real Estate Corp. v. Peoples Bank & Trust Co.*, 160 Ind App 88, 310 NE2d 275 (1974). However, when the shareholders unanimously consent to a distribution, it is not necessarily invalid because the directors did not authorize the distribution. *Zimmerman v. Kyte*, 53 Wash App 11, 765 P2d 905 (1988).

The power of shareholders to vote for the issuance of dividends is discussed more fully in Sections 4.02 and 4.07 of this book.

***C. Example - technical amendments to articles of incorporation*.**

RCW 23B.10.020 provides that certain housekeeping amendments to the articles of incorporation may be made simply by vote of the board of directors, unless the articles of incorporation provide otherwise.

While more substantive changes to the articles of incorporation are required to be voted upon by the shareholders, the board of directors must refer the proposed amendment to the shareholders before they can vote on the proposed amendment. RCW 23B.10.030(2)(a). The shareholders do not have the power to initiate amendments to the articles of incorporation. *See:* Section 3.07 of this book.

***D. Example - amending bylaws*.**

The board of directors may amend the bylaws, and may do so without shareholder approval. RCW 23B.10.200(1).

There are two exceptions: (i) a board of directors may not amend the bylaws if the articles of incorporation provide otherwise; and (ii) a board of directors may not amend or repeal a particular bylaw provision if the shareholders previously expressly provided that the board of directors could not amend or repeal that bylaw provision. RCW 23B.10.200(1).

Shareholders may amend the bylaws even though the directors also possess that power. RCW 23B.10.200(2).

Special rules exist for amending bylaw provisions dealing with quorums. RCW 23B.10.210. *See:* Section 3.08 of this book.

***E. Example - dissolution*.**

Another example of a power exclusively in the hands of the board of directors concerns the dissolution of a corporation. Except for dissolutions before the issuance of shares, RCW 23B.14.010, the dissolution of a corporation may occur only after the board of directors has voted to dissolve and, thereafter, submitted the matter for a shareholder vote. RCW 23B.14.020.

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A mere majority of the shareholders may not vote to dissolve a corporation without prior action by the board of directors. *See:* Section 12.04 of this book.

> **NOTE:** The Comment to RCW 23B.14.020 by the Washington State Bar Association's Corporate Act Revision Committee indicates that the Committee considered, but rejected, a provision which would have permitted the shareholders to consent to dissolution without the dissolution proposal being referred to them by the directors.

***F. Power to delegate duties*.**

Some older cases hold that a board of directors could only delegate ministerial, not discretionary, duties to officers. *Ames v. Goldfield Merger Mines Co.*, 227 F 292, 301-2 (WD Wa 1915); *Patterson v. Portland Smelting Works*, 35 Or 96, 56 P 407 (1899). The more modern view is that directors may delegate substantial discretion to officers and other agents. A board of directors may not, however, delegate those duties which lay at the heart of their management of the corporation, such as their duty to use their own best judgment on management matters. *Morgan v. State Farm Mutual Automobile Insurance Co.*, 402 A2d 1211 (Del Supr 1979). *See:* Section 5.11 of this book.

Section 5.09 Compensation

Under the current Washington Business Corporation Act, a board of directors is specifically empowered to set compensation for directors, unless the articles of incorporation or the bylaws provide otherwise. RCW 23B.08.110; *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987).

Directors have no inherent right to compensation for their services as directors, nor may they recover against the corporation on a quantum meruit theory. *Wonderful Group Mining Co.* v. Rand, 111 Wash 557, 191 P 631 (1920); *Keenan v. Eshleman*, 23 Del Ch 234, 2 A2d 904 (1938). Directors may, however, recover compensation for non-director tasks undertaken for the corporation. *Hudson v. Pacific Truck & Tractor Co.*, 151 Wash 46, 274 P 789 (1929); *Wood v. Lost Lake Manufacturing Co.*, 23 Or 20, 23 P 848 (1890).

> To recover upon a quantum meruit [claim] for services rendered wholly outside the scope of his official duties a director or officer must show, in addition to the fact that the services were extraordinary, that they were rendered under circumstances from which a promise to pay compensation may properly be implied. *North Carolina Agricultural Credit Corp. v. Boushall*, 193 NC 605, 137 SE 721, 723 (1927).

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Under older case law, directors could not vote compensation to themselves as directors, and such authority was required to come from some other source, such as the articles of incorporation or the bylaws. *Burns v. Commencement Bay Land & Improvement Co.*, 4 Wash 558, 30 P 668, 30 P 709 (1892); *Green v. Felton*, 42 Ind App 675, 84 NE 166, *motion granted*, 44 Ind App 321, 89 NE 320 (1908); 175 ALR 577. Any board of director vote for compensation was voidable, not void. *Albrecht v. Bellinger*, 167 Wash 95, 8 P2d 983 (1932).

> Directors cannot vote salaries to themselves. Nor can they vote a salary to one of their number as president or secretary or treasurer, at a meeting where his presence is necessary to a quorum. And such votes, if passed, are voidable by the corporation, and if money has been paid it may be recovered back.
>
> The reason and justice of the rule is apparent. Directors have no authority to act for the corporation in matters in which they are personally interested. They owe their whole duty to the corporation, and they are not to be permitted to act when duty conflicts with interest. They cannot serve themselves and the corporation at the same time. (citations omitted) *Bates v. Street Shirt Co. v. Waite*, 130 Me 352, 156 A 293, 297 (1931).

The more modern view, however, is that directors may vote to set their own compensation. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987). The current Act specifically empowers a board of directors to set its own compensation, unless the articles of incorporation or the bylaws provide otherwise. RCW 23B.08.110.

Section 5.10 *Ultra Vires* Acts

"The phrase `ultra vires' describes corporate transactions that are outside the purposes for which a corporation was formed and, thus, beyond the power granted the corporation be the Legislature." *Harstene Point Maintenance Association v. Diehl*, 95 Wash App 339, 344, 979 P2d 854, 856 (1999).

Historically, there is considerable case law on the issue of whether a board of directors exceeded its power in authorizing a corporate act, that is, whether the board of directors acted *ultra vires*.

Today, corporations are vested with broad powers under RCW 23B.03.010 and RCW 23B.03.040; the doctrine of *ultra vires* is narrowly applied and *ultra vires* issues are raised only infrequently. RCW 23B.03.040 provides that "corporate action may not be challenged" as being *ultra vires* except (i) by a shareholder seeking to enjoin the act; (ii)

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by the corporation itself, directly or derivatively; or (iii) by the Attorney General. *See also: Noel v. Cole*, 98 Wash 2d 375, 379, 655 P2d 245, 248 (1982)("the Legislature statutorily eliminated the ultra vires defense in this state in 1965") *Goodman v. Ladd Estate Co.*, 246 Or 621, 427 P2d 102 (1967); *Ladd Estate Co. v. Wheatley*, 246 Or 627, 426 P2d 878 (1967).

A. Constitutional limitations on the power of a board of directors.

Article 12, Section 6 of the Washington Constitution provides:

> Corporations shall not issue stock, except to *bona fide* subscribers therefor, or their assignees; nor shall any corporation issue any bond, or other obligation, for he payment of money, except for money or property received or labor done. . . . All fictitious increase of stock or indebtedness shall be void.

In *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995), the Washington Supreme Court assumed, without deciding, that a corporation's borrowings from a bank and its repeated issuances of notes to the bank constituted an *ultra vires* act in violation of the Article 12, Section 6 of the Washington Constitution. In an action by the corporation's trustee in bankruptcy to avoid the notes, the Court held that the trustee's claim was barred by the doctrine of estoppel and ratification, stating:

> So long as a contractual agreement is not contrary to public policy or the terms of a statute, a corporation that has received directly or indirectly the benefits of a contract, including a contract of guaranty, generally is estopped from asserting the defense of ultra vires. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 277, 892 P2d 98, 103 (1995).

Apparently, the Supreme Court believed that violation of the state's constitution is not as grave as the violation of a statute or public policy. The Supreme Court went on to hold that absent fraud, the corporation's repeated ratification of the note likewise estopped the corporation and the trustee from asserting the note to be *ultra vires*.

B. Statutory limitations on the power of a board of directors.

Current Washington law prohibits directors from authorizing certain specified acts. Illegal acts differ from *ultra vires* acts. Illegal acts are void. *Field v. Haupert*, 58 Or App 117, 647 P2d 952 (1982)(it was illegal, not *ultra vires*, for a corporation to repurchase its stock while insolvent).

For example, RCW 23B.08.310 prohibits a board of directors from authorizing distributions to shareholders when a corporation is insolvent.

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See: Section 4.02 of this book.

RCW 23B.10.030 and RCW 23B.10.200 limit a board's authority to amend a corporation's articles of incorporation without shareholder consent.

RCW 23B.12.020 limits the authority of the board to contract for the sale of substantially all of the corporation's assets outside the ordinary course of business unless two-thirds of the shareholders approve. *See also: Carson v. Isabel Apartments, Inc.*, 20 Wash App 293, 579 P2d 1027 (1978).

RCW 23B.11.030 limits the authority of a board of directors to cause the merger a corporation with another corporation, unless the shareholders consent to the merger.

***C. Acts contrary to articles of incorporation & bylaws*.**

A corporation cannot disregard its own articles of incorporation or its bylaws. But even if a corporation disregards its own articles or bylaws, such an act is not *ultra vires*. *Harstene Point Maintenance Association v. Diehl*, 95 Wash App 339, 979 P2d 854 (1999); *Twisp Mining & Smelting Co. v. Chelan Mining Co.*, 16 Wash 2d 264, 133 P2d 300 (1943), *cert denied*, 320 US 705, *cert denied*, 320 US 716 (1944), *cert denied*, 325 US 837 (1945). Such an act is "not void as ultra vires, but only voidable if successfully challenged." *Harstene Point Maintenance Association v. Diehl*, 95 Wash App 339, 345, 979 P2d 854, 857 (1999).

***D. Ultra vires - history*.**

A corporation, being a creature of statute, only has such powers as are expressly conferred upon it by law and by its own articles of incorporation. *In re Borman's Estate*, 50 Wash 2d 791, 314 P2d 617 (1957); *City of Spokane v. Amsterdamsch Trustees Kantoor*, 22 Wash 172, 60 P 141 (1900).

> As a general rule, a corporation can have and exercise only such powers as are expressly conferred on it by the act of incorporation, and such implied powers as are necessary to enable it to perform its prescribed duties. *Randall v. Mickle*, 103 Fla 1229, 138 So 14 (1931), *affirmed,* 103 Fla 1229, 141 So 317 (1932).

At one time, the powers which were granted to a corporation were quite narrow. Many early cases involved issues related to whether or not a corporation possessed the power to undertake a certain act. If a corporation lacked the power to undertake an act, its board of directors lacked the power to authorize that act. Acts which exceeded the power of a corporation or its board of directors were said to be *ultra vires* acts.

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Section 5.10

Ultra vires is latin meaning "beyond the powers."

> Ultra vires is "the modern technical designation, in the law of corporations, of acts beyond the scope of their powers, as defined by their charters or acts of incorporation." * * * "A term used to express the action of a corporation which is beyond the powers conferred upon it by its charter, or the statutes under which it was instituted." (citations omitted) *State v. Holston Trust Co.*, 79 SW2d 1012, 1016 (Tenn 1935).

The term "*ultra vires*" is used in a number of ways. Sometimes it is used in the context that a corporate act runs afoul of public policy; sometimes it is used to indicate that a corporate act goes beyond the powers granted corporations in general by statute; sometimes it is used to indicate that a corporate act goes beyond the scope of the powers set out in the corporation's own articles of incorporation or bylaws; and sometime it is used to refer to an act undertaken outside of a corporate agent's authority.

> We will consider first the question as to the obligation being ultra vires. The doctrine of ultra vires has been declared to be entirely the creation of the courts and is of comparatively recent origin. The term is used in a variety of ways, and its meaning is to be gathered from the sense or context in which it is being used. An illegal transaction in the sense of being in violation of a statute, is an ultra vires act. A corporate transaction may be illegal in the true and proper sense, or it may be ultra vires without being illegal. When corporate acts are spoken of as ultra vires, it is ordinarily not meant that they are illegal, but that they are not within the power conferred upon the corporation by its charter. The great weight of authority in all the States today is to the effect that a transaction which is merely ultra vires is, if performed by one party, not void as between the parties, and that an action may be brought directly thereon. A corporation may be estopped from claiming that a transaction was ultra vires to the extent that it has been performed by the other party. This doctrine has been followed by the Georgia courts and made especially applicable to private corporations. "The law sustains a defense of ultra vires only where an imperative rule of public policy requires it." "The doctrine of ultra vires has no proper place in the law of private corporations, organized merely for the purpose of private gain, except in respect of contracts which are *bad in themselves* (italics ours), the making of which is prohibited by a consideration of public morals or justice, or of sound public policy, or prohibited by the statute law on grounds connected with the public good." "Where, although officers of a corporation are without authority to execute a contract, they do in fact execute it, and the fruits thereof are applied to the proper corporate uses, the corporation will be liable thereon, notwithstanding the want of authority in its officers. (emphasis in original; citations omitted) *Corbin Supply Co. v. Loftis*, 50 Ga App 309, 311, 178 SE 185, 186-7 (1935).

Even under early case law, a corporation could not assert the defense of *ultra vires* if the corporation accepted the benefits of the act. *Twisp Mining & Smelting Co. v. Chelan Mining Co.*, 16 Wash 2d 264, 133 P2d 300 (1943), *cert denied*, 320 US 705, *cert denied*, 320 US 716 (1944), *cert denied*, 325 US 837 (1945); *Stephan v. Equitable Savings &*

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Loan Assn., 268 Or 544, 533 P2d 478 (1974).

An early discussion of *ultra vires* acts appears in Carpenter, *Should the Doctrine of Ultra Vires Be Discarded*, 3 OR L REV 1 (1923).

E. Ultra vires - today.

Courts now view the *ultra vires* defense with disfavor. *Total Automation, Inc. v. Illinois National Bank & Trust Co. of Rockford*, 40 Ill App 3d 266, 351 NE2d 879 (1976); *Stadium Realty Corp. v. Dill*, 233 Ind 378, 119 NE2d 893 (1954). Today "[i]t is a well established principle that a corporation has the *implied* power to do all necessary act to accomplish the *objects* of its creation and to perform its authorized functions. *Collins v. Collins Fruit Co.*, 189 So2d 262, 264 (Fla 2d DCA 1966).

In dicta, the Washington Supreme Court stated: "the Legislature statutorily eliminated the ultra vires defense in this state in 1965." *Noel v. Cole*, 98 Wash 2d 375, 379, 655 P2d 245, 248 (1982).

A more detailed discussion of the *ultra vires* doctrine appears in Kulwicki, *Amalgamated Sugar: The Auspicious Return of the Ultra Vires Doctrine*, 49 OHIO ST L J 841 (1988); Schaeftler, *Ultra Vires-Ultra Useless: The Myth of State Interest in Ultra Vires Acts of Business Corporations*, 9 J CORP L 81 (1983); 4 Notre Dame L 99 (1958).

Section 5.11 Delegation of Duties - Agents & Committees

A. Delegation to agents.

Since a corporation is not a physical being, it must act through agents.

> Since corporations can only act through their officers and agents, they have power to appoint agents with full authority to act for the corporation, and as a general rule all acts within the powers of a corporation may be performed by agents of its own selection. *Sherman, Clay & Co. v. Buffum & Pendleton, Inc.*, 91 Or 352, 358, 179 P 241, 243 (1919).

At one time, case law looked with disfavor on the delegation of the management of the corporation to officers and other agents by the board of directors. One early case stated:

> The law . . . will not permit the business and concerns of a corporation to be delegated to any officers or men, however capable, or however high their standard for integrity and honesty may be, and that fraud will be implied upon the delegation of such power and right, and the exercise thereof by men who may be the controlling stockholders, even though, in their own conscience, they may believe that everything has been done to the very best interests of the concern. *Ames v. Goldfield Merger Mines Co.*, 227 F 292, 301-2 (WD Wa 1915).

The modern view is that a board of directors has broad authority to delegate management functions to officers and other agents. 2

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FLETCHER CYC CORP § 495 (Perm Ed 1998).

Still, a board of directors may not delegate **all** corporate management to officers and other agents. *Chapin v. Benwood Foundation, Inc.*, 402 A2d 1205 (Del Ch 1979).

> The board of directors of a corporation cannot delegate total control of the corporation to an individual officer. Neither can it delegate authority which is so broad that it enables the officer to bind the corporation to extraordinary commitments or significantly to encumber the principal asset or function of the corporation. (citations omitted) *Boston Athletic Association v. International Marathons, Inc.*, 392 Mass 356, 467 NE2d 58, 62 (1984).

Some older cases hold that a board of directors could delegate only ministerial, not discretionary, duties to officers. *Patterson v. Portland Smelting Works*, 35 Or 96, 56 P 407 (1899). The more modern view is that directors may delegate substantial discretion to officers and other agents. A board of directors may not, however, delegate those duties which lay at the heart of their management of a corporation, such as their duty to use their own best judgment on management matters. *Morgan v. State Farm Mutual Automobile Insurance Co.*, 402 A2d 1211 (Del Supr 1979).

Short of total delegation, a board of directors may delegate broad authority to officers and agents to manage day-to-day corporate affairs. RCW 23B.08.410 contemplates that officers may be delegated broad powers through the bylaws and through resolutions of the board of directors.

***B. Delegation to board committees*.**

A board of directors may create committees of the board and may generally delegate to them the power to "exercise the authority of the board of directors." RCW 23B.08.250. Board committees may exercise discretionary authority, if so authorized. *Teren v. First National Bank of Chicago*, 243 Or 251, 412 P2d 794 (1966).

There are limitations. RCW 23B.08.250(5) provides that a board of directors may not delegate any of the following to a board committee:

> (a) Authorize or approve a distribution except according to a general formula or method prescribed by the board of directors;
>
> (b) Approve or propose to shareholders action that this title requires be approved by shareholders;
>
> (c) Fill vacancies on the board of directors or on any of its committees;
>
> (d) Amend articles of incorporation pursuant to RCW 23B.10.020;

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(e) Adopt, amend, or repeal bylaws;

(f) Approve a plan of merger not requiring shareholder approval; or

(g) Authorize or approve the issuance or sale or contract for sale of shares, or determine the designation and relative rights, preferences, and limitations of a class or series of shares, except that the board of directors may authorize a committee, or a senior executive officer of the corporation to do so within limits specifically prescribed by the board of directors.

There must be at least two directors on each board committee. RCW 23B.08.250(1). *See also: Harstene Point Maintenance Association v. Diehl*, 95 Wash App 339, 979 P2d 854 (1999)(committees of nonprofit corporations). As a general rule, a committee can act only through a majority of its membership. *Superior Portland Cement, Inc. v. Pacific Coast Cement Co.*, 33 Wash 2d 169, 205 P2d 597 (1949).

A board's authority to create committees or its authority to delegate power to committees may be limited either by the articles of incorporation or by the bylaws. RCW 23B.08.250(1).

Section 5.12 Standard of Care

A directorship is not a mere "bestowal of an honor" on the person named to that position, but rather, a seat on a corporation's board of directors imposes "important duties and responsibilities." *Barnes v. Eastern and Western Lumber Co.*, 205 Or 553, 572, 287 P2d 929, 938 (1955). "[D]irectors may not be mere ornaments and figureheads but must carry out their responsibilities of obedience to the law and loyalty as a fiduciary with the diligence of an ordinarily prudent man." *Davis v. Ben O'Callaghan Co.*, 139 Ga App 22, 24, 227 SE2d 837, 839-40 (1976).

> It is the habit in these days for certain well-to-do men with influence in their respective communities to accept positions on boards of directors of corporations as honorary positions, and they never render any service except to sign on the dotted line, vote as requested by the one in charge, and afterwards to cash their director's check for attending the meeting. They give no thought to the affairs of the company, exercise no judgment upon questions of business policy, and make no investigation of the real financial condition of the company. It is this kind of service by directors that helps to extract such a tremendous annual toll out of the public who happen to own industrial securities. The law requires a different kind of service of them. *Chapple v. Jacobson*, 234 Mich 558, 208 NW 754, 755 (1926).

"[O]fficers and directors have an affirmative duty to be aware of the companies they serve and that they can be held liable for activities of other officers and directors which they reasonably should know about." *Senn v. Northwest Underwriters, Inc.*, 74 Wash App 408, 414, 875 P2d

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637, 640 (1994).

A. Standard at common law.

At common law, directors were required to exercise such care as an ordinarily prudent and diligent person would exercise in similar circumstances. *Para-Medical Leasing, Inc. v. Hangen*, 48 Wash App 389, 739 P2d 717 (1987); *Devlin v. Moore, 64 Or 433, 130 P 35 (1913)*; *Woodward v. Stewart*, 149 Ga 620, 101 SE 749 (1919)(which contains an extensive review of cases and commentary on this issue as it was then viewed).

At common law, the degree of care, skill, and diligence required was a question of fact, determined in light of all the circumstances surrounding the act or decision.

> In any view the degree of care to which these defendants were bound is that which ordinarily prudent and diligent men would exercise under similar circumstances, and in determining that the restrictions of the statute and the usages of business should be taken into account. What may be negligence in one case may not be want of ordinary care in another, and the question of negligence is, therefore, ultimately a question of fact, to be determined under all the circumstances. *Briggs v. Spaulding*, 141 US 132, 152 (1891).

In one early case, the court discussed the standard of care required of bank directors -- a standard much like the standard applicable to other corporate directors:

> As a general rule, directors are charged with the duty of reasonable supervision over the affairs of the bank. It is their duty to use ordinary diligence in ascertaining the condition of its business, and to exercise reasonable control and supervision over its affairs. They are not insurers or guarantors of the fidelity and proper conduct of the executive officers of the bank and are not responsible for losses resulting from their wrongful acts or omissions, provided they have exercised ordinary care in the discharge of their own duties as directors.
>
> Ordinary care, in this matter as in other departments of the law, means that degree of care which prudent and diligent men would ordinarily exercise under similar circumstances. The degree of care required further depends upon the subject to which it is to be applied, and each case must be determined in view of all the circumstances of that particular case. If nothing has come to the knowledge to awaken suspicion that something is going wrong, ordinary attention to the affairs of the institution is sufficient. If, on the other hand, directors know, or by the exercise of ordinary care should have known, any facts which would awaken suspicion and put a prudent man on his guard, then a degree of care commensurate with the evil to be avoided is required, and a want of that care makes them responsible. Directors cannot, in justice to those who deal with the bank, shut their eyes to what is going on around them. Directors are not expected to watch the routine of every day's business, but they ought to have a general knowledge of the manner in which the bank's business is conducted, and upon what securities its larger lines of credit are given, and generally to know of and give direction to the important and general affairs of the bank. They are not

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> required to be bookkeepers. *Devlin v. Moore*, 64 Or 433, 462-3, 130 P 35, 45 (1913).

See also: Kahn v. Roberts, [1993-4 Transfer Binder] FED SEC L RPTR (CCH) ¶ 98,201 (Del Ch February 28, 1994); *Super Valu Stores, Inc. v. First National Bank of Columbus, Georgia*, 463 F Supp 1183 (MD Ga 1979).

B. Current statutory standard.

The standard of care imposed on directors today is set forth in RCW 23B.08.300(1), which requires that directors discharge their duties:

> (a) In good faith;
>
> (b) With the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
>
> (c) In a manner the director reasonably believes to be in the best interests of the corporation. RCW 23B.08.300(1).

The Washington Court of Appeals has interpreted similar language in the predecessor to this section (RCW 23A.08.343) to be a codification of existing common law, but noted that the statute "must be strictly construed and limited to its plain intent and scope." *Para-Medical Leasing, Inc. v. Hangen*, 48 Wash App 389, 397, 739 P2d 717, 722 (1987).

Under Washington law, "officers and directors have an affirmative duty to be aware of the companies they serve and that they can be held liable for activities of other officers and directors which they reasonably should know about." *Senn v. Northwest Underwriters, Inc.*, 74 Wash App 408, 414, 875 P2d 637, 640 (1994).

> The logic of this proposition is irrefutable. One cannot discharge a duty by remaining ignorant of what that duty entails. Just as ignorance of the law is no excuse for the violation of a law, ignorance of the affairs of a business to which one owes a duty of diligence, care and skill does not excuse a director from liability for his or her colleagues' fraud or malfeasance. *Senn v. Northwest Underwriters, Inc.*, 74 Wash App 408, 416, 875 P2d 637, 640 (1994).

In discharging their duty of care, directors may rely on information, opinions, reports, and statements of certain officers, employees, professionals and experts. RCW 23B.08.300(2); *Hines v. Data Line Systems, Inc.*, 114 Wash 2d 127, 787 P2d 8 (1990); *Rowen v. Le Mars Mutual Insurance Company of Iowa*, 282 NW2d 639 (Iowa 1979); *Graham v. Allis-Chambers Manufacturing Co.*, 41 Del Ch 78, 288 A2d 125 (1963). But the director may not use such advise as a "cloak of immunity. Each case turns on its own facts." *Horton v. Whitehill*, 121 Or App 336, 341, n

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6, 854 P2d 977, 980, *review denied*, 318 Or 25, 862 P2d 1305 (1993).

If a director discharges his/her duties in the manner prescribed by RCW 23B.08.300(1), the director is not liable. RCW 23B.08.300(4).

***C. Business judgement rule*.**

The business judgment rule is discussed in detail in Section 5.13 herein.

The business judgment rule gives a board of directors wide latitude in carrying out its duties.

> The "business judgment rule" immunizes management from liability in a corporate transaction undertaken within both the power of the corporation and the authority of management where there is a reasonable basis to indicate that the transaction was made in good faith. *Nursing Home Building Corp. v. DeHart*, 13 Wash App 489, 498, 535 P2d 137, 143 (1975).

But the business judgment rule does not go so far as to permit the directors to act fraudulently or dishonestly. *Riss v. Angel*, 131 Wash 2d 612, 934 P2d 669 (1997); *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995). It may not even permit incompetent or negligent judgment and performance. *Shinn v. Thrust IV, Inc.*, 56 Wash App 827, 786 P2d 285 (1990); *Seafirst Corp. v. Jenkins*, 644 F Supp 1152 (WD Wash 1986); *Schwarzmann v. Association of Apartment Owners of Bridgehaven*, 33 Wash App 397, 655 P2d 1177 (1982). One court has said that the assumption underlying the business judgment rule is that "reasonable diligence has been used in reaching that which the rule is invoked to justify." *Miller v. American Telephone & Telegraph Co.*, 507 F2d 759, 762 (3rd Cir 1974).

The business judgment rule may not be used as a shield by a director who makes no effort at an informed judgment. *Kahn v. Roberts*, [1993-4 Transfer Binder] FED SEC L RPTR (CCH) ¶ 98,201 (Del Ch February 28, 1994); *Cede & Co. v. Technicolor, Inc.*, 634 A2d 345 (1993). Directors have a duty to keep themselves informed of the assets and activities of the corporation. *Barnes v. Eastern & Western Lumber Co.*, 205 Or 553, 287 P2d 929 (1955).

> A director cannot blindly take action and later avoid the consequences by saying he was not aware of the effect of the action he took. A director has some duty to become informed about the actions he is about to undertake. (citation omitted) *W & W Equipment Co., Inc. v. Mink*, 568 NE2d 564, 575 (Ind App 1991).

The business judgement rule assumes that "reasonable diligence has been used in reaching that which the rule is invoked to justify." *Miller*

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v. American Telephone & Telegraph Co., 507 F2d 759, 762 (3rd Cir 1974). There is a strong presumption that a director knows of the corporation's financial affairs. *Gantenbein v. Bowles*, 103 Or 277, 203 P 614 (1922); *Devlin v. Moore*, 64 Or 433, 130 P 35 (1913). The Delaware Supreme Court has said:

> It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. (citations omitted) *Aronson v. Lewis*, 473 A2d 805, 812 (Del Supr 1984).

Additional discussion of this topic appears in Palm & Kearney, *A Primer on the Basics of Directors' Duties in Delaware: The Basic Rules of the Game (Part I)*, 40 VILL L REV 1297 (1995); *Surviving Enhanced Judicial Scrutiny of Directors' Decisions: Reaching the Protection of the Business Judgment Rule*, 60 MO L REV 677 (1995); Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L J 1155 (1990); Soderquist, *The Proper Standard For Director Negligence Liability*, 66 Notre Dame 37 (1990); Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 Notre Dame 456 (1985).

D. Director liability may be limited.

RCW 23B.02.020(5)(j) provides that the articles of incorporation may contain a provision wherein "[a] director's personal liability to the corporation or its shareholders for monetary damages may be eliminated or limited under RCW 23B.08.320."

No such provision may eliminate or limit liability of a director:

> for acts or omissions that involve intentional misconduct by a director or a knowing violation of law by a director, for conduct violating RCW 23B.08.310, or for any transaction from which the director will personally receive a benefit in money, property, or services to which the director is not legally entitled. RCW 23B.08.320.

No such provision may eliminate or limit liability retroactively. RCW 23B.08.320.

E. Liability for breach of standard of care.

Directors are liable to the corporation for breach of their standard of care. *Shinn v. Thrust IV, Inc.*, 56 Wash App 827, 786 P2d 285 (1990); *Horton v. Whitehill*, 121 Or App 336, 341, n 6, 854 P2d 977, 980, *review denied*, 318 Or 25, 862 P2d 1305 (1993); *Devlin v. Moore*, 64 Or 433, 130 P 35 (1913).

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Section 5.13

Section 5.13 Business Judgment Rule

A. Generally.

The business judgement rule immunizes directors from actions taken by them in good faith and not for some corrupt purpose. The rule is applied under the rationale that in order for a corporation to be managed properly and efficiently, directors must be given wide latitude to handle corporate business.

> Courts are reluctant to interfere with the internal management of corporations and generally refuse to substitute their judgment for that of the directors. The "business judgment rule" immunizes management from liability in a corporate transaction undertaken within both the power of the corporation and the authority of management where there is a reasonable basis to indicate that the transaction was made in good faith. An excellent statement of the "business judgment rule" is found in W. Fletcher § 1039 at pages 621-25:
>
> > It is too well settled to admit of controversy that ordinarily neither the directors nor the other officers of a corporation are liable for mere mistake or errors of judgment, either of law or fact. In other words, directors of a commercial corporation may take chances, the same kind of chances that a man would take in his own business. Because they are given this wide latitude, the law will not hold directors liable for honest errors, for mistakes of judgment, when they act without corrupt motive and in good faith, that is, for mistakes which may properly be classified under the head of honest mistakes. And that is true even though the errors may be so gross that they may demonstrate the unfitness of the directors to manage the corporate affairs. This rule is commonly referred to as the "business judgment rule." (citations omitted) *Nursing Home Building Corp. v. DeHart*, 13 Wash App 489, 498-9, 535 P2d 137, 143-4 (1975).

The business judgement rule is a presumption, not an absolute defense.

> The business judgment rule is a presumption that in making a business decision, not involving self-interest, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company. *Spiegal v. Buntrock*, 571 A2d 767, 774 (Del Supr 1990).

"There is a strong presumption that [directors] exercised their best judgment in conducting the affairs of the" corporation. *Devlin v. Moore*, 64 Or 433, 461, 130 P 35, 45 (1913).

> It is a presumption that in making a business decision the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interests of the company. Absent an abuse of discretion, that judgment will be respected by the courts. (citations omitted) *Aronson v. Lewis*, 473 A2d 805, 812 (Del Supr 1984).

Courts have applied the business judgment rule to corporate

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boards of directors since early days. *Hedges v. Paquett*, 3 Or 77 (1869). One court noted that the business judgment rule has been part of the common law for at least 150 years. *Gries Sports Enterprises, Inc. v. Cleveland Browns Football Co., Inc.*, 26 Ohio St3d 15, 496 NE2d 959, 963 (1986).

If a court finds that the business judgment rule applies, it will generally decline to substitute its judgment for the judgment of a board of directors, the persons elected by the shareholders to manage corporate affairs. *Riss v. Angel*, 131 Wash 2d 612, 934 P2d 669 (1997); *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995); *Lowry v. Lowry*, 590 NE2d 612, 621 (Ind App 1992); *Gries Sports Enterprises, Inc. v. Cleveland Browns Football Co., Inc.*, 26 Ohio St3d 15, 496 NE2d 959, 963 (1986). As one court stated: "judges are not business experts." *Dodge v. Ford Motor Co.*, 204 Mich 459, 170 NW 668, 684 (1919).

> If there are plausible business reasons supportive of the decision of the board of directors, and such reasons can be given credence, a Court will not interfere with a corporate board's right to make that decision. It is not our function to referee every corporate squabble or disagreement. It is our duty to redress wrongs, not to settle competitive business interests. Absent any bad faith, fraud, breach of fiduciary duty or abuse of discretion, no wrong cognizable by or correctable in the Courts has occurred. *Gay v. Gay's Super Markets, Inc.*, 343 A2d 577, 580 (Me 1975).

One Washington decision held that it is the business judgment of directors, not minority shareholders, which should guide corporate operations. *Sanders v. E-Z Park, Inc.*, 57 Wash 2d 474, 358 P2d 138 (1960). Another Washington decision stated that "directors . . . may in the exercise of their honest business judgment adopt a valid method of eliminating what appears to them a clear threat to the future of their business by any lawful means." *Hendricks v. Mill Engineering & Supply Co.*, 68 Wash 2d 490, 495, 413 P2d 811, 813-4 (1966).

With two exceptions discussed below, the business judgment rule means that neither the judgment of the court nor the judgment of the minority shareholders can properly be substituted for the judgment of the majority of the directors.

> Unless there is evidence of fraud, dishonesty, or incompetence (*i.e.,* failure to exercise proper care, skill, and diligence), courts generally refuse to substitute their judgment for that of the directors. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 279, 892 P2d 98, 104 (1995).

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Section 5.13

Additional discussion of the business judgment rule appears in Palm & Kearney, *A Primer on the Basics of Directors' Duties in Delaware: The Basic Rules of the Game (Part I)*, 40 VILL L REV 1297 (1995); *Surviving Enhanced Judicial Scrutiny of Directors' Decisions: Reaching the Protection of the Business Judgment Rule*, 60 MO L REV 677 (1995); Romano, *Corporate Governance in the Aftermath of the Insurance Crisis*, 39 EMORY L J 1155 (1990); Soderquist, *The Proper Standard For Director Negligence Liability*, 66 Notre Dame 37 (1990); *"Poison Pill" Warrants and the Business Judgment Rule: Moran v. Household International, Inc.*, 66 OR L REV 373 (1987) Peeples, *The Use and Misuse of the Business Judgment Rule in the Close Corporation*, 60 Notre Dame 456 (1985).

***B. Example - Chicago Cubs*.**

A good illustration of the application of the business judgment rule involves a minority shareholder derivative suit filed against the directors of the Chicago Cubs for their decision not to install lights at Wrigley Field. Without lights, no baseball games could be played at home after dark.

> Plaintiff alleges that since night baseball was first played in 1935 nineteen of the twenty major league teams have scheduled night games. In 1966, out of a total of 1620 games in the major leagues, 932 were played at night. Plaintiff alleges that every member of the major leagues, other than the Cubs, scheduled substantially all of its home games in 1966 at night, exclusive of opening day, Saturdays, Sundays, Holidays and days prohibited by league rules. Allegedly this has been done for the specific purpose of maximizing revenue and income.
>
> The Cubs, in the years 1961-65, sustained operating losses from its direct baseball operations. Plaintiff attributes those losses to inadequate attendance at Cubs' home games. He concludes that if the directors continue to refuse to install lights at Wrigley Field and schedule night baseball games, the Cubs will continue to sustain comparable losses and its financial condition will continue to deteriorate. *Shlensky v. Wrigley*, 95 Ill App 2d 173, 237 NE2d 776, 777 (1968).

The court reviewed many cases involving the business judgment rule. Noting that "judges are not business experts," the court refused to substitute its judgment for the judgment of the duly elected directors. It then dismissed the derivative suit, stating:

> Finally, we do not agree with plaintiff's contention that failure to follow the example of the other major league clubs in scheduling night games constituted negligence. . . Furthermore, it cannot be said that directors, even those of corporations that are losing money, must follow the lead of the other corporations in the field. Directors are elected for their business capabilities and judgment and the courts cannot require them to forego their judgment because of the decisions of directors of other companies. Courts may not decide these questions in the absence of a clear showing of dereliction of duty on the part of the specific directors

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> and mere failure to "follow the crowd" is not such a dereliction. *Shlensky v. Wrigley*, 95 Ill App 2d 173, 237 NE2d 776, 781 (1968).

C. Two exceptions to business judgement rule.

There are two principal exceptions to the business judgment rule. One exception is the requirement of good faith; the other relates to a corrupt purpose.

> The so-called business judgment rule pre-supposes a decision by board members that is honest, unbiased, in compliance with fiduciary obligations, and a judgment that has been exercised reasonably and with due care. *Evans v. Armour and Co.*, 241 F Supp 705, 713 (ED Pa 1965).

D. Bad faith exception.

The business judgment rule gives a board of directors wide latitude in carrying out its duties.

> The "business judgment rule" immunizes management from liability in a corporate transaction undertaken within both the power of the corporation and the authority of management where there is a reasonable basis to indicate that the transaction was made in good faith. *Nursing Home Building Corp. v. DeHart*, 13 Wash App 489, 498, 535 P2d 137, 143 (1975).

But the business judgment rule does not go so far as to permit the directors to act fraudulently or dishonestly. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995). It may not even permit incompetent or negligent judgment and performance. *Id.*; *Seafirst Corp. v. Jenkins*, 644 F Supp 1152 (WD Wash 1986); *Schwarzmann v. Association of Apartment Owners of Bridgehaven*, 33 Wash App 397, 655 P2d 1177 (1982); *Kahn v. Roberts*, [1993-4 Transfer Binder] FED SEC L RPTR (CCH) ¶ 98,201 (Del Ch February 28, 1994); *Cede & Co. v. Technicolor, Inc.*, 634 A2d 345 (1993); *Brane v. Roth*, 590 NE2d 587 (Ind App 1992). The exact rule in Washington is unclear.

> The scope of the "business judgment" rule in Washington is somewhat unclear. It has been said that the rule generally immunizes management from liability in a corporate transaction where a reasonable basis exists to indicate that the transaction was made in good faith. It as also been said that the rule protects corporate officers rom liability for honest mistakes, even if the mistake may be so gross that it may demonstrate the unfitness of the directors to manage the corporation. These and other Washington decisions can be read as requiring only good faith efforts by management in order to satisfy the business judgment rule.
>
> However, several other cases indicate that the rule not only requires directors to act with good faith, but also requires then to act with such care as an ordinarily prudent person would use under similar circumstances.

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> * * * *
>
> We find this analysis of the relevant case law persuasive. The business judgment rule does not appear to protect a defendant's conduct in Washington if the defendant did not exercise proper care, skill, and diligence. *Shinn v. Thrust IV, Inc.*, 56 Wash App 827, 833-5, 786 P2d 285, 289-90 (1990).

Another court has said that the assumption underlying the business judgment rule is that "reasonable diligence has been used in reaching that which the rule is invoked to justify." *Miller v. American Telephone & Telegraph Co.*, 507 F2d 759, 762 (3rd Cir 1974).

E. Corrupt purpose exception.

The corrupt purpose exception means that directors are required to act in accordance with their fiduciary duties to the corporation and its shareholders. Thus, the business judgment rule may not apply if the act involves fraud or dishonesty. *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 279, 892 P2d 98, 104 (1995).

> The "business judgment" rule immunizes management from liability in a corporate transaction undertaken within the corporation's power and management's authority where a reasonable basis exists to indicate that the transaction was made in good faith. Such immunity from liability is absent where a corporate director or officer is shown t have acted in bad faith and with a corrupt motive. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 509, 728 P2d 597, 603 (1986), *review denied*, 107 Wash 2d 1022 (1987).

Thus, while courts generally will not closely examine board decisions, courts will vigorously scrutinize transactions involving conflicts of interest or self-dealing. *Central Bldg. Co. v. Keystone Shares Corp.*, 185 Wash 645, 56 P2d 697 (1936); *Larson v. A.W. Larson Const. Co.*, 36 Wash 2d 271, 217 P2d 789 (1950); *Tefft v. Schaefer*, 148 Wash 602, 269 P 1048 (1928); *Westland v. Post Land Co.*, 115 Wash 329, 197 P 44 (1921); *Quinn v. Cardiovascular Physicians, P.C.*, 254 Ga 216, 326 SE2d 460 (1985); *Merger Mines Corp. v. Grismer*, 137 F2d 335, 340 (9th Cir), *cert denied*, 320 US 794 (1943).

A more detailed discussion of the fiduciary duties of directors appears in Sections 5.14 and 5.15 of this book.

F. Business judgement rule - examples.

The business judgment rule has broad application. For instance, a court will generally decline to interfere in disputes involving the exchange of a corporation's stock for the assets of another corporation, *Sanders v. E-Z Park, Inc.*, 57 Wash 2d 474, 358 P2d 138 (1961); the issuance of notes to fund a leveraged buyout, *Spokane Concrete*

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Products, Inc. v. U. S. Bank of Washington, 126 Wash 2d 269, 892 P2d 98 (1995); business expenses, salary, fringe benefits and reimbursed expenses, *Nursing Home Building Corp. v. DeHart*, 13 Wash App 489, 535 P2d 137 (1975); executive compensation, *Cole Real Estate Corp. v. Peoples Bank and Trust Co.*, 160 Ind App 88, 310 NE2d 275 (1985); vacation pay and Christmas bonuses, *Dobry v. Dobry*, 324 P2d 534 (Okla 1958); employee retirement benefits, *Teren v. First National Bank of Chicago*, 243 Or 251, 412 P2d 794 (1966), "golden parachute" provisions for an executive officer, *Royal Crown Companies, Inc. v. McMahon*, 183 Ga App 543, 359 SE2d 379 (1987); the removal of a corporate officer, *Kiess v. Eason*, 442 F2d 712 (7th Cir 1971); retained earnings, even in cases involving S corporations, *Iwasaki v. Iwasaki Bros., Inc.*, 58 Or App 543, 649 P2d 598 (1982); and the liquidation of a corporation, *McMunn v. ML&H Lumber, Inc.*, 247 Or 319, 429 P2d 798 (1967).

***G. Example - dividends*.**

The decision whether of not to issue dividends clearly falls within the business judgement rule.

> It is settled law in this State that the declaration and payment of a dividend rests in the discretion of the corporation's board of directors in the exercise of its business judgement; that, before the courts will interfere with the judgment of the board of directors in such matter, fraud or gross abuse of discretion must be shown. *Gabelli & Co., Inc. v. Liggett Group Inc.*, 479 A2d 276, 280 (Del Supr 1984).

"The question of whether a dividend shall be declared is ordinarily one of internal management with which the courts will not interfere." *Ostlind v. Ostlind Valve, Inc.*, 178 Or 161, 186, 165 P2d 779, 789 (1946). *See also: Barnes v. State Farm Mutual Automobile Insurance Co.*, 16 Cal App 4th 365, 20 Cal Rptr 2d 87 (1993); *Dodge v. Ford Motor Co.*, 204 Mich 459, 170 NW 668, 684 (1919); *Baillie v. Columbia Gold Mining Co.*, 86 Or 1, 166 P 965, 167 P 1167 (1917).

> We have recognized that those in control of corporate affairs have fiduciary duties of good faith and fair dealing toward the minority shareholders. Insofar as dividend policy is concerned, however, that duty is discharged if the decision is made in good faith and reflects legitimate business purpose rather than the private interests of those in control. (citations omitted) *Zidell v. Zidell, Inc.*, 277 Or 413, 418, 560 P2d 1086, 1089 (1977).

The decision to hold funds in reserve for exigencies before paying dividends to preferred shareholders also falls within the rule. *Collins v. Portland Electric Power Co.*, 7 F2d 221, *affirmed*, 12 F2d 671 (D Or 1925). "As a general rule the officials of a corporation are the sole judges as to

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the propriety of declaring dividends and the courts will not interfere with the proper exercise of that discretion." *W. Q. O'Neall Co. v. O'Neall*, 108 Ind App 116, 25 NE2d 656, 659 (1940).

However, if the decision to withhold dividends is made in bad faith, the court will intervene and protect shareholders. *Maul v. Kirkman*, 270 NJ Super 596, 637 A2d 928 (1994).

H. Example - consideration for stock.

One area in which courts have often acted to reverse or modify a board's business judgment relates to valuation of property received for a corporation's stock.

RCW 23B.06.210(3) provides that the board's determination as to the adequacy of the consideration received for shares is conclusive, provided the determination is made in good faith. The business judgment rule applies to that determination. The business judgment rule applies to that determination. *In the Matter of Delk Road Associates, Ltd.*, 37 BR 354 (ND Ga 1984); *Garbe v. Excel Mold, Inc.*, 397 NE2d 296 (Ind App 1979); *Smith v. Schmitt*, 112 Or 687, 699, 231 P 176 (1924).

When the directors are also the promoters, however, their judgment as to the adequacy of the consideration is subject to scrutiny.

> The judgment of the directors of a corporation upon the value of property or stock to be taken and accepted by the corporation in exchange for its own stock in payment of a subscription contract, the exercise of which, when acted upon, is made conclusive by statute, refers to an honest attempt to determine the value of the property or stock by a board of directors representing the corporation alone and jealous of its right and interests and anxious to secure for the corporation all that it is justly entitled to. Anything less than that is dishonest and fraudulent. The directors may be honestly mistaken. They may exercise a very poor judgment and make a very poor bargain, but this is wholly immaterial so long as they have no personal interests of their own to further and act fairly and honestly by the corporation they profess to represent. *Atwell v. Schmitt*, 111 Or 96, 106, 225 P 325, 328 (1924).

The business judgment of the board of directors may also be limited by Article 12, Section 6 of the Washington Constitution which provides:

> Corporations shall not issue stock, except to *bona fide* subscribers therefor, or their assignees; nor shall any corporation issue any bond, or other obligation, for he payment of money, except for money or property received or labor done. . . . All fictitious increase of stock or indebtedness shall be void.

In *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 892 P2d 98 (1995), the Washington Supreme Court assumed, without deciding, that a corporation's borrowings from a bank

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and its repeated issuances of notes to the bank constituted an *ultra vires* act in violation of the Article 12, Section 6 of the Washington Constitution. But in an action by the corporation's trustee in bankruptcy to avoid the notes, the Court held that the trustee's claim was barred by the doctrine of estoppel and ratification.

***I. Example - derivative lawsuits*.**

In a derivative lawsuit, a minority shareholder makes demand upon the board of directors to sue a third party. If the board improperly refuses to sue, the shareholder may then sue the third party, with the corporation as a nominal defendant. Derivative lawsuits are discussed in more detail in Section 8.04 of this book.

In deciding whether a board's decision not to sue is proper, courts sometimes apply the business judgement rule.

> Thus, the demand requirement implements "the basic principle of corporate governance that the decision of a corporation - including the decision to initiate litigation - should be made by the board of directors or the majority of shareholders." (citations omitted) *Kamen v. Kemper Financial Services, Inc.*, 500 US 102 (1991).

The board of directors is free to make a good faith evaluation of the claim and to decide whether it is wise for the corporation to assert the claim being demanded.

> It does not follow from what has been said in this connection, however, that a stockholder or a minority group of stockholders may impose their unbridled wills upon the officers or directors of a corporation by launching the corporation into litigation for the purpose of obtaining for it certain benefits which the complaining parties deem to belong or be due to the corporation. Business policy may dictate that, under certain circumstances, it would be unwise or unprofitable to insist upon one's rights, and accordingly the directors of a corporation or the majority of its stockholders may decline to bring or maintain a suit which a single stockholder of a minority group believes should be instituted. *Goodwin v. Castleton*, 19 Wash 2d 748, 762, 144 P2d 725, 732 (1944).

If the decision not to sue is one supportable by the business judgment rule, courts will not permit the minority shareholder to sue derivatively. *Opportunity Christian Church v. Washington Water Power Co.*, 136 Wash 2d 116, 238 P2d 641 (1925); *Millsap v. American Family Corp.*, 208 Ga App 230, 430 SE2d 385 (1993); *Auerbach v. Bennett*, 47 NY2d 619, 419 NYS 2d 920, 393 NE2d 994 (1979). *See:* Section 8.04 of this book.

More detailed discussions of the business judgment rule and derivative lawsuits appear in *When Should Courts Allow the Settlement of Duty-of-Loyalty Derivative Suits?*, 109 HARV L REV 1084 (1996);

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Kinney, *Stockholder Derivative Suits: Demand and Futility where the Board Fails to Stop Wrongdoers*, 78 MARQ L REV 172 (1994); Murdock, *Corporate Governance - The Role of Special Litigation Committees*, 68 WASH L REV 79 (1993).

***J. Burden of proof*.**

The business judgment rule is a presumption "that in making a business decision, not involving self-interest, the directors of a corporation acted on an informed basis, in good faith and in the honest belief that the action taken was in the best interest of the company." *Spiegal v. Buntrock*, 571 A2d 767, 774 (Del Supr 1990). But the rule is a rebuttable presumption. *Maul v. Kirkman*, 270 NJ Super 596, 637 A2d 928 (1994).

Except in cases involving self-dealing or other breaches of fiduciary duty, a minority shareholder has the burden of proving that the business judgement rule should not apply.

> Upon a careful review of treatises and pertinent case authorities, we hold that the business judgment rule requires a shareholder who challenges a nonself-dealing transaction to prove that the corporate director or officer in authorizing the transaction (1) failed to act in good faith, (2) failed to act in a manner he reasonably believed to be in the best interest of the corporation, or (3) failed to exercise such care as an ordinarily prudent person in a like position would use in similar circumstances. (footnote omitted) *Lussier v. Mau-Van Development, Inc.*, 4 Haw App 359, 667 P2d 804, 817 (1983).

In cases where self-dealing or self-interest is alleged, the minority shareholder has the initial burden of proving that the director(s) had a conflict of interest. *Smith v. Pacific Pools, Inc.*, 12 Wash App 578, 530 P2d 658, *review denied*, 85 Wash 2d 1016 (1975); *Bay City Lumber Co. v. Anderson*, 8 Wash 2d, 191, 111 P2d 771 (1941); *Aronson v. Lewis*, 473 A2d 805, 812 (Del Supr 1984). Once sufficient evidence of self-interest is introduced, the burden shifts to the director(s) to show that the transaction was fair. *Turner Broadcasting System, Inc. v. CBS*, Inc., 627 F Supp 901, 910 (ND Ga 1985).

> Once it is established that one with a fiduciary duty has attempted to benefit from a questioned transaction, the law presumes fraud. At this point, the burden of proof shifts to the party with the fiduciary duty to overcome the presumption by showing his actions were honest and in good faith. (citations omitted) *Dotlich v. Dotlich*, 475 NE2d 331, 342 (Ind App 1985).

Even though the burden of proof shifts to the directors to prove the fairness of the self-dealing transaction, the burden of proof does not shift to require the directors to prove the fairness of all transactions. The party alleging improper conduct has the initial burden of proving that each such transaction involves self-dealing or personal benefit, but if the transaction

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involves self-dealing, then the burden shifts to the officer/director to show good faith. *Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987). That party alleging improper conduct also bears the burden of proving damages. *Id.*

Section 5.14 Directors as Fiduciaries

A. Rule today.

Today, nearly all courts describe directors as having a fiduciary duty to the corporation, as well as to the shareholders, *as a group*. The duty of directors to individual shareholders is discussed in Section 5.15 below.

As a fiduciary, a corporate director owes undivided loyalty to, and must deal fairly, honestly and openly with, the corporation and its shareholders. *State ex rel Hayes Oyster Co. v. Keypoint Oyster Co.*, 64 Wash 2d 375, 381, 391 P2d 979, 983 (1964); *Horton v. Whitehill*, 121 Or App 336, 854 P2d 977, *review denied*, 318 Or 25, 862 P2d 1305 (1993); Ryan, *Strange Bedfellows: Corporate Fiduciaries and the General Law Compliance Obligation In Section 2.01(a) of the American Law Institute's Principles of Corporate Governance*, 66 WASH L REV 413 (1991).

> The law is well settled that the relation of a [director] of a corporation to it is fiduciary, and that he must at all times act in good faith and unselfishly toward it. *Tefft v. Schaefer*, 148 Wash 602, 606-7, 269 P 1048, 1049 (1928).

A more recent Washington case quotes Judge Cardozo's language defining fiduciaries, language which the court deemed "classic."

> Many forms of conduct permissible in a workaday world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the disintegrating erosion of particular exceptions. Only thus has the level of conduct of fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court. (citation & internal quotes omitted) *Kane v. Klos*, 50 Wash 2d 778, 784, 314 P2d 672, 676-7 (1957)(quoting from *Meinhard v. Salmon*, 249 NY 458, 164 NE 545).

To establish liability for a director's breach of fiduciary duty, either the corporation or the shareholder has the burden of showing (i) that the director breached his/her fiduciary duty, and (ii) that the breach was a proximate cause of the losses sustained. *Senn v. Northwest Underwriters, Inc.*, 74 Wash App 408, 875 P2d 637 (1994); *Interlake*

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Porsche & Audi, Inc. v. Bucholz, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987).

***B. History*.**

Courts have not always described directors as fiduciaries. At various times, courts have described directors as trustees, agents, and by other similar terms. Each of these terms implied a high standard of duty and care in a director's personal dealings with the corporation.

> Directors of a private corporation occupy a somewhat peculiar position. They have been variously classified as agents, mandataries, bailees and trustees; and it has been sought to define their duties and liabilities to the corporation and its stockholders on the basis of such relations. A great deal of learning has been expended, and perhaps some of it wasted, in efforts to rigidly apply one or another of these analogies to facts to which it has not always been fully applicable. Directors are agents, but they are also agents clothed with a fiduciary character; and, while they are not express or technical trustees, they are selected to manage the affairs and property of the corporation for its benefit, and they bear to it and to its stockholders a relation which in many respects may be called a trust relation; and thus by numerous courts they have been called trustees. *McEwen v. Kelly*, 140 Ga 720, 79 SE 777, 778-9 (1913).

Until 1933, Washington law did not use the term "director," rather the board which governed corporations was called the "board of trustees." In 1933, Washington adopted the more universally accepted nomenclature "board of directors." Session Laws, Chapter 185, Section 31 (1933). Before the terminology was changed from "trustee" to "director," the Washington Supreme Court stated:

> The law is well settled that the relation of a trustee of a corporation to it is fiduciary, and that he must at all times act in good faith and unselfishly toward it. *Tefft v. Schaefer*, 148 Wash 602, 606-7, 269 P 1048, 1049 (1928).

In 1941, a federal trial court in Washington said that:

> directors are trustees' is rhetorically sound but technically inexact. It is a statement often found in opinions but is true only to a limited extent. They are mandataries. They are agents. They are trustees in the sense that every agent is a trustee for his principal and bound to exercise diligence and good faith. *Robinson v. Lindfield College*, 42 F Supp 147, 155 (ED Wa 1941)(quoting from *Wallace v. Lincoln Sav. Bank*, 89 Tenn 630, 15 SW 448).

More recently the Washington Supreme Court has stated that:

> Certain basic concepts have long been recognized by courts throughout the land on the status of corporate officers and directors. They occupy a fiduciary relation to a private corporation and the shareholders thereof akin to that of a trustee, and owe undivided loyalty, and a standard of behavior above that of the workaday world. *State ex rel Hayes Oyster*
>
> *Co. v. Keypoint Oyster Co.*, 64 Wash 2d 375, 381, 391 P2d 979, 983 (1964).

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See also: Williams v. Queen Fisheries, Inc., 2 Wash App 691, 469 P2d 583 (1970).

One commentator has suggested that the treatment of directors turns on the nature of the plaintiff and whether the action is in equity or at law. 3 FLETCHER CYC CORP § 842 (Perm Ed 1994). Actions initiated by a corporation are generally in equity and in such actions courts generally treat officers and directors as trustee or quasi-trustees. On the other hand, actions initiated by creditors are generally at law and the rules of agency arguably apply. An earlier opinion noted:

> While courts of law generally treat the directors as agents, courts of equity treat them as trustees, and hold them to a strict account for any breach of the trust relation. For all practical purposes they are trustees when called upon in equity to account for their official conduct. (citations omitted) *Bosworth v. Allen*, 168 NY 157, 61 NE 163, 165 (1901).

More recent Washington decisions usually speak in terms of a director's "fiduciary" duty, rather than in terms of trustees and agents. *See, for example: Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986), *review denied*, 107 Wash 2d 1022 (1987); *Leppaluoto v. Eggleston*, 57 Wash 2d 393, 357 P2d 725 (1960). But agency terminology may still be applied if a director acts outside the usual director role and becomes an agent of the corporation.

Section 5.15 Fiduciary Duty to Individual Shareholders

Although case law indicates that directors owe a fiduciary duty to their corporations and to the corporation's shareholders *as a group*, case law is less clear on whether a director owes a fiduciary duty to each individual shareholder. In other words, case law is mixed on the question of whether a director is operating under a fiduciary duty when dealing on a personal, individual level with a single shareholder.

> **NOTE:** Some cases involve corporations with only two shareholders. When such is the case, the class of all shareholders (other than the acting shareholder) just happens to consist of a class of one. This Section 5.15 does not address the majority shareholder/director's fiduciary duty to the single, other shareholder.

The issue of whether a director owes a fiduciary duty to a single shareholder most often arises when a director personally purchases the corporation's stock from an individual shareholder and the shareholder later accuses the director of possessing, but not disclosing, special

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knowledge as to the true value of that stock.

The traditional, and possibly still majority view, is that a director owes no special duty to an individual shareholder. The minority view is that a director does owe individual shareholders a fiduciary duty.

To complicate matters, there is a newer, third view. It may, in fact, now be the true majority view. It is the view followed by Washington. Commentators refer to it as the "special facts" view.

Under the "special facts" view, a director owes a limited fiduciary duty to individual shareholders to disclose knowledge possessed by the director which the shareholder has a right to know, such as a pending sale of corporate assets. 3A FLETCHER CYC CORP § 1171 (Perm Ed 1994).

> In any given jurisdiction, whether or not a managing officer or director has a fiduciary relationship to individual stockholders depends upon whether that jurisdiction follows what one text writer describes as the "older or so-called majority" rule that a director's trust relationship to the corporation does not extend to an individual stockholder in the sale and purchase of stock; the "minority" rule in which directors are considered trustees for individual stockholders with respect to their stock; or the "special facts" rule in which the director owes a limited fiduciary duty in transactions with a stockholder involving the transfer of stock. *See:* 3 Fletcher, Cyclopedia Corporations §§ 1167-1174 (Perm Ed revised 1965). Although Washington formerly followed the majority rule, it now appears to follow the "special facts" rule. The limitation on the fiduciary relationship appears to apply to the circumstances under which the duty might arise and not on the extent of the obligation when once it has been determined that the relationship exists. (some citations omitted) *Shermer v. Baker*, 2 Wash App 845, 853, 472 P2d 589, 594 (1970).

In any case, this issue is more commonly overshadowed by the duties imposed on *all* stock and other securities purchasers to comply with the anti-fraud, disclosure requirements of the state and federal securities laws.

> The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers. The duty of disclosure stems from the necessity of preventing a corporate insider from utilization his position to take unfair advantage of the uninformed minority stockholders. It is an attempt to provide some degree of equalization of bargaining position in order that the minority may exercise an informed judgment in any such transaction. Some courts have called this a fiduciary duty while others state it is a duty imposed by the "special circumstances." One of the primary purposes of the Securities Exchange Act of 1934, 15 USCA § 78a et seq., was to outlaw the use of inside information by corporate officers and principal stockholders for their own financial advantage to the detriment of uninformed public security holders. *Shermer v. Baker*, 2 Wash App 845, 850, 472 P2d 589, 593 (1970)(quoting *Speed v. Transamerica Corp.*, 99 F Supp 808, 828 (DC Del 1951)).

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Regardless of whether corporate law or securities law is invoked, Washington requires that a corporate director, who possesses special insider information concerning the value of the corporation's stock, must disclose that information before purchasing the stock of an individual shareholder ignorant of such information.

Section 5.16 Conflicts of Interest

A. Transactions between director and corporation are governed by director's fiduciary duty.

Directors owe a duty of undivided loyalty to their corporations. This duty demands of directors a standard of behavior above that of the workaday world. *Williams v. Queen Fisheries, Inc.*, 2 Wash App 691, 460 P2d 583 (1970); *Kane v. Klos*, 50 Wash 2d 778, 314 P2d 672 (1957); *Modern Materials, Inc. v. Advanced Tooling Specialists, Inc.*, 206 Wis2d 434, 557 NW2d 835, 838 (1996).

A director's dealings with the corporation must be inherently fair and in good faith and will be vigorously scrutinized to insure such fairness. *Central Bldg. Co. v. Keystone Shares Corp.*, 185 Wash 645, 56 P2d 697 (1936); *Larson v. A.W. Larson Const. Co.*, 36 Wash 2d 271, 217 P2d 789 (1950); *Tefft v. Schaefer*, 148 Wash 602, 269 P 1048 (1928); *Westland v. Post Land Co.*, 115 Wash 329, 197 P 44 (1921).

A director who deals with the corporation has the burden of proving the fairness and reasonableness of the transaction. *Naas v. Lucas*, 86 Or App 406, 739 P2d 1051, *opinion adhered to as modified*, 88 Or App 141, 744 P2d 586, *review denied*, 304 Or 680, 748 P2d 142 (1987).

> A director is a fiduciary. So is a dominant or controlling stockholder or group of stockholders. Their powers are powers in trust. Their dealings with the corporation are subjected to rigorous scrutiny and where any of their contracts or engagements with the corporation is challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein. The essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain. If it does not, equity will set it aside. (footnotes & citations omitted) *Pepper v. Litton*, 308 US 295, 306-7 (1939).

Courts have long recognized that some self-dealing must inevitably occur between directors and their corporations.

> I am irresistibly led to the conclusion that the law of this state contemplates that directors will sometimes act and exercise the powers of the corporation in matters where the interests of the individual director are not in all respects coincident with those of the corporation, and that the rule in regard to transactions by trustees should apply only so far that the decision of the interested director should not be conclusive, but

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> subject to be reviewed and set aside, if it is not equal and just and free from any taint of fraud or partiality. In other words, the decisions and proceedings of such interested directors are always open to examination, and it is always incumbent on them to show that the utmost good faith has characterized their actions. *Hedges v. Paquett*, 3 Or 77, 82 (1869).

Today, such transactions are permitted, so long as they are fair and free from fraud.

B. Early case law.

At one time, a transaction between a director and the corporation was voidable by the corporation, regardless of the fairness of that transaction to the corporation. Marsh, *Are Directors Trustees?*, 22 BUS LAW 35, 38 (1966).

The courts will enforced transactions, despite a director's self-dealing, where the corporation approved of the transaction after full disclosure of all relevant facts. *Gold Ridge Mining & Development Co. v. Rice*, 77 Wash 384, 137 P 1001 (1914).

> There is nothing in the law to prevent trustees or other officers of a corporation, who may as individuals own certain property which it is necessary or advantageous for the corporation to acquire, from selling such property to the corporation at its fair value, and making a profit on the transaction, when such sale is made with a full disclosure on the one side and a full understanding on the other side of all the facts entering into or affecting the transaction. In so doing they are not within the rule contended for by appellant--dealing with the property of the corporation and reserving to themselves the profits. They are dealing with their own property, which, if desired by the corporation, can be sold and purchased as may any other property derived from any other source. *Baker v. Seattle-Tacoma Power Corp.*, 61 Wash 578, 585, 112 P 647, 650 (1911).

Eventually, the fairness of the transaction to the corporation and its shareholders became the most important factor to consider.

> By 1960 it could be said with some assurance that the general rule was that no transaction of a corporation with any or all of its directors was automatically voidable at the suit of a shareholder, whether there was a disinterested majority of the board or not; but that the courts would review such a contract and subject it to rigid and careful scrutiny, and would invalidate the contract if it was found to be unfair to the corporation. Marsh, *Are Directors Trustees?*, 22 BUS LAW 35, 43 (1966).

Courts began to uphold such transactions, despite later challenge by a shareholder, if the transaction was fair to the corporation and if the transaction had been approved by a majority of disinterested directors after full disclosure by the interested director. *Beebe v. Pacific Realty Trust*, 578 F Supp 1128 (D Or 1984); *Miller v. Ortman*, 235 Ind 641, 136 NE2d 17 (1956).

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> But we think it is not true that one who holds the position of director is incapable, under all circumstances, of devesting (sic) himself of his representative character in a particular transaction, and dealing with the corporation through others competent to represent it, as other trustees may deal directly with the beneficiaries. The corporation is a separate entity, for which its board of directors acts. The persons having the beneficial interest in the property are the stockholders, but their rights are centered in the corporation, and are managed and controlled through the board of directors as the active representative of the company; and it is through it, and not the stockholders, that business dealings are carried on. When a personal interest of one of them springs up, adverse to that of the corporation, it disqualifies him to act concerning it as one of the representatives or agents. **But the others do not lose their representative capacity, and still have power to bind the company.** The disqualified director cannot deal with them as a stringer, because the position of confidence which he has held has enabled him to gather an intimate knowledge of the affairs of the corporation, and to exercise influence upon those associated with him in their management. **But the company is represented by those who alone can act for it, and, if they are disinterested, he can, we think, deal with them as any other trustee can deal with the cestui que trust, if he makes a full disclosure of all facts known to him about the subject, takes no advantage of his position, deals honestly and openly, and concludes a contract fair and beneficial to the company.** The board, in such transactions, acts in a fiduciary capacity to the stockholders, and for this reason should not be allowed, in making a contract with their co-director, to sacrifice the interests of those committed to their charge. Such a transaction is always to be subjected to the closest examination, and a contract between those so situated which is prejudicial to the corporation should be held to be a fraud upon it; but it by no means follows from this, we think, that they can make no contract at all which is binding on the company and stockholders. The true interests of all may be best promoted in this way. A director, on account of his knowledge of the affairs of the company, and his interest in its welfare, may be, often is, in a position to make a trade better for all concerned than can be made with strangers. The duty of the board of directors in such a situation being to look alone to the interests of the corporation, it would seem to conflict with a rule that they cannot deal with one of the body where that duty would be best performed by so doing. Such an absolute rule would put it in the power of one stockholder, where the corporation will not act, to avoid, at his mere option, a transaction which was beneficial to all, and which all but himself desire to maintain. (emphasis added; citations omitted) *Tenison v. Patton*, 95 Tex 284, 67 SW 92, 95 (1902).

Under the modern view, a transaction between a director and the corporation will be upheld if it is fair to the corporation. This is true even if the transaction was not approved or ratified by a majority of disinterested directors or by the shareholders. Fairness to the corporation became the litmus test.

> Traditionally, because of their fiduciary duties, officers and directors were not allowed to contract with their corporation unless a disinterested majority of the board of directors approved, or the transaction was ratified by a vote of the stockholders. In the absence of such approval, the transaction was voidable at the option of the corporation even if made in good faith and without regard to the fairness of the transaction. However, there has been a liberalizing trend toward enforcing contracts

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> which otherwise would be voidable because of the relationship of the contracting officer or director to the corporation if, upon close scrutiny, the transaction is affirmatively shown to be fair to the corporation. This rule has recently been adopted in Oregon by statute. This change would allow the enforcement of contracts between a corporation and its directors even when it has not been approved by a disinterested board or ratified by the stockholders, so long as "the contract or transaction is fair and reasonable to the corporation." (footnotes & citations omitted) *American Timber & Trading Co. v. Niedermeyer*, 276 Or 1135, 1146, 558 P2d 1211, 1218-19 (1977).

Today, as long as a director acts in good faith, a fair transaction between that director and the corporation is voidable, not void. *Sanders v. E-Z Park, Inc.*, 57 Wash 2d 474, 358 P2d 138 (1960); *Tefft v. Schaefer*, 136 Wash 302, 239 P 837, 239 P 1119, *modified*, 239 P 1119 (1925).

A discussion of the development of the law on director conflicts of interest appear in Kay, *Director Conflicts of Interest Under the Model Business Corporation Act: A Model For All States?*, 69 WASH L REV 207 (1994) and in *Note and Comment*, 42 OR L REV 61 (1962).

C. Current statute.

The "fair to the corporation" standard has been codified. Even if a director has a direct or indirect interest in the transaction, RCW 23B.08.710 provides that a transaction may not be enjoined, set aside, or give rise to an award of damages, if only one of the following is true:

(a) the transaction is ratified by disinterested ("qualified") directors pursuant to RCW 23B.08.720; or

(b) The transaction is ratified, after disclosure, by the shareholders pursuant to RCW 23B.08.730; or

(c) "[t]he transaction, judged according to the circumstances at the time of commitment, is established to be fair to the corporation." RCW 23B.08.710(2)(c).

Under current law, a director's conflict of interest alone is insufficient to set aside a transaction. A court must evaluate the transaction and determine whether or not it is fair to the corporation.

Finally, with respect to an issue often present in today's climate of hostile corporation takeovers, once the directors of a corporation decide that the corporation should be sold, they have a fiduciary duty to the shareholder "to the maximization of the company's value at a sale for the stockholders' benefit." *Revlon, Inc. v. MacAndrews & Forbes Holdings*, 506 A2d 173 (Del 1986).

Section 5.17 Directors As Creditors

A. General rule - director may become corporate creditor.

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As a general rule, a director may lend money to, and become a creditor of, his/her corporation. *Belcher v. Webb*, 176 Wash 446, 29 P2d 702 (1934); *In re Black Ranches, Inc.*, 362 F2d 19 (8th Cir 1966). "While equity will scrutinize loans made by an officer to a corporation which he represents, such loans will be upheld if they are fair, open and made in utmost good faith." *Stein v. Gable Park, Inc.*, 223 Or 17, 24, 353 P2d 1034, 1037 (1960).

As a creditor, a director may enforce his/her right to repayment by the corporation. This is true even though a director stands in a fiduciary relationship to the corporation. A director "is nevertheless entitled to demand payment of an honest debt due him from the corporation of which he is a director." *Troglia v. Bartoletti*, 152 Mont 365, 451 P2d 106, 108 (1969). For instance, directors may use corporate assets to secure loans from themselves in a good faith effort to keep an insolvent, but going concern, alive. *Belcher v. Webb*, 176 Wash 446, 29 P2d 702 (1934); *Stumbo v. Paul B. Hult Lumber Co.*, 251 Or 20, 444 P2d 564 (1968); *In re Lake Chelan Land Co.*, 257 F 497 (9th Cir 1919).

A director may, in good faith, take actions adverse to the corporation to enforce his or her rights against the corporation.

> There is no reason why a solvent corporation may not borrow money from a person who occupies the position of a director in such corporation, and give him a mortgage to secure the debt thus created. It is said in such cases that the giving of the mortgage is viewed with suspicion, but that it is legal when it is perfectly free from actual fraud. (citations omitted) *Rylander v. Sheffield*, 108 Ga 111, 115, 34 SE 348, 349 (1899).

There is some case law, however, which holds that in a judicial sale of corporate property, a director may not purchase corporate property for his/her personal benefit. *Weissman v. A. Weissman, Inc.*, 374 Pa 470, 97 A2d 870 (1953).

***B. Exception - transactions at or near insolvency*.**

Transactions with officers and directors just prior to, or after, their corporation becomes insolvent are more likely to be scrutinized and set aside.

Directors may use corporate assets to secure loans from themselves to keep a technically insolvent, but going concern, alive. *Belcher v. Webb*, 176 Wash 446, 29 P2d 702 (1934); *Stumbo v. Paul B. Hult Lumber Co.*, 251 Or 20, 444 P2d 564 (1968); *In re Lake Chelan Land Co.*, 257 F 497 (9th Cir 1919). But it may be a breach of their fiduciary duty to the corporation and its creditors if directors lend money to the

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corporation and secure such loans with corporate assets after the corporation has become insolvent and given up the ghost. *Houston's Inc. v. Hill*, 111 Or App 502, 826 P2d 644, *review denied*, 313 Or 354, 833 P2d 1283 (1992); *Bivens v. Hancock*, 71 Or App 273, 692 P2d 153 (1984).

> A corporation may borrow money from its officers or directors, and when such persons have so provided the company with means to carry on its business or pay its debts, they may enforce collection the same as any other creditor. When, however, the act of a person who has dealt with a corporation of which he is an officer or director is assailed, his conduct will be closely scrutinized to ascertain that any indebtedness he claims to be due him from such company is a *bona fide* claim against the company, and that he has not abused the power of his position to obtain an unfair advantage over other creditors. (citations omitted) *Bossert v. Geis*, 57 Ind App 384, 107 NE 95, 98 (1914).

Some states still apply the "trust theory" to directors once the corporation has become insolvent and ceased to be a going concern. Washington has limited the application of this theory, instead adopting a statutory scheme for dealing with transfers at or about the time of insolvency. RCW 23.72.010 *et seq*. *See:* Section 12.07 of this book.

Substantial transfers to officers and directors around the time that the corporation becomes insolvent may also subject insiders to liability under the theory of corporate disregard (*see:* Sections 10.01 through 10.10 of this book), or under a fraudulent conveyance theory (*see:* RCW 19.40.011 *et seq*). Likewise, such transfers may constitute a preference under the Bankruptcy Code. 11 USC § 547.

Section 5.18 Usurping Corporate Opportunities

As fiduciaries to the corporation, directors and officers are prohibited from taking personal advantage of opportunities that would otherwise be appropriate for the corporation. "The corporate opportunity doctrine prohibits directors or officers from appropriating to themselves business opportunities that rightfully belong to the corporation. *Wagner v. Foote*, 128 Wash 2d 408, 413, 908 P2d 884, 886 (1996). "Where the trust duty of directors of a corporation and personal interest conflicts, the latter must give way." *Young v. Columbia Land & Inv. Co.*, 53 Or 438, 441, 99 P 936, 937, 101 P 212 (1909). "The general rule is that the fiduciary cannot lure away corporate business or clients which in equity and fairness belongs to his corporation." *Hartung Architects Hartung/Odle/Burke, Inc.*, 157 Ind App 546, 301 NE2d 240, 245 (1973). "The business opportunity principle . . . is but specie of the command that fiduciaries act with undivided loyalty, and is another manifestation of the requirement of utmost good faith." *Quinn v. Cardiovascular Physicians,*

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P.C., 254 Ga 216, 326 SE2d 460 (1985).

One court has said that directors may not retain any personal profit or advantage gleaned "on the side." *Leppaluoto v. Eggleston*, 57 Wash 2d 393, 402, 357 P2d 725, 731 (1960). Yet, courts will uphold such a transaction when the transaction is made openly and where the corporation is unwilling to avail itself of that opportunity. *Smith v. Pacific Pools, Inc.*, 12 Wash App 578, 530 P2d 658, *review denied*, 85 Wash 2d 1016 (1975).

In one of the leading cases involving officers and directors usurping corporate opportunities, the court held:

> Corporate officers and directors are not permitted to use their position of trust and confidence to further their private interests. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of his duty, not only affirmatively to protect the interest of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers. The rule that requires an undivided and unselfish loyalty to the corporation demands that there shall be no conflict between duty and self-interest. 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.
>
> If an officer or director of a corporation, in violation of his duty as such, acquires gain or advantage for himself, the law charges the interests so acquired with a trust for the benefit of the corporation, at its election, while it denies to the betrayer all benefit and profit. The rule, inveterate and uncompromising in its rigidity, does not rest upon the narrow ground of injury or damage to the corporation resulting from a betrayal of confidence, but upon a broader foundation of a wise public policy that, for the purpose of removing all temptation, extinguishes all possibility of profit flowing from a breach of the confidence imposed by the fiduciary relation. Given the relation between the parties, a certain result follows; and a constructive trust is the remedial device through which precedence of self is compelled to give way to the stern demands of loyalty. *Guth v. Loft, Inc.*, 23 Del Ch 255, 5 A2d 503, 510 (1939).

In determining whether a director has acted in good faith toward the corporation, courts tend to give weight to whether the director openly made use of that opportunity and whether the corporation itself was willing and/or able to avail itself of that opportunity. *Smith v. Pacific Pools, Inc.*, 12 Wash App 578, 530 P2d 658, *review denied*, 85 Wash 2d 1016 (1975); *Regenstein v. J. Regenstein Co.*, 213 Ga 157, 97 SE2d 693 (1957). Important considerations include whether the director used knowledge gained as a director and whether the transaction was fair to the

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corporation. *Tower Recreation, Inc. v. Beard*, 141 Ind App 649, 231 NE2d 154 (1967). "The particular facts and circumstances of each case must be examined to determine if the opportunity belonged to the corporation or if it is one personal to the individual." *Hartung v. Architects Hartung/Odle/Burke, Inc.*, 157 Ind App 546, 301 NE2d 240, 244 (1973).

The obligation of a director with regard to a corporate opportunity is less rigid than in the case of director self-dealing in corporate assets. *State ex rel Hayes Oyster Co. v. Keypoint Oyster Co.*, 64 Wash 2d 375, 391 P2d 979 (1964).

A. Transaction must be open.

A director may take personal advantage of a transaction otherwise appropriate to the corporation when the transaction is made openly and where the corporation is unwilling to avail itself of that opportunity. *Smith v. Pacific Pools, Inc.*, 12 Wash App 578, 530 P2d 658, *review denied*, 85 Wash 2d 1016 (1975); *Sabre Farms, Inc. v. Jordan*, 78 Or App 323, 717 P2d 156 (1986).

> There is no dispute that the corporate opportunity doctrine precludes corporate fiduciaries from diverting to themselves business opportunities in which the corporation has an expectancy, property interest or right, or which in fairness should otherwise belong to the corporation. The doctrine follows from a corporate fiduciary's duty of undivided loyalty to the corporation. 2
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> * * *
>
> Note 2: [Officers and directors] must devote themselves to the corporate affairs with a view to promote the common interests and not their own, and they cannot, either directly or indirectly, utilize their position to obtain any personal profit or advantage other than that enjoyed also by their fellow shareholders. In short, there is demanded of the officer or director of a corporation that he furnish to it his undivided loyalty; if there is presented to him a business opportunity which is within the scope of its own activities and of present or potential advantage to it, the law will not permit him to seize the opportunity for himself; if he does so, the corporation may elect to claim all of the benefits of the transaction. Nor is it material that his dealings may not have caused a loss or been harmful to the corporation; the test of his liability is whether he has unjustly gained enrichment. (citations omitted) *Klinicki v. Lundgren*, 298 Or 662, 666-7, 695 P2d 906, 910 (1985).

This rule is in keeping with the more general rule that as fiduciaries, directors may not earn secret profits from their dealings with the corporation. *State ex rel Hayes Oyster Co. v. Keypoint Oyster Co.*, 64 Wash 2d 375, 391 P2d 979 (1964).

B. Corporation must knowingly reject opportunity.

The issue of usurping a corporate opportunity frequently arises

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when a director or officer obtains for his/her own benefit a corporate opportunity and later argues that the corporation was unable or unwilling to avail itself of that opportunity. The poor financial condition of the corporation is frequently invoked.

One of the better reasoned decisions on corporate opportunities is *Klinicki v. Lundgren*, 298 Or 662, 695 P2d 906 (1984). *Klinicki* includes a detailed discussion of the wide range of views taken on this issue.

Klinicki involved a close corporation. The majority shareholder/director of this first corporation formed a second corporation which, in turn, secretly entered into a third party contract which the director had originally been pursuing on behalf of the first corporation. After a lawsuit was file to set aside this transaction, the director argued that the first corporation did not have the financial resources to pursue the contract. This argument proved unpersuasive. *Klinicki* sets down rules to be followed by close corporations in such circumstances:

> Where a director or principal senior executive of a close corporation wishes to take personal advantage of a "corporate opportunity," . . . the director or principal senior executive must comply strictly with the following procedure:
>
> (1) The director or principal senior executive must promptly offer the opportunity and disclose all material facts known regarding the opportunity to the disinterested directors or, if there is no disinterested director, to the disinterested shareholders. If the director or principal senior executive learns of other material facts after such disclosure, the director or principal senior executive must disclose these additional facts in a like manner before personally taking the opportunity.
>
> (2) The director or principal senior executive may take advantage of the corporate opportunity only after full disclosure and only if the opportunity is rejected by a majority of the disinterested directors or, if there are no disinterested directors, by a majority of the disinterested shareholders. If, after full disclosure, the disinterested directors or shareholders unreasonably fail to reject the offer, the interested director or principal senior executive may proceed to take the opportunity if he can prove the taking was otherwise "fair" to the corporation. Full disclosure to the appropriate corporate body is, however, an absolute condition precedent to the validity of any forthcoming rejection as well as to the availability to the director or principal senior executive of the defense of fairness.
>
> (3) An appropriation of a corporate opportunity may be ratified by rejection of the opportunity by a majority of disinterested directors or a majority of disinterested shareholders, after full disclosure subject to the same rules as set out above for prior offer, disclosure and rejection. Where a director or principal senior executive of a close corporation appropriates a corporate opportunity without first fully disclosing the opportunity and offering it to the corporation, absent ratification, that director or principal senior executive holds the opportunity in trust for the corporation. (footnotes omitted) *Klinicki v. Lundgren*, 298 Or 662, 681-3, 695 P2d 906, 919-920 (1985).

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Klinicki implies that the test should be even more stringent for public corporations. In a public corporation, the typical shareholder is much more passive and removed from management and thus is more reliant on the good faith of inside directors and officers.

In another decision, the court described three tests to determine whether or a director has breached the director's fiduciary duty to the corporation in taking personal advantage of a corporate opportunity.

> (1) The "interest or expectancy" test, which precludes acquisition by corporate officers of the property of a business opportunity in which the corporation has a "beachhead" in the sense of a legal or equitable interest or expectancy growing out of a preexisting right or relationship; (2) the "line of business" test, which characterizes an opportunity as corporate whenever a managing officer becomes involved in an activity intimately or closely associated with the existing or prospective activities of the corporation; and (3) the "fairness" test, which determines the existence of a corporate opportunity by applying ethical standards of what is fair and equitable under the circumstances. *Miller v. Miller*, 301 Minn 207, 222 NW2d 71, 79-80 (1974).

***C. Forced sales*.**

One context in which this issue has arisen in Washington relates to an officer or director's purchase of corporate assets at a forced sale. In *Collins v. Hoffman*, 62 Wash 278, 113 P 625 (1911), the court held that the corporation's manager and secretary could not purchase the corporation's property at a delinquent tax sale.

Another court held that a director, who had done all that he could to prevent or delay foreclosure of corporate property, "was as free to bid as a purchaser of the property as was any other creditor." *Buchler v. Black*, 226 F 703, 706 (9th Cir 1915). Likewise a director, who openly becomes a creditor of the corporation, is entitled to the same remedies as any other creditor. *Grunden v. German*, 110 Wash 237, 188 P 491 (1920).

***D. Non-Competition Agreements*.**

In a recent case, the Washington Supreme Court held that in connection with the sale of corporate assets, a noncompetition agreement entered into between the purchaser and the majority shareholder was not necessarily the usurpation of a corporate opportunity, unless the amount paid for the corporate assets is reduced below the fair market value of the assets sold.

> In sum, we hold that the opportunity for a corporate officer/shareholder to enter into a noncompetition agreement in conjunction with the sale of the corporation's assets is not a corporate business opportunity. However, when the consideration for such an agreement made in

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> conjunction with the sale of corporate assets results in the corporation receiving less than fair market value for the corporate assets, the corporate assets have been unlawfully diverted in violation of the corporate officer/shareholder's fiduciary duty. *Wagner v. Foote*, 128 Wash 2d 408, 416, 908 P2d 884, 887-8 (1996).

A noncompetition agreement is not itself a corporate opportunity, but the majority shareholders cannot use a noncompetition as a subterfuge of siphoning off for themselves a portion of the true price for the corporation.

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