CHAPTER FIVE

DIRECTORS

Section 5.01 Generally

Every Oregon business corporation must have a board of directors. ORS 60.301(1); *Necanicum Inv. Co. v. Employment Dept.*, 345 Or 138, 190 P3d 368 (2008). A corporation's board of directors has full power and authority to manage the corporation. ORS 60.301(2).

"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 1961). A corporation's "general business" 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, their power to manage the corporation is extremely limited. 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).

The shareholders' management power is generally limited to the election of directors and to voting on certain extraordinary events – events such as mergers, the sale of all corporate assets, dissolutions and the like. 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 of the directors is a collective power – not an individual one. A corporation's board of directors may only act by collectively deliberating and acting. 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 corporation is represented by its officers, and a director thereof in his individual right possesses no authority to act for it unless he has been appointed its agent, or his acts and declarations have been ratified by it. (citations omitted) *Guillaume v. K.S.D. Land Co.*, 48 Or 400, 404, 86 P 883, 884, 88 P 586 (1907).

See also 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); *Fradkin v. Ernst*, 571 F Supp 829 (ND Ohio 1983).

A director has no authority to act unilaterally to dissolve and wind up corporate affairs, even if the only other director has breached his fiduciary duty to the corporation and caused its business to fail. *Horton v. Whitehill*, 121 Or App 336, 854 P2d 977 (1993).

> 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).

"[D]irectors act as a body, not by the statements of an individual director." *Georgia Casualty and Surety Co. v. Seaboard Surety Co.,* 210 F Supp 644, 652 (ND Ga 1962).

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

While the proper function of the board of directors is to deliberate and decide, the board of directors does not itself act to implement those decisions. Corporate officers and agents implement those decision.

> **NOTE:** The proper form for a board of directors resolution is to set out the board's decision and then to authorize corporate agents to implement that decision. This is an example of a proper resolution:
>
> > RESOLVED, that the corporation enter into a lease agreement with Smith and that the president is hereby authorized to execute such lease agreement on behalf of the corporation.

The role of a board of directors is one of policy maker. An individual director has little power beyond that of deliberating, persuading and, ultimately, casting a vote on board decisions. *Georgia Casualty and Surety Co. v. Seaboard Surety Co.,* 210 F Supp 644, 652 (ND Ga 1962); *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.

Since a corporation acts through its officers, employees and agents, not

generally through individual directors, individual directors have no inherent right to act on behalf of the corporation. "[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 (1960). *See also Twisp Mining & Smelting Co. v. Chelan Mining Co.*, 16 Wash 2d 264, 133 P2d 300 (1943).

Nor is an individual director usually deemed to be an employee of the corporation, solely be reason of being a director. *Grantham v. Beatrice Co.*, 776 F Supp 391 (ND Ill 1991). In Oregon, corporate directors serving solely as directors do not fall within the statutory definition of an "employee" for purposes of the unemployment tax. *Necanicum Inv. Co. v. Employment Dept.*, 345 Or 138, 190 P3d 368 (2008).

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); *Federal Deposit Ins. Corp. v. Aetna Casualty & Surety Co.*, 426 F2d 729 (5th Cir 1970).

Some of the issues discussed in this Chapter do not necessarily apply to corporations in which the shareholders have entered into an agreement to restrict the power of the board of directors and otherwise complied with the requirements of ORS 60.265. A discussion of ORS 60.265 is contained in Section 4.07 of this book.

C. Manner of acting.

Generally, the board of directors acts by adopting resolutions authorizing action by the corporation and its agents.

> A resolution is not a bylaw; it is an informal enactment of a temporary nature providing for the disposition of a certain administrative business of the corporation. In contrast, bylaws are the laws adopted by the corporation for the regulation of its actions and the rights and duties of its members. (citations omitted) *Brennan v. Minneapolis Society for the Blind, Inc.,* 282 NW2d 515, 523 (Minn 1979).

The Act does not set out the procedures for proposing and adopting resolutions.

> **NOTE:** In this author's experience, it is uncommon for the bylaws to contain much detail over the procedures for adopting a resolution. While some boards seem to follow a procedure akin to Robert's Rules of Order, such procedures are usually not mandated by the bylaws or prior resolutions.
>
> While the custom of making and seconding a motion is sometimes used, such a custom seems inappropriate in boards of one to three members. Custom, however, may sometimes be deemed to be part of the bylaws. *St. Yves v. Mid State Bank,* 50 Wash App 95, 748 P2d 633 (1987); *Johnson v. Busby*, 278 F Supp 235 (ND Ga 1967); *but see Powers v. Marine Engineers' Beneficial Ass'n., No. 35*, 52 Cal App 551, 199 P 353 (1921); *District Grand*

Lodge No. 4 v. Cohn, 20 Ill App 335 (1886).

Section 5.02 Number and Qualification

A. Size of the board of directors.

An Oregon corporation may have any number of directors, including only one director. ORS 60.307. This was not always true.

A board of directors is a body where *collective* decision-making occurs. *Georgia Casualty and Surety Co. v. Seaboard Surety Co.*, 210 F Supp 644, 651 (ND Ga 1962), *affirmed*, 327 F2d 666 (5th Cir 1964); *Ames v. Goldfield Merger Mines Co.*, 227 F 292, 301-2 (WD Wa 1915). "Collective" implies more than one. At one time, most states required that a board consist of at least three individuals. Most states now permit a corporation to have only one director. Oregon is such a state. ORS 60.307.

To prevent deadlock, boards with an odd number of directors are 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 if the board is deadlocked, the person last appointed president would likely remain president indefinitely.

Deadlock, however, is one ground for judicial dissolution of the corporation. ORS 60.661(2)(a) & 60.952(1). This power is discretionary and the courts are generally reluctant to dissolve corporations. *Baker v. Commercial Body Builders, Inc.*, 264 Or 614, 507 P2d 387 (1973); *Jackson v. Nicolai-Neppach Co.*, 219 Or 560, 348 P2d 9 (1959). *See* Sections 7.13 and 12.06 of this book.

The number of directors may be specified in, or fixed in accordance with, either the articles or the bylaws. ORS 60.307(1). Either the articles or the bylaws may establish a variable range for the size of the board of directors. ORS 60.307(1). Since corporations may wish to vary the number of directors from time to time, and since the bylaws may be amended much more easily than the articles, it is common practice to specify the number of directors in the bylaws.

B. Qualifications.

At one time, director qualifications were common. Many state statutes required directors to be shareholders and/or to be a resident of that state. *Silsby v. Strong*, 38 Or 36, 62 P 633 (1900); *State ex rel Reed v. Smith*, 15 Or 98, 15 P 137 (1887); *Moore v. Los Lugos Gold Mine*, 172 Wash 570, 21 P2d 253 (1933). *See also Annotation*, 30 ALR 248; *Annotation*, 130 ALR 156. For instance, Washington once required that at least one board director of its corporations be a Washington resident and required a majority of directors be United States citizens. *Hastings v. Anacordes Packing Co.*, 29 Wash 224, 69 P 776 (1902).

Oregon law long ago did away with most qualification requirements. Today, a director of an Oregon corporation must be an "individual" – corporations and other non-human entities are ineligible. ORS 60.307. Otherwise, the Oregon Act contains no director qualifications.

Even though Oregon law imposes no qualifications on directors, a corporation itself may do so by including director qualifications in its articles or in its bylaws. ORS 60.304.

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

Section 5.03 Election & Term

A. Election.

A corporation's initial board of directors either: (i) may be named in the articles of incorporation, or (ii) may be elected by the incorporator(s). ORS 60.047(2)(a) and 60.057(2).

Once the organizational meeting has occurred and once subscriptions are accepted, shareholders elect directors beginning at the conclusion of the term of the initial directors. "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 Hinckley v. Swaner*, 13 Utah 2d 93, 368 P2d 709 (1962).

Unless the articles provide otherwise, "directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present." ORS 60.251(1).

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). Otherwise, the chairperson may establish rules for the shareholder voting. ORS 60.209(2). Public corporations are now required to appoint an inspector of elections to supervise shareholder voting, and nonpublic corporations are permitted, but not required, to do so. ORS 60.223.

***B. Term*.**

The terms of the initial directors "expire at the first shareholders' meeting at which directors are elected." ORS 60.314(1). This need not occur at the first meeting of shareholders, only at the first meeting of shareholders at which there is an election of directors.

Thereafter, directors are elected at the annual shareholder meeting and hold office until the next annual shareholder meeting. ORS 60.307(3). Exceptions occur in the case of vacancies or where directors are elected to staggered terms. Both are discussed below.

ORS 60.314(5) provides that despite the expiration of a director's term, the director continues to serve until a successor is elected. 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. *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); *Stewart v. Lady,* 251 Va 106, 465 SE2d 782 (1996).

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 (1959).

***C. Vacancies*.**

A board vacancy is deemed to exist either if a director fails to finish his/her term or if the size of the board of directors increases. ORS 60.331(1). This is contrary to earlier law where increases in the size of the board were not deemed to be “vacancies.” *Belle Island Corp. v. MacBean*, 30 Del Ch 373, 61 A2d 699 (1948).

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 of directors, unless the articles provide otherwise. ORS 60.331(1). *See Homac, Inc. v. DSA Financial Corp*., 661 F Supp 776 (ED Mich 1987).

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. ORS 60.331(1)(c).

ORS 60.331(1) permits either the board or the shareholders to fill vacancies on the board of directors. The statute does not indicate what would happen if the

shareholders and board 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 longer 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 has class voting for directors and the shareholders, rather than the directors, act to fill that vacancy, 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. ORS 60.331(2).

D. Staggered terms.

If the articles or the bylaws so provide, directors may be elected to groups with staggered terms of two or three years. Each group must be nearly equal in number as possible. ORS 60.317. If the corporation has cumulative voting, terms of directors may be staggered only if authorized by the articles of incorporation and each group of directors contains at least three members. ORS 60.317(3).

Each year, there must be an election of at least one director and the number elected each year must, as closely as possible, be equal. Thus, if directors hold office for a two-year terms, half (or as close to half as possible) must stand for election each year. If directors hold office for a three-year terms, one-third (or as close to one-third as possible) must stand for election each year.

Prior to January 1, 2004, staggered voting was only permitted if there were six or more directors. On or after that date, the six director requirement was eliminated to bring Oregon in conformity with the latest version of the Model Business Corporation Act. That Model Act, however, did not permit corporations to adopt staggered terms through their bylaws – only through their articles of incorporation.

Beginning May 25, 2005, ORS 60.317 was amended to permit adoption of staggered terms in the bylaws, as well as in the articles (unless the corporation has cumulative voting for directors).

> **NOTE:** Bylaws provisions allowing staggered director terms are invalid if they were adopted during the period January 1, 2004 to May 25, 2005. In such cases, the corporation should now take corrective action by re-adopting the staggered term provisions, if staggered voting is still desired.
>
> Since any directors elected during this period of non-compliance were elected to one-year terms – regardless of the terms set out in the ineffective bylaws and in any shareholder resolutions – corrective action might also be needed related to actions taken be directors whose terms had technically

expired.

This may be a good time to review all existing bylaws (and all form bylaws) to ensure they comply with current law.

E. Cumulative voting.

When 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 Oregon, cumulative voting is defined to mean:

> that the shareholders designated are entitled to multiply the number of votes they are entitled to cast by the number of directors for whom they are entitled to vote and cast the product for a single candidate or distribute the product among two or more candidates. ORS 60.251(3).

Early statutes favored cumulative voting, that is, a corporation was deemed to use cumulative voting unless the articles provided otherwise. Today, the reverse is true in most states, including in Oregon.

Under the current Oregon Business Corporation Act, directors may be elected by cumulative voting only if the articles so provide. ORS 60.251(3).

NOTE: Since the opposite was once true, it is good practice to include language in the articles 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.

EXAMPLE: ABC, Inc. has issued and outstanding 300 shares of a single class of stock. The board 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 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, there will be only one election and C will have 300 votes (100 shares times the 3 director positions). Since the top 3 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 shareholders 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 using cumulative voting, a twenty percent shareholder will not be assured of a directorship if there are three or fewer directorships available.

NOTE: While Oregon has an "opt-in" provision for cumulative voting, Washington is an "opt-out" state. Under Washington law, corporations have cumulative voting unless their articles specifically eliminate cumulative voting. RCW 23B.07.280(1) & 23B.02.020(3)(w).

F. Voting by class.

Unless the articles provide otherwise, "directors are elected by a plurality of the votes cast by the shares entitled to vote in the election at a meeting at which a quorum is present." ORS 60.251(1).

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

Voting by class is an alternative method of assuring minority representation on the board of directors. ORS 60.131(3)(a). *See Walden Investment Group v. Pier 67, Inc.*, 29 Wash App 28, 627 P2d 129 (1981). In such case, the classes may be treated the same for all other purposes, or the classes may have other specified differences.

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. IRC § 1361(b)(1)(D). *See also* Treas Reg § 1.1361-1(l)(1); *Pollack v. Commissioner*, 47 TC 92 (1966), *affirmed*, 392 F2d 409 (5th Cir 1968).

EXAMPLE: A, B, and C decide to form a corporation. Based on their respective contributions, they agree on an ownership split as follows: A - 60%; B - 30%; C - 10%. In order to assure each 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 assured of selecting 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 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) from receiving a disproportionate share of the corporate profits through salaries, leasing contracts and the like.

The concept of class voting for directors, illustrated in the examples above, is quite common where the contribution of one shareholder consists primarily of the business concept and day-to-day management and the contribution of the other shareholder consists primarily of the cash necessary to make the business concept a reality. Often, the first such shareholder is primarily interested in control; the second in economic gain. The use of class voting for directors permits one shareholder to maintain control of day-to-day operations through the ability to elect a majority of directors while enabling the other shareholder to obtain a greater share of distributions.

Several courts have said: “Cumulative voting for directors, on the other hand, as a somewhat more recent development in corporate practice is in derogation of the common law and not to be permitted unless specifically authorized by constitutional, statutory or charter provisions.” *Bohannan v. Corporation Commission*, 82 Ariz. 299, 313 P2d 379, 381 (1957); *see also Swanson v. Perham,* 30 Wash 2d 368, 191 P2d 689 (1948).

***G. Oath of office*.**

Many states, including Oregon, once required directors to take an oath upon taking office. *Hunt v. Ketrell*, 197 Or 659, 253 P2d 272 (1953); *Doehler v. Lansdon*, 135 Or 687, 298 P 200 (1931); *Swenson v. McFerson*, 91 Colo 519, 17 P 530 (1932).

This is no longer true. Oregon no longer requires directors or officers to take an oath upon taking office.

Section 5.04 Meetings

***A. Organizational meeting*.**

A corporation may hold its organizational meeting after the articles are filed

with the Secretary of State's office. ORS 60.057. A majority of the initial directors are authorized to call the organizational meeting. ORS 60.057(1). The current Act does not specifically authorize the incorporator to call a meeting of the initial directors.

If the articles contain the names of the initial directors, these initial directors conduct the organizational meeting. At this meeting, the initial directors appoint officers, adopt bylaws, and carry on any other business brought before the meeting. ORS 60.057(1). The organization of a corporation is only complete when the initial directors have met, accepted shareholders, adopted bylaws, and appointed officers. ORS 60.057; *Nickum v. Burckhardt*, 30 Or 464, 47 P 788 (1897); *R.A.C. Realty Co. v. W.O.U.F. Atlanta Realty Corp.*, 205 Ga 154, 52 SE2d 617 (1949).

If the names of initial directors are not set forth in the articles, the organizational meeting is held either by the incorporator or by the directors elected by the incorporator. ORS 60.057(2).

Even if the incorporator conducts the organizational meeting, some matters must await a meeting of board of directors. For instance, ORS 60.147 does not give the incorporator authority to accept subscriptions.

> **NOTE:** While the incorporator has no statutory authority to accept subscriptions, shareholders may accept subscriptions if the articles so provide. ORS 60.147(1). In such a case, 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 is contained in Section 3.03 of this book.

***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 commonly referred to as the "annual meeting of directors."

ORS 60.344(1) provides that regular meetings may be held without notice of the date, time, place or purpose of the meeting. Prior 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."

Unless the articles or bylaws provide for a longer or shorter period, notice of a special director meeting must be given to directors at least two days in advance of the meeting. ORS 60.344(2). This notice must contain the date, time and place of the meeting, but it need not describe the meeting's purpose, unless required to do so by the articles or by the bylaws. *Id.*

Notice of a special director meeting must be in writing, unless oral notice is reasonable in the circumstances in which the notice is given. ORS 60.034(1).

Notice by electronic transmission is deemed to be written notice by ORS 60.034(2)(a). This includes email.

> "Electronic transmission" means any process of communication that does not directly involve the physical transfer of paper and that is suitable for the retention, retrieval and reproduction of information by the recipient. ORS 60.001(12).

Effective January 1, 2018, there are significant changes in the provisions of ORS 60.034 related to permissible methods by which notice may be delivered and the methods for determining the effective date of any such notice.

NOTE: A corporation's articles and/or the bylaws may prescribe notice requirements not inconsistent with ORS 60.034(8), including more restrictive notice requirements than provided in the new statute. In order to take advantage of the more liberal notice requirements of the new statute, articles and bylaws should be reviewed and updated.

As a practical matter, the notice requirement becomes important only if there is a dissenting director. ORS 60.347 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, a properly noticed board meeting may later ratify acts undertaken at a defective meeting held earlier. *Johnson v. Busby*, 278 F Supp 235 (ND Ga 1967); *Wright v. McLaury*, 81 F2d 96 (7th Cir 1936).

ORS 60.064 and 60.081 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 an unnotified director does not 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).

See also State ex rel Reed v. Smith, 15 Or 98, 14 P 814, 15 P 137 (1887).

> The problem with failing to provide advance notice of a special board meeting in the manner required by the bylaws is that a director who does not receive notice cannot attend and participate in his capacity as a director: Discretionary powers, questions of policy, business administration, all imply the personal attendance at the meeting, so that each director may have the benefit of not only the vote, but the voice of every other director, or at least of enough other directors to constitute a quorum. (citations & internal quotations omitted) *Klassen v. Allegro Development Corp*, Del Ct Chancery, 2013 WL 5739680 (Del. Ch.) (Nov 7, 2013).

NOTE: Directors have the right to persuade other directors. A director is unable to persuade others if that 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 that director would have been able to persuade a sufficient number of directors to adopt an alternative course of action.

Under some circumstances, actions taken at improperly held meeting may be ratified by later 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 notif y everyone.

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

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, unless the articles

of or bylaws provide otherwise. ORS 60.341.

Compliance with the rules related to "electronic signatures" set out in ORS 60.001(11) and ORS 84.004(8) could make a series of email communications into a consent resolution under ORS 60.341.

The requirement that all directors sign a written consent is different from the rule that less than all shareholders may sometimes act to take and action if the articles of so provide. See Section 7.04 of this book.

Under prior case law, resolutions by unanimous written consent of the directors were permitted only when the directors owned all of a corporation's stock. *Vawter v. Rogue River Valley Canning Co.*, 124 Or 94, 257 P 23, 262 P 851 (1928). ORS 60.341 changes the old rule.

An action taken by written consent becomes effective on the date the last director signs the consent, unless an earlier or later date is specified in the consent. ORS 60.341(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*.**

A director meeting may take place using "any means of communication by which all directors participating may simultaneously hear each other during the meeting." ORS 60.337(2).

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. Likewise, internet "chat room" type meetings would not constitute a legitimate meeting unless there was an audio component to the internet communication.

On the other hand, compliance with the rules related to "electronic signatures" set out in ORS 60.001(11) & 84.004 could make a series of email communications into a consent resolution under ORS 60.341.

***F. Location*.**

Director meetings may be held inside or outside the state of Oregon. ORS 60.337(1).

The notice of a special meeting must contain the location of the meeting. ORS 60.344(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 an exception. The Oregon Act permits 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 ORS 60.265.

***H. Director proxies*.**

Unlike shareholders, directors generally may not vote by proxy. *Aharon v. Applied Cleantech, inc.,* Del Ct Chancery 12719-VCL (Feb 12, 2017); *In re Audubon Quartet, Inc.,* 275 BR 783 (WD Va 2002); *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 Oregon Act permits shareholders to enter into a written agreement allowing directors to vote by proxy under certain circumstances. Any such shareholder agreement must meet the strict requirements of ORS 60.265.

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

It is unclear whether an individual director has the right to have that 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 nevertheless barred such attorneys based upon language in the corporation's bylaws).

See also Posner v. Southern Exhaust & Blow Pipe Co.,109 La 658, 33 So 643 (1902); 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 American Center for Education, Inc. v. Cavnar, 80 Cal App 3d 476, 145 Cal Rptr 736 (1978); *Burt v. Irvine Co.*, 224 Cal App 2d 50, 36 Cal Rptr 270

(1964)(applying West Virginia law).

> **NOTE:** This problem usually does not arise in the context of shareholder meetings since most shareholders own more than one share and a shareholder can designate a proxy (the shareholder's attorney) to attend the meeting and vote one of these shares while the shareholder retains voting rights of the remainder of the shares.

Section 5.05 Quorum

A. Generally.

A quorum is the number of directors who must be present in order for the board of directors' actions to be binding. BLACK'S LAW DICTIONARY; *Griffith v. Sprowl*, 45 Ind App 504, 91 NE 25 (1910). Without a quorum present, an action of the board is generally "void and of no force and effect." *Schoen v. Consumer United Group, Inc.*, 670 F Supp 367, 377 (D DC 1986)(interpreting Delaware law). *See also Doyle v. Chladek*, 240 Or 598, 401 P2d 18, *modified*, 403 P2d 381 (1965); *McDonald v. Dalheim,* 114 Ohio App 3d 543, 683 NE2d 447 (1996). Other cases hold that actions taken at a board meeting lacking a quorum are voidable, but may be later ratified at a meeting at which a quorum is present. *Burton v. Lithic Mfg. Co.*, 73 Or 605, 144 P 1149 (1914); *Weiss Medical Complex, Ltd. v. Kim*, 87 Ill App 3d 111, 408 NE2d 959 (1980); *Sanders v. E-Z Park*, Inc., 57 Wash 2d 474, 358 P2d 138 (1960).

Unless changed by the articles or the bylaws, a quorum consists of a majority of the number of directors specified, or fixed, in accordance with the articles or bylaws. *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); *Silsby v. Strong*, 38 Or 36, 62 P 633 (1900). This is likely true even if some of these positions are vacant. *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); *Avien v. Weiss*, 50 Misc2d 127, 269 NYS2d 836 (1966).

ORS 60.351(1) provides this quorum majority consists of:

> (a) If the corporation has a fixed board size, a majority of the fixed number of directors; or
>
> (b) If the corporation has a variable-range size board, a majority of the number of directors prescribed, or if no number is prescribed, a majority of the number in office immediately before the meeting begins.

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 number of directors present, not just the number voting

favorably on the motion. ORS 60.351(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, 133 P2d 300, 311 (1943).

A quorum is measured at the time of the vote, not just at the start of the meeting. ORS 60.351(3). This is different than the requirement for shareholder meetings. ORS 60.241(2).

***B. Changing the quorum requirement*.**

An Oregon corporation may lower the quorum requirement to as few as one-third of the directors by appropriate language in its articles or its bylaws. ORS 60.351(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. An Oregon corporation may increase the quorum necessary for its board to conduct business by appropriate language in its articles or its bylaws. ORS 60.351(1). No maximum is described; a quorum requirement of 100% of all directors may be required.

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

The minimum number of directors necessary to establish a quorum is 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); *Avien v. Weiss*, 50 Misc2d 127, 269 NYS2d 836 (1966).

Thus, if the articles 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 does not have a quorum to conduct business. The board may still act, however, to fill the vacancies. ORS 60.331(1)(C).

> We recognize that, generally, if a corporation has fewer directors than the minimum required by statute, the issue arises whether the directors may act as a board. However, there are exceptions to the general rule that they may not act. These exceptions may include internal affairs of the corporation which must be carried on from necessity, and matters in which third parties reasonably believe a duly constituted board has acted on the corporation's behalf. 2 W. Fletcher, Cyclopedia of Law of Private Corporations § 421 (1990); *Jacobson v. Moskowitz, supra; Twisp Mining & Smelting Co. v. Chelan Mining Co.,* 16 Wash.2d 264, 133 P.2d 300 (1943); *Wright v. Commonwealth,* 109 Pa. 560, 1 A. 794 (1885)(the power of a board of directors is not suspended by vacancies in board unless the number be reduced below a quorum). *White v. Thatcher Financial Group, Inc.,* 940 P 2d 1034, 1037 (Colo App 1996).

***D. Variable range boards*.**

If a corporation has a variable-range size board and no number is prescribed, a quorum consists of the number of directors in office immediately before the meeting begins. ORS 60.351(1)(b). Once again, board vacancies generally will not reduce the minimum number necessary for a quorum. If there are seven board positions and three such positions are vacant, all four directors must to be present for there to be a quorum.

***E. 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. *Rugger V. Mt. Hood Electric Co.*, 143 Or 193, 20 P2d 412, 21 P2d 1100 (1933); *Hein v. Gravelle Farmers Elevator Co.*, 164 Wash 309, 2 P2d 741 (1931).

> 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).

The Revised Model Act approach – adopted in Oregon – reduces the number of directors necessary to achieve a quorum in instances where one or more of the directors have a conflict of interest in a given matter. For such a vote, the quorum is deemed present if a majority of directors (but not less than two), having no direct or indirect interest in a transaction vote to authorize, approve or ratify the transaction. ORS 60.361(3). Thus, on a seven-person board with two interested directors, if three disinterested directors vote to approve the transaction, a quorum is deemed present, regardless of the number of directors actually present for the vote.

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 ratified by a subsequent vote of the shareholders. ORS

60.361(3); *Burton v. Lithic Mfg. Co.*, 73 Or 605, 144 P 1149 (1914); *Sanders v. E-Z Park, Inc.*, 57 Wash 2d 474, 358 P2d 138 (1960). *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. ORS 60.771(1).

The secretary is responsible for preparing these minutes. ORS 60.371(3). However, the task of preparing minutes may be delegated to subagents, such as the corporation's attorney. *Teiser v. Swirsky*, 137 Or 595, 2 P2d 920, 4 P2d 322 (1931).

One court held 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). Other courts take a more lenient view. “As to closely held corporations, in particular, action taken informally can be valid even though corporate formalities are not followed.” *White v. Thatcher Financial Group, Inc.,* 940 P 2d 1034, 1037 (Colo App 1996).

> Although it would have been more orderly and businesslike, if the directors of the corporation had evidenced the understandings between the different stockholders by formal resolutions, rather than to proceed in the informal manner which they chose, nevertheless in such an instance as this, wherein all the stock of the corporation is owned by a few, and all or most of the stockholders are actively engaged in the enterprise of the corporation, it is often the practice to transact ordinary business without formal resolutions. (citations omitted) *Roles v. Roles Shingle Co.*, 147 Or 365, 371, 31 P2d 180, 182 (1934).

See also Acmer Corp. v. State Transport Co., 275 Or 1, 549 P2d 1114 (1976); *McMunn v. ML&H Lumber, Inc.*, 247 Or 319, 429 P2d 798 (1967); *Alpha Phi of Sigma Kappa v. Kincaid*, 180 Or 568, 178 P2d 156 (1947); *First National Bank of Burns v. Frazier*, 143 Or 662, 19 P2d 1091, 22 P2d 325 (1933). *But see* ORS 60.771(1).

It is good practice for a corporation to hold formal meetings and keep formal minutes. But at least in close corporations and in family-owned corporations, board actions taken without these formalities have been upheld.

> 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).

Other courts have also recognized this more lenient attitude toward close corporations:

Section 5.07

> 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).

Board resolutions and minutes become part of the permanent history of a corporation. Generally, future boards and third parties 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).

The shareholders have a right to inspect these board minutes upon reasonable notice. ORS 60.774. *See* Section 4.06 of this book.

While the minutes are prima facie evidence of board resolutions, they are not conclusive and may be supplemented or disproved by competent testimony. *Acmer Crp. 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 A2d 789, 794 (Superior Ct Del 1940).

Parol evidence is admissible to prove that a board of directors adopted or rejected a resolution. *Myrtle Point Mill & Lumber Co. v. Clarke*, 102 Or 533, 203 P 588 (1922); *Columbia Nav. Co. v. Vancouver Trans. Co.*, 32 Or 532, 52 P 513 (1898). “Furthermore, corporate minutes and other records are not instruments within the meaning of the parol evidence rule; the rule does not apply to documents that contain no obligations. Corporate minutes are not contracts or notes or bills.” *Houck v. Martin*, 82 Ill App 3d 205, 402 NE2d 421, 427 (1980). *See also Wilson v. Red Bluff Daily News,* 237 Cal App2d 87, 46 Cal Rptr 591, 594 (1965).

Not all cases agree, particularly where the minutes constitute a contract, such as organizational minutes accepting an offer to subscribe to stock. *Gannon v. Baker,* 807 SW2d 793 (Tex App 1991); *Mordka v. Mordka Enter., Inc.,* 143 Ariz 298, 693 P2d 953, 956-57 (Ariz Ct App1984).

Section 5.07 Removal & Resignation

***A. Removal, generally*.**

A director may be removed by the shareholders. ORS 60.324. A director my be removed with or without cause, unless the articles specifically provide that a director may only be removed for cause. ORS 60.324(1). The Act does not authorized the board of directors to remove a director.

Shareholders may only remove a director at a special shareholder meeting called for that purpose. ORS 60.324(4). Notice for such a meeting must include a statement that a vote will occur on the removal of a director. *Id.*

***B. Removal when cumulative or class voting used*.**

In the event a corporation uses the cumulative voting method of electing directors, a reverse procedure must be used for removal. ORS 60.324(3).

Class voting for directors also necessitates a reverse removal procedure. ORS 60.324(2). A group with the power to elect a director has the power to remove that director. *Boatmen's First National Bank v. Southern Missouri District Council of the Assemblies of God,* 806 SW2d 706 (Mo App 1991); *Auer v. Dressel,* 306 NY 427, 118 NE2d 590 (1954).

Thus, if a minority shareholder group (such as the preferred shareholders) has the right to elect a director, only that minority group may remove that director. Alternatively, a majority of shareholders – voting as a whole – cannot turn around and remove a director elected by the minority without the consent of that minority.

***C. Directors removing directors*.**

A board of directors may not vote to remove one of its own members, absent authority in the articles. *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 (3rd Cir 1971)(interpreting Delaware law); *Horn v. Kaupp*, 82 SD 437, 147 NW2d 607 (1967).

One Oregon court impliedly accepted the board of directors removing a director in a corporation where 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). Despite this case, it is better to follow the normal practice of having the shareholders vote on director removals.

A Delaware court upheld a provision in a corporation's articles which imposed a qualification on directors and gave the board the power to determine whether these qualifications were met. The court rejected the argument that this provision gave the board the power to remove a director. *Stroud v. Millikan Enterprises, Inc.,* 585 A2d 1306 (Del Ch 1988).

Unlike Oregon, some other state corporate statutes do provide for directors being removed by vote of the board of directors. *See Murray v. Conseco, Inc.,* 795 NE2d 454 (Ind 2003).

***D. Removal by court order*.**

A director may be removed by order of the court.

ORS 60.327(1) permits the circuit court for the county in which a corporation's

principal office in Oregon 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 or gross abuse of authority or discretion 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 its shareholders holding 10% or more of its stock.

The authority of the court to remove a director is an alternative to ORS 60.321 or provisions in the articles of incorporation. *See Goodsell v. Eagle–Air Estates Homeowners Ass'n,* 249 Or App 639, 278 P3d 133 (2012).

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

Director qualifications may be prescribed in either the articles of incorporation or in the bylaws. ORS 60.304. If either the articles or the bylaws contains a qualification requirement, once a director ceases to meet that qualification requirement, that director immediately ceases to be a director. *Smith v. Great Basin Grain Co.*, 98 Idaho 266, 561 P2d 1299, 1311 (1977); *In re Andrews*, 265 Mich 661, 252 NW 482 (1934); *Oudin & Bergman Fire Clay Min. & Mfg. Co. v. Conlan*, 34 Wash 216, 75 P 798 (1904).

***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 (3rd 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 Act has adopted this view. ORS 60.321(2).

There is an exception. If the resignation specifies a later date, the resignation is effective on the date specified. ORS 60.321(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). "[T]he powers vested in the corporation are exercised by the directors." *Baillie v. Columbia Gold Mining Co.*, 86 Or 1, 16, 166 P 965, 969, 167 P 1167 (1917). "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).

ORS 60.301(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, the board of directors, subject to any limitation set forth in the articles of incorporation or in an agreement authorized by ORS 60.265.

Unless the shareholders enter into an agreement which restricts the power of the board of directors and the agreement otherwise complies with the requirements of ORS 60.265, the power to manage corporate affairs rests in the directors – not in the shareholders. *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); *Levine v. Smith*, 591 A2d 194 (Del Ch 1991); *Trethewey v. Green River Gorge, Inc.*, 17 Wash 2d 697, 136 P2d 999 (1943).

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. FLETCHER CYC CORP § 505 (Perm Ed)(citing J.C. BAKER, DIRECTORS AND THEIR FUNCTION, 131).

In order to exercise these duties properly, 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); *Schwarzmann v. Association of Apartment Owners of Bridgehaven*, 33 Wash App 397, 655 P2d 1177 (1982).

NOTE: Some of the issues discussed in this Section may not apply to corporations in which the shareholders have entered into an agreement to restrict the power of the board of directors and otherwise complied with the requirements of ORS 60.265.

***A. Power reserved to shareholders*.**

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

Shareholders elect directors and may vote to remove them. ORS 60.307, 60.311 and 60.324.

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. ORS

60.204(1)(b). (The articles may decrease or increase this percentage, but may increase it to no more than 25%).

A shareholder vote is required in connection with certain extraordinary events, such as non-ministerial amendments of the articles, mergers, sales of substantially all assets and dissolutions. Generally however, such extraordinary actions must be initiated by board of directors, not the shareholders themselves, and the board of directors must then refer the matter to the shareholders for their concurrence. ORS 60.437, 60.487, and 60.627. *But see* ORS 60.624 (addressing dissolution by written consent of shareholders).

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

***B. Example – dividends*.**

The declaration of a dividend or other distribution is the exclusive function of the board of directors. ORS 60.181(1); *Stipe v. First National Bank of Portland*, 208 Or 251, 301 P2d 175 (1956); *Baillie v. Columbia Gold Mining Co.*, 86 Or 1, 166 P 965, 167 P 1167 (1917).

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, 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).

A few cases have held that when the shareholders *unanimously* vote to authorize 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).

But shareholders generally do not have the power to vote for the issuance of dividends. *See* Sections 4.02 and 4.07 of this book.

***C. Example – technical amendments to articles*.**

ORS 60.434 provides that certain housekeeping amendments to the articles of incorporation may be made simply by vote of the board of directors, unless the articles provide otherwise.

While more substantive changes to the articles require a vote by the shareholders, the board of directors must refer any such proposed amendment to the shareholders before they can so vote. ORS 60.437. The shareholders do not have the power to initiate amendments to the articles. *See* Section 3.07 of this book. The board may condition the submission of the proposed amendment on any basis. ORS 60.437(3).

***D. Example – amending bylaws*.**

The board of directors may amend the bylaws, and may do so without

shareholder approval. There are two exceptions: (i) a board of directors may not amend the bylaws if the articles provide otherwise; and (ii) a board may not amend or repeal a particular bylaw provision if the shareholders previously expressly provided that the board could not amend or repeal that bylaw provision. ORS 60.461(1).

Shareholders may amend the bylaws even though the directors also possess that power. ORS 60.461(2).

Special rules exist for amending bylaw provisions dealing with quorums. ORS 60.464. *See* Section 3.08 of this book.

***E. Example – dissolution*.**

Corporate dissolution is another example of a power exclusively in the hands of the board of directors. A corporation's dissolution may occur only after the board has voted to dissolve and, thereafter, submitted the matter for a shareholder vote. ORS 60.627; *Powell v. Oregonian Ry. Co.*, 38 F 187 (D Or 1889). A mere majority of the shareholders may not vote to dissolve a corporation without prior action by the board. *See* Section 12.04 of this book.

The only exception to this general rule is where 100% of the shareholders sign a written consent to dissolve. ORS 60.624,

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

Some older cases hold that a board of directors could only delegate 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 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 Super 1979). *See* Section 5.11 of this book.

Section 5.09 Compensation

Under the Oregon Business Corporation Act, a board of directors is specifically empowered to set compensation for directors, unless the articles or the bylaws provide otherwise. ORS 60.334. *See also Interlake Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986).

Directors have no inherent right to compensation for their services as directors, nor may they recover against the corporation on a quantum meruit theory. *Wood v. Lost Lake Manufacturing Co.*, 23 Or 20, 23 P 848 (1890); *Keenan v. Eshleman*, 23 Del Ch 234, 2 A2d 904 (1938); *Wonderful Group Mining Co. v. Rand*,

111 Wash 557, 191 P 631 (1920). Directors may, however, recover compensation for non-director tasks undertaken for the corporation. *Wood v. Lost Lake Manufacturing Co.*, 23 Or 20, 23 P 848 (1890); *Hudson v. Pacific Truck & Tractor Co.*, 151 Wash 46, 274 P 789 (1929).

> 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).

Under older case law, directors could not vote themselves compensation as directors. Directors had no inherent authority to pay themselves; such authority needed to flow from some other source, such as from the articles or the bylaws. *Green v. Felton*, 42 Ind App 675, 84 NE 166, *motion granted*, 44 Ind App 321, 89 NE 320 (1908); 175 ALR 577.

> 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).

Today, a board of directors is specifically empowered to set compensation for directors, unless the articles or the bylaws provide otherwise. ORS 60.334. However, the directors owe a fiduciary duty to the corporation not to pay themselves excessive compensation. *Hall v. Staha,* 303 Ark 673, 800 SW2d 396 (1990).

Section 5.10 Ultra Vires Acts

In earlier years, there was considerable litigation over 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*. As discussed below, today corporate powers are generally so broad that *ultra vires* issues are raised only infrequently.

Today, corporations are vested with broad powers under ORS 60.074 and 60.077. Thus, the *ultra vires* doctrine is narrowly applied.

ORS 60.084 provides that "the validity of corporate action may not be challenged" as being *ultra vires* except (i) by a shareholder seeking to enjoin the act;

(ii) by the corporation itself; or (iii) by the Attorney General. *See also Goodman v. Ladd Estate Co.*, 246 Or 621, 427 P2d 102 (1967); *Ladd Estate Co. v. Wheatley*, 246 Or 627, 426 P2d 878 (1967); *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").

***A. Statutory limitations on the power of board*.**

Current Oregon 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, ORS 60.181 prohibits a board of directors from authorizing distributions to shareholders when a corporation is insolvent, and any such distributions are void. *In re Enron Corp.*, 323 BR 857 (Bankr SDNY 2005). *See* Section 4.02 of this book.

ORS 60.437 limits a board's authority to amend a corporation's articles of incorporation without shareholder consent.

ORS 60.487 limits the authority of a board of directors to cause the merger a corporation with another corporation, unless a majority of the shareholders approve the merger.

B. Acts contrary to provisions in articles or bylaws.

A corporation cannot disregard its own articles or its bylaws. But even if a corporation disregards its own articles or bylaws, such an act may not be an *ultra vires* act. *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).

Acts in violation of the articles or bylaws are "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).

***C. Ultra vires – history*.**

Early case law contains many examples of litigation over whether the corporation exceeded its authority in undertaking a particular act. As mentioned above, most of this case law has been superceded by broad grants of corporate power in modern corporation acts.

Early cases held that a corporation, being a creature of statute, only had such powers as were expressly conferred upon it by law and by its own articles. *In re Borman's Estate*, 50 Wash 2d 791, 314 P2d 617 (1957).

> 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 the issue of whether or not a corporation possessed the power to undertake a certain act. These cases held that 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.

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 or bylaws; and sometimes 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).

Early Oregon case law held that a corporate board of directors was without

power to authorize compensation to officers for past services, *Wood v. Lost Lake Manufacturing Co.*, 23 Or 20, 23 P 848 (1890), or to guarantee loans to third parties unless the guarantee was in legitimate furtherance of a corporation's business. *Depot Realty Syndicate v. Enterprise Brewing Co.*, 87 Or 560, 170 P 294, 171 P 223 (1918). Such acts were considered to be *ultra vires*.

Even under early case law, a corporation could not assert the defense of *ultra vires* if the corporation accepted the benefits of the act. *Stephan v. Equitable Savings & Loan Assn.*, 268 Or 544, 533 P2d 478 (1974); *Twisp Mining & Smelting Co. v. Chelan Mining Co.*, 16 Wash 2d 264, 133 P2d 300 (1943).

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

***D. 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 an action on a contract, a corporation is estopped from claiming its own act of executing the contract was *ultra vires* if the corporation received the benefits of the contract. *Stephan v. Equitable Savings & Loan Assn.*, 268 Or 544, 522 P2d 478 (1974). However, this does not stop a corporation from asserting as a defense the illegality of its own acts. *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); *In re Enron Corp.*, 323 BR 857 (Bankr SDNY 2005).

While older cases seem to view the giving of corporate gifts with hostility, more modern cases accept this practice as legitimate. *Iwasaki v. Iwasaki Bros. Inc.*, 58 Or App 543, 649 P2d 598 (1982).

A 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).

See also Coe v. American Fruit Growers, Inc., 164 Or 90, 100 P2d 234 (1940); *Doolittle v. Pacific Coast Safe & Vault Works*, 79 Or 498, 154 P 753 (1916); *Calvert v. Idaho Stage Co.*, 25 Or 412, 36 P 24 (1894).

At one time, case law disfavored the board of directors delegating the management of the corporation to officers and other agents. One early case held:

> 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. FLETCHER CYC CORP § 495.

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).

This rule springs from the fiduciary relationship between the corporate directors and the shareholders: "Directors of a corporation are regarded as fiduciaries and are required to exercise their own independent judgment for the highest welfare of the corporation and its stockholders." *Vermont Dept. of Public Service v. Massachusetts Mun. Wholesale Elec. Co.,* 151 Vt 73, 558 A2d 215, 224 (1988) (quoting *Stoneman v. Fox Film Corp.,* 295 Mass 419, 425, 4 NE2d 63, 66 (1936).

Some older cases held 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 Super 1979).

Short of total delegation, a board may delegate broad authority to officers and agents to manage day-to-day corporate affairs. ORS 60.374 contemplates that officers may be delegated broad powers through the bylaws and through resolutions of the board of directors. One case indicates that a bylaw may confer authority to declare a dividend on an officer, even though that is usually a core board area of authority. *Blair v. Bishop's Restaurants, Inc.,* 202 Okla 648, 217 P2d 161 (1950).

***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 powers of the board of directors." ORS 60.354(4). 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. ORS 60.354(5) provides that a board of directors may not delegate the following to a board committee:

> (a) Authorize or approve distributions, except according to a formula or method, or within limits, prescribed by the board of directors;
>
> (b) Approve or propose to shareholders action that this chapter requires be approved by shareholders;
>
> (c) Fill vacancies on the board of directors or, subject to subsection (7) of this section, on any of its committees; or
>
> (d) Adopt, amend or repeal bylaws.

Under a change enacted to take effect in 2003, as few as one director may be appointed to a committee. ORS 60.354(1). Prior law had required at least two directors on a committee. Bylaws adopted under the old statute may still require two directors on a committee.

The board may also appoint directors as alternate committee members to serve in the absence or disqualification of a committee member. ORS 60.354(7).

The board's authority to create committees or its authority to delegate power to committees may be limited either by the articles or by the bylaws. ORS 60.354(1).

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).

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 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. *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 Oregon Supreme 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 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, 1994 WL 70118, 1994 Del Ch LEXIS 33 (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 ORS 60.357(1), which requires:

> A director shall discharge the duties of a director, including the duties as a member of a committee, in good faith, with the care an ordinarily prudent person in a like position would exercise under similar circumstances and in a manner the director reasonably believes to be in the best interests of the corporation.

The Washington Court of Appeals has interpreted similar language to be the 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. ORS 60.357(2). *See also 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). "While outside directors may not 'close their eyes' to the conduct

of corporate affairs, at least until they have reason to suspect impropriety, they may within reasonable limits rely on those who have primary responsibility for the corporate business." *Trieweiler v. Sears,* 268 Neb 952, 689 NW2d 807 (2004).

But a 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 6, 854 P2d 977, 980 (1993).

If a director discharges his/her duties in the manner prescribed by ORS 60.357, the director is not liable. ORS 60.357(4)

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

The business judgment rule is discussed in detail in Section 5.13 of this book.

The business judgment rule is principle of corporate governance which has been part of the common law for more than 170 years. *Gries Sports Enterprises, Inc. v. Cleveland Browns Football Co., Inc.,* 26 Ohio St3d 15, 496 NE2d 959, 963 (1986). This principle 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 protect the directors when there is a conflict of interest, fraud, oppression or corruption. *FDIC v. Castetter*, 184 F3d 1040, 1046 (9th Cir 1999); *Riss v. Angel*, 131 Wash 2d 612, 934 P2d 669 (1997). It may not protect directors when they act grossly negligently or in ignorance. *Potter v. Pohlad*, 560 NW2d 389 (Minn App 1997); *Shinn v. Thrust IV, Inc.*, 56 Wash App 827, 786 P2d 285 (1990); *Smith v. Van Gorkom,* 488 A2d 858 (Del 1985).

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 the 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).

Directors have a duty to keep reasonably informed as to the affairs of the

corporation. *Devlin v. Moore*, 64 Or 433, 130 P 35 (1913). “Accordingly, it was the duty of Mrs. Spangler, as a director, to keep herself informed concerning the assets and activities of the . . . Company. *Barnes v. Eastern & Western Lumber Co.,* 205 Or 553, 573, 287 P2d 929 (1955).

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 held:

> 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 is contained 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*.**

ORS 60.047(2)(d) provides that the articles of incorporation may contain a "provision eliminating or limiting the personal liability of a director to the corporation or its shareholders for monetary damages."

No such provision may eliminate or limit liability retroactively. *Id.* Likewise, no such provision may eliminate or limit liability where the act is a breach of the director's duty to the corporation, is not in good faith, involves an improper distribution or is one in which the director derived an improper personal benefit. *Id.*

***E. Liability for breach of standard of care*.**

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

Even though a director/shareholder may be liable to the corporation for wrongdoing, if the director/shareholder sells all of his/her stock in the corporation to a third party with knowledge of the wrongdoing, the new owner may be barred from causing the corporation to sue the director/shareholder for pre-sale acts. *Damerow Ford Co. v. Bradshaw*, 128 Or App 606, 876 P2d 788 (1994).

Section 5.13

F. Public benefit companies.

The standard of care for governors (directors) of a public benefit company is set forth in ORS. 60.760.

Governors (directors) of a benefit company are not personally liable for any action or omission made in their official capacity unless the action or omission constitutes self-dealing, willful misconduct or a knowing violation of law. ORS 60.762(5).

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 business judgment rule 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. A hallmark of the business judgment rule is that a court will not substitute its judgment for that of the board if the latter's decision can be attributed to any rational business purpose. The business judgment rule generally operates to bar judicial inquiry into actions of corporate directors taken in good faith and in the exercise of honest judgment in the lawful and legitimate furtherance of corporate purposes. (citations & internal quotation marks omitted) *Crandon Capital Partners v. Shelk,* 219 Or App 16, 31, 181 P3d 773 (2008).

The Delaware courts have said:

> Our law presumes 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." Those presumptions can be rebutted if the plaintiff shows that the directors breached their fiduciary duty of care or of loyalty or acted in bad faith. If that is shown, the burden then shifts to the director defendants to demonstrate that the challenged act or transaction was entirely fair to the corporation and its shareholders. (citations omitted) *In re Walt Disney Co. Derivative Litigation*, 906 A2d 27, 52 (Del 2006).

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, 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).

Some courts refer to the business judgment rule as a “rebuttable presumption.” *In re M Silverman Laces, Inc.,* 404 BR 345, 363 (Bankr SDNY 2009); *In re PSE & G Shareholder Litigation,* 173 NJ 258, 801 A2d 295, 306-07 (2002).

An early Oregon decision held that "[t]here 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 (1913). More recently, the Oregon Supreme Court said:

> 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. *Zidell v. Zidell,* 277 Or 413, 419, 560 P2d 1086, 1089 (1977).

“A substantial number of courts . . . . have clearly articulated that the business judgment rule protects corporate officers as well as corporate directors.” *Selcke v. Bove,* 258 Ill App 3d 932, 629 NE2d 747, 750 (1994). *See also Hill v. State Farm Mutual Automobile Ins. Co.,* 166 Cal App 4th 1438, 83 Cal Rptr 3d 651 (2008).

Courts have applied the business judgment rule to corporate 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 it finds the business judgment rule applies, courts will usually decline to substitute the court’s judgment for the judgment of a board of directors, the persons elected by the shareholders to manage corporate affairs. *Naito v. Naito*, 178 Or App 1, 35 P3d 1068 (2001); *Riss v. Angel*, 131 Wash 2d 612, 934 P2d 669 (1997); *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 well-known decision states: "judges are not business experts.” *Dodge v. Ford Motor Co.*, 204 Mich 459, 170 NW 668, 684 (1919).

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> 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. *Zidell v. Zidell, Inc.*, 277 Or 413, 419, 560 P2d 1086, 1089 (1977)(quoting *Gay v. Gay's Super Markets, Inc.*, 343 A2d 577, 580 (Me 1975)).

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. *Horner v. Pleasant Creek Mining Corp.*, 165 Or 683, 107 P2d 985, 109 P2d 1044 (1941).

> 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).

"Incompetence" likely means "gross negligence," not ordinary negligence. *Potter v. Pohlad,* 560 NW2d 389, 392 (Minn App 1997).

The business judgment rule applies to the managers of an Oregon limited liability company. *HLHZ Invs., LLC v. Plaid Pantries, Inc.,* 2007 US Dist LEXIS 86863 (D Or 2007).

Additional discussion of the business judgment rule is contained 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, holding:

> 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 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).

In hindsight, the decision of the Cubs' management has been proved correct.

C. Two exceptions to business judgement rule.

There are two principal exceptions to the business judgment rule. One exception is the requirement of an informed decision – the other requires good faith or the lack of 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).

One Oregon case stated:

> 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.*** (emphasis added; quotations omitted) *Zidell v. Zidell, Inc.*, 277 Or 413, 419, 560 P2d 1086, 1089 (1977).

D. Uninformed decision – gross negligence exception.

The board of directors has an obligation to make informed decisions and the courts will not use the business judgment rule to shield directors from their own gross negligence. "When courts say that they will not interfere in matters of business judgment, it is presupposed that judgment – reasonable diligence – has in fact been exercised." *Casey v. Woodruff*, 49 NYS2d 625, 643 (1944).

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> As part of their fiduciary duties, corporate officers have a duty to inform themselves, prior to making a business decision, of all material information reasonably available to them. Having become so informed, they must then act with requisite care in discharging their duties. This duty of care is judged under a gross negligence standard. (citations & internal quotes omitted) *Potter v. Pohlad,* 560 NW2d 389, 392 (Minn App 1997).

Delaware goes even further:

> [T]o afford guidance we address the issue of **whether gross negligence** (including a failure to inform one's self of available material facts), **without more, can also constitute bad faith. The answer is clearly no.**
>
> From a broad philosophical standpoint, that question is more complex than would appear, if only because (as the Chancellor and others have observed) "issues of good faith are (to a certain degree) inseparably and necessarily intertwined with the duties of care and loyalty...." But, in the pragmatic, conduct-regulating legal realm which calls for more precise conceptual line drawing, **the answer is that grossly negligent conduct, without more, does not and cannot constitute a breach of the fiduciary duty to act in good faith.** The conduct that is the subject of due care may overlap with the conduct that comes within the rubric of good faith in a psychological sense, but from a legal standpoint those duties are and must remain quite distinct. Both our legislative history and our common law jurisprudence distinguish sharply between the duties to exercise due care and to act in good faith, and highly significant consequences flow from that distinction. (emphasis added)
>
> *In re Walt Disney Co. Derivative Litigation*, 906 A2d 27, 64-65 (Del 2006).

Directors have the 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).

Directors have a duty to keep reasonably informed as to the affairs of the corporation. *Devlin v. Moore*, 64 Or 433, 130 P 35 (1913). There is a strong presumption that a director knows of the corporation's financial affairs. *Id; Gantenbein v. Bowles*, 103 Or 277, 203 P 614 (1922).

> To that end, *Devlin* informs that officers "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." *Id.* at 462 (emphasis added). Use of the word "provided" here means that exercising ordinary care in the first instance is a threshold requirement to the protections of the business judgment rule. *Fed. Deposit Ins. Corp. v. Christensen*, Case No: 3:13-cv-00109-PK, 2013 WL 3305242, at *2 (D Or June 28, 2013).

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).

This exception is closed related to the standard of conduct duty codified in ORS 60.357.

E. Bad faith – 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. While the business judgement rule means that courts will not hold directors liable for poor judgment, directors will be liable if they act without diligence or in bad faith.

> 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).

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). Because the business judgment rule "was developed to analyze duty of care issues, courts do not typically apply the business judgment rule to duty of loyalty issues." *Summers v. Cherokee Children & Family Services, Inc.,* 112 SW3d 484, 528-9 (Tenn App 2002).

Oregon courts have reversed or modified board action based on self-dealing or bad faith. In one such case, the Supreme Court prevented majority shareholders/directors from freezing out a minority shareholder by issuing massive amounts of stock to the majority shareholders for little consideration. *Browning v. C & C Plywood Corp.*, 248 Or 574, 434 P2d 339 (1968). Both the majority and dissent stated the court would not interfere with the majority action unless it served "no corporate purpose." The dissent found that some business purpose existed for the new stock issuance; the majority did not.

While courts generally will give great deference to board decisions, they will vigorously scrutinize transactions involving conflicts of interest or self-dealing. *Summers v. Cherokee Children & Family Services, Inc.,* 112 SW3d 484, 504 (Tenn App 2002) (such transactions "are subject to close scrutiny"); *Spokane Concrete Products, Inc. v. U. S. Bank of Washington*, 126 Wash 2d 269, 279, 892 P2d 98, 104 (1995); *Quinn v. Cardiovascular Physicians, P.C.*, 254 Ga 216, 326 SE2d 460 (1985); *Merger Mines Corp. v. Grismer*, 137 F2d 335, 340 (9th Cir 1943).

> 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).

Oregon courts have "viewed with suspicion," *Jones v. Hale*, 32 Or 465, 470,

52 P 311, 313 (1898), or "closely scrutinized," *Glaser v. Slate Construction Co.*, 196 Or 625, 653, 251 P2d 441, 454 (1952), transactions between a director and the corporation.

Bad faith – or maybe more accurately a lack of good faith – can exist even when the director is not motivated by personal self-interest.

> The good faith required of a corporate fiduciary includes not simply the duties of care and loyalty, in the narrow sense that I have discussed them above, but all actions required by a true faithfulness and devotion to the interests of the corporation and its shareholders. A failure to act in good faith may be shown, for instance, where the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary intentionally fails to act in the face of a known duty to act, demonstrating a conscious disregard for his duties. There may be other examples of bad faith yet to be proven or alleged, but these three are the most salient. *In re Walt Disney Co. Derivative Litigation*, 906 A2d 27, 67 (Del 2006).

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

F. ALI's codification of business judgment rule.

Unlike the Model Act and the Oregon Act, the American Law Institute's Principles of Corporate Governance directly addresses the business judgment rule, Section 4.01(c) of which provides:

> A director or officer who makes a business judgment in good faith fulfills the duty under this Section (Duty of Care) if the director or officer:
> (1) is not interested in the subject of the business judgment;
> (2) is informed with respect to the subject of the business judgment to the extent the director or officer reasonably believes to be appropriate under the circumstances; and
> (3) rationally believes that the business judgment is in the best interests of the corporation.

Comment d. to Section 4.01 states that the term "rationally believes" in §4.01(c)(3):

> is intended to permit a significantly wider range of discretion than the term 'reasonable,' and to give a director or officer a safe harbor from liability for business judgments that might agruably fall outside the term 'reasonable' but are not so removed from the realm of reason when made that liability should be incurred. Stated another way, the judgment of a director or officer will pass muster under §4.01(c)(3) if the director or officer believes it to be in the best interest of the corporation and that belief is rational.

Even under the ALI Principle, the business judgement rule does not insulate self-dealing transactions or those made decisions made without some degree of informed decision-making.

***G. Business judgement rule – examples*.**

The business judgment rule has broad application. For instance, a court will generally decline to interfere in:

Shareholder disputes over shareholder assessments, *Budd v. Multnomah*

Street Railway Co., 15 Or 413, 15 P 659 (1887);

Executive compensation, *Cole Real Estate Corp. v. Peoples Bank and Trust Co.*, 160 Ind App 88, 310 NE2d 275 (1985);

Employee retirement benefits, *Teren v. First National Bank of Chicago*, 243 Or 251, 412 P2d 794 (1966);

"Golden parachute" provisions for an executive officer, *Hanrahan v. Kruidenier,* 473 NW2d 184 (Iowa 1991); *Royal Crown Companies, Inc. v. McMahon*, 183 Ga App 543, 359 SE2d 379 (1987); but see

Business expenses, salary, fringe benefits and reimbursed expenses, *Nursing Home Building Corp. v. DeHart*, 13 Wash App 489, 535 P2d 137 (1975);

Vacation pay and Christmas bonuses, *Dobry v. Dobry*, 324 P2d 534 (Okla 1958);

The removal of corporate officers, *Kiess v. Eason*, 442 F2d 712 (7th Cir 1971);

Disputes involving retained earnings, even in cases involving S corporations, *Iwasaki v. Iwasaki Bros., Inc.*, 58 Or App 543, 649 P2d 598 (1982);

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); and

Disputes over the liquidation of a corporation, *McMunn v. ML&H Lumber, Inc.*, 247 Or 319, 429 P2d 798 (1967).

***H. Example – dividends*.**

The decision whether of not to issue dividends usually 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 Naito v. Naito*, 178 Or App 1, 28, 35 P3d 1068, 1083 (2001); *Baillie v. Columbia Gold Mining Co.*, 86 Or 1, 166 P 965, 167 P 1167 (1917); *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).

> 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).

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See also Davis v. Brockamp & Jaeger, Inc., 216 Or App 518, 530, 531, 174 P3d 607 (2007).

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 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). At least one case has held that the business judgment rule may not apply to dividends in a close corporation.

> When it is also considered that in close corporations dividend withholding may be used by controlling shareholders to force out minority shareholders, the traditional judicial restraint in interfering with corporate dividend policy cannot be justified. *Fox v. 7L Bar Ranch Co.*, 645 P2d 929, 935 (Mont 1982).

***I. Example – consideration for stock*.**

One area in which courts have historically acted to reverse or modify a board's business judgment relates to valuation of property received for a corporation's stock. But such decisions are now governed by ORS 60.147(3) which now makes conclusive a board of director's determination of the adequacy of the consideration received in exchange for the corporation's stock. Task Force Report § 38 states ORS 60.147(3) should be read in conjunction with ORS 60.357 regarding "fraud and bad faith actions of the directors."

In interpreting an older statute which set out a standard much like the current standard, the Oregon Supreme Court said the statute "introduces no novelty into the law, but simply makes a statutory declaration of the law." *Smith v. Schmitt*, 112 Or 687, 699, 231 P 176, 180 (1924). The business judgment rule is applicable.

> 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).

Other decisions have also held the business judgment rule applies to the adequacy of the consideration. *Smith v. Schmitt*, 112 Or 687, 699, 231 P 176 (1924); *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).

In both *Rugger v. Mt. Hood Electric Co.*, 143 Or 193, 20 P2d 412, 21 P2d 1100 (1933) and *Compton v. Perkins*, 144 Or 346, 24 P 670 (1933), property-for-stock transactions were set aside after the courts found that the property received for the stock had been grossly overvalued and that a majority of the directors voting in favor of the transaction were personally interested in the outcome.

***J. 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.

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 90, 101 (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, many courts will not permit the minority shareholder to sue derivatively. *Bernards v. Summit Real Estate Management, Inc.,* 229 Or App 357, 213 P3d 1 (2009); *Millsap v. American Family Corp.*, 208 Ga App 230, 430 SE2d 385 (1993);*Opportunity Christian Church v. Washington Water Power Co.*, 136 Wash 2d 116, 238 P2d 641 (1925). *See* Section 8.05 of this book.

Comment a. to §7.07 of the ALI's Principles of Corporate Governance state:

> Section 7.07(a)(1) sets forth a substantive rule that has received virtually universal acceptance: if the action is against a third party – that is, a person who is neither a director, senior executive, nor controlling person of the corporation (nor an associate of any of them) – then the board's authority is governed by the business judgment rule.

Courts give great deference to the business judgment of the directors. In the

leading case on this issue, New York's highest court said that the inquiry should be limited to an examination of the of the board's (or board committee's) independence and the sufficiency of its procedures and emphasized that "[w]hile the court may properly inquire as to the adequacy and appropriateness of the committee's investigative procedures and methodologies, it may not under the guise of consideration of such factors trespass in the domain of business judgment." *Auerbach v. Bennett*, 47 NY2d 619, 634, 419 NYS 2d 920, 393 NE2d 994 (1979). *See also Will v. Englebretson & Co.,* 213 Cal App3d 1033, 261 Cal Rptr 868, 872-3 (1989); *Black v. NuAire, Inc.,* 426 NW2d 203, 209-10 (Minn App 1988); *Genzer v. Cunningham,* 498 F Supp 682, 686-9 (ED Mich 1980).

Not all states so apply the business judgment rule. One commentator notes there "are at least five different standards being applied by various jurisdictions across the country." Ferrell, *A Hybrid Approach: Integrating the Delaware and the ALI Approaches to Shareholder Derivative Litigation,* 60 OHIO ST L J 241, 251, n 36 (1999).

Other courts have applied a "modified business judgment rule."

> we shall apply a modified business judgment rule that imposes an initial burden on a corporation to demonstrate that in deciding to reject or terminate a shareholder's suit the members of the board (1) were independent and disinterested, (2) acted in food faith and with due care in their investigation of the shareholder's allegations, and that (3) the board's decision was reasonable. *In re PSE&G Shareholder Litigation,* 173 NJ 258, 801 A2d 295, 312 (2002).

See also Lewis v. Boyd, 838 SW2d 215 (Tenn App 1992); *Houle v. Low*, 407 Mass 810, 556 NE2d 51 (Sup Jud Ct 1990); *Alford v. Shaw,* 320 NC 465, 358 SE2d 323 (1987).

More detailed discussions of the business judgment rule and derivative lawsuits are contained in Horn, *Delaware Courts' Delicate Response to the Corporate Governance Scandals of 2001 and 2002: Heightening Judicial Scrutiny on Directors of Corporations*, 41 WILL L REV 207 (2005); *When Should Courts Allow the Settlement of Duty-of-Loyalty Derivative Suits?*, 109 HARV L REV 1084 (1996); 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); Crain, *Decisions of Special Litigation Committees: Solving the Problem of Control Under Texas Law*, 44 BAYLOR L REV 171 (1992).

K. Example – employment issues in close corporation.

Normally, the decision to fire an employee falls squarely within the business judgment rule. This sometimes conflicts with the principle that shareholders in close corporations owe each other a fiduciary duty.

An issue that has been increasingly litigated nationally has been whether the firing of a shareholder/employee falls within the business judgment rule or constitutes a breach of the majority's fiduciary duty. *Gigax v. Repka,* 615 NE2d 644 (Ohio App 1992); *Pedro v. Pedro,* 463 NW2d 285 (Minn App 1990); *Wilkes v. Springfield Nursing Home, Inc.,* 353 NE2d 657 (Mass 1976).

> A shareholder who reasonably expected that ownership in the corporation would entitle him or her to a job, a share of corporate earnings, a place in corporate management, or some other form of security, would be oppressed in a very real sense when others in the corporation seek to defeat those expectations and there exists no effective means of salvaging the investment. *Matter of Kemp & Beatley, Inc.,* 64 NY2d 63, 473 NE2d 1173, 1179 (1984).

Some case law indicates the business judgment rule does not insulate the corporation or the controlling shareholder from oppression claims related to the firing of a founding shareholder. For example, one court found that whether the minority shareholder was discharged "for cause or in [the majority's] good business judgment is irrelevant" because the minority shareholder's reasonable expectations had been damaged. *Topper v. Park Sheraton Pharmacy, Inc.*, 107 Misc 2d 25, 28, 433 NYS2d 359 (1980); *see also O'Donnel v. Marine Repair Servs*, 530 F Supp 1199, 1205-08 (SDNY 1982) (rejecting the defendants' asserted business justification for terminating the minority shareholder as a pretext).

See also Douglas K. Moll, Shareholder Oppression in Texas Close Corporations: Majority Rule (Still) Isn't What It Used To Be, 9 Hous Bus & Tax L J 33, 52 (2008) ("the fact that courts applying the oppression doctrine are subjecting the majority's actions to 'reasonable expectations' or 'burdensome, harsh and wrongful conduct' standards suggests that courts are requiring majority shareholders to do more than merely articulate a rational business purpose for their decisions."); Hendon, *Combating Legal Theft: Arguments for Shareholder/Employees Terminated from Close Corporations,* 77 OR L REV 735 (1998); Ferraro, *Ingle v. Glamore Motor Sales, Inc.: The Battle Between Ownership and Employment in the Close Corporation,* 8 HOFSTRA LAB L J 193 (1990).

L. Example – Takeovers.

The issue of hostile takeovers is an area of considerable disagreement with some viewing such takeovers as positive while others view them negatively. *See discussion in Dynamics Corp. of America v. CTS Corp.,* 795 F2d 250, 253 (7th Cir 1986), *rev on other grounds,* 481 US 69 (1987).

Likewise, there is much disagreement on how to apply the business judgment rule in the area since the interests of management and the interests of shareholders are often in conflict during a hostile takeover. *See for example Panter v. Marshall Field & Co.,* 486 F Supp 1168 (ND IL 1980); *affirmed*, 464 F2d 271 (1981) (pro); *Hall v. Staha,* 314 Ark 71, 858 SW2d 672 (1993)(con).

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One court has noted:

> When corporate directors adopt defensive measures, however, the possibility that they might be acting to protect their own interests rather than those of the corporation and shareholders creates an enhanced duty which calls for judicial examination at the threshold before the protections fo the business judgment rule may be conferred. (internal quotes & citations omitted) *Katz v. Chevron Corp.,* 22 Cal App 4th 1352, 27 Cal Rptr 2d 681, 689 (1994).

The Delaware courts have adopted a heightened standard for determining whether the business judgment rule should apply in hostile takeover situations. This standard is called the *"Unocal"* test after the decision in *Unocal v. Mesa Petroleum*, 493 A2d 946 (Del 1985). Under this test:

> When the board of a Delaware corporation takes action to resist a hostile bid for control, the board of directors' defensive actions are subjected to "enhanced" judicial scrutiny. For a target board's actions to be entitled to business judgment rule protection, the target board must first establish that it had reasonable grounds to believe that the hostile bid constituted a threat to corporate policy and effectiveness; and second, that the defensive measures adopted were "proportionate," that is, reasonable in relation to the threat the board reasonably perceived. *Quickurn Design Systems, Inc. v. Shapiro,* 721 A2d 1281, 1290 (Del 1998).

Other jurisdictions have also adopted the *Unocal* test. *Burcham v. Unison Bancorp, Inc.,* 77 P3d 130 (Kan 2003); *Simon Property Group, Inc. v. Taubman Centers, Inc.,* 261 F Supp 2d 919 (ED Mich 2003); *Katz v. Chevron, supra.*

Judge Robert E. Jones held that the *Unocal* standard "is triggered only when directors adopt defensive measures; it does not apply to board responses to merger proposals. *Kahn v. Sprouse,* 842 F Supp 423, 426 (D Or 1993).

See Aronstam, *The Interplay of Blasius and Unocal – A Compelling Problem Justifying the Call for Substantial Change,* 81 OR L REV 429 (2002).

M. 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 a case where self-dealing or self-interest is alleged, a minority shareholder has the initial burden of proving that the director(s) had a conflict of interest. *Aronson v. Lewis*, 473 A2d 805, 812 (Del Supr 1984); *Smith v. Pacific Pools, Inc.*, 12 Wash App 578, 530 P2d 658 (1975); *Bay City Lumber Co. v. Anderson*, 8 Wash 2d, 191, 111 P2d 771 (1941). Once sufficient evidence of self-interest is introduced, the burden shifts to the director(s) to show that the transaction was fair. *Becker V. Knoll,* 239 P3d 830 (Kan 2010); *In re Walt Disney Co. Derivative Litigation,* 906 A2d 27, 52 (Del 2006); *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).

ALI's Principles of Corporate Governance § 4.01(d) provides:

> A person challenging the conduct of a director or officer under this Section has the burden of proving a breach of the duty of care, including the inapplicability of the provisions as to the fulfillment of the duty under [reliance on others and business judgment provisions of this rule], and, in a damage action, the burden of proving that the breach was the legal cause of damage suffered by the corporation.

In some states, 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. In Washington, 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 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). The party alleging improper conduct also bears the burden of proving damages. *Id.*

One Oregon case held that a breach of fiduciary duty need be proved by a preponderance of the evidence, not by clear and convincing evidence. *Sealacota Trust v. Harrison,* 1998 US Dist LEXIS 21699 (D Or 1998).

Section 5.14 Directors as Fiduciaries

A. The 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.

Section 5.14

As a fiduciary, a corporate director must deal fairly, honestly and openly with the corporation and the shareholders. *Horton v. Whitehill*, 121 Or App 336, 854 P2d 977 (1993); *Kahn v. Sprouse,* 842 F Supp 423, 425 (D Or 1993); *Chiles v. Robertson,* 94 Or App 604, 619, 767 P2d 903 (1989); *State ex rel Hayes Oyster Co. v. Keypoint Oyster Co.*, 64 Wash 2d 375, 381, 391 P2d 979, 983 (1964); *Singer v. Magnavox Co.,* 380 A2d 969 (Del 1977). *See* 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).

> It is well established that a corporate officer or director is under a fiduciary duty of loyalty, good faith and fair dealing in the conduct of corporate business. *Modern Materials, Inc. v. Advanced Tooling Specialists, Inc.*, 206 Wis2d 434, 557 NW2d 835, 838 (1996).

Many cases discussing the fiduciary duty of directors quote from a famous opinion by Judge Cardozo:

> 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 omitted) *Meinhard v. Salmon*, 249 NY 458, 164 NE 545, 546 (1928).

See for example Fouchek v. Janicek, 190 Or 251, 225 P2d 783, 788-89 (1950).

The concept of fiduciary duty involves self-dealing.

> Because in this context the concept of a breach of fiduciary duty necessarily involves "self-dealing," or the agent acting for his or her own benefit rather than for the principal's benefit, we conclude that the trial court did not err on this record in taking from the jury the allegation that plaintiff had breached his fiduciary duty to defendant by making unauthorized bonuses to other employees. *Miller v. CC Meisel Co, Inc.,* 183 Or App 148, 167, 51 P3d 650 (2002).

See also Locati v. Johnson, 160 Or App 63, 72, 980 P2d 173 (1999).

Directors owe a fiduciary duty to the corporation and its shareholders, *Naito v. Naito,* 178 Or App 1, 20, 35 P3d 1068 (2001); but directors do not owe a fiduciary duty to fellow officers and directors. *Byington v. Vegas Biotechnologies, Inc.,* 869 F Supp 338 (D Md 1994).

In Oregon, 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 (1987).

In Oregon, a breach of fiduciary duty need be proved by a preponderance of the evidence, not by clear and convincing evidence. *Sealacota Trust v. Harrison,*

1998 US Dist LEXIS 21699 (D Or 1998).

In Washington, 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 Porsche & Audi, Inc. v. Bucholz*, 45 Wash App 502, 728 P2d 597 (1986).

Persons who assist a director in breaching the director's fiduciary duty to the corporation or its shareholders – including attorneys – may also be liable for the breach. *Granewich, II v. Harding*, 329 Or 47, 945 P2d 1067 (1999). For public policy reasons, this rule does not generally apply to attorneys acting within the scope of an attorney-client relationship. *Reynolds v. Schrock,* 341 Or 338, 142 P3d 1062 (2006).

***B. History*.**

Courts have not always described directors as fiduciaries. At one time, courts described directors as trustees or agents or 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).

Historically, Oregon courts have not been consistent on the term used to describe the duty owed by directors to the corporation. In an early decision, the Oregon Supreme Court held directors to be trustees:

> And finally, being a director of the company, he was acting in a trust capacity towards all the stockholders of the corporation, and in respect to all of its property. The rules of equity applicable to the dealings by a trustee with trust property are therefore to be applied to this transaction. *Schetter v. Southern Oregon Co.*, 19 Or 192, 197, 24 P 25, 27 (1890).

Only three years later, the same court said that directors were trustees, agents and fiduciaries:

> The directors of a corporation occupy a fiduciary position-they are trustees and agents of the corporation and stockholders, and are governed by the same rules as are applied to the dealings of other persons holding fiduciary relations. They are subject to the strict rules which govern the relation of trustee and *cestui que trust* in all their dealings. *Hutchinson v. Bidwell*, 24 Or 219, 223-4, 33 P 560, 561 (1893).

See also Davis v. Hofer, 38 Or 150, 63 P 56 (1900).

Later, the Oregon Supreme Court later held in that directors were fiduciaries, not trustees in a technical sense:

> The general rule as stated in Fletcher's Cyclopedia of the law of corporation, is that directors and other officers, while not trustees in the technical sense in which that term is used, occupy a fiduciary relation to the corporation and to the stockholders as a body. (citations omitted) *Enyart v. Merrick*, 148 Or 321, 329, 34 P2d 629, 632 (1934).

The next year, the same court said that the managing officer "is often spoken of as a trustee but is rather a quasi-trustee." *Jansen v. Tyler*, 151 Or 268, 288, 47 P2d 969, 49 P2d 372, 373 (1935). *See also Hurt v. Cotton States Fertilizer Co.*, 159 F2d 52, 58 (5th Cir 1947).

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. FLETCHER CYC CORP § 842. 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. *See Marsters v. Umpqua Oil Co.*, 49 Or 374, 90 P 151 (1907). 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).

Recent Oregon decisions refer to directors as fiduciaries, not as trustees and agents. *See for example Naas v. Lucas*, 86 Or App 406, 739 P2d 1051, *opinion adhered to as modified*, 88 Or App 141, 744 P2d 586 (1987); *American Timber & Trading Co. v. Niedermeyer*, 276 Or 1135, 558 P2d 1211 (1977). This is true nationally as well.

C. Termination of fiduciary duty.

There is no hard and fast rule as to when the fiduciary duty of directors terminates.

Some cases hold that the fiduciary duty terminates when the director's term ends. *Lowell Staats Mining Co., Inc. v. Philadelphia Electric Co.,* 878 F2d 1271, 1277 (10th Cir 1989).

Some cases hold that the fiduciary duty ends when the director's term ends, but the director has a continuing duty not to use confidential information obtained through the directorship to the detriment of the corporation. *DSG Corp. v. Anderson,* 754 F2d 678, 682 (6th Cir 1985).

One case holds that it is a breach of fiduciary duty for a former director to

consummate a contract disadvantageous to the corporation and originally put in motion during the director's term. *Microbiological Research Corp. v. Muna*, 625 P2d 690, 695 (Utah 1981). *See also Today Homes, Inc. v. Williams,* 634 SE2d 737 (Va 2006); *Thompson v. Cent. Ohio Cellular, Inc.,* 93 Ohio App3d 530, 543, 639 NE2d 462 (1994).

Under some circumstances, a corporate agent may make arrangements to compete with the corporation after end of the agent's term. Comment e to § 393 Restatement of Agency (Second) states:

> Even before the termination of the agency, he is entitled to make arrangements to compete, except that he cannot properly use confidential information peculiar to his employer's business and acquired therein. Thus, before the end of his employment, he can properly purchase a rival business and upon termination of employment immediately compete. He is not, however, entitled to solicit customers for such rival business before the end of his employment nor can he properly do other similar acts in direct competition with the employer's business.

See PFS Distribution Co. v. Raduechel, 492 F Supp2d 1061, 1075, (SD Iowa 2007); *Electrolux Corp. v. Lawson,* 654 P2d 340 (Colo 1982); *Spring Steels, Inc. v. Molloy*, 400 Pa 354, 162 A2d 370 (1960).

Cases seems more likely to find a breach of fiduciary duty when the agent solicits co-workers to join the competing business before the original agency terminates. *See for example Porth v. Iowa Dept of Job Service,* 372 NW2d 269 (Iowa 1985); *Bancroft-Whitney Co. v. Glen,* 49 Cal Rptr 825, 411 P2d 921 (1966).

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. In such corporations, the class of all shareholders (other than the acting shareholder) just happens to be a class of one (the non-acting shareholder). This Section 5.15 does not address the majority shareholder/director's fiduciary duty to the second shareholder.

This issue arises most often 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 knowledge as to the true value of that stock.

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

individual shareholders a fiduciary duty.

To complicate matters, there is a newer, third rule. It may, in fact, now be the true majority rule. Commentators refer to it as the "special facts" rule. Under this rule, 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. FLETCHER CYC CORP § 1171 (Perm Ed).

> 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) *Sherman v. Baker*, 2 Wash App 845, 472 P2d 589, 594 (1970).

See also Walta v Gallegos Law Firm, PC, 131 NM 544, 40 P3d 449 (NM App 2001).

Directors may have a duty to disclose in the context of close corporations, but not necessarily the same duty in publicly traded corporations. *See Van Schaack Holdings, Ltd. v. Van Schaack,* 867 P2d 892 (Colo 1994); *Caruthers v. Underhill*, 230 Ariz 513, 287 P3d 807 (Ariz App 2012).

The Oregon courts have not specifically addressed the issue of whether directors have a duty of disclosure. One federal court – acknowledging the absence of Oregon case law – indicated its belief that Oregon would apply the special facts rule.

> Elsewhere than in Oregon, the general rule seems to be that a director of a corporation does not sustain a fiduciary relation to an individual shareholder with respect to his stock, and the mere failure on the part of a director in acquiring the shares of a stockholder, to disclose inside information, will not militate against him so long as he does not actively mislead the seller or perpetrate a fraud. There is respectable authority to the contrary. * * * *
>
> The local rule is not clearly defined. In *Enyard v. Merrick, supra*, [148 Or 321, 34 P2d 632], the court expressed an unwillingness to extend without limit "the analogy of the directors' and stockholders' relationship to that of trustee and cestui que trustent." In Oregon, as elsewhere, it is to be gathered that much depends on the facts of the particular case. We think from the tenor of the decisions there that, in appraising a transaction involving the purchase of shares, the fact that one party is a corporate director and the other a stockholder is to be taken into account. Transactions between persons standing in that relationship will be closely scrutinized. *Hayes v. Kelley*, 112 F2d 897, 901 (9th Cir 1940).

In *Barnes v. Eastern & Western Lumber Co.*, 205 Or 553, 570-1, 287 P2d 929, 937-8 (1955), the court specifically declined to address this issue. There still is no

Oregon appellate case on point.

Numerous Oregon cases hold directors and majority shareholders owe a fiduciary duty to minority shareholders. *Noakes v. Schoenborn*, 116 Or App 464, 841 P2d 682 (1992); *Chiles v. Robertson*, 94 Or App 604, 767 P2d 903, *reconsideration allowed in part, opinion modified*, 96 Or App 658, 774 P2d 500 (1989). Some of these Oregon cases involve a only one or two majority shareholders and a single minority shareholder. *Wulf v. Mackey*, 135 Or App 655, 899 P2d 886 (1995). But unlike cases in which an individual director is purchasing stock for the director's personal account from a single shareholder, the Oregon cases involving a single minority shareholder do not make clear whether the director's fiduciary duty runs to minority shareholders *as a group*, or to each individual shareholder.

Likewise, in close corporations, Oregon courts have held that majority shareholders owe a fiduciary duty to minority shareholders, *Zidell v. Zidell, Inc.*, 277 Or 413, 418, 560 P2d 1086, 1089 (1977). These cases hold that a 50% shareholder owes a fiduciary duty to the other 50% shareholder. *Lee v. Mitchell*, 152 Or App 159, 175, 953 P2d 414 (1998); *Delaney v. Georgia-Pacific Corp.*, 278 Or 305, 311, 564 P2d 277 (1977), *supplemented*, 279 Or 653, 569 P2d 604 (1977), *appeal after remand*, 42 Or App 439, 601 P2d 475 (1979).

This author does not know whether discussions in these cases regarding the fiduciary duty of directors to minority shareholders apply to an individual director's personal dealings with an individual shareholder.

Oregon courts have held, however, a director does ***not*** owe a fiduciary duty to inform the other shareholders of the terms of the director's stock sales to third parties, even if the director is being paid more per share than are the other shareholders. *Tyron v. Smith*, 191 Or 172, 229 P2d 251 (1951). But in that case, the director was not purchasing the shares from one of the other shareholders.

There is an added complication. The interpretation of the securities laws has expanded over the past half century and now includes transactions of this sort. Thus cases which 50 years ago might have addressed this issue are now more likely to be filed alleging a violation of the securities laws rather than alleging a director's breach of fiduciary duty.

> 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)).

Securities claims against directors are discussed in *Everts v. Holtmann*, 64 Or App 145, 667 P2d 1028 (1983); *Basic, Inc. v. Levinson*, 485 US 224 (1988). *See also* § 10(b) of the 1934 Act; ORS 59.115 & 59.127.

Section 5.16 Conflicts of Interest

A. Transactions between director & corporation 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. *Hutchinson v. Bidwell*, 24 Or 219, 33 P 560 (1893); *Modern Materials, Inc. v. Advanced Tooling Specialists, Inc.*, 206 Wis2d 434, 557 NW2d 835, 838 (1996); *Williams v. Queen Fisheries, Inc.*, 2 Wash App 691, 460 P2d 583 (1970).

A director's dealings with the corporation must be inherently fair, open, and honest. A director's personal dealings with the corporation will be "viewed with suspicion," *Jones v. Hale*, 32 Or 465, 470, 52 P 311, 313 (1898), and "closely scrutinized," *Glaser v. Slate Construction Co.*, 196 Or 625, 653, 251 P2d 441, 454 (1952). *See also 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. *Pollock v. D.R. Horton, Inc.,* 190 Or App 1, 77 P3d 1120 (2003); *Naas v. Lucas*, 86 Or App 406, 739 P2d 1051, *opinion adhered to as modified*, 88 Or App 141, 744 P2d 586 (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 and 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 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, self-dealing 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).

In Oregon, a fair transaction between a director and the corporation was voidable, not void, as long as the director was acting in good faith. *Ostlind v. Ostlind Valve, Inc.*, 178 Or 161, 165 P2d 779 (1946). It was voidable only by the corporation, not by third party creditors. *Marsters v. Umpqua Oil Co.*, 49 Or 374, 90 P 151 (1907).

> 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).

Fairness to the corporation became the most important factor in determining whether or not to set aside the self-dealing transaction.

***C. Fairness became most important factor*.**

The manner by which courts handle self-dealing transactions continues to evolve. Courts began to uphold such transactions, despite later challenge by a shareholder, if the transaction was fair to the corporation or 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).

> 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 – even if the corporation or a shareholder later seeks to set the transaction aside. Fairness to the corporation became the litmus test for self-dealing transactions between a director and the corporation.

> 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 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).

***D. Current statute*.**

The "fair to the corporation" standard has been codified. ORS 60.361. Even if a director has a direct or indirect interest in the transaction, ORS 60.361(1) provides

that the corporation may not later set the transaction aside if any one of the following exist:

> (a) The material facts of the transaction and the director's interest were disclosed or known to the board of directors or a committee of the board of directors and the board of directors or committee authorized, approved or ratified the transaction;
>
> (b) The material facts of the transaction and the director's interest were disclosed or known to the shareholders entitled to vote and they authorized, approved or ratified the transaction; or
>
> (c) The transaction was fair to the corporation.

Under current law, a director's conflict of interest alone is an insufficient basis for setting aside a transaction. The transaction must be evaluated to determine whether or not it is fair to the corporation.

Under an earlier – but similarly worded statute – Oregon courts have set aside the transfers of substantial corporate assets to an officer/director after finding the transaction to be unfair to the corporation. *Naas v. Lucas*, 86 Or App 406, 739 P2d 1051, *opinion adhered to as modified*, 88 Or App 141, 744 P2d 586 (1987); *American Timber & Trading Co. v. Niedermeyer*, 276 Or 1135, 558 P2d 1211 (1977). The burden of proof is on the director. *Pollock v. D.R. Horton, Inc.*190 Or App 1, 77 P3d 1120 (2003).

In the context of hostile corporate take-overs, 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).

***E. Exception – loans to directors*.**

In Oregon, there is a statutory exception to the fairness rule. Either a shareholder or the corporation may set aside a loan to a director, even if fair, unless the loan was approved by the shareholders or by the board of directors. ORS 60.364.

A corporation's guarantee of a director's debt to a third party is not a loan within the meaning of this statute. *Ladd Estate Co. v. Wheatley*, 246 Or 627, 426 P2d 878 (1967)(court did not address issue of whether actual payment on the guarantee falls within the statute since the person whose loan was guaranteed ceased being a director before defaulting on the underlying debt).

Section 5.17 Directors As Creditors

***A. General rule – directors can become corporate creditors*.**

As a general rule, a director may lend money to, and become a creditor of, his/her corporation. *Jones v. Hale*, 32 Or 465, 52 P 311 (1898); *In re Black Ranches, Inc.*, 362 F2d 19 (8th Cir 1966); *Belcher v. Webb*, 176 Wash 446, 29 P2d 702 (1934).

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"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). "However, this rule must be tempered with the qualification that there are circumstances under which equity will not permit him to do so." *Id; Schulz, Davis & Warren v. Marinkovich*, 203 Mont 12, 661 P2d 5 (1983).

Directors may use corporate assets to secure loans from themselves in a good faith effort to keep an insolvent – but going concern – alive. *Stumbo v. Paul B. Hult Lumber Co.*, 251 Or 20, 444 P2d 564 (1968); *Belcher v. Webb*, 176 Wash 446, 29 P2d 702 (1934); *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 scrutinized and more likely to be set aside.

Directors may use corporate assets to secure loans from themselves to keep a technically insolvent, but going concern, alive. *Stumbo v. Paul B. Hult Lumber Co.*, 251 Or 20, 444 P2d 564 (1968); *Belcher v. Webb*, 176 Wash 446, 29 P2d 702 (1934); *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 corporation and secure such loans by 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 (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).

Oregon applies the "trust theory" to directors once the corporation has become insolvent and ceased to be a going concern. *See* Section 12.07 of this book.

Substantial transfers to officers and directors around the time that a 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* ORS 95.200 *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. "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).

"[A] 'corporate opportunity' includes any opportunity to engage in a business activity that the director knows or reasonably should know is closely related to the business in which the corporation is engaged or may reasonably be expected to engage." *Horton v. Whitehill,* 121 Or App 336, 340, 854 P2d 977 (1993).

"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). "The general rule is that the fiduciary cannot lure away corporate business or clients which in equity and fairness belongs to his corporation." *Hartung v. 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, P.C.*, 254 Ga 216, 326 SE2d 460 (1985).

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 acted in good faith, courts give weight to whether the director made open 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 (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 corporation. *Davis v. Brockamp & Jaeger, Inc.*, 216 Or App 518, 538-9, 174 P3d 607 (2007); *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).

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. *Sabre Farms, Inc. v. Jordan*, 78 Or App 323, 717 P2d 156 (1986); *Gillett v. Dodge*, 50 Or 552, 89 P 741 (1907); *Smith v. Pacific Pools, Inc.*, 12 Wash App 578, 530 P2d 658 (1975).

> 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).

The rule against usurping a corporate opportunity 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 corporate opportunities frequently arises when a director or officer seizes a corporate opportunity, later arguing the corporation was unable or unwilling to avail itself of that opportunity, often pointing to the corporation's poor financial condition to justify not offering the opportunity to the corporation. That tactic is usually only successful where the corporation is truly financially unable to avail itself of the opportunity.

> Invoking an exception to the corporate opportunity doctrine, defendants argue that they are immune from the application of the rule in this case because of the financial inability of the parent or subsidiary corporations to take advantage of the opportunity. Where the corporation is, in fact, insolvent in the sense that it is defunct as a practical matter, the doctrine of corporate opportunity does not apply and the corporate officials are free to act for their own benefit. But in most jurisdictions, corporate financial difficulty short of actual insolvency as defined above is inadequate by itself to exonerate a fiduciary who appropriates an opportunity. Thus, mere technical insolvency such as (the corporation's) inability to pay current bills when due or ... mere inability to secure credit will not absolve a director. The reason for that rule was aptly stated in *Irving Trust Co. v. Deutsch,* 73 F.2d 121, 124 (2d Cir 1934):
>
>> If directors are permitted to justify their conduct on such a theory (corporate financial inability), there will be a temptation to refrain from exerting their strongest efforts on behalf of the corporation since, if it does not meet the obligations, an opportunity of profit will be open to them personally.
>
> *Nicholson v. Evans,* 642 P2d 727, 731-32 (Utah 1982) (citations & internal quotations omitted).

One of the best reasoned decisions in this area 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 whose majority shareholder (who was also a director) 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 filed to set aside this transaction, the director argued that the first corporation had not had the financial resources to pursue the contract. This argument proved unpersuasive. *Klinicki* sets down rules to be followed by close corporations in such circumstances:

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> 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).

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 *Sabre Farms, Inc. v. Jordan*, 78 Or App 323, 717 P2d 156 (1986), the court applied the *Klinicki* rules and held that the board chairman and officers, holding they had breached their fiduciary duty to the corporation by acquiring certain assets. The court also noted that actions for usurpation of corporate opportunities are governed by a two-year statute of limitations.

Klinicki is discussed in a casenote in 22 WILL L REV 163 (1986).

***C. Other tests*.**

Courts have developed 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).

***D. Forced sales*.**

A director is sometimes charged with usurping a corporate opportunity when the director purchases a corporate asset at a forced sale. In *Collins v. Hoffman*, 62 Wash 278, 113 P 625 (1911), the court held the corporation's manager and secretary could not purchase the corporation's property at a delinquent tax sale. On the other hand, 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).

E. Non-competition agreements.

In the context of the sale of all corporate assets, a noncompetition agreement entered into between the purchaser and the majority shareholder is 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 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 agreement as a subterfuge of siphoning off for themselves a portion of the true price for the corporation.

F. Preparations to compete.

Generally, a corporate agent may not compete while still an agent. *Alexander & Alexander Benefits Services, Inc. v. Benefit Brokers & Consultants, Inc.*, 756 F Supp 1408 (D Or 1991). But under some circumstances, a corporate agent may make arrangements to compete with the corporation after end of the agent's term. Comment e to § 393 Restatement of Agency (Second) states:

> Even before the termination of the agency, he is entitled to make arrangements to compete, except that he cannot properly use confidential information peculiar to his employer's business and acquired therein. Thus, before the end of his employment, he can properly purchase a rival business and upon termination of employment immediately compete. He is not, however, entitled to solicit customers for such rival business before the end of his employment nor can he properly do other similar acts in direct competition with the employer's business.

See PFS Distribution Co. v. Raduechel, 492 F Supp2d 1061, 1075, (SD Iowa

2007); *Electrolux Corp. v. Lawson,* 654 P2d 340 (Colo 1982); *Spring Steels, Inc. v. Molloy*, 400 Pa 354, 162 A2d 370 (1960).

Cases seem more likely to find a breach of fiduciary duty when the agent solicits co-workers to join the competing business before the original agency relationship terminates. *See for example Porth v. Iowa Dept of Job Service,* 372 NW2d 269 (Iowa 1985); *Bancroft-Whitney Co. v. Glen,* 49 Cal Rptr 825, 411 P2d 921 (1966).

***G. Statute of limitations*.**

In Oregon, an action alleging that a director has usurped a corporate opportunity is governed by a two-year statute of limitations. *Sabre Farms, Inc. v. Jordan*, 78 Or App 323, 717 P2d 156 (1986).

The statute of limitations on a corporate opportunity's claim is tolled until the corporation learns of the director's breach of duty. *Dotlich v. Dotlich*, 475 NE2d 331, 342 (Ind App 1985); *Quinn v. Forsyth*, 116 Ga App 611, 158 SE2d 686 (1967).

If a majority of the directors are involved in the improper act, the statute of limitations is tolled for as long as the culpable directors remain in the majority.

> Under the disinterested majority version, a plaintiff benefits from a presumption that the cause of action does not accrue or the statute of limitations does not run so long as the culpable directors remain in the majority, i.e., until the corporation has a disinterested majority of nonculpable directors. *FDIC v. Smith,* 328 Or 420, 427, 980 P2d 141 (1999).

In a derivative lawsuit context, a minority shareholder will not be barred from bringing a claim as long as the wrongdoers remain in control of the corporation.

H. Oppression.

"Diversion of a corporate opportunity is a breach of fiduciary duty." *Davis v. Brockamp & Jaeger, Inc.,*, 216 Or App 518, 537, 174 P3d 607 (2007). "When a corporate opportunity is usurped by the majority shareholder of a closely held corporation, that breach may constitute minority shareholder oppression." *Id*; *Hayes v. Olmsted & Associates, Inc.,* 173 Or App 259, 266, 21 P3d 178 (2001).